Virtual Currency Transactions – Retail and Otherwise: Actualizing Actual Delivery

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An Overview of Today's Presentation

- **PART 1:** Digital Assets and the Commodity Exchange Act
- **PART 2:** The Regulation of Retail Commodity Transactions – History and Background
- **PART 3:** An Overview of the CFTC's Actual Delivery Guidance
- **PART 4:** The Significance of the Guidance for the Industry

Part 1:

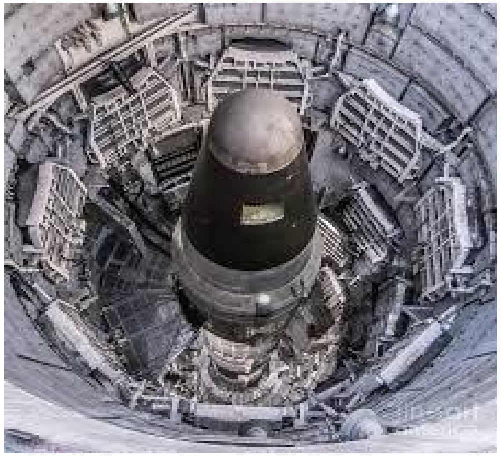
Digital Assets and the Commodity Exchange Act

What is a Digital Asset?

- An intangible asset generated on a decentralized network, known as a blockchain or distributed ledger
- Issued to a digital wallet address (i.e., an account) on that blockchain that may be controlled by a natural person or self-executing computer code (a "**smart contract**")
- The same blockchain can have many types of digital assets that
  - Operate in the same general way BUT
  - Differ in terms of how they are "offered" and the functions that they serve
- As a result, digital assets may be
  - "Securities" under the federal securities laws
  - Non-security "commodities" under the federal commodity laws
  - "Convertible virtual currencies" under federal money services business laws

What is a Digital Wallet ?

- An account on a blockchain that holds a particular digital asset
- Custodial vs. non-custodial wallets
  - Custodian maintains private key information associated with the wallet and controls the user's digital wallets (aka, hosted wallet)
  - User maintains their own private key information and controls their digital assets (aka, unhosted wallet)
- Multi-signature digital wallets
  - Requires multiple private keys to initiate a transaction, like control over nuclear weapons
  - All or a quorum of keyholders must agree to initiate a transaction
  - Effectively "breaks up" a private key into multiple private keys



Digital Assets Are Commodities (And Sometimes More)

- **<u>All</u>** digital assets are commodities under §1a(9) of the CEA
- CFTC's focus been on digital assets that are "virtual currencies"

A digital asset that encompasses any digital representation of value or unit of account that is or can be used as a form of 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

- **<u>Some</u>** digital assets are securities under federal securities laws
  - The SEC has exclusive jurisdiction over securities
  - Some "ERC20 tokens" issued in ICOs on Ethereum blockchain

Part 2:

The Regulation of Retail Commodity Transactions – Under §2(c)(2)(D) of the CEA History and Background

Understanding the CEA: §5 Findings and Purpose

Findings

- Transactions subject to CEA are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities

General Purpose

- To serve this public interest through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under CFTC oversight

Supporting Purposes

- Deter and prevent price manipulations or other disruptions to market integrity
- Ensure financial integrity of all transactions subject to CEA and avoid systemic risk
- Protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets
- Promote responsible innovation and fair competition among market participants

Why Did Congress Enact §2(c)(2) of the CEA?

- To address fraud in the retail markets for commodities by subjecting certain retail transactions to the same regulatory standards and requirements that apply to futures contracts
- Rolling Spot Transactions were especially problematic
  - Speculative in nature
  - Involve leverage, margin or financing
  - Delivery supposed to occur on date certain (2 days for FX)
  - Term extended without delivery of the underlying
  - Buyer pays fees for ongoing exposure to underlying
- §2(c)(2)(D) regulates retail transactions in commodities other than currencies
  - Added in 2010

Examples of Transactions That Are Not RCTs

Transaction #1

- Buyer pays BTC to seller of ETH; Seller transfers ownership of ETH to Buyer in exchange for BTC
- Transaction done at market rates
- Why?
  - The buyer owned the assets that constituted the consideration paid to the seller
  - Put differently, the buyer’s purchase of the ETH was not offered or entered into on a leveraged or margined basis, or financed by the seller, or a person acting in concert with the seller

Transaction #2

- Lender loans ETH to borrower; borrower has unrestricted use of ETH and has to return it to Lender upon maturity of loan

What is a Retail Commodity Transaction?

An **agreement, contract or transaction in any commodity** that is

(1) Entered into with, or offered to (even if not entered into with),
a person that is **not an eligible contract participant or eligible commercial entity**; and

(2) Entered into, or offered to (even if not 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.

(3) And not one of the **statutory exceptions**

What is the Significance of a Transaction Being an RCT?

An RCT is regulated like a futures contract:

- It must be conducted on or subject to the rules of a designated contract market ("**DCM**") or a foreign board of trade ("**FBOT**"); and
- It is subject to anti-fraud standards applicable to futures contracts

How does a Natural Person Qualify as an ECP?

- By having amounts invested on a discretionary basis, the aggregate of which exceeds $10,000,000
- By having amounts invested on a discretionary basis, the aggregate of which exceeds $5,000,000, and who enter into the agreement, contract or transaction to manage the risk with an asset owned or liability incurred, or reasonably likely to be owned or incurred,
- Amounts Invested on a Discretionary Basis is determined by reference to Rule 2a51-1 under the 1940 Act
  - Value of a real estate does not count if held for personal purposes or as a place of business, unless owned by a real estate developer
  - Value of interests in privately owned company with shareholders' equity of less than $50 million does not count

How does an Entity Qualify as an ECP?

- By having total assets exceeding $10,000,000
- By having its obligations under the transaction guaranteed by another entity that has $10,000,000 in total assets
- By (1) having a **net worth***** exceeding $1,000,000and (2) entering into the transaction in connection with the conduct of its business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by it in the conduct of its business

***In calculating its net worth, an entity can combine its net worth with the net worth of its owners if:

1) The entity is entering into the transaction to hedge or mitigate commercial risk; and
2) All of the entity's owners qualify as an ECP.

What is an Eligible Commercial Entity?

- Certain types of entities (other than collective investment vehicles) that qualify as ECPs and that:
  - Have a demonstrable ability, directly or through separate contractual arrangements, to make or take delivery of the underlying commodity;
  - Incurs risks, in addition to price risk, related to the commodity; or
  - Are dealers that regularly provide risk management or hedging services to, or engage in market-making activities with, the foregoing entities involving transactions to purchase or sell the commodity or derivative agreements, contracts, or transactions in the commodity.
- Certain types of collective investment vehicles (CIVs) and other that regularly enter into transactions to purchase or sell the commodity or derivative agreements contracts, or transactions in the commodity
  - Must be part of a very large commonly controlled group of CIVs (aggregate total assets of $1,000,000,000) or other entities (total assets of $100,000,000)

What Are the Statutory Exceptions?

- Agreement, contract or transaction in (A) foreign currency (including retail forex transactions), (B) government securities, (C) security warrants, (D) security rights, (E) resales of installment loan contracts, (F) repos in an excluded commodity (like fixed income securities), or (G) mortgages.
- Any security
- Any contract of sale that results in "actual delivery" within 28 days or such other longer period as the Commission may determine by rule or regulation based upon the typical commercial practice in cash or spot markets for the commodity involved
- Any contract of sale 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 the buyer
- Any security or agreement, contract or transaction that is listed on a national securities exchange registered under section 6(a) of the Securities Exchange Act of 1934
- An identified banking product

Part 3:

An Overview of the CFTC's Actual Delivery Guidance

The Actual Delivery Exception: A Brief Overview of Its Brief History

2010
Congress Enacts §2(c)(2)(D)

2013
CFTC Issues Final Guidance on Actual Delivery in Precious Metals Markets

2014
Eleventh Circuit's Ruling in *Hunter Wise Commodities LLC*

2015
CFTC Defines Virtual Currency
In Re Coinflip

2016
Certain virtual currency transactions were unlawful RCTs
In re Bitfinex

2017
CFTC Proposes Guidance on Digital Assets in Context of RCTs

2020 Interpretive Guidance: Principle #1 – Functional Approach

- The CFTC will employ a **<u>functional approach</u>**
  - Examine how an agreement, contract or transaction is marketed, managed and performed
  - CFTC will not relay solely on language used by the parties in the agreement, contract or transaction
  - Scrutiny will be placed on an arrangement under which the party offering a digital asset transaction to another person takes the opposite side of a transaction

2020 Interpretive Guidance: Principle #2 – Assess Relevant Factors

The CFTC will continue to assess **all relevant factors** that inform an actual delivery determination

- Focus will be on meaningful possession and control of the commodity
- Ownership, possession, title, and physical location of the commodity purchased or sold, both before and after execution of the agreement contract or transaction
- Nature of relationship between the buyer, seller, and possessor of the commodity
- Manner in which purchase and sale is recorded and completed may also be relevant
- Whether offeror or seller retains any ability to access or withdraw any quantity of the commodity purchased from buyer’s account or walled

2020 Interpretation: Actual Delivery Occurs When

OFFEROR AND SELLER…

- And any party acting in concert with the offeror and seller, does 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

CUSTOMER (BUYER) SECURES…

- Possession and control of entire quantity of virtual currency
- Ability to use the entire quantity freely in commerce – away from any particular execution venue – within 28 days of the date of the transaction and at all times thereafter

Who are the (potential) parties to a RCT?

BUYER

- The counterparty that is using leverage, margin or other financing to purchase virtual currency from the seller

OFFEROR AND SELLER COUNTERPARTY

- Offeror makes the retail commodity transaction available to the purchaser
- Seller is the party that transfers ownership of the virtual currency to the purchaser
- ***Any person acting in concert with the offeror or seller counterparty***

Who is an “Offeror” and a “Seller” ?

An offeror may include…

- Those with operational control of a particular blockchain protocol
- An execution venue that makes the virtual currency available for purchase by a retail customer
- A venue that provides a purchaser with the ability to source financing or leverage from other users or third parties

A seller is…

- Not necessarily the offeror
- Although, it could be the same party
  - An execution platform itself takes the opposite side of a virtual currency transaction or if the purchaser of the virtual currency enjoyed privity of contract solely with the platform rather than the seller

2020 Interpretive Guidance: Example #1 – Actual Delivery ✓

Actual delivery will have occurred if, within 28 days after entering the Transaction, **there is a record on the relevant public distributed ledger or blockchain address** of the transfer of the entire quantity of purchased (includes any portion of the purchase made using leverage, margin, or other financing)

- Transfer from the seller's blockchain address to the purchaser's blockchain address
- If an execution venue or third-party offeror acts as an intermediary, then the VC's public distributed ledger must show two transfers

SELLER → INTERMEDIARY → BUYER

- Buyer must have **sole possession and control of blockchain address** to which VC is ultimately transferred

2020 Interpretive Guidance: Example #2 – Actual Delivery ✓

Actual delivery will have occurred if, within 28 days after entering the Transaction, if within 28 days after entering the Transaction, the following **three conditions are met**:

- Transfer from the seller or offeror to **a depository** (e.g., wallet) that (a) is not under common control with the seller or any party acting in concert with the seller and (b) has entered into an agreement with the buyer to hold VC as agent of buyer ***only***
  - Depository cannot be licensed outside of U.S.
- Buyer has secured **full control** over the VC
- With respect to the VC being delivered, **no liens** relating to the use of margin, leverage, or financing use to obtain the entire quantity of VC **will continue after the 28-day period** has elapsed

2020 Interpretive Guidance: Example #3 – Actual Delivery X

Actual delivery will **NOT** have occurred if, within 28 days after entering the Transaction, if within 28 days after entering the Transaction the full amount of the purchased VC 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)
- Received by a **separate, independent, appropriately licensed, depository or blockchain address** in which the customer maintains possession and control in accordance with Example 2
  - Depository cannot be licensed outside of U.S.

2020 Interpretive Guidance: Example #4 – Actual Delivery X

Actual delivery will **NOT** have occurred if, within 28 days after entering the Transaction, if within 28 days after entering the 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 (Record on Public Distributed Ledger or Blockchain) or Example 2 (Record at Depository), actually delivered the entire quantity of the VC purchased

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2020 Interpretive Guidance: Example #5 – Actual Delivery X

- Actual delivery will **NOT** have occurred if, within 28 days after entering the Transaction, if within 28 days after entering the Transaction, the transaction for the purchase or sale of VC is
  - **Rolled, offset against, netted out, or settled in cash** or VC (other than the purchased VC) between the customer and the offeror or counterparty seller (or persons acting in concert with the offeror or counterparty seller)
- The CFTC used Example 5 to draw a distinction between physical settlement and cash settlement.

Part 4:

The Significance of the Guidance for the Industry

The CFTC's DAO Report Equivalent?

- The SEC put ICO issuers on notice when it issued the "DAO Report"
- The Interpretation marks a significant reference point and potential line in the sand in the development of a timeline for elevated enforcement risks
  - Chairman Tarbert announced an enforcement forbearance period that ended late September 2020
- Recent enforcement activities to be discussed later

Regulatory and Enforcement

- Leverage, margin, and financing are important
- Distinctions between swaps and retail commodity transactions are not
  - Not mutually exclusive
  - So, the same transaction can be both a swap and a RCT
- What goes on in the U.S. stays in the U.S.
  - If it happens here, then the CFTC has an interest in it
  - Even if products are sold exclusively offshore
  - Largely an area of development
- If you offer it, they (CFTC's Division of Enforcement) will come

The 2020 Actual Delivery Interpretation

- Narrowly drafted exclusion
    - Not a path to offering a suite of margined products to retail customers

- What can be offered
    - 10% down if payment of the 90% balance occurs within 28 days (or default is triggered)
    - And, if payment is made, buyer actually gets unrestricted rights to VC

What May This Mean for the Development of Leveraged Digital Asset Transactions

- An exchange may offer a leveraged purchased
  - Affiliated depository not entirely off-limits if it is
  - A financial institution
  - A separate line of business from the offeror
  - Predominantly operated as a VC custodian
  - Appropriately licensed (not offshore)
  - Offer the ability for customer to utilize and engage in cold storage
  - Contractually authorized by customer to act as agent