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**PROGRAM MATERIALS**

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# **Crypto and Digital Assets in Private Funds: Regulatory Updates, Investment Trends and Top Considerations for Investment Managers and their Legal Counsel**

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# **Crypto and Digital Assets in Private Funds:**

*Regulatory Updates, Investment Trends and  
Top Considerations for Investment Managers  
and their Legal Counsel*

June 7, 2022

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# Crypto and Digital Assets in Private Funds

WHAT WE WILL COVER



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# Crypto and Digital Assets in Private Funds

## Overview

- Introduction
- Defining Crypto/Digital Assets
- How Does it Relate to the Blockchain Economy?
- Are Crypto/Digital Assets Regulated?
- The Battle Between the SEC and CFTC
- Biden's Executive Order
- Key Challenges

# Crypto and Digital Assets in Private Funds

## Introduction

The crypto and digital asset space is on everyone's minds – even John Oliver! But it remains a growing and complex sector due to legal restrictions and increased regulatory uncertainty and scrutiny.



*Source: Cryptocurrencies - Last Week Tonight with John Oliver (HBO)*

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# Crypto and Digital Assets in Private Funds

## DEFINING CRYPTO/DIGITAL ASSETS



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# Crypto and Digital Assets in Private Funds

## Defining Crypto/Digital Assets

- Any form of currency that exists digitally or virtually and uses cryptography to secure transactions.
- A peer-to-peer digital payment system that doesn't rely on banks to verify transactions and can enable anyone, anywhere, to send and receive payments.
- Crypto payments are digital entries to an online database describing specific transactions - when crypto funds are exchanged, the transactions are recorded in a public ledger.



# Crypto and Digital Assets in Private Funds

## Defining Crypto/Digital Assets

- The recent Form PF proposal is the first time a regulatory body has tried to define crypto/digital assets.
- The SEC voted January 26, 2022 to propose Form PF amendments defining crypto/digital assets in the glossary entry as:
  - An “asset that is issued and/or transferred using distributed ledger or blockchain technology (‘distributed ledger technology’), including, but not limited to, so called ‘virtual currencies,’ ‘coins,’ and ‘tokens.’”



# Crypto and Digital Assets in Private Funds

## Defining Crypto/Digital Assets

### What Is Cryptocurrency?

Cryptocurrency is digital money created from code.

The cryptocurrency economy is monitored by a peer-to-peer internet protocol.

Cryptocurrency is an encrypted string of data or a hash, encoded to signify one unit of currency.

### Examples of Cryptocurrency

Bitcoin

Ethereum

Ripple

Source: [What Is Cryptocurrency and How Does it Work?](#)

# Crypto and Digital Assets in Private Funds

HOW DOES IT RELATE TO THE BLOCKCHAIN ECONOMY?



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# Crypto and Digital Assets in Private Funds

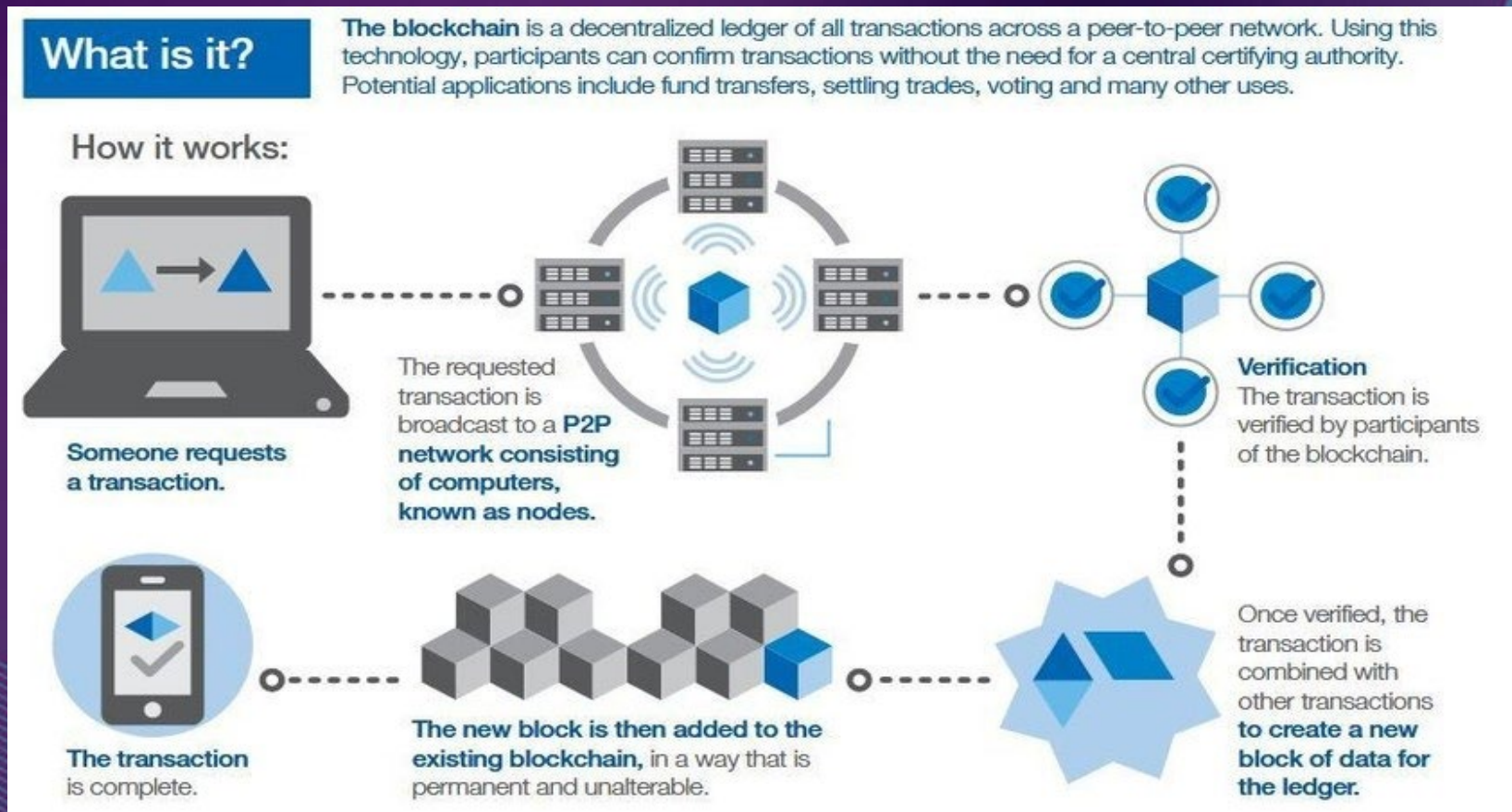
## How Does it Relate to the Blockchain Economy?

- Cryptocurrencies run on a distributed public ledger called blockchain, a record of all transactions updated and held by crypto/digital asset holders.
- Blockchain is similar to traditional ledgers – it confirms ownership, identity, status, and authority. BUT it does those things solely for decentralized, digital assets.



# Crypto and Digital Assets in Private Funds

## How Does it Relate to the Blockchain Economy?





# Crypto and Digital Assets in Private Funds

ARE CRYPTO/DIGITAL ASSETS REGULATED?



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# Crypto and Digital Assets in Private Funds

## Are Crypto/Digital Assets Regulated?

- No federal laws or statutes directly address crypto/digital assets:
  - Congress has deferred to regulatory agencies to deal with any issues
  - No current regulations that specifically address crypto/digital assets
- Lack of guidance on which digital assets should be classified as securities:
  - Some cryptocurrencies (Bitcoin and Ethereum) are not considered securities
  - Initial coin offerings (“ICOs”) and Decentralized Autonomous Organization (“DAO”) issued tokens can be considered securities offerings and fall under the SEC’s jurisdiction



# Crypto and Digital Assets in Private Funds

## Are Crypto/Digital Assets Regulated?

- Should crypto/digital asset managers register as investment advisers with the SEC
- Two schools of thought:
  1. The underlying asset held in the portfolio is not a security because crypto/digital assets generally are not treated as a security.
    - a. Should Securities Portfolios Test apply?
  2. Registration is necessary by virtue of managing a pooled investment vehicle exempt from registration under Section 3(c)1 or 3(c)7 of the Investment Company Act of 1940 ("Private Fund") irrespective of the classification of the underlying asset.
    - a. In this case, no need to conduct the Securities Portfolios Test.
    - b. Per Form ADV instructions, if the manager is advising a Private Fund, the total AUM of such fund should be included in the calculation of regulatory assets under management.

# Crypto and Digital Assets in Private Funds

## Current Regulatory Obligations - Digital Asset Securities Risk Alert

- The SEC issued a Risk Alert highlighting a focus on regulatory compliance associated with the following items as they related to Investment Advisers:
  - Portfolio management
  - Books and records
  - Custody
  - Disclosures
  - Pricing of client portfolios
  - Registration issues



# Crypto and Digital Assets in Private Funds

## Are Crypto/Digital Assets Regulated? Howey Test

- In *SEC v. W.J. Howey Co.*, 328 US 293 (1946), Howey failed to register transactions that the SEC, and later, the U.S. Supreme Court determined were leaseback arrangements that qualified as investment contracts.
- As a result, the following four-pronged criteria was created to determine if an investment contract exists, which must involve each of the following:
  - An investment of money
  - In a common enterprise
  - With the expectation of profit
  - To be derived from the efforts of others

# Crypto and Digital Assets in Private Funds

## Current Regulatory Obligations – Audet v. Fraser

### Audet v. Fraser (2021)

- A class action lawsuit was filed against Fraser for securities fraud based on his involvement with four crypto products. Fraser claimed that the crypto products were not securities and therefore, he cannot be held liable.
- The Court sent the issue of whether the crypto products were securities to the jury.
- Under Howey, the jury determined that the four crypto products were not securities. This is the first time that a jury has been asked to weigh in on the issue of whether a particular cryptocurrency product should be considered a security.



# Crypto and Digital Assets in Private Funds

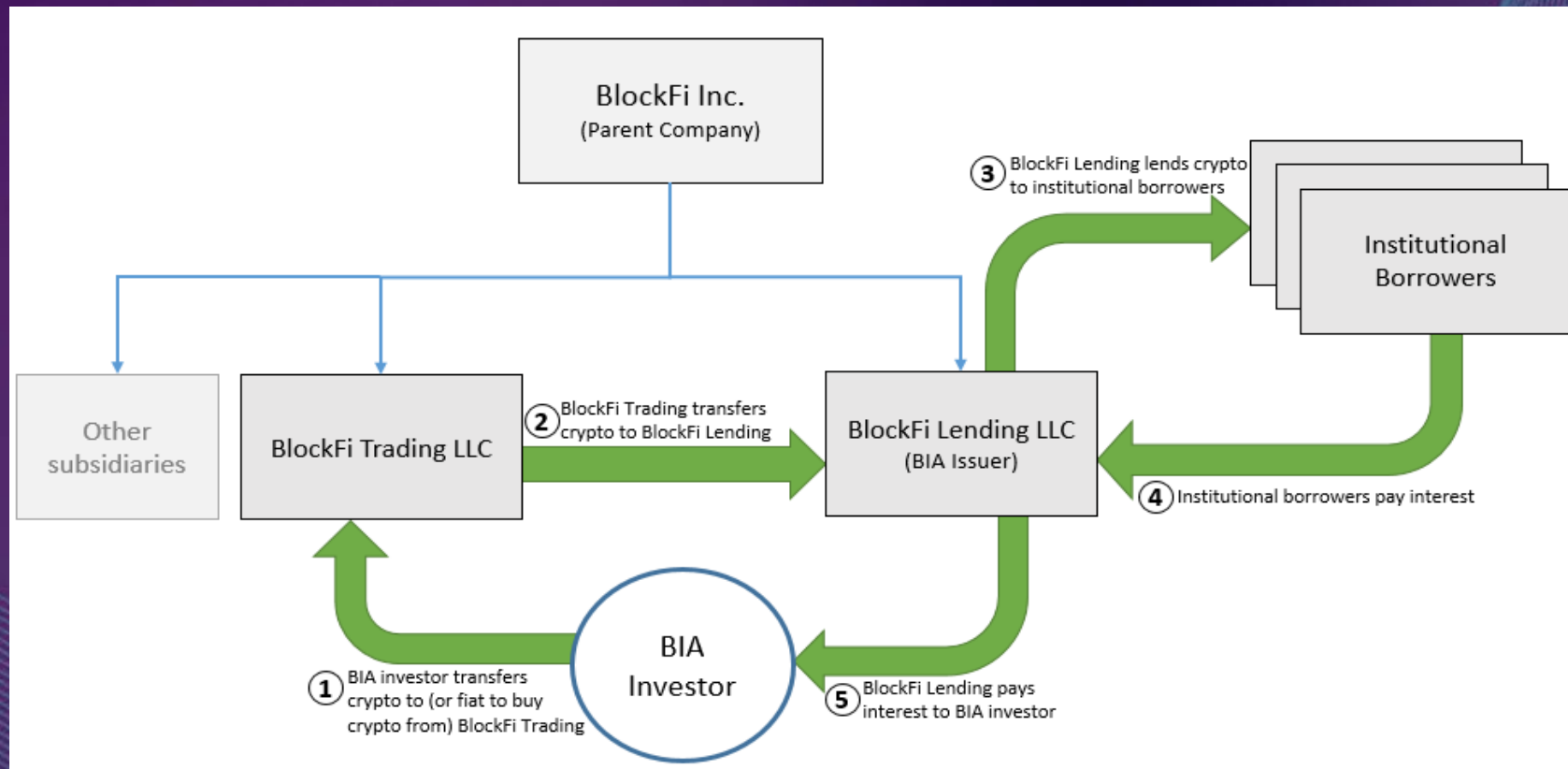
## Are Crypto/Digital Assets Regulated?

- SEC has pursued enforcement actions against companies who deal in digital assets.
- There has been some federal case law regarding the classification of certain digital assets as securities.
- States have taken different approaches to handling cryptocurrencies and digital assets:
  - For example, Wyoming law ([W.S. 34-29-101](#) and [W.S. 34-29-106](#)) separates digital assets into three classifications:
    1. “Digital consumer assets”
    2. “Digital securities”
    3. “Virtual currency”

# Crypto and Digital Assets in Private Funds

## Blockfi Lending LLC

- Example of the SEC determining that registration was necessary:



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# Crypto and Digital Assets in Private Funds

## Blockfi Lending LLC

- SEC charged BlockFi for “failing to register the offers and sales of its retail crypto lending product” and violating the registration provisions of the Investment Company Act of 1940 (“ICA”).
- BlockFi offered and sold the BlockFi Interest Accounts (“BIAs”) to the general public without registering with the SEC or an exemption from registering. SEC determined that the BIAs were securities and BIA investors “had a reasonable expectation of obtaining a future profit” and that BlockFi would use their “invested crypto assets in their lending and principal investing activity[.]”
- BlockFi agreed to: pay \$100 million in penalties; a cease-and-desist order from violating the provisions of the Securities Act and ICA; and stop offering/selling BIAs in the U.S.
- Commissioner Hester M. Peirce said that she does not agree with the SEC’s approach to crypto lending.



# Crypto and Digital Assets in Private Funds

## Ripple Labs Inc.

- In December 2020, the SEC charged Ripple Labs Inc. and two of its executive officers (collectively, “Ripple”) alleging that Ripple raised over \$1.3 billion in unregistered offerings of the digital asset XRP but failed to register its offers and sales of XRP, or satisfy any exemption from registration, in violation of Section 5 of the Securities Act of 1933.
- The matter will likely drag on into next year after Ripple and the SEC agreed on a schedule for the next phase of the case.
- The lawsuit’s outcome could have far-reaching implications for crypto:
  - If SEC prevails, it could upend the way crypto companies operate, setting a precedent that the digital assets they offer users must be subject to the strict reporting and registration rules that apply to securities.
  - If Ripple wins, it would be a major victory for crypto at a time when the industry is growing rapidly but also facing more intense regulatory scrutiny on multiple fronts.



# Crypto and Digital Assets in Private Funds

## Coinbase Lend

- Coinbase Lend was a digital assets interest account.
- The SEC sent a Wells Notice to Coinbase, stating that the SEC staff would advise an enforcement action against them if they offered the Lend product to the public.
  - The Wells notice also stated that the Coinbase Lend product is a “note” under *Reves v. Ernst & Young* and also an “investment contract” under *SEC v. W.J. Howey Co.* No additional clarification was given by the SEC.
- Coinbase stated that they have “been proactively engaging with the SEC about Lend for nearly six months.”
- On September 17, 2021, Coinbase Lend was completely cancelled.

# Crypto and Digital Assets in Private Funds

## SEC v. Kik Interactive

### SEC v. Kik Interactive, Inc. (2020)

- The SEC brought a lawsuit against the defendant and alleged that they participated in an unregistered sale of securities. Kik sold \$100 million USD of “Kin”, a digital token. Kik claimed that their digital token was not a security, but a currency that can be used inside their own marketplace.
- Using the Howey Test, the Court determined that the defendant’s marketplace was a common enterprise. The Court concluded that Kik’s statements about how the value of their digital token would increase based on the defendant’s “entrepreneurial and managerial efforts” meant that their Kin investors were “led to expect profits solely from the efforts of” others.
- Key takeaway: “every cryptocurrency, along with the issuance thereof, is different and requires a fact-specific analysis.”



# Crypto and Digital Assets in Private Funds

## Are Crypto/Digital Assets Regulated?

Insider trading considerations:

- Challenging to apply securities laws to this asset class
- How does material, non-public information (MNPI) apply to transactions of crypto/digital assets?
- See Berk v. Coinbase, Inc. as example

# Crypto and Digital Assets in Private Funds

## Berk v. Coinbase, Inc.

### Berk v. Coinbase, Inc.

- The class action lawsuit claimed that Coinbase had artificially inflated the prices of Bitcoin Cash (“BCH”) for Bitcoin customers.
- Plaintiff alleged that a “month after tipping off its own employees as to when it would commence fully supporting BCH, the defendant suddenly announced that it was opening up its books to the buying and selling of BCH within minutes after its announcements.”
- The case was dismissed because plaintiff failed “to describe the scope or content of Coinbase’s duty in anything more than broad generalities.” Plaintiff appealed and claimed that “Coinbase owed an independent duty of care to ensure a functioning marketplace for BCH” (Biakanja v. Irving).
- The Court of Appeals disagreed, stating that a “business entity has no duty to prevent financial loss to others with whom it deals directly.”



# Crypto and Digital Assets in Private Funds

THE BATTLE BETWEEN THE SEC AND CFTC



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# Crypto and Digital Assets in Private Funds

## The Battle Between the SEC and CFTC – CFTC’s Side

Reasons former Chairman of CFTC, J. Christopher Giancarlo, believes the CFTC should be the primary regulator, according to interview given to [Yahoo! Finance](#) on [February 17, 2022](#):

- Lack of regulatory clarity and congestion over crypto regulation are major obstacles.
- He doesn’t see Congressional consensus for a “comprehensive crypto bill” to pass this year because of midterm elections.
- The CFTC would help facilitate institutions engaging in retail markets, monitor consumer protection, and fraudulent activity, according to Giancarlo.



# Crypto and Digital Assets in Private Funds

## The Battle Between the SEC and CFTC – SEC's Side

Reasons SEC Chair Gary Gensler believes the SEC should be the primary regulator:

- Crypto/digital asset managers need to conform to existing rules, not the other way around.
- In remarks made at the Penn Law Capital Markets Association Annual Conference on April 4, 2022, Chair Gensler reiterated the SEC's responsibility of overseeing the capital markets and its three-part mission:
  - Protecting investors
  - Facilitating capital formation
  - Maintaining fair, orderly, and efficient markets

# Crypto and Digital Assets in Private Funds

## The Battle Between the SEC and CFTC – SEC's Side

- Key takeaway from Chair Gensler's remarks:
  - "[w]e ought to apply these same protections in the crypto markets. Let's not risk undermining 90 years of securities laws and create some regulatory arbitrage or loopholes."
  - Additionally, he commented that "[w]ithin the policy perimeter, regulators also care about guarding against illicit activity, a role that is so important to us and our partners at the Department of the Treasury and the Department of Justice; and about financial stability, which is important to all financial regulators."



# Crypto and Digital Assets in Private Funds

## BIDEN'S EXECUTIVE ORDER





# Crypto and Digital Assets in Private Funds

## “Executive Order on Ensuring Responsible Development of Digital Assets”

- Biden’s Executive Order was the first “whole-of-government approach to addressing the risks and harnessing the potential benefits of digital assets and their underlying technology.”
- Key takeaway is that digital assets are a top priority for various agencies at the highest levels of government.



# Crypto and Digital Assets in Private Funds

## KEY CHALLENGES



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# Crypto and Digital Assets in Private Funds

## Key Challenges

- Custody of Assets:
  - Qualified Custodians?
  - Cybersecurity and Accounting Risks:
    - Crypto assets change hands quickly and have significant price volatility, making them different to protect than more traditional financial assets.
    - Far fewer regulatory requirements for exchanges or companies holding crypto assets on behalf of users, and that they may not be complying properly with regulations, increasing risks to investors.
    - Unique risks for entities who safeguard crypto-assets and also maintain the cryptographic key to access those crypto-assets.



# Crypto and Digital Assets in Private Funds

## Key Challenges

- Monitoring Personal Trading:
  - Compliance platforms generally do not support direct broker feeds for digital assets and direct feeds for digital asset wallets (i.e., Coinbase).
    - Some compliance platforms (ComplySci and MCO) are working on expanding their services to cover digital assets.
- Regulatory Implications of New Digital Asset Business Lines:
  - Crypto Lending Pools – Decentralized Finance
  - NFTs – Digital Property Rights

# Crypto and Digital Assets in Private Funds

## Key Challenges

- General legal ambiguity surrounding the classification of digital assets
- Retention of electronic communications
- Due Diligence of:
  - Counterparties
  - Assets in which advisers invest



# Crypto and Digital Assets in Private Funds

ABOUT SILVER REGULATORY ASSOCIATES



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# Speakers



**Fizza Khan**  
*Chief Executive Officer*



**Nicholas Nunez**  
*Managing Director and  
Head of Regulatory  
& Compliance*

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# Biographies

## Fizza Khan, CEO, Silver Regulatory Associates

Fizza Khan is an expert on regulations governing investment advisers, broker-dealers and registered and private funds. As a hands-on leader across the firm's flagship service lines – Regulatory Compliance, ESG and Due Diligence Preparation – Fizza ensures Silver's clients are fully prepared to withstand regulator and investor scrutiny.

Prior to founding Silver, Fizza was the Chief Operating Officer for U.S. Compliance Consulting and a Managing Director at Duff & Phelps. She joined Duff & Phelps in January 2016 as a result of their acquisition of CounselWorks LLC where she was a Partner. At both Duff & Phelps and CounselWorks, Fizza managed the day-to-day provision of compliance services to firm clients and built the foundations upon which advice was given.

Fizza received a Bachelor of Science in Business from Drexel University, where she concentrated on Finance and Economics and published a thesis on the effects of derivative trading regulation. She earned a Juris Doctor from the University of Maryland School of Law.



# Biographies

## Nicholas Nunez, Managing Director and Head of Regulatory & Compliance

As the managing director and head of regulatory and compliance, Nicholas Nunez works with investment advisers and broker dealers to register with regulatory authorities, develop and maintain their compliance programs and withstand scrutiny under both regulator examination and investor due diligence. In addition, Nicholas works with the CEO to manage the operations of Silver.

Prior to joining Silver, Nicholas served as the Deputy Director of Compliance at Commonwealth Opportunity Capital (CWOC), an SEC and CFTC-registered adviser that employed global macro strategies. At CWOC, he ensured implementation of numerous aspects of the compliance program, including development and execution of policies and procedures, administration of forensic testing and management of compliance trainings and also served as the firm's cybersecurity responsible officer. Prior to CWOC, Nicholas was an Associate Director at CounselWorks LLC, a regulatory and business strategy consulting firm to investment advisers and broker dealers.

Nicholas holds a Bachelor of Science in Business Administration from Saint Joseph's University.



# About Silver Regulatory Associates

## Firm Overview

Silver prepares investment firms for success under regulator examination and investor due diligence. We combine multifaceted industry expertise and innovation savvy to align firm processes with regulator and investor expectations without creating unmanageable complexity. Silver's customized guidance of private equity, venture capital, hedge fund and crypto/digital asset firms reflects each client's size, strategy and culture.

Our stringent, yet practical, approach reflects Silver's roots in regulatory compliance rigor and investment firm business realities. We calibrate best practices with business considerations to find sustainable approaches for each client. Silver gets to know a client quickly and becomes an extension of their team. We take on ownership and the heavy-lifting, carrying out the routine and most time-consuming tasks.

The logo for Silver Regulatory Associates, featuring the word "SILVER" in a bold, white, sans-serif font. The text is centered within a dark, rectangular box that has a subtle gradient and a slight shadow effect, making it stand out against the dark blue background of the slide.



# About Silver Regulatory Associates

## Crypto/Digital Assets Specialty Services

### Crypto/Digital Asset Specialty Services

- Regulatory risk and best practice review tailored to crypto/digital asset investing
- Customized, compliance programs that focus on issues most relevant to crypto/digital asset investing:
  - investment suitability
  - portfolio management and trading practices
  - custody and safety of client assets
  - pricing and valuation
  - anti-money laundering (AML) risks for crypto/digital assets
- Due Diligence Questionnaires that fit crypto/digital asset investing and operations and address customary
- investor inquiry
- Access person and employee conflicts of interest review and management advice



# Questions & Answers


## Thank You


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*Please feel free to reach out with any follow up questions.*

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