Regulatory Void in Crypto Fund Regulation

By Arina Shulga, Partner at Mitchell Silberberg & Knupp LLP

Introduction

In the past several years, we have witnessed a proliferation of digital assets due to the advent of the Ethereum 2.0 protocol. Digital assets now represent a new asset class in the eyes of the fund managers. According to investing.com, as of February 5, 2019, there were 2,520 different digital currencies that were being traded on multiple digital exchanges throughout the world, with Bitcoin taking 31.81% of the total trading volume. According to CryptoFundResearch, as of February 2019, there were 741 investment funds that invested into digital assets and blockchain, out of which 350 were crypto hedge funds and 372 were crypto venture capital funds, the rest being crypto ETFs and crypto private equity funds. As of January 1, 2019, they collectively managed approximately $10.21 billion (an increase from $6.86 billion as of January 1, 2018). 357 of 741 funds were based in the United States.

There has been significant price volatility in the crypto markets and the prices of several influential digital currencies have decreased over the last few months, which resulted in a slowdown in the crypto fund formation and profitability. However, despite the recent negative market performance, the digital asset class is here to stay and is likely to proliferate.

This overview analyzes the current U.S. laws and regulations applicable to private U.S. crypto investment funds and their managers. It illustrates how, due to the classification of crypto currencies under the existing laws, hedge funds and their managers that invest solely into non-security digital tokens fall outside of the realm of existing U.S. laws and regulations that apply to traditional hedge funds.

Different Types of Digital Assets

Before diving into the analysis of applicable laws and regulations, let us clarify the meaning of the term "digital assets." Digital assets are comprised of various forms of financial instruments that are recorded on a distributed ledger. They include digital currencies (synonymous with crypto currencies), digital tokens that are not currencies but have a utility function and that have been issued through a process referred to as an ICO (initial coin offering) (the so-called "commodity tokens"), and other digital instruments backed by real assets (such as precious metals, real estate, or a mix of crypto currencies).

Currencies

Some digital assets are currencies, just simply a medium of exchange. However, digital currencies are not national currencies. They are not issued by a central bank. They exist in a global world transcending geographic and political boundaries. Bitcoin is one such example. It is exchangeable into traditional currencies, such as U.S. dollar, and is accepted by merchants (e.g. Microsoft, Overstock, Expedia, Cheap Air, etc.) and even one state, Ohio, which appears to be the first U.S. state to accept Bitcoin as payment for taxes. For tax purposes, digital currencies are treated as property, and not as traditional currencies.

Securities or Commodities

Other digital assets are digital tokens that may be treated as securities or commodities under the U.S. laws. Great uncertainty still surrounds the issuance and resale of digital tokens in the United States. Most digital tokens have been issued by companies as means of raising capital to finance their operations through a process unfortunately coined as an "initial coin offering," or an ICO, confusingly referencing an initial public offering, or an IPO. Many ICOs were conducted in an unregistered and unregulated manner with a belief that utility tokens (i.e., digital assets that were issued to function only on a certain platform) were not securities within the meaning of the Securities Act of 1933 but rather resembled commodities. To further complicate the matter, the director of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC"), William Hinman, suggested in his June 14, 2018 speech that some digital tokens that were securities at the time of their issuance could cease being securities when the underlying platform becomes sufficiently decentralized.

New Types of Digital Assets

New types of digital assets like stablecoins and security tokens, have also recently emerged. Stablecoins are cryptocurrencies whose value is tied or pegged to the value of a certain asset that is (typically, but not always) held in reserve. For example, a Tether stablecoin is pegged 1:1 to a U.S. dollar (kept in reserve), so Tether holders can exchange their Tethers into dollars at any time. Other stablecoins are pegged to gold or silver, or a cryptocurrency index. There is an ongoing debate in the legal community as to whether stablecoins should be treated as securities for U.S. federal and state securities law purposes.

Security tokens, on the other hand, are undoubtedly securities. Again, there are different types of security tokens. Some are equity tokens, backed by the stock of a company, which gives tokenholders equal rights, in terms of voting and dividends, to the traditional shareholders. Others are asset tokens that are backed by a reserve of certain assets, such as precious metals (thus resembling stablecoins) or real estate. Finally, there are debt tokens that contain a promise to repay principal and interest.

U.S. Laws Applicable to Investment Funds and Their Managers

Having somewhat categorized the vast universe of digital assets, let us survey the vast universe of U.S. laws and regulations that apply to investment funds and their managers who invest into this asset class. Essentially, there are four federal securities laws that are relevant to our analysis:

1. the Investment Advisers Act of 1940, as amended (the "Advisers Act");

2. the Investment Company Act of 1940, as amended (the "ICA");
3. the Commodity Exchange Act of 1936, as amended (the "CEA"); and
4. the Securities Act of 1933, as amended (the "Securities Act") and the Securities and Exchange Act of 1934, as amended (the "Exchange Act").

1. The Investment Advisers Act

The Advisers Act regulates fund managers and outlines their role and responsibilities. Section 202(a)(11) defines an investment adviser (spelled "advisor") as:

> "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

Note that the Advisers Act regulates those that provide advice and recommendations on securities rather than on other types of financial instruments. Therefore, the question of whether a particular asset is a security becomes paramount in determining whether the provisions of the Advisers Act apply to the activities of a fund manager. If the fund manager advises on investments into security tokens or tokens that have been issued as part of a fundraising process and are, therefore, an "investment contract" under the Howey Test (more on this below), such manager falls under the Advisers Act definition of an "investment adviser," and the Advisers Act applies. Conversely, if the fund manager only advises on utility tokens (gray area) or digital currencies, such manager may not be regulated by the Advisers Act.

Assuming that a fund manager is regulated by the Advisers Act, it must register with either state authorities or with the Securities and Exchange Commission. Registered investment advisers become subject to various rules relating to advertising, custody, record keeping, fees, etc. Among them is the Advisers Act Rule 206(4)-2 known as the Custody Rule. The Custody Rule is about possession, ownership, and control over "client funds or securities." It requires registered investment advisers who have custody of client funds or securities to keep client funds and securities under the care of a "qualified custodian." An argument can be made here that since not all digital assets are "funds or securities," the Custody Rule may not apply to all digital assets (see Question II.3 of the Staff Responses to Questions About the Custody Rule).

However, given the legislative history of the Advisers Act, which makes the protection of investors' assets a priority[1], it is likely that most, if not all, digital assets would be considered "funds or securities" for the purposes of the Advisers Act and the Custody Rule. These assets would, therefore, need to be under the care of a "qualified custodian" -- a role that has traditionally been taken on by prime brokerages. However, there are currently few entities that operate as "qualified custodians" in the sphere of digital assets. Dearth of "qualified custodians" in this space makes it problematic for crypto fund managers to comply with the Custody Rule and increases the risks that arise from transferring private keys to another entity.

However, not all fund managers are required to register with the SEC. In general, subject to certain exceptions, only investment advisers with $100 million or greater in assets under

---

[1]H.R. Report No. 76-2639 (1940); Senate Report No. 76-1744 (1940).

management ("AUM") must so register. Investment advisers with principal place of business in New York can generally register if they have $25 million or more in AUM. Internet-only advisers and advisers that would otherwise be required to register in 15 or more states can register with the SEC regardless of AUM. Certain advisers that are exempt from registration with the SEC or state regulators may still be required to file annual reports as "exempt reporting advisers" or ERAs.

State registration requirements vary considerably. For example, New York requires registration only if the fund manager has more than five New York clients. Registering with a state or filing for an ERA status with a state often subjects the fund managers to regulations similar to those that exist on the federal level.

2. The Investment Company Act

The ICA regulates investment companies and defines them as any company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." For investment companies that do not hold themselves out as such, there is a numerical test in Section 3(a)(1)(C) that qualifies as investment companies entities that hold or intent to acquire "investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."

Investment companies that fall within the above definitions must either register with the SEC or qualify for an exemption. If registered, companies fall under a statutory regime that imposes rules and restrictions on corporate governance, use of leverage, capital structure and trading activities. One of such rules is the ICA Custody Rule that requires registered investment companies to maintain their "securities and similar investments" with certain types of custodians under conditions designed to assure the safety of the fund's assets. Although not all digital assets are securities, it can be assumed that, given the legislative intent of the ICA and similarly to the Advisers Act, digital assets are likely to be included within the definition of "securities and similar investments" and are, therefore, likely to be subject to the ICA Custody Rule.

There are two commonly used exemptions from the definition of "investment company." One is found in Section 3(c)(1) of the ICA. It exempts from ICA registration private funds with less than 100 beneficial owners (or, in the case of a qualifying venture capital fund, 250 persons), subject to look-through rules regarding the ownership. The second exemption is in Section 3(c)(7) of the ICA and exempts funds with unlimited investors that are "qualified purchasers," which is a more restrictive standard than "accredited investors." Most private investment funds are structured to qualify for one of the two exemptions.

3. The Commodities Exchange Act

The CEA regulates the commodities futures market and delegates the regulatory authority over commodities traded as futures, swaps and other derivative contracts to the Commodity Futures Trading Commission (the "CFTC"). Trading of such products must occur on designated exchanges that are overseen by the CFTC. Fund managers that trade or invest in commodity-based futures or derivatives have to register with the National Futures Association as a commodity pool operator (a "CPO") or a commodity trading advisor (a "CTA"), unless an exemption is available. The CFTC has repeatedly declared that virtual currencies are commodities under the CEA and has established jurisdiction over commodity derivative contracts that are based on Bitcoin and other virtual currencies. If, for example, a fund manager traded or invested in Bitcoin futures or binary options, such manager's actions would fall under CFTC regulation and could require registration as a CPO or a CTA.

The CEA applies even if the fund managers do not trade futures or derivatives based on digital currencies. Although its regulatory oversight over commodity cash markets is limited, the CFTC still has general anti-fraud and manipulation enforcement authority over transactions involving digital currencies in interstate cash markets. This was recently confirmed by a New York federal court final judgment, issued on August 23, 2018, against Patrick McDonnell and CabbageTech, Corp. d/b/a Coin Drop Market. CFTC brought the lawsuit and alleged fraud in connection with virtual currencies. On March 6, 2018, the same court issued a memorandum and order in which it analyzed in detail and settled the jurisdiction of the CFTC over virtual currency cash markets.

Therefore, if a fund manager does not engage in transactions in futures or other derivatives that are based on digital currencies, it will largely avoid regulation by the CFTC, except that the CFTC will still maintain its general anti-fraud and manipulation enforcement authority.

4. The Securities Act and the Exchange Act

The Securities Act regulates the offer and sale of interests in the fund to prospective investors. Section 5 of the Securities Act requires all offers and sales of securities to be registered with the SEC unless an exemption from registration is available. It is uncontroverted that limited partnership or limited liability company membership interests in an investment fund are securities if such partners or members are passive investors who invested the money into the fund with an expectation of deriving a profit from the managerial efforts of the fund managers. According to the test developed by the U.S. Supreme Court in the Howey case (SEC v. Howey Co., 328 U.S. 293 (1946)), these are investment contracts, and therefore, securities.

Although funds may rely on a number of exemptions when offering their interests to prospective investors, two exemptions stand out as the most common: those found in Rule 506(b) and Rule 506(c) of Regulation D promulgated under the Securities Act. Neither exemption limits the size of the offering. Rule 506(b) is available for offers and sales to an unlimited number of accredited investors and up to 35 unaccredited but financially sophisticated investors (or, as the Rule defines it, those who "either alone or with his purchaser's representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment …"). If the fund accepts any unaccredited investors, then certain disclosures must be prepared by the fund and provided to such investors. Rule 506(c) is available only for sales to accredited investors whose investor status has been verified by the issuer.

Rule 506(b) does not allow general solicitation of investors or advertising of the offering, prompting the issuer instead to reach out to prospective investors with whom its principals have pre-existing relationships. Rule 506(c), on the other hand, allows the issuer to advertise and solicit, so long as the issuer has a reasonable belief and takes reasonable steps to verify that all of the investors in the offering are accredited. Finally, to be able to rely on either exemption, there must be no "bad actor" disqualification with respect to the fund, its investment manager, affiliates, officers, directors, beneficial owners of 20% or more of its outstanding securities, promoters, general partner, and others engaged in the offering. Offerings pursuant to both exemptions require the filing of Form D with the SEC and “blue sky” notice filings in the states where the investors are from. For additional information on the two exemptions see this Bloomberg Law Comparison Table.

Additionally, all offerings and sales of securities must comply with the anti-fraud provisions of the Securities Act (Section 17(a)) and the Exchange Act (Section 10(b)), which impose liability for fraudulent offers and sales of securities and make it unlawful to “employ any device, scheme, or artifice to defraud,” or “to obtain money or property” by means of false material facts or omissions” or to “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

When raising capital for a fund, the fund managers must comply with the provisions of the Securities Act regardless of the type of assets the fund will invest in because it is the offering that is being regulated, and not the investment fund or its manager.

Some Crypto Funds Fall Through the Cracks

The United States has a complex and comprehensive framework of laws and regulations that govern the activities of traditional investment managers and investment funds, and the offer and sale of interests in such funds. Private funds that invest solely into commodity tokens and digital currencies still fall under the regulation of the Securities Act and the Exchange Act, as well as the general anti-fraud regulation of the CEA. However, because of the recent regulatory pronouncements and decisions, the private crypto funds that invest into commodity tokens and digital currencies fall outside of regulatory framework of the Advisers Act, the ICA, and largely, the CEA.

If a fund invests in security tokens or tokens that are treated as securities because they were issued for fundraising purposes, the fund manager would need to comply with the Advisers Act and the ICA. Becoming a registered investment adviser will subject the fund manager to the Advisers Act Custody Rule compliance, which presents challenges for digital assets. Complying with the provision of ICA limits the type of investors that the fund may have (either up to 100 accredited investors or an unlimited number of qualified purchasers). Further, investing in derivative instruments such as futures contracts or options on digital currencies may render the fund a “commodity pool” and, therefore, require the fund manager to register as a CPO or a CTA.

However, the fund manager will not need to comply with the Advisers Act if it does not engage in the business of advising others as to “the value of securities” or “investing in, purchasing, or selling securities.” Because not all digital assets are securities, limiting investment activities to those instruments that are not securities (e.g. digital currencies) will place the fund managers outside of the reach of the Advisers Act. Similarly, the ICA would not apply if the fund itself is not “in the business of investing, reinvesting, or trading in securities” or if it does not hold “investment securities having a value exceeding 40 per centum of the value of” the issuer’s total assets. Finally, if the fund does not trade or invest in derivate products based on commodities, the fund manager would not be subject to the registration requirements of the CEA. Most of the transactions that involve commodity tokens and digital currencies (which the CFTC views as commodities) do not involve derivative products and are settled either on the spot or for future physical delivery and cash.

However, such crypto funds and fund manager would not be entirely unregulated. The fund will not be able to entirely avoid the CEA even if commodity tokens and digital currencies are its only assets; the CFTC will still have general anti-fraud and manipulation enforcement authority over the fund. Further, the anti-fraud rules of the Securities Act and the Exchange Act would still apply. Any offering and sale of the interests in the fund would also have to comply with the provisions and limitations of the Securities Act.

Conclusion

As the digital asset class grows and matures, fund managers may structure their fund investment strategies in multiple ways. Although there is a myriad of laws and regulations that generally apply to funds and fund managers, there is a regulatory gap when it comes to funds that operate solely within a certain subset of the digital asset space. Perhaps we will see additional regulation in this space in the near future. Until then, the regulatory gap is there and is vulnerable to exploitation.