

# CFTC Adopts Final Interpretation on the Actual Delivery Exception for Leveraged Retail Virtual Currency Transactions

March 27, 2020

## Virtual Currencies

The CFTC intends the Final Guidance to address actual delivery only of “virtual currencies”—not all types of digital assets and not other types of commodities. A virtual currency is described by the CFTC as a digital asset that is, or can be used as, a medium of exchange in commerce, including within a particular blockchain ecosystem. The CFTC focuses on the ability of the digital asset to be used as a medium of exchange in determining whether it is a virtual currency.

The Commodity Exchange Act prohibits any leveraged, margined, or financed transaction in a commodity with a retail customer (the **Retail Commodity Transaction Provisions**), unless the transaction is conducted as if it were a futures contract.<sup>1</sup> A transaction is excluded from this prohibition if it results in “actual delivery” within 28 days (**Actual Delivery Exception**).<sup>2</sup>

The CFTC unanimously approved **final interpretive guidance (Final Guidance)** describing what constitutes “actual delivery” of a **virtual currency** for purposes of the Actual Delivery Exception. The Final Guidance is of key importance for cryptocurrency and digital asset intermediaries, such as digital asset exchanges and dealers, as it may significantly constrain the ability to offer leveraged or margined trading to retail customers.

The Final Guidance will be effective upon its publication in the *Federal Register*. Although not stated in the Final Guidance itself, CFTC Chairman Tarbert said that he would anticipate a 90-day period during which the CFTC would forbear enforcement action “addressing aspects of this guidance that were not plainly evident from prior CFTC guidance, enforcement actions, and case law.”<sup>3</sup>

## Background on the Retail Commodity Transaction Provisions

The Dodd-Frank Act added the Retail Commodity Transaction Provisions to the Commodity Exchange Act, providing the CFTC with new statutory authority over **Retail Commodity Transactions**.<sup>4</sup> These are defined to include any agreement, contract or transaction in a commodity that is entered into or offered (even if not entered into):

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<sup>1</sup> Section 2(c)(2)(D) of the Commodity Exchange Act. 7 U.S.C. § 2(c)(2)(D).

<sup>2</sup> Section 2(c)(2)(D)(ii)(III)(aa) of the Commodity Exchange Act. 7 U.S.C. § 2(c)(2)(D)(ii)(III)(aa).

<sup>3</sup> Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets (Mar. 24, 2020), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a>.

<sup>4</sup> Section 742(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Public Law 111–203, 124 Stat. 1376 (2010).

**Retail Customer**

A retail customer is a person that is not an eligible contract participant as defined in Section 1a(18) of the Commodity Exchange Act or an eligible commercial entity as defined in Section 1a(17) of the Commodity Exchange Act.

1. with a **retail customer**; and
2. 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.<sup>5</sup>

The Retail Commodity Transaction Provisions prohibit a Retail Commodity Transaction unless the transaction is conducted as if it were a futures contract. The transaction, thus, would need to be traded on a regulated futures exchange and cleared through a futures commission merchant or other authorized clearing member. As a practical matter, the Retail Commodity Transaction Provisions significantly restrict the ability of digital currency exchanges, dealers, and other intermediaries to offer leveraged, margined, or financed transactions in digital assets that are commodities to retail customers, away from the regulated futures markets.

The Actual Delivery Exception excludes from the Retail Commodity Transaction Provisions transactions that result in “actual delivery” within 28 days. Neither the Commodity Exchange Act nor CFTC regulations define “actual delivery” for this purpose. The CFTC issued **interpretive guidance** on the meaning of “actual delivery” in 2013 (the **2013 Guidance**),<sup>6</sup> before the CFTC began to consider the treatment of digital assets as commodities. The phrase has been considered in several court cases and a CFTC enforcement action, one of which was in the context of digital assets.<sup>7</sup>

The Final Guidance addresses the application of the Actual Delivery Exception, and what constitutes actual delivery, to Retail Commodity Transactions in virtual currencies. It is not intended to address actual delivery of other types of digital assets or other types of commodities. And it is not meant to inform other Commodity Exchange Act provisions, such as those governing swaps.

**The Final Guidance**

The Final Guidance provides that, for purposes of the Actual Delivery Exception, actual delivery of a virtual currency has occurred when:

- (1) a customer secures:
  - (i) possession and control of the entire quantity of the commodity, whether purchased on margin, or using leverage, or any other financing arrangement, and

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<sup>5</sup> These provisions apply to Retail Commodity Transactions in commodities other than foreign exchange, which are separately regulated under Section 2(c)(2)(C) of the Commodity Exchange Act.

<sup>6</sup> Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52,426 (Aug. 23, 2013).

<sup>7</sup> CFTC v. Hunter Wise Commodities, LLC, et al., 749 F.3d 967 (11th Cir. 2014); CFTC v. Monex Credit Company, et al., 931 F.3d 966, 972-75 (9th Cir. 2019); In re BFXNA INC. d/b/a BITFINEX, CFTC Docket No. 16-19 (June 2, 2016).

- (ii) the ability to use the entire quantity of 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.

*Offerors and counterparty sellers.* The Final Guidance reiterates that the CFTC interprets the term “offeror” broadly in this context to include any person that presents, solicits or otherwise facilitates a Retail Commodity Transaction. Indeed, the Final Guidance may result in some decentralized finance applications being subject to the Retail Commodity Transaction Provisions. It states that an offeror may include someone with operational control of a blockchain protocol that offers Retail Commodity Transactions. Depending on the circumstances, this can include a person that has control over such a protocol by means of “a participation interest in a foundation, consensus, or other collective that controls operational decisions on the protocol, or any other persons with an ability to assert control over the protocol that offers [Retail Commodity Transactions].”

The Final Guidance recognizes that the offeror of a Retail Commodity Transaction and the counterparty seller may be different entities or the same. As described in the Final Guidance, the offeror of the transaction could be a “virtual currency execution venue that makes the transaction available to a retail customer or otherwise facilitates the transaction.” That virtual currency execution venue could also be considered a counterparty seller to the transaction if, for example, the execution venue “takes the opposite side of the transaction or the purchaser of the virtual currency enjoyed privity of contract solely with the [execution venue] rather than the seller.”

In addition, the Final Guidance provides that, where a virtual currency execution venue provides a purchaser with the ability to source financing or leverage from other users or third parties, the third party would be viewed as “acting in concert with the offeror or counterparty seller on a similar basis” for these purposes.

*Functional approach.* Consistent with the 2013 Guidance, the CFTC will assess all relevant factors and “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” when interpreting the term actual delivery.

## Examples and Commentary

The Final Guidance sets out five, non-exclusive examples under which the CFTC would view actual delivery of a virtual currency to have, or have not, occurred. The examples are set out below in full with commentary following.

*Example 1: On-Chain Delivery to Purchaser's Blockchain Address*

**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 1 seems to be the most straightforward and clear case of actual delivery—where actual delivery is satisfied by transmission of a virtual currency to a public blockchain address that is possessed and controlled only by the purchaser.

Although this delivery method was a focus of the proposed guidance, in the Final Guidance this method is fashioned as merely an example of circumstances under which actual delivery would occur, and other methods are possible. The Final Guidance states that the CFTC will focus on whether the purchaser has “secured a meaningful degree of possession and control of the virtual currency” rather than only whether the purchaser has “possession of a particular key or blockchain address.” Together with Examples 2 and 3, which contemplate delivery to a depository, it appears that the Final Guidance would not require delivery of virtual currency to a purchaser's public blockchain address to satisfy actual delivery, so long as the purchaser otherwise has possession and control over the entire quantity of virtual currency that was the subject of the Retail Commodity Transaction. In addition, the example's use of the phrase “sole possession and control” seems also not to be a definitive requirement for actual delivery, given that the guidance itself refers to a customer securing “possession and control” of the virtual currency.

**Examples 2 and 3: Lien-Free Delivery to Buyer's Depository**

**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.

**Affiliated depositories.** Examples 2 and 3 focus on delivery of virtual currency to a depository, such as digital asset trading platforms and custodians, as a means of satisfying actual delivery. The Final Guidance separately describes actual delivery occurring through receipt by a depository when there is:

## Financial Institution

A financial institution includes (among others):

- a depository institution (as defined in section 1813 of title 12);
- a foreign bank or a branch or agency of a foreign bank (each as defined in section 3101 of title 12);
- any financial holding company (as defined in section 1841 of title 12);
- a trust company; or
- a similarly regulated subsidiary or affiliate of a financial institution.

- (1) a transfer of the virtual currency (that is the subject of the Retail Commodity Transaction) away from the counterparty seller, offeror, and any offeror execution venue ledger or digital account system; and
- (2) receipt by a separate blockchain address or depository that is chosen by the customer and allows the customer to use the virtual currency freely in commerce, where accepted, as soon as technologically practicable.

Under this guidance and Examples 2 and 3, delivery to a depository affiliated with the offeror or counterparty seller is generally *inconsistent* with actual delivery. However, the Final Guidance recognizes limited circumstances under which delivery to a depository affiliated with an offeror, counterparty seller, or their execution venues (an **Affiliated Depository**) would be consistent with actual delivery. The Affiliated Depository would need to be “completely separated from any execution venue services” and would need to be a separate, independent legal entity from the offeror or counterparty seller and would need to meet specified safeguards designed to ensure that the customer receives actual possession and control over the purchased commodity within the 28-day actual delivery period. These safeguards include that the Affiliated Depository must be:

- a **financial institution** as defined by section 1a(21) of the Commodity Exchange Act;
- a separate line of business from the offeror not subject to the offeror’s control;<sup>8</sup>
- a separate legal entity from the offeror and any offeror execution venue;
- predominantly operated for the purpose of providing custodial services, including for virtual currency and other digital assets;
- appropriately licensed to conduct such custodial activity in the jurisdiction of the customer;
- offering the ability for the customer to utilize and engage in cold storage of the virtual currency; and
- contractually authorized by the customer to act as its agent, and the customer should be free to revoke such contractual agency relationship at any time.

The Affiliated Depository’s status as a separate line of business and separate legal entity would be central to the CFTC’s determination of whether actual delivery has occurred.

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<sup>8</sup> The Final Guidance states that, for this purpose, “control” would include the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

*Forced sale scenarios.* The Final Guidance addresses what it terms “forced sale” scenarios, generally viewing these arrangements as inconsistent with actual delivery. A forced sale scenario, as described by the CFTC, includes where a purchaser of virtual currency grants a security interest (or similar right) in the purchased virtual currency to the offeror or counterparty seller, so that the offeror or counterparty seller can liquidate or acquire the pledged virtual currency in satisfaction of a debt obligation related to the virtual currency transaction, with or without the prior consent of the purchaser. This arrangement is common for virtual currency margin trading services.

While the CFTC recognizes that “a customer should have the ability to cover an outstanding debt obligation (unrelated to the initial retail commodity transaction) with their purchased virtual currency,” the CFTC takes the view that where a purchaser “cannot practically use the virtual currency freely in commerce as a medium of exchange (and the offeror or seller can essentially take it back), it is difficult to argue the customer truly received or secured control over it in the first instance.”

The CFTC seeks to distinguish these “forced sale scenarios” from other common lien scenarios, such as home mortgages or car loans, on the basis that in those cases the purchaser can “use those items for their primary purposes.” In contrast, in the CFTC’s view, a purchaser pledging purchased virtual currency “as a practical matter does not allow the [purchaser] to fully use the virtual currency for its purpose as a medium of exchange both within and away from a relevant execution venue service.” This approach seems to conflate the definition of virtual currencies—digital assets that *can* be used as a medium of exchange—into a mandate that they be used for that purpose in order to satisfy the actual delivery requirement.

#### *Examples 4 and 5: Book Entry Delivery and Netting*

##### **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).

Examples 4 and 5 focus on methods of delivery that are insufficient to satisfy the actual delivery requirement. This includes delivery through mere book entry that “purports” to show delivery without employing other means of actual delivery as described in Examples 1 and 2 or otherwise in the Final Guidance.

*Offeror acting as counterparty seller.* The Final Guidance expresses concern about conflicts of interest raised by what the CFTC calls “bucket shop” arrangements, where a Retail Commodity Transaction offeror that is an execution venue also acts as principal to some customer trades. Similar arrangements are common in securities and other regulated markets and are not, absent other bad conduct, typically characterized as bucket shop activities. And although the status of the offeror as counterparty seller does not appear probative as to whether actual delivery has occurred, the CFTC indicated that it will consider such arrangements as a factor weighing against actual delivery. For example, the CFTC would not consider actual delivery to occur in Example 2 if an offeror is also the counterparty seller in the transaction—effectively eliminating the Actual Delivery Exception from being available to virtual currency dealers that operate their own execution venues, even where virtual currency purchased on margin is in fact delivered out to a blockchain address under the purchaser’s or its independent custodian’s sole possession and control.

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