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# Recent Developments in Cryptocurrencies and Blockchain Technology in the Fund Industry

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The era of virtual or “crypto” currencies arrived in 2008 with the founding of Bitcoin. Cryptocurrencies are digital representations of value that can be digitally traded and function as a medium of exchange, unit of account, or store of value. Cryptocurrencies are not, however, legal tender – that is, they cannot necessarily be tendered to a creditor as a valid and legal payment. Cryptocurrencies such as Bitcoin are created and disseminated using “blockchain” or distributed ledger technology (DLT). This technology utilizes a network of independent computers connected over the internet to verify and irrevocably log transactions in a decentralized public transaction ledger known as the “blockchain.” The blockchain is a record of transactions written as a series of equations. Blockchain technology powers Bitcoin but can be used for other purposes as well. This alert explores some of the recent securities law developments in cryptocurrencies, blockchain technology developments in the fund industry, and related fund director responsibilities.

## Recent Securities Law Developments in Cryptocurrencies

### SEC Guidance

Jay Clayton, Chairman of the Securities and Exchange Commission (SEC), delivered a Statement on Cryptocurrencies and Initial Coin Offerings (the “Statement”) on December 11, 2017. The Chairman noted that the rapid growth of the virtual currency and initial coin offering (ICO) market presents investors and other market participants with a multitude of questions, including whether the product or offering is legal, whether the trading markets are fair, and whether there is a significant risk of loss or theft. Chairman Clayton warned that virtual currency markets are substantially less regulated and offer fewer investor protections than traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. He urged market professionals to (i) review recent SEC guidance<sup>1</sup> and enforcement actions and (ii) read closely the Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934: The DAO (the “DAO Report”).

<sup>1</sup>Investor Bulletin on ICOs; Statement on the Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others

The DAO Report focuses on the securities law implications of ICOs. An ICO is an offering of a new digital coin – sometimes called a token – in order to raise capital for a business or project. ICOs generally give the holders of the tokens some type of right related to the business or project being funded.

The SEC concluded in the DAO Report that under the present facts and circumstances, the DAO tokens were securities. In the DAO Report, the SEC admonished that, depending on the facts and circumstances, cryptocurrencies may be considered securities requiring registration, unless valid exemptions apply. The SEC further advised that, depending on the facts and circumstances, the platforms used to trade cryptocurrencies on the secondary market are securities exchanges.

Chairman Clayton further emphasized two points in the Statement. First, in determining whether a virtual currency or ICO constitutes a security or an offering of a security, the SEC will consider substance over form, stating that “simply calling something a ‘currency’ does not mean it is not a security” and that “before launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must (i) be able to demonstrate that the currency is not a security or (ii) comply with applicable registration and other requirements ....” Second, broker-dealers and other market participants who use cryptocurrencies to facilitate market transactions should ensure they are not violating anti-money laundering and know-your-customer obligations.

### SEC Action on ICOs and Cryptocurrencies

The Statement came hours after a California company halted an initial coin offering after being notified by the SEC that its ICO was an illegal and unregistered offering of securities. The company also consented to a cease and desist order wherein the SEC reiterated its analysis and conclusion from the DAO Report, i.e., that under certain facts and circumstances, virtual currencies are securities and ICOs must comply with federal securities laws or find a valid exemption.

Last month, the SEC also obtained an emergency asset freeze to halt an ICO fraud that began in August 2017 and had raised up to \$15 million from thousands of investors. The charges were the first to be filed by the SEC’s newly created Cyber Unit. The Cyber Unit’s mandate is to focus on cyber-related misconduct, including violations involving DLT and ICOs.

These actions highlight, among other things, regulators' concerns over the extreme price volatility (e.g., Bitcoin rose more than 40 percent in a 40-hour period in December) and risk of complete loss of value of cryptocurrencies. Cybersecurity also remains a concern. Although cryptocurrency transactions generally must be verified with the holder's individualized "private key" before being recorded, concerns remain over the integrity of blockchain technology and the potential for hacking or manipulation of distributed ledgers.

### ETF Registration Statements

Chairman Clayton noted in the Statement that to date, no ICOs have been registered with the SEC and that the SEC has not approved any exchange-traded products holding cryptocurrencies. We should note, however, that there are at least six exchange-traded fund (ETF) sponsors who have filed registration statements for ETFs that would hold Bitcoin or obtain exposure to Bitcoin through futures contracts. The SEC has put out a call for public comment on two proposed rule changes to the Chicago Board Options Exchange that would allow the exchange to list the first Bitcoin related ETFs. No action has been taken to date on the registration statements, however, and at least one of those applications was withdrawn.

### CFTC and Futures Actions

The first U.S. Bitcoin futures contracts began trading on Sunday, December 11, 2017, on an exchange run by Cboe Global Markets Inc. CME Group began trading Bitcoin futures one week later, and other exchanges are planning to introduce their own Bitcoin futures in the coming weeks. The debut of Bitcoin futures has renewed efforts to launch the first Bitcoin-related ETFs and exchange-traded products. Of note, the Commodities Futures Trading Commission considers (i) Bitcoin and other cryptocurrencies to be commodities, (ii) derivatives contracts based on a cryptocurrency to be one area of its oversight, and (iii) its jurisdiction implicated wherever there is fraud or manipulation involving a cryptocurrency traded in interstate commerce.

## Blockchain Technology Developments in the Fund Industry

Fund shops, custodians and other service providers are reportedly looking into possible uses of blockchain or distributed ledger technology for, among other things, trade processing and settlement, proxy voting, and repurchase agreements. Because DLT allows for control and transparency by documenting the author and creating a record of each change to a given ledger, the technology has the potential to reduce the risk of operational errors or fraud on trading platforms and in the clearance and settlement process, and to aid in regulatory reporting, audit and compliance. DLT could also streamline the trade clearance and settlement process through the use of "smart contracts," i.e., digital contracts that are stored in computer code and that can be digitally executed once two or more parties enter their individual "private keys." The technology also has the potential to provide for a more efficient process for complying with anti-money laundering and know-your-customer obligations by allowing one organization's verification of

a client to be accessed by another organization without beginning the process over.

Certain fund industry providers have also announced specific blockchain-based initiatives. Vanguard recently tested and has plans to go live with a blockchain-based system that will automate the sharing of index data with one of its top benchmark providers. The Depository Trust & Clearing Corporation (DTCC), working with Digital Asset – a DLT developer – demonstrated in early 2017 the first successful netting of the "start" leg of repo transactions with prior end-of-day net securities obligations in the DTCC environment. Nasdaq Private Market, a Nasdaq market that services the equity shares of privately held companies, has also launched a blockchain proof of concept called Ling, which currently records shares of privately held firms. Additionally, Broadridge, J.P. Morgan, CME Group, State Street and others have joined the Hyperledger Project, an open-source project aimed at driving the adoption and standardization of DLT.

## Fund Director Responsibilities

Fund directors are responsible for the oversight of various aspects of a fund's investments, disclosures, operations and risk management. Blockchain technology and cryptocurrencies are both frontier issues for the fund industry and the potential benefits and risks remain to be seen. Fund directors may wish to consider asking fund sponsors for management's view on blockchain technology, ICOs and cryptocurrencies. Some specific questions that fund directors may wish to consider with respect to the use of blockchain technology in fund operations and a fund's holding of cryptocurrencies or cryptocurrency derivatives are listed below.

### Oversight of Investments

- To what extent, if any, will a fund invest directly or indirectly in cryptocurrencies and/or ICOs?
- How will Bitcoin and other virtual currencies be categorized under the Investment Company Act of 1940 (e.g., an asset other than a security, cash or cash equivalent)?

### Oversight of Fund Operations

- To what extent is management considering using blockchain technology in fund operations? For what functions? What are the potential risks, rewards and liabilities associated with this technology as proposed?
- Should transactions in Bitcoins and other virtual currencies be covered by the code of ethics applicable to a fund's investment personnel?
- If a fund elects to keep its cryptocurrencies in the custody of a bank or broker, who will have access to and control of the fund's private key associated with its virtual currency holdings?
- If a fund complies with the self-custody rules, should arrangements be made to deposit its private key in the safekeeping of a bank "or other company whose functions and facilities are supervised by a federal or state authority" (e.g., some states

have established comprehensive frameworks for regulating and issue licenses under state banking or similar laws to businesses involved with virtual currencies)?

#### Oversight of Risk

- What is the role of compliance and risk management in DLT technology as used by a fund?
- What are the privacy and confidentiality ramifications relating to the use of this technology?
- What risks do cryptocurrencies or cryptocurrency derivatives pose to a fund and its shareholders; are they appropriate for the portfolio of an open-end mutual fund structure?
- Will cryptocurrency holdings affect the implementation of fund liquidity risk management programs?

#### Oversight of Disclosure

- If blockchain technology is used in fund operations, are the risks sufficiently disclosed?
- Do the fund's registration statement and related documents properly disclose the risks related to a fund's holding of cryptocurrencies or cryptocurrency derivatives (e.g., risks surrounding the potentially illiquid nature, extreme price volatility and cyber security of cryptocurrencies)?
- How will valuation and financial reporting requirements be met for a fund's cryptocurrencies and cryptocurrency derivative holdings (e.g., are they valued based on quoted prices, but involving some degree of judgement by the fund because of the nature of the markets in which they trade)?

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