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## Crypto: What the regulators are planning to do

### Law firm Kramer Levin outlines key regulatory issues for hedge funds investing in cryptocurrencies

By Jennifer Banzaca, 24 October

As a record number of cryptocurrency hedge funds have launched in 2018, both additional regulation and increased enforcement can be expected so it's critical for hedge fund managers to understand the applicable regulations.

According to San Francisco-based Crypto Fund Research, 90 crypto hedge funds launched in the first three quarters of 2018, on track for 120 for the fiscal year. About half of the crypto hedge funds launched this year are based in the US.

During a recent seminar on crypto legal issues, partners from law firm Kramer Levin noted that while the CFTC and the SEC fight over jurisdiction to regulate crypto assets and crypto funds, they are still subject to securities and commodities laws and will be, and have been, sanctioned for violations.

Managers trading cryptocurrencies or investing in initial coin offerings (ICOs) have questions about which regulatory agencies have jurisdiction over this emerging market and what these regulations mean for hedge funds' compliance teams.

Are digital token securities under the jurisdiction of the SEC, or treated as commodities under CFTC jurisdiction, or subject to other regulations?

As more hedge fund managers have launched or are considering launching funds investing in these digital assets, they need to understand which regulations apply and how to stay compliant.

*HFMCompliance* sets out some of key terms, issues and takeaways from the Kramer Levin seminar:

#### **Cryptocurrency**

The most recognisable example of cryptocurrency is bitcoin. Generally, cryptocurrencies are decentralised peer-to-peer payment systems. Cryptocurrencies run on various types of blockchain technology.

#### **ICOs**

An ICO is where investors participate in a fundraising to transfer fiat currency, whether it's the US dollar, euro or cryptocurrencies, to the issuer in exchange for digital tokens. "The tokens give you some right to do certain things on the platform," explains Kramer Levin partner Christopher Auguste. "ICOs are the cryptocurrency version of crowdfunding."

#### **Classifications**

There are two general classifications of cryptocurrency that regulators use to determine whether securities or commodities laws apply.

Utility tokens, or consumer consumption tokens, are used for consuming or acquiring a specific good or service. Whereas security tokens are usually backed by an asset or collateral.

"The qualification is critical in terms of how the SEC views the tokens, whether it's a security or utility token," explains Auguste. "As the features of tokens issued in ICOs can widely vary, every token has to be assessed individually."

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Regulators use the Howey test to determine if the token is a utility token or a security token. Auguste explains that the Howey test looks at whether there is an investment of money; there is an expectation of profits; the investment of money is in a common enterprise; and if any profit comes from the efforts of a promoter or third party. If it is a security token then the SEC governs sale of securities.

Kramer Levin partner Kevin Scanlon says tokens in an ICO are typically issued by a by a SAFT (simple agreement for future tokens), which is essentially a forward contract to receive the token when the token is issued.

"Once the CFTC announced that virtual currencies are commodities, it became clear that the SAFT, which is nothing more than a forward on a commodity, was now regulated by the CFTC as a forward contract," Scanlan explains.

## **AML & KYC**

Because of the anonymity, liquidity and inexact nature of cryptocurrencies and their regulation, the asset class is fraught with potential fraud, making the area attractive to potential money launderers.

Auguste says regulators are questioning the origin of investors' funds, and the risks of money laundering or terrorism financing and stressed the importance of having proper policies and procedures in place to determine where an investor's money is coming from.

Managers need to have procedures to collect identity documents and verifying the information.

## **Custody**

Regulators also want to be sure hedge funds are complying with rules requiring them to hold assets with qualified custodians, usually banks or brokerages, to prevent misappropriation. Because digital tokens are typically held in virtual wallets, this can create custody concerns for managers.

"Custody, especially for funds run by registered investment advisers, is a concern because there are very few banks out there dealing with cryptocurrencies that are qualified custodians," Scanlan says. "Basically, fund managers are trying to comply with a rule that is about 70 years old with these current assets and it's very difficult."

## **Regulation**

Depending on the facts and circumstances, the SEC has said the offer and sale of digital assets may be treated as trading securities and fall under the federal securities laws. If a cryptocurrency is classified as a security, the issuers of the digital assets must register offers and sales of the securities unless a valid exemption applies.

Under SEC regulation, ICOs may be structured as Reg D or Reg S offering and will require a registration statement or the manager may pursue an exemption.

Auguste notes that ICOs may be structured as exempt transactions under Rule 506(c) of Reg D, which requires heightened verification requirements for investors issued securities in the offering. Following the filing of a Form D with the SEC, hedge fund managers may market the offering publicly and utilise websites and social media platforms to advertise the offering.

Reg S is only used for offshore sales.

While ICOs and the resulting tokens are seen as securities, the CFTC generally views virtual currencies as commodities.

"Any agreements or contracts related to the future price of a commodity would be 'commodity interests' and subject to regulation by the CFTC," Auguste explains.

Fund managers that invest in cryptocurrency futures contracts, as opposed to direct investments in cryptocurrencies, must register as a CTA and CPO with the CFTC and with the National Futures Association (NFA), or satisfy an exemption.

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## **State law**

Even if a coin or token is not deemed to be a security or a commodity and thereby regulated by the SEC or CFTC, it may still be treated as a security under state law.

Scanlan notes that on 23 June 2015, the New York Department of Financial Services (NYDFS) issued its final "BitLicense" virtual currency rule. The rule applies to business that transmit, store or issue a cryptocurrency.

Crypto exchanges are captured under the rule and currency business must be licensed to engage New York customers and/or operate in New York. New York is not only focused on the offering of tokens but also on the platforms and exchanges to trade tokens.

On 18 September, NY Office of the Attorney General released a 40-page Virtual Market Integrity Report regarding the state of crypto or virtual currency exchanges which focused on the jurisdiction, acceptance of fiat currency, and fee disclosures; trading policies and market fairness; management of conflicts of interest; security, insurance and protection of customer funds; and access to customer funds, suspensions and outages.

## **Enforcement**

Last month, the SEC charged Crypto Asset Management with misrepresentation and registration failures in the US regulator's first-ever enforcement action against a digital asset-focused hedge fund.

The hedge fund manager, and its sole principal Timothy Enneking, raised more than \$3.6m over a four-month period in late 2017 while falsely claiming that the fund was the "first regulated crypto asset fund in the United States" and claimed the fund had filed registration statements with the SEC.

While not a hedge fund, on 23 August a New York federal court entered final judgment against Patrick McDonnell and CabbageTech, Corp. d/b/a Coin Drop Markets based on charges brought by the CFTC.

The company claimed that, in exchange for sending digital assets, customers could receive expert crypto trading advice or have the company trade on their behalf.

However, no such expert advice or trading services were provided. The company was charged with fraud and was fined more than \$290,000 in restitution and \$871,000 in civil penalties, plus interest.