

Derivatives Alert

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CFTC Issues Proposed Interpretation of 'Actual Delivery' in Virtual Currency Retail Commodity Transactions

On December 15, 2017, the Commodity Futures Trading Commission (CFTC or Commission) released its proposed interpretation of the term “actual delivery” with respect to virtual currency retail commodity transactions.¹ A retail commodity transaction is defined in Commodity Exchange Act (CEA) Section 2(c)(2)(D) as a transaction in a commodity that is offered to or entered into with a retail (non-institutional) customer on a margined, leveraged or financed basis.²

The CFTC regulates futures and swaps trading. If a transaction qualifies as a retail commodity transaction then it will be treated as if it were a futures contract and subject to CEA Sections 4(a), 4(b) and 4b.³ Essentially, this means that retail commodity transactions must be traded on a licensed domestic futures exchange or a foreign board of trade. In addition, the transaction would be subject to CFTC anti-fraud prohibitions.

One of the exceptions that removes a transaction from the retail commodity transaction definition is for transactions that result in “actual delivery” of the commodity to the buyer within 28 days.⁴ The CFTC had previously issued a final interpretation of “actual delivery” in August 2013;⁵ however, in order to address the burgeoning market in virtual currencies, the Commission is asking for comments from market participants about how the statutory term applies to the virtual currency space.⁶

The CFTC’s proposal declined to set forth a bright-line definition of virtual currency. But the CFTC did state that for the purposes of the proposal, virtual currency or digital currency

[e]ncompasses 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

¹ Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60,335 (proposed Dec. 15, 2017) (interpreting 17 C.F.R. pt. 1) (hereafter “2017 Proposed Interpretation”).

² CEA Section 2(c)(2)(D)(i). Specifically, the types of entities (“eligible contract participants”) that would not be considered a retail customer under the CEA include financial institutions, insurance companies and investment companies trading for their own account. Individuals meeting certain investment thresholds are also not considered retail customers. See CEA Section 1a(18).

³ CEA Section 2(c)(2)(D)(iii).

⁴ CEA Section 2(c)(2)(D)(ii)(III)(aa).

⁵ Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52,426 (Aug. 23, 2013) (interpreting 17 C.F.R. pt. 1) (hereafter “2013 Final Interpretation”).

⁶ See generally 2017 Proposed Interpretation.

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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.⁷

The CFTC did not distinguish between virtual currency and digital currency for the purposes of its proposal; however, it did note that digital currency is viewed by some as fiat currency — which is typically endorsed by a government as legal tender — while virtual currency is not.⁸ It also made clear that its interpretation did not apply to foreign currency retail transactions covered by CEA Section 2(c)(2)(C).⁹

In its 2013 final interpretation of “actual delivery,” the CFTC emphasized that whether actual delivery is accomplished turns on a “functional approach” that considers facts beyond the four corners of the contract between the parties.¹⁰ The 2013 interpretation explained that actual delivery occurs only if there is a transfer of title and possession of the commodity to the buyer or a depository acting on the buyer’s behalf.¹¹ The CFTC’s new proposal attempts to adapt the concept of actual delivery to the unique characteristics of virtual currency as a commodity. The CFTC provided the following examples of what would be considered actual delivery with respect to virtual currency:

- Actual delivery occurs if within 28 days of entering into the agreement, a full transfer of the virtual currency is recorded on the blockchain for that currency — including any portion purchased using financing — from the seller’s virtual wallet to the buyer’s virtual wallet.¹²
- If a third-party offeror acts as intermediary between the seller and the buyer, actual delivery occurs within 28 days of entering into the agreement if the ledger on the virtual currency’s blockchain reflects that the purchased virtual currency was transferred from the seller’s virtual wallet, to the third party’s virtual wallet, to the buyer’s virtual wallet. The buyer’s virtual wallet cannot be affiliated with the seller or third party.¹³
- Actual delivery occurs if within 28 days of entering into the agreement, the seller delivers the full quantity of virtual currency purchased — including the amount purchased with financing — to a depository that has agreed to hold virtual currency as an agent for the buyer. The seller must transfer title to the buyer and there must be no liens resulting from the financing used to

obtain the virtual currency. In addition, the buyer must have “full control” over the virtual currency “(i.e., the ability to immediately remove the full amount of purchased commodity from the depository).”¹⁴

In addition to providing examples of what constitutes “actual delivery,” the CFTC also asked some specific questions in its request for comments that illustrate some of the challenges posed by the “actual delivery” definition. Some of the key questions included:

- Although the CFTC is limited in its ability to shorten the actual delivery time period down from 28 days, would a shorter time period (i.e., the two days required by CEA Section 2(c)(2)(C), which covers foreign currency retail transactions) more accurately apply to virtual currency?¹⁵
- What constitutes “full control” of a virtual currency? Is possession of a unique crypto key that provides access to the virtual currency enough?¹⁶
- Given the Securities and Exchange Commission’s (SEC) recent guidance on the application of securities law to initial coin offerings,¹⁷ and considering that securities are excepted from the CEA’s retail commodity transaction provision,¹⁸ are there any concerns about the scope of the CFTC’s proposed interpretation of “actual delivery?”¹⁹

While the CFTC’s interpretation of “actual delivery” in the context of virtual currency is still in its proposal stage, the CFTC made some notable statements regarding its jurisdiction in the proposal. The CFTC stated that it has exclusive jurisdiction over all derivatives that fall within the definition of swap as well as futures and related options contracts, meaning that no other U.S. regulator — federal or state — may exercise jurisdiction over those products.²⁰ In addition, it reaffirmed that the CFTC views virtual currency as a commodity.²¹

⁷ 2017 Proposed Interpretation at 60,338.

⁸ *Id.* at 60,338, n.46.

⁹ *Id.*

¹⁰ 2013 Final Interpretation at 52,428.

¹¹ *Id.*

¹² 2017 Proposed Interpretation at 60,340.

¹³ *Id.*

¹⁴ *Id.* According to the CFTC, actual delivery will *not* have occurred within 28 days if the virtual currency transaction is offset or settled in cash or another virtual currency between the seller and buyer. *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at 60,341.

¹⁷ See SEC, Release No. 34-81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>. Recently, the SEC issued a settlement order imposing a cease and desist order on Munchee, Inc. after the company initiated an initial coin offering without registering the offering as a security. In the Matter of Munchee Inc., Securities Act Release No. 10,445, (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>. The order did not impose a monetary penalty because Munchee shut down the initial coin offering and returned the proceeds before issuing the tokens. *Id.*

¹⁸ CEA Section 2(c)(2)(D)(ii)(II).

¹⁹ 2017 Proposed Interpretation at 60,341.

²⁰ *Id.* at 60,336.

²¹ *Id.* at 60,337, n.37.