

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 51 No. 10 May 23, 2018

STRUCTURING OPTIONS FOR RETAIL CRYPTO FUND PRODUCTS

The author describes categories of cryptocurrency assets and then explores four different structuring options for retail crypto-fund structures, and the regulatory issues they have raised.

By Susan Gault-Brown *

In last month's article, *Blockchain Basics for Investment Managers: A Token of Appreciation* ("Blockchain Basics"), the authors provided a comprehensive review of the application of investment management laws, including the Investment Company Act of 1940 and Investment Advisers Act of 1940, to blockchain and cryptocurrency products.¹ Building from their discussion, the purpose of this article is to explore the various structuring options for creating a retail fund product that invests in cryptocurrencies, such as bitcoin and ether, and/or in other types of coins and tokens, such as those issued in initial coin offerings ("ICOs").

With respect to funds with a primary investment strategy of investing in cryptocurrencies, this article describes some of the pros and cons of four potential retail "crypto-fund" structures: (1) an open-end mutual fund or exchange-traded fund ("ETF") registered under the Investment Company Act (an "Open-End Fund"); (2) a closed-end fund registered under the Investment

Company Act (a "Closed-End Fund"); (3) a fund that is not registered under the Investment Company Act, interests of which are registered under the Securities Act of 1933 (a "33 Act Fund" or "33 Act ETP"); and (4) a commodity pool, interests of which are registered under the Securities Act (a "Commodity Pool"). Before discussing each of these structures, this article first will review the types of instruments such funds might hold.

DESCRIPTION OF CRYPTO INVESTMENTS

Cryptocurrency assets currently can be grouped into three distinct categories. The first category includes cryptocurrencies like bitcoin and ether that are being used, to some extent, to purchase goods and services. It can be argued that these assets function more like fiat currency than like a security (as defined under the federal securities laws). Nevertheless, in December of 2017, Jay Clayton, Chair of the Securities and Exchange Commission, questioned the assertion that such cryptocurrencies are not securities, emphasizing that "[w]hether this assertion proves correct with respect to any digital asset that is labeled as a cryptocurrency will

¹ Baris & Klayman, *Blockchain Basics for Investment Managers: A Token of Appreciation*, 51 Rev. Sec. & Comm. Reg. 6 and 7 (Mar. 21, 2018).

*SUSAN GAULT-BROWN is a Financial Services Partner in the Washington, DC office of Morrison & Foerster LLP and Chair of the firm's Investment Management Practice. Her e-mail address is sgaultbrown@mofo.com.

depend on the characteristics and use of that particular asset.”²

The second category of cryptocurrency assets encompasses coins or tokens that are issued in ICOs or traded in secondary sales that are closely associated with the issuer or creator of a coin or token. These assets in most cases are likely to be deemed securities under the investment contract analysis articulated in the classic *Howey* test.³ In this regard, the SEC has taken the view in several recent statements and enforcement actions that such tokens are securities because, among other things, the token holders can share in the potential profits from the token creator’s project, and those profits would be derived from the managerial and entrepreneurial efforts of another, i.e., the tokens’ creator.⁴

The third category of cryptocurrency assets is derivatives that reference one or both of the assets described in the previous two categories. For example, in December 2017, both the Cboe Global Markets Inc. and CME Group Inc. went live with bitcoin futures, and other derivative contracts are surely on the way. The Commodity Futures Trading Commission has deemed cryptocurrencies to be “commodities,”⁵ and, as a result, derivatives that reference cryptocurrencies are subject to regulation by the CFTC.⁶

STRUCTURING OPTIONS

What follows are some high-level thoughts on four retail crypto-fund structures. Keep in mind that other structuring options may be — and likely are — available.

Open-End Fund Structure

As discussed in *Blockchain Basics*, in January 2018, Dalia Blass, the Director of the SEC’s Division of Investment Management, issued a letter to two investment management industry groups entitled “Engaging on Fund Innovation and Cryptocurrency-related holdings.”⁷ The letter stated that the SEC staff had “significant outstanding questions how funds holding significant amounts of cryptocurrencies and related products would satisfy the requirements of the 1940 Act and its rules.” The letter identified and invited comment on several cryptocurrency-related issues, including valuation, liquidity, custody, arbitrage for ETFs, potential manipulation, and other risks.⁸ Significantly, the letter stated that, until such issues are addressed, the SEC staff does “not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products.”⁹ The letter also noted that the staff had asked sponsors with cryptocurrency fund registration statements on file to withdraw them.

Assuming that a cryptocurrency fund falls within the definition of an investment company,¹⁰ an Open-End

² SEC Chairman Jay Clayton, “Statement on Cryptocurrencies and Initial Coin Offerings” (Dec. 11, 2017).

³ *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

⁴ See, e.g., SEC Rel. No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017); see also *Blockchain Basics*.

⁵ See, e.g., Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 (Dec. 20, 2017) (proposed interpretation).

⁶ A fourth category of cryptocurrency assets could refer to so-called “utility tokens,” or tokens that are not securities. However, because it is not clear that any tokens currently fall into this category, I am omitting this category from this discussion.

⁷ SEC Staff Letter (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm> (the “Blass Letter”).

⁸ Blass Letter; see also *Blockchain Basics* at 81-82.

⁹ *Id.* at 82.

¹⁰ For purposes of this article, put aside the question of whether an Open-End Fund that invests in some or all of the categories of cryptocurrency assets falls within the definition of an investment company under the Investment Company Act and therefore is entitled to register as such with the SEC. See the definition of “investment company” in Section 3 of the Investment Company Act.

Fund’s sponsor, in order to register the fund, must be able to provide satisfactory responses to the concerns raised in Dalia Blass’ letter. It is not clear how long the process of responding to the SEC’s cryptocurrency concerns may take or even if engaging with the SEC staff at the present time on the questions raised in the Blass letter will ultimately result in any approvals to begin registrations of Open-End Funds. As a result, the path forward for Open-End Funds may be difficult.

Closed-End Fund Structure

The Blass letter did not address the registration of Closed-End Funds that invest in cryptocurrencies. Nevertheless, many of the issues raised in the Blass letter would seem to apply in equal measure to a Closed-End Fund as to an Open-End Fund (for example, concerns about custody of crypto-assets). As a result, a Closed-End Fund sponsor may be required to respond to some or all of the issues raised in the Blass letter before submitting a registration statement.

An additional question for a Closed-End Fund is whether to seek to have its shares traded on an exchange, or alternatively, to provide liquidity periodically through either a tender offer or interval fund structure.

Perhaps the biggest roadblock to date for cryptocurrency funds – whether registered under the Investment Company Act or not – has been in obtaining the SEC approval needed pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder (the “19b-4 process”) in order for a cryptocurrency fund’s shares to trade on an exchange. Issues arising in the 19b-4 process would not be limited to funds structured as Closed-End Funds. In fact, these issues have already arisen in connection with funds structured as ETFs, as non-investment company exchange-traded products (ETPs), and as exchange-traded Commodity Pools. In March 2017, citing the lack of regulation in bitcoin markets, the SEC denied an application to list and trade shares of the Winklevoss Bitcoin Trust (a non-investment company ETP) on the Bats BZX Exchange.¹¹

More recent responses to applications to list and trade shares of cryptocurrency funds have signaled that the agency intends to continue denying such applications. For example, in response to a relatively recent application to list and trade shares of ProShares Bitcoin ETF and ProShares Short Bitcoin ETF (exchange-traded Commodity Pools) on NYSE Arca, the SEC stated that it

was “providing notice of the grounds for disapproval under consideration” and set forth a number of questions for public comment.¹² Among the questions posed by the SEC were those addressing concerns about manipulation (“What are commenters’ views on the potential impact of manipulation in the underlying bitcoin markets on the Funds’ NAV?”); valuation (“What are commenters’ views on how the Funds’ valuation policies would address the potential for the bitcoin blockchain to diverge into different paths (i.e., a ‘fork’)?”); liquidity (“What are commenters’ views on how the substantial margin requirements for Bitcoin Futures Contracts, and the nature of liquidity and volatility in the market for Bitcoin Futures Contracts, might affect the Trust’s ability to meet redemption orders?”); and concentration (“What are commenters’ views on whether such a concentration of holdings could affect the Funds’ portfolio management, the liquidity of the Funds’ respective portfolios, or the pricing of the Bitcoin Futures Contracts or the Financial Instruments?”).

In light of the SEC’s concerns regarding exchange trading, a cryptocurrency fund, including a Closed-End Fund, may consider foregoing the listing and trading of its shares on an exchange. As an alternative, a Closed-End Fund could provide periodic liquidity to shareholders either by making periodic tender offers pursuant to Exchange Act tender offer rules (“Tender Offer Fund”) or could elect to operate as an interval fund under Investment Company Act Rule 23c-3 (“Interval Fund”). Importantly, although generally prohibited under Regulation M of the Exchange Act, a Closed-End Fund – whether a Tender Offer Fund or an Interval Fund – is permitted to continuously offer and redeem its shares simultaneously.¹³ Without this permission, a Closed-End Fund would either not be able to take in new capital or would not be able to offer shareholders liquidity.

33 Act Fund/ETP Structure

As noted above, many of the cryptocurrency fund products that have sought approval to list and trade shares on an exchange to date have been non-investment company products. These products register their shares under the Securities Act, but because they have determined that they are not required to register under the Investment Company Act, they do not register the fund itself. Generally, the assets of these funds are not

¹¹ SEC Rel. No. 34-80206 (March 10, 2017).

¹² SEC Rel. No. 34-82939 (March 23, 2018).

¹³ See Regulation M, Rule 102(b)(2)(i), (ii).

deemed to be securities for Investment Company Act purposes. For example, in the filings mentioned above, the funds are intended to hold only bitcoin, bitcoin futures, or bitcoin swaps.

For purposes of this article, assume that a 33 Act Fund/ETP only holds assets that are not securities and are not “commodity interests” (i.e., interests, including bitcoin futures and bitcoin swaps, that would subject the fund’s adviser to regulation as a commodity pool operator). An example would be a fund that only holds bitcoin (assuming bitcoin is not a security). What are the pros and cons of this fund? One pro is that the sponsor of this fund does not have to respond to the issues set forth in the Blass letter, because the fund is not an investment company. However, a con – just like with the exchange-trading issues discussed above – is that a fund structured as an ETP would have to go through the 19b-4 process and would likely face a roadblock. It may be possible, however, to structure a 33 Act Fund using a “tender offer fund” model to allow for periodic liquidity, provided the fund is structured as a limited partnership.¹⁴ That said, publicly offering a limited partnership may come with its own drawbacks that are beyond the scope of this article.

Commodity Pool Structure

The last structuring option is the public Commodity Pool. Like the 33 Act Fund, this fund’s shares are registered under the Securities Act. However, unlike the 33 Act Fund, the Commodity Pool holds “commodity

interests,” which may include futures, options on futures, swaps, and options on swaps, among other derivatives. Although the Commodity Pool itself is not registered or directly regulated, it is indirectly regulated through its adviser, which will be required to register with the CFTC as a commodity pool operator. As with the 33 Act Fund, a Commodity Pool’s sponsor would not have to address the issues in the Blass letter, and provided it did not seek an exchange listing, it would not have to undertake the 19b-4 process; although if the fund did seek to list and trade its shares, I expect that it would face the same issues as the funds discussed above. Finally, with respect to Regulation M, there is a specific exemption from the prohibition on simultaneous offers and redemptions for commodity pools, and, as a result, providing periodic liquidity should not be an issue for such funds.¹⁵

CONCLUSION

This article only skims the surface of structuring options for cryptocurrency funds, as within each of the above categories, are several subcategories and additional issues – including tax issues – to be unearthed and addressed. What this discussion hopefully demonstrates, however, is that, as with any new financial product, the right initial structure may not be the final structure but may be a means of going to market. In this regard, while this article focused on various retail fund options, it is worth asking in parting whether a public product limited to accredited investors might be the best first step toward an eventual retail product.¹⁶ ■

¹⁴ Regulation M, Rule 102(b)(3).

¹⁵ *Id.*

¹⁶ The term “accredited investor” is defined in Rule 501 of Regulation D under the Securities Act.