CFTC PROPOSED INTERPRETATION ON VIRTUAL CURRENCY "ACTUAL DELIVERY" IN RETAIL COMMODITY TRANSACTIONS

OVERVIEW

For questions on the note below, please contact Kevin Batteh or Kwon Park at (202) 547-3035.

On December 15, 2017, the U.S. Commodity Futures Trading Commission (CFTC or Commission) issued a proposed interpretation (interpretation) concerning its authority over retail commodity transactions involving virtual currency. CFTC Chairman Christopher J. Giancarlo and Commissioners Brian Quintenz and Rostin (Russ) Behnam voted for the interpretation. See below for a summary prepared by Delta Strategy Group.

Key Takeaways

- For virtual currency, whether actual delivery has occurred requires:
  1. A customer having the ability to:
     - Take possession and control of the entire quantity of the commodity purchased on margin, or using leverage, or any other financing arrangement; and
     - Use it freely in commerce (both within and away from any particular platform) within 28 days of the transaction; and
  2. The offeror and counterparty not retaining any interest in or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.
- A sham delivery does not constitute actual delivery – actual delivery of virtual currency connotes the ability of the purchaser to utilize the virtual currency purchased on the spot to immediately purchase goods and services with the currency elsewhere.
- Physical settlement of the commodity must occur – a cash settlement or offset mechanism will not satisfy the actual delivery exception.
- The Commission provides 4 non-exclusive examples (described in detail below) of whether a transaction does or does not constitute actual delivery of virtual currency and solicits feedback on 9 questions regarding this interpretation.
- The interpretation is open for public comment for 90 days from publication in the Federal Register.

SUMMARY

Background

Jurisdiction Over Retail Commodity Transactions

Dodd-Frank Act (Dodd-Frank) Section 742(a) amended the Commodity Exchange Act (CEA or the Act) to add Section 2(c)(2)(D)[1] entitled "Retail Commodity Transactions" to provide the Commission the explicit oversight authority to bring a cause of action against unregistered trading platforms or entities offering leveraged, margined, or financed commodities trading (like bitcoin and other virtual currencies).

The origin of this amendment stems from a decision in the *Zelener* case, where the court's narrow interpretation of "commodity future" resulted in legal precedent that prevented the Commission from

[1] CEA Section 2(c)(2)(D) provides that such an agreement, contract or transaction is subject to CEA Sections 4(a), 4(b), and 4b "as if the agreement, contract or transaction was a contract of sale of a commodity for future delivery."

pursuing certain actions in the retail commodity marketplace. *Zelener* involved retail foreign currency transactions with contract documents that were characterized as spot sales but, in practice, customer positions were held open indefinitely and customers never took delivery of the foreign currency.

In 2008, Congress amended the CEA to provide the Commission with additional authority over retail foreign currency transactions. As a result, the Commission implemented a new regulatory regime for retail foreign exchange dealers (RFEDs), but uncertainty still remained regarding other retail commodity transactions. Consequently, to provide the Commission with additional authority over non-foreign currency retail commodity transactions, Dodd-Frank amended the Act to add CEA Section 2(c)(2)(D).

Actual Delivery Exemption

CEA Section 2(c)(2)(D) broadly applies to any agreement, contract, or transaction in any commodity that is entered into with, or offered to, a non-eligible contract participant or non-eligible commercial entity (retail customers) 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.

However, the statute exempts a contract of sale that results in "actual delivery" within 28 days . . . based upon the typical commercial practice in cash or spot markets for the commodity involved. To provide the public with additional clarity, the Commission issued interpretive guidance of actual delivery in 2013. The CFTC explained that it will consider evidence "beyond the four corners of contract documents" to assess whether actual delivery of the commodity occurred. The guidance also included a list of relevant factors the Commission will consider, along with examples of transactions that may or may not constitute actual delivery.

Per the guidance, the only satisfactory examples of actual delivery involve transfer of title and possession of the commodity to the purchaser or a depository acting on the purchaser's behalf – mere book entries and instances where a purchase is "rolled, offset, or otherwise netted with another transaction" do not constitute actual delivery. The Eleventh Circuit reinforced the Commission's interpretation in the *Hunter Wise* case.

Virtual Currency is a Commodity

After the *Hunter Wise* decision, the Commission confirmed that virtual currency is a commodity in two separate enforcement actions. The Commission brought its first enforcement action against Coinflip Inc. (involving options on bitcoin) and a subsequent case against, Bitfinex, a trading platform that offered virtual currency transactions to retail customers on a leveraged, margined, or financed basis without registering with the Commission. In the *Bitfinex* case, the Commission determined that Bitfinex violated the Act as the actual delivery exception was not satisfied because of the manner in which Bitfinex held the private keys for customer bitcoins. Specifically, the Commission found that the unregistered entity "did not actually deliver bitcoins purchased from them" as prescribed within the actual delivery exception. Bitfinex ultimately agreed to settle the matter, leaving the interpretation on actual delivery of virtual currency untested and open to dispute.

For additional background please click here.

Commission Interpretation of Actual Delivery for Virtual Currency

Virtual Currency as a Commodity

The Commission interprets the term virtual currency broadly, but does not intend to create a bright line definition at this time given the evolving nature of the commodity and, in some instances, its underlying public distributed ledger technology (DLT or blockchain). In this context, virtual or digital currency:

- Encompasses any digital representation of value (a digital asset);

- That functions as a medium of exchange and any other digital unit of account that is used as a form of a currency (i.e. transferred from one party to another as a medium of exchange);
- May be manifested through units, tokens, or coins, among other things; and
- May be distributed by way of digital "smart contracts," among other structures.

The Commission's Interest in Virtual Currency

In the interpretation, the Commission recognizes that certain virtual currencies and their underlying blockchain technologies have the potential to yield notable advancements in applications of financial technology (FinTech).

This interpretation is specifically focused on retail commodity transactions, whereby an entity or platform:

- Offers margin trading or otherwise facilitates the use of margin, leverage, or financing arrangements for their retail market participants;
- Typically to enable such participants to speculate or capitalize on price movements of the commodity – two hallmarks of a regulated futures marketplace.

The Commission asserts that the emergence of these nascent markets have been negatively marked with a variety of retail customer harm that warrants the Commission's attention, including:

- Flash crashes and other market disruptions;
- Delayed settlements;
- Alleged spoofing;
- Hacks;
- Alleged internal theft;
- Alleged manipulation;
- Smart contract coding vulnerabilities;
- Bucket shop arrangements; and
- Other conflicts of interest.

Actual Delivery of Virtual Currency

Retail commodity transactions may be excepted from CFTC jurisdiction if <u>actual delivery</u> of the commodity occurs within 28 days of the transaction. The CEA only provides the Commission ability to <u>lengthen</u> its actual delivery exception time period, therefore, Congressional action is needed to <u>reduce</u> the actual delivery exception.

The Commission interprets the term actual delivery by employing a <u>functional approach</u> and examining how the agreement, contract, or transaction is marketed, managed, and performed, instead of relying solely on language used by the parties in the agreement, contract, or transaction.

For virtual currency, whether actual delivery has occurred requires:

1. A customer having the ability to:
    - <u>Take possession and control</u> of the entire quantity of the commodity purchased on margin, or using leverage, or any other financing arrangement; and
    - <u>Use it freely</u> in commerce (both within and away from any particular platform) within 28 days of the transaction; and
2. The offeror and counterparty (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) not retaining any interest in or

control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.

A sham delivery does not constitute actual delivery – actual delivery of virtual currency connotes the ability of the purchaser to utilize the virtual currency purchased on the spot to immediately purchase goods and services with the currency elsewhere.

Physical settlement of the commodity must occur – a cash settlement or offset mechanism will not satisfy the actual delivery exception.

Non-Exclusive Examples of Actual Delivery

Example 1

- Actual delivery will have occurred if:
  - Within 28 days of entering into an agreement, contract, or transaction;
  - There is a record on the relevant public distributed ledger network or blockchain of the transfer of virtual currency;
  - Whereby the entire quantity of the purchased virtual currency, including any portion of the purchase made using leverage, margin, or other financing, is transferred from the counterparty seller's blockchain wallet to the purchaser's blockchain wallet; and
  - The counterparty seller retains no interest in or control over the transferred commodity and the counterparty seller has transferred title of the commodity to the purchaser.
- When a matching platform or other third party offeror acts as an intermediary, the virtual currency's public distributed ledger must reflect the purchased virtual currency transferring from the counterparty seller's blockchain wallet to the third party offeror's blockchain wallet and, separately, from the third party offeror's blockchain wallet to the purchaser's blockchain wallet, provided that the purchaser's wallet is not affiliated with or controlled by the counterparty seller or third party offeror in any manner.

Example 2

- Actual delivery will have occurred if:
  - Within 28 days of entering into a transaction;
  - The counterparty seller has delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, into the possession of a depository (i.e. wallet or other relevant storage system) other than one owned, controlled, or operated by the counterparty seller (including any parent companies, partners, agents, affiliates, and others acting in concert with the counterparty seller) that has entered into an agreement with the purchaser to hold virtual currency as agent for the purchaser without regard to any asserted interest of the offeror, the counterparty seller, or persons acting in concert with the offeror or counterparty seller on a similar basis;
  - The counterparty seller has transferred title of the commodity to the purchaser;
  - The purchaser has secured full control over the virtual currency (i.e. the ability to immediately remove the full amount of purchased commodity from the depository); and
  - No liens (or other interests of the offeror, counterparty seller, or persons acting in concert with the offeror or counterparty seller on a similar basis) resulting from the use of margin, leverage, or financing used to obtain the entire quantity of the commodity purchased will continue forward at the expiration of 28 days from the date of the transaction.

Example 3

- Actual delivery will not have occurred if:
  - Within 28 days of entering in to a transaction;
  - A book entry is made by the offeror or counterparty seller purporting to show that delivery of the virtual currency has been made to the purchaser;
  - But the counterparty seller or offeror has not actually delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, and transferred title to that quantity of the virtual currency to the purchaser;
  - Regardless of whether the agreement, contract, or transaction between the purchaser and offeror or counterparty seller purports to create an enforceable obligation to deliver the commodity to the purchaser.

Example 4

- Actual delivery will not have occurred if:
  - Within 28 days of entering into a transaction;
  - An agreement, contract, or transaction for the purchase or sale of virtual currency is rolled, offset against, netted out, or settled in cash or virtual currency (other than the purchased virtual currency) between the purchaser and the offeror or counterparty seller (or persons acting in concert with the offeror or counterparty seller).

Request for Comment

Question 1: Length of Actual Delivery

- Would a 2-day actual delivery period more accurately apply to virtual currency transactions?
- Would another actual delivery period be more appropriate?
- What additional information should the Commission consider in determining an appropriate actual delivery exception period for retail commodity transactions in virtual currency?
- Should the Commission engage Congress to consider an adjustment to the actual delivery exception – to be more aligned with the broader delivery period adjustment language in the Model State Commodity Code?

Question 2: Additional Examples

- Are there additional examples the Commission should consider in satisfaction of the actual delivery exception?

Question 3: Conflicts of Interest – situations such as an offeror or its principals taking the opposite side of a customer transaction, either directly or through an affiliated liquidity provider or market maker (e.g. bucket shops):

- How should the Commission evaluate circumstances if a platform seeks to avail itself of the actual delivery exception?
- Are there any additional factors that the Commission should consider in its determination of whether the actual delivery exception is available?

Question 4: Registration - absent an exception, a retail commodity transaction must be offered on or subject to the rules of a designated contract market (DCM), and an entity soliciting or accepting orders for retail commodity transactions and accepting money, securities, or property to margin, guarantee, or secure such transactions must register as a futures commission merchant (FCM).

- What factors may be relevant to consider regarding the Commission's potential use of its exemptive authority under CEA Section 4(c)?
- Describe the potential to establish a distinct registration and compliance regime for entities that seek to offer retail commodity transactions in virtual currency.
- What other alternatives should the Commission consider instead of establishing a distinct registration and compliance regime?

Question 5: Actual Delivery to a Depository

- What should the Commission consider in further clarifying the meaning of depository – could the depository maintain certain licenses or registration in order to qualify for example 2?
- Should the Commission further prohibit the depository from being owned or operated by the offeror, including any offeror parent company, partner, agent, and other affiliates?

Question 6: Full Control by the Purchaser

- What types of circumstances would ensure a purchaser has obtained full control of the commodity – is possession a unique key or other credentials that allow full access and ability to transfer virtual currency sufficient to provide full control?
- How should the Commission view full control by a user in light of commonly used cybersecurity techniques and money transmitter procedures otherwise required by law?

Question 7: Liens

- In what circumstances would a lien be considered terminated – are there circumstances where the Commission should consider allowing forced sale scenarios, whereby the purchased virtual currency is used to satisfy any resulting liens from the retail commodity transaction, while still interpreting the transactions having resulted in actual delivery to the purchaser?
- Should the Commission consider other types of lien scenarios or interests, such as those liens that would not provide a right to repossession of the commodity?

Question 8: Title

- In examples 1 and 2, title may be reflected by linking an individual purchaser with proof of ownership of the particular wallet to wallets that contain the purchased virtual currency – what examples should the Commission consider to address the status of title for the purposes of an actual delivery determination?

Question 9: Other Exceptions - ICOs may be commodities, commodity options, derivatives, and / or virtual currency depending on their use. However, tokens that are deemed securities would be excepted from the retail commodity transaction definition.

- Are there concerns with the scope of this exception with regard to retail commodity transactions?
- What factors should the Commission consider if it were to issue further guidance regarding this exception?

The Commission also encourages comments including background information, actual market examples, best practice principles, expectations regarding the possible impact on further innovation, and estimates of any asserted costs and expenses.