Articles + Publications | October 8, 2024

Breaking Down CFTC's Novel Theory Driving Uniswap Action

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This article was originally published on October 8, 2024 on Law360 and is republished here with permission.

Although Congress has neither formulated a regulatory framework for the digital asset industry nor anointed a federal regulatory agency as the de facto overseer of digital asset-related activities affecting interstate commerce, the U.S. Commodity Futures Trading Commission continues to advance its position that the scope of its enforcement authority arising under the Commodity Exchange Act[1] may be broadly applied to digital asset stakeholders.

In its Sept. 4 enforcement action against Uniswap Labs — creator of Uniswap, a popular decentralized exchange, or DEX, and automated market maker — the CFTC reemphasized that it is permitted to subject digital asset companies to its enforcement authority because "[c]ertain virtual currencies, including bitcoin and ether, are 'commodities' under the [CEA.]"[2] Yet, the CFTC's analysis did not end there.

For the first time, the CFTC deployed a novel theory suggesting that any DEX facilitating either the buying or selling of digital assets that inherently provide a purchaser access to the price movement of bitcoin or ether, i.e., in the form of compounded yield, but not the asset itself — index tokens — is facilitating "retail commodity transactions." Because the purchasers of the index tokens (1) were not eligible contract participants, and (2) the purchasing of index tokens did not result in actual delivery within 28 days of execution of the transactions, the CFTC alleged that Uniswap violated Section 4(a) of the CEA by allowing the index tokens to be sold on its DEX.

The order filing and settling charges against Uniswap is concerning for two reasons. First, the index tokens that the CFTC relied upon to support its theory that Uniswap impermissibly facilitated retail commodity transactions are neither "margined" nor "leveraged" as those terms are commonly understood in the traditional futures market that the CFTC regulates.

Second, although the CFTC has relied on the CEA's extremely broad definition of "commodity" to govern the digital asset industry, Congress' definition of that term only textually encompasses items in which "contracts for futures delivery are presently or in the future dealt in."[3]

The index tokens at issue in this enforcement action are not futures contracts because they are not tethered to underlying assets that will be delivered to their respective purchasers once the asset reaches a certain price.[4] Instead, the index tokens are stand-alone digital assets. As a result, for the CFTC to have a colorable basis for commencing an enforcement action against Uniswap, the index tokens must be commodities as defined by the

CEA.

It appears the CFTC utilized its enforcement action against Uniswap to test its position that the index tokens are commodities under the CEA because they can be categorized as belonging to the same asset class as bitcoin and ether, two digital assets the CFTC has formally designated as commodities.[5]

As the index tokens were added to Uniswap's DEX by an unaffiliated third party, the CFTC has seemingly adopted the stance that a DEX can be vicariously liable for all conduct occurring on its platform, even if the DEX did not act "as a liquidity provider, extend credit, actively trade [the index tokens] or collect trading fees on transactions [involving the index tokens]," according to CFTC Commissioner Summer Mersinger's dissent to the Uniswap enforcement action.[6]

The CFTC's novel theory of liability has not been tested through litigation, but as detailed below, we anticipate it will be.

Uniswap's Business Model and Free Market Participation

Uniswap's DEX is an automated market maker. To draw a distinction, Binance, on the other hand, is a centralized exchange.

Uniswap and Binance share the same objective — i.e., providing a platform by which users can purchase and sell digital assets. However, these companies employ very different means to achieve that end.

For example, to facilitate Bitcoin transactions on behalf of its users, Binance needs bitcoin on its books to sell. To obtain bitcoin, Binance may engage an over-the-counter trading desk specializing in large transaction sizes to increase its coffers.

Conversely, Uniswap's DEX relies on the free market for its liquidity. Simply listing a digital asset on a DEX does not necessarily mean there is sufficient liquidity for buyers and sellers to transact in that asset.

This is an important distinction between DEXs and centralized exchanges. If free market participants believe there will be ample transaction volume in a certain asset over an extended period, then, through a DEX, those participants may provide liquidity by purchasing liquidity pool tokens. Liquidity pool tokens are effectively a receipt attesting to the fact that the holder owns a share of the overall liquidity pool. In exchange for providing liquidity, purchasers generally will be rewarded a percentage of the transaction fees incurred by users executing transactions in a particular digital asset.

Uniswap's DEX is an automated market maker because, through the combination of liquidity pools and smart contract technology,[7] its DEX can automatically execute the purchasing and selling of digital assets on behalf of users during all hours of the day without the need of an intermediary.

The CFTC's Novel Theory Under Section 4(a) of the CEA

According to Section 4(a) of the CEA, it is unlawful for any entity to facilitate retail commodity transactions unless

such transactions are facilitated through a designated contract market registered with the CFTC under Section 5 of the CEA[8] and the terms of the transaction are recorded in writing, and such terms include (1) the date of execution, (2) the parties to the contract and their addresses, (3) the property covered by the contract and its price, and (4) the terms of delivery of the commodity subject to the contract.[9]

It is true that Uniswap's DEX is not a designated contract market and the transactions occurring through Uniswap's DEX involving the index tokens did not include the terms of delivery of the commodity, as required by Section 4(a) of the CEA. The CEA defines a "retail commodity transaction" as follows:

[Any transaction] that is —

(I) entered into with, or offered to (even if not entered into with), a person that is not an eligible contract participant or eligible commercial entity; and

(II) entered into, or offered (even if not entered into) on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis.[10]

Consumers who purchased the index tokens on Uniswap's DEX were not eligible contract participants because that term only encompasses certain entities like financial institutions or state-regulated insurance companies.[11] The CFTC's position on this point is not controversial. However, the same cannot be said about the CFTC's position as to the index tokens being offered on a "leveraged or margined basis" within the spirit and letter of the CEA.[12]

The index tokens were created by Index Coop, a decentralized autonomous organization whose primary purpose is to create complex financial strategies that can be translated into a single digital asset that a purchaser can hold.[13] Traditionally, margin trading comes with the benefit of leverage — enabling the trader to open large positions with a relatively nominal amount of capital by leveraging the capital of the entity financing the trade — but with the detrimental consequence of being margin-called, an event that can ultimately result in a trader's entire capital investment being liquidated due to sporadic swings in the price of an asset. This is the type of margin trading the CFTC has customarily regulated under its CEA authority.[14]

Consequently, the CFTC's usage of digital asset-based index tokens, which were created to mitigate the risk of being margin-called as contemplated in traditional futures trading, marks a dramatic shift in the CFTC's quest to regulate the decentralized finance industry.

Bitcoin and ether are assets with a combined market capitalization of approximately $1.5 billion. Additionally, due to increased interest in digital assets by traditional financial institutions, as well as the creation of bitcoin and ether exchange-traded fund products, it seems highly implausible that the market capitalizations of either bitcoin or ether will ever deplete to $0. In other words, the liquidation risks associated with traditional margin trading are significantly higher than the virtually nonexistent liquidation risks associated with the index tokens.

Therefore, notwithstanding the fact that the index tokens serving as the CFTC's jurisdictional hook are not futures contracts — and as a result, arguably not "commodities" as defined by the CEA[15] — if the primary purpose of the CFTC is to promote responsible innovation, combat fraud and mitigate manipulation of futures markets,[16] its

enforcement action against Uniswap contravenes that mission. Instead, the CFTC's enforcement action appears to be a unilateral attempt to expand its regulatory authority in the absence of official congressional approval.

Conclusion

The digital asset industry is nuanced, complex and never dormant. New digital asset offerings — like the index tokens — are created day in and day out. And importantly, in DeFi, such strategic offerings to the public would not be possible without a DEX.

The order suggests that the CFTC either does not recognize this reality, or, if it does, it similarly understands that effectively promulgating a theory that makes DEXs vicariously liable for digital asset offerings manufactured by unaffiliated third parties will result in stifling the free-flowing innovation that DeFi stakeholders have become accustomed to.

The order resolving this enforcement action contains no allegations of fraud, manipulation or other substantive forms of wrongdoing. But this is not surprising. As Mersinger noted in her dissent to the order, "[t]his case has all the hallmarks of what we have come to know as regulation through enforcement: [a] settlement with a de minimis penalty [of $175,000] that bears little relationship to the conduct alleged, sweeping statements about the broader industry that are not germane to the case at hand, and legal theories that have not been tested in court."[17]

Considering the order and the CFTC's clear desire to expand its regulatory authority over the digital asset industry, stakeholders offering DEXs to the public should, at the very least, maintain a master list of the digital assets offered on their platforms to ensure they are not offering any digital asset-based index tokens that provide compounded yield until either Congress or the judiciary formally approves or rejects the CFTC's position.

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[1] The CEA—ratified by Congress approximately 70 years before the inception of Bitcoin during 2009—permits the CFTC to regulate "retail commodity transactions." See generally 7 U.S.C. § 1 et seq.

[2] See In re Universal Navigation Inc. d/b/a Uniswap Labs, CFTC Docket No. 24-25 at pg. 4.

[3] The CEA contains an expansive definition of "commodity" – "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tubersum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by the first section of Public Law 85-839 (7 U.S.C. 13-1)) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1(a)(9).

[4] The Chicago Mercantile Exchange defines a futures contract as follows: "An exchange-traded futures contract

specifies the quality, quantity, physical delivery[,] time and location [a] given product." CME Group, Definition of a Futures Contract, https://www.cmegroup.com/education/courses/introduction-to-futures/definition-of-a-futures-contract.html (last visited October 4, 2024).

[5] See In re Universal Navigation Inc. d/b/a Uniswap Labs, CFTC Docket No. 24-25 at pg. 4.

[6] See Dissenting Statement of Commissioner Summer K. Messinger on In re Universal Navigation Inc. d/b/a Uniswap Labs, https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement090424 (last visited October 3, 2024).

[7] "Smart contracts" consist of a bundle of deterministic computer code that automatically effectuates predefined outcomes through "if this then that" logic when certain conditions are met. For example, if an escrow-related smart contract is programmed to send Bob $10 dollars' worth of Ether if Alice sends Bob $10 dollars, the smart contract will automatically disburse the Ether to Bob upon Alice's payment.

[8] See 7 U.S.C. § 7.

[9] See id. at § 6(a)(1)-(3).

[10] See id. at § 2(c)(2)(D.

[11] See id. at § 1(a)(18).

[12] To establish that a "retail commodity transaction" has occurred, one party to the transaction must be a non-eligible contract participant (i.e., a person that does not fall within the scope of the CEA's definition of "eligible contract participant"). However, even if the transaction does involve a non-eligible contract participant, the term "retail commodity transaction" does not apply to transactions resulting in "actual delivery [of the commodity] within 28 days . . . ." See 7 U.S.C. § 2(c)(2)(D)(ii)(III)(aa). The Order asserts that "the Leveraged Token transactions did not result in actual delivery within twenty-eight days." See fn. 2 at pg. 5. However, executing transactions involving the index tokens through Uniswap's DEX would have resulted in immediate delivery of the index tokens to the digital wallets of the purchasers. See United States CFTC v. Southern Trust Metals, Inc., 894 F.3d 1313, 1324 (11th Cir. 2018) (noting that "actual delivery" under the CEA means "giving real and immediate possession of the commodity to the buyer or the buyer's agent."); see also United States CFTC v. Monex Credit Co., 931 F.3d 966, 974 (9th Cir. 2019) ("On the other hand, sales where customers obtain meaningful control or possession of commodities, i.e., when actual delivery occurs, do not mimic futures trading and are therefore exempt from registration and related CEA requirements."). Therefore, if the index tokens, as a digital asset distinct from Bitcoin and Ether, are in fact stand-alone "commodities" as defined by the CEA, then "actual delivery" did occur here. See United States v. Reed, 2022 U.S. Dist. LEXIS 35089, *11 ("Thus, under the plain language of the CEA, cryptocurrencies [generally] fall within the definition of commodities.").

The CFTC did not discuss cryptography, the near-instantaneous settlement functionality of blockchain technology, and their collective impact on the "actual delivery" exception. But these functionalities appear to be viable

defenses to the CFTC's position that "actual delivery" of the index tokens did not occur.

[13] For example, the BTC 2x Flexible Leverage index token that the CFTC discussed in its Order allows holders to obtain access to Bitcoin's price movement at a 2x yield. If a consumer buys $100 worth of the BTC 2x Flexible Leverage index token and Bitcoin's value depreciates by 10%, the notional value of the consumer's holdings of the BTC 2x Flexible Leverage index token will decrease by 20% and vice versa if Bitcoin's value appreciates by 10%.

[14] See, e.g., In re Matter of BFXNA INC. d/b/a BITFINEX, CFTC Docket No. 16-19 (alleging that "Bitfinex's platform permitted users, including individual entities that did not meet the definition of an eligible contract participant . . . to borrow funds from other users on the platform in order to trade bitcoins on a leveraged, margined, or financed basis."

[15] The text of the CEA is clear. Notwithstanding the vast range of items that qualify as commodities under the CEA, a "commodity" must involve "contracts for future delivery." See 7 U.S.C. § 1(a)(9).

[16] As described by Congress, "[i]t is the purpose of [the CEA] . . . to deter and prevent price manipulation or any other disruptions to market integrity . . . to protect all market participants from fraudulent or other abusive sales practices and misuses of consumer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants." See 7 U.S.C. § 5(b).

[17] See Dissenting Statement of Commissioner Summer K. Messinger on In re Universal Navigation Inc. d/b/a Uniswap Labs, https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement090424 (last visited October 3, 2024).

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