



Christopher Kirkpatrick, Secretary
U.S. Commodity Futures Trading Commission
3 Lafayette Square
1155 21st Street NW
Washington, DC 20581

**Re: Proposed Guidance on Retail Commodity Transactions Involving Virtual Currency,
RIN 3038-AE62**

Dear Mr. Kirkpatrick:

Thank you for the opportunity to comment on the U.S. Commodity Futures Trading Commission's (Commission's) proposed guidance on actual delivery of virtual currencies under Section 2(c)(2)(D) of the Commodity Exchange Act. Coinbase supports and applauds the Commission's efforts to promote strong customer protections and market integrity in the markets for digital assets such as bitcoin.

I. Executive Summary

As a leader in the digital asset market,¹ Coinbase wants that marketplace to be open, fair, and governed by smart regulation, which is essential to the wider adoption of digital assets. Although Coinbase does not offer any leveraged or margin trading, we welcome the Commission's examination of the application of Section 2(c)(2)(D) to digital assets, which have different characteristics and pose different challenges than other types of commodities.

Coinbase's comment letter will focus on three points.

First, Coinbase is concerned that two of the examples in the proposed guidance would unintentionally raise the threat of cybertheft while undermining anti-money laundering (AML) and economic sanctions programs enforced by exchanges acting under a variety of Federal and state regulations. Coinbase recommends replacing examples #2 and #3 with a different example of what constitutes actual delivery of digital assets that focuses on the usability of the digital assets by the purchaser.

Second, Coinbase is concerned that the proposed guidance distracts the Commission from established and clear prohibitions on margined transactions that function like futures contracts. Where the law is clear, regulatory forbearance on entities offering illegal products only punishes compliant entities.

¹ The proposed guidance is focused on virtual currencies, which the Commission has noted includes Bitcoin, Ether, and Litecoin. See LabCFTC, "A CFTC Primer on Virtual Currencies," Oct. 17, 2017 (LabCFTC Primer). Digital assets is a broader category that includes virtual currencies, security tokens, and utility tokens. Both the CFTC and SEC have stated that certain of these digital assets may fall under their respective jurisdictions. For purposes of this comment letter, Coinbase will refer to the broader set of digital assets because Section 2(c)(2)(D) may apply to any digital asset considered to be a commodity.

Third, while not directly addressed in the proposed guidance, Coinbase requests that the Commission and the U.S. Securities and Exchange Commission (SEC) offer clear guidance to the digital assets marketplace on what tokens would fall under the jurisdictions of the respective agencies. The lack of guidance has a chilling effect on compliant players in the market and threatens the success of this new technology.

II. Background on Digital Asset Exchanges

Digital assets are in many ways different from other types of commodities. Digital assets, including virtual currencies, are a nascent financial innovation with the potential to revolutionize payments by allowing the trustless transfer of assets for the purchase of goods and services. Virtual currencies can also act as a store of value not subject to devaluation from central bank monetary policy. At present, the primary way for a user to access virtual currencies and other digital assets – whether they be retail investors, online merchants accepting Bitcoin, or financial institutions speculating on the price movements in the currencies – is through a spot exchange. Spot exchanges such as Coinbase allow for the conversion of fiat currency into digital assets (e.g., USD to BTC) or the conversion of one digital asset into another digital asset (e.g., BTC to ETH).

Digital assets are held in wallets, which can either be held by the owner or hosted by a third party such as an exchange. The ability to transfer digital assets from one wallet to another is dependent on access to a private key; for wallet operators such as Coinbase, storage of those private keys can include placing the keys in “cold storage”, meaning a storage method not connected to the internet and therefore not subject to hacking.

A. Regulation of Digital Asset Exchanges

Digital asset exchanges are subject to a variety of state and Federal regulation. As a money services businesses (MSBs), exchanges are subject to anti-money laundering (AML) regulations under the Bank Secrecy Act (BSA).² Additionally, spot exchanges are money transmittal services under a variety of state money transmitter regulations. Coinbase is also one of only four entities to hold a bitlicense from the New York Department of Financial Services, the only license in the United States specifically dealing with digital assets. Finally, any U.S. entity is subject to economic sanctions regulations promulgated by the Department of Treasury’s Office of Foreign Asset Control (OFAC), covering transactions with states such as Iran and North Korea, as well as transactions involving drug smugglers and war criminals.

While spot exchanges themselves are not subject to CFTC registration requirements, trading on spot exchanges³ is subject to the Commission’s anti-fraud and anti-manipulation

² See Department of the Treasury Financial Crime Enforcement Network (FinCEN), “Application of FinCEN’s Regulation to Persons Administering, Exchanging, or Using Virtual Currencies,” March 18, 2013, available at <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

³ See Testimony of Chairman Giancarlo to Senate Banking Committee, Feb. 6, 2018, available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo37>.

authority.⁴ The Commission has already asserted jurisdiction over the virtual currencies Bitcoin⁵ and Litecoin⁶ as commodities, and applied Section 2(c)(2)(D) to Bitcoin and Litecoin leveraged trading.⁷ The Commission has also referred to other products as virtual currencies, including Ether.⁸

B. Coinbase's Spot Exchange

Coinbase provides three core services relevant to the proposed guidance: (a) hosted digital wallet services, where Coinbase securely stores virtual currencies in a combination of hot wallet and cold storage; (b) conversion services, where Coinbase sells virtual currencies to and purchases them from customers for fiat currencies; and (c) the GDAX exchange platform, which offers a continuous central limit order book for buying and selling virtual currencies.

Coinbase's hosted digital wallet service allows customers to store their digital assets in a secure environment using a combination hot wallet and cold storage. Coinbase holds between 98 and 99 percent of all digital assets in cold storage. This allows customers to avoid the risk of their personal wallets being hacked or the loss of their personal private keys.

The conversion services and GDAX exchange platform are provided on a fully collateralized basis. For GDAX, market participants can only place buy or sell orders up to the amount of fiat or virtual currency balances in their hosted wallets. GDAX does not offer margin or leveraged trading. For conversion services, full collateralization means that Coinbase either (a) must receive the full fiat currency value of a transaction before selling a virtual currency or (b) deliver the full purchased amount but place restrictions on its transfer or use pending clearing of the payment. Neither of the spot transaction methods discussed constitute financing of a purchase as they both require full payment at the time of execution.

For technological and practical reasons, Coinbase uses an internal ledger to show changes in ownership in the majority of conversion services and GDAX transactions. Coinbase's daily transaction count exceeds the capacity of the Bitcoin blockchain, meaning it would be impossible for all of Coinbase's spot transactions to be put on the public ledger without overwhelming the blockchain. The use of an internal ledger also avoids miner's fees and allows for immediate settlement of transactions, as opposed to public ledger settlement which requires a certain number of blocks to be validated before a transaction is considered settled.

To allow cold storage of the vast majority of digital assets, Coinbase places daily withdrawal limits on its customers' hosted digital currency wallets. It may take several hours to pull digital assets out of cold storage into the hot wallet for transfer. Requiring all assets to be available for immediate transfer would mean that all assets would be held in a hot wallet

⁴ The SEC's Division of Enforcement and Division of Trading and Markets have publicly stated that digital assets which are securities must be traded on national securities exchanges or licensed alternative trading systems. As noted in the introduction, there is a lack of clarity in the marketplace about the dividing line between CFTC jurisdictional and SEC jurisdictional products. Given that CFTC jurisdictional commodities can be traded on unregistered spot exchanges such as Coinbase, while securities products must be traded on registered stock exchanges or ATSSs, the distinction has a fundamental impact on the market.

⁵ See *In the Matter of Coinflip, Inc. d/b/a Derivabit*, CFTC Docket No. 15-29 (Sept. 17, 2015).

⁶ See *In the Matter of BFXNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016).

⁷ See Bitfinex settlement.

⁸ See LabCFTC Primer, at 5.

(meaning a wallet where the private keys are held on computers connected to the internet) and therefore be at a significantly greater risk of cybertheft.

III. Proposed Guidance's Examples of Actual Delivery

The Commission has correctly focused on the ability of the purchaser to use the purchased virtual currency when determining whether actual delivery has occurred. However, when giving examples of what does and does not constitute actual delivery, the Commission offers two examples that are apparent and require no additional guidance, and two examples that threaten to undermine regulatory objectives and customer protections.

Examples #1 and #4 are obvious without the Commission's proposed guidance. Example #1 involves the transfer of the full amount of purchased virtual currency to the purchaser's wallet while the offeror or counterparty seller maintains no interest in the virtual currency. This clearly constitutes actual delivery.

Example #4 involves a transaction for virtual currency where the transaction is rolled, offset against, netted out, or settled in cash or a different virtual currency. Existing Commission guidance and enforcement precedent establishes that this would not be actual delivery -- even if the purchaser had the option of offsetting or netting a position but did not.

Examples #2 and #3, however, include conditions that undermine regulatory objectives and customer protections. Example #2 requires four conditions for actual delivery:

1. Delivery of the full amount of purchased virtual currency to a depository unaffiliated with the seller that is acting as an agent for the purchaser;
2. Transfer of title to the virtual currency to the purchaser;
3. The purchaser has secured full control (i.e. the ability to immediately remove the full amount of the purchased commodity from the depository); and
4. There are no liens or other interests of the counterparty seller on the virtual currency resulting from the offering of margin.

Separately, example #3 states that there is no delivery if the transaction is recorded as a book entry by the counterparty seller, absent meeting the conditions of example #2. This implies that an entry on the public ledger or blockchain is necessary to effect delivery.

The condition in example #2 requiring the wallet holder to have unfettered access to digital assets in those wallets undermines AML and economic sanctions controls, while also unnecessarily exposing digital assets to cybertheft. At the same time, the requirement that the leverage provider be unaffiliated with the wallet operator conflicts with existing Commission guidance in the precious metals delivery context. Finally, the statement in example #3 that an internal ledger entry would not evidence delivery conflicts with how other financial assets are treated, and fails to recognize limitations on the capacity of the public ledger. While distributed ledger technology underpinning digital assets offers a solution to the double-spending problem, the blockchain has capacity limitations.

A. Wallet Operation and "Control" Over Digital Assets

The proposed guidance states that “[t]he offeror and counterparty seller, including their agents, must retain no interest or control whatsoever in the virtual currency acquired by the purchaser at the expiration of 28 days from the date of entering into the transaction.”⁹ However, a wallet operator’s obligations under AML and economic sanctions regulations result in some limitations on a wallet holder’s ability to transfer assets held in wallets operated by MSBs. For instance, if a hosted wallet holder attempts to transfer digital assets to a wallet known to be tied to North Korea, U.S. regulations would require the wallet operator to block that transaction.

Separately, the unfettered ability of a wallet holder to transfer digital assets out of a hosted wallet would require the wallet operator to maintain all digital assets in a “hot wallet” to be able to satisfy any demands at any point in time. This would be the equivalent of requiring banks to hold all of their currency at the teller’s window instead of a bank vault. Doing so would place all customer digital assets at constant risk of cybertheft and prohibit the most effective methods of safeguarding those assets.¹⁰

Requiring unfettered ability to transfer digital assets would effectively mean that U.S. entities and regulated entities, or entities using cold storage or other asset protection methods, could not hold digital assets acquired through margined transactions. This result would simply drive margin lending offshore or into unregulated entities, where the CFTC and other Federal agencies would have no way to provide effective oversight or customer protection.

B. Relationship Between Leverage Provider and Wallet Provider

The proposed requirement that the leverage provider and wallet provider be unaffiliated conflicts with the Commission’s 2013 guidance on actual delivery for precious metals.¹¹ In the 2013 guidance, the Commission stated that delivery could be met where the commodity was transferred to a financial institution, depository for a DCM, or regulated storage facility, regardless of whether that depository is affiliated with the offeror or counterparty seller.¹² The Commission noted the regulated nature of the entities accepting delivery as a reason for the amendment.

Rather than focusing on the relationship between the financing provider and wallet provider, the Commission should adopt guidance consistent with the 2013 guidance, which will encourage digital assets to be held at regulated entities. Such regulated entities could include qualified custodians designated by the SEC, MSBs registered with FinCEN, CFTC registrants, or depositories recognized for delivery purposes for digital assets by a DCM.

C. Use of Internal Ledgers to Record Virtual Currency Transactions

⁹ Proposed Guidance on Actual Delivery, at 60339 (emphasis added).

¹⁰ Requiring unfettered access to move digital assets out of a wallet could also inhibit an exchange’s ability to monitor for fraud or perform market surveillance functions. In both cases, a platform may need to freeze assets it believes to be associated with activity violating the rules of the exchange. Additionally, wallet operators may be required by court order to freeze assets as part of criminal or civil investigations and prosecutions.

¹¹ CFTC Interpretation, “Retail Commodity Transactions Under Commodity Exchange Act,” 78 F.R. 52426, 52427 (Aug. 23, 2013).

¹² Notably, the Commission’s proposed guidance in 2013 would have prohibited an affiliation between financing provider and depository, but this prohibition was removed in the final guidance.

Example #3 in the proposed guidance states that a book entry showing a transaction does not qualify as actual delivery unless the conditions of example #2 are met. However, internal ledgers are a necessary and legitimate method of tracking ownership for digital assets. Requiring public ledger updates for all spot market and other transactions in digital assets would swamp the blockchain's capacity. Transactions on Coinbase alone would exceed the capacity of the Bitcoin public ledger. Moreover, public ledger updates incur mining fees, making internal ledgers a more economical method for customers.

Internal ledgers at financial institution are the bedrock for tracking ownership in virtually every financial product, including futures contracts tracked at DCOs and securities tracked at broker-dealers and central securities depositories. Internal ledgers of digital asset exchanges can offer the same proof of ownership, particularly where those ledger may be subject to inspection by a self-regulatory organization or an independent auditor.

D. Preventing Unintended Consequences on Spot and Other Transactions

Coinbase requests clarification from the Commission that the proposed guidance on "actual delivery" of retail leveraged transactions would have no application to spot transactions, such as Coinbase's conversion service or GDAX platform, or to forwards, swaps or other transactions involving digital assets. Based on the unique characteristics of digital assets -- including the wallet structure, limitations on public ledger capacity, and AML and sanctions policies at spot exchanges -- there are a wide array of transaction types that would not meet the conditions set out in the proposed guidance's examples.¹³ A clarification that the "actual delivery" guidance does not apply outside of the context of retail leveraged or margined transactions would provide legal certainty for forwards, swaps, and other types of transactions.¹⁴

¹³ For example, a hypothetical forward contract for 100 Bitcoin results in the delivery of that Bitcoin into a purchaser's hosted wallet at an exchange, which is recorded in the exchange's internal ledger. Sale or transfer of that 100 Bitcoin may be subject to withdrawal delays because digital assets are held in cold storage, or restricted by the exchange's AML or sanctions compliance programs. Under examples #2 and #3, the 100 Bitcoin may never have been "delivered" to the purchaser, potentially making the entire transaction a non-deliverable forward. An unregulated forward contract might now be treated as a swap, as a result of cybersecurity, AML, and sanctions policies that are intended to protect customer funds and detect criminal activity.

¹⁴ It does not appear that the Commission's intention in issuing the guidance was to regulate spot exchanges. Chairman Giancarlo testified before Congress that the Commission does not have regulatory jurisdiction over the spot market in commodities such as virtual currencies. To the extent that the proposed guidance would result in a spot transaction being treated as a futures product, that guidance would conflict with Chairman Giancarlo's public statements that the CFTC does not regulate the spot markets.

Further, where the guidance has unintended consequences affecting spot markets, it risks being regulation outside of the normal Administrative Procedures Act (APA) process. The guidance does not include a full cost-benefit analysis under Section 15(a) of the Commodity Exchange Act, Regulatory Flexibility Act analysis, or Paperwork Reduction Act analysis. As a result, such guidance may be unenforceable. Moreover, the virtual currency market in the United States is significant, with Coinbase alone facilitating over \$100 billion in transactions. As a result, any regulation that would materially impact the operation of the spot markets could constitute a "major rule" under the Congressional Review Act. Enacting such regulation through guidance would circumvent potential Congressional oversight over the rulemaking process.

IV. Recommended Example and Focus on Usability of Virtual Currency (Questions 2, 3, 5, and 6)

Coinbase supports the Commission's focus on the ability to transfer or use the virtual currency as the hallmark of actual delivery. We believe that actual delivery should be deemed to occur once the customer is able to use the virtual currency to either trade on an exchange platform or transfer it off-platform to purchase goods or service. However, this ability to transfer, trade or use funds cannot be absolute given the policy and cybersecurity reasons discussed above.

Further, actual delivery must be divorced from the relationship between a financing provider and a wallet provider. In other contexts, Commission staff has explicitly stated that a financing provider and depository can be affiliated entities. To change that guidance as it applies to digital assets would drive activity into unregulated or offshore entities, hampering the Commission's ability to protect customers.

Finally, Commission staff should encourage the use of internal ledgers, with proper accounting to track all customer digital asset balances, as the golden source of truth for transactions on digital asset exchanges such as GDAX. Requiring that every transaction on an exchange be recorded on the public ledger would overwhelm the blockchain and cause unnecessary transaction fees, thereby harming both customers and the public ledger.

Based on these considerations, Coinbase would propose that an example of actual delivery be that, within 28 days of purchase:

1. The digital asset is held in a digital wallet either in the control of the purchaser (i.e., not hosted by a third party) where the purchaser has the private key to the wallet, or in a hosted digital wallet operated by an entity licensed as a qualified custodian with the SEC, registered as a money services business with FinCEN, registered with the Commission, or designated as a warehouse for delivery purposes by a designated contract market for a futures contract on that asset.
2. If held in the purchaser's digital wallet, the transaction is reflected in the public ledger of the relevant digital asset; if held at a QC, MSB, CFTC registrant, or depository, the transaction is reflected in an internal ledger that is subject to examination by a designated self-regulatory organization such as NFA or FINRA, or an independent outside auditor.
3. The purchaser has the ability to transfer, trade, or use the full amount of the digital asset (including any margined amounts), subject to (a) any legal or regulatory obligations of a wallet operator under applicable law to restrict or block transactions, and subject to (b) reasonable restrictions on withdrawals by the wallet operator designed to protect digital assets. The finance or margin provider should not hold any lien on the digital assets or be able to otherwise restrict transfer resulting from the provision of financing or leverage.

Coinbase would propose no restrictions on the affiliation between financing provider and wallet provider. Coinbase would recommend the removal of examples #2 and #3 in the proposed guidance.

V. Existing Guidance on Offsetting and Netting Positions as a Hallmark of a Futures-Type Contract

While Coinbase proposes the example of actual delivery above, Coinbase believes that the Commission should focus on how the transactions themselves function, as noted in example #4 in the proposed guidance.¹⁵ Several digital asset exchanges have for years offered margin trading to non-ECP, retail customers. Some of these exchanges matched margined orders on the spot exchange (against either other margined orders or spot orders), allowed long positions to be offset or netted out by short positions, and forcibly liquidated margined positions if the market price moved against the position resulting in a loss of all equity in the trade. All of these are hallmarks of futures contracts and transactions with these qualities should be traded on regulated contract markets, regardless of whether the contracts close within 28 days.

Coinbase believes that the Commission has offered sufficient guidance to date through enforcement actions, such as the Bitfinex settlement and prior guidance on leveraged precious metals products,¹⁶ to put the digital asset industry on notice that these retail transactions – if not executed on a registered DCM – are illegal. Regulatory forbearance on exchanges that offer these products only serves to punish exchanges that, recognizing the legal issues, do not.

VI. Need for Clarity on Jurisdictional Scope from CFTC and SEC (Question 9)

Coinbase requests that the Commission and SEC confer with each other on the scope of their respective jurisdictions as they relate to digital assets. Market participants making efforts to comply with all CFTC and SEC regulations, such as Coinbase, face uncertainty around what regulations govern which digital assets. For instance, tokens that are commodities may be traded on spot exchanges not registered with either agency, but tokens that are securities must be traded on national securities exchanges or alternative trading systems. The uncertainty on which tokens are securities has a chilling effect on the market and threatens the success of this new technology. A delineation between the agencies, as the CFTC and SEC has done for stock indices and swaps, would bring much needed clarity.

VII. Conclusion

In summary, Coinbase applauds the Commission's focus on customer protection in the digital asset space. We believe that the Commission is correct in looking to the usability of digital assets as the hallmark of whether those assets have been "actually delivered" for purposes of Section 2(c)(2)(D). However, Coinbase recommends a different example of how that delivery occurs in the context of digital assets to account for regulatory and security concerns specific to the digital asset marketplace.

¹⁵ Coinbase would note that example #4 only speaks to positions that are offset or netted within 28 days. The ability to offset or net a position, even if not exercised and delivery is taken upon repayment of the financed amount, would render a transaction to be a 2(c)(2)(D) transaction and therefore must be treated as a futures.

¹⁶ 2013 Guidance, at 52427-28 (stating that the Commission will not consider delivery to actually have occurred if the purchaser is able to cancel or offset a leveraged transaction, except "due to extraordinary market circumstances.")

Where -- as in example #4 in the proposed guidance -- there is existing clarity around what transactions should be treated as futures under Section 2(c)(2)(D), Coinbase believes that no further guidance is needed and in fact only distracts the Commission from enforcing rules that are apparent to the industry.

Finally, the area where guidance is most needed is in the dividing line between commodities and securities as it relates to digital assets. Uncertainty in the market has a chilling effect on the development in a regulated and responsible way of this financial innovation. Coinbase requests that the Commission and SEC provide clarity on this point.

Thank you for the opportunity to comment on the proposed guidance. If you have any questions on our comment letter, please feel free to contact me at mike.lempres@coinbase.com or Andrew Ridenour, counsel for the GDAX exchange, at andrew.ridenour@coinbase.com.

Sincerely,



Mike Lempres
Chief Legal and Risk Officer
Coinbase, Inc.

Cc: Hon. Christopher Giancarlo, Chairman
Hon. Brian Quintenz, Commissioner
Hon. Rostin Behnam, Commissioner
Amir Zaidi, Director DMO
David van Wagner, Chief Counsel DMO
Philip Raimondi, Special Counsel DMO
Juan Suarez, Vice President, Legal, Coinbase