

The logo for K&L GATES is displayed in white, uppercase letters on a dark blue rectangular background. The background of the entire slide features a complex digital visualization with orange and blue tones, including a world map composed of dots, a candlestick chart, and a line graph. A specific data point on the line graph is labeled '+11,00.00' in orange text.

K&L GATES

2018 Investment Management Conference

Cryptocurrency-Focused Private Funds

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Deloitte

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K&L Gates LLP

AGENDA

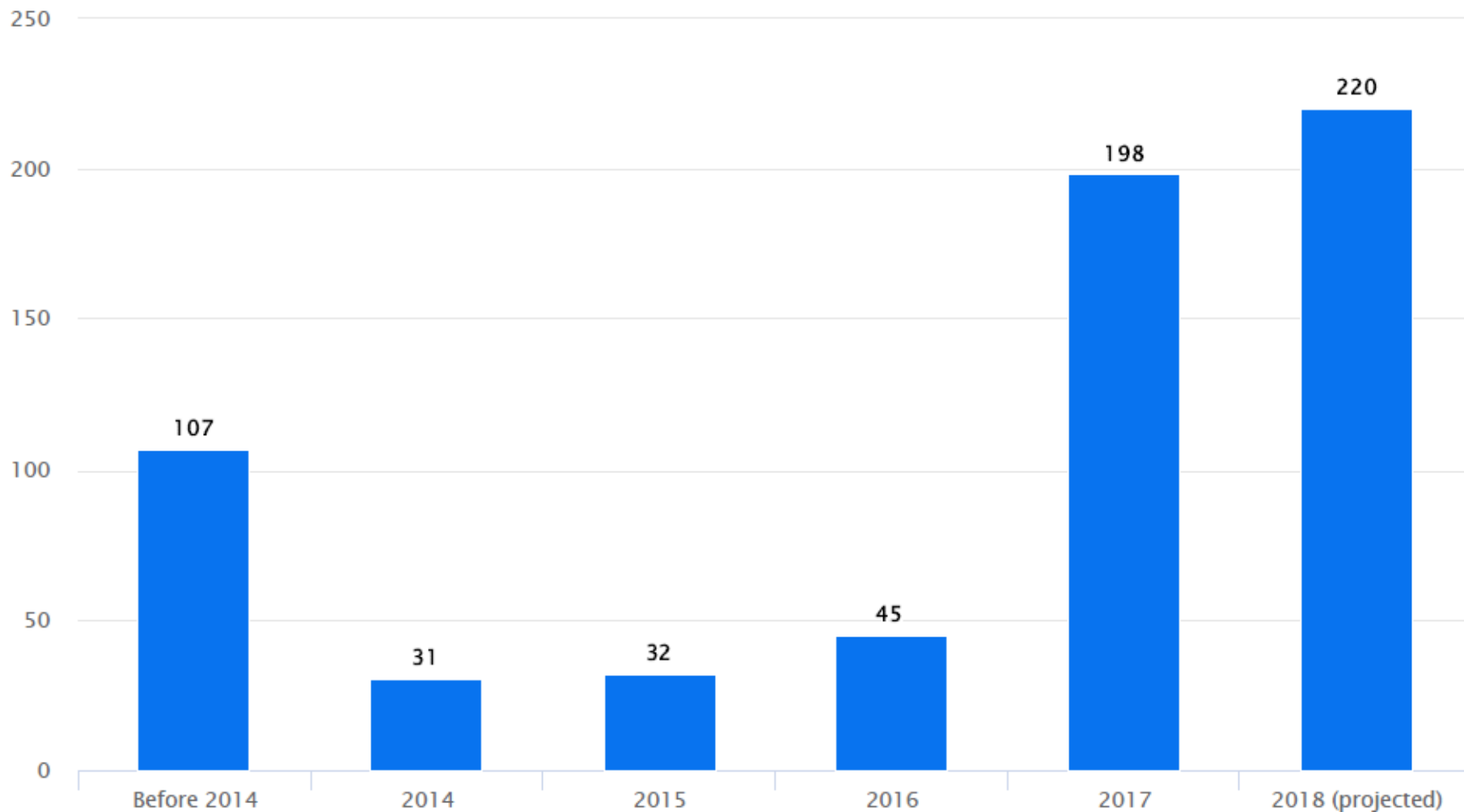
- Market Overview
- General Fund Structure
- Open End Fund Terms
- Closed End Fund Terms
- Tax Considerations
- Valuation
- Regulatory Considerations
- Custody
- Tokenized Private Funds



MARKET OVERVIEW

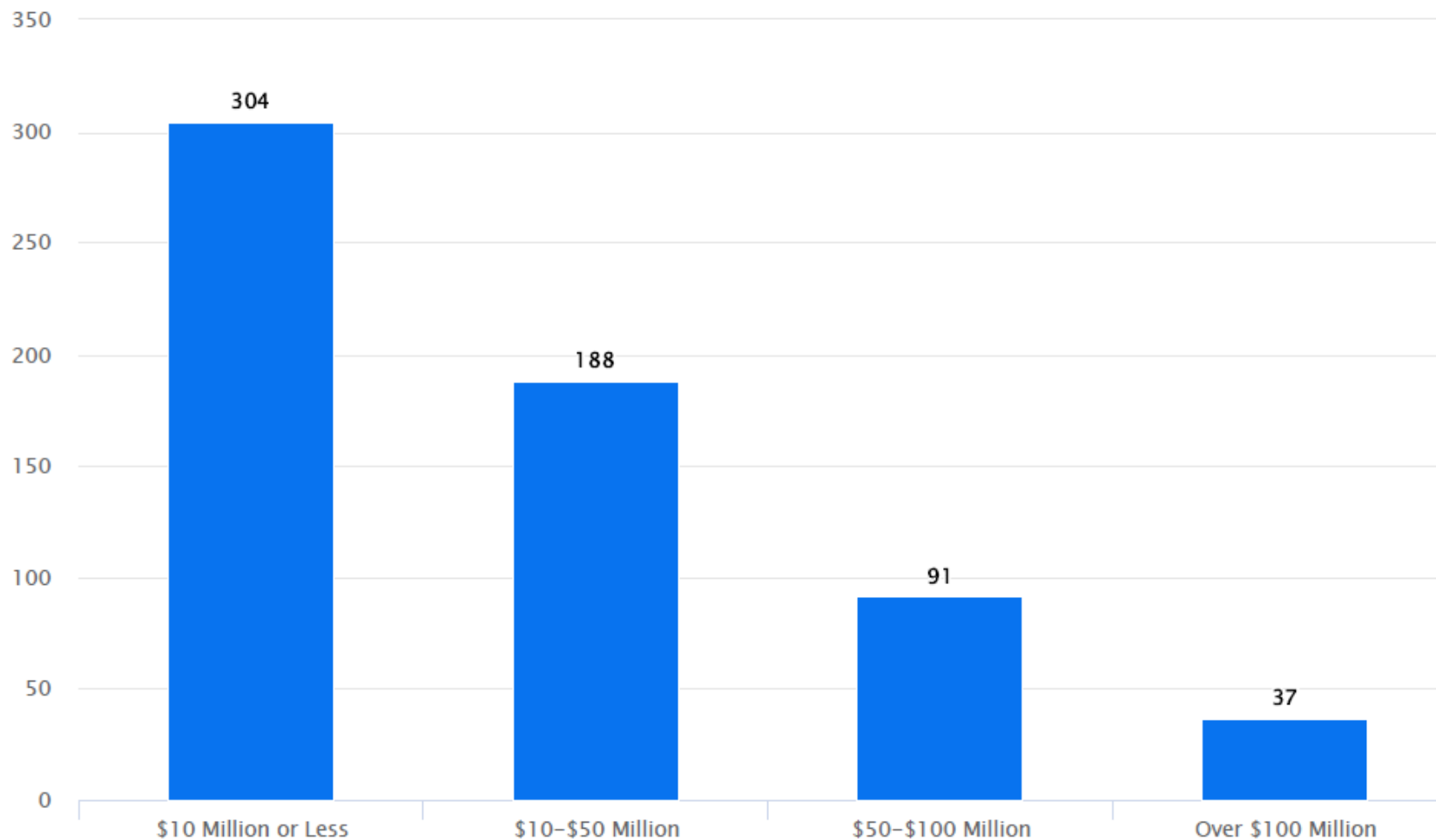


CRYPTOCURRENCY FUND LAUNCHES



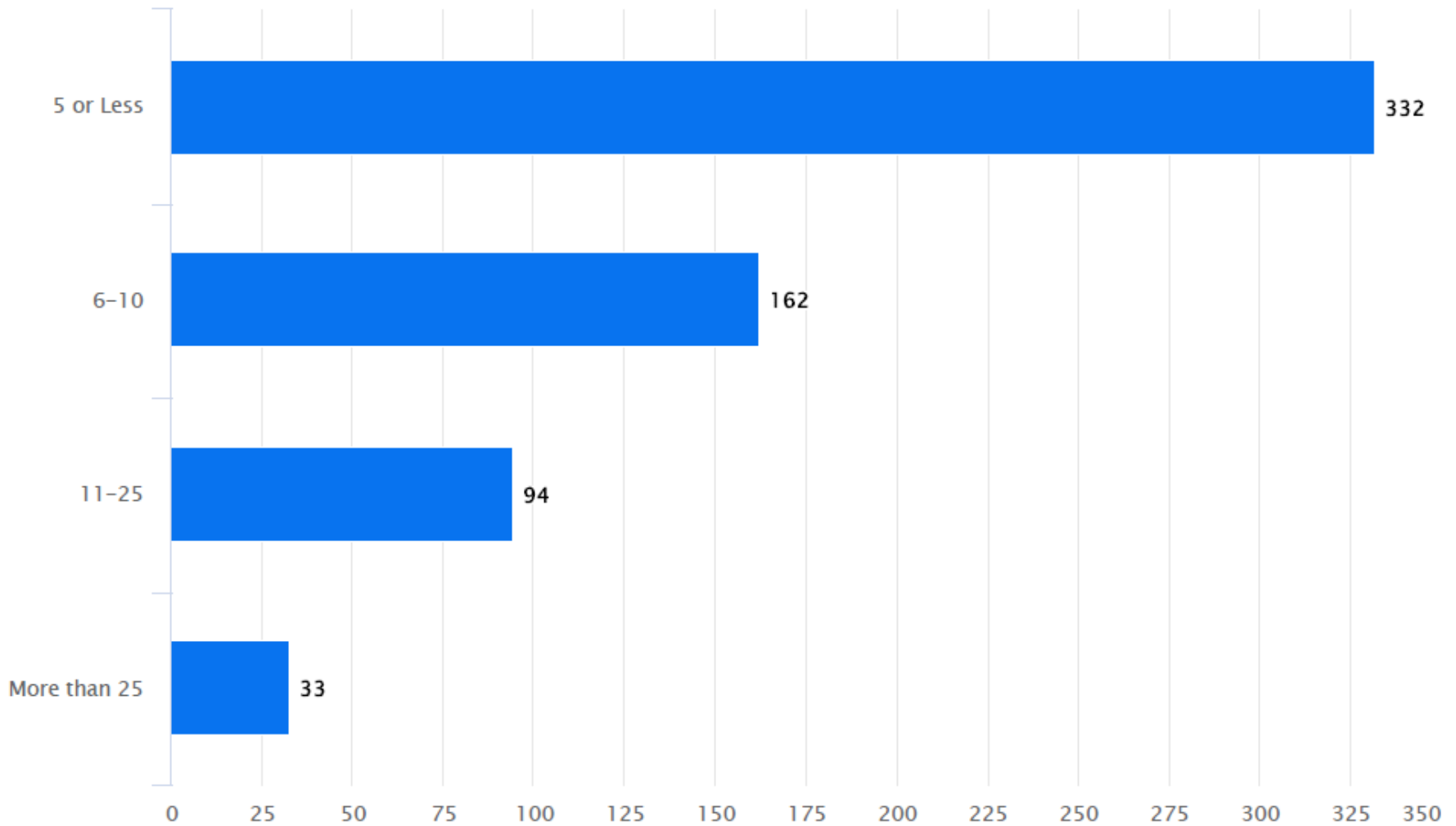
Source: Crypto Fund Research, "Cryptocurrency Investment Fund Industry Graphs and Charts," available at <https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/> (accessed October 15, 2018). Chart includes hedge funds, venture funds and private equity funds focusing on cryptocurrency assets and blockchain technology.

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).

CRYPTO FUNDS BY # EMPLOYEES



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



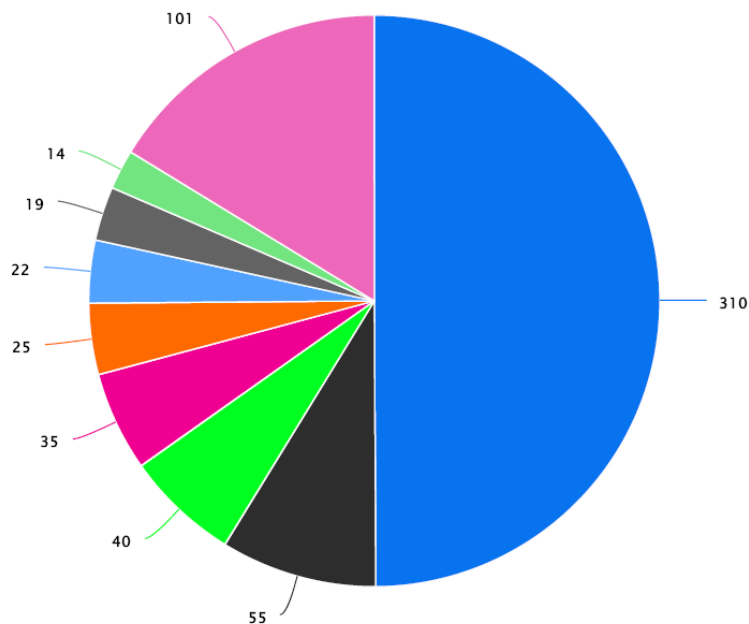
GROWTH OF CRYPTO AUM



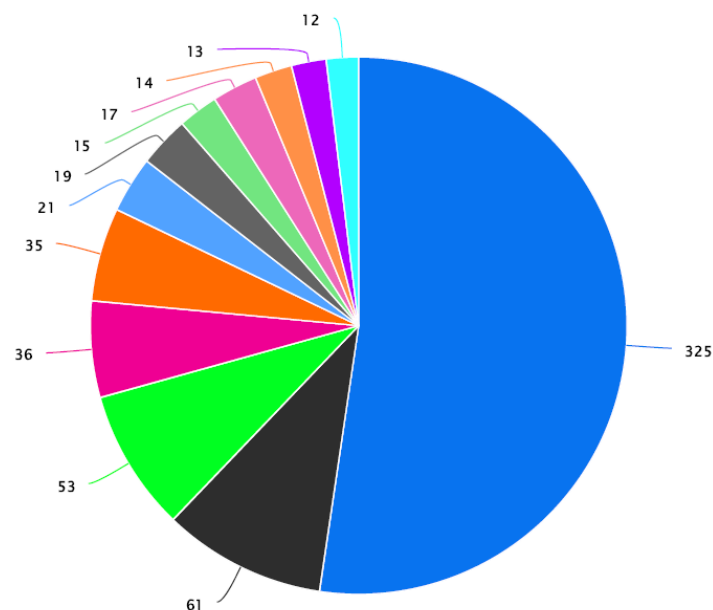
Source: Crypto Fund Research, "Cryptocurrency Investment Fund Industry Graphs and Charts," available at <https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/> (accessed October 15, 2018).

GEOGRAPHY OF FUND SPONSORS

Crypto Funds by Country



Crypto Funds by City



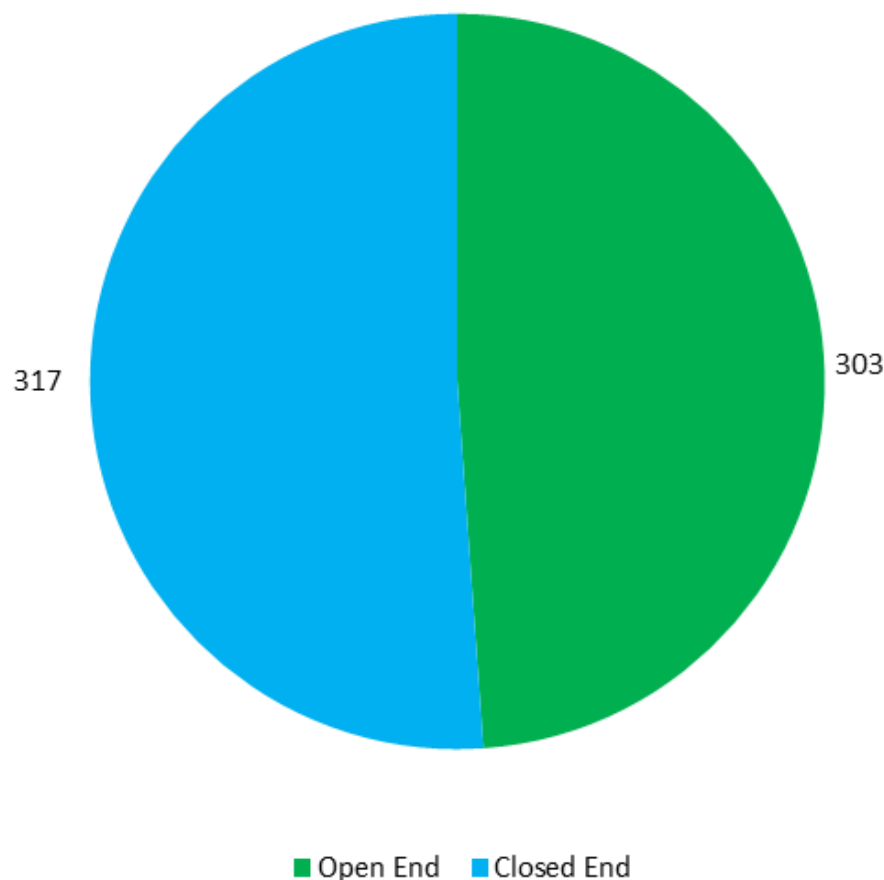
- United States
- China/Hong Kong
- United Kingdom
- Singapore
- Switzerland
- Canada
- Other
- San Francisco
- New York
- London
- Singapore
- Hong Kong
- Chicago
- Australia
- Germany
- Other
- Shanghai
- Los Angeles
- Zug
- Menlo Park
- Vancouver



Half of fund sponsors are based in the U.S. and a plurality are in the SF Bay Area.

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

CRYPTO FUND STRUCTURES



Open End

- Hedge Fund asset strategies, largely focusing on liquid cryptocurrencies and ICOs.
- Side Pockets for illiquid investments such as SAFTs or other VC-type strategies.

Closed End

- PE/VC funds investing in blockchain companies.
- Buy/Hold strategies for liquid cryptocurrencies, ICOs and SAFTs.

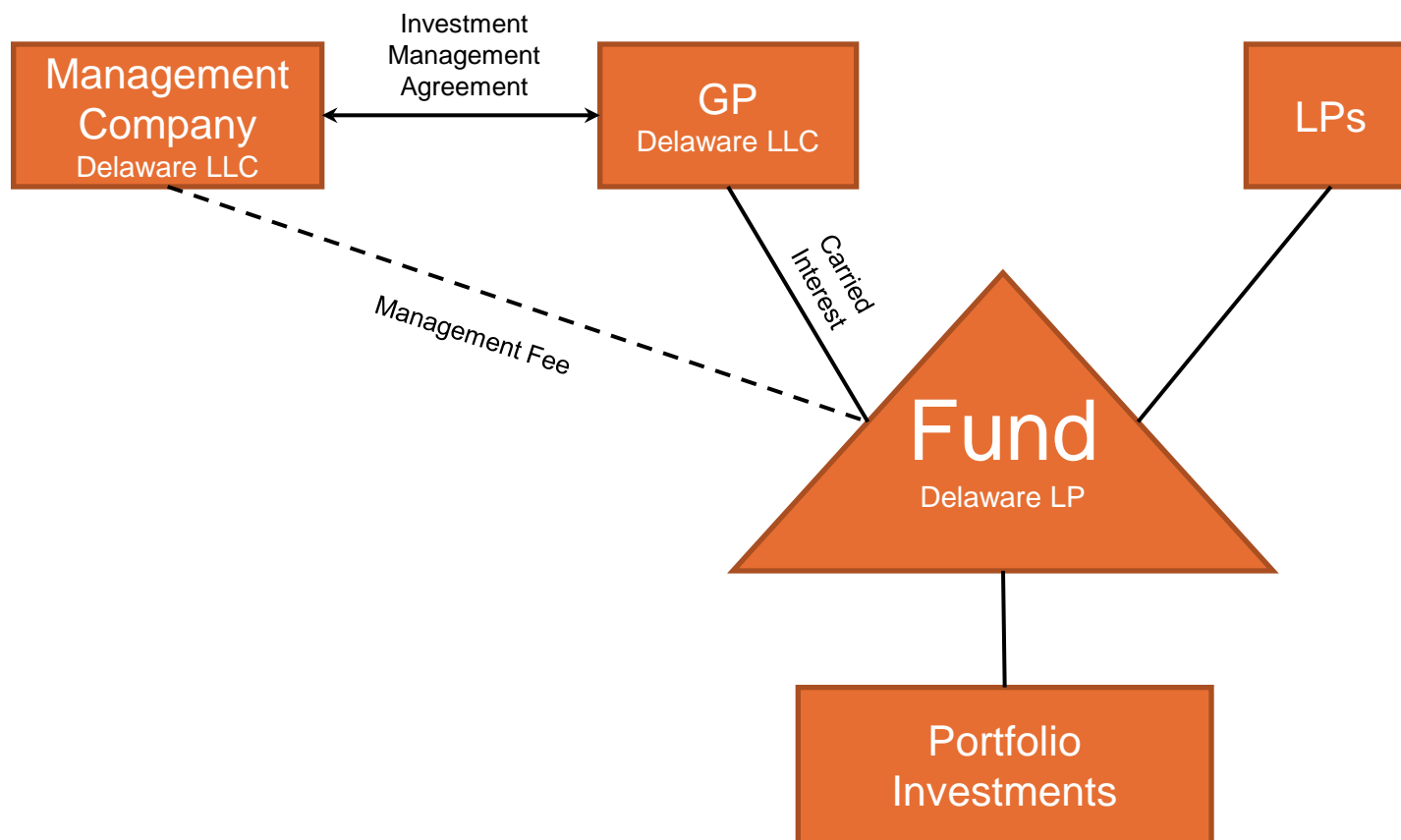
Source: Crypto Fund Research, "Cryptocurrency Investment Fund Industry Graphs and Charts," available at <https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/> (accessed October 15, 2018).



GENERAL FUND STRUCTURE



U.S. LEGAL STRUCTURE (BASELINE)



The Management Company is typically the investment adviser entity that holds the fund sponsor's employees, office lease, intellectual property, etc. The General Partner delegates management responsibility for the fund to the management company in exchange for all management fees that would be payable by the fund to the General Partner.

STRUCTURAL PERMUTATIONS

- If any investors are non-U.S. persons or tax exempt U.S. persons, the fund sponsor might contemplate a parallel fund or master fund structure to mitigate adverse tax implications.
- Such structural permutations often require the formation of a vehicle in an offshore jurisdiction (typically, the Cayman Islands or BVI).

TYPES OF INVESTMENTS / ACTIVITIES

- Virtual Currencies (*i.e.*, Bitcoin, Ether, XRP, EOS, etc.)
- ICO Tokens
- SAFTs and Pre-Sale Instruments
- Beyond investing, some fund managers also may seek to engage in crypto mining activities (both proof of work and proof of stake).
- Blockchain-oriented startups.

▶ ***If the Fund invests in ICOs or SAFTs, the Manager likely will be subject to registration as an investment adviser or exempt reporting adviser.***

GENERAL CONSIDERATIONS

- Fund Administration and Reporting
- Valuation
- Audit
- Custody
- Tax
- Banking
- Cybersecurity
- AML

▶ ***Administration / valuation issues can sometimes make closed end fund structures more cost efficient than hedge fund structures.***

OTHER COMMON ISSUES

- Regulatory Posture of the Manager and Fund
- Investor Qualification
- Adequate Disclosure*
 - Nature of Investments
 - Terms
 - General and Regulatory Risks
 - Conflicts of Interest
- GP Termination Rights
- Warehousing
- Leverage

* The NFA prescribes specific disclosure requirements for FCMs, CPOs and CTAs engaging in virtual currency activities. See <https://www.nfa.futures.org/news/PDF/CFTC/InterpretiveNoticeRegardingMembersVirtualCurrencyDisclosures.pdf>.



OPEN END FUNDS

ADVANTAGES/DISADVANTAGES

- Advantages
 - Investor liquidity.
 - Conducive to trading more liquid assets.
 - Periodic payments of carried interest.
 - Investors invest at current NAV; no make-up contributions.
- Disadvantages
 - Potentially costly periodic valuations.
 - Potentially more complicated fund administration.
 - Short termism / potential volatility.



Assuming a liquid investment strategy, an open end fund structure generally proves more conducive to LPs and the GP alike.

COMMON TERMS

- Management Fee: 1.0% - 2.0% of capital account balance, payable quarterly
- Carried Interest: 20% of net capital appreciation, subject to a high watermark and occasionally a holdback.
- Investor Admission: Monthly / Quarterly
- Investor Lock-up: Six months to one year
- Redemption Windows (Monthly, Quarterly or Annually)
 - Investor Level Gates (more common) and Fund Level Gates (less common)
 - Suspension of NAV
- Side Pockets for Illiquid Investments



CLOSED END FUNDS

ADVANTAGES/DISADVANTAGES

- Advantages
 - Minimize potentially costly periodic valuations.
 - Potentially simpler fund administration.
 - Ride out volatility.
 - Conducive to buy-and-hold and generally illiquid assets.
- Disadvantages
 - No liquidity for investors.
 - Bias towards buy-and-hold as opposed to active trading strategies.
 - Make-up contributions complicated in a volatile market.

CLOSED END FUND TERMS

- Term: Typically 5-10 years
- Fundraising Period: Usually no more than 12 months
- Contributions: 10 days' notice
- Investment Period
 - 2-5 years
 - Thereafter, call for expenses and follow-ons

ECONOMIC TERMS

- Management Fee
 - 1.5-3.0%; typically charged on commitments during investment period and contributions thereafter.
 - Paid quarterly, in advance
- Carried Interest
 - Disproportionate share of profits allocated to the sponsor for managing high-risk investments
 - Typically 20%, but may be lower or higher
- Preferred Return
 - Priority rate of return on investor's contributed capital, usually 8%.
 - Exception: venture funds
- GP Catch-Up
 - GP usually receives a "catch-up" distribution equal to 20% of all profits distributed

DISTRIBUTION WATERFALLS

- European Model
 - Return all contributed capital to LPs before GP gets any carried interest
 - Not deal-by-deal
 - Exception for tax distributions
 - Clawback concerns typically not an issue
- American Model
 - Typically deal-by-deal
 - Raises clawback concerns

▶ ***An American model generally does not make sense for portfolios consisting mostly of liquid cryptocurrencies and ICO tokens.***

The background features a dark blue and black color palette with glowing digital elements. On the left, there's a grid of light blue dots forming a map-like shape. To the right, a bar chart with orange bars is visible. The bottom half of the image is dominated by vertical lines and circles in orange, red, and white, creating a sense of data flow and connectivity.

TAX CONSIDERATIONS

LIMITED PARTNER CONSIDERATIONS

- Blocker entity / Jurisdiction
- State income tax issues
- Compliance burdens

GENERAL PARTNER CONSIDERATIONS

- Standards and norms of fund performance
- Cash flow modeling / Tax withholding
- Distributions:
 - Timing
 - In kind
- Shareholder loans and other repatriation issues
- New U.S. global taxation rules
- Controlled Foreign Corporation (CFC) issues
- Passive Foreign Investment Company (PFIC) issues:
 - Capital gains v. ordinary income
 - QEF Election
 - 1294 Election (undistributed earnings)



VALUATION



VALUATION

- GAAP and Fair Value
- Valuation Policy
- Open End Funds v. Closed End Funds



REGULATORY FRAMEWORK



REGULATORY FRAMEWORK

- Securities Act of 1933
 - Section 4(a)(2) – private placement exemption
 - Regulation D
 - Accredited Investors
 - 506(b) – no general solicitation
 - 506(c) – general solicitation
- Investment Company Act of 1940
 - Section 3(c)(1) Fund – up to 100 investors
 - Section 3(c)(7) Fund – unlimited number of Qualified Purchasers (*i.e.*, not less than \$5 million in investments for individuals)

REGULATORY FRAMEWORK

- Investment Advisers Act of 1940 (“Advisers Act”) and state law
 - Adviser registration or exemptions from registration
 - Carried interest charged only against “qualified clients” (*i.e.*, at least \$1 million invested with sponsor or net worth of \$2.1 million)
 - Performance presentation issues
- Employee Retirement Income Security Act of 1974 (“ERISA”)
 - Plan asset regulations – 25% test
 - Venture Capital Operating Company exemption:
 - At least 50% of assets, valued at cost, in “venture capital investments”*; and
 - Actually exercise “management rights” for one investment during the prior 12-month period

* Not to be confused with “venture capital” definitions under the Advisers Act; look for management rights with respect to operating companies.

REGULATORY FRAMEWORK

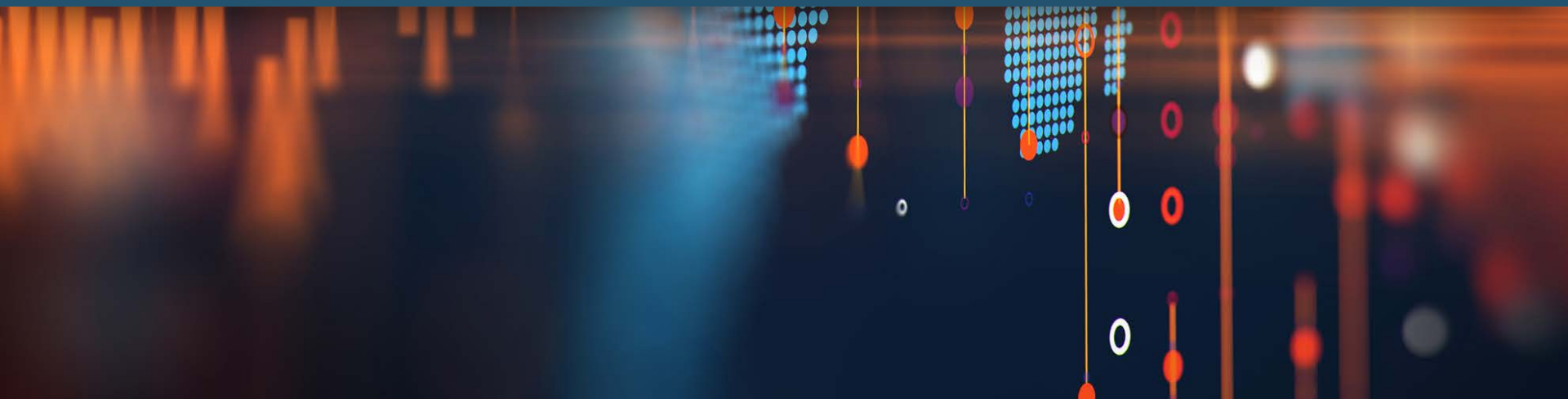
- Commodity Futures Trading Commission
 - Is the Fund manager a commodity pool operator or commodity trading adviser?
 - Has the Fund manager obtained an exemption from being so deemed?
 - Are virtual currency investments subject to “Actual Delivery” within 28 days?
- Overseas Marketing Rules
- New York Bitlicense Regulatory Framework?

CRYPTO FUND MANAGERS

- Depending on the fund investment strategy, may be subject to registration as an investment adviser with the SEC or as an exempt reporting adviser with one or more states.
- Probably not eligible to be a venture capital adviser.
- Funds likely subject to an audit.
- Fund likely should only accept investors who both qualify as “accredited investors” and “qualified clients.”
- Potential application of the custody rule.



CUSTODY



CUSTODY OPTIONS

- Hot wallets
- Cold storage
- “Qualified Custodians”
- Backpacks (??)

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.
- California has its own custody rule, but it does not apply to ERAs.

DIFFICULTIES IN APPLYING THE CUSTODY RULE

- Are fund assets “funds or securities” subject to the Rule?
- How do auditors verify ownership?
- Minimal regulatory guidance.
- A few businesses identify themselves as “qualified custodians,” but do they meet the requirements of the rule? Are they capable of safeguarding the assets and operating in a fast paced trading environment?
- How does one custody crypto?
 - 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?

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.



TOKENIZED FUNDS

THE ASPIRATION

- Solve liquidity problem for venture capital investors
- Raise capital more efficiently using general solicitation process across borders.
- Disintermediate existing VC industry by providing cheaper capital to startups.

THE CHALLENGE

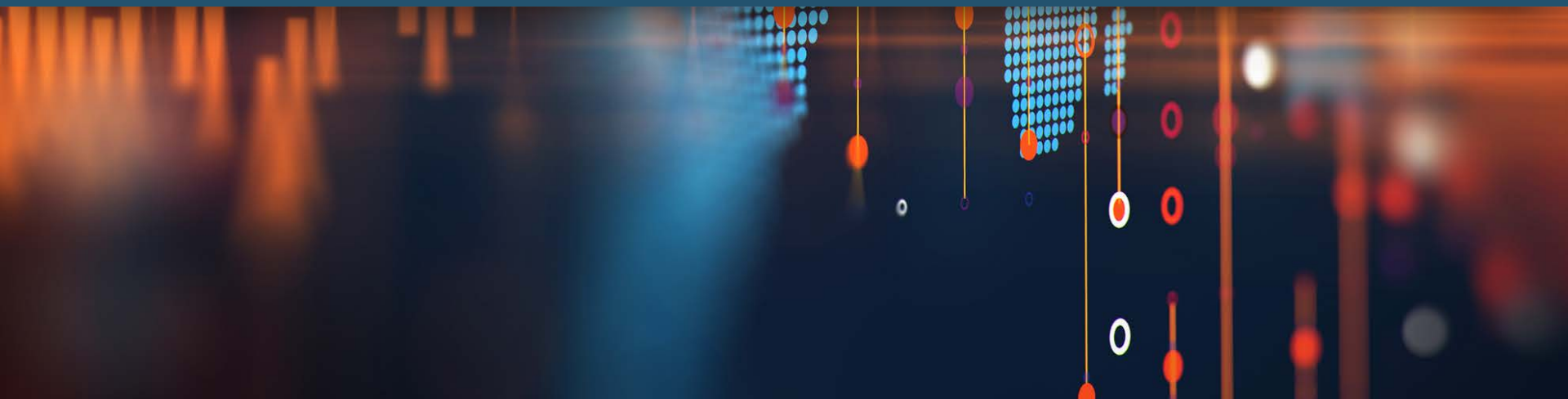
- Transfer restrictions under Rule 506(c).
- Lack of securities exchanges for hosting trading in securities tokens.
- Investor limitations:
 - Accredited Investors
 - Limited number of investors (100 investor limitation if a 3(c)(1) fund).
- Limited float once tokens are issued.
- Tax considerations and administration.

SEARCHING FOR A SOLUTION

- Offshore offering with Regulation S safe harbor.
- Overseas exchanges.



OUTLOOK



OUTLOOK

- Optimistically, with time, new regulatory frameworks:
 - Applications of securities laws to cryptocurrencies and ICOs.
 - Registration of cryptocurrency exchanges as national registered exchanges or alternative trading systems.
 - Custody Rule and maturation of a regulated approach to custody..
 - Cross-border offerings of cryptocurrencies and ICOs.
- Regulatory innovation may occur in correspondence with further technological innovation in blockchain technology, particularly with respect to AML/KYC and cybersecurity.
- A clearer regulatory framework for cryptocurrency exchanges could potentially open new opportunities for both private funds and retail fund products.



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Nicholas Cerasuolo advises technology companies, venture capital/private equity firms and corporate multinationals on a variety of cross-border strategic tax planning transactions, with a specific focus on blockchain, cryptocurrency and tokenization transactions. He has advised on 100+ M&A transactions, both buy-side and sell-side, ranging from \$10m to \$10b during his 10 year career in public accounting. Most recently, he focuses on several initial coin offerings/token launches for US based technology companies. Nicholas provides international restructuring services, cash tax modeling, foreign tax credit planning, due diligence and other transactional and cross-border tax services.

Nicholas is a chartered global management accountant and a certified public accountant.

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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 cryptocurrency offerings. 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.

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