

BLOCKCHAIN AND DIGITAL ASSETS

PERKINS COIE LLP:

MUTUAL FUND DIRECTORS FORUM

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TODAY'S PRESENTERS



Val Dahiya

**Partner, Investment
Management**

Washington, D.C.

VDahiya@perkinscoie.com



Mike Didiuk

**Partner, Investment
Management**

New York

MDidiuk@perkinscoie.com

AGENDA

1. OVERVIEW OF BLOCKCHAIN AND
DIGITAL ASSETS

2. REGULATORY LANDSCAPE

3. INVESTING

- a. WHAT CRYPTO ASSETS CAN A FUND INVEST IN?
- b. WHAT ARE CONSIDERATIONS FOR FUNDS AND BOARDS?
- c. WHAT QUESTIONS SHOULD BOARDS BE PREPARED TO ASK?
- d. HOW ELSE CAN FUNDS INVEST IN DIGITAL ASSETS?

4. QUESTIONS

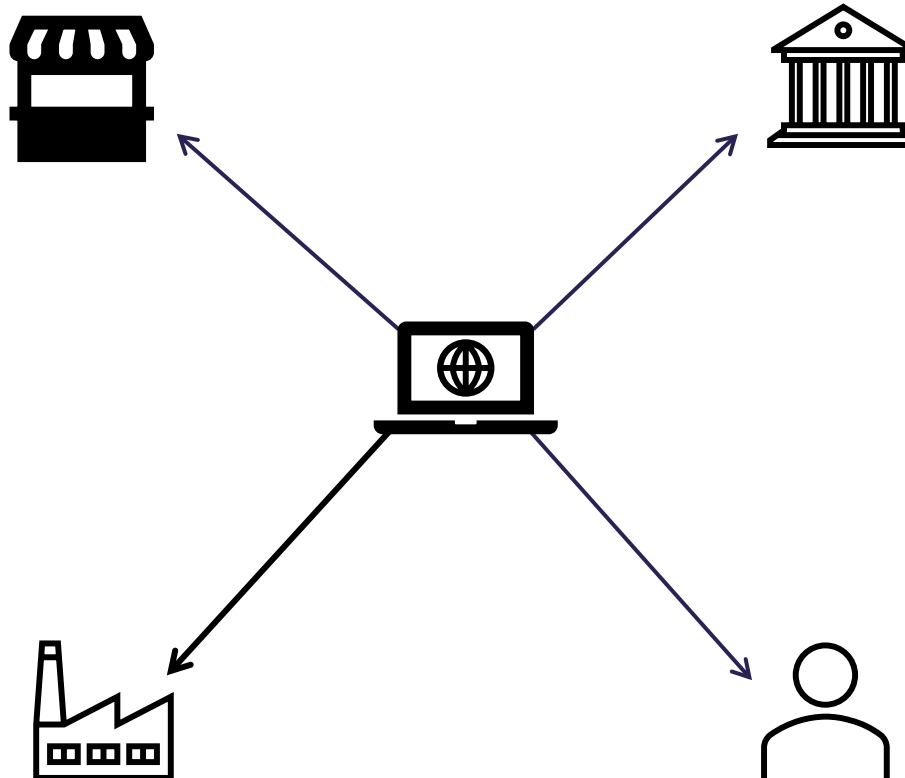
OVERVIEW OF BLOCKCHAIN

BRIEF TECHNICAL OVERVIEW

WHAT IS A BLOCKCHAIN?

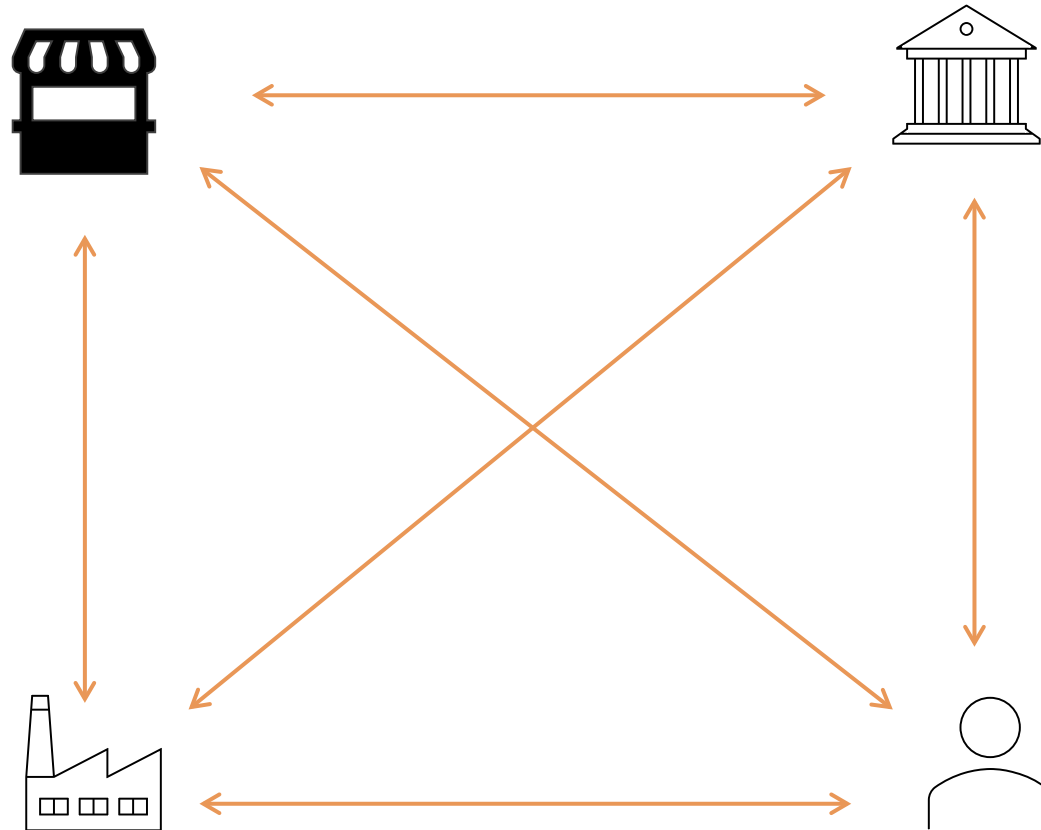
In its simplest form, a type of **distributed ledger**, which differs from the centralized ledgers currently used to store information

Centralized Ledger



DISTRIBUTED LEDGERS

A **distributed ledger** has no central authority, and every node is responsible for maintaining the ledger.



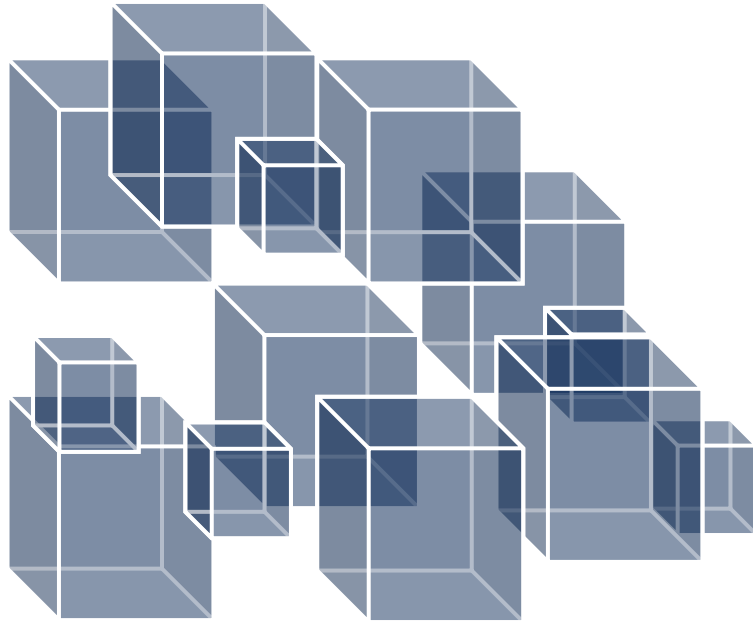
CORE CHARACTERISTICS OF A BLOCKCHAIN

A blockchain consists of a distributed group of **connected computers** that programmatically **reach agreement** with respect to the status of, or changes to, certain **shared data**. The process is also known as the consensus mechanism.

BLOCKCHAIN SYSTEMS INVOLVE:

1. A P2P network (**connected computers**)
2. A consensus mechanism (a programmatic way for users of the network to **reach agreement**, using cryptography)
3. Certain **shared data** (often embodied in a “token,” but could be any other data set or digital asset)

BLOCKCHAIN SUMMARIZED



- A **protocol + platform** technology
- An expanding list of cryptographically signed, **irrevocable** blocks of record
- Shared by all participants in a **P2P network**
- Each block of records is time stamped and references link to previous data blocks
- Anyone with access rights can trace historically a state change in data or an event, belonging to any participant
- Can support a single shared version of immutable truth among participants that can be independently verified by each entity
- With no single entity in overall control

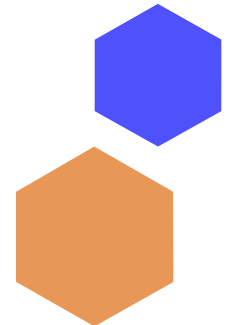
SMART CONTRACTS – DEFINITIONAL CONFUSION

A smart contract is neither inherently smart, nor inherently a legal contract



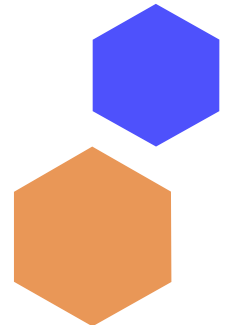
Key Characteristics

- Event-driven functionality
- External data can be supplied by “oracles”
- Track changes in state
- Autonomous
- Guaranteed executions once conditions are met



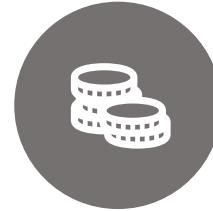
SMART CONTRACT DEFINITION

- **A smart contract is:**
(1) a computer protocol—an algorithm, (2) that can self-execute, self-enforce, self-verify and self-constrain the performance of its instructions.
- **It is:**
(A) an event-driven program, (B) with state, (C) which runs on a replicated, shared ledger and (D) which can take custody over assets on that ledger.



TYPES OF DIGITAL ASSETS (“AKA CRYPTOCURRENCY”)

Digital assets (or “*cryptoassets*”) are digital representation of currencies, rights to goods or services, commodities, securities, or other assets, which can be used to fractionalize or digitize asset ownership, increase liquidity, track provenance, and improve transaction speed among token holders



Currency Tokens
Payment tokens, similar to traditional fiat currencies (e.g., Bitcoin, Ether)



Utility Tokens
Rights to goods or services like data storage, or ownership and licensing rights

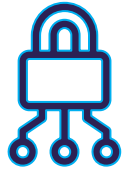


Commodity-Backed Tokens
Rights to the value of an underlying commodity like gold, oil or coffee



Security Tokens
Digital representation of a security in a company or an investment contracting with entitlement to profits or rise in company value

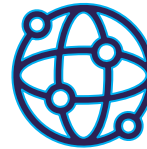
KEY CHARACTERISTICS OF CRYPTOCURRENCIES



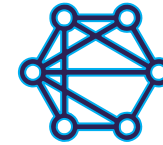
Uses encryption techniques to control the creation of money and to verify the transfer of funds



Has no intrinsic value in that it is not redeemable for another commodity, such as gold



Has no physical form and exists only in the network



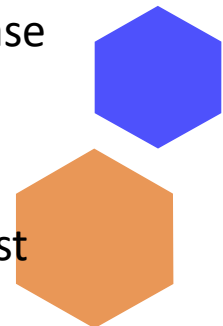
Its supply is not determined by a central bank and the network is completely decentralized

REGULATORY LANDSCAPE

LATEST REGULATORY DEVELOPMENTS

WHITE HOUSE'S COMPREHENSIVE FRAMEWORK FOR RESPONSIBLE DEVELOPMENT OF DIGITAL ASSETS

- White House issued an Executive Order in March 2022 requiring federal agencies to examine risk and benefits of crypto currencies and issue reports on their findings. It identified six key priorities: consumer and investor protection, promoting financial stability, countering illicit finance, leadership in global financial system, inclusion, and responsible innovation.
- On September 16, 2022, the White House released a framework for digital asset development, based on reports from various government agencies, including the US Department of Treasury, the Department of Justice, and the Department of Commerce.
- Under the framework, the Biden-Harris Administration plans to:
 - Encourage regulators to pursue enforcement actions
 - Encourage agencies to issue guidance and rules to address current and emergent risks
 - Support the development and use of innovative technologies by payment providers to increase access to instant payments
 - Consider creating a federal framework to regulate nonbank payment providers
 - Evaluate whether to call upon Congress to amend the Bank Secrecy Act (BSA) and laws against unlicensed money transmission to apply explicitly to digital asset service providers



DEFI, INSIDER TRADING, SEC ACTIVITY

Decentralized Finance (DeFi)

Recently, DeFi has faced heightened regulatory scrutiny following the collapse of TerraUSD and LUNA.

- *“The first is stablecoins are not stable. Clearly, to have an \$18-billion-dollar stablecoin crash so quickly, I think showed that.”* - Comptroller of the Currency Michael Hsu
- *“In light of recent turmoil in the crypto market, we are concerned that the OCC’s actions on crypto may have exposed the banking system to unnecessary risk, and ask that you withdraw existing interpretive letters that have permitted banks to engage in certain crypto-related activities,”* - U.S. Senators Elizabeth Warren, Dick Durbin, Sheldon Whitehouse, and Bernie Sanders

Additionally, the U.S. Treasury Department’s Office of Foreign Assets Control issued sanctions against Tornado Cash, a DeFi mixer, in August 2022.

Insider Trading

The first insider trading cases for digital assets were filed this year.

- On July 21, 2022, the SEC brought an insider trading enforcement action against a former manager in Coinbase’s Assets and Investing Products group. In the complaint, the employee repeatedly tipped his brother and friend about the timing and content of Coinbase’s “listing announcements”.
- On June 1, 2022, the DOJ charged a former OpenSea employee with wire fraud and money laundering in connection with a scheme to commit insider trading in “NFTs” by using confidential information about what NFTs were going to be featured on OpenSea’s homepage for his personal financial gain.

Recent SEC Activity

SEC’s SAB 121 provides guidance for entities with obligations to safeguard or custody crypto assets.

- Seeks to address technological, legal, and regulatory risks
- How to account for obligations to safeguard crypto-assets for platform users
- Disclosures to provide regarding obligations for crypto-assets on platform

Additionally, the SEC announced that the Division of Corporation Finance is building a new office to tailor public disclosures for crypto companies – one for legal and one for accounting.

INVESTING IN CRYPTO AS A FUND

WHAT TO CONSIDER

AVAILABLE INVESTMENTS

There are different types of available investments that provide exposure to this new asset class including:



Cryptocurrencies

Examples of cryptocurrencies include **Bitcoin (BTC)**, **Ether (ETH)**, and **Solana (SOL)**.

SEC Chair Gensler believes most cryptocurrencies are securities. Some SEC staff have informally taken the position that BTC and ETH are not securities.

The CFTC, however, has similarly determined that most cryptocurrencies, including BTC and ETH, are commodities. For the cryptocurrencies that are commodities, the CFTC has the authority to police fraud and manipulation in the spot markets.



Commodity interests

Various futures markets offer crypto-related commodity interests:

- CME offers BTC futures contracts
- ErisX offers BTC and ETH futures contracts
- Delta Exchange offers both crypto-related futures contracts and interest rate swaps



Pooled investment vehicles

To date, the SEC has still not approved an **exchange-traded fund** that holds (spot) cryptocurrency.

There are available pooled investment vehicles that hold cryptocurrencies that are not registered funds.

There are also available exchange-traded products registered under the Securities Act of 1933.



Stablecoins

The term “stablecoin” generally refers to “a digital asset that purports to minimize price volatility.”

A stablecoin could be pegged and/or backed by specific assets, controlled by algorithms, or the value could freely float.

A stablecoin, depending on the facts, could be considered a security, a commodity, or a convertible virtual currency.

CONSIDERATIONS FOR FUNDS AND BOARDS

The key considerations for funds and boards continue to track the issues raised in the “Blass Letter” issued by then-Director of DIM, Dalia Blass in January 2018, which include:

- Valuation
- Liquidity
- Custody
- Arbitrage (for ETFs)
- Potential manipulation and other risks

QUESTIONS BOARDS SHOULD BE PREPARED TO ASK

- What is the relevant asset? Is it a security? Commodity? Commodity interest? Who has made that determination and on what basis?
- What regulated intermediaries are involved with a particular digital asset, transaction, or investment strategy under consideration? Do the intermediaries hold the appropriate licenses and registrations for their contemplated activity?
- For any contemplated custodian of digital assets, do they meet the definition as a “qualified custodian” under the 1940 Act?
- What are the cybersecurity measures of any intermediary? Do they hold cybersecurity or other insurance? In addition, for any custodian, what measures do they take to ensure the security of digital assets (when assets are both in motion vs. at rest)?
- What is the risk of fraud or manipulation of any particular digital asset? What institutional measures or safeguards exist to limit any potential risk?
- How is the applicable digital asset valued? Are third-party services used? What are their valuation inputs?
- What is the liquidity for the particular digital asset, or asset related to digital assets (e.g., a futures contract)?

QUESTIONS?

VALERIE DAHIYA
vdahiya@perkinscoie.com

MICHAEL S. DIDIUK
mdidiuk@perkinscoie.com