



Morgan Lewis

**ADVANCED TOPICS IN
HEDGE FUND PRACTICES
CONFERENCE**

Manager and Investor Perspectives

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Trading and Investment Practices Affecting Hedge Funds

Speakers



Erin E. Martin
+1.202.739.5729
[erin.martin@
morganlewis.com](mailto:erin.martin@morganlewis.com)



Ignacio A. Sandoval
+1.202.739.5201
[ignacio.sandoval@
morganlewis.com](mailto:ignacio.sandoval@morganlewis.com)

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Crypto Regulation

Q: How are cryptocurrency and digital assets regulated in the United States?

A: Depends on type of entity and activity.

Crypto Regulation

Cryptocurrency and digital assets are currently subject to a patchwork of regulation in the United States:

- Startups/Issuers
- Banks and financial institutions
- Funds and investment vehicles
- Exchanges and digital asset platforms (trading, DeFi, etc.)
- Custodians and other service providers
- Broker-dealers, CPOs, CTAs, swap dealers, and retail brokers
- Individual traders and miners
- Other parties

Crypto Regulation

Primary US federal regulators with jurisdiction over parties accessing US markets

Securities and Exchange Commission (SEC)

Investor protection, enforcement of US securities laws

Commodity Futures Trading Commission (CFTC)

Commodities, antifraud, registration of exchanges/platforms, FCMs

Financial Crimes Enforcement Network (FinCEN)

Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) – money services businesses (“money transmitters”)

Office of Foreign Assets Control (OFAC)

International sanctions, AML, countering the financing of terrorism (CFT)

US prudential bank regulators: OCC, FDIC, Federal Reserve/FRB

Digital asset and crypto activities of banks (November 23, 2021 joint statement)

US Treasury/Internal Revenue Service (IRS)

Taxation

US Department of Justice (DOJ)

Criminal enforcement

Crypto Regulation

Applicable state statutes and regulations:

- State virtual currency business statutes – including New York State BitLicense framework
- State money services business (MSB) statutes and money transmitter laws and related licensing requirements
- State securities laws – BlockFi action (NJ, AL, TX, VT, KY), NYAG (Coinseed, GTV)
- State business statutes – NY General Obligations Law (NYAG – Tether/Bitfinex)
- State DAO statues (WY)
- State crypto banking regulations (TX)
- State money-laundering statutes (FL)

Also subject to regulation by:

- Self-regulatory organizations (SROs) – FINRA (broker-dealers), NFA (swap dealers, CPOs, CTAs)
- Global standard-setting bodies – FATF, BCBS, IOSCO, BIS (CPMI), FSB

Crypto and the SEC



DAO Report

On July 25, 2017, the SEC issued a report, known as the DAO Report, which indicated that digital coins sold in ICOs may be securities subject to the federal securities laws under the ***Howey test***.



Howey test: SEC v. W.J. Howey Co., 328 U.S. 293 (1946) – Is there an investment contract?

- Investment of money
- In a common enterprise
- Reliance on the efforts of others
- Reasonable expectation of profits

Crypto and the SEC

SEC April 2019 Framework for analyzing offer and sale of digital assets

On April 3, 2019, the SEC Strategic Hub for Innovation and Financial Technology (FinHub) provided additional guidance on these elements as applied to digital assets—based on June 14, 2018 speech by former Director of SEC Division of Corporation Finance William Hinman. Coincided with TurnKey Jet no-action.

TurnKey Jet No-Action (April 2019):

Issued on the same day as SEC Framework for analyzing offer and sale of digital assets and provided no-action relief to the company that the tokens used on its platform were not securities.

Crypto and the SEC

Reves test: Reves v. Ernst & Young, 494 U.S. 56 (1990) – is a “note” a security?

Under Reves, absent any statutory exception, a “note” is presumed to be a security unless it “bears a strong resemblance” under a four-factor test to one of the court’s enumerated non-securities. The four factors are (1) motivations, (2) plan of distribution of the instrument, (3) reasonable expectations of the public, and (4) presence of a risk-reducing factor.

Notes that are not considered “securities” include the following: a note delivered in consumer financing; a note secured by a mortgage on a home; a short-term note secured by a lien on a small business or some of its assets; a note evidencing a character loan to a bank customer; short-term notes secured by an assignment of accounts receivable; a note that simply formalizes an open-account debt incurred in the ordinary course of business; and notes evidencing loans by commercial banks for current operations.

Crypto and the SEC

United States Case Law on Digital Asset Securities

- ***SEC v. LBRY, Inc.***

- The New Hampshire District Court determined that the defendants engaged in an unregistered securities offering with the token LBRY, finding that LBRY was a security under *Howey*.

SEC v. Telegram Group Inc.

- On March 24, 2020, the US District Court for the Southern District of New York issued a preliminary injunction barring the delivery of Grams and finding that the SEC had shown a substantial likelihood of proving that Telegram's sales were part of a larger scheme to unlawfully distribute the Grams to the secondary public market. The court concluded that the entire pre-sale scheme as a whole, including the Gram purchase agreements and the accompanying understandings and undertakings made by Telegram, were securities. Telegram ultimately settled with the SEC.

SEC v. Kik Interactive Inc.

- A federal district court entered a final judgment on consent against Kik Interactive Inc. to resolve the SEC's charges that Kik's unregistered offering of digital "Kin" tokens in 2017 violated the federal securities laws. The SEC's complaint, filed in the US District Court for the Southern District of New York, alleged that Kik sold digital asset securities to US investors without registering its offer and sale as required by the US securities laws. The court granted the SEC's motion for summary judgment on September 30, 2020, finding that undisputed facts established that Kik's sales of "Kin" tokens were sales of investment contracts.

Crypto and the SEC

SEC Policy Statement on the Custody of Digital Assets by Special-Purpose Broker-Dealers (April 27, 2021)

Intended to address the questions surrounding compliance with the customer protection rules, which require broker-dealers to maintain the physical possession or control of all fully paid securities and excess margin securities carried or received by the broker-dealer for the account of customers.

Crypto and the SEC

- **The “Special Broker-Dealer” Policy Statement outlined the steps that broker-dealers of digital asset securities must take to comply with a safe harbor available for five years following its publication:**
 - Broker-dealer may not deal in, effect transactions in, maintain custody of, or operate an alternative trading system for *traditional securities*;
 - Broker-dealer must establish, maintain, and enforce policies and procedures to establish whether the digital asset is a security offered and sold in compliance with the federal securities laws;
 - Broker dealer must establish, maintain, and enforce policies and procedures to assess the digital asset security’s DLT and associated network;
 - Broker-dealer must establish, maintain, and enforce reasonably designed policies, procedures, and controls for safekeeping and demonstrating 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 the private keys necessary to access and transfer the digital asset securities the broker-dealer holds in custody;
 - Broker-dealer must establish, maintain, and enforce policies, procedures, and arrangements to address specific event responses;
 - Broker-dealer must provide written disclosures to prospective customers about the risks of investing in or holding digital asset securities; and
 - Broker-dealer must 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, custodizing, liquidating, and otherwise transacting in digital asset securities on behalf of the customer.

Crypto and the SEC

Prometheum Ember Capital LLC announced on May 23, 2023 that it received the first approval from FINRA to operate as a special purpose broker-dealer for digital asset securities. The FINRA approval permits Prometheum to custody digital asset securities on behalf of retail and institutional clients.

Crypto and the SEC

Significant Uptick in Crypto Cases Under Current Administration

- Current administration has made crypto an Enforcement priority
- SEC's current position is that the current rules and regulations work for the crypto industry
- SEC brought Enforcement actions against Binance and Coinbase in the first week of June 2023

Crypto and the SEC

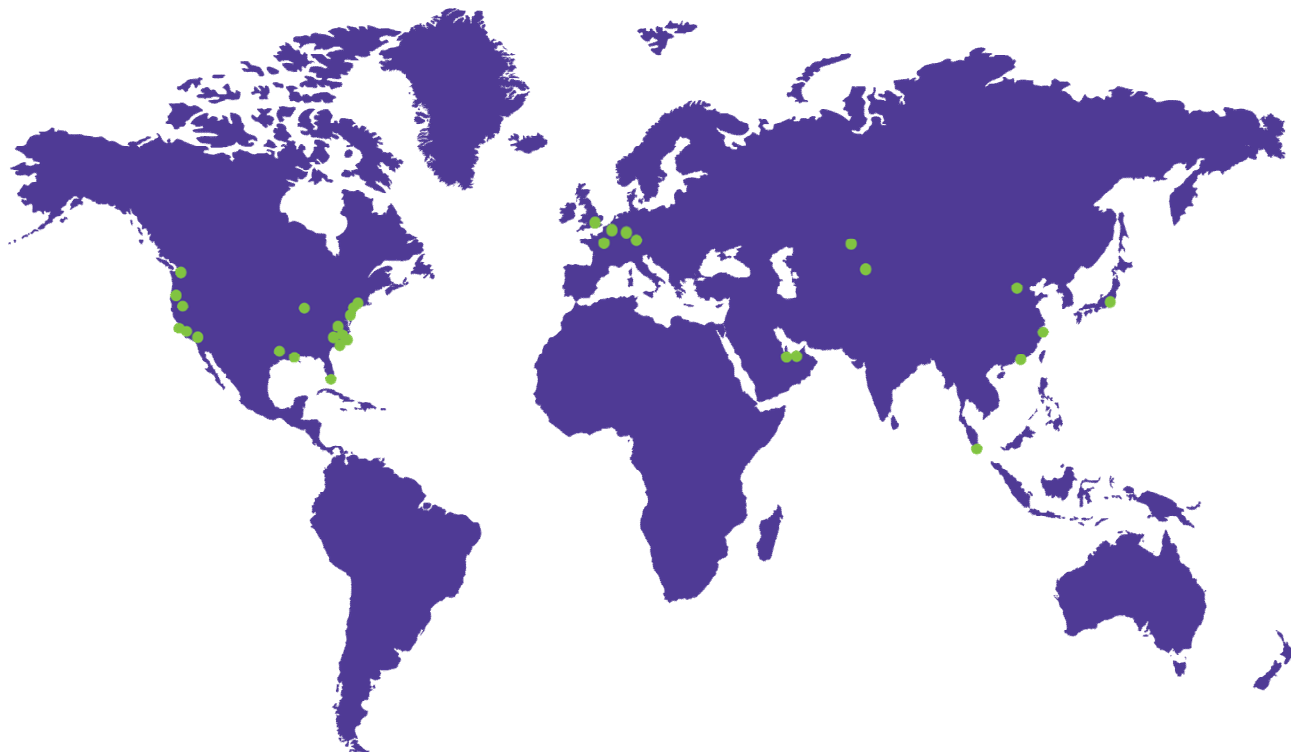
- **What does this mean for funds interested in investing in the crypto space?**
 - Investing in companies offering services related to crypto comes with risk if the companies are located, or offering services, in the United States.
 - Investing in digital assets requires understanding:
 - The nature of the product being purchased or in which transactions are being effected.
 - If the products are securities, understanding the regulatory status of the forum in which transactions are being effected.
 - As noted, only one “digital asset broker-dealer” has been approved, and that approval was very recent.
 - Other entities offering transactions in crypto may be vulnerable to regulatory and civil actions alleging violations of federal and/or state laws and regulations.
 - Understanding risks of loss:
 - Cold wallets—key loss
 - “Omnibus wallets” in the name of an intermediary

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