

The Growing Interest in Cryptocurrencies

Q&A with SRZ's Blockchain Technology & Digital Assets Group

The *Hedge Fund Journal* spoke with the leading lawyers of Schulte Roth & Zabel's (SRZ) Blockchain Technology & Digital Assets Group. The growing interest in cryptocurrencies is among the many trends the lawyers will discuss at SRZ's 27th Annual Private Investment Funds Seminar in New York in January 2018.

This Q&A features: Stephanie R. Breslow, SRZ partner, co-head of the Investment Management Group and a member of the firm's Executive Committee; Brian T. Daly, SRZ partner in the Investment Management Regulatory & Compliance Group and Seetha Ramachandran, SRZ partner in the Litigation Group, all also members of the firm's Blockchain Technology & Digital Assets Group.

Q. How do you start up a fund to invest in digital assets and blockchain technology?

Stephanie R. Breslow: Digital assets and blockchain technology are creating novel investment opportunities. Digital asset funds are privately placed, so there are rules about how they can be advertised and offered, and who the investors can be. Sponsors haven't yet been able to do retail public offerings in this space.

Privately placed funds pursue a variety of strategies, including investing in a single digital currency, strategically investing in multiple digital currencies, investing in initial coin offerings (ICOs) or in venture opportunities relating to blockchain technology, and acting as a fund of funds into other funds in the space.

Your choice of strategy will determine the best choice of terms, with liquidity ranging from almost daily liquidity (for funds that basically act as wallets) to locked-up, private equity structures (for funds that invest in venture-stage companies). Fund sponsors should be aware that the tax and regulatory treatment of these assets is in flux.

Q. What are the regulatory considerations for blockchain and Bitcoin investing?

Brian T. Daly: Everyone is asking about cryptocurrencies. These instruments have the potential to fundamentally change how we buy and how we sell deal with payment counterparties, and the blockchain technology underlying these instruments will be a disruptor in many industries.

After some initial confusion, the SEC has taken a step back from direct regulation of digital currencies, on the theory that they are commodities (like corn and gold) and not securities. This leaves the field open to the Commodity Futures Trading Commission (CFTC), but the funny thing is that the CFTC can only regulate commodity futures and derivatives, not the actual commodity itself. (You do not, for example, see the CFTC regulating the size and quality of corn kernels that are sold in supermarkets.) So Bitcoin futures fall under the CFTC's jurisdiction, although Bitcoin themselves generally do not.

The SEC has not abandoned the field, however. There was a flurry of issuances of ICOs, which may be stylized as cryptocurrency and services-related interests that are outside of the SEC's jurisdiction. The SEC, however, has concluded at least some of these ICOs are, in fact, securities and therefore ICO issuances that resemble securities are subject to the US securities laws. SEC Chairman Clayton himself recently issued guidance that, among other things, highlighted the risks of noncompliance in ICO issuances for financial industry gatekeepers.

Q. If cryptocurrencies are not classified as money, do anti-money laundering (AML) rules, per se, only apply when exchanges between cryptocurrencies, and money, are made?

Seetha Ramachandran: The applicability of the AML laws generally turns on the type of activity at issue, not the definition of money. The AML rules apply to entities that are defined, under the Bank Secrecy Act (BSA), as "financial institutions." This definition includes

exchangers of virtual currency because they are engaged in money transmission.

Q. Some Bitcoin exchanges and counterparties claim to be applying AML and know your customer (KYC) checks. Is this just a voluntary measure and are they actually regulated by the regulators that enforce AML?

Seetha Ramachandran: The US Department of Treasury's Financial Crimes Enforcement Network (FinCEN) has clarified that accepting and transmitting anything of value that substitutes for currency renders that person a money transmitter under the implementing regulations of the BSA, and the government has brought enforcement actions on that theory. Accordingly, most Bitcoin exchangers are subject to AML requirements.

However, someone who simply uses virtual currency to purchase goods or services is usually not engaged in money transmission and therefore not subject to AML requirements.

Q. What safeguards can ICOs, or asset managers investing in cryptocurrencies, introduce to mitigate AML type risks?

Seetha Ramachandran: Throughout the private investment fund industry, asset managers have voluntarily adopted AML programs as a best practice – even though such programs are not yet mandatory – because they want to mitigate AML risks. The cornerstone of these AML programs has always been "Know Your Investor." Mitigating AML risks as part of an ICO or investment in cryptocurrency is no different – an asset manager should ask the right questions about the investor and its source of funds, even where an AML program may not be required by law. **THFJ**

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