CFTC Enforcement Highlights Potential Compliance Risks to Crypto Exchanges for Derivatives Trading

Blockchain and the Law on **April 6, 2023**

Binance is the latest major crypto industry player to be sued by a U.S. regulator. On March 27, 2023, the CFTC announced that it had filed a civil enforcement action against Binance Holdings Limited (and related legal entities) (collectively, "Binance"), its CEO, Changpeng Zhao ("Zhao"), and its former chief compliance officer, Samuel Lim ("Lim"), for violating the Commodity Exchange Act and CFTC regulations. (*CFTC v. Zhao*, No. 23-01887 (N.D. Ill. Filed Mar. 27, 2023)). The CFTC, among other things, alleges that Binance allowed U.S. customers to make use of their centralized digital asset trading platform without Binance first properly registering with the CFTC and also allegedly failed to implement an effective anti-money laundering ("AML") program as required under applicable law. The complaint states that Binance has "never been registered with the CFTC in any capacity." The CFTC is seeking disgorgement, civil monetary penalties, permanent trading and registration bans, and a permanent injunction against further violations of the Commodity Exchange Act and CFTC regulations.

Binance is a cryptoasset exchange that, according to the CFTC, offers trading in digital asset commodities and related derivatives, among other financial products and services, to over 100 million customers throughout the world, including in the U.S. In response to the CFTC's complaint, Binance CEO Zhao replied in a blog post that Binance refutes the allegations and lamented the filing as "an unexpected and disappointing civil complaint, despite our working cooperatively with the CFTC for over two years."

The Commodity Exchange Act and CFTC regulations require all swaps trading platforms that are located in the U.S. or that service U.S. customers to be registered with the CFTC as a swap execution facility or a designated contract market. Anyone who holds U.S. customer funds to margin commodity derivative transactions is required to register with the CFTC as a futures commission merchant (“FCM”).[1] The CFTC notes that FCMs are “a critical component of the U.S. financial system” and must comply with numerous regulatory requirements including “know-your-customer,” AML and customer protection rules.

Of note, the CFTC states in the complaint that certain digital assets, such as bitcoin, ether, litecoin and certain stablecoins (i.e., tether (USDT) and the Binance USD (BUSD)), meet the definition of “commodity” under the Commodity Exchange Act. Interestingly, such declarations in the complaint perhaps indicate a quiet turf battle over which financial regulator, the CFTC or the SEC, should be the lead regulator over certain cryptoasset transactions. SEC Chair Gary Gensler has previously stated that that crypto exchanges and DeFi platforms “likely are trading securities” as “many of the tokens trading on these platforms may well meet the definition of ‘securities.’” Gensler recently reiterated that while Bitcoin is not a security, most other cryptocurrencies and digital assets are likely securities and, therefore, are subject to the jurisdiction of the SEC (and not the jurisdiction of the CFTC). Gensler has also suggested both agencies should continue to collaborate on how best to register and regulate platforms “where the trading of securities and non-securities is intertwined.”

Under The Dodd-Frank Wall Street Reform and Consumer Protection Act the CFTC has jurisdiction over all “swaps,” which is defined to include any option, forward, or swap on a commodity. The SEC has jurisdiction over “security-based swaps” (swaps based on a single equity, loan, or narrow-based security index) and the CFTC and SEC have joint jurisdiction over “mixed swaps” (a swap that meets the definition of both “swap” and “security-based swap”). Whether the other coins mentioned in the CFTC’s complaint against Binance (ether, litecoin, tether and Binance USD) fall under the definition of “commodity” and therefore are rightfully subject to the CFTC’s jurisdiction, or meet the definition of “security” and are subject to the SEC’s jurisdiction, has yet to be finally decided.

We will be watching this latest enforcement closely. Besides affecting market liquidity in the cryptoasset space (especially given the recent banking failures in the U.S.), the CFTC action could have other repercussions, including offering some clarity about how certain U.S. regulations apply to crypto entities operating globally and spurring other exchanges to reexamine legal compliance controls related to derivatives trading.

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[1] As outlined in the complaint a "futures commission merchant" ("FCM") is an individual, association, partnership, corporation, or trust that (i) is engaged in soliciting or in accepting orders for regulated transactions including futures, swaps, commodity options, or retail commodity transactions, or (ii) acts as a counterparty to retail commodity transactions; and which, in connection with either of these activities, "accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom." Commodity Exchange Act, § la(28)(A), 7 U.S.C. § la(28)(A).

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Related Professionals

- **Elanit Snow**
  Senior Counsel