

BLOCKCHAIN AND CRYPTOCURRENCIES

Legal Issues Faced by Investors in Cryptocurrencies

Presented by Seward & Kissel's Blockchain and Cryptocurrency Group

What This Presentation Will Cover

- Brief Introduction of Terms
- Introducing the S&K Coin
- Is This a Passing Fad?
- The Offer and Sale of Cryptoassets
- Valuation and Custody of Cryptoassets
- Cryptoassets as Commodities
- Cryptoassets as Collateral
- Cryptoassets in Bankruptcy
- Tax Considerations
- Questions

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Brief Introduction of Terms

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Coins, Tokens, Cryptos, Oh My!

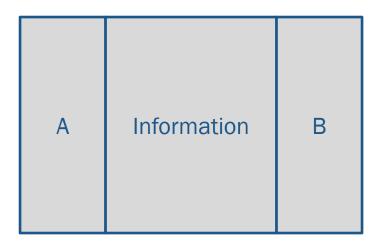
- Area uses much jargon and many confusing terms
 - Coins
 - Tokens
 - Cryptocurrencies or Virtual Currencies
 - While there are some important distinctions, often used interchangeably which adds to confusion
 - "Cryptoassets"— What they all have in common is that they are based on blockchain and distributed ledger technology

Some Terms and Definitions

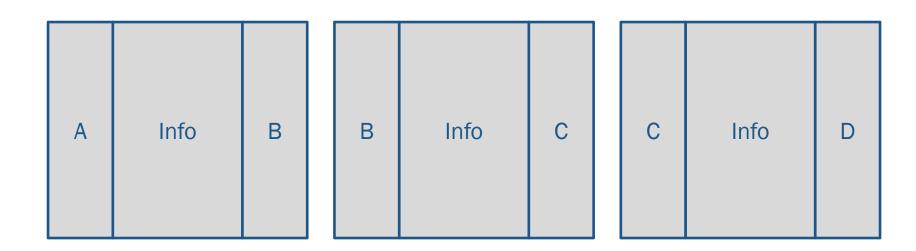
Blockchain

- Way to keep record of transactions
- In theory, each transaction for a particular unit is represented in a block
- But "pruning" may occur
- Blockchain generally uses distributed ledger technology (DLT)
- Blockchain generally is de-centralized but blockchains with "central" authority are possible

- Each block contains three sets of information:
 - The transaction information stored in the block
 - The "hash" of the previous block ("A")
 - The "hash" of the new block ("B")

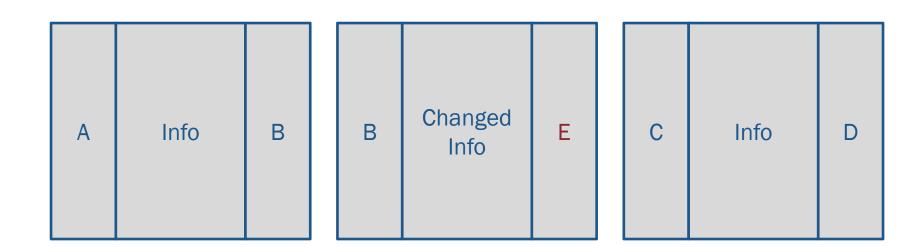


 Blocks form a chain, matching hashes like points on dominoes, with each new block added at the end of the chain



Any change in the block causes its hash to change

 Safeguard 1: if someone changes the info in the block, its hash will change and the chain no longer recognizes the block as legitimate



 A hacker could work around this by changing all of the subsequent blocks as well

- Safeguard 2: Make it "expensive" to change a block
 - Solving a mathematical equation, which takes time, computing power and energy ("Proof of Work")
 - Ponying up an ante ("Proof of Stake")
- Safeguard 3: Have many recordkeepers keep the same information, publicly
 - Distributed ledger technology
 - Designed to take record-keeping out of the hands of a central authority
 - Open data system
 - Anyone can join as recordkeeper ("nodes")
 - Anyone can see (blockexplorer.com)
 - Majority rule

Terms and Definitions

- Public Address and Private Key
 - Both keys are necessary to sign a valid transaction
 - Public address shows at which address the asset resides.
 - House at 116 Main Street
 - o Identity of owner is not public
 - Private key allows access to the asset
 - Cannot use the asset without the key
 - ✓ Loss of key is catastrophic
 - o The key for 116 Main Street does not open the door to 117 Main Street

Terms and Definitions

- "Electronic" Wallet
 - Is just a system that allows you to do electronic transactions
 - ApplePay (holds your CC info)
 - Electronic
 - Hot storage (using a wallet that is connected to a computer system)
 - Cold storage (air gapped)—think USB stick
 - Paper (both the most and least secure form)
 - Cannot be hacked

Is This a Passing Fad?

Is This a Passing Fad?

- Bitcoin, bitcoin, bitcoin
- Ether, Litecoin, Ripple, Monero, Dogecoin (no really, Dogecoin!), Zcash, Dash, Namecoin, Swiftcoin, Bytecoin, Peercoin, Emercoin, Feathercoin, Gridcoin, Omni, Primecoin, Nxt, Auracoin, Blackcoin, Burstcoin, Coinye, NEO, MazaCoin, Tether, PotCoin, Synereo AMP, Titcoin, Verge, Stellar, Ethereum Classic, Bitcoin Cash, SixEleven, IOTA, Waves, Lisk, Zclassic, Ubig, EOS, Electroneum, TRON, Cardano, Kodakcoin, Petro, VeChain, Populous, OmiseGo, RaiBlocks, Binance Coin, Steem, Siacoin, Stratis, Bytecoin, Ardor, Bitshares, Status, Augur, Maker, Walton, Ox, Veritaseum, Komodo, KuCoin, Ark, Decred, Loopring, Dentacoin, Hshare, Dragonchain, PIVX, DigiByte, QASH, Golem, Byteball Bytes, aelf, Gas, Kyber Network, Rchain, Funair, WAX, Ethos, SmartCash, Cryptonex, Aeternity, SALT, Factom, Cindicator, Bytom, Power Ledger, Nebulas, Dent, Aion, DigixDAO, Zclassic, Nxt, Syscoin, SIRIN Labs Token, Enigma, ReddCoin, GXShares, Request Network, Nexus, MaidSafe Coin, Bancor, Partici, Neblio, Kin, Quantstamp, ChainLink, Mediblok, TenX, Substratum, Bitcore, Gnosis, Xplay, SophiaTX, Emercoin, Pillar, GameCredits, Civic, Iconomi, iExec RLC, Po.et, Time New Bank, Raiden Network, BitcoinDark, Skycoin, Stori, DigitalNote, DEW, SingularDTV, Vertcoin, BLOCKv, PACcoin, Bridgecoin, Enjin Coin, NAV Coin, Storm, Blocknet, ETHLend, Santiment Network, PayPie, Ripio Credit Network, VIBE, Dynamic Trading Rights, Red Pulse, Cobinhood, Achain, Counterparty, Monaco, Decentraland, Revain, HTMLCOIN, Aragon, Simple Token, AirSwap, Telcoin, Appcoins, INS Ecosystem, Unikoin Gold, DeepBrain Chain, Einsteinium, Bibox Token, XTRABYTES, WaBi, Spankchain, BitBay, Tierion, SuperNET, Edgeless, Ambrosus, Bitconnect, Peercoin, SONM, Theta Token, AdEx, CyperMiles, Centra, ZenCash, Streamr DATACoin, Melon, Modum, Asch, Quantum Resistant Ledger, Nuis, IoT Chain, Metal, Gulden, ECC, Etherparty, Agoras Token, Internet Node Token, ATMChain, UTRUST, Electra, Trinity Network, NAGA, Viacoin, Wings, Metaverse ETP, districtOx, LBRY Credits, HempCoin, Wagerr, QLINK, Medishares, Rise, Burst, Triggers, CoinDash

Is This a Passing Fad?

- Most of those currencies or tokens will likely disappear or become "penny stocks"
 - Pets.com died but Amazon survived
- Cryptocurrencies and tokens are the attention getters but blockchain and DLT are the stars
 - Many applications will emerge in near future
 - Loan participations
 - Record keeping
 - Supply chain
 - "Fedcoin"
 - Marshall Islands just announced sovereign coin that will be legal tender
 - ✓ Swedish e-krona
 - ✓ Swiss e-franc

The Offer and Sale of Cryptoassets

The Offer and Sale of Cryptoassets (Enter Securities Laws)

- Initial Coin Offering ("ICO")
 - How most coins and tokens have been offered in the past
 - Organic rather than planned
 - Early users thought that the blockchain aspect made the offering process exempt from securities laws
 - DAO Report (July 2017) results in "Howey Test" trending on Twitter
 - SAFTs and utility tokens
 - o Wrong again?
- Current position of SEC is that just about every ICO may involve an offering of securities
- Safe approach is to assume that most tokens offered in ICOs are a security
- But clearly some cryptoassets are not: bitcoin, probably ether

The Offer and Sale of Cryptoassets (Enter Securities Laws)

- Very fact specific
- Offering liability
 - For issuers
 - For investors
- Reg D offerings (SAFTs, other instruments)
- Registered offerings

Valuation and Custody of Cryptoassets

SEC's Staff Letter on Certain Issues Related to Cryptocurrencies

- On January 18, 2018, the staff of the Investment Management Division sent a letter to the Investment Company Institute ("ICI") and the Securities Industry and Financial Markets Association ("SIFMA") highlighting a number of investor protection issues regarding cryptocurrencies.
 - Valuation
 - Custody

SEC's Specific Concerns Related to Valuation

- Do advisers have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products?
- How would advisers develop and implement policies and procedures to value, and in many cases "fair value," cryptocurrency-related products?
- How would advisers' accounting and valuation policies address the information related to "significant events" relevant to cryptocurrencies?
- What policies would an adviser implement to identify, and determine eligibility and acceptability for, newly created cryptocurrencies offered by promoters?
- How would differences among various types of cryptocurrencies impact advisers' valuation and accounting policies?
- How would advisers consider the impact of market information and any potential manipulation in the underlying cryptocurrency markets on the determination of the settlement price of cryptocurrency futures?

Framing the SEC's Concerns: Bitcoin at a Glance

Exchange	Current Price	Location	Volume (%)
OKEx	\$10,443.80	China	7.58%
Bitfinex	\$10,424.00	Hong Kong SAR	6.66%
Binance	\$10,949.10	Hong Kong SAR	4.87%
Upfit	\$10,454.30	South Korea	3.41%
bitFlyer	\$10,454.60	Japan	3.04%

- The table above sets forth (1) the top five cryptocurrency exchanges where Bitcoin trades, (2) the current price of Bitcoin on those exchanges, (3) the location of the exchange, (4) approximate trading volume as a percentage of total trading
 - Key takeaways from the information above are:
 - There is a difference of 5.0% from the highest and lowest prices on these exchanges.
 - None of these exchanges are located in the U.S.
 - Most of the trading volume of Bitcoin is not in U.S. dollars.
 - The aggregate trading volume of the top five bitcoin exchanges is only 25.56% of the total volume globally.

Distilling the Issues and Approaches to Valuation

- Fragmentation: Cryptocurrencies trade on multiple venues, trade at different prices
- Volatility: Cryptocurrencies are extremely volatile. According to Bloomberg, Bitcoin, which
 may be the least volatile cryptocurrency, is approximately 10 times more volatile than the
 S&P 500 and almost 35 times more volatile than U.S. treasuries.
- 24-hour Global Markets: Cryptocurrencies are traded 24 hours a day and a large portion
 of the trading is outside of the U.S. and therefore not in U.S. dollars
- "Virtual Currency Events" have Real World Implications: Forks and air drops functionally
 are similar to corporate events that affect equity securities. A "fork" in its simplest terms is
 a split in a blockchain, which is similar to a corporate spin out, and an "air drop" is similar
 to a special dividend.

Practical Considerations of Valuation Policies

- Timing of valuations (when and where)
- Flexibility to handle periods of extreme volatility
- FX considerations
- How to address "Virtual Currency Events"

Custody

- Under the Custody Rule (Section 206(4)-2 of the Advisers Act), "it is a fraudulent, deceptive or manipulative act, practice or course of business" for an investment adviser who is registered with the SEC to "have custody of client funds or securities" unless:
- Client funds or securities are held at a qualified custodian
- Currently, there are very few qualified custodians in the United States authorized to hold cryptocurrencies
- Concerns raised by the SEC:
 - Validation of exclusive ownership and software functionality of private cryptocurrency keys and other ownership records
 - Cybersecurity threats, such as the potential for hacks on digital wallets
 - Ability to receive and custody underlying cryptocurrency in physical settlement of cryptocurrency-related derivatives

Who is a Qualified Custodian?

- Under the Custody Rule, a "qualified custodian" is:
 - A bank, a trust company or a savings association with deposits insured by FDIC;
 - A broker-dealer;
 - A futures contract merchant; and
 - A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

Question: I am not an SEC-registered investment adviser. Do I need to care about the Custody Rule?

Practical Custody Issues

- Immutable nature of transactions of blockchain makes reversal of transaction in case of error impossible
- In order for custodian to have Control of a cryptoasset, it likely needs to be transferred to the custodian
- Hot Storage versus Cold Storage
 - Risk allocation between security and ease of access for transactions

Cryptoassets as Commodities

Cryptocurrencies as "Commodities": A CFTC/NFA Perspective

- Pursuant to Section 1(a)(9) of the Commodities Exchange Act, cryptocurrencies are generally considered to be "commodities", and agreements, contracts or transactions related to future price of a "commodity" are generally deemed to be a "swap" under Section 1(a)(47) of the Commodity Exchange Act
- Consequently, the CFTC has jurisdiction over any "commodity interest" that references a cryptocurrency (assuming that cryptocurrency is not a "security")
- Additionally, under Section 9(1) of the Commodity Exchange Act, the CFTC has
 jurisdiction over any manipulative activity in the spot market for a cryptocurrency
 that would be deemed to be a commodity
- The NFA has imposed a requirement on its members pursuant to Notice I-17-28 (the "NFA Members' Notice")
- Under the NFA Members' Notice, any commodity pool operator or commodity trading advisor must "immediately notify NFA if it executes a transaction involving any virtual currency or virtual currency derivative on behalf of a pool or managed account."

Cryptocurrencies as "Commodities": A CFTC/NFA Perspective

- A CPO or CTA's notice to the NFA will be evidenced by amending the adviser's annual questionnaire to answer the following questions:
 - CPO Questions
 - Does your firm operate a pool that has executed a transaction involving a virtual currency (e.g., bitcoin)?
 - Does your firm operate a pool that has executed a transaction involving a virtual currency derivative (e.g., a bitcoin future, option or swap)?
 - CTA Questions
 - Does your firm offer a trading program for managed account clients (other than a pool you reported under the CPO questions) that has engaged in any transaction involving a virtual currency (e.g., bitcoin)?
 - Does your firm manage an account (other than a pool you reported under the CPO questions) that has executed a transaction involving a virtual currency derivative (e.g., a bitcoin future, option or swap)?

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- Treatment under the Uniform Commercial Code ("UCC")
 - Article 9
 - Article 9 of the UCC adopted in all 50 states, and provides for the consensual creation of liens on personal property ("security interests") and the rights and duties of the parties to these arrangements
 - Assets grouped into specific classes of collateral, such as accounts receivable, inventory, goods, instruments, investment property, and money
 - Catch-all class of "general intangibles," which includes any personal property that does not fall within any other enumerated class
 - Classification is significant because there are different rules with respect to different types of collateral
 - ✓ For example, rules regarding what action a secured party must take to "perfect" its security interest in order to receive full benefit of UCC rights
 - Consensus is that cryptoassets would be treated as general intangibles

- Significance of treatment as a general intangible
 - Liens on general intangibles are pervasive
 - Generally, if a corporate entity has obtained secured credit, the collateral would include a lien on general intangibles
 - o Thus, any cryptoassets would likely be subject to the lien
 - Impacts method of perfection
 - A secured party can perfect its security interest by filing a UCC financing statement in the appropriate state office (usually the Secretary of State)
 - Financing statement can be as general as "all assets"

- Significance of treatment as general intangible
 - Security interest continues
 - A security interest in general intangibles continues notwithstanding transfer of the collateral, unless the secured party consents to the transfer free of its interest, the underlying obligations have been satisfied, or the security interest is otherwise terminated
 - Good faith purchaser with no notice of lien could ultimately find itself in a dispute with secured creditor of transferor
 - Example: Secured party has a lien on general intangibles of a corporate borrower.
 Borrower uses cryptoasset to purchase services from vendor. Vendor performs. Borrower subsequently defaults, and assets insufficient to satisfy lien of secured party. Secured party could trace cryptoasset to vendor, and make claim on that asset.

- Alternative UCC treatment
 - Cryptoassets that are held by a "securities intermediary" could be considered to be "financial assets" under Article 8 of the UCC
 - Securities intermediary maintains "securities accounts" for others in the ordinary course e.g., a broker-dealer
 - Parties can elect to treat cryptoassets as financial assets
 - Can be perfected by filing financing statement or control
 - Most significant distinction is that asset can be transferred free of existing security interests provided purchaser provided value and did not have notice of existing security interests

Cryptoassets in Bankruptcy

Cryptoassets in Bankruptcy

- One reported case to date with limited impact (In re Hashfast LLC)
 - California bankruptcy court addressed the issue of whether bitcoins should be considered as a currency or a commodity in fraudulent transfer litigation
 - Liquidating trustee of bankruptcy estate brought suit for transfer of 3,000 bitcoins to a promoter prior to company's collapse
 - Trustee can generally seek to recover the property transferred or the value of the property transferred
 - Defendant argued that the bitcoin were same as dollars
 - if treated as US currency, trustee could simply recover that static value (here, at time of transfer, roughly \$360,000)
 - Trustee argued should be treated as a commodity
 - Would allow trustee to recover actual bitcoins or equivalent value at time of recovery (here, at time of decision, was \$1.3 million)
 - Court ultimately only needed to decide that bitcoins were not US currency (which it did)
 - While not significant in and of itself, may preview issues in bankruptcy

Cryptoassets in Bankruptcy

- Volatility issues
 - Volatile nature of cryptoassets can lead to a great deal of uncertainty in the bankruptcy cases where cryptoassets are a significant estate asset
 - Valuation issues permeate bankruptcy cases
 - Adequate protection
 - ✓ Is a secured creditor "adequately protected?"
 - ✓ Must provide secured creditor with "adequate protection" of its collateral, maintaining value as of the petition date
 - ✓ If secured creditor's collateral value has depreciated greatly, adequate protection that was sufficient one day may be insufficient the next
 - Solvency (preference/fraudulent transfer analysis)
 - ✓ Must prove insolvency at time of transfer
 - Treatment of secured creditors (oversecured/undersecured)
 - Oversecured creditors entitled to payment of postpetition interest, attorneys' fees (if so provided in underlying agreements)
 - Plan feasibility
 - ✓ Will debtor's plan work?

Cryptoassets in Bankruptcy

- Traceability
 - Double-edged sword
 - Traceability of cryptoassets may lead to competing interests
 - Can also be helpful to debtor estate from recovery perspective
 - Trustee or debtor-in-possession can "avoid" transactions as "preferential" or "fraudulent"
 - o Trustee's burden to establish that asset at issue is debtor's property
 - Given traceability of cryptoassets, could be done at minimal cost and expense

Tax Considerations

Tax: General Considerations

- Limited guidance from IRS
 - Notice 2014-21
 - Applies to virtual currencies that are readily convertible into cash are property, not currency
 - Takeaways:
 - General tax principles that apply to transactions in property apply to crypto
 - Mining → self employment income
 - Can be held as a capital asset
- Crypto-for-crypto exchanges are likely taxable!
- FBAR and Form 8938 filing obligations if holding crypto offshore

Tax: Crypto Funds

- Investor, trader or dealer?
- Can traders mark-to-market?
- Bitcoin futures as 1256 Contracts?
- Specific identification issues?
- US trade or business considerations?
 - Is crypto a commodity that is "of a kind" that is customarily dealt in on organized commodities exchanges?
- NYC UBT: Crypto should qualify for "trading on one's own account exception" from NYC UBT

Tax: ICOs

- Most token issuers in the US should recognize income after ICO
- Token presales may be structured as prepaid forward contracts
- Can security tokens be equity for US tax purposes?
 - How to deal with withholding?
- Utility tokens not directly covered by Notice 2014-21, but its principles should apply.



Questions

Questions?



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