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CLIENT ALERT

CFTC's Final Interpretation of "Actual Delivery" for Virtual Currency Follows Measured, Functional Approach

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On March 24, 2020, the Commodity Futures Trading Commission (the "CFTC") unanimously approved final interpretive guidance concerning the meaning of "actual delivery" of virtual currencies as it relates to specific provisions of the Commodity Exchange Act (the "CEA") that cover retail commodity transactions (the "Final Interpretation").[1] The Final Interpretation establishes the criteria necessary to demonstrate actual delivery, and provides specific examples designed to provide market participants with greater clarity as to how the CFTC evaluates actual delivery within the context of a nascent and evolving asset class. The Final Interpretation is specific to digital assets that serve as a medium of exchange, colloquially known as "virtual currencies."

Overall, the Final Interpretation follows a measured and functional approach because the CFTC was concerned that an overly prescriptive interpretation might stifle innovation in this ever-evolving area. CFTC Chairman Heath P. Tarbert

[1] The Voting Draft of the Final Interpretation is available on the CFTC's website at <https://www.cftc.gov/media/3651/votingdraft032420/download>. Willkie expects the final interpretation to be published in the *Federal Register* in the coming weeks.

noted that the Final Interpretation "reflects the CFTC's growing expertise in this space as well as my commitment to continued U.S. fintech leadership and providing our market participants with clarity."[2]

Background

CEA Section 2(c)(2)(D) provides that retail commodity transactions executed on a leveraged or margined basis are regulated as futures contracts.[3] Absent an exception, retail commodity transactions that are leveraged or margined are subject to the requirement, among others, that they be executed on or subject to the rules of a futures exchange referred to as a designated contract market ("DCM"). One of the main exceptions to treating these retail commodity transactions as futures contracts is the CEA exception for any contract "that results in actual delivery within 28 days or such longer period as the Commission may determine by rule or regulation […]."[4]

In 2013, the CFTC published a general interpretation of the term "actual delivery" that focused on more traditional commodities such as energy and metals products.[5] The 2013 interpretation did not address actual delivery within the context of virtual currencies. In 2016, the CFTC published an enforcement settlement with a cryptocurrency exchange for failure to register as a DCM because the exchange offered leveraged transactions in virtual currency to retail customers. Ultimately, the CFTC found that those transactions did not provide for actual delivery. The 2016 settlement generated significant interest across the industry for greater guidance as to what constitutes actual delivery of virtual currency. In response to requests for greater clarity, the CFTC under Chairman J. Christopher Giancarlo proposed an interpretation in 2017 that discussed how it would interpret actual delivery for virtual currencies.[6]

After consideration of public comments, the CFTC finalized its interpretation of the actual delivery exception for retail commodity transactions involving virtual currencies.

Key Takeaways

The Final Interpretation sets forth two main factors that establish "actual delivery" in the context of retail commodity transactions of virtual currencies:

1. A customer secures: (i) possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage or any other financing arrangements, and (ii) the ability to use the entire quantity of

[2] Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets (March 24, 2020), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a?utm_source=govdelivery>.

[3] Retail commodity transactions involve a transaction with a person that does not meet the definition of an eligible contract participant or eligible commercial entity, both of which are standards used to identify sophisticated market participants.

[4] *See* CEA Section 2(c)(2)(D)(ii)(III)(aa).

[5] *See Retail Commodity Transactions Under the Commodity Exchange Act*, 78 Fed. Reg. 52,426 (Aug. 23, 2013).

[6] *See Id.*, 82 Fed. Reg. (Dec. 20, 2017).

the commodity freely in commerce (away from any particular execution venue) no later than 28 days from the date of the transaction and at all times thereafter; and

2. The offeror and counterparty seller (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) do not retain any interest in, legal right, 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.

In the CFTC's view, the focus should be "whether the customer has secured a meaningful degree of possession and control of the virtual currency."[7] Having full possession and control means that the seller or offeror has delivered the entire purchase of virtual currencies to the buyer, including any portions of the sale made using leverage, margin, or other financing *and* the purchaser can freely transfer, move, or use the full amount of purchased virtual currencies from one depository to another.[8] Moreover, to show that the customer has full possession, there should be no lien on purchased virtual currency that extends beyond 28 days from the date of transaction.[9]

The Final Interpretation includes five examples that showcase when actual delivery will and will not have occurred. Compared to the 2017 proposed interpretation, the examples in the Final Interpretation are less prescriptive, reflecting the evolving concept of delivery in the context of virtual currencies. Below are the key modifications to the examples in the Final Interpretation compared to the proposed interpretation:

- The CFTC determined that whether a purchaser had "title" to the virtual currency would not provide much benefit to the analysis of whether actual delivery has occurred because the concept of "title" has not yet sufficiently developed in the virtual currency space.[10] Therefore, the CFTC did not prescribe a specific definition of title in the context of virtual currency at this time. Instead, when analyzing whether actual delivery occurred, the CFTC will focus on whether the purchaser is able to freely use and have full functional control over the purchased commodity.

- The CFTC noted that possession of a private key is not a requirement to demonstrate full control for the purposes of "actual delivery."

- The Final Interpretation provides that a purchaser can receive actual delivery when the purchaser utilizes a depository as agent to secure the purchased virtual currency. Consistent with the 2017 proposed interpretation, the CFTC proposed restrictions on the ability of the counterparty seller to be affiliated with the depository

[7] Final Guidance at p. 16, *supra* fn 1.
[8] *Id.*, p. 33.
[9] *Id.*, pp. 23-24.
[10] *Id.*, p. 12.

> institution. In response to comments from industry participants, the CFTC decided to strike a balance that would recognize actual delivery notwithstanding some level of offeror affiliation with a depository that is a separate, independent legal entity, as long as "there are certain safeguards to ensure that the customer receives actual possession and control […]."[11]

The full text of the five examples from the Final Interpretation can be found in Appendix I below.

This new guidance from the CFTC reflects a continued effort to provide greater clarity to both the cryptocurrency exchanges and parties to any retail commodity transactions in light of experience and increased understanding of the evolution of digital assets and cryptocurrency markets. But it also demonstrates the CFTC's flexible stance when dealing with retail commodity transactions in the evolving digital assets market.

[11] *Id.*, p. 18.

Appendix I

Example 1: Actual delivery of virtual currency will have occurred if, within 28 days after entering into an agreement, contract, or transaction, there is a record on the relevant public distributed ledger or blockchain address 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 address to the purchaser's blockchain address, over which the purchaser maintains sole possession and control. When an execution venue or other third party offeror acts as an intermediary, the virtual currency's public distributed ledger should reflect the purchased virtual currency transferring from the counterparty seller's blockchain address to the third party offeror's blockchain address and, separately, from the third party offeror's blockchain address to the purchaser's blockchain address, over which the purchaser maintains sole possession and control.

Example 2: Actual delivery will have occurred if, within 28 days after entering into a transaction:

(1) the counterparty seller or offeror 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, operated by, or affiliated with, the counterparty seller (including any parent companies, subsidiaries, 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;

(2) the purchaser has secured full control over the virtual currency (e.g., the ability to remove as soon as technologically practicable and use freely up to the full amount of purchased commodity from the depository at any time, including by transferring to another depository of the customer's choosing); and

(3) with respect to the commodity being delivered, no liens (or other interests or legal rights of the offeror, counterparty seller, or persons acting in concert with the offeror or counterparty seller on a similar basis) resulting or relating to the use of margin, leverage, or financing used to obtain the entire quantity of the commodity delivered will continue after the 28-day period has elapsed. This scenario assumes that no portion of the purchased commodity could be subjected to a forced sale or otherwise removed from the customer's control as a method of satisfying this example.

Example 3: Actual delivery will not have occurred if, within 28 days of entering into a transaction, the full amount of the purchased commodity is not transferred away from a digital account or ledger system owned or operated by, or affiliated with, the offeror or counterparty seller (or their respective execution venues) and received by a separate, independent, appropriately licensed, depository or blockchain address in which the customer maintains possession and control in accordance with Example 2.

Example 4: Actual delivery will not have occurred if, within 28 days of entering into 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 customer, but the counterparty seller or offeror has not, in accordance with the methods described in Example 1 or Example 2, actually delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, 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 customer.

Example 5: Actual delivery will not have occurred if, within 28 days of entering into a transaction, the 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 customer and the offeror or counterparty seller (or persons acting in concert with the offeror or counterparty seller).

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