

## **Part 2: CFTC Finalizes Guidance on Digital Assets in the Context of Retail Commodity Transactions**

### The Regulation of Retail Commodity Transactions—History and Background

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), the issuance of which represents a significant milestone in the regulation of virtual currency and other digital asset transactions. In Part 2 of our update series, we explore the history and background of the regulation of retail commodity transactions (RCTs) and virtual currencies, with the goal of providing an analytical context for the Guidance.

The regulation of RCTs has been relevant to transactions involving virtual currency from the most embryonic stages of what can be described—even at the present time—as a nascent and emerging area of law. For practitioners steeped in derivatives regulatory matters, the "nearly instantaneous" coupling of the regulation of RCTs and virtual currencies was, at best, amusing and, at worst, vexing, since the "law" was almost as new as the digital asset technologies to which it was being applied.

### **The Regulation of RCTs Generally**

The Commission has exclusive jurisdiction over the marketplace for "retail commodity transactions," arrangements that Section 2(c)(2)(D) of the Commodity Exchange Act (the CEA) describes as an agreement, contract, or transaction that is offered or entered into by a party:

- 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
- To or with persons who do not qualify as either an eligible contract participant (ECP) or an eligible commercial entity (ECE)

The definitions of ECP and ECE are found in Section 1a(18) and 1a(17) of the CEA, respectively. In short, an ECP must be a type of regulated entity (such as a financial institution), or satisfy certain financial qualification tests, while an ECE is a sub-set of ECPs that use a commodity for the commercial purposes specified in the CEA. An ECP can be either an entity or a natural person.

Section 2(c)(2)(D) was added to the CEA in 2010. Although technically part of the Dodd-Frank Act, the regulation of retail commodity transactions is a chapter of regulatory history that pre-dates the systemic risk concerns that underpinned many of the other more well-known regulatory initiatives that followed on the heels of the 2008 financial market crises, and subsequent standards for the derivatives markets adopted at the 2009 G-20 Pittsburgh Summit.

In particular, Section 2(c)(2) of the CEA was amended in order to:

1. Address perceived, and in some cases actual, fraud in the retail currency and commodity markets
2. More generally, bring a heightened level of regulatory oversight to those markets

In short, Congress revised the CEA in direct response to certain judicial decisions (the most notable of which was *CFTC v. Zelener*)[1] that hampered the ability of the Commission to oversee these retail markets.

### **Leverage, Margin, and Financing and the Relationship With RCT Regulation**

The regulatory principle behind the CFTC's oversight of retail commodity transactions is that such arrangements are speculative in nature and have indicia of futures contracts by virtue of the use of leverage, margining, or financing.[2] When viewed through that lens, it makes sense that the Proposed Guidance was issued in December 2017, literally only days after the commencement of trading in bitcoin futures contracts in November 2017.[3]

If an arrangement constitutes a retail commodity transaction, then it is subject to the same regulatory standards and requirements as a futures contract (which in the language of the CEA is called a "contract of sale of a commodity for future delivery"). In effect, a retail commodity transaction must be entered into over a CFTC-regulated futures exchange (which in the language of the CEA is called a "designated contract market"). At the present time, no futures exchange lists any retail commodity contracts nor, to our knowledge, has any futures exchange indicated its intentions (at least publicly) to facilitate leveraged commodity trading on a retail basis. They do, obviously, list futures contracts, which are economically leveraged transactions made available to retail traders who access the contracts through a regulated intermediary (i.e., a futures commission merchant). The well-established regulation of futures contracts and market participants distinguishes these contracts from this more recently added concept of retail commodity transactions.

Significantly, not every arrangement that involves the leveraged, margined, or financed purchase or sale of a commodity will be regulated as a retail commodity transaction. In particular, Section 2(c)(2)(D)(ii)(III) of the CEA excepts two types of transactions:

1. A contract of sale that results in actual delivery within 28 days
2. A 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

The Guidance focuses on the first of these two exceptions, but it is not the first time that the CFTC has issued an interpretation in respect of the "actual delivery" exception.

### **A Brief Overview of the Brief History of the "Actual Delivery" Exception and the Regulation of Virtual Currencies Under the CEA**

In 2013, the Commission issued final guidance regarding the interpretation of the term "actual delivery" for purposes of Section 2(c)(2)(D) of the CEA in the context of certain physical commodity transactions (the 2013 Guidance).[4] In 2014, the U.S. Court of Appeals for the Eleventh Circuit issued an opinion in a case involving Hunter Wise Commodities LLC (Hunter Wise) stating that actual delivery, in the context of a retail commodity transaction, "denotes '[t]he act of giving real and immediate possession to the buyer or the buyer's agent;" and

constructive delivery does not suffice.[5] Additionally, in 2019, the U.S. Court of Appeals for the Ninth Circuit indicated that the actual delivery exception to RCT regulation requires "some meaningful degree of possession or control by the Customer".[6] The Commission cited to each of these cases in the Guidance.

The ink barely dried on the 2013 Guidance and the Eleventh Circuit's opinion involving Hunter Wise when transactions involving bitcoin and virtual currencies rapidly took center stage. In September 2015, the Commission determined that a virtual currency is a commodity as that term is defined by Section 1a(9) of the CEA and, in so doing, defined a "virtual currency" to mean "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction." [7] Then, less than a year later in May 2016, the Commission brought its first enforcement action against a platform that offered virtual currency transactions to retail customers on a leveraged, margined, or financed basis without registering with the Commission.[8] At the heart of the 2016 enforcement action was the notion that the platform transactions were RCTs since they did not involve the actual delivery of bitcoin from a seller to a buyer.

Experienced derivatives practitioners labored to fit the square peg of virtual currency transactions into the round hole of the 2013 Guidance. But, it was evident from almost the start, that the (new) 2013 Guidance was not suitable for the (newer) digital asset transactions. So, in December 2017, the Commission issued the Proposed Guidance related to the application of the actual delivery exception that became the Guidance that will be further explored in the third and final part of this multi-part update series.

Read the entire series covering the regulation of retail commodity transactions and the CFTC's final interpretive guidance:

[Part 1: Commentary on the Significance of the Guidance for the Industry](#)

[Part 3: CFTC Finalizes Guidance on Digital Assets in the Context of Retail Commodity Transactions](#)

## **Endnotes**

[1] *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004). *See also CFTC v. Erskine*, 512 F.3d 309 (6th Cir. 2008).

[2] For additional context, consider the following statement from Commission Chairman Tarbert's support of the Guidance:

*Since the creation of the CFTC, the agency has had exclusive jurisdiction over commodity futures. Simply put, a futures contract is a standardized agreement that allows the long (short) side to buy (sell) a given commodity at a specified price at a later date. Under the CEA, these contracts must be traded on organized exchanges that the CFTC regulates. Some percentage of the contract value is deposited as margin with the exchange's clearinghouse during the duration of the futures contract.*

*Futures contracts are different from bills of sale, which represent a transaction consummated in the present, as opposed to a later date. (We call these cash or "spot" transactions.) They are also different from forward contracts, which are less standardized, i.e., more bespoke to the parties to the agreement, and nearly always contemplate delivery of the relevant commodity.*

*But let us suppose that someone decides to purchase a given commodity with some money down, with both delivery and final payment to be made at some future date. Suppose also that the individual could decide to trade out of the position at any time to lock in whatever gains or losses he or she has incurred. Then guess what? That starts to look an awful lot like a futures contract—with identical economics yet without any regulation.*

*The CFTC necessarily began to treat these arrangements as futures contracts. But some courts disagreed, holding these schemes were wholly outside the CEA. So Congress took action. While making clear that look-alike products would be regulated as futures contracts, Congress also prescribed a number of exceptions to ensure that section 2(c)(2)(D) would cover only those transactions that closely resemble futures and other CFTC-regulated derivatives, and not ordinary financed commercial sales.*

*One key exception carves out transactions that "result[ ] in actual delivery within 28 days." The guidance we are issuing today interprets this "actual delivery" exception as it applies to any digital asset that is a "commodity" under the CEA—such as Bitcoin and Ether, for example—and is used as a medium of exchange (so-called "virtual currencies").*

Statement of Chairman Heath P. Tarbert in Support of Interpretive Guidance on Actual Delivery for Digital Assets, accessed on April 28, 2020, at

<https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a> (footnotes omitted).

[3] Consistent with the CFTC's ordinary rulemaking process, the Commission sought public comment after publishing the Proposed Guidance. Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60,335, proposed Dec. 15, 2017 (available at:

<https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2017-27421a.pdf>).

Public comments submitted in respect of the Proposed Guidance are available at:

<https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2851>.

[4] Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed Reg 52, 426 (Aug. 23, 2013).

[5] Guidance at p.5, citing in footnote 26 to *CFTC v. Hunter Wise Commodities, LLC, et. al.*, 749 F. ed 967 (11th Cir. 2014).

[6] *Id.*, citing in footnote 31 to *CFTC v. Monex Credit Company, et. al.*, 931 F. 3d 966, 972-975 (9th Cir. 2019).

[7] In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Dkt. No. 15-29 at n.2 (Sept. 17, 2015).

[8] In the Matter of BFXNA Inc. d/b/a Bitfinex, CFTC Dkt. No 16-19 (June 2, 2016). The CFTC's position that virtual currencies are commodities under the CEA has been affirmed in at least two federal district court cases to date. See *CFTC v. My Big Coin Pay, Inc.*, No. CV 18-10077-RWZ, 2018 WL 4621727 (D. Mass. Sept. 26, 2018), and *CFTC v. McDonnell*, 287 F. Supp. 3d 213 (E.D.N.Y.).

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