



K&L GATES

2017 INVESTMENT MANAGEMENT CONFERENCE

FinTech and Cryptocurrencies

Linda Odom, Partner, Washington, DC

Lawrence B. Patent, Of Counsel, Washington, DC

Anthony R. G. Nolan, Partner, New York, NY

OVERVIEW OF PRESENTATION

- Overview
 - What is Fintech?
 - What are cryptocurrencies?
 - What is blockchain?
 - What is artificial intelligence?

- Selected Regulatory Issues
 - Securities issues
 - Commodity Issues
 - Tax
 - Other Regulatory Issues

HOW CAN IM COMPANIES PARTICIPATE?

How can IM companies participate today?

- Invest in bitcoin
- Create new products or incorporate cryptocurrencies into existing products
- Use blockchain technologies to your advantage.
- Use artificial intelligence to improve products and customer service and to better target marketing

UNDERSTANDING FINTECH

- What is Fintech?

Fintech is the financial services technology that powers new financial services.

- What are cryptocurrencies?

- What is blockchain?

- What is artificial intelligence?



DISTRIBUTED LEDGER/BLOCKCHAIN

- What is Distributed Ledger / Blockchain?
 - “A distributed ledger is a database that is ***consensually shared and synchronized*** across network spread across multiple sites, institutions or geographies. It allows transactions to have public ‘witnesses,’ thereby making a cyberattack more difficult. The participant at each node of the network can access the recordings shared across that network and can own an identical copy of it. Further, any changes or additions made to the ledger are reflected and copied to all participants in a matter of seconds or minutes. Underlying the distributed ledger technology is the blockchain, which is the technology that underlies bitcoin.” See [Investopedia Definition of “Distributed Ledger”](#).
- Core principles of trust, verifiability, immutability and transparency.
- Distributed ledger as a technology will have multiple uses for multiple industries.
- Cryptocurrencies are just one use case for blockchain.
- Another major aspect is reduction of auditing / verification costs

DISTRIBUTED LEDGER/BLOCKCHAIN

- Distributed ledger technology has multiple uses for multiple industries:
 - Financial services
 - Energy
 - Logistics
- Government blockchain initiatives:
 - State records on blockchain: Delaware, Illinois
 - Central bank digital currency initiatives: Uruguay, Sweden, Vietnam
- Cryptocurrencies are just one aspect of the uses for blockchain – but they are very important for the popularity of ICOs.

DISTRIBUTED LEDGER/BLOCKCHAIN

- Bitcoin is a single purpose blockchain; its purpose is limited to creation of Bitcoins.
- Ethereum is a distributed ledger separate and apart from Bitcoin. Currency of denomination for Ethereum is Ether.
- Ethereum is an application blockchain; it provides for the ability to create “smart contracts” on a distributed ledger. These smart contracts enable the issuance of separate digital tokens in exchange for a contribution of Ether or other cryptocurrencies or fiat currency to the sponsor.
- Ethereum has spawned a proliferation of over 350 cryptocurrencies that are based on smart contracts.
- These cryptocurrencies are the digital tokens that are typically offered in ICOs.

TYPES OF CRYPTOCURRENCIES

- Primary cryptocurrencies
 - A primary cryptocurrency is typically not centrally administered, is designed as a sort of payment system and has tended to be regarded by some as a store of value. Typically the blockchain for that cryptocurrency has limited uses beyond creating the cryptocurrency.
 - Core cryptocurrencies include Bitcoin, Litecoin, Dash, Monero and Ether.
 - Ether is a primary cryptocurrency, but the Ethereum blockchain has made possible the issuance of digital tokens that fuel the ICO craze.
 - Ethereum “smart contracts” smart contracts enable application developers to issue their own separate digital tokens in exchange for a payment of (typically) Bitcoin or Ether.
 - Primary cryptocurrencies are not considered securities, though there may be nuances depending on how the blockchain works. Ether as an example.

TYPES OF CRYPTOCURRENCIES

- Digital tokens
 - Often issued pursuant to creation of a smart contract formed on Ethereum distributed ledger. Other ledgers, like Tezos, also provide this flexibility.
 - Tokens are issued for various purposes and implicate various regulatory frameworks.
 - Tokens often trade off-market. Not all cryptocurrency exchanges accept them.
 - Tokens are issued and offered in “Initial Coin Offerings.”
- Digital tokens often have the following features alone or in combination:
 - Equity like features (e.g., voting rights and rights to distributions).
 - Debt like features (e.g., right to receive fixed additional tokens or revenue from mining or other activities).
 - Consumptive use tokens (e.g., prepayment of right to use services on the platform).



SECURITIES REGULATORY ISSUES



APPLICATION OF SECURITIES LAW

- The SEC has regulatory jurisdiction over securities and security-based swaps and (jointly with the CFTC) mixed swaps
- Whether a digital token is a security depends on the facts and circumstances of the particular case.
- If a token is a security it can be offered and sold only in compliance with United States securities law.
 - Under the Securities Act, is the offering properly registered or exempt from registration? If exempt, are the investors accredited investors and did they receive adequate disclosure?
 - Under the Exchange Act, is the offering conducted through a platform compliant with Regulation Crowdfunding? Are any intermediaries, such as token exchanges or brokers, registered as broker-dealers?
 - Depending on the structure of a token offering, investment advisory considerations may be applicable, including the SEC custody rule. Similarly, investment company act issues may come into play.
- Derivatives with cryptocurrency underlyings must be analyzed under the SEC's security-based swap rules or the CFTC's swap rules depending on the nature of the derivative

THE DAO REPORT

- Recently, the U.S. Securities and Exchange Commission issued a report under Section 21(a) of the Securities Exchange Act concluding that the tokens issued by the DAO constituted securities.
- The DAO was a virtual organization embodied in computer code and executed on a distributed ledger or blockchain.
- Investors contributed Ether in exchange for DAO Tokens.
- DAO Tokens had limited voting and ownership rights.
- The DAO intended to earn profits by funding projects that would provide DAO Token holders a return on investment.
- No limit on number of DAO Tokens offered or on the number or accreditation status of purchasers
- Capital raise equivalent to US\$150 million.

THE *HOWEY* TEST

- The SEC applied the US Supreme Court's *Howey* test to determine whether DAO Tokens constituted an “investment contract” (and thus a security) under Section 2(a)(1) of the U.S. Securities Act of 1933 and Section 3(a)(1) of the U.S. Securities Exchange Act of 1934.
- Pursuant to the *Howey* test a transaction is an “investment contract” if all of these features exist:
 - (1) an investment of money
 - (2) in a common enterprise
 - (3) with a reasonable expectation of profits
 - (4) to be derived from the entrepreneurial or managerial efforts of others.

SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)

- The foregoing factors would also be relevant to characterization as a security under the Investment Company Act and the Advisers Act.

THE *HOWEY* TEST

- Utility tokens – i.e., those with a consumptive use -- might not be securities because of their consumptive or redemptive qualities.

“[W]hen a purchaser is motivated by a desire to use or consume the item purchased – ‘to occupy the land or to develop it themselves,’ as the *Howey* Court put it, - the securities laws do not apply. . . .” *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).
- Securities regulatory characterization may depend on the nature of the smart contract, features of the token, accounting treatment, the use of proceeds and the extent and nature of presale or build-out activities.
- The SEC will look closely at facts and circumstances and whether a token represents consumptive value or an investment contract. An important consideration may be whether the consumptive use is immediately available.

OTHER TESTS

- *Howey* might not be the only test that could be applied.
- The application of a particular test may depend in part on whether the token has debt or equity features as discussed in a prior section
 - *Risk Capital Test.* *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811 (1961).
 - *Family Resemblance Test.* *Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1990).
 - (1) “the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]”;
 - (2) “the ‘plan of distribution’ of the instrument,” including an assessment of whether “there is common trading” of the instrument “for speculation or investment”;
 - (3) “the reasonable expectations of the investing public”;
 - and (4) “whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the investment, thereby rendering application of the Securities Acts unnecessary.”

SAFT

- Simple Agreement for Tokens (“SAFT”) – Balances (i) need for fundraising to build a platform, and (ii) *attempting* to ensure a token issued after the buildout is not a security and thus can trade on a secondary basis.
- The token is issued sometimes months after the SAFT fundraising.
- SAFT issued typically in a Rule 506(c) offering and deemed a security. Simple document verifying investor identity and accredited investor status. Issuance benefits from NSMIA pre-emption.
- Token issued subsequent to SAFT deemed not a security based on consumptive use (if it indeed has consumptive use after build-out).
- **Untested.**

COMPLIANCE ISSUES FOR ADVISERS

- Custody and cybersecurity
 - Digital tokens raise unique custody issues owing to the importance of the private code for tokens and cryptocurrencies
 - Implications of Advisers Act Rule 206(4)
- Managing fraud risk
- Offshore ICO offerings to avoid US regulation
 - how to police Regulation S compliance
 - Many non-US regulators are expressing skeptical views of ICOs – e.g. Ontario securities regulator recently Kik from offering Kin digital tokens to Ontarian investors



COMMODITY ISSUES



DEFINITION OF A COMMODITY

- The Commodity Exchange Act (“CEA”) defines the term “commodity” broadly to include virtually all goods and articles, as well as “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in”
- The Commodity Futures Trading Commission (“CFTC”) first held that cryptocurrencies are commodities in 2015 ‡
- Cryptocurrencies are classified as “exempt” commodities, and thus treated like physical items such as gold or oil, rather than as “excluded” commodities (financials and currency) or agricultural commodities

‡ *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (September 17, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>

CFTC JURISDICTION

- The CFTC has regulatory jurisdiction over futures, options on futures and swaps
- The CFTC also has enforcement jurisdiction if it suspects that there is fraud or manipulation involved in a commodity transaction in interstate commerce
 - Beyond instances of fraud or manipulation, the CFTC generally does not oversee “spot” or cash market transactions and transactions involving commodities that do not utilize margin, leverage, or financing



CFTC JURISDICTION

- The CFTC has stated that there is no inconsistency between the SEC's analysis in The DAO Report and the CFTC's holding that cryptocurrencies are commodities
- Virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances
- The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the CEA and CFTC regulations



CRYPTOCURRENCY TRANSACTIONS

- Futures or options on futures must be traded on a designated contract market (“DCM”)
- Swaps may be traded on a swap execution facility (“SEF”), a DCM or bilaterally
- To trade on a SEF or bilaterally, the parties must be “eligible contract participants” (“ECP”)
 - ECPs include financial institutions, insurance companies, registered investment companies, commodity pools and pension plans with assets > \$5 million, entities with assets > \$10 million, governmental entities, and an individual who has invested on a discretionary basis > \$10 million, among others – unlike with actual currency, there is no look-through to pool participants to determine ECP status



PERMITTED ACTIVITIES

- TeraExchange, LLC, a SEF, entered the cryptocurrency market in 2014 by listing a Bitcoin swap for trading
- North American Derivatives Exchange Inc. (“NADEX”), a DCM, listed binary options based on the Tera Bitcoin Price Index from November 2014 to December 2016
- LedgerX, LLC (“LedgerX”) registered with the CFTC as a SEF and Derivative Clearing Organization (“DCO”) in July 2017. It plans to list cryptocurrency options and day-ahead swaps



CFTC REGULATORY JURISDICTION

- Any agreement, contract, or transaction in any commodity that is—
- (I) entered into with, or offered to (even if not entered into with), a person that is not an ECP or eligible commercial entity; and
- (II) entered into, or offered (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

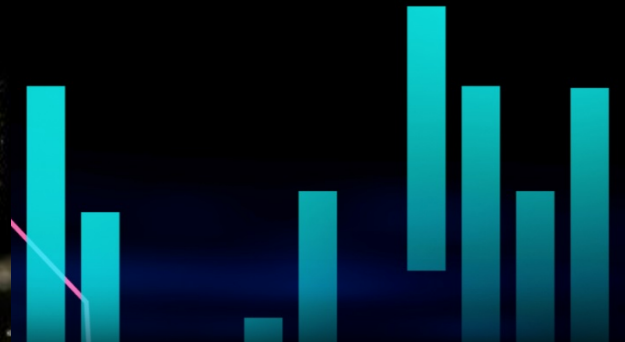
NO CFTC REGULATORY JURISDICTION

- For cryptocurrency, the spot market includes a contract of sale that results in “actual delivery” within 28 days
- For fiat currency, the spot market cut-off is two days

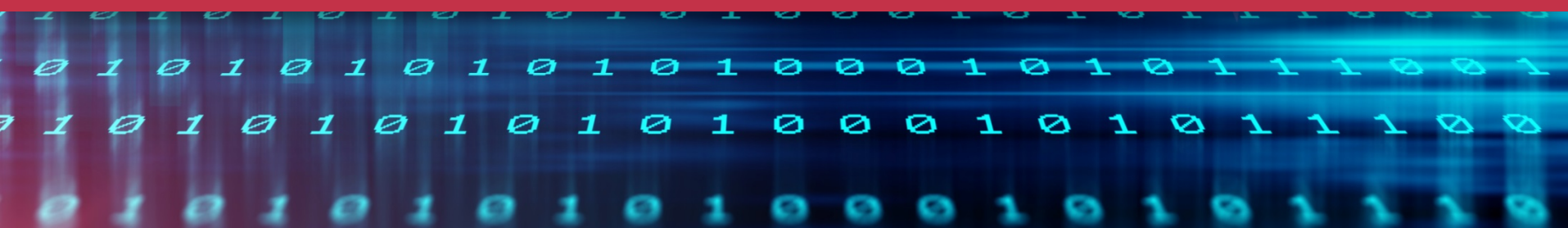


WHAT IS “ACTUAL DELIVERY”?

- In June 2016, the CFTC brought and settled charges against BFXNA Inc., doing business as Bitfinex, for allegedly engaging in prohibited, off-exchange commodity transactions with retail clients and failing to register as a futures commission merchant. *In the Matter of BFXNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016)
- The issue in the Bitfinex case was whether the Bitcoins were delivered given the nature of the instruments; because Bitfinex retained control of the private keys involved and could force liquidate positions if account equity fell below a preset level, the CFTC held that there was no actual delivery
 - It may be possible to work around the delivery issue by trading in options or swaps, as Ledger X appears to be doing
 - Following Bitfinex, a petition for rulemaking was filed asking the CFTC to further clarify what is meant by “actual delivery,” but to date the CFTC has not responded



OTHER REGULATORY CONSIDERATIONS



TAXATION OF CRYPTOCURRENCY

- IRS regards cryptocurrency as property. See [Notice 2014-21](#).
- IRS position compromises use as a payment system.
- John Doe Litigation with Coinbase.
- Pseudonymity raises issues of tax reporting, compliance with bearer instruments restrictions, withholding.
- Cryptocurrency Tax Fairness Act of 2017 (bill)

REGULATION AND PSEUDONYMITY

- Tax Evasion and Exchange Control Evasion
- Anti-money Laundering
- Smart contracts and fiduciary duty
- Practical custody of private key
- Cybersecurity
- Money Transmission Laws – federal and state
- Extraterritorial Considerations
- Accounting Treatment of Utility Tokens
- Proper Custody
- Promoter Liability

GROWING INTERNATIONAL CONSENSUS

- Regulators globally have expressed concern about the potential for fraud, money laundering, tax evasion and cybersecurity risks.
- Securities law implications of certain digital-token offerings are also of particular concern.
- Regulators from these countries have signaled concerns with ICOs:
 - Singapore
 - Canada
 - Peoples Republic of China
 - Republic of Korea
 - Russian Federation
 - Hong Kong
 - United Kingdom
 - Malaysia
 - Thailand
 - Dubai
 - Cayman Islands?
 - Switzerland?
- Regulators in Japan and Taiwan have been more relaxed
- “Offshore” jurisdictions are expected to be more relaxed



Questions?



K&L GATES