

Latham & Watkins [Financial Institutions Group](#)

January 19, 2018 | Number 2268

CFTC Proposes Interpretation of “Actual Delivery” for Virtual Currencies

The proposed interpretation would further clarify the CFTC’s jurisdiction over virtual currency platforms that facilitate retail commodity transactions.

On December 15, 2017, the US Commodity Futures Trading Commission (CFTC) issued a proposed interpretation for the term “actual delivery” as applied to retail commodity transactions involving virtual currencies (Proposed Interpretation).¹ Under Section 2(c)(2)(D) of the Commodity Exchange Act (the Retail Commodity Rules), commodity transactions (i) between persons that are not eligible contract participants (ECPs) and (ii) that are margined, financed, or leveraged (retail commodity transactions) are subject to regulation by the CFTC as if they were futures contracts, unless there is actual delivery of the underlying commodity within 28 days. While the Proposed Interpretation, if finalized, would have significant implications for virtual currency and token trading platforms offering commodity transactions on a financed basis, the proposal leaves important questions unanswered, with the CFTC pivoting to the market for feedback.

Under the Proposed Interpretation, the CFTC would consider the following factors to be necessary for actual delivery of virtual currencies to occur:

- Within 28 days from the date of the retail commodity transaction, the customer must:
 - Be able to take possession and control of the entire quantity of the virtual currency, no matter if the purchase was on margin, using leverage, or through some other financing arrangement, **and**
 - Be able to use the purchased virtual currency freely in commerce, both within and outside of any particular platform.
- Upon the expiration of 28 days from the date of the retail commodity transaction, the offeror, counterparty seller, and any respective affiliates thereof must not retain any interest in or control over the financed virtual currency.²

The Proposed Interpretation is open to public comment for 90 days, with the comment period ending on March 20, 2018.

Regulatory Framework

Retail Commodity Rules

Section 742 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act),³ as codified in Section 2(c)(2)(D) of the Commodity Exchange Act, as amended (the CEA),

extended the CFTC's jurisdiction to include financed, leveraged, or margined retail commodity transactions. Under the Retail Commodity Rules, transactions in any commodity entered into (i) with, or offered to, a person that does not qualify as an ECP or eligible commercial entity (*i.e.*, a retail investor) and (ii) on a leveraged or margined basis, or financed by the offeror, the counterparty seller, or a person acting in concert with the offeror or counterparty seller, are subject to certain provisions of the CEA, as if such agreements were a contract of sale of a commodity for future delivery (*i.e.*, a futures contract). Applicable provisions include Section 4(a) of the CEA, which requires all futures contracts to be traded on a registered designated contract market (DCM).⁴

Section 2(c)(2)(D) of the CEA excludes any retail commodity transaction from regulation as a futures contract, provided such transaction results in actual delivery of the commodity within 28 days.⁵ The meaning of "actual delivery" has been the subject of commentary and litigation.

2013 Guidance

In 2013, the CFTC issued interpretive guidance for the Retail Commodity Rules (the 2013 Guidance).⁶ The 2013 Guidance stated that the CFTC would apply a broad, multifactor and functional approach when making actual delivery determinations, instead of relying solely on the face of an agreement.⁷ In particular, how the retail commodity agreement, contract, or transaction is marketed, managed, and/or performed will be an important component of analyzing questions of actual delivery. The 2013 Guidance provided a list of examples which indicated that actual delivery required the transfer of title and possession to the purchaser or the purchaser's depository. Importantly, the CFTC stated that book entries in which a purchase is rolled or offset **do not** constitute actual delivery.⁸

The 2013 Guidance was complemented by a 2014 opinion issued by the Eleventh Circuit in *CFTC v. Hunter Wise Commodities, LLC*.⁹ The *Hunter Wise* decision held that actual delivery "denotes the act of giving real and immediate possession to the buyer or the buyer's agent," and that constructive delivery **is not** sufficient.¹⁰ The court found that this understanding of actual delivery comported with both the 2013 Guidance and the legislative history behind the Retail Commodity Rules.¹¹

Bitfinex Order

Having ruled in a 2015 enforcement action that Bitcoin and other virtual currencies are "commodities" under the CEA,¹² the CFTC had occasion to apply the concept of "actual delivery" to virtual currencies the following year. In a 2016 order (the Bitfinex Order), the CFTC filed and simultaneously settled charges against BFXNA, Inc., *d/b/a* Bitfinex (Bitfinex), in connection with Bitfinex's operation of an online virtual currency trading platform (the Bitfinex Platform). Specifically, the Bitfinex Order found that Bitfinex facilitated the execution of illegal, off-exchange commodity transactions in violation of the CEA by:

- Permitting retail and non-retail users to engage in financed virtual currency transactions on the Bitfinex Platform that did not result in actual delivery of the virtual currency within 28 days, and
- Failing to register the Bitfinex Platform with the CFTC as a DCM and a futures commission merchant (FCM).¹³

Importantly, the CFTC found that, under each of the three different methods that Bitfinex used to hold the financed virtual currency purchased by its users, Bitfinex had not transferred possession and control of the virtual currency to the customer, and that Bitfinex instead had retained some degree of possession and control over the purchased virtual currency by depositing it into wallets controlled by the company.¹⁴

For a detailed discussion of the Bitfinex Order, please refer to Latham's [Client Alert](#) published in 2016.

Actual Delivery for Virtual Currencies

The Bitfinex Order raised a number of questions for market participants concerning actual delivery determinations in the virtual currency context, and in particular how custody of virtual currency can impact such determinations. The Proposed Interpretation offers a response to these concerns.

The Proposed Interpretation

The CFTC's proffered guidance in the Proposed Interpretation establishes two baseline tests for making actual delivery determinations under the Retail Commodity Rules for retail commodity transactions in virtual currencies:

- First, the customer must be able to take possession and control over the entire quantity of virtual currency within 28 days of the date of the retail commodity transaction, regardless of how the transaction was financed (i.e., whether on margin, leverage, or another financing arrangement). The customer must also be able, within 28 days of the date of the transaction, to use the purchased virtual currency both within and away from any particular platform.
- Second, upon the expiration of 28 days from the date of the transaction, neither the offeror nor counterparty seller, nor any affiliate or other person acting in concert with the offeror or counterparty seller, may retain any interest in or control over the financed virtual currency.

The Proposed Interpretation highlights two aspects of the 2013 Guidance that are especially relevant in the virtual currency context. First, the interpretation provides that sham delivery **is not** actual delivery. The purchaser must have the ability to utilize the purchased virtual currency “on the spot” immediately to purchase goods or services elsewhere. To note, however, not all virtual currencies may be used outside of any particular platform. For instance, there are virtual currencies that have a limited economy which is relevant to the purchase and sale of goods only pertaining to the platform on which it was purchased. The CFTC will need to consider exactly what it means by “within and away from any particular platform” given the complexity of virtual currencies. Second, actual delivery of virtual currency requires physical settlement (i.e., delivery of the virtual currency itself). Cash settlement or an offset mechanism **will not** qualify as actual delivery of the virtual currency.

More generally, the CFTC will follow the 2013 Guidance and continue to look to function over form when interpreting the language parties choose for their agreement, contract, or transaction.¹⁵ The CFTC will also continue to consider all relevant factors – including ownership, possession, title, location of the commodity, the relationship between buyer and seller, and the manner of contract recordation and settlement – when making an actual delivery determination.¹⁶

Actual Delivery Examples

The Proposed Interpretation offers four illustrative examples of actual delivery, summarized below.

Example 1: Control

The first example clarifies the meaning of control in the virtual currency context.¹⁷ In a peer-to-peer setting, actual delivery requires a record on the relevant public distributed ledger or blockchain of the virtual currency transfer from seller's wallet to buyer's wallet. The seller must retain no interest or control in the sold virtual currency, and title must be transferred to the buyer. The same requirements apply if a third party intermediates the sale – the relevant public distributed ledger or blockchain must reflect the transfer of the purchased virtual currency from the seller's wallet to the third-party offeror's wallet and from the third-party offeror's wallet to the buyer's wallet. The buyer's wallet must not be affiliated with or controlled by the counterparty seller, the third-party offeror or any agent thereof. Further, title may be

reflected by linking an individual purchaser with proof of ownership of the particular wallet that contains the purchased virtual currency.¹⁸

Example 2: Depositories

The second example contemplates a depository (*i.e.*, a third-party wallet or other storage system) taking possession of the purchased virtual currency.¹⁹ In this context, for there to be actual delivery, the entire quantity of virtual currency must be placed into the possession of the depository. The depository (i) must not be owned, controlled, or operated by the seller or any affiliate or agent of the seller and (ii) must have agreed with the purchaser both to act as the purchaser's agent and to hold the purchased virtual currency. The seller must transfer title to the purchaser, and no liens or other interests resulting from the financing of the purchase may continue forward upon the expiration of 28 days from the date of purchase.

Examples 3 and 4: Not Actual Delivery

The third and fourth examples draw attention to transactions that do not feature actual delivery.

Example 3 clarifies that a book entry purporting to show delivery of the virtual currency **is not** sufficient on its own for actual delivery to have occurred. Rather, the requirements outlined in examples 1 and 2 must be met in addition to the book entry.

Example 4 clarifies that there is no actual delivery without physical delivery.²⁰ Any mere rollover, offset, netting, or cash settlement within 28 days of the transaction would not constitute actual delivery.

Key Takeaways

While clarifying various aspects of actual delivery in the context of retail commodity transactions for virtual currencies, the Proposed Interpretation raises some new issues for consideration, while also leaving unanswered several key questions regarding depositories and multisignature authentication structures which arose from the Bitfinex Order.

Virtual Currency Depositories

While Example 2 of the Proposed Interpretation clarifies that the seller, or any affiliate or agent or person acting in concert with the seller, may not own, control, or operate the depository in which a buyer's virtual currency is held, the CFTC's proposed guidance **does not** appear to prohibit an offeror — or an affiliate, agent or person acting in concert with the offeror, who intermediates the transaction — from owning, controlling, or operating such a depository. The CFTC has requested comment in the Proposed Interpretation as to whether or not it should prohibit offerors from having such a relationship with depositories as it would for sellers.

Further, the CFTC has also requested comment in the Proposed Interpretation as to whether it should further define "depository" to require certain licenses or authorizations in order to qualify as a depository for purposes of the Retail Commodity Rules. The Proposed Interpretation does not currently define "depository" other than to reference it as a "wallet or other relevant storage system."²¹

Requirements that would require the virtual currency depository to be independent from the trading platform and/or require additional licenses or authorizations could substantially increase the cost of doing business in the retail virtual currency commodity markets.

Multisignature Authentication

The Proposed Interpretation does not address how or whether multisignature authentication structures would comply with the requirement that the buyer have full possession and control of the virtual currency.

For instance, the CFTC's proposed guidance does not address whether external authentication scripts would fail to provide full possession or control to the buyer. Importantly, the CFTC has requested comment as to how to address such authentication and cybersecurity concerns in its final interpretation.

28-Day Delivery

The CFTC has asked for feedback in the Proposed Interpretation as to (i) whether the 28-day delivery period is appropriate in the context of virtual currencies, and (ii) whether a two-day period, such as the one that exists for retail foreign exchange transactions, is more appropriate in this circumstance.²² Given that the 28-day period is proscribed by statute, however, the CFTC is limited in its ability to revise the timeframe and presumably would need to engage Congress to shorten the relevant statutory period.

Virtual Currency Execution Facility

Interestingly, the CFTC has also requested feedback in the Proposed Interpretation on whether a distinct registration and compliance regime is warranted for retail commodity transactions in virtual currencies. This may be an indication that the CFTC regards its current regulatory regime as insufficient to regulate retail commodity transactions in virtual currencies.

Final Thoughts

While the Proposed Interpretation is limited to financed retail commodity transactions in virtual currencies, what constitutes actual delivery under the Retail Commodity Rules arguably will also serve as a reference when determining whether a virtual currency was delivered in a "spot" transaction. For instance, if under the Retail Commodity Rules depositories for virtual currencies are required to be independent from the platforms on which such virtual currency is purchased, will virtual currency exchanges that do not offer financing arrangements for virtual currency purchases need to comply with the same depository requirements? As such, market participants engaged in virtual currency trading generally, and particularly those offering transactions on a margined, financed, or leveraged basis, should review the Proposed Interpretation for its potential impact on market structure and product development. Firms should consider whether structural changes may be necessary going forward in anticipation of the CFTC issuing final guidance on this important aspect of its emerging regulatory approach for virtual currencies. Moreover, market input will be very important to help guide the CFTC to formulate practical and workable guidance as to how authentication and security concerns can be addressed in the context of possession and control of the virtual currency by the buyer, as well as concerns over independence and regulation of depositories. And finally, whether a new regulatory regime for virtual currency trading is in our near future may depend on whether the CFTC feels it can properly regulate these markets with the regulatory tools it has at hand.

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The authors wish to thank Jeffrey Glass for his contributions to this *Client Alert*.

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Endnotes

- ¹ Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 (proposed Dec. 20, 2017) (proposing amendment of 17 C.F.R. pt. 1), available at <https://www.gpo.gov/fdsys/pkg/FR-2017-12-20/pdf/2017-27421.pdf> (Proposed Interpretation).
- ² Proposed Interpretation, 82 Fed. Reg. at 60339.

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- ³ Public Law 111-203, 124 Stat. 1376 (2010).
- ⁴ 7 U.S.C. § 2(c)(2)(D)(iii).
- ⁵ 7 U.S.C. § 2(c)(2)(D)(ii)(III)(aa).
- ⁶ Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52426 (Aug. 23, 2013), available at <https://www.gpo.gov/fdsys/pkg/FR-2013-08-23/pdf/2013-20617.pdf> (2013 Guidance).
- ⁷ 2013 Guidance, 78 Fed. Reg. at 52428.
- ⁸ 2013 Guidance, 78 Fed. Reg. at 52429.
- ⁹ *CFTC v. Hunter Wise Commodities, LLC, et al.*, 749 F. 3d 967 (11th Cir. April 15, 2014).
- ¹⁰ *Hunter Wise*, 749 F. 3d at 978-79.
- ¹¹ *Hunter Wise*, 749 F. 3d at 977.
- ¹² See *In re Coinflip, Inc., d/b/a Derivabit, et al.*, CFTC Docket No. 15-29 (Sept. 17, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>; *In re TeraExchange LLC*, CFTC Docket No. 15-33 (Sept. 24, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>. For further discussion, please refer to Latham's *Client Alert* regarding the Derivabit Order: *Cryptocurrencies Are Commodities: CFTC's First Bitcoin Enforcement Action*, *Client Alert* No. 1874 (Sept. 21, 2015), available at <https://www.lw.com/thoughtLeadership/LW-CFTC-first-bitcoin-enforcement-action>.
- ¹³ *In re BFXNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf> (Bitfinex Order). For further discussion, please refer to Latham's *Client Alert* regarding the Bitfinex Order: *CFTC Brings Significant Enforcement Action Against Online Cryptocurrency Exchange*, *Client Alert* No. 1980 (June 20, 2016), available at <https://www.lw.com/thoughtLeadership/CFTC-brings-significant-enforcement-action-against-online-cryptocurrency-exchange>.
- ¹⁴ Bitfinex Order at 6.
- ¹⁵ Proposed Interpretation, 82 Fed. Reg. at 60339.
- ¹⁶ Proposed Interpretation, 82 Fed. Reg. at 60337, n. 28.
- ¹⁷ Proposed Interpretation, 82 Fed. Reg. at 60340.
- ¹⁸ Proposed Interpretation, 82 Fed. Reg. at 60340, n. 70.
- ¹⁹ Proposed Interpretation, 82 Fed. Reg. at 60340.
- ²⁰ Proposed Interpretation, 82 Fed. Reg. at 60340.
- ²¹ Proposed Interpretation, 82 Fed. Reg. at 60340.
- ²² 7 U.S.C. § 2(c)(2)(C)(i).