
This webinar will begin shortly.

Digital Asset Regulation and Insights for Asset Managers

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Presentation prepared by K&L GATES

Agenda

- Introductions
- Current Landscape
- Jurisdictional Overview
- Legal Considerations
- Recent Enforcement Actions
- Predictions for 2023

Current Landscape

Current Landscape

- Crypto Winter? The market cap of the largest 100 digital assets fell 62% year-over-year in 2021-2022.
- But institutional and investment interest in these assets remains strong.
- A number of large financial institutions have reported that, despite the market downturn, institutional investors still express interest in their digital asset offerings, and some institutions have announced the development of digital asset trading platforms.
- Still, because some believe that the market downturn was caused by lack of oversight and unmitigated enthusiasm, limited partners are imposing tighter compliance and security standards for funds and separately managed accounts backing digital assets and crypto-related companies.

Current Landscape

- In early October, the Treasury Department released a report about risks in investing in digital asset companies.
- The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) continue to press enforcement and bring cases under novel theories.
- Regulators are focusing on stablecoins, given their potential to undercut USD and the failures of certain algorithmic stablecoins.
- In response to digital asset firm failures that rattled investor confidence in stablecoins, Tether is expected to undergo an audit in 4Q ’22 or 1Q ’23, although some are still skeptical, given that Tether has been promising an audit since 2017.

Jurisdictional Overview

Regulation At A Glance

Product and Market determine the regulator:

Product	Market	Regulator
Bitcoin (U.S. Person)	Spot	States, FinCEN and CFTC
Bitcoin Futures (U.S. Exchange)	Futures (CME, CBOE, NADEX, Bakkt, FTX)	CFTC
Bitcoin Swaps (U.S. Person/SEF)	Swap (FTX, Changelly, SwapSpace)	CFTC
Bitcoin Forward (U.S. Person)	Commodity Forward or Swap	CFTC
Bitcoin "Non-Deliverable Forwards" (U.S. Person)	Swap (OTC)	CFTC
"Token Sale" (U.S. Entity/Person)	Security (Automated Trading System) (not all token sales are securities)	SEC
Bitcoin Derivatives (Non-U.S. Person)	Foreign Exchange, Non-US Counterparties	CFTC

CFTC Jurisdiction Over Digital Assets

- The CFTC has asserted that ether and bitcoin are commodities because they are the underlying asset for futures and options traded on CFTC-registered exchanges.
- Questions have arisen about ether's status as a commodity following the Merge in September 2022.
  - Ethereum shifted from a "proof-of-work" consensus mechanism to "proof-of-stake"
  - SEC chair Gary Gensler has stated that any digital asset based on a proof of stake system could presumptively be a security
- In a series of enforcement actions, the CFTC also has claimed that certain stablecoins and other broadly defined "virtual currencies" are commodities subject to its jurisdiction.

SEC Jurisdiction Over Digital Assets

- Whether a digital asset is a "security" depends on the facts and circumstances of the offer and sale of the particular asset.
- According to the seminal *Howey* test, an asset is an "investment contract" and thus a security if it involves "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."
- Thus, whether a given digital asset is a security depends on the structure of the offered asset and the nature of the transaction rather than on the label applied to the asset.
- For example, if a promoter distributes a token to others with the understanding that the distributor will work to improve the functionality of the token and that this functional improvement will raise the value of the token, the SEC likely would consider the token to be an investment contract under this test.

SEC Jurisdiction Over Digital Assets

- If a digital asset constitutes a "security," an offering of such security must be registered with the SEC or qualify for an exemption from registration.
  - If a digital asset is a security, the Exchange Act requires that it is offered by licensed broker-dealers and on an SEC-licensed exchange or Alternative Trading System.
  - Entities that invest or hold digital assets that are securities may be deemed to be an "investment company" and subject to the Investment Company Act of 1940.
  - Similarly, those who provide investment advice regarding digital assets that are securities may be subject to regulation as advisers under the Investment Advisers Act of 1940.

Legal Considerations

Investments in Spot Digital Assets

- Compared to traditional investments in regulated securities, there is a natural transparency to public network blockchain technology, as all transactions are recorded on-chain.
- However, substantive disclosures for spot digital asset investments may be useful, as they could allow investors to understand the technology behind the digital asset as well as the plans for the investments.
- Risks associated with digital assets such as stablecoins may be substantively different from those associated with utility tokens and other digital assets, and even sophisticated investors may not always be aware of these risks.

OTC Crypto Derivatives

- OTC crypto derivatives trading allows for bespoke contractual arrangements, and standard derivatives contracts may fail to address the unique legal framework that digital assets require.
- The International Swaps and Derivatives Association (ISDA) established the Digital Assets Legal Group, which published a paper exploring the key issues that need to be addressed.
  - The paper emphasizes developing contractual standards for covering disruptive events like forks, which are inapplicable to other asset classes.
  - ISDA is also developing language to address the ambiguous regulatory landscape for digital assets and how to integrate that into standardized contracts.
- ISDA is expected to publish a set of digital asset definitions as it has for more traditional asset classes like equities, interest rate, and FX.

Developments in the Asset Management Industry

Exchange Traded Funds (ETFs)

- To date, the SEC has only approved bitcoin futures-based ETFs while rejecting spot bitcoin ETFs.
- Proshares successfully launched a bitcoin futures ETF in 2021, allowing traditional investors to gain exposure to bitcoin.
- Proshares invests primarily in bitcoin futures contracts, which are traded on CME.
- The SEC views futures trading on a regulated U.S. exchange more favorably than other digital asset related investments.

Exchange Traded Funds (ETFs)

- In October 2021, Grayscale filed a Form 19b-4 with the SEC to convert their bitcoin trust to a spot bitcoin ETF, which the SEC denied, citing other spot bitcoin ETFs whose petitions the SEC had previously denied.
- In August 2022, Grayscale filed a petition for review with the United States Court of Appeals for the D.C. Circuit of the SEC order denying Grayscale's petition to turn its bitcoin trust into an ETF.
- In October 2022, Grayscale submitted its opening brief which was joined by many Amicus briefs.
- SEC's brief is due in December 2022.
- If Grayscale is successful, it will have the first ever spot bitcoin ETF, potentially paving the way for similar products linked to different spot digital assets.

Exchange Traded Funds (ETFs)

- In its denial of Grayscale's petition the SEC stated that bitcoin-based ETFs can meet their obligations only if they demonstrate that they have "a comprehensive surveillance agreement with a regulated market [for bitcoin] of significant size" in order to prevent manipulation.
- Though Grayscale has surveillance programs in place with CME and NYSE Arca, the SEC maintains that this is not sufficient.
- Grayscale asserts that its anti-manipulation measures are sufficient, and also that the SEC has been applying its rules inconsistently by allowing ETFs for bitcoin derivatives, while denying approval for a bitcoin spot ETF, as both derivatives and spot ETFs obtain their spot pricing from the same markets.

Hedge Funds and Form PF

- The SEC has proposed that large hedge funds may need to disclose digital asset holdings through Form PF, a form that the SEC uses to evaluate market-wide risk.
- Regulators worry that volatility in digital asset holdings by large private funds could create a chain reaction when digital asset prices dip.
- The harm regulators want to avoid is exemplified by Three Arrows Capital, whose default on a $670 million loan led to the bankruptcy of Voyager Digital, a digital asset exchange, and Celsius, a digital asset lending platform.
- The comment period for this proposal ended on October 11, 2022.

Fiduciary Duty

- Investment Advisers Act of 1940 (Advisers Act) reflects a congressional intent to at least expose, if not eliminate, all conflicts of interest that could incite an investment adviser to provide advice that is not disinterested.
- The Investment Company Act of 1940 imposes additional substantive obligations and restrictions on investment advisers and their affiliates to refrain from self-dealing.
- SEC's June 2019 interpretive release conveyed that an adviser's fiduciary duty to clients is comprised of a duty of care and a duty of loyalty, and that in satisfying the duty of loyalty, an investment adviser must "eliminate or make full and fair disclosure of all conflicts of interest that might include an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict."
- Key Takeaway: Before recommending digital assets to clients, investment advisers must ensure they are satisfying their fiduciary duties to them. This requires close attention to issues such as valuation, best execution, code of ethics, and personal trading.

Valuation

- In 2021, the SEC observed in a Risk Alert that investment advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation.
- Advisers should review their valuation methodologies with respect to any digital assets held in client accounts, and at a minimum, should ensure that:
  - They can identify and monitor for events that could impact the valuation of digital assets held in client accounts (e.g., "airdrops" and forks).
  - Their fair valuation procedures are up to date, and confirm there are appropriate means of determining price inputs.

Code of Ethics

- Pursuant to Rule 204A-1, issued under the Advisers Act, an investment adviser must establish and enforce a code of ethics that, among other things, requires all of the adviser's "access persons" (e.g., directors, officers, partners, and certain other supervised persons of the adviser) to report their personal securities transactions and holdings in compliance with the rule.
- Advisers must decide if the digital assets they hold are "securities" and whether the code of ethics should cover digital assets regardless of how the products are classified from a regulatory perspective.
- Advisers may also wish to require preclearance of transactions in digital assets and the information that should be required in holdings and transaction reports.

Virtual Currency Disclosures

- The National Futures Association (NFA) Interpretive Notice 9073 establishes disclosure requirements for futures commission merchants (FCMs), introducing brokers, commodity pool operators (CPOs) and commodity trading advisors (CTAs) that engage in activities related to virtual currencies or virtual currency derivatives.
- The NFA expects its members that offer virtual currency products to include specific disclosures in their client facing agreements, which disclosures vary depending on the member's registration category.
- CPO and CTA members should carefully consider the risks arising from their activities in virtual currencies and derivatives, and customize their disclosure documents. At a minimum, CPOs and CTAs should consider and include disclosures on the following: i) unique features of virtual currencies; (ii) price volatility; (iii) valuation and liquidity; (iv) cybersecurity; (v) opaque spot markets; (vi) virtual currency exchanges, intermediaries, and custodians; (vii) regulatory landscape; (viii) technology; and (ix) transaction fees.
- NFA Compliance Rule 2-29 prohibits the use of any promotional materials that are misleading or deceptive.

Custody Rule

- Rule 206(4)-2 under the Advisers Act (the Custody Rule), adopted in 1962, provides that an investment adviser has "custody" of client assets if it holds, directly or indirectly, client "funds" or "securities." An adviser may gain custody of client assets inadvertently, such as by being authorized by a custodial agreement to withdraw client funds or securities or, in connection with digital assets, where an adviser has access to a client's private key to a digital asset.
- In light of the broad reach of the Custody Rule and the many ways in which an adviser may inadvertently gain custody of client assets, an adviser that does not assume that it has custody of all digital assets held in client accounts should carefully evaluate its authority with respect to such assets (e.g., standing letter of instruction).
- An adviser that has determined it has custody of its clients' digital assets and that such assets are funds or securities—or at least has a policy of treating such assets as funds or securities for purposes of the Custody Rule—must hold such assets with a qualified custodian. SEC has stressed that determining whether an institution is a qualified custodian for purposes of the Custody Rule is a facts and circumstances based analysis.

Custody: Recent Developments

- The nature of digital assets and the reliance on distributed ledger technology makes the application to digital assets uncertain.
- Currently major banks and state-chartered trust companies provide custodial services that include legal agreements and technical control over digital assets.
- Wyoming special purpose depository institutions approved on state level to act as a qualified custodian; SEC has yet to determine.
- SAB 121- Requires reporting companies that take key-level custody to report custodied assets as their own liabilities.
- BNY Mellon recently launched its Digital Asset Custody platform for select clients.

Digital Asset Enforcement Actions

Enforcement Focus on Digital Assets

- On October 20, the CFTC announced its enforcement results for fiscal year 2022 (October 1, 2021 – September 30, 2022).
- More than 20% of the CFTC's enforcement actions involved conduct relating to digital assets.
- CFTC Chair Behnam: "This FY 2022 enforcement report shows the CFTC continues to aggressively police new digital commodity asset markets with all of its available tools."
- On May 3, 2022, the SEC announced that it had nearly doubled the size of its Crypto Assets and Cyber Unit to 50 dedicated positions.
- SEC stated that it would focus on investigating securities laws violations related to non-fungible tokens (NFTs), Decentralized Finance (DeFi), stablecoins, digital asset exchanges, and digital asset lending and staking products.

SEC v. Wahi

- In July, the SEC announced "insider" trading charges against Coinbase product manager Ishan Wahi, alleging that he shared with his brother Nikhil and his friend Sameer Ramani material non-public information about when certain digital assets would be listed on Coinbase's trading platform.
- "Ishan violated the duty of trust and confidence he owed to Coinbase when he repeatedly tipped Nikhi and Ramani" who sold the tokens for a profit.
- The SEC asserted jurisdiction over the tokens under the *Howey* test and characterized the tokens as "crypto asset securities".
- The SEC did not bring actions against the issuers of the tokens for violation of registration requirements found in Section 5 of the '33 Act.
- CFTC Commissioner Pham issued a public statement saying: "The case *SEC v. Wahi* is a striking example of 'regulation by enforcement.'"
- Pleadings suggest the possibility of an amended complaint.

U.S. v. Wahi

- In July, the U.S. Department of Justice (DOJ) obtained an indictment charging Ishan Wahi, Nikhil Wahi, and Sameer Ramani with wire fraud and conspiracy to commit wire fraud.
- In the indictment, DOJ did not identify the "crypto assets" as securities and, unlike the SEC, does not need to prove that the tokens were securities.
- Nikhil pleaded guilty on September 12, less than two months after indictment. Sentencing set for December 13.
- Nikhil told the court: "I learned information about which new cryptocurrency coins would be listed on Coinbase before finding out publicly about that information. While I did not believe that cryptocurrency was a security, I knew it was wrong to receive Coinbase's confidential information and make trading decisions based on that confidential information."
- DOJ responded that whether cryptocurrency is a security is not relevant to the crime of wire fraud.

CFTC v. Ooki Dao

- In September, the CFTC filed and settled a complex and novel enforcement action against bZeroX, LLC and two individuals. In the words of the settlement order:
- The Respondents designed, deployed, marketed, and made solicitations concerning a blockchain-based software protocol (the bZx Protocol) that accepted orders for and facilitated margined and leveraged retail commodity transactions (functioning similarly to a trading platform).
- The bZx Protocol permitted users to contribute margin (collateral) to open leveraged positions whose ultimate value was determined by the price difference between two digital assets from the time the position was established to the time it was closed. The bZx Protocol purported to offer users the ability to engage in these transactions in a decentralized environment—i.e., without third-party intermediaries taking custody of user assets.
- In August 2021, bZeroX, LLC transferred control of the bZx Protocol to the bZx DAO, a decentralized autonomous organization (DAO), which subsequently renamed itself and is now doing business as the Ooki DAO.

CFTC v. Ooki Dao

- The CFTC asserted that the Ooki DAO is an unincorporated association comprised of holders of Ooki DAO tokens who vote those tokens to govern the bZx Protocol which the Ooki DAO renamed the Ooki Protocol.
- The CFTC asserted, in the context of this uncontested case, that virtual currencies such as ETH, DAI, and others traded on the bZx Protocol are "commodities" under the Commodity Exchange Act (CEA).
- The CFTC asserted that the two individuals were "controlling persons" of bZeroX, LLC. Therefore, bZeroX, LLC and the two individuals:
  - Engaged in unlawful off-exchange leveraged and margined retail commodity transactions.
  - Unlawfully engaged in activities that could only lawfully be performed by a registered FCM.
  - Failed to operate a Customer Identification Program, which is required of an FCM.

CFTC v. Ooki Dao

- Though Ooki DAO itself did not settle with the CFTC, the order asserted that Ooki DAO had committed the violations above, and that the two individuals were "personally liable" for those violations because they voted their Ooki tokens to govern the Ooki DAO by directing the operation of the Ooki Protocol.
- bZeroX, LLC and the two individuals were ordered to pay, jointly and severally, a civil monetary penalty of $250,000.
- On the same day the CFTC settled this case, it filed an enforcement action against Ooki DAO in federal court in California.
- CFTC Commissioner Mersinger issued a forceful dissent concerning both the CFTC settlement and the court case. Though she did not take issue with sanctioning bZeroX, LLC and the two individuals for the CEA violations, she took issue with holding the two individuals "personally responsible" for the "debts" of Ooki DAO, an unincorporated association, by virtue of using their using Ooki tokens to vote on governance proposals. She called the novel use of state law "blatant regulation by enforcement" particularly since the "aiding and abetting" liability theory found in the CEA would be applicable.

CFTC v. Ooki Dao

- In the federal court case, the CFTC requested and received permission from the court to serve Ooki DAO by providing a copy of the summons and complaint through the Ooki DAO's Help Chat Box, with contemporaneous notice by posting in the Ooki DAO's Online Forum.
- The DeFi Education Fund, LeXpunK, and Paradigm Operations LP, filed amicus briefs explaining to the court the nature of DAOs, challenging the method of service, and raising important issues about DAO governance, accountability, and legal liability.
- Speaking publicly about this case, Chair Behnam warned that people creating a DAO or participating in a DAO should not think the structure is a free pass from regulation. He called the conduct "clear fraud" that was "structured to avoid and evade CFTC regulation." He also said the conduct was "so egregious and so obvious that we would be essentially objectively failing to do our job if we did not bring this case."
- There are many diverging viewpoints.

Dept. of Treasury/Office of Foreign Asset Control

- 2018 - Office of Foreign Asset Control (OFAC) first added crypto public key addresses to its Specially Designated Nationals (SDN) list.
- 2018-2022- OFAC added addresses of terrorists, drug kingpins, hostile foreign powers, and exchanges used to launder value.
- 2021- Blender- mixer used to obscure relationship between sender/recipient in digital asset transactions.
- All sanctions against people or companies using crypto to transact.

Dept. of Treasury/Office of Foreign Asset Control

- In August 2022, OFAC sanctioned virtual currency mixer Tornado Cash, which it claimed had laundered more than $7 billion worth of virtual currency since its creation in 2019. The sanction means that the Tornado Cash website and associated Ethereum smart contract addresses have been added to the OFAC Specially Designated Nationals blacklist.
- The Tornado Cash sanction targets technology—open source software code on the Ethereum blockchain—not people or groups.
- In September 2022, several plaintiffs who identified themselves as Coinbase employees and Tornado Cash users filed a lawsuit against the U.S. Department of Treasury, Treasury Secretary Janet Yellen, OFAC, and OFAC Director Andrea Gacki challenging the designation.
- In October 2022, Coin Center also filed a lawsuit challenging the designation.
- OFAC's *Sanctions Compliance Guidance for the Virtual Currency Industry* is highly-recommended reading.

Predictions for 2023

SEC and CFTC

- Many believe that the SEC and CFTC continue to regulate by enforcement rather than create clear rules.
- The CFTC and the SEC continue to jockey for position, with both regulatory agencies seeking to carve out regulatory territory.
- The SEC has suggested that the United States is falling behind on its approach to digital asset issuance.

Congress

- Digital asset legislation is pending at both the federal and state level.
- Among these are bills pending in Congress that would provide the CFTC or the SEC expanded regulatory authority over digital currencies.
- Given that both the CFTC and the SEC have at different times defined different blockchain technologies as either commodities or securities depending on particular facts and circumstances, appropriate regulatory navigation requires a firm grasp of the facts and technology.
- It appears that many industry insiders prefer to be regulated by the CFTC, whom many see as more industry-friendly than the SEC.

The Responsible Financial Innovation Act

- The Lummis-Gillibrand Responsible Financial Innovation Act (RFIA) aims to establish a comprehensive U.S. regulatory regime for digital assets.
- According to the text of the proposed bill, the CFTC would be the primary regulator of most digital assets except for digital assets that provide the holder with:
  - (i) a debt or equity interest; (ii) liquidation rights; (iii) an entitlement to an interest or dividend payment; (iv) a profit or revenue share derived solely from the entrepreneurial or managerial efforts of others; or (v) any other financial interest.
- Given the flexibility of the test used to classify assets as securities, and the lack of restraint or limitation on the SEC's jurisdiction, it is unclear how many digital assets would be subject to the CFTC's jurisdiction under the RFIA.

The Digital Commodities Consumer Protection Act

- The Boozman-Stabenow Digital Commodities Consumer Protection Act would provide the CFTC (which sits within the jurisdiction of the Senate Agriculture Committee) authority to regulate digital commodities.
- The bill offers a much narrower approach than the RFIA.
- The legislation excludes securities from its definition of digital commodities.
- The bill would require all digital commodity platforms and companies—including trading facilities, brokers, dealers, and custodians—to register with the CFTC through several new registration categories. This would allow the CFTC to fill the regulatory gap and hold digital commodities to existing standards. It also creates a funding instrument for CFTC oversight by enabling the regulator to impose user fees on digital commodity platforms.

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