

The Hot Money: Cryptocurrencies and Implications for Investment Advisers

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Cryptocurrencies and offerings tied to them are everywhere these days. According to one recent article, capital raising through cryptocurrencies exceeded \$1.3 billion in the third quarter of 2017. Regulators have taken notice and in some cases have provided their views concerning the application of certain regulatory requirements to cryptocurrencies and related offerings; but cryptocurrencies and related offerings are evolving rapidly and regulatory guidance available may require fact specific legal analysis and can be difficult to apply. All the while investors are seeking to access this new investment asset and are pouring ever larger amounts into it.

This article seeks to answer several basic questions about cryptocurrencies and highlight certain regulatory considerations under the Investment Advisers Act of 1940 (Advisers Act) in dealing with cryptocurrency and related instruments that are securities. The article concludes by suggesting additional issues to consider.

What is Cryptocurrency or Virtual Currency?

Generally, in today's usage, "cryptocurrency" refers to a virtual currency that uses blockchain technology and is operated in a decentralized system. A "virtual currency" is a digital representation of value that can be electronically traded and functions as a medium of exchange, a unit of account or a store



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of value, but that does not have legal tender status in any jurisdiction. Virtual currency is not issued or guaranteed by any government or country, and fulfills the above functions only by agreement within the community of users of the virtual currency.

Virtual currency is distinct from "fiat" currency, which is legal tender whose value is backed by the country that issues it and is customarily used and accepted as a medium of exchange. An example of fiat currency is the U.S. dollar. Virtual currency also is distinct from "electronic money," or "e-money", which is a digital representation of fiat currency used to electronically transfer value denominated in the fiat currency. One example of e-money is pre-paid credit cards.

"Blockchain" refers to distributed ledger technology, which enables recordkeeping of shared information by multiple parties without any one party having to trust any other party's recordkeeping integrity. A blockchain is a shared, immutable and continuously reconciled ledger that is hosted by many users in many different locations. Each "block" of information is stored in every link of the "chain." Blockchain has many potential applications, but its currently best known application is cryptocurrency.

The best known cryptocurrency is bitcoin. "Alt-coins," such as Ethereum or Litecoin, are coins or tokens other than bitcoin that use blockchain. "Tokens" are a type of cryptocurrency, which are often designed to be used on a proprietary platform but which may also be held or traded like other cryptocurrency. For instance, Steem tokens are used to reward persons that post content to and curators of the Steem platform, but they can also be bought and sold by holders that own these tokens for investment purposes rather than to use them on Steem.

There are now more than 700 existing cryptocurrencies, the most prominent of which are bitcoin (BTC),

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Ethereum or Ether (ETH), and Litecoin (LTC). Cryptocurrency can be exchanged with other users through a blockchain, or it can be exchanged for traditional currency through “exchanges.” One feature of an exchange is a “wallet,” which allows users to hold their cryptocurrency in something akin to an encrypted bank account and transact for goods or services using the cryptocurrency as payment to a counterparty that also has an electronic wallet.

“Smart contracts” are electronic contracts that are coded to take certain actions under specified circumstances. They can be coded into blockchain, resulting in a coin or token that takes certain actions automatically. For instance, a note issued as blockchain could pay interest to the holder of the note automatically.

When Is a Cryptocurrency a “Security” For Purposes of the Federal Securities Laws?

With the ever-increasing popularity of bitcoin, members of the financial service industry have wrestled with how to classify cryptocurrencies, including bitcoin, from a regulatory perspective. For advisers, one of the key questions is whether a cryptocurrency is a security. The Advisers Act defines “security” broadly to include any note, stock, security future, bond, evidence of indebtedness and investment contract and certain foreign currency options traded on a national securities exchange. Through various interpretations under the Advisers Act, the staff of the Securities and Exchange Commission (SEC) has taken the position that advice regarding coins, currency and commodities does not involve advice with respect to securities.

A “Single Feature” Cryptocurrency by Itself Likely Is Not a Security.

Bitcoin as it currently exists could be characterized as a “single feature” cryptocurrency; that is, it is a medium of exchange based on blockchain technol-

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ogy with no other features. An analogy could be the U.S. dollar; it is an accepted medium of exchange or payment but has no other features (e.g., a U.S. dollar does not pay interest while a note has a feature that does). Many commentators have reached the conclusion that whatever bitcoin is, it is not a security, and the Commodity Futures Trading Commission (CFTC) has taken the position that bitcoin and other virtual currencies are commodities under the Commodity Exchange Act (CEA) (see “Additional Issues to Consider” below).

A Cryptocurrency with Multiple “Features” May be a Security.

If a cryptocurrency has features other than being a medium of exchange or store of value, it could be a security under certain circumstances. For instance, in July 2017, the SEC issued a Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934 that described the SEC staff’s investigation of the initial coin offering (ICO) of tokens by The DAO, an unincorporated organization, and certain of its affiliates and intermediaries (DAO Tokens). The offering of the DAO Tokens raised Ethereum worth approximately \$150 million. The Report concluded that the ICO of DAO Tokens violated U.S. securities laws because it was an un-

registered offer and sale of securities.

After evaluating the facts and circumstances of the offering, the SEC staff concluded that each DAO Token was an “investment contract” and therefore a security. An investment contract is a scheme that “involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The SEC staff concluded that the purchasers of DAO Tokens invested in a common enterprise expecting to earn profits based on the efforts of others, in this case the founders and curators of The DAO. In the view of the SEC staff, the DAO Tokens met the *Howey* test and thus were investment contracts, and the offering of DAO Tokens was an unregistered offering of securities. While the SEC ultimately determined to not bring an enforcement action against The DAO, the Report clarifies that certain offerings of coins or tokens based on distributed ledger or blockchain may be subject to the U.S. securities laws, and therefore offerings of certain tokens to the public may need to be registered offerings. The SEC staff highlighted that the presence of electronic or automated features and use of smart contracts and computer code do not remove conduct such as an offering of tokens from the purview of U.S. securities laws if such laws are otherwise applicable.

One of the factors that made the DAO Tokens investment contracts was the ability of DAO Token holders to receive a dividend. Another factor that may be relevant in making an investment contract determination is the context surrounding the offering. Many coins or tokens are offered in an ICO, which gives investors the opportunity to purchase future cryptocurrency (sometimes referred to as “software presale tokens”); the proceeds are then used to develop or fund the platform on which the presale tokens can be used. Because the coins or tokens are designed

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to be used on one particular platform, the value of the coins or tokens (aside from speculative value) ultimately depends entirely on the efforts of the platform's developers; if the platform fails, the value (speculative or otherwise) of the coins or tokens may go to zero. This could lead to a conclusion that the coins or tokens offered are investment contracts and thus securities.

If Tokens or Coins Are Securities, What Are the Consequences to Advisory Firms?

There are a number of potential consequences if a coin or token is a security. Most are those that any adviser would confront when its advice relates to instruments that are well-understood to be securities. The following are a few unique considerations.

Status as Investment Adviser

Under the Advisers Act, an investment adviser is a person who, for compensation, engages in the business of advising others as to the advisability of investing in, purchasing or selling securities. Any entity providing advice concerning investing in coins or tokens for compensation could meet the definition of investment adviser under the Advisers Act and applicable state securities laws. In such an event, the act of providing such advice subjects the person to the anti-fraud provisions of the Advisers Act and similar applicable state laws, irrespective of whether the conduct requires registration as an investment adviser under federal or state laws.

Custody

Under the custody rule, registered advisers are required to maintain client "funds and securities" with a "qualified custodian." If coins or tokens are deemed to be securities, they must be maintained with a qualified custodian absent the availability of an exemption from the qualified custodian requirement. It may be difficult to find a qualified custodian willing to hold such

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coins or tokens. Currently, at least one trust company that operates under the direct supervision and regulatory authority of the New York State Department of Financial Services specializes in holding cryptocurrency and may meet the custody rule's definition of "qualified custodian." In the future, we expect that other actors will enter this arena.

Code of Ethics Requirements

Under Rule 204A-1, access persons of registered advisers are required to report their personal securities holdings and personal securities transactions and to preclear any transaction in which they acquire beneficial ownership of any security in an initial public offering or in a limited offering. For coins or tokens that are securities, all holdings and transactions in such coins or tokens will need to be reported under the investment adviser's code of ethics in holdings reports and securities transactions reports, and acquisitions of such coins or tokens in an ICO or a limited offering would need to be pre-cleared.

Additional Issues to Consider

The Division of Enforcement of the CFTC has brought a number of enforcement actions based on the interpretation that bitcoin and other virtual currencies are encompassed in the definition of commodity under Section 1a(9) of the CEA. Investment advisers should treat them as they would any

other commodity interest and consider whether investments in virtual currency rise to a level that would require registration, or the claiming of an exemption, as a commodity pool operator or commodity trading advisor.

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) does not regulate users of virtual currency, but administrators and exchangers must register as money transmitters and Money Services Businesses (MSB). Designation as an MSB will trigger the registration, reporting and recordkeeping requirements of the Bank Secrecy Act. A "user" is a person that obtains virtual currency to purchase goods or services. An "exchanger" is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency. An "administrator" is 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. It is unlikely that an investment adviser engaging in customary adviser activities will be deemed to be an "exchanger" or "administrator."

Conclusion

Not every token or cryptocurrency is a security, and not every ICO necessarily involves the offering of a security. Because the analysis of whether a coin or token is an investment contract (and therefore a security) is based on the features of such coin or token or the context in which the coin or token is offered, it may be prudent to treat cryptocurrencies as securities for compliance purposes, including for purposes of compliance with the custody rule and Rule 204A-1. In addition, given the enforcement actions brought by the Division of Enforcement of the CFTC, cryptocurrencies should be treated as commodities under the CEA subject to the rules and regulations of the CFTC.

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