

CFTC's Proposed Interpretation of "Actual Delivery" for Virtual Currencies and Potential Consequences to the Industry

February 23, 2018

Once the Commodity Futures Trading Commission (the "CFTC") has determined that Bitcoins and other virtual currencies on blockchain protocols are commodities subject to its jurisdiction, it is only a matter of time before the CFTC addresses the regulation of virtual currency trading by retail investors.

On December 15, 2017, the CFTC issued its proposed interpretation of the "actual delivery" exception for retail commodity transactions on virtual currencies¹ (the "Proposed Interpretation") to inform the public of its views on the limitations it proposes to impose on retail investors who want to trade virtual currency transactions on a margined or leveraged basis and to request comments.

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The Proposed Interpretation is open for public comment until March 20, 2018.

In this "Debevoise In Depth," we discuss the Proposed Interpretation, potential consequences for the virtual currency industry and some solutions we offer for consideration.

¹ The CFTC interprets "virtual currency" broadly to include "any digital representation of value 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." For example, Bitcoin and other cryptocurrencies are "virtual currency" under the Proposed Interpretation.

The “Actual Delivery” Exception for Retail Commodity Transactions

Under the Commodity Exchange Act (the “CEA”), the CFTC has direct oversight authority over transactions in any commodity that is entered into with, or offered to, any “retail person” – that is, someone who is not an eligible contract participant or eligible commercial entity – and which is entered into 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.

Unless an exception applies, these retail commodity transactions are regulated as “commodity interests” by the CFTC, in the same manner as futures and swaps. The intent of the regulations is to prohibit unregulated trading platforms from offering to retail persons cash-settled futures-like contracts on commodities because, in the absence of an exception, a retail person is only allowed to enter into such transactions on a designated contract market.

An exception from such regulations is a retail commodity transaction that results in the “actual delivery” of the commodity within 28 days from the date of the transaction. In the Proposed Interpretation, the CFTC has set out how this “actual delivery” exception applies to retail commodity transactions when the commodities are virtual currencies.

Existing Guidance and Interpretation of the “Actual Delivery” Exception

2013 Guidance

In 2013, the CFTC issued a guidance (the “2013 Guidance”)² on its interpretation of the “actual delivery” exception for retail commodity transactions, which stated that the CFTC would “employ a functional approach and examine 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” in determining whether actual delivery of the commodity has occurred.

² Retail Commodity Transactions Under Commodity Exchange Act, 78 FR 52426 (Aug. 23, 2013).

The 2013 Guidance also specified that the relevant factors in this determination include the ownership, possession, title, and physical location of the commodity purchased or sold; the nature of the relationship between the buyer, seller, and possessor of the commodity purchased or sold; and the manner in which the purchase or sale is recorded and completed.

The 2013 Guidance provided two examples of scenarios in which actual delivery is deemed to have occurred:

- (1) The seller has physically delivered the entire quantity of the commodity purchased by the buyer into the possession of the buyer and has transferred title to that quantity of the commodity to the buyer; or
- (2) The seller has physically delivered the entire quantity of the commodity purchased by the buyer, whether in specifically segregated or fungible bulk form, into the possession of a depository that is not affiliated with the seller and that is: (a) a financial institution as defined by the CEA, (b) a depository, the warrants or warehouse receipts of which are recognized for delivery purposes for any commodity on a contract market designated by the CFTC, or (c) a storage facility licensed or regulated by the United States or any United States agency, and has transferred title to that quantity of the commodity to the buyer.

The takeaways from these examples Guidance are that the only satisfactory examples of actual delivery entail the *transfer of the physical commodity and title to the purchaser or a certain depository acting on the purchaser's behalf*, and that mere book entries and certain instances where a purchase is “rolled, offset, or otherwise netted with another transaction” do not constitute actual delivery.

Hunter Wise and Bitfinex

The CFTC's interpretation in the 2013 Guidance was further affirmed when the CFTC obtained a preliminary injunction from the Eleventh Circuit in *CFTC v. Hunter Wise Commodities, LLC* (“Hunter Wise Opinion”). In the Hunter Wise Opinion, the Eleventh Circuit stated that delivery “denotes a transfer of possession and control,” which involves “[t]he act of giving real and immediate possession to the buyer or the buyer's agent” and “constructive delivery does not suffice for actual delivery.”

In 2016, after the CFTC had established that virtual currencies are commodities under its jurisdiction,³ it brought an enforcement action against Bitfinex, an

³ See our client update [“In Two Recent Orders, CFTC Holds that Bitcoins Are Commodities”](#).

online platform for the exchange and trading of cryptocurrencies (mainly Bitcoin), on the ground that it offered retail commodity transactions on cryptocurrencies without registration. Bitfinex allowed retail persons to borrow U.S. Dollars and cryptocurrencies from other users to enter into cryptocurrency transactions on a leveraged, margined or financed basis. The CFTC found that Bitfinex did not “actually deliver” Bitcoins to the purchasers until outstanding loans and fees incurred by the purchasers were paid in full; instead, Bitfinex held the Bitcoins in either deposit wallets owned and controlled by Bitfinex or in multisignature wallets established by a third-party over which Bitfinex retained control of the private key. The CFTC thus concluded that there was no actual delivery of Bitcoin or other cryptocurrency to a customer who traded it on a leveraged basis.

The Proposed Interpretation

In the Proposed Interpretation, the CFTC states that, following the 2013 Guidance, it will continue to employ a functional approach and examine how the transaction is marketed, managed, and performed, and that it will look beyond the four corners of the contract or agreement. Like the 2013 Guidance, the Proposed Interpretation states that a sham delivery does not constitute “actual delivery.”

More specifically, the CFTC states that “actual delivery” of virtual currencies in a retail commodity transaction requires:

- (1) A customer having the ability to: (i) take possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage or any other financing arrangement, and (ii) use it to immediately purchase goods or services no later than 28 days from the date of the transaction; and
- (2) The offeror and seller (including any of their respective affiliates or other persons acting in concert with the offeror or seller on a similar basis)⁴

⁴ The CFTC notes that the offeror and the ultimate counterparty could be the same entity. For example, a virtual currency platform that makes transactions available to the retail customer or otherwise facilitates transactions would be deemed to be an offeror. The platform could also be considered a counterparty to the transaction if it also took the opposite side of the transaction or if the purchaser of the virtual currency enjoyed privity of contract solely with the platform rather than the seller. Further, the CFTC would consider third-parties or other users on a platform who provide financing or leverage to its retail customers to be acting in concert with the platform 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.

The Proposed Interpretation differs significantly from the 2013 Guidance in two main areas:

- First, while the 2013 Guidance only required physical delivery of the commodity into the possession or control of the purchaser or a depository unaffiliated with the seller (together with transfer of title), the Proposed Interpretation provides that in the context of virtual currency, the offeror and seller cannot retain any interest or control whatsoever in the virtual currency at the expiration of the 28 days.
- Second, the Proposed Interpretation also states that actual delivery of virtual currency connotes the ability of a purchaser to utilize the virtual currency purchased to immediately purchase goods or services with the currency elsewhere. This was not mentioned in the 2013 Guidance.

The CFTC provides no explanation for these differences, nor does it explain why the actual delivery of virtual currency would have to meet these additional conditions.

Examples of Satisfactory “Actual Delivery”

In the Proposed Interpretation, the CFTC provides four nonexclusive examples to illustrate the meaning of actual delivery in the context of transactions involving virtual currencies:

Example 1 of satisfactory “actual delivery” based on transfer of possession and control from seller to purchaser: Actual delivery of virtual currency will have occurred if within 28 days there is a record on the relevant publicly distributed ledger network or blockchain of the transfer of virtual currency, whereby the entire quantity of the purchased virtual currency (whether purchased using leverage or not) is transferred from the seller’s blockchain wallet to the purchaser’s blockchain wallet. The title of the virtual currency has to be transferred to the purchaser with the seller retaining no control or interest over the virtual currency.

Example 2 of satisfactory “actual delivery” using a depository: Actual delivery will have occurred if within 28 days: (1) the seller has delivered the entire quantity of the virtual currency purchased (whether purchased using leverage or not) into the possession of a depository that is not owned, controlled, or operated by the seller (including any entity acting in concert with the seller) and which has

entered into an agreement with the purchaser to hold virtual currency as agent for the purchaser; (2) the seller has transferred title of the virtual currency to the purchaser; (3) the purchaser has full control over the virtual currency; and (4) no liens or other interests resulting from the use of margin, leverage, or financing used to obtain the entire quantity of the virtual currency purchased will continue at the expiration of 28 days.

Examples of Not Satisfactory Deliveries

The two examples provided by the CFTC to illustrate a transfer that does not satisfy “actual delivery” indicate that:

Example 3 of book-entry indication is not “actual delivery”: a mere book-entry indication made by the offeror or seller on its books to show the transfer of a virtual currency to the purchaser, without an actual delivery as described in examples 1 or 2 above, does not qualify for “actual delivery.”

Example 4 of the rolling, offsetting, or netting of transactions is not “actual delivery”: the rolling, offsetting against, netting out, or settling in cash or virtual currency (other than the purchased virtual currency) between the purchaser and the offeror or seller within 28 days does not qualify for “actual delivery.”

Potential Consequences of the Proposed Interpretation on the Virtual Currency Industry

The main challenge facing the CFTC with respect to virtual currencies is trying to adapt a regulatory framework designed for the physical world to the virtual one.

Under the 2013 Guidance, the buyer of a physical commodity can use financing provided by the seller (or an affiliate of the seller) and acquire title, possession and control, all subject to a security interest granted to the provider of financing, and still be in compliance with the “actual delivery” exception. This is possible because there are different methods to transfer title, control and possession in a commodity subject to valid and perfected security interest of a creditor in the same commodity (thereby sharing control over the commodity between the owner and the creditor). For example, title transfer can be accomplished by way of a transfer of the paper or electronic warehouse receipt or paper or electronic certificate of title, while security interest can be granted and perfected by way of the notation on the books of the warehouse receipt or certificate issuer or

administrator or by way of a control agreement entered into among the buyer, the financing provider and the warehouse or custodian.

In the case of a virtual currency, however, while a buyer can acquire title and control of a virtual currency and grant a security interest to a financing provider; presently, the only way to perfect such a security interest when the virtual currency is stored in the buyer's wallet is to give the financing provider the private key necessary to access the virtual currency.⁵ However, it is not clear why this current technological shortcoming should result in the CFTC permanently banning the granting of any sort of lien to a financing provider for virtual currency purchased by retail persons for a period longer than 28 days.

Understandably, as the CFTC points out in the Proposed Interpretation, it has an interest in preventing harm to retail customers from trading in the nascent virtual currency markets. However, it is not clear to us how the additional requirements in the Proposed Interpretation would protect retail investors. Rather, imposing the new requirements as currently set forth in the Proposed Interpretation runs the risk of unintentionally stunting the advancements of the virtual currency industry by discouraging the development of the very technology that is needed for the creation and perfection of security interest in connection with virtual currency trading.

More fundamentally, we believe that the CFTC should reconsider whether it is appropriate to issue an interpretation of the general applicability of the "actual delivery" requirement to virtual currencies at this point in time when blockchain technology is still at its early stage of development.

Potential Solutions With Respect to the Granting of Security Interest and Virtual Currencies

Virtual currencies encompass a broad category of different instruments. For example, a virtual currency like Bitcoin is actually a different instrument from a virtual currency like a token representing a physical commodity (e.g., gold bullion) because Bitcoin is meant to be a currency substitute and used as a means of payment, while a physical commodity token is just a virtual representation of an ownership interest in the underlying commodity.

⁵ If the buyer holds a virtual currency through a depository or other custodian, then the security interest could be perfected by way of a control agreement similar to a deposit account control agreement over cash deposit at a bank. We are also aware of multisignature online wallets, but such technology is not the same as a control agreement and does not offer an adequate way of tracking the granting of a security interest in a virtual currency.

The creation and perfection of a security interest in Bitcoin thus should be effected in the same manner as one currently creates and perfects security interest in cash or in a cash deposit account (e.g., via transfer of cash or a control agreement). On the other hand, a security interest in a physical commodity token should be perfected in the same manner as one currently creates and perfects a security interest in a warehouse receipt or title certificate (e.g., via a transfer of warehouse receipt or certificate, a notation by the central issuer of receipt or certificate on its books, or a control agreement). Applying the methods of perfection in the physical world to the virtual world, the possession of Bitcoin or a physical commodity token can be transferred by the transmission of the private key to the wallet holding the Bitcoin or such token. Alternatively, a custodian of the Bitcoin or such token can enter into a control agreement with the owner and the creditor. In the case of physical commodity tokens, a warehouse holding the underlying commodity could also issue different types of token: one type of token representing unencumbered commodity and another type of token representing encumbered commodity.

One of the original premises of blockchain technology was to disrupt the modern system of asset ownership and shift it away from centralized ledgers maintained by intermediaries to decentralized ledgers. While it is important to protect investors and preserve market integrity, it is equally important to avoid impeding technological improvement and innovation. As we noted before, we encourage the CFTC to consider implementing a regulatory sandbox for virtual currencies that would promote needed innovation while maintaining regulatory oversight.

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