The CFTC's Final Guidance on Actual Delivery: **Five Things To Know**

On March 24, 2020, the Commodity Futures Trading Commission ("CFTC") unanimously voted to adopt final interpretive guidance on when "actual delivery" of retail commodity transactions in virtual currencies occurs within the meaning of Section 2(c)(2)(D) of the Commodities Exchange Act ("CEA"). Section 2(c)(2)(D)(ii)(III)(aa) provides an exception from regulation as a futures contract for any contract "that results in actual delivery within 28 days or such longer period as the Commission may determine by rule or regulation . . . ." (emphasis added). The CFTC published interpretive guidance in 2013 on the meaning of "actual delivery" for traditional commodities. With the increase in recent years of trading in cryptocurrencies and other virtual currencies, the CFTC has attempted to formulate an appropriate regulatory framework to delineate when actual delivery occurs for retail commodity transactions of this type. In 2017, it sought public input through proposed guidance. The recent adoption of final guidance builds off of the 2017 proposed guidance and public comments to provide greater clarity on the applicability of the "actual delivery" exception to retail transactions in virtual currency.

1 How the CFTC Evaluates Actual Delivery Under the Final Guidance

The core of the final guidance uses a two-pronged approach in evaluating whether actual delivery has occurred. First, it looks to the degree of control and use that a customer has over the commodity, inquiring whether the customer has secured "(i) 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) 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 . . . ." Second, it looks to the control or influence that an offeror, counterparty seller, affiliate, or other persons acting in concert maintain over the commodity, requiring that they "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." If both of these requirements are met, the CFTC's view is that actual delivery of the transaction has occurred.

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2 How the Final Guidance Differs from the 2017 Proposed Guidance

While the CFTC made few changes from the core text of the 2017 proposal, the Final Guidance included new footnotes and illustrative examples that demonstrate openness toward a wider variety of business models in the virtual currency space. For instance, the Final Guidance rejects the 2017 proposal's requirement that a customer obtain "a particular key or blockchain address" in order to possess or control the commodity. Additionally, the Final Guidance adds a footnote clarifying that the CFTC takes a broad view of the term "offeror" to include "any persons that present, solicit, or otherwise facilitate a retail commodity transaction" under the CEA. This implicates digital exchange firms that provide platforms that facilitate transactions in virtual currencies.

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3 CFTC Example: Actual Delivery Involving the Use of a Depository

The five illustrative examples included in the Final Guidance describe circumstances in which the CFTC would or would not take the view that actual delivery has occurred. One example would afford offerors, including digital exchange firms facilitating transactions, flexibility to deliver the virtual currency into a depository, so long as that depository is not owned, controlled, operated by, or affiliated with the counterparty. This would loosen restrictions in the 2017 proposal that would have sharply limited the occurrence of actual delivery when parties use virtual currency wallets or similar mechanisms. Still, a footnote to this example clarifies that, while an offeror acting as an intermediary "could act in concert with both the purchaser and counterparty seller," actual delivery will not occur if "the offeror, the offeror's execution venue, or any of its subsidiaries or affiliates, is also the counterparty" to the transaction. This could implicate virtual currency exchange firms that use in-house traders or proprietary trading algorithms to serve as counterparties.

4 CFTC Example: Actual Delivery Involving an Intermediary

Another example indicates that actual delivery will occur when: (i) a record is made on the public distributed ledger or blockchain address noting the transfer, (ii) the transfer of virtual currency occurs, and (iii) the purchaser maintains sole possession and control. This scenario contemplates the use of an execution venue or other third party as an intermediary. For actual delivery to occur, the applicable ledger or address must contain notations of each transaction in the chain, and the purchaser must maintain sole possession and control within 28 days of the transaction.

5 What the Final Guidance Could Mean for Cryptocurrency Exchanges

CFTC Chairman Heath Tarbert released a statement praising the final guidance. In his statement, he indicated that "[t]o prevent any potential market disruptions associated with efforts to assimilate this guidance, I anticipate 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 applicable law (emphasis added). Chairman Tarbert's statement may serve as an implicit warning to existing actors in the cryptocurrency trading space that enforcement could begin as soon as once the 90-day window has elapsed on June 22, 2020. Participants in this space should therefore move quickly to review the applicability of the Final Guidance to their business and make certain that their business models align with the requirements of the Final Guidance by June 22. The Futures and Derivatives team at Covington, with its experience and expertise in cryptocurrency markets and before the CFTC, is well-positioned to assist clients in assessing the applicability of the guidance of their business functions, as well as advising on organizational and business changes needed to ensure that cryptocurrency firms are in compliance with all applicable law.

For further information or details on this topic, please contact:

Anne Termine
Washington
+1 202 662 5827
atermine@cov.com

Uttara Dukkipati
Washington
+1 202 662 5274
udukkipati@cov.com

Grady Jung
San Francisco
+1 415 591 7032
gjung@cov.com

B. Graves Lee
Washington
+1 202 662 5722
blee@cov.com