# Blockchain and Digital Assets

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Stephanie is co-head of the Investment Management Group and a member of the firm's Executive Committee and Operating Committee. She maintains a diverse practice that includes liquid funds, private equity funds and the structuring of investment management businesses. She focuses her practice on the formation of private equity funds (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds, hybrid funds, credit funds and activist funds) as well as providing regulatory advice to investment managers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses and funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

Recently serving as chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of former Third Way Capital Markets Initiative, a former member of the Board of Directors and current member of 100 Women in Finance, a member of the Board of Visitors of Columbia Law School and a member of the Board of Directors of the Girl Scouts of Greater New York. Stephanie has received the highest industry honors. She was named to the inaugural *Legal 500 US* Hall of Fame in the category of "Investment Fund Formation and Management: Alternative/Hedge Funds." Stephanie is also listed in *Chambers USA: America's Leading Lawyers*, *Chambers Global: The World's Leading Lawyers*, *Crain's* Notable Women in Law, *IFLR1000*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the Who's Who Legal Awards 2014 and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. Stephanie's representation of leading private investment funds has won numerous awards, including most recently *Law360*'s Asset Management Practice Group of the Year. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute), co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private*

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Don is co-head of the Bank Regulatory Group. He focuses his practice on the regulation of banks, thrifts and licensed financial services providers, and specifically the regulation, acquisition and sale of payments companies and money transmitters, and the laws and practices applicable to mobile, digital, virtual, electronic, paper- and card-based payment products and systems. Don has represented leading banks, payments companies, card associations, money transmitters and private equity firms in transactional and regulatory matters associated with payments, prepaid cards, digital currencies and money transmission, including the negotiation of payments products and processing agreements.

Don has been recognized by *IFLR1000*, *The Legal 500 US* and *New York Super Lawyers* as a leading attorney in banking, mergers and acquisitions and consumer law. Don is a frequent author and public speaker on topics of interest to the prepaid card industry. He spoke on "The Future of Virtual and Crypto Currencies, Tokenization and the ICO Phenomenon" at ACI's Legal, Regulatory and Compliance Forum on FinTech and Emerging Payment Systems Conference, "Prepaid Card Compliance 101: An In-depth Guide To Compliance Essentials for Financial Institutions, Issuing Banks, and Other Industry Players" at ACI's 18th National Forum on Prepaid Card Compliance, "State Money Transmitter Licensing Laws: Are They Killing Payments Industry Innovation?" at the Money20/20 Conference and on "Prepaid Access" at the Money Transmitter Regulators Association Annual Conference & Examiners' School. His recent publications include co-authoring the *SRZ Alerts* "FinCEN and Federal Banking Agencies Issue Statement on Pooling Resources for BSA Compliance," "OCC Begins Accepting Fintech Charter Applications," and "NYDFS Issues Guidance to Deter Fraud and Manipulation in Virtual Currency Markets." Don received his J.D., *cum laude*, from St. John's University School of Law, where he served as notes and comments editor of the *St. John's Law Review*. He earned his B.A. from the State University of New York at Stony Brook.

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Julian is listed in *Chambers USA* and *The Legal 500 US* as a leading financial services regulatory lawyer. A recognized thought leader, he co-authored the *SRZ Alert* "SEC Adopts New Transparency Requirements for NMS Stock Alternative Trading Systems," which was republished in *Law360*. He also co-authored the *SRZ Alert* "Cross-Border Implementation of MiFID II Research Provisions – SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance" and he was featured in "Execution Enforcement Actions Escalate," both published in *The Hedge Fund Journal*. Julian earned his J.D. from American University Washington College of Law and his B.A. from Dickinson College.

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## Craig S. Warkol

Craig is co-chair of the Broker-Dealer Regulatory & Enforcement Group. His practice focuses on securities enforcement and regulatory matters for broker-dealers, private funds, financial institutions, companies and individuals. Drawing on his experience both as a former enforcement attorney with the SEC and as a Special Assistant U.S. Attorney, Craig advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA and other self-regulatory organizations and state regulators. He also represents clients in connection with regulatory and enforcement matters related to blockchain technology and digital assets. Craig leads training sessions for clients on complying with insider trading and market manipulation laws and assists hedge funds and private equity funds in connection with SEC examinations. Craig also has experience representing entities and individuals under investigation for, or charged with, securities fraud, mail/wire fraud, accounting fraud, money laundering, Foreign Corrupt Practices Act violations and tax offenses. In his previous roles in the U.S. Attorney's Office for the Eastern District of New York and the SEC, Craig prosecuted numerous complex and high-profile securities fraud, accounting fraud and insider trading cases.

Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written about enforcement actions against hedge funds and other industry-related topics. Most recently, he co-authored the *SRZ Alert* "SEC Charges Hedge Fund Manager with Short-and-Distort Scheme," which was republished in *The Hedge Fund Journal*. Craig earned his J.D., *cum laude*, from Benjamin N. Cardozo School of Law and his B.A. from University of Michigan.

# Blockchain and Digital Assets

## I. Definitions

A. Cryptocurrency – A digital or virtual currency that utilizes encryption and cryptography to control the generation of new units of currency as well as secure and verify transactions of that currency.

B. App or Use Token – A special kind of virtual currency token that resides on its own blockchain and represents an asset or utility.

C. Decentralized Ledger – A ledger of transactions or contracts maintained in a decentralized form across different locations and people, eliminating the need of a central authority to keep a check against manipulation; all the information on it is stored using cryptography and can be accessed using keys and cryptographic signatures.

D. Private/Public Hash – A private hash/key consists of alphanumerical characters that gives a user access and control over their funds to their corresponding cryptocurrency address; the private key is used to sign transactions that allow the user to spend their funds. A public hash/key also consists of alphanumeric characters generated by the private key to an account and this can be publicly shared so that miners can verify digitally signed transactions; a user's private key is private to the user and the public key is known to everyone.

E. Initial Coin Offerings ("ICOs") – An event in which a new cryptocurrency sells advance tokens from its overall Coinbase, in exchange for upfront capital; frequently used for developers of a new cryptocurrency to raise capital; similar to an IPO.

F. SAFT/SAFE – A Simple Agreement for Future Tokens ("SAFT") is a form of fundraising, intended for digital-currency startups and directed at accredited investors, which promises tokens when the project or company becomes operational; while a SAFT sounds very similar to a standard ICO, the difference is that under an ICO the tokens are issued immediately; under a SAFT it is a promise to deliver tokens.

A Simple Agreement for Future Equity ("SAFE") is an agreement between an investor and a company that provides rights to the investor for future equity in the company similar to a warrant, except without determining a specific price per share at the time of the initial investment. The SAFE investor receives the futures shares when a priced round of investment or liquidation event occurs. SAFEs are intended to provide a simpler mechanism for startups to seek initial funding than convertible notes.

G. Stable Coin – A cryptocurrency designed to minimize the effects of price volatility; to minimize volatility, the value of the stable coin can be pegged to a currency, or to exchange traded commodities; stable coins backed and collateralized by currencies or commodities directly are said to be centralized, whereas those leveraging other cryptocurrencies are referred to as decentralized.

H. Staking – Using the Proof of Stake algorithm that is the basis of many new cryptocurrencies, staking involves the purchase of cryptocoins and holding them in a wallet for a particular period of time (akin to a fixed deposit in the non-digital currency sphere). This enables the protocol to update without minting new coins.

I. Blockchain – The public, decentralized ledger in a cryptocurrency network that records all transactions of that cryptocurrency.

 

J. Smart Contract Protocol – A computerized transaction protocol that executes the terms of a contract; smart contracts can be automatically executed by a computing system, such as a suitable distributed ledger system.

## II. Fund Products

A. Wallet Funds

1. The basic vehicle that is offered is essentially a wallet. A wallet fund invests in cryptocurrency and pays cash back to investors when they decide to redeem. These funds provide value to investors by buying and storing digital assets safely, but the fund does not make the strategic decision of when to trade in and out.

2. The terms for these vehicles typically include:

(a) Frequent (if not daily) liquidity;

(b) Modest management fees; and

(c) No incentive fee.

B. Funds That Invest in Multiple Cryptocurrencies

1. More recent products strategically invest in multiple cryptocurrencies. These funds allow managers to diversify their portfolio and make strategic bets on particular currencies. Funds also may be able to short cryptocurrencies that the sponsor thinks are overvalued.

2. Fund terms:

(a) An incentive fee may be charged; and

(b) Liquidity will likely be no more frequently than quarterly.

C. Funds That Invest in Venture Capital Companies

Funds may also invest in blockchain technology. Funds that invest in blockchain-related venture companies cannot provide liquidity and cannot easily justify charging fees based on mark-to-market values. Instead, they will probably be written to hold assets for a period of years and then pay investors out as assets are offered through an IPO or sold.

D. ICOs

1. The risks of ICOs are greater because they are not yet tested in the market. The Bitcoin protocol has been used globally for an extended period of time. On the other hand, newer currencies and their underlying protocols are more speculative, and generally the ICO is issued before the cryptocurrency it represents has been launched. U.S. Securities and Exchange Commission Chairman Jay Clayton, in a public statement addressing cryptocurrencies and ICOs, noted the concern that there is less investor protection and more opportunities for fraud and manipulation.[1]

[1] *See* Public Statement, "Statement on Cryptocurrencies and Initial Coin Offerings" (Dec. 11, 2017) *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

 

2. If the underlying asset in an ICO is a token, it is important to think about what that token represents. A token that functions like stock of an ICO issuer will be a security, with its own layers of regulation. A token that can be converted into a precious metal may be a commodity. A SAFT is a contract to buy crypto assets in the future. Depending on what will be bought, a SAFT could be a derivative, a security or neither.

E. Audit Issues

Other issues to think about when raising or investing in digital asset funds are how to structure a fund so that it is not a cryptocurrency exchange, and how crypto assets should be stored, audited and traded. Registered investment advisers ("RIAs") will also need to have auditors who can provide statements on time. Given the complexity and volatility of crypto assets, many accounting firms have refrained from auditing crypto assets.

F. Offering Issues

1. Consider offering with public advertising under Rule 506(c).

2. If a fund will hold securities, it needs to comply with Sections 3(c)(1)-3(c)(7).

3. Publicly traded partnership issues if frequent liquidity and more than 99 investors.

G. New Developments

1. Institutional investors are beginning to invest in this space.

2. Some managers are now registered as RIAs.

3. Increased interest in stable coins.

4. Increased regulatory focus on exchanges.

5. First settlements on ICOs treated as securities.

6. SEC once again denied the Winklevoss twins' effort to launch cryptocurrency.

7. Plunge in Bitcoin prices.

8. Substantial slowdown of ICO token trading.

## III. Regulatory and Compliance Issues

A. Are Digital Currencies Securities?

1. The issue is what is meant by "currency." The Commodity Futures Trading Commission ("CFTC") has asserted jurisdiction over "pure play" digital currencies, such as Bitcoin, but the SEC has asserted jurisdiction over "digital coins" or "digital tokens." In July 2017, the SEC released a Report of Investigation on an offering of digital tokens by an entity called "The DAO."[2] After examining The DAO's digital tokens under the *Howey* test, the SEC concluded that The DAO tokens were securities under the Securities Act of 1934 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), as the tokens essentially looked like the issuance of stock. In a recent order, the SEC explained that a token can be a

[2] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017).

 

security based on the long-standing facts and circumstances test, which includes assessing whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.[3]

2. In determining whether digital currencies are securities, regulators seem to be applying a functional and resemblance approach. Where a digital asset looks more like an investment contract or another variety of security (e.g., if it is an investment in a common enterprise with an expectation of profits to be derived from the efforts of others) the SEC will expect the requirements of the Securities and Exchange Acts to be followed.

B. Registration Issues

If a fund manager is advising others on trading digital assets that are securities, they may have to register with the SEC as an investment adviser. If a manager is required to register it will have to comply with the custody rule, which requires client funds and securities to be maintained with qualified custodians in an account either under the client's name or under the name of an agent or trustee of the client. Also consider exempt reporting adviser registration.

C. SEC Jurisdiction

Vehicles such as ETFs holding digital currencies clearly fall within the jurisdiction of the SEC. The SEC has rejected applications for Bitcoin on the basis of the fact that there is too much room for manipulation in the underlying instruments (a factor the SEC must consider before approving an ETF) given the largely unregulated nature of Bitcoin exchanges. However, Bitcoin futures are now being issued on major exchanges such as the Chicago Mercantile Exchange ("CME") and the Chicago Board Options Exchange ("CBOE"). A more robust futures market may ease the SEC's concerns about potential market manipulation. Since the launch of futures contracts by the CME and CBOE, several more applications for Bitcoin ETFs have been filed with the SEC.

D. Custody

RIAs are subject to Rule 206(4)-2, the Custody Rule, which generally requires that "client funds and securities" be held at a "qualified custodian." An increasing number of businesses are beginning to offer custodial services for digital assets but compliance with this aspect of the Custody Rule remains challenging.

E. SEC Enforcement

*Unregistered Offerings*

1. In December 2017, the SEC ordered a company selling digital tokens to investors to halt its ICO and refund investor proceeds after the SEC found that the ICO constituted the offer and sale of unregistered securities.[4] During the course of the ICO, the company, which was selling digital tokens to raise capital for its blockchain-based food review service, emphasized that investors could expect that efforts by the company and others would lead to an increase in the value of the tokens, and that the company would create and support a secondary market for the tokens. According to the SEC's order, the digital tokens should have been classified as an investment contract requiring SEC registration because purchasers for the tokens had a reasonable expectation of making a profit on their investment. Notably, this was the SEC's first time shutting down an ICO without alleging fraud, demonstrating the widening breadth of scrutiny on ICOs.

[3] *See In the Matter of Munchee Inc.*, File No. 3-18304 (Dec. 11, 2017).

[4] *See In the Matter of Munchee Inc.*, File No. 3-18304 (Dec. 11, 2017).

 

2. In November 2018, the SEC settled charges against two companies for failing to register ICOs.[5] Both companies held their ICOs after the SEC released the DAO Report, cautioning that those who offer and sell digital securities must comply with the federal securities laws. The SEC found that each company's token was a security under the *Howey* test, and neither company registered their ICOs as securities offerings or qualified for registration exemptions. These were the SEC's first cases imposing civil penalties solely for ICO securities offering registration violations. The SEC enjoined the defendants from violating Sections 5(a) and 5(c) of the Securities Act, and ordered each defendant to compensate harmed investors and pay civil penalties.

*Unregistered Exchanges and Brokerage Activity*

1. In November 2018, the SEC settled charges against the founder of a digital "token" trading platform for operating an unregistered securities exchange.[6] The SEC found that the platform allowed users to trade tokens that the SEC considers to be securities, making it an unregistered securities exchange. This was the SEC's first enforcement action based on findings that such a platform operated as an unregistered national securities exchange. The SEC enjoined the defendant from violating Section 5 of the Exchange Act, and ordered the defendant to pay disgorgement and civil penalties.

2. In February 2018, the SEC charged a company and its founder with operating an unregistered online securities exchange and defrauding users of the exchange.[7] The SEC also charged the operator of the exchange with making false and misleading statements in connection with an unregistered offering of securities. In the charges, the SEC alleged that the defendants misappropriated customer Bitcoins and failed to disclose a cyberattack that resulted in the theft of a significant number of Bitcoins. The SEC also alleged that the defendants sold unregistered securities that purported to be investments in the exchange and misappropriated funds from that investment. The SEC sought to enjoin the defendants from violating Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

3. In September 2018, the SEC settled charges against a self-described "ICO Superstore" and its owners for acting as unregistered broker-dealers.[8] The SEC found that the company, which promoted its website as a marketplace for purchasing ICOs and as a secondary digital asset trading site, was soliciting investors for securities transactions and facilitating the sale of digital tokens as part of ICOs. This was the SEC's first case charging unregistered broker-dealers for selling digital tokens after the SEC issued the DAO Report. The SEC enjoined the defendants from violating Section 15(a) of the Exchange Act and Sections 5(a) and 5(c) of the Securities Act, and ordered the defendants to pay disgorgement and civil penalties.

*Fraud*

1. In June 2017, the SEC obtained a final judgment against two Bitcoin mining companies for defrauding investors.[9] The defendants offered shares to investors in their mining operation, but the defendants did not own enough computing power for the mining they promised to conduct. The SEC found that the companies sold what they did not own, misrepresented what they were selling, and robbed one investor

[5] *See* Press Release, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities (Nov. 16, 2018); *available at* https://www.sec.gov/news/press-release/2018-264

[6] *See* Press Release, SEC Charges EtherDelta Founder With Operating an Unregistered Exchange (Nov. 8, 2018); *available at* https://www.sec.gov/news/press-release/2018-258

[7] *See* Press Release, SEC Charges Former Bitcoin-Denominated Exchange and Operator With Fraud (Feb. 21, 2018); *available at* https://www.sec.gov/news/press-release/2018-23

[8] *See* Press Release, SEC Charges ICO Superstore and Owners With Operating as Unregistered Broker-Dealers (Sept. 11, 2018); *available at* https://www.sec.gov/news/press-release/2018-185

[9] *See* Litigation Release No. 23852 (June 5, 2017).

 

to pay another. The U.S. District Court for the District of Connecticut enjoined the defendants from violating Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and ordered each defendant to pay disgorgement and civil penalties.

2. In September 2017, the SEC charged an individual and two companies with defrauding investors through the offering of ICOs backed by investments in real estate and diamonds. The SEC alleged that the defendants were selling unregistered securities and that the underlying assets did not exist.[10] Further, the defendants made material misstatements and misrepresentations to investors about how the ICO proceeds would be invested and how much money they had raised. The SEC sought to enjoin the defendants from violating Section 10(b) of the Exchange Act, and Rule 10b-5(a)-(c) promulgated thereunder.

3. In December 2018, the SEC obtained a final judgment against two executives for defrauding investors.[11] The defendants were accused of, among other things, offering and selling unregistered investments in their purported cryptocurrency by falsely depicting their company as a first-of-its-kind decentralized bank offering a variety of services to retail investors, but the firm was not authorized to conduct banking services and the defendants instead used investor money for personal expenses. The U.S. District Court for the Northern District of Texas enjoined the defendants from violating Section 10(b) of the Exchange Act and Rule 10b-5(b) promulgated thereunder, and ordered each defendant to pay disgorgement and civil penalties. Further, the defendants were also barred from participating in future offerings of digital securities. This is the first and only instance to date of such a bar being imposed.

F. CFTC Regulation

1. In a 2015 ruling, the CFTC issued an order against an online platform and its CEO for facilitating trading in Bitcoin options contracts.[12] The key takeaway was that the CFTC asserted that virtual currencies are considered commodities. This assertion is meaningful in three ways.

   (a) First, it means that the CFTC considers itself to have jurisdiction over virtual currency derivatives, as they could now be considered "commodity futures" or "commodity options."

   (b) Second, it means that the CFTC has jurisdiction over virtual currency OTC instruments such as "swaps."

   (c) Third, while the CFTC does not have jurisdiction over trading of digital assets, it can still assert jurisdiction over the spot market if it believes that manipulation of the spot market will affect the derivatives markets. The CFTC historically has brought enforcement actions for manipulation of the spot FX and agricultural markets — markets it technically does not have direct jurisdiction over. The CFTC could do the same for digital assets if it believes that it is affecting the derivatives market.

2. Impact on fund managers

   (a) Funds that are holding digital currency derivatives may be considered "commodity pools" and will need to either register with the CFTC or comply with the Commodity Pool Operator *de minimis* exemption.

[10] *See* Press Release, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017); *available at* https://www.sec.gov/news/press-release/2017-185-0.

[11] *See* Press Release, Executives Settle ICO Scam Charges (Dec. 12, 2018); available at https://www.sec.gov/news/press-release/2018-280.

[12] *See In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan* (Sept. 17, 2015).

 

(b) While funds that are currently only holding digital assets but are not trading any CFTC-regulated instruments would not be commodity pools, those fund managers should also consider whether they need the capability to hedge this exposure with derivatives.

(c) Firms that offer to buy and sell Bitcoin derivatives will be considered "futures exchanges," which would require such firms to be registered with the CFTC as derivatives contract markets.

G. Compliance Policies

1. Personal trading.

2. MNPI issues.

3. Rule 144 holding periods.

4. Valuation.

## IV. Tax Aspects

A. Characterization of Virtual Currency for U.S. Federal Tax Purposes

1. The Internal Revenue Service ("Service") provided guidance in Notice 2014-21 that virtual currency (e.g., Bitcoin, Ethereum, Litecoin, etc.) generally is treated as property for U.S. federal tax purposes and is not considered a "currency" that would trigger foreign currency gain or loss under Section 988 of the Code. As property, the character of gain or loss from the sale or exchange of virtual currency generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Accordingly, taxpayers who hold virtual currency as a capital asset should recognize capital gain or loss on the disposition of such virtual currency.

2. Unlike the CFTC, the Service has not clarified whether or not virtual currencies are characterized as commodities for U.S. federal tax purposes.

3. Some virtual currencies, such as Bitcoin, function as media of exchange. Others, however, exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange. The tax treatment of such virtual currencies or other such digital assets may be characterized as equity interests in an underlying constructive joint venture or association, in which case owners of such digital assets may be taxable on their share of any items of income deemed allocated or deemed distributed from the constructive joint venture or association to them.

B. Considerations for Investment Funds Investing in Virtual Currencies

1. *Publicly Traded Partnerships.* Investment funds operating as partnerships for U.S. federal tax purposes generally operate in a manner so as to avoid being treated as "publicly traded partnerships" ("PTPs") taxable as corporations within the meaning of Section 7704 of the Code. Many investment funds (especially long-short equity funds) rely on the "qualifying income" exception for PTP purposes. The characterization of virtual currency as a "commodity," or otherwise, could affect an investment fund's ability to satisfy the qualifying income exception. Alternatively, virtual currency investment funds that offer frequent liquidity to their investors could restrict their investor base to fewer than 100 partners in order to satisfy the "100-partner" PTP safe harbor.

2. *Mark-to-Market Elections.* The mark-to-market election under Section 475(f) of the Code could apply to virtual currencies, if virtual currencies are characterized as "securities" or "commodities."

 

3. *Effectively Connected Income and the Trading Safe Harbors.* Investment funds generally rely on Section 864(b)(2) safe harbors to avoid treating income and gain from trading in securities and commodities as effectively connected with a U.S. trade or business. The Service has yet to provide guidance on whether or not virtual currencies constitute securities or commodities. Furthermore, even if virtual currencies constitute commodities, not all commodities fall under the commodities safe harbor — only those that are "of a kind customarily dealt in on an organized commodity exchange" and even then, only if the transactions effected in such commodities are "of a kind customarily consummated at such place." The Service currently does not offer guidance on these aspects of the commodities trading safe harbor.

4. *Virtual Currencies and ICOs as Deemed Equity Interests.* Virtual currencies that exhibit characteristics that resemble securities or otherwise function as other than a medium of exchange, such as certain ICOs, may be characterized by the Service as equity interests in an underlying constructive joint venture or association for U.S. federal tax purposes. An investment in such virtual currencies or ICOs that would be treated as constructive joint ventures or associations for U.S. federal tax purposes may cause non-U.S. investors or tax-exempt U.S. investors to earn effectively connected income or unrelated business taxable income, respectively. Furthermore, if the constructive joint venture or association were regarded as a foreign corporation, U.S. investors may be subject to certain anti-deferral rules (e.g., PFIC, CFC, etc.) with respect to any income or deemed income of the constructive joint venture or association.

## V. Money Transmission

A. Fund managers that manage funds that invest in digital assets directly, or invest in companies that issue, sell or exchange digital assets, should be aware of the potential applicability of state and federal money transmission laws.

B. State Regulation

1. Nearly all U.S. states regulate money transmission, typically defined as: receipt of money or monetary value for transmission; sale or issuance of payment instruments; or sale or issuance of stored value that can be redeemed for cash or at multiple, unaffiliated merchants (commonly referred to as "open-loop" stored value). Many states also regulate currency exchange under money transmission regulations.

2. A small but increasing minority of states, by statute or guidance, have interpreted monetary value, "money or its equivalent" or similar terms to include certain digital assets, including virtual currency, that function as a medium of exchange. Accordingly, transmitting digital assets to a third party, issuing digital assets or storing digital assets for others, may require a state money transmission license.

3. For example, the Alabama Monetary Transmission Act, effective August 2017, defines "monetary value" as "[a] medium of exchange, including virtual or fiat currencies, whether or not redeemable in money." The act requires persons engaging in the business of receiving monetary value, including virtual currencies, to obtain a money transmitter license.

4. The New York State Department of Financial Services has also adopted regulations requiring a license (commonly known as a "BitLicense") for any person engaged in virtual currency business activity, which is defined as:

(a) Receiving virtual currency for transmission or transmitting virtual currency (subject to an exception for transactions undertaken for non-financial purposes and not involving a transfer of more than a nominal amount of virtual currency);

(b) Storing, holding or maintaining custody or control of virtual currency on behalf of others;

 

(c) Buying and selling virtual currency as a customer business;

(d) Performing exchange services as a customer business; or

(e) Controlling, administering or issuing a virtual currency.

5. Although the Texas Department of Banking has concluded that cryptocurrency is not "money or monetary value" because it is not currency and does not represent a claim that can be converted into currency, it has advised that *stablecoins* that are pegged to sovereign currency may be considered a claim that can be converted into currency and thus fall within the definition of money or monetary value under the [Texas Money Transmitter Act]. *See* Texas Supervisory Memo – 1037 (Jan. 2, 2019).

6. Applicable state laws do, however, contain certain exemptions:

(a) Banks (generally exempt in all states);

(b) Limited Purpose Trust Companies (generally exempt in many states); and

(c) Registered broker-dealers (expressly exempt in certain states, to the extent of its operation as such a broker-dealer; registered broker-dealers may be exempt in many other states as a matter of policy; however, not exempt under NY BitLicense if engaging in virtual currency business activity).

C. Federal Regulation

1. On March 18, 2013, the Financial Crimes Enforcement Network ("FinCEN") issued guidance entitled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," clarifying how the Bank Secrecy Act implementing regulations ("BSA Regulations") apply to "users," "administrators" and "exchangers" of "convertible virtual currency," which is defined as virtual currency that "has either an equivalent value in real currency, or acts as a substitute for real currency."

2. The guidance provides that an "administrator" or "exchanger" that (i) accepts and transmits a convertible virtual currency or (ii) buys or sells convertible virtual currency for any reason is a money transmitter and therefore a "money services business" ("MSB") under the BSA Regulations, subject to any applicable limitation or exemption.

(a) An "administrator" of virtual currency under the guidance is defined as "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency."

(b) An "exchanger" of virtual currency is defined as "a person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency."

(c) The guidance also provides that "users" of convertible virtual currency are not considered MSBs under the BSA Regulations.

3. The BSA Regulations require all MSBs to establish and maintain an effective written anti-money laundering program reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities. Accordingly, any fund manager or fund engaged in activities involving convertible virtual currencies should assess the impact of the guidance on their obligations under the BSA Regulations.

 

D. Evaluation of the application of state and federal money transmission laws to activities involving digital assets, such as virtual currencies, and to the persons or companies, issuing, selling or exchanging such assets is an important component of investor diligence and as part of the fund's comprehensive compliance program. Fund managers should conduct diligence on all parties involved in the issuance, sale or exchange of digital assets (including digital assets created via ICOs) to ensure that all parties have the appropriate licenses/registrations. In addition, each fund engaging in activities involving digital assets will need to evaluate its own activities to ensure that the fund does not engage in activities that require a money transmission license/registration. In this context, important questions to consider are whether the fund is:

    1. Holding digital assets (that function as a medium of exchange or convertible virtual currency) on behalf of others, or for its own account;

    2. Performing exchange services for investors, or if it is only accepting investments in real currency for interests in the fund and redeeming those interests for the same type of real currency; or

    3. Buying and selling digital assets (that function as a medium of exchange or convertible virtual currency) as a business, or solely as an investor.

E. Fund managers should also be aware that an investment of the fund in any company that is engaging in, or proposes to engage in, a licensable activity, that aggregates to ownership interest in such a company of 10 percent or more, may require the fund to register as a "control person" under state money transmission laws. Such registration may require the provision of background, biographical and/or financial information to states. Ownership may be by shares or digital assets representing an ownership interest.

F. Internal Regulation

    1. Increased regulation and cooperation among nations.

    2. The Financial Action Task Force ("FATF"), an inter-governmental body established in 1989 to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the international financial system, updated its policies regarding digital currencies and firms involved in cryptocurrency-related activities in October 2019.

 

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