
2018 INVESTMENT MANAGEMENT CONFERENCE

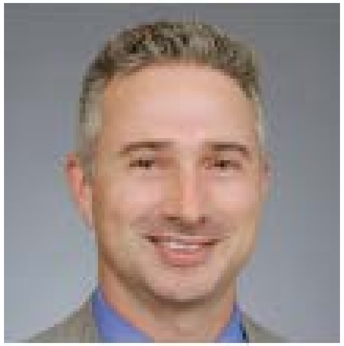
New York, October 30, 2018

# Cryptocurrencies and Related Investment Products

Peter J. Shea, Partner, New York
Derek N. Steingarten, Partner, New York and Boston
Anthony R.G. Nolan, Partner, New York

# PANELISTS

**Peter Shea**
Partner
Investment Management
New York
+1.212.536.3988
Peter.Shea@klgates.com



**Derek Steingarten**
Partner
Financial Services
Boston
+1.617.261.3295
derek.steingarten@klgates.com

**Anthony Nolan**
Partner
Finance
New York
+1.212.536.4843
anthony.nolan@klgates.com

# OVERVIEW OF PRESENTATION

- Overview of Crypto Market Dynamics
- Threshold Regulatory Issues
  - Commodity Issues
  - Securities Issues
- Current/Proposed Cryptocurrency Investment Products
  - Private Funds
  - Exchange-Traded Products
  - Futures
- Investment Adviser Regulatory & Trading Concerns
  - Risks of Cryptocurrency Exchanges
  - Risks and Regulatory Issues of Cryptocurrency Custody

# Overview of Crypto Market Dynamics

K&L GATES

# 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

# BITCOIN AND ETHERIUM

- Bitcoin is a single purpose blockchain; it’s purpose is limited to creation and trading of Bitcoins.
- Etherium is a distributed ledger separate and apart from Bitcoin. Currency of denomination for Etherium is Ether.
- Etherium 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.
- Etherium has spawned a proliferation of over 350 digital tokens that are based on smart contracts.
- These digital tokens are typically what are offered in ICOs.

K&L GATES

# DISTINGUISHING COINS FROM ICO TOKENS

- Digital tokens should be distinguished from cryptocurrencies.
  - Often issued pursuant to creation of a smart contract formed on Etherium distributed ledger.
  - Many different purposes for tokens and can implicate various regulatory frameworks.
  - Often trade off-market.  Not all cryptocurrency exchanges accept them.
- 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).

K&L GATES

# ICO BASICS

- Why do an ICO? *Perceptions* of:
  - Easy fund raising / No investor relation headaches
  - No dilution of ownership
  - No liquidation preference
  - ***Easy Transferability***
- Primary role of secondary market
- Crowdfunding / General Solicitation

# Cryptocurrency Investment Products

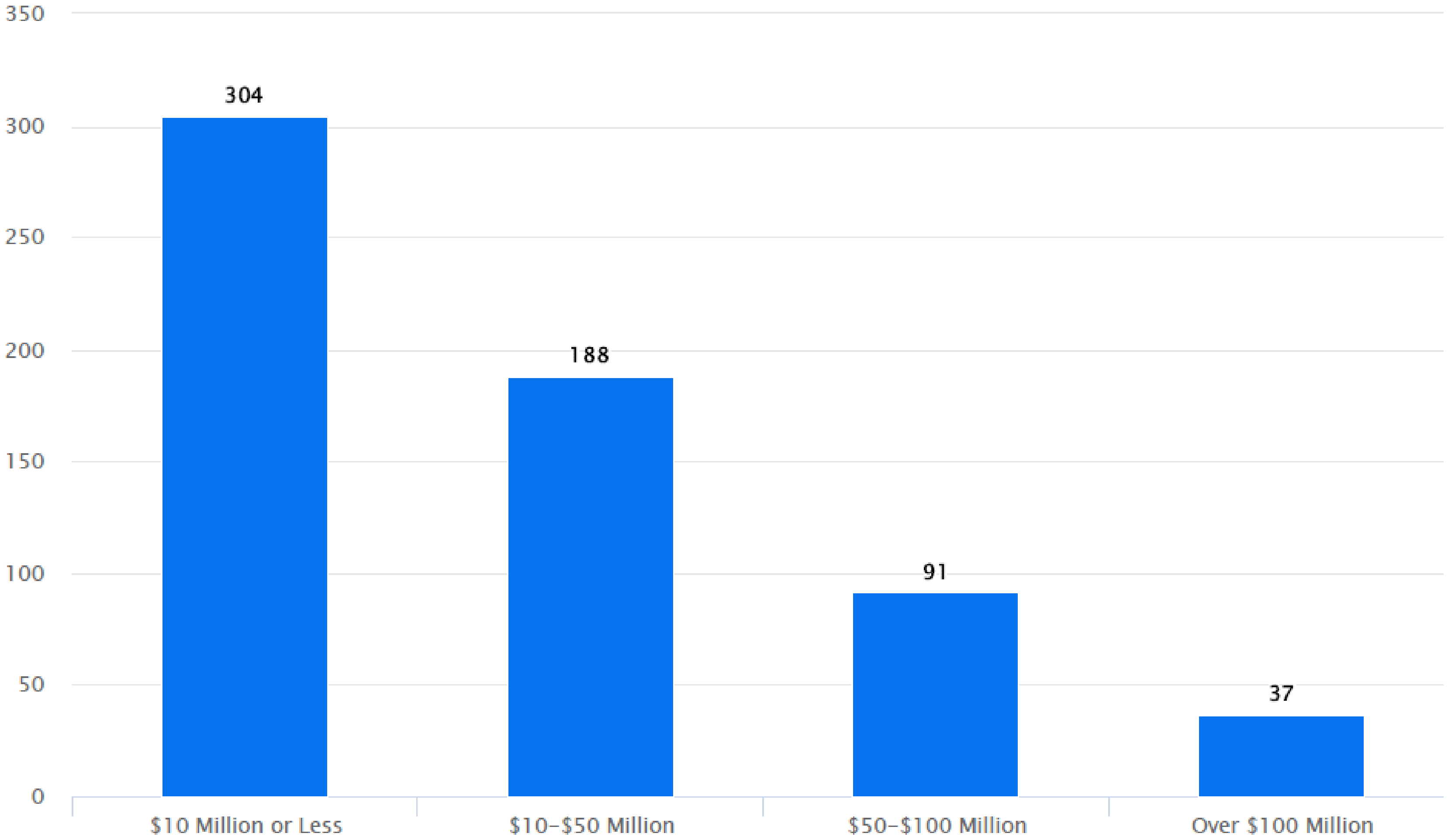
K&L GATES

# EXISTING VEHICLES

- Private funds
  - Hedge funds
  - Commodity pools with exposures to cryptocurrency futures
  - 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.

K&L GATES

# CRYPTO FUND AUM




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

# BITCOIN FUTURES

- Bitcoin futures
  - LedgerX LLC registered with the CFTC as a SEF and 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 submit for the SEC's approval a listing rule under Rule 19b-4 of the Securities Exchange Act of 1934 (the "Exchange Act").
- Subject to public notice and public comment.
- SEC must make specific findings that the issuance of the listing rule would comport with public policies furthered by the Exchange Act.
- Delegation to SEC's Trading & Markets Division ("T&M Division").

# 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, as many cryptocurrency-focused ETPs might be, are also subject to regulation by the CFTC and the National Futures Association.
- 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 the 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.
- Formed without a governing board; sponsors operate them within the strictures of the governing trust agreements.
- Create and redeem their shares in-kind.

K&L GATES

# SEC REJECTIONS OF PROPOSED CRYPTO ETPS

- For two years, SEC and T&M Division have published a significant record of concerns about cryptocurrency ETPs.
- Rationale for rejecting:
  - 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.

K&L GATES

# IM DIVISION'S CONCERNS

- On January 18, 2018, Dalia Blass, the SEC Director of Investment Management, sent a letter (found here) to each of the Investment Company Institute and the Securities Industry and Financial Markets Association regarding regulated products and cryptocurrencies.

- 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

- 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

K&L GATES

# 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. 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 vs. 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
- Retail commodity transaction – actual delivery under CEA s.2(c)(2)(D)
  - Platform offering "commodity" on margin to persons that are not eligible contract participants or eligible commercial entities must "deliver" it to buyer on spot (within 28 days) or register as a futures commission merchant
  - CFTC interpretation – buyer must have free control
  - CFTC asks whether Congress should shorten delivery time for cryptocurrency spot

# U.S. SECURITIES REGULATION

- 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.

K&L GATES

# U.S. STATE OVERSIGHT FOR CRYPTOCURRENCY EXCHANGES

- 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-charted 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”

K&L GATES

# 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

K&L GATES

# REGULATORY VACUUM

- Cryptocurrency now in operation are not registered or regulated as securities or commodities exchanges.
- Nor have they implemented common standards for security, internal controls, market surveillance protocols, disclosures, or other investor and consumer protections.
- Accordingly, customers of virtual asset trading platforms face significant risks., including
  - 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.

# 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.

# 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.

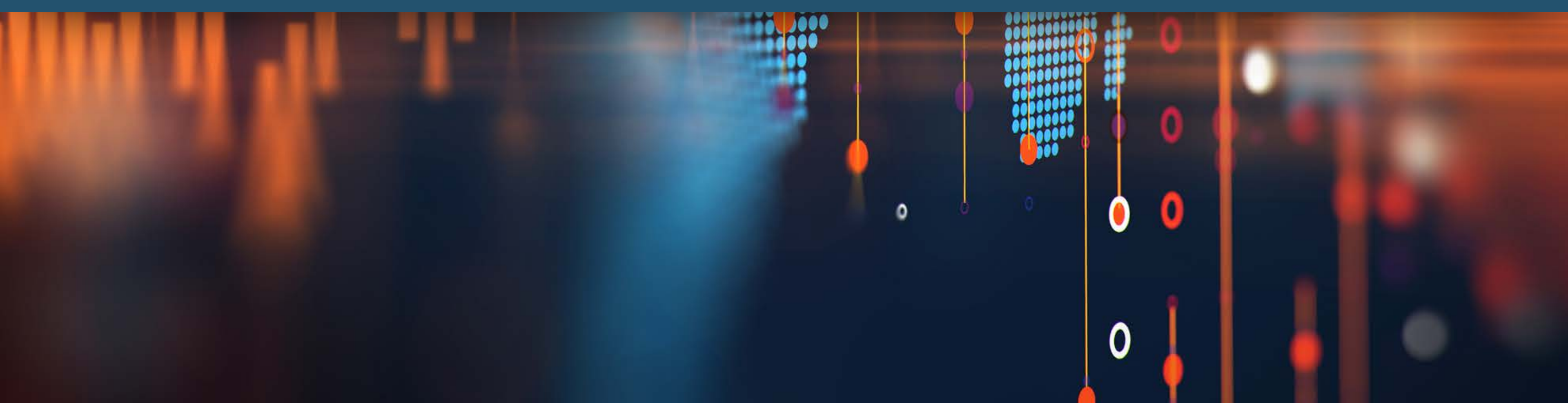
# DIFFICULTIES IN APPLYING THE CUSTODY RULE

- 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
- Zero-knowledge protocols

# DIFFICULTIES IN APPLYING THE CUSTODY RULE

- Cold storage 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

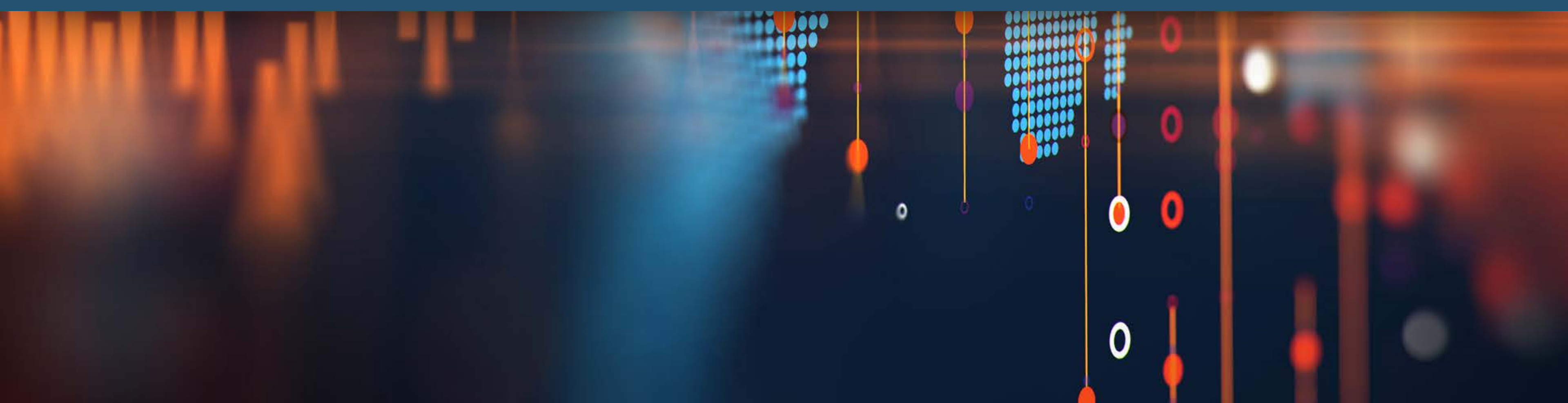


K&L GATES

# ISSUES FOR CRYPTOCURRENCY CREDIT FUNDS

- Perfection
  - Article 9
  - Article 8
  - Private key management
- Leveraged retail commodity transactions “actual delivery”
- Timely liquidation of collateral

# QUESTIONS ?



# Presenters

K&L GATES