



K&L GATES



2018 INVESTMENT MANAGEMENT CONFERENCE
Washington, DC – November 8, 2018

Cryptocurrencies and Related Investment Products

Robert M. Crea, Partner San Francisco
Anthony R.G. Nolan, Partner, New York
Lawrence B. Patent, Washington, DC

OVERVIEW OF PRESENTATION

- Overview of Crypto Market Dynamics
- Regulatory Considerations
 - Commodity Issues
 - Securities Issues
- Cryptocurrency Investment Products
- Risks of Cryptocurrency Exchanges
- Risks and Regulatory Issues of Cryptocurrency Custody



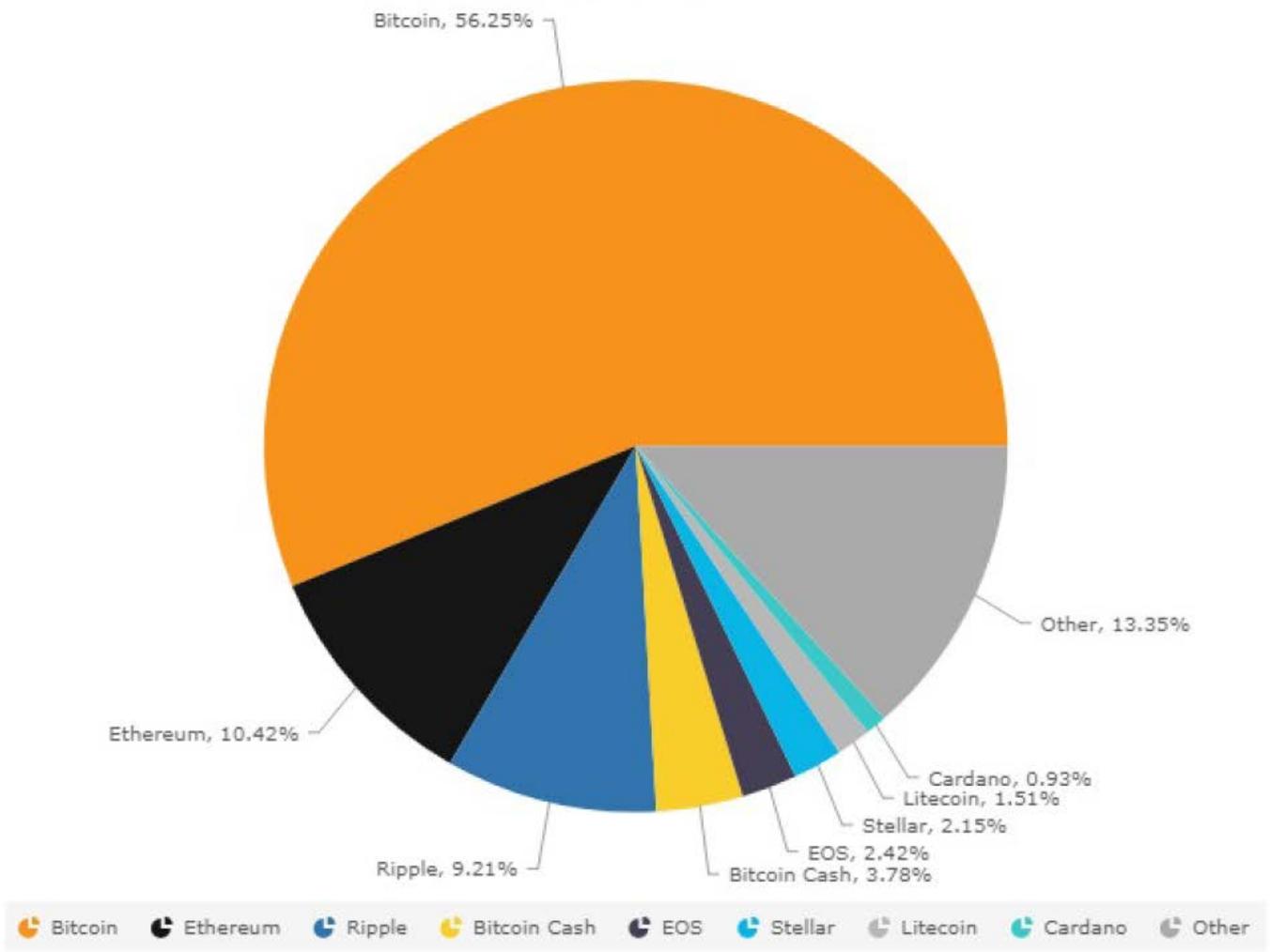
Overview of Crypto Market Dynamics

BLOCKCHAIN BASICS

- Digital assets are issued on a blockchain
- Traded either bilaterally or on crypto exchanges
- Blockchain facilitates pseudonymous and sometimes anonymous holding
- But digital assets can be traced to wallets by hackers and law enforcement

CRYPTOCURRENCIES BY MARKET CAP

Cryptocurrencies by Market Cap
coin.dance

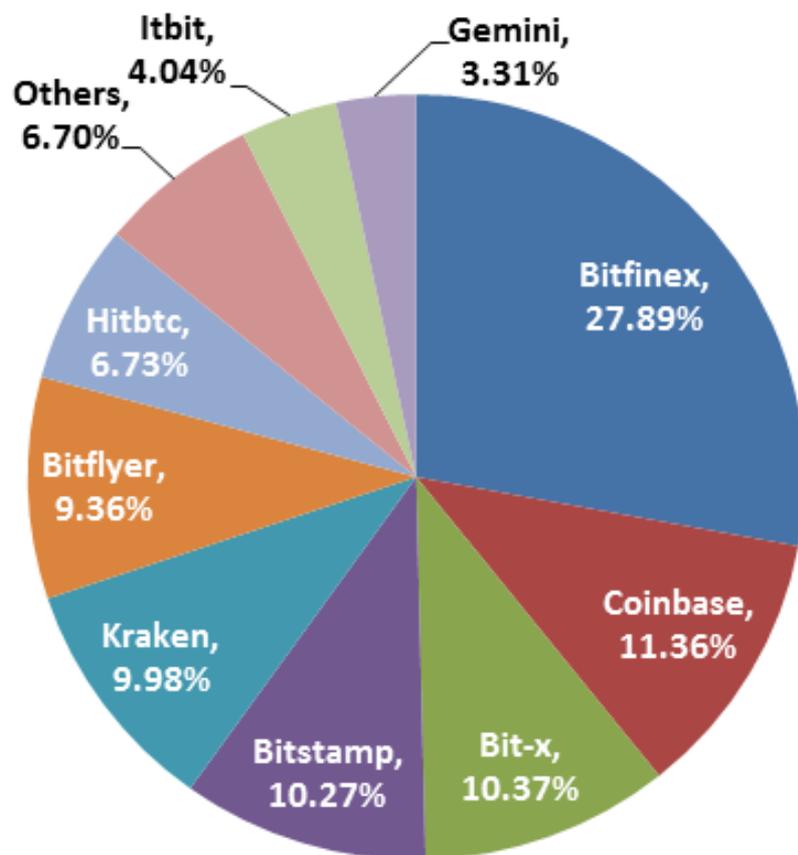


Source: CoinDance as of October 31, 2018.



CRYPTOCURRENCY SECONDARY MARKETS

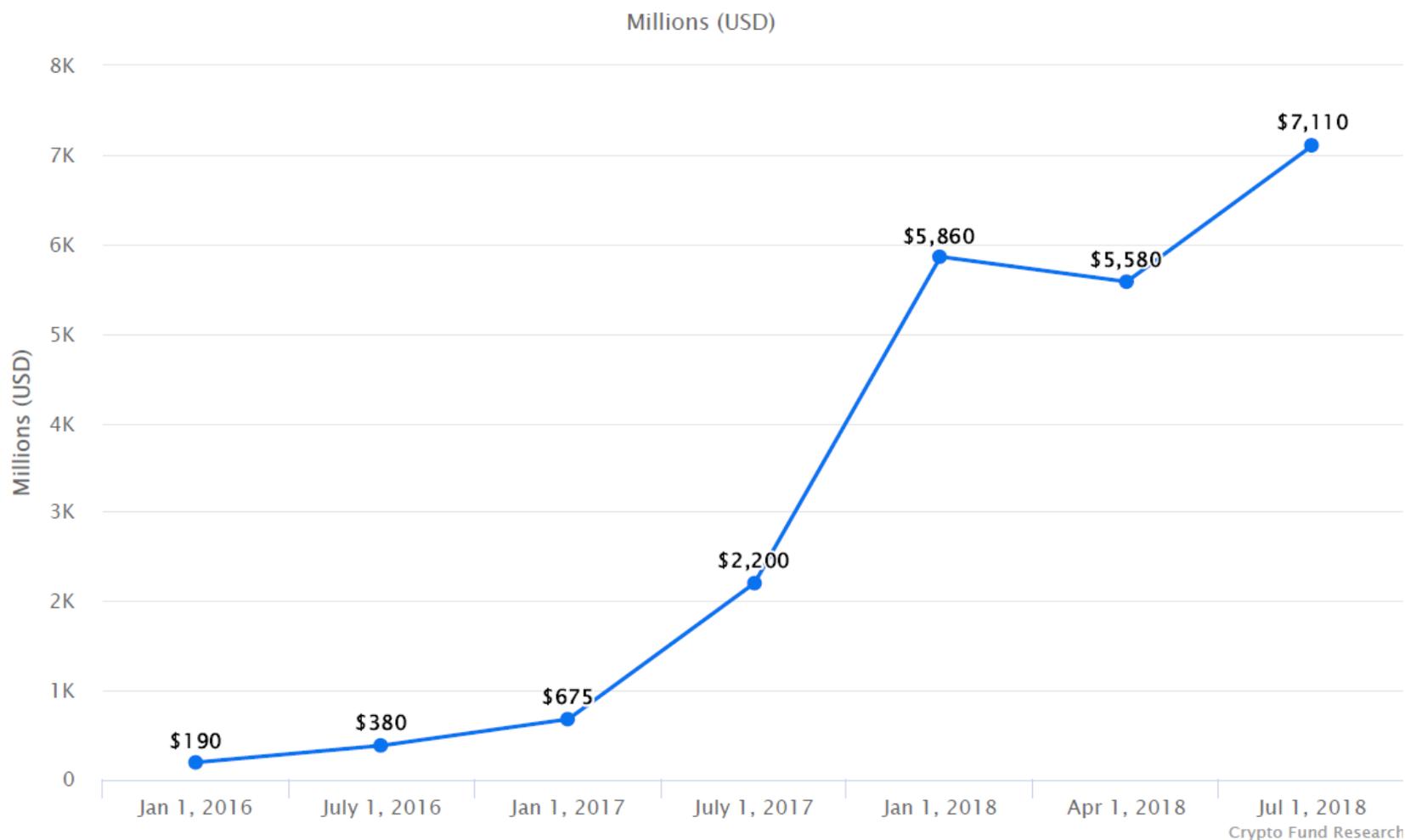
Approximate market share of key exchanges



NOTE: This chart does not reflect the free-exchange trading platforms and trades done off platform.

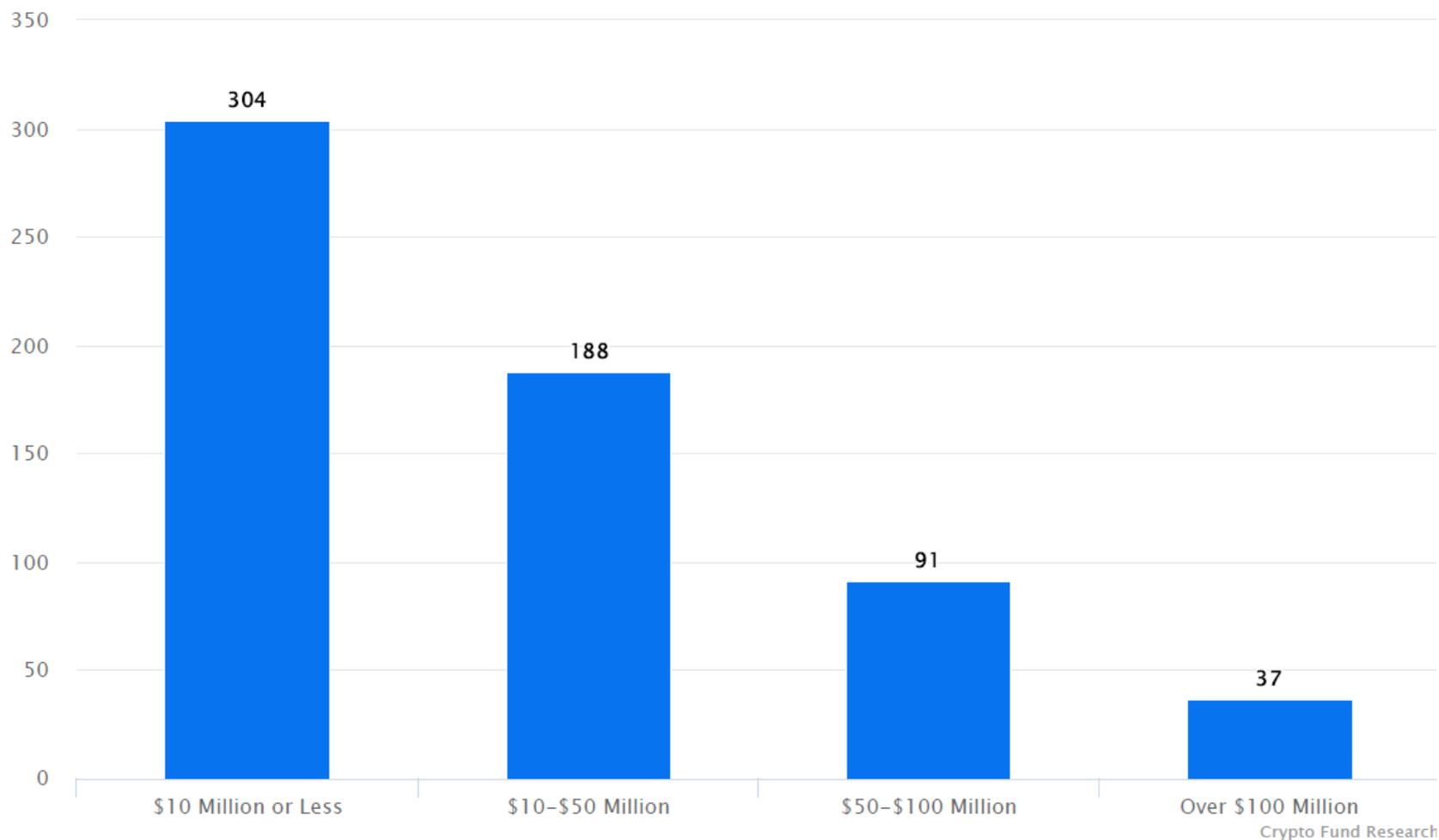
Source: Bitcoinity. Based on average trading volume between April 31, 2018 – October 31, 2018.

GROWTH OF PRIVATE CRYPTO FUNDS AUM



Source: Crypto Fund Research, "Cryptocurrency Investment Fund Industry Graphs and Charts," available at <https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/> (accessed October 31, 2018).

DISTRIBUTION OF CRYPTO AUM BY FUND SIZE



Source: Crypto Fund Research, "Cryptocurrency Investment Fund Industry Graphs and Charts," available at <https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/> (accessed October 15, 2018).



Cryptocurrency Investment Products



EXISTING VEHICLES

- Private funds
 - Hedge funds
 - Commodity pools with exposures to cryptocurrency futures, options on futures, or swaps, which include options on cryptocurrency itself
 - Closed-end funds
- Privately-offered grantor trusts:
 - Grayscale's Bitcoin Investment Trust ("GBTC").
 - Sold pursuant to Rule 506(c) of Regulation D. Quoted on over-the-counter dealer quotation market called "OTCQX".
 - Attempted to register public offering of shares on NYSE Arca but withdrew registration statement on 10/25/2017.
 - GBTC has spot exposure to a commodity; not subject to regulation under the Investment Company Act of 1940.

BITCOIN FUTURES

■ Bitcoin futures

- LedgerX LLC registered with the CFTC as a swap execution facility (SEF) and derivatives clearing organization (DCO) in July 2017 for Bitcoin swaps.
 - Physically-settled – traders post or receive actual bitcoins
 - Offers options and day-ahead swaps
 - Eligible contract participants only – no retail participation
- Cboe Futures Exchange (CFE) exchange-traded Bitcoin future (XBT).
 - First offered December 10, 2017
 - Cash-settled based on Gemini Exchange BTC auction price, not based on an average or index price
- CME Group exchange-traded Bitcoin futures contract.
 - First offered December 18, 2017
 - Cash-settled based on proprietary Bitcoin Reference Rate (BRR), which aggregates bitcoin trading activity across major bitcoin spot exchanges

POTENTIAL CRYPTO ETP STRUCTURES

- Listing exchange for a prospective exchange traded product (“ETP”) must obtain a listing rule under Rule 19b-4 of the Securities Exchange Act of 1934 (the “Exchange Act”).
- Listing rules are subject to public notice and comment procedures.
- SEC must specifically find that issuance of a listing rule would comport with public policies furthered by the Exchange Act.

POTENTIAL CRYPTO ETP STRUCTURES

- If an ETP trades securities, it is an investment company under the 1940 Act and categorized as an exchange-traded fund (“ETF”).
- All ETFs are ETPs, but not all ETPs are ETFs.
- ETFs are regulated by the SEC’s Investment Management Division (“IM Division”).

POTENTIAL CRYPTO ETP STRUCTURES

- ETPs proposed as commodity pools are also subject to regulation by the CFTC and National Futures Association (“NFA”).
- Pool sponsors are regulated as commodity pool operators and may employ regulated commodity trading advisers.
- Commodity pool ETPs typically do not create / redeem shares in-kind because futures contracts they hold cannot easily be broken into “odd” lots.

POTENTIAL CRYPTO ETP STRUCTURES

- Grantor Trust ETPs are the most common form of ETPs proposed to date
- Grantor trust characteristics:
 - Formed without a governing board
 - sponsors operate them within the strictures of the governing trust agreements
 - Create and redeem their shares in-kind

SEC REJECTIONS OF PROPOSED CRYPTO ETPS

- For two years, SEC has rejected proposed cryptocurrency ETPs
- Rationale for rejecting ETP applications:
 - Exchange on which the ETP would trade cannot have surveillance-sharing agreements with significant markets that host trading in Bitcoin
 - Underlying markets for Bitcoin are not regulated in a manner comparable to a national securities or futures exchange
 - Concerns about unreliable pricing; underlying markets are opaque in their operations and subject to manipulation

IM DIVISION'S CONCERNS

- On January 18, 2018, Dalia Blass, the SEC Director of Investment Management, sent a letter to the ICI and SIFMA regarding regulated products and cryptocurrencies.
- The letter enumerates significant outstanding questions on how funds holding substantial amounts of cryptocurrencies and related products could satisfy the 1940 Act and its rules.

IM DIVISION'S CONCERNS

- The letter raises the following specific concerns:
 - Trading issues and illiquidity
 - Custody, regulatory rules and internal controls
 - Valuation - lack of established valuation protocols; reliability and fairness with extreme price movements
 - Accounting, verification and audit
 - Suitability of asset class for retail and other investors



Overview of Cryptocurrency Regulatory Issues Relevant to Investors



SEC VS. CFTC JURISDICTION

- Whether a digital token is a security depends on the facts and circumstances of the particular case
- ***“Every ICO I’ve seen is a security”*** -- SEC Chairman Clayton, February 6, 2018
- Commodities: Bitcoin, Litecoin, Monero
- The special place of Ether
- The diminishing role of utility tokens
- CFTC only has anti-fraud jurisdiction over spot markets in commodities

U.S. SECURITIES REGULATION

- If a token is a security it can be offered, sold and traded only in compliance with U.S. securities law:
 - Securities Act: is the offering properly registered or exempt from registration? If exempt, are the investors accredited investors and did they receive adequate disclosure?
 - 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?
 - Advisors Act: Depending on the structure of a token offering, investment advisory considerations may be applicable, including the SEC custody rule.
 - 1940 Act: Investment company act issues may also come into play.

U.S. COMMODITIES REGULATION

- Bitfinex / Coinflip enforcement actions (CFTC 2016)
 - Virtual currency is a commodity
 - CFTC has regulatory jurisdiction over exchanges and trading venues other than spot market transactions
- CFTC v. CabbageTech dba Coin Drop Markets (EDNY 2018)
 - Virtual currency is a commodity
 - CFTC has jurisdiction over fraud and manipulation in underlying spot markets for virtual currencies even if not related to a future or derivative
 - Other regulators may also have jurisdiction
- CFTC v. My Big Coin Pay, Inc. (D. Mass. September 26, 2018)
 - My Big Coin is a virtual currency
 - There is futures trading in virtual currencies, specifically Bitcoin)
 - It is therefore sufficient to hold that My Big Coin is a commodity, even if it does not underlie a futures contract; treating all virtual currencies as a class
 - Confirms antifraud and anti-manipulation jurisdiction

U.S. COMMODITIES REGULATION

- Retail commodity transactions: actual delivery standard
 - CEA s.2(c)(2)(D)
 - Platform offering a “commodity” on margin to persons other than eligible contract participants or eligible commercial entities must “deliver” to buyer on spot or register as a futures commission merchant
 - Spot is 28 days – versus 2 days for fiat currency
- CFTC Proposed Interpretation of “actual delivery” for cryptocurrency
 - Buyer must have free control
 - Counterparty cannot retain any interest in or control over any of the commodity
 - Delivery may be made to a purchaser’s blockchain wallet, or to a third-party wallet/storage system that (a) has entered into an agreement with the purchaser to hold virtual currency as agent for the purchaser, and (b) is not affiliated with or controlled by the counterparty
 - CFTC asks if Congress should shorten cryptocurrency spot delivery time

TAXATION OF CRYPTOCURRENCY

- IRS regards virtual currencies as property. See [Notice 2014-21](#).
- IRS position restricts use as a payment system.
- John Doe Litigation with Coinbase.
- Pseudonymity issues -- tax reporting, compliance with bearer instruments restrictions, withholding.
- Congressional Policy Moves.
- IRS enforcement crackdown on tax evasion.



Risks Associated with Cryptocurrency Exchanges



REGULATORY VACUUM

- Cryptocurrency exchanges are not federally regulated as securities or commodities exchanges – but see Coinbase
- Current patchwork of regulations includes state-by-state licensing and regulation of virtual currency exchanges
 - States typically require virtual currency exchanges and administrators to be licensed as “money transmitters”
 - “Bitlicense” regulation: In 2015 New York’s Department of Financial Services (“DFS”) adopted licensing requirements for virtual currency businesses operating in New York State
 - BUT very few “Bitlicense” holders (e.g., Coinbase)
 - Very limited exemptions for state-chartered banks but not federal banks, broker-dealers, or other institutions
- July 2017 by Uniform Law Commission for a “Uniform Regulation of Virtual-Currencies Businesses Act”

REGULATORY VACUUM

- Lack of regulation results in wide disparity of standards for security, internal controls, market surveillance protocols, disclosures, other investor and consumer protections
- Risks to customers of virtual asset trading platforms include:
 - Hacking of wallets held by exchanges
 - Frequent delays and outages on trading platforms that leave customers unable to withdraw funds and susceptible to significant losses given volatile prices
 - Certain trading platforms to deceptive and predatory practices, market manipulation, and insider abuses
- Trading platforms vary in how they have responded to these risks.
- NFA instituted additional reporting requirements for CPOs and CTAs earlier this year, and effective last week (October 31, 2018), additional disclosure requirements

NYAG VIRTUAL MARKETS STUDY

VIRTUAL MARKETS INTEGRITY INITIATIVE

REPORT



Office of the New York State
Attorney General

Barbara D. Underwood
Attorney General

September 18, 2018

NYAG VIRTUAL MARKETS STUDY

- On September 19, 2018 the New York State Attorney General issued the report of findings of its investigation into cryptocurrency markets integrity.
- Key findings:
 - The various business lines and operational roles of trading platforms create potential conflicts of interest.
 - Trading platforms have yet to implement serious efforts to impede abusive trading activity.
 - Protections for customer funds are often limited or illusory.
- Based on this investigation, the OAG referred Binance, Gate.io, and Kraken to the Department of Financial Services for potential violation of New York's virtual currency regulations.

NYAG VIRTUAL MARKETS STUDY

One Perspective

“NY is that abusive, controlling ex you broke up with 3 years ago but they keep stalking you, throwing shade on your new relationships, unable to accept that you have happily moved on and are better off without them.
#getoverit”

-- Jesse Powell, CEO, Kraken
September 19, 2018



Risks and Regulatory Issues of Cryptocurrency Custody



CUSTODY RULE

- Rule 206(4)-2 of the Advisers Act – RIAs must maintain custody of client funds or securities with a “qualified custodian.”
 - Qualified custodians include certain banks, savings associations, broker-dealers, futures commission merchants and foreign financial institutions that customarily hold financial assets for advisory clients segregated from proprietary assets.

DIFFICULTIES IN APPLYING THE CUSTODY RULE

- Are crypto assets “funds or securities” per Rule 206(4)-2?
- How do auditors verify ownership?
- Minimal regulatory guidance.
- How does one actually custody crypto?
 - Importance of wallet private key
 - Hot wallets – third party providers that often are vertically integrated with the services of a cryptocurrency exchange.
 - Cold storage – firewalled computer, USB drives, external hard drives, printed paper stored in vaults?
- Cybersecurity
- Potential impact of zero-knowledge protocols

DIFFICULTIES IN APPLYING THE CUSTODY RULE

- Cold storage is convenient for closed-end funds but less so for hedge funds with active trading strategies.
- Further safeguards:
 - Multi-signature
 - Subdivision of private key addresses into multiple, separate files
- Risk of loss might not always be due to bad actors but negligence or acts of god.
- Many ERAs decide to custody crypto assets through variety of means, including third-party hot wallets and self-custody.



Special Issues for Crypto Lending Funds

ISSUES FOR CRYPTOCURRENCY CREDIT FUNDS

- Perfection
 - Article 9
 - Article 8
 - Private key management
- “Actual delivery” issue depending on context
- Timely liquidation of collateral



QUESTIONS?





Presenters



PRESENTERS

**Robert M. Crea**

San Francisco

+1.415.882.8199

robert.crea@klgates.com

Robert M. Crea counsels investment advisers, private fund managers and broker-dealers on a variety of fund formation, regulatory and compliance, and securities law matters. He regularly works with clients to structure and document U.S. and offshore private investment funds and assists clients with a variety of state and federal regulatory and compliance issues. He represents pension plans and other institutional investors in connection with their investments in hedge funds, private equity, venture capital and real estate funds.

Mr. Crea also counsels on regulatory matters affecting cryptocurrencies and blockchain technology. In addition, he advises emerging companies regarding formation and financing and mergers and acquisitions. Mr. Crea is a CFA charterholder and CAIA charterholder and a member of each of the CFA Institute and CAIA Association.

PRESENTERS



Anthony R.G. Nolan

New York

+1.212.536.4843

Anthony.nolan@klgates.com

Anthony Nolan is a finance partner in the New York office. Mr. Nolan has a domestic and international practice that emphasizes lending transactions, fixed income securities, structured finance, structured products and derivatives. He works at the intersection of finance and investment management, including trading and regulation of swaps and security-based swaps, loan trading, securities lending and repo as well as traditional borrowing and leverage transactions.

Mr. Nolan has significant experience in (i) securities laws affecting asset-backed securities, corporate debt securities, initial coin offerings and security-based swaps, (ii) commodity futures laws impacting swaps and commodity pool participants and (iii) banking laws that regulate the derivatives and securities activities of depository institutions and their affiliates and (iv) securities and commodities regulation of digital assets and initial coin offerings.

PRESENTERS

**Lawrence B. Patent**

Washington DC

+1.202.778.9219

Lawrence.Patent@klgates.com

Mr. Patent regularly counsels businesses with respect to commodity interest trading compliance and the legal requirements governing trading in over-the-counter derivatives and exchange-traded futures, including both international and U.S. markets. His clients include, among others, hedge funds, currency dealers, commodity pool operators, commodity trading advisors, futures commission merchants, and introducing brokers.