

CFTC Finalizes Guidance on Digital Assets in the Context of Retail Commodity Transactions

On March 24, 2020, the U.S. Commodity Futures Trading Commission (the Commission or the CFTC) finalized long-awaited interpretive guidance regarding what constitutes the "actual delivery" of a digital asset in the context of a retail commodity transaction (RCT) under Section 2(c)(2)(D) of the Commodity Exchange Act (the CEA).

This multi-part update series will explore the regulation of retail commodity transactions and the Commission's final interpretive guidance (the Guidance),^[1] the issuance of which represents a significant milestone in the regulation of virtual currency and other digital asset transactions. This update series consists of three parts:

Part 1: Commentary on the Significance of the Guidance for the Industry

[Part 2: The Regulation of Retail Commodity Transactions—History and Background](#)

[Part 3: An Overview of the Guidance](#)

In addition, we have prepared an **Appendix**, as an attachment to Part III, which contains the actual text of the Commission's interpretation of the term "actual delivery" with a "side-by-side" view of: (1) the Commission's commentary in respect of select elements of this interpretation; and (2) additional analysis and considerations in respect of the Guidance.

Part 1: Commentary on the Significance of the Guidance for the Industry

We begin our series on the CFTC's actual delivery guidance with commentary on the significance of this guidance for emerging digital currency industry.

The CFTC's "DAO Report"?

The Commission finalized guidance on actual delivery of digital assets a few weeks ago. The Commission didn't include any bold language allowing for U.S. digital asset trading venues to offer trading with leverage tantamount to popular overseas platforms. It didn't permit trading venues to offer margined short sales or any other financial product that generally constitutes a regulated derivative instrument. It did very little to move the needle for trading venues that seek to offer innovative new products without the undertaking the significant regulatory compliance obligation of operating a Commission-regulated futures exchange.

Despite these relatively low-key aspects of its release, the Guidance nevertheless constitutes a significant reference point in the development of a timeline for elevated enforcement risks that may be faced by the parties to a margined transaction that involves a digital asset, including the operators of any centralized exchange or decentralized network that facilitates these transactions. In particular, [Commission Chairman Heath Tarbert stated that](#) "for a period of 90 days the CFTC will forbear from initiating enforcement actions addressing aspects of this guidance that were not plainly evident from prior CFTC guidance, enforcement actions, and case law."

The Securities and Exchange Commission (the SEC) similarly put the initial coin offering (ICO) issuers on notice when it [issued its report of investigation on The DAO](#). In an accompanying public statement to this report, William Hinman, director of the SEC's Division of Corporation Finance, said that the report "confirms that sponsors of offerings conducted through the use of distributed ledger or blockchain technology must comply with the securities laws." The SEC subsequently brought numerous enforcement actions against issuers of ICO tokens, in which the report's publication has often been referenced as a form of *de facto* constructive notice.

Market participants should consider the CFTC's Guidance a warning that legal repercussions may follow if they do not come into compliance within that 90-day timeframe.

The Development of Bucket Shops and the Market for "To Arrive" Agricultural Contracts...

The Guidance is informed by a long history of scrutiny of contracts that involve a commodity, such as a digital asset, but do not require delivery of the commodity. Permutations of the "to arrive" or "delayed delivery" contract have been around in various forms for centuries. These contracts, which provide for the pre-purchase and future delivery of a commodity, allow farmers to market their crops and businesses to meet future materials requirements.

In the late 19th century—before legislation mandated that such contracts, outside of a limited commercial context, generally be required to trade on regulated exchange platforms—firms operating "bucket shops" allowed people to make speculative wagers on the future price of a commodity outside of the domain of the commodity exchange trading floor. These "bucket shops," which were operated by the equivalent of "bookies," disappeared with gamblers' money overnight. Nevertheless, these operations came to compete with the major commodity exchanges of the day, such as the Chicago Board of Trade, and were targeted by state and federal legislation.

After the passage of legislation requiring that such contracts trade on regulated exchange platforms, many of the bucket shops disappeared for good. However, grain elevators and others began [entering into "hedge-to-arrive" contracts](#) with farmers and ranchers that permitted the farmers and ranchers "to extinguish their delivery obligations by means other than the actual delivery of grain" by rolling the delivery obligation forward indefinitely. The Commission determined that such contracts constituted illegal off-exchange futures and required that the counterparties take their business to a Commission-regulated "designated contract market."

...And Their Relationship With 21st Century Digital Commodities

With the advent of bitcoin in the 2007-2008 timeframe and the subsequent Cambrian explosion of digital assets of all types, the Commission has applied the CEA and regulations promulgated thereunder to rein in the offering of "to arrive" style contracts involving digital assets off of Commission-regulated exchange platforms. This policy position is informed by decades of experience with illegal off-exchange trading of commodity contracts in bucket shops that duped many unsophisticated investors.

Although undefined, the term "futures contract" has been interpreted narrowly by the courts to exclude certain products that are not easily offset through purchase of an opposite contract. To close this loophole, which has come to be referred to as the "Zelener Fix," Congress granted to the Commission authority to regulate contracts offered to retail persons for the leveraged, margined, or financed purchase of any commodity as if they are future contracts, unless an exemption applies. Congress amplified the Commission's authority over the over-the-counter derivatives markets further with new swap regulations in the Dodd-Frank Act. As a result, the only leveraged,

margined, or financed virtual currency transactions that may be offered to retail persons are contracts for sale that settle with "actual delivery" of the virtual currency within 28 days.[2] For this reason, the meaning of the term "actual delivery" is of paramount importance to the development of trading markets for virtual currencies and similarly situated digital assets.

Enter the March 2020 "Actual Delivery" Interpretation Guidance...

In light of all of this background, it is not likely to be a surprise that the Commission's Guidance does not afford businesses much flexibility to offer contracts that resemble futures contracts to retail customers off of a CFTC-regulated futures exchange. The exclusion for virtual currency transactions that result in actual delivery within 28 days is very small and should not be regarded as a path to offering a suite of margined products to retail customers. If the Commission were to allow virtual currency margin trading to be freely offered to retail customers on an off-exchange basis, it would be treating margin trading of virtual currency by retail customers disparately from margin trading by retail customers involving other commodities.

The CEA permits trading venues to offer the leveraged, margined, or financed purchase of digital assets, as long as the "actual delivery" requirement has been satisfied.[3] In other words, an exchange can allow its customers to purchase a bitcoin by putting 10% down, so long as within 28 days the transaction concludes with the payment of the 90% balance and "actual delivery" of the bitcoin or, in the case of a customer's inability to make a payment, a customer default. Most other types of transactions involving a commodity and margin, leverage, or financing are regulated derivative instruments. The Guidance does not change this. The purpose of the Guidance is to clarify what "actual delivery" means in the context of the very narrow "28-day" exclusion.

The Guidance explains that "actual delivery means that the purchaser of the digital asset has (1) possession and control of the entire quantity of the digital asset and (2) the ability to use the entire quantity of the digital asset freely in commerce (away from any particular execution venue). Additionally, the offeror of the commodity cannot retain any interest in, legal right, or control over the digital asset. In other words, after the 28-day period ends, the purchaser must have the right to freely walk away from the transaction with their purchased digital asset(s) and have no ongoing obligation to the offeror. The exchange may not use the purchaser's exchange trading account as collateral after the 28-day window expires.

...And What It May Mean for the Development of Leveraged Digital Asset Transactions

All of that having been said, there is a silver lining in terms of a potential path forward for the development of leveraged digital asset transactions. Specifically, the CFTC's Guidance clarified that there is a path for exchanges to offer leveraged purchases by establishing or associating with an affiliated depository to serve as custodian at the expiration of the 28-day period, so long as the purchaser chooses to utilize such depository.

The Guidance explains that "such an affiliated depository should be: (i) a "financial institution" as defined by CEA section 1a(21); (ii) a separate line of business from the offeror not subject to the offeror's control; (iii) a separate legal entity from the offeror and any offeror execution venue; (iv) predominantly operated for the purpose of providing custodial services for virtual currency and other digital assets; (v) appropriately licensed to conduct such custodial activity in the jurisdiction of the customer; (vi) offering the ability for the customer to utilize and engage in cold storage of the virtual currency; and (vii) contractually authorized by the customer to act as its agent." The Guidance further clarifies that "actual delivery does not occur if the offeror, the offeror's execution venue, or any of its subsidiaries or affiliates, is also the counterparty to the retail commodity transaction at issue." In other words, this small novel twist on the [Proposed Guidance from 2017](#) will not allow exchanges to use the purchaser's exchange trading account or its account at the depository as collateral beyond

the 28-day period.

Takeaways

In closing, and as we will explore in the next part of this series, the Guidance is an update to the more general guidance from 2013 related to the application of the "actual delivery" requirement in the context of retail transactions involving commodities other than virtual currencies. Specifically, the Guidance provides small accommodations that make it operationally possible for businesses to test the waters with margined purchases of virtual currency, while clarifying in no uncertain terms that these businesses are still not permitted to offer margin trading to retail customers more broadly off of a CFTC-registered exchange.

Endnotes

[1] As of the date of publication of this update, the Commission did not publish the official draft of the Guidance in the Federal Register. Therefore, all references and citations in this update to the Guidance means the voting draft version of the Guidance available as of the date of this update at <https://www.cftc.gov/media/3651/votingdraft032420/download>.

[2] Note that the CEA refers broadly to "any agreement, contract, or transaction in any commodity" that is leveraged, margined, or financed in defining an RCT. However, the actual delivery exception, which is the subject of the Guidance, is only applicable to "contracts of sale" (e.g., purchases of virtual currency). It is therefore possible that the actual delivery exception may not be applicable to all forms of agreements, contracts, or transactions in virtual currency.

[3] Separate and apart from the "actual delivery" interpretation and the related Guidance, the CEA also permits commercial parties to enter into an agreement, contract, or transaction that creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver and accept delivery, respectively, in connection with the line of business of the seller and buyer.

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