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Virtual Wine in Clay Amphoras: The SEC's Approach to the Regulation of Investment Funds of Digital Assets

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Cryptocurrencies and other digital assets are of great interest to the public, to regulators, to politicians, and to the asset management industry. The responses of the Securities and Exchange Commission (SEC), in the first instance, and Congress, as perhaps the ultimate arbiter, to the issues cryptocurrencies and other digital assets present will be a significant test for the continuing viability of the United States' approach to securities regulation in a global, and now incorporeal, age. Because the congressional debate is in its early stages, this article first focuses on the SEC's present approach, which is to deny securities exchange listing rule applications[1] for exchange-traded products (ETPs) having direct or "spot" exposures to cryptocurrencies[2] while permitting listing rules for ETPs that are regulated under the Investment Company Act of 1940 (the 1940 Act) and providing indirect exposure to Bitcoin through exchange-traded Bitcoin futures regulated by the Commodity Futures Trading Commission (CFTC).[3] Given this approach, it is left to private funds to provide direct exposure to cryptocurrencies. This article then turns to some of the key issues for these private funds.

With its focus on "Main Street" or retail investor protection, the SEC has taken relatively little action with respect to investment by private fund vehicles in cryptocurrencies and other digital assets. SEC Staff guidance and commentary for private fund investment in cryptocurrencies and other digital assets boils down to fitting cryptocurrencies into existing regulatory requirements applicable to all asset classes, such as valuation and custody. As such, this article concludes with a review of three issues of interest to sponsors of private products: (1) the regulation of private funds offering access to crypto assets; (2) the ability to privately offer such funds to large numbers of high net worth investors; and (3) the regulatory challenges relating to the custody of digital assets for private fund sponsors.

Cryptocurrencies and the Federal Securities Laws

Since their enactment in the New Deal era, the federal securities laws have continually evolved to address market forces undreamed of at their creation. Some of this evolution is the result of congressional action. Thus, for instance, the hostile takeover boom in the late 1960s led to the passage of the Williams Act and proxy reform.[4] In the mid-1990s, with the ever-growing volume of interstate securities offerings, the National Securities Market Improvements Act of 1996 significantly streamlined the prior cumbersome overlapping dual federal and state system of regulating such offerings.[5]

In areas where Congress granted the Securities and Exchange Commission (SEC) regulatory exemptive and rulemaking powers, the SEC on its own has been able to further the evolution of the federal securities laws. Thus, for instance, the SEC adopted in 2019 Rule 6c-11 (the ETF Rule) under the 1940 Act, placing ETFs, which did not exist until the mid-1990s, on the same regulatory footing as mutual funds.[6] Further, the SEC in 2020, "harmonize[d], simplif[ied] and improve[d] the multilayered and overly complex exempt offering framework" under the Securities Act of 1933 (the Securities Act).[7] Thirty years after the passage of the Securities Act, the SEC recognized that the securities laws were intended to be "dynamic,"[8] a theme the Commission and its Chairpersons have returned to repeatedly over the intervening decades. While Chairman Gensler explicitly declined to address crypto in his recent Dynamic Regulation Speech, he noted that the "central question" for securities regulation is "[w]hen new technologies come along and change the face of finance, how do we continue to achieve our core public policy goals?"[9]

SEC Jurisdiction—Cryptocurrencies and Digital Assets as Securities

Whether the SEC has regulatory jurisdiction over a given cryptocurrency or other digital asset depends on whether that cryptocurrency or other digital asset is a "security" for purposes of the Securities Act. If that asset is a "security" for purposes of the Securities Act, it is also likely a "security" for purposes of the 1940 Act, the primary federal statute regulating investment funds, and the Investment Advisers Act of 1940 (the Advisers Act), the primary federal statute regulating those providing investment advice.

The SEC's public positioning on cryptocurrencies and digital assets began in early 2018. On February 6, 2018, then-SEC Chairman Jay Clayton testified before the Senate Banking Committee regarding the regulatory outlook for "virtual currencies."[10] Chairman Clayton broke his analysis of cryptocurrency into three categories: "First, a promising new technology referred to as 'distributed ledger technology' or 'blockchain' … The second and third categories are cryptocurrencies and initial coin offerings (ICOs), respectively."[11] Chairman Clayton spoke favorably regarding blockchain technology and even suggested that such technology may alleviate inefficiencies in markets; however, he spoke much less favorably regarding cryptocurrencies and ICOs.

With respect to cryptocurrency, Chairman Clayton stated:

> [S]imply calling something a "currency" or a currency-based product does not mean that it is not a security…. [M]any products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that *rely on the efforts of others*, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic.[12]

With respect to ICOs, Chairman Clayton stated, "[t]okens and offerings that incorporate features and marketing efforts that emphasize the potential for *profits based on the entrepreneurial or managerial efforts of others* continue to contain the hallmarks of a security under US law."[13] Even before his testimony in 2018, Chairman Clayton clarified that, "just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an initial coin offering that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements."[14] Thus, offerings of ICOs as securities would fit within the existing clay jar through which Regulation D exempt offerings are permitted.[15]

The Hinman Test and the *Howey* Test

On June 14, 2018, then Director of the Division of Enforcement, William Hinman, indicated that particular cryptocurrencies would not

be deemed securities under US law if they are "sufficiently decentralized."[16] Under the "Hinman Test," he articulated how the third prong of the *Howey* Test applies to cryptocurrencies.[17] Director Hinman stated that "[i]f a network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets may not represent an investment contract." In other words, as a network becomes more decentralized, it becomes difficult to identify a promoter.

Director Hinman noted that it is the nature of the transaction, and not the item being sold, that determines whether an offering of securities has occurred. Because a token "all by itself is not a security, just as the orange groves in *Howey* were not," a token sold in a securities offering, such as an ICO, might later be sold in a transaction that does not constitute a security. As such, while a digital asset is not a security because the digital asset itself is simply code, the way it is sold "as part of an investment; to non-users; by promoters to develop the enterprise—can be, and, in that context, most often is, a security—because it evidences an investment contract."[18] However, if the network on which the token or coin is sufficiently decentralized, where purchasers no longer reasonably expect a person or group to carry out essential managerial tasks, the assets likely do not represent an investment contract. In such cases, as "a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosure becomes less meaningful." Bitcoin and Ether are decentralized and not dependent on the efforts of third parties for their success. Thus, under the Hinman Test, they do not qualify as securities based on the second and third prongs of the *Howey* test.[19]

The SEC's views on crypto assets have not changed with the appointment of Gary Gensler as SEC chairman in 2021. Chairman Gensler continues to urge Congress to grant the SEC more jurisdictional scope to oversee the digital asset sector, specifically noting that the cryptocurrency market is "more like the Wild Wild West" as it does not operate within an established regulatory framework that can protect investors.[20]

SEC Is Permitting Bitcoin Futures ETFs but Not Spot Cryptocurrency ETPs—What's the Difference?

To date, sponsors have sought listing rule approval for two types of ETPs. One principal early type would hold Bitcoin directly. The other would invest in Bitcoin-related futures contracts.[21] Before October 2021, the SEC consistently rejected listing rules that would permit the listing ETPs holding Bitcoin directly for two primary reasons: first, because the exchange on which the proposed ETP would trade would not have surveillance-sharing agreements[22] with significant markets that host trading in Bitcoin; and second, because the underlying markets for Bitcoin are not regulated, or not regulated in a manner comparable to a national securities or futures exchange.[23] In effect, the SEC's position was that Bitcoin and other cryptocurrency pricing is unreliable because underlying markets for those cryptocurrencies are unregulated (or, at least, not comparably regulated to national securities exchanges), are opaque in their operations, and are susceptible to manipulation. As a result, the pricing of the proposed ETP products might also be unreliable, creating risks of investor harm. On this logic, all spot and futures exposure-based cryptocurrency ETPs had met with SEC denial of their listing rules.

This SEC's posture changed in October 2021 with respect to ETFs with exposures to Bitcoin futures regulated by the CFTC. Although as described above the SEC has taken the position that Bitcoin and other virtual currencies are beyond SEC regulation insofar as they are not securities, the CFTC has expressly stated that Bitcoin and other virtual currencies are spot "commodities" under the Commodity Exchange Act.[24] While the CFTC does not directly regulate spot commodity markets, such

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as cryptocurrency markets, the CFTC does directly regulate futures contracts on crypto assets.[25] Where, as described below, ETFs subject to SEC registration and regulation invest in futures contracts on crypto assets directly regulated by the CFTC, the SEC began to become comfortable that, unlike prior structures, these structures afforded sufficient protection to investors to permit these structures to be listed.

The "Managed Futures" ETF

In particular, the SEC became comfortable with, and as a result granted listing rule approval to, a group of exchange traded funds structured similarly to managed futures mutual funds. These ETFs hold approximately 75 percent or more of their assets in fixed income securities such as US government securities and no more than 25 percent in the shares of an entity treated as a controlled foreign corporation for US federal income tax purposes (CFC) which invests solely in Bitcoin futures traded on the Chicago Mercantile Exchange (CME).[26] This structure, where the exposure to securities outweighs the actual (if indirect) exposure to Bitcoin, causes the ETF to be an investment company subject to 1940 Act registration and regulation that is overseen by the SEC's Division of Investment Management (IM). Consequently, 1940 Act regulation of these Bitcoin futures ETFs was a key consideration by the SEC in approving their listing rules.[27]

Spot Exposure ETPs

Unlike the "managed futures" ETFs described above, ETPs offering spot exposures to Bitcoin or other established cryptocurrencies will not be subject to 1940 Act regulation because the SEC acknowledges that such cryptocurrencies are not securities. Without a portfolio consisting predominately of securities, these ETPs cannot register under the 1940 Act.[28] As a result, these ETPs will not have, among other things, the internal governance requirements, conflict of interest prohibitions and SEC inspection burdens to which an ETF would be subject under the 1940 Act and regulation thereunder, which, in turn, contributed to SEC denial of their proposed listing rules.[29]

The History of Change

Hints of the SEC's change in logic on Bitcoin futures ETFs were visible in speeches and testimony by Chairman Gensler earlier in 2021. On August 3, 2021, Chairman Gary Gensler noted in remarks to the Aspen Security Forum that at that time there were a "number of mutual funds that invest in Bitcoin futures on the [CME]."[30] Further, Chairman Gensler indicated that he expected there to be additional registration filings for ETFs under the 1940 Act, and that he "look[ed] forward to the Staff's review of such filings," in particular as to ETFs limited to CME-traded Bitcoin futures.[31] Chairman Gensler also noted that the 1940 Act, together with the "other federal securities laws," provide "significant investor protections." The crypto industry took the Chairman's remarks to signal his belief that investment in crypto assets via the futures markets, and in particular through regulated exchanges such as the CME, is safer for investors than via the spot market.[32]

The crypto industry's expectations were borne out by a series of SEC actions in the fall of 2021. On October 19, 2021, the SEC permitted a Bitcoin managed futures ETF, Proshares Bitcoin Strategy ETF (NYSE ARCA: BITO) (the Proshares ETF), to list shares on a national securities exchange, and shortly thereafter permitted two other Bitcoin futures ETFs[33] to list their shares on national securities exchanges. Then, just days after the SEC permitted the Proshares ETF to list its shares, the SEC declined to permit the CBOE BZX Exchange (the BZX) to list and trade shares of two ETPs formed to invest directly in Bitcoin on the spot markets.[34]

In both Denial Orders, the SEC took the position that listing rules that permitted shares of ETPs with direct exposure to Bitcoin spot markets created potential for investor risk that was inconsistent with

requirements under the Securities Exchange Act of 1934 (the Exchange Act) that national securities exchange rules be "designed to prevent fraudulent and manipulative acts and practices" and "protect investors and the public interest."[35] For Bitcoin-based ETPs, the SEC concluded, as it had in denying each prior listing rule application for cryptocurrency ETPs, that a listing exchange can meet these requirements by "demonstrating that the exchange has a comprehensive surveillance-sharing agreement with a regulated market of significant size related to the underlying or reference bitcoin assets[,]"[36] or, in the alternative, by establishing that the Bitcoin market "inherently possesses a unique resistance to manipulation beyond the protections that are utilized by traditional commodity or securities markets[.]"[37] On the latter point, the SEC noted that "[s]uch resistance to fraud and manipulation must be novel and beyond those protections that exist in traditional commodities or securities markets."[38] In each of the Denial Orders, the SEC was unmoved by the BZX's arguments that the Bitcoin market broadly is inherently and uniquely resistant to manipulation.[39] Of particular import in light of Chairman Gensler's comments in August, the SEC noted that, in contrast to Bitcoin futures markets, "[B]itcoin spot trading platforms are not required to register with the CFTC, and the CFTC does not set standards for, approve the rules of, examine, or otherwise regulate [B]itcoin spot markets[,]" and further that "US law 'does not provide for direct, comprehensive Federal oversight of underlying Bitcoin or virtual currency spot markets.'"[40]

Next, the SEC concluded that, notwithstanding that both the BZX and the CME are members of the Intermarket Surveillance Group (ISG), and therefore the BZX is deemed to have a surveillance-sharing relationship with the CME, the CME is not a "market of significant size" for this purpose. Again, this point is identical to that made in each prior listing rule application denial for cryptocurrency ETPs. Whether a particular market is a "market of significant size" depends on whether:

1. There is a "reasonable likelihood that a person attempting to manipulate the ETP would have to trade on the CME bitcoin futures market to successfully manipulate the ETP[;]" and
2. It is unlikely that trading in the ETP would be the predominant influence on prices in that market.[41]

Regarding manipulation, the SEC concluded that the mere fact that trading volume and open interests in the CME Bitcoin futures market have increased over time do not, by themselves, demonstrate to a reasonable likelihood that a person attempting to manipulate the ETP could not do so except through the CME Bitcoin futures market.[42] Moreover, the SEC found that the BZX failed to show that CME Bitcoin futures lead the CME Bitcoin spot market from a pricing perspective, which is central to understanding whether a potential manipulator would need to trade on the CME futures market to manipulate the spot market,[43] and also noted that it would be possible to trade on futures markets other than the CME.[44] Regarding influence on prices, the SEC noted that there was no stated upper limit on the size of the proposed ETP's Bitcoin holdings, and that therefore it was possible that the ETP's trades could be a predominant influence on prices in that market, even though that would be highly unlikely given the sheer size of the CME bitcoin futures market and the size of the underlying market for Bitcoins.

As presaged by Chairman Gensler's comments in August 2021, the SEC appears, at least at present, to be more comfortable with Bitcoin futures ETPs than with Bitcoin spot ETPs, even though each would invest in the same underlying asset class through a publicly offered vehicle. Several commentators have pointed out this inconsistency in the SEC's policy position.[45] More fundamentally, by preferring one form of investment in Bitcoin to another, the SEC's approach appears to diverge from the explicit standard of approval for listing rules in Section 19(b) of the Exchange Act. The SEC's

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approach in all denial orders recognizes the statutory requirements that exchange rules advance transparency and resist manipulation, but does not analyze how to meet those requirements for particular assets, or how those requirements could be met (if at all) for any listing of an investment security providing direct exposure to digital asset returns. For example, despite its repeated protestations to the contrary, the SEC is seeking an ironclad demonstration that a cryptocurrency market cannot be manipulated—an impossible standard and one not applied to other physically-backed and futures-based commodity ETPs. The relevant standard, which was previously applied to assets such as oil or gold, is a showing that the cryptocurrency's market is not readily susceptible to manipulation; digital assets have been subject to a different, much higher standard.[46]

Given that registered ETPs trading in the spot markets are currently unavailable to US retail investors, private funds remain the viable alternative for investors who meet their suitability requirements. There are a number of issues to consider for such private funds.

Private Cryptocurrency Investment Vehicles—Direct Exposures Permitted

Unlike other private funds, which must qualify for exemption from registration under the 1940 Act to remain private,[47] many crypto funds with exclusively futures or spot exposure to cryptocurrencies will not be regulated by the 1940 Act since they do not hold securities. For example, funds that invest exclusively in crypto assets such as Bitcoin or Ethereum, which are not securities, would not be subject to the 1940 Act, regardless of whether they meet the requirements of the typical exemptions from investment company status.

In addition, given the lack of an applicable exchange listing rule, crypto funds not regulated by the1940 Act must, as a practical matter, be privately offered. For an offering to be considered a "private" offering, private funds typically take advantage of the private placement safe harbor provided by either Rule 506(b) or 506(c) of Regulation D.[48] Rule 506(b) limits funds to up to 35 "sophisticated" but unaccredited investors and an unlimited number of accredited investors.[49]

In contrast, Rule 506(c) permits private funds to engage in general solicitation for their securities offerings if the issuer takes reasonable steps to verify that all purchasers are accredited investors and has a reasonable belief that such purchasers were accredited investors at the time of the sale. Initially, fund managers were hesitant to use Rule 506(c), principally because the adopting release did not specify with particularity what "reasonable steps" meant. Instead, the adopting release presented broad principles that managers would need to apply (and thereby subject themselves to second-guessing by the SEC and other market participants). To address this and other concerns, in November 2020, the SEC amended Rule 506(c) by inserting new Rule 506(c)(2)(ii)(E).[50] In the adopting release for that rule, the SEC reaffirmed that issuers have "significant flexibility in deciding the steps needed to verify a person's accredited investor status[,]" and moreover that issuers are not obligated to any specific method to verify accredited status, but may instead "apply the reasonableness standard directly to the specific facts and circumstances presented" by a particular offering and its intended investors.[51] After the more recent guidance, use of Rule 506(c) for private fund offerings has increased dramatically, as the ability to use general solicitation greatly expands investment advisers' range of permissible marketing activities.

Public Exchange Act Reporting Requirements

Crypto funds that are privately offered but have a large number of holders, as determined under Section 15(d) of the Exchange Act, must comply with public company reporting requirements under the Exchange Act. Once an entity has at least 2,000 holders of its equity securities, it is subject to a number of Exchange Act requirements, including the

requirement to register with the SEC;[52] file annual reports on Form 10-K;[53] quarterly reports on Form 10-Q;[54] and current reports on Form 8-K;[55] the requirement to disseminate a proxy statement or information statement in connection with shareholder actions;[56] and the requirement that insiders disclose their trading in entity securities activities and holdings and, under certain circumstances, disgorge their short-swing profits derived from trading entity securities.[57]

A private fund required to register under Section 15(d) of the Exchange Act may do so on a Form 10 filed with the SEC. A Form 10 registration statement automatically becomes effective 60 days after it is filed, although it remains subject to SEC review and comment. Once the registration statement is effective, the fund is a public reporting company under the Exchange Act.

Form 10 requires information primarily regarding the operations, equity structure, and securities issued by the private fund.[58] The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements. Form 10-Q includes unaudited financial statements and provides a continuing view of the company's financial position during the year. In both the annual reports and the quarterly reports, a fund's chief executive officer and chief financial officer must certify the financial and other information contained in the reports. Finally, the private fund would be subject to file current reports Form 8-K for any major operational, structural, financial, or ownership changes in the private fund, generally within four business days of the occurrence. Events that trigger Form 8-K include unregistered sales of equity securities, and changes in control of the company.

Custody of Digital Assets

Under Advisers Act Rule 206(4)-2 (the Custody Rule), investment advisers registered with the SEC must take special measures to protect client funds or securities as to which they have "custody." The Custody Rule defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."[59] Among other requirements, the Custody Rule requires that the assets of a pooled investment vehicle advised by a registered investment adviser will be held by a "qualified custodian,"[60] which includes FDIC-insured banks and savings associations, broker dealers, futures commission merchants, and certain foreign financial institutions.[61]

As a threshold matter, the Custody Rule applies only to (1) registered investment advisers, and (2) where an adviser has custody of "client funds or securities." Investment advisers not required to register under the Advisers Act, including state-registered advisers and advisers solely to private funds with regulatory assets under management under US$150 million,[62] are not subject to the Custody Rule (although state-registered advisers may be subject to analogous state laws). Whether digital assets that are not securities are "client funds" for purposes of the Custody Rule is a more difficult question, and to date the SEC has not directly answered this question (though it has solicited public input on this point).[63]

The SEC has not given direct guidance on how digital assets must be custodied under the Custody Rule. Instead, the SEC has requested public comment on several questions addressing the interplay between digital assets and the Custody Rule, starting first in 2018 with the Dalia Blass Letter, and then in a 2019 letter to the Investment Adviser Association (the Staff Custody Letter).[64] In the Staff Custody Letter, the SEC expressly asked for input from market participants on, among other questions, whether digital assets are "client funds," how advisers evaluate potential digital asset custodians, and what risks are attendant to settlements of peer-to-peer and intermediated digital asset transactions.[65] Further, in November 2020, the SEC released a Staff Letter (the Wyoming Letter) responding to a letter published by the Wyoming Division of Banking that addressed

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the Wyoming Division of Banking's views on, among other matters, the definition of "qualified custodian" under the Custody Rule.[66] In the Wyoming Letter, the SEC solicited public feedback on the extent to which safeguarding digital assets requires certain qualities in a custodian that other asset classes do not, and the relative advantages (or disadvantages) of using state-chartered trust companies as qualified custodians.[67]

In February 2021, the SEC took an initial step toward tailored rules for custody of client digital assets by regulated parties. In a Commission Statement relating to custody of digital asset securities by special purpose broker dealers (the B/D Statement),[68] the SEC set out a series of procedural steps that, if taken during the five-year period starting on the effective date of the B/D Statement, would preclude enforcement action by the SEC under Exchange Act Rule 15c3-3. That rule requires broker-dealers holding fully paid or excess margin digital assets for a customer to be in "exclusive physical possession or control" of such assets.[69] The procedural steps a broker-dealer could take to be within the temporary safe harbor created by the B/D Statement include:[70]

- Limiting its business solely to digital asset securities, thereby excluding both traditional securities and digital asset non-securities;
- Establishing, maintaining, and enforcing written policies and procedures to:
  - — determine whether a digital asset security is offered and sold in accordance with the applicable provisions of the Securities Act or an exemption from registration thereunder;
  - — assess the characteristics of a digital asset security's distributed ledger technology and associated network, including, among other aspects, the technology's performance, transaction speed and throughput, scalability, resiliency, security and relevant consensus mechanism, complexity, extensibility and visibility, and governance;
  - — establish controls for safekeeping and monitoring that the broker-dealer has exclusive possession or control over digital asset securities that are consistent with industry best practices to protect against the theft, loss, and unauthorized and accidental use of private keys held in the broker-dealer's custody; and
  - — specifically identify in advance what the broker-dealer will do in response to events that could affect custody of its digital asset securities (for example, malfunctions or attacks), allow the broker-dealer to comply with a court-ordered freeze or seizure, and allow the transfer of digital asset securities in the event the broker-dealer can no longer continue as a going concern;
- Provide written disclosures to prospective investors about the risks of investing in or holding digital asset securities; and
- Enter into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, taking custody, liquidating, and otherwise transacting in digital asset securities on behalf of the customer.

By its terms the B/D Statement applies solely to broker-dealers, and not to investment managers. However, the steps described in the B/D Statement as a practical matter do not appear limited to the activities a broker-dealer would undertake, for example, an investment adviser managing a private fund would likely consider, as a diligence matter, the security and safety of a potential investment's distributed ledger technology and associated network. Whether the SEC would expressly require an investment adviser to undertake any of these steps in connection with the adviser's obligations under the Custody Rule remains to be seen.

Private funds investing in cryptocurrencies and other digital assets have broad latitude in

their investment programs, given adequate disclosure. These funds can be, and often are, actively managed, and can take both long and short positions. Some funds may be passively managed, and designed to replicate the returns from a single cryptocurrency or a basket of cryptocurrencies. With the exception of the Custody Rule, other Advisers Act issues relating to these funds tend to be the same as for other private funds. For instance, valuation of the fund's portfolio, and the sponsor's conflicts in managing the fund, require careful consideration, procedural rigor, and adequate disclosure.

National Futures Association Analysis

A private fund that invests in futures contracts is subject to regulation as a "commodity pool" as defined under the Commodity Exchange Act (CEA).[71] The sponsor of a commodity pool (a commodity pool operator) is subject to regulation by the CFTC and is required to be a member of the National Futures Association (NFA) (the self-regulatory organization for the US derivatives industry).[72] Absent an exemption from regulation under the CEA, a commodity pool must satisfy several onerous regulatory requirements, including prospectus review and comments by the NFA and regular reporting obligations to investors.[73] Leaving aside commodity pools that use crypto futures solely for hedging purposes (unlikely, at least at present), a commodity pool can avoid substantial regulation if all of the investors in the pool are "qualified eligible persons" under CFTC Rule 4.7.[74] "Qualified eligible persons" include, among other categories, qualified purchasers (as defined under Section 2(a)(51)(A) under the Investment Company Act), non-US persons, and investors who own securities of unaffiliated issuers and other investments with an aggregate market value of at least US$2 million, (an amount slightly higher than the US$1 million net worth test for accredited investor status under Rule 506(c)).[75]

The universe of private funds that would qualify for exemption from registration with the SEC under Rule 506, but not qualify for exemption under CFTC Rule 4.7, consists of funds offered to accredited investors who are not qualified eligible persons (as a practical matter, a relatively small group). For all practical purposes, given the expense and effort associated with regulated commodity pools, most private fund sponsors choose to limit offerings of commodity pools to investors that qualify as qualified eligible persons, eliminating retail investors.

Conclusion

The SEC has provided a path to the retail market for 1940 Act-regulated ETFs that have exposure solely to Bitcoin CME futures contracts regulated by the CFTC. The existence of the Denial Orders demonstrates that the SEC is holding in place the bar it has imposed historically on ETPs and ETFs that have direct exposure to cryptocurrencies. At best, the SEC's actions are a good faith attempt to address retail interest in digital assets within a regulatory framework created in the very different historical framework of the New Deal era. Absent congressional action, the SEC appears unlikely to revisit the viability of crypto ETPs with direct exposure to cryptocurrencies unless the SEC comes to believe that there are major improvements in the oversight and regulation of cryptocurrency trading markets. For instance, the advent of a true Bitcoin clearing market that represents a significant percentage of Bitcoin trading may be one such improvement.

Until the state of affairs changes, private funds remain the only available route to providing spot (that is, direct) cryptocurrency exposure to cryptocurrencies for accredited investors. The implications of the Custody Rule in particular will need to be carefully considered by sponsors of such funds, along with the other issues private fund sponsors typically need to consider and manage. However, private funds permit both passive and active management of cryptocurrency exposure.

In addition, private funds allow exposure to cryptocurrency futures. Private cryptocurrency futures funds are subject to NFA prospectus review

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and approval if they are offered to accredited investors who are not also qualified eligible persons. However, a cryptocurrency futures fund which is only offered to qualified eligible persons is relatively lightly regulated; its sponsors must register with the CFTC and be members of the NFA as commodity pool operators, and must abide by the reporting and other requirements applicable to such pools.

The present state of affairs with the SEC reflects an attempt to fit digital assets, including cryptocurrencies, into the current regulatory scheme of federal securities laws. To a certain extent this situation is exacerbated by the US division of securities regulation from commodities regulation. Thus, the SEC, which has securities regulatory authority, is left attempting to pour virtual "wine" assets into New Deal-era clay amphorae. It is therefore likely that Congress will have the final say on how the regulation of cryptocurrencies, and investor access to investment products providing exposure to them, furthers the "core public policy goals" of the securities laws.[76]

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NOTES

1 In order to list an investment product on a US securities exchange, that product must satisfy the criteria of a listing rule permitting its admission to the relevant exchanges. The SEC must approve all exchange listing rules. *See* 15 U.S.C. § 78s(b)(1) and Rule 19b-4 promulgated thereunder.

2 In parallel with its ETP listing rule denials, the SEC Staff has blocked registered investment companies, such as mutual funds, from having any significant direct exposure to cryptocurrencies. *See* Inv. Co. Inst. and Sec. Industry and Fin. Markets Ass'n, SEC Staff Letter, (Jan. 18, 2018), *https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm* (the Dalia Blass Letter). The Dalia Blass Letter concluded:

> Until the [SEC's] questions [about the applicability of 1940 Act regulation to cryptocurrencies] can be addressed satisfactorily, we do not believe that it is appropriate for [registered] fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and we have asked sponsors that have registration statements filed for such products to withdraw them. In addition, we do not believe that such funds should utilize [Securities Act of 1933 rule 485], which allows post-effective amendments to previously effective registration statements for registration of a new series to go effective automatically. If a sponsor were to file a post-effective amendment under rule 485(a) to register a fund that invests substantially in cryptocurrency or related products, we would view that action unfavorably and would consider actions necessary or appropriate to protect Main Street investors, including recommending a stop order to the [SEC].

3 As further discussed below, ETPs regulated under the 1940 Act are exchange-traded funds (ETFs), subject to an intensive, merit-based SEC regulatory scheme, and cryptocurrencies are not directly regulated under any federal statute.

4 6 Louis Loss, Joel Seligman & Troy Paredes, Securities Regulation 91 (6th ed. 2021) (hereinafter Loss Seligman) (*citing* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 22, 26-35 (1977) (footnotes omitted)).

5 1 Loss Seligman 164.

6 17 C.F.R. § 270.6c-11. *See also Exchange Traded Funds,* Exchange Act Release No. 33-10695 (Sept. 25, 2019), *https://www.sec.gov/rules/final/2019/33-10695.pdf*, at p. 5 ("This rule will modernize the

regulatory framework for ETFs to reflect our more than two decades of experience with these investment products.").

7 Press Release, "SEC Harmonizes and Improves 'Patchwork' Exempt Offering Framework", (Nov. 2, 2020), *https://www.sec.gov/news/press-release/2020-273*.

8 Gary Gensler, Chairman, SEC, Prepared Remarks: Dynamic Regulation for a Dynamic Society, Before the Exchequer Club of Washington, D.C. (Jan. 19, 2022), *https://www.sec.gov/news/speech/gensler-dynamic-regulation-20220119* (the Dynamic Regulation Speech) (*citing* Sec. and Exchange Comm'n, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, Pt. 1 (1963)).

9 *Id.*

10 *See* Jay Clayton, Chairman, SEC, Testimony on Virtual Currencies: The Roles of the SEC and CFTC (Feb. 6, 2018), *https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission*.

11 *Id.*

12 *Id.* (emphasis added). At the time of his speech, the SEC was investigating a number of cryptocurrency schemes where the money from early cryptocurrency investors was used to finance and pay computer programmers to develop and complete the underlying code necessary for the cryptocurrency to function.

13 *Id.* (emphasis added).

14 *See* Jay Clayton, Chairman, SEC, Chairman's Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), *https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#_ftnref4*.

15 One example of the limiting effect of the clay jar is that tokenized offerings of ICOs are outside the jar, and thus impermissible, because the tokens do not "come to rest" with the initial purchaser. It would be difficult, as a practical matter, to prove that the purchasers of tokens had an investment, rather than a resale, intent.

16 William Hinman, "Digital Asset Transactions: When Howey Met Gary" (Plastic) (June 14, 2018), *https://www.sec.gov/news/speech/speech-hinman-061418* (the Hinman Speech).

17 SEC v. W.J. Howey Co., 328 U.S. 293 (1946). The *Howey* Test refers to the US Supreme Court case for determining whether a transaction qualifies as an "investment contract," and therefore would be considered a security. An "investment contract" is a transaction with the following properties: (i) an investment of money, (ii) with the expectation of profits, (iii) in a so-called "common enterprise" (*i.e.,* investors and the business succeed or fail together), and (iv) the expectation of profits is based upon the entrepreneurial or managerial efforts of others.

18 *See* Hinman Speech, *supra* n.16.

19 *Id.*

20 *See* Paul Kiernan, "Crypto 'Wild West' Needs Stronger Investor Protection, SEC Chief Says," *Wall St. J.* (Aug. 3, 2021 6:21 PM), *https://www.wsj.com/articles/sec-will-police-cryptocurrencies-to-maximum-possible-extent-chair-gary-gensler-says-11628007567*.

21 Until recently, most ETPs were based on Bitcoin exclusively. Newer ETPs also include Ether and other Ethereum-based cryptocurrencies, mixes of cryptocurrencies, and related futures.

22 A surveillance-sharing agreement is an agreement between a commodity exchange operator and a self-regulatory organization that oversees that commodity exchange operator to share information about market trading activity, clearing activity, and customer identity. Moreover, under such agreements, parties to the agreement are reasonably able to access and produce requested information to each other, and no existing rules, laws or practices impede one party's capability of obtaining this information from or producing it to another party. *See, e.g.,* Self-Regulatory Organizations; Bats BZX Exchange, Inc.; *Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, To List and Trade Shares of the Winklevoss Bitcoin Trust,* Exchange Act Release No. 34-83723, 83 Fed. Reg. 37,579, at 37,593 (Aug. 1, 2018), *https://www.gpo.gov/fdsys/pkg/FR-2018-08-01/*

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pdf/2018-16427.pdf (the Winklevoss Bitcoin Trust SEC Decision).

23 *Id.* at 37,599.

24 Noting that "the definition of a 'commodity' is broad…Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities." In the Matter of: Coinflip, Inc., d/b/a Derivabit, CFTC No. 15-29. While the CFTC has not formally made any pronouncements on Litecoin, it has settled two enforcement actions involving Litecoin against BitMEX and Laino Group Ltd. *See also* CFTC v. HDR Global Trading Limited, Case No. 1:20-cv-08132 (S.D.N.Y. 2021); CFTC v. Laino Group Limited d/b/a Paxforex, Case No. 4:20-cv-03317 (S.D. Tex. 2021).

25 Section 1a(9) of the Commodity Exchange Act defines "commodity" to include, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9). The resulting definition of a "commodity" is broad. *See, e.g.,* Board of Trade of City of Chicago v. SEC, 677 F.2d 1137, 1142 (7th Cir. 1982).

26 Thus, these ETFs offer a "total return" based on the return of the CFC's futures portfolio and the return on the ETF's fixed income portfolio. The limit of 25 percent of assets in the CFC allows the ETF to comply with tax transparency afforded to regulated investment companies (RICs) under sub-chapter M of the Internal Revenue Code. For purposes of the 1940 Act, both the fixed income securities and the shares of the CFC are "securities." As a result, the ETF is subject to 1940 Act regulation, even though the economic return from the ultimate Bitcoin exposure, particularly in a low interest rate environment, is likely to outweigh the fixed income return, perhaps by large multiples.

27 *See*, *e.g.*, Gary Gensler, Chairman, SEC, Remarks Before the Aspen Security Forum, (August 3, 2021) *https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03* (the Aspen Remarks). It should be noted, however, that the SEC does not typically, and did not in connection with the ETFs referred to here, publish a statement of its reasoning in an order approving a listing rule. Thus, analysis of the SEC's rationales for approving the listing rules for these can only be surmised from informal commentary by Commissioners and SEC staff, such as the Aspen Remarks. By contrast, the SEC usually does publish a statement of its reasoning in denying a listing rule. *See infra* ns.34-44 and accompanying text.

28 Registered investment companies currently cannot directly invest in cryptocurrencies such as Bitcoin and Ethereum which are not securities. In 2018, the SEC Staff expressed its position that it is inappropriate for registered funds to invest directly in cryptocurrency and related products and requested that any registration statements for funds with such investments as their primary objective be withdrawn or put on hold. *See* Dalia Blass Letter*, supra* n.2.

29 Unlike the rigorous ongoing regulation to which ETFs are subjected by IM, ETPs are lightly regulated by the SEC's Division of Corporate Finance (Corp Fin), which solely reviews the adequacy of the ETPs registration statement and other periodic public filings. Both ETFs and ETPs, by virtue of their shares being exchange traded, are indirectly subjected to the regulation by the SEC's Division of Trading and Markets (TM). TM acts as a gatekeeper for all ETFs and ETPs securities exchange trading through its review and approval or denial of all proposed listing rules that would permit the listing and trading of ETF and ETP shares on the exchange. Each of IM, Corp Fin, and TM oversee different federal securities laws that have different public policy goals. For approval of listing rules, TM is charged with, among other things, ensuring that rules are designed to prevent fraudulent and manipulative acts and practices and generally protect investors and the public interest. *See* 15 U.S.C. § 78b.

30 Aspen Remarks, *supra* n.27.

31 *Id.*

32 *See*, *e.g.*, Nate DiCamillo, "Gensler's Preference for Bitcoin Futures Products Is Likely Bad News for a Spot BTC ETF," *Coindesk.com* (August 5, 2021),

https://www.coindesk.com/policy/2021/08/05/genslers-preference-for-bitcoin-futures-products-is-likely-bad-news-for-a-spot-btc-etf/.

33 Valkyrie Bitcoin Strategy ETF (NASDAQ: BTF); VanEck Bitcoin Strategy ETF (Cboe BZX: XBTF).

34 *Order Disapproving a Proposed Rule Change to List and Trade Shares of the VanEck Bitcoin Trust under BZX Rule 14.11(e)(4), Commodity Based Trust Shares,* Exchange Act Release No. 34-93559, 86 Fed. Reg. 64,539 (November 12, 2021) (the VanEck Denial Order); *Order Disapproving a Proposed Rule Change to List and Trade Shares of the WisdomTree Bitcoin Trust under BZX Rule 14.11(e)(4), Commodity Based Trust Shares,* Exchange Act Release No. 34-93700, 86 Fed. Reg. 69,322 (December 1, 2021) (the WisdomTrust Denial Order, and, together with the VanEck Denial Order, the Denial Orders). Three days after it approved the listing of the VanEck Bitcoin Strategy ETF, the SEC issued the VanEck Denial Order.

35 Exchange Act § 6(b)(5).

36 VanEck Denial Order, 86 Fed. Reg. at 64,540; WisdomTrust Denial Order, 86 Fed. Reg. at 69,322.

37 VanEck Denial Order, 86 Fed. Reg. at 64,540; WisdomTrust Denial Order, 86 Fed. Reg. at 69,323.

38 VanEck Denial Order, 86 Fed. Reg. at 64,542; WisdomTrust Denial Order, 86 Fed. Reg. at 69,322. Other commenters have noted that the SEC has never explained what "unique resistance to manipulation" means, or what it means for such resistance to be "novel and beyond" currently existing protections. *See*, *e.g.*, Davis Polk & Wardwell, Comment Letter in Support of Notice of Filing of Proposed Rule Change to List and Trade Shares of Grayscale Bitcoin Trust (BTC) under NYSE Arca Rule 8.201-E (November 29, 2021) (the Grayscale Letter), *https://www.sec.gov/comments/sr-nysearca-2021-90/srnysearca202190-9410842-262990.pdf*.

39 For example, in the WisdomTrust Order, the SEC pointed to the facts that, among other items, the proposed ETP would purchase Bitcoin through spot platforms that are not regulated as national securities exchanges. WisdomTrust Denial Order, 86 Fed. Reg. at 69,331.

40 WisdomTrust Denial Order, 86 Fed. Reg. at 69,328.

41 VanEck Denial Order, 86 Fed. Reg. at 64,540; WisdomTrust Denial Order, 86 Fed. Reg. at 69,330.

42 *Id.*

43 VanEck Denial Order, 86 Fed. Reg. at 64,547; WisdomTrust Denial Order, 86 Fed. Reg. at 69,331.

44 *Id.*

45 *See*, *e.g.*, the Grayscale Letter, *supra* n.38.

46 Both oil and gold are markets which, at times, have been viewed by at least some commentators as being subject to manipulation, such as during the OPEC-related oil crises of 1973 and 1979, or more recent allegations with respect to gold. *See*, *e.g.*, Frank Holmes, "Yes, Gold is Being Manipulated. But to What Extent?," *Forbes* (May 20, 2019).

47 Most private funds rely on one of two exemptions to avoid being regulated by the 1940 Act. Section 3(c)(1) of the 1940 Act exempts a private fund from the 1940 Act if it is comprised of 100 or fewer accredited investors. Section 3(c)(7) of the 1940 Act contains no limit on the number of beneficial owners, but requires that such owners be "qualified purchasers." Once a private fund meets these qualifications and is exempt from the 1940 Act, it may directly invest in cryptocurrencies, in part, so long as the income and assets of the fund continue to meet the thresholds for securities portfolios under the 1940 Act.

48 17 C.F.R. § 230.506.

49 Rule 501(a) of Regulation D under the Securities Act defines "accredited investors" generally as certain institutional investors, entities having US$5 million or more in assets, individuals (with or without spouses) having an acceptable (*e.g.*, exclusive of their home) net worth in excess of US$1 million, and individuals having at least US$200,000 (or US$300,000 jointly with their spouse) of income for the previous two years and a reasonable expectation of that income in the current year. *See* 17 C.F.R. § 230.501(a). Given the statutory rescission rights given to the "sophisticated" but unaccredited investors who invest in the offerings without receiving all

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of the information which they would have gotten in a registered offering using Form S-1 pursuant to Rule 502(b) (17 C.F.R. § 230.502(b)), in practice, Rule 506(b) offerings are typically limited to accredited investors.

Private funds which rely on Section 3(c)(1) are limited to 100 or fewer beneficial owners, even in a Rule 506(b) offering. *See* 1940 Act § 3(c)(1) and the rules promulgated thereunder. Only § 3(c)(7) funds can have an unlimited number of investors, and the requirement to be a "qualified purchaser" to invest in a § 3(c)(7) fund limits the target market considerably. "Qualified purchasers," defined under Section 2(a)(51)(A) of the 1940 Act, generally include natural persons with US$5 million in investments and entities with US$25 million in investments.

50 *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, 1933 Act Release No. 33-10884, 86 Fed. Reg. 3,496 (Nov. 2, 2020) (effective March 15, 2021) (the 506(c) Updating Release).

51 *Id*. at 3527.

52 *See* Exchange Act § 12, 15 U.S.C. § 78l. If a fund qualifies as an "emerging growth company," it may permissibly rely on rules permitting less fulsome disclosure for the required reports. An "emerging growth company" is defined as a company that: (1) has a total annual gross revenue of less than US$1.07 billion during its most recently completed fiscal year end, and (2) as of 8 December 2011 had not sold common equity securities under a registration statement. *See* Exchange Act § 2(a)(19), 15 U.S.C. § 77b(a)(19).

53 Exchange Act §§ 13, 15(d), 15 U.S.C. §§ 78m; 78o(d).

54 *Id.*

55 *Id.*

56 *See* 17 C.F.R. §§ 240.14a-3; 240.14a-15.

57 Exchange Act § 16, 15 U.S.C. § 78p.

58 Form 10 is not tailored to the business of a fund but is generically geared to operating companies.

59 17 C.F.R. § 275.206(4)-2(d)(2). An adviser that is entitled to pay itself management fees out of a private fund's assets has "custody" for purposes of the Custody Rule, as does a general partner of a limited partnership or managing member of a limited liability company. *See* 17 C.F.R. § 275.206(4)-2(d)(2)(ii).

60 17 C.F.R. § 275.206(4)-2(a)(4).

61 17 C.F.R. § 275.206(4)-2(a)(6).

62 *See* Investment Advisers Act § 203(m), 15 U.S.C. § 80b-3.

63 Karen Barr, SEC Staff Letter, Engaging on Non-DVP Custodial Practices and Digital Assets (March 12, 2019), *https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.*

64 *Id.*

65 *Id.*

66 SEC Staff Statement on WY Division of Banking's NAL on Custody of Digital Assets and Qualified Custodian Status (November 9, 2020), *https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets*.

67 *Id.*

68 *Custody of Digital Asset Securities by Special Purpose Broker-Dealers,* Exchange Act Release No. 34-90788 (Effective April 27, 2021), 86 Fed. Reg. 11,627-32 (Feb. 26, 2021).

69 B/D Statement, 86 Fed. Reg. at 11,629.

70 B/D Statement, 86 Fed. Reg. at 11,629-31.

71 7 U.S.C. § 1a(10).

72 7 U.S.C. §§ 1a(11); 6(d). The CFTC has delegated registration responsibility to the National Futures Association.

73 17 C.F.R. §§ 4.20-4.27.

74 17 C.F.R. § 4.7(a)(2).

75 *Id.*

76 *See* nn. 9-10, *supra.*

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