CLIENT ALERT

Cryptocurrency in Small Bytes: What's in, What's Out, and What's a Spot? Understanding CFTC Jurisdiction

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The Commodity Futures Trading Commission (CFTC) is one of the regulators that has affirmed that cryptocurrencies constitute commodities, and thus to some extent all transactions in cryptocurrencies fall under its jurisdiction. However, there are important gaps in the CFTC's jurisdiction over cryptocurrency transactions – namely, that "spot" transactions, as opposed to "transactions for future delivery," are only subject to very limited regulation. This makes sense in the context of most commodity transactions – for example, a farmer selling corn for next month's delivery shouldn't need to make his/her sale on a regulated exchange. However, purchasers of cryptocurrencies are very often buying for speculative or investment purposes, and the lack of jurisdiction over spot transactions prevents the CFTC from requiring that most cryptocurrency trades be done on a regulated platform.

Proposed CFTC Guidance for Retail Transactions

The Commodity Exchange Act (CEA) and the regulations issued thereunder do not specifically define "contract for future delivery." The interpretation of this term is critical, because the CFTC's jurisdiction is generally limited to "contracts for future delivery," and transactions not involving a "contract for future delivery," such as spots or forwards, are generally subject to the CFTC's jurisdiction only to a limited extent. Although determination of whether a particular transaction involves a "contract for future delivery" typically involves a facts-and-circumstances determination, the parties to the transaction, as well as their intent to make or take delivery and their capacity to do so are usually key facts in this determination. In an effort to provide greater clarity around what constitutes a "contract for future delivery" as opposed to a spot or forward transaction in the context of a cryptocurrency transaction, the CFTC recently released proposed guidance on what constitutes "actual delivery" of cryptocurrency.

The proposed guidance was issued in the context of "retail commodity transactions." Simply put, a "retail commodity transaction" is a leveraged, margined or financed contract in which the purchaser of the commodity is not an "eligible contract participant" (ECP) (generally, a sophisticated and wealthy investor able to bear significant losses from commodity contracts). Retail commodity transactions are treated just like futures transactions and must be traded on and cleared through a CFTC- or foreign equivalent registered exchanges and clearing organizations – unless the transaction results in "actual delivery" of the commodity within 28 days.

While the CFTC emphasized that the test for whether "actual delivery" has occurred would remain facts-and-circumstances based, the CFTC will look to whether, after 28 days, the customer is able to take possession or control of the entire quantity of the cryptocurrency purchased, regardless of whether the purchase was leveraged or financed, and use it freely in commerce away from any particular platform, without the seller or platform retaining any security interest in that cryptocurrency. A book-out or cash settlement, or a situation where the cryptocurrency is retained in an omnibus wallet where the platform operator retains the private keys, will not constitute "good delivery" for this purpose. The CFTC did recognize that trading platforms may have relationships with cryptocurrency depositories, and that a platform may have a relationship with such a depository for its customers, but the platform (and any financing provider) may not retain an interest in the cryptocurrency deposited therein.

The CFTC has exercised its jurisdiction over a cryptocurrency trading platform offering margin trading at least once. In 2016, Bitfinex had offered platform participants, including non-ECPs, the opportunity to engage in financed cryptocurrency transactions, and did not actually "deliver" those cryptocurrencies within 28 days. Here the CFTC alleged, and Bitfinex agreed, that "delivery" was not accomplished because Bitfinex continued to hold the cryptocurrencies purchased by its customers in an omnibus wallet to which it held the private keys until the customers paid off their financing arrangements. Bitfinex settled with the CFTC and agreed to pay a monetary penalty.

Broader Implications of the Guidance

Although the proposed guidance was only issued in the context of leveraged or financed transactions, its implications are far broader. The CFTC might, for example, take the position that any trading platform that does not satisfy the "good delivery" standard (for example, a platform that holds all customer cryptocurrency in an omnibus wallet and limits withdrawals) would be required to register as a futures exchange.

At least for now, the CFTC appears to have taken the position that exchanges offering non-leveraged products are free to determine their method of delivering cryptocurrency, and that it will not seek to regulate those platforms as futures exchanges. Instead, a number of CFTC commissioners have called on cryptocurrency business participants to create a self-regulatory organization, and the Chairmen of both the CFTC and the SEC have testified before Congress regarding a potential new regulatory framework. However, if cryptocurrency markets do not begin to self-police and new legislation is stalled, it is possible that the CFTC will revisit this view.

What should market participants do next?

The CFTC's proposed standard for "good delivery" is open for comments until March 20. Market participants should consider commenting on the proposed standards, as well as inquiring whether such standards will be used by the agency for other purposes, including for determining when a transaction is considered a less-regulated "spot."

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