WINSTON & STRAWN LLP

CLIENT ALERT

A Tale of Two Crypto Funds

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The Crypto Asset Management Action

On September 11, 2018, the Securities and Exchange Commission (SEC) brought its first-ever enforcement action against a crypto-asset hedge fund for operating as an unlawfully unregistered "investment company."[1]

Crypto Asset Management, LP (CAM) offered limited liability company interests in Crypto Asset Fund, LLC (CAF), an investment fund that invested in a portfolio of "digital assets." In the CAM Order, the SEC asserted (without providing analysis) that the "digital assets" in question constituted "investment securities" within the meaning of Section 3(a)(2)[2] of the Investment Company Act of 1940, as amended (ICA).

During the relevant period, CAF's portfolio of such digital asset "investment securities" had a value exceeding 40% of the value of CAF's total assets (exclusive of "government securities" (as defined in the ICA) and cash items) on an unconsolidated basis. Accordingly, during the relevant period, CAF operated as an "investment company" within the meaning of Section 3(a)(1)(C) of the ICA.[3]

However, according to the CAM Order, although CAF "met the definition of 'investment company' during the Relevant Period, it did not register with the Commission as an investment company, meet any statutory exemptions or exclusions from the definition of an investment company, or seek an order from the Commission declaring that it was primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities, or exempting it from complying with any provisions of the Investment Company Act or the rules thereunder. Thus, during the Relevant Period, CAF should have registered with the Commission as an investment company."

Further, although the CAM Order did not explicitly say so, the "exclusions" from the definition of "investment company" provided by Section 3(c)(1) or Section 3(c)(7) of the ICA, on which hedge funds typically rely, were not available to CAM. These is because neither of these "exclusions" is available to a fund that engages in a "public offering" of its securities, but CAM caused CAF to engage in an (unlawful) public offering of its limited liability company interests to investors. In this regard, the CAM Order notes that the "[r]espondents did not have pre-existing relationships with these investors and engaged in a general solicitation of public interest in the offering through CAM's website, social media accounts, and traditional media outlet interviews. CAM did not file or cause to

be filed a [Securities Act] registration statement with the Commission, and no exemption from registration was available…" [4]

Finally, in marketing CAF, the respondents falsely claimed that the fund was the "first regulated crypto asset fund in the United States" and had filed a registration statement with the SEC.

The CAM Order charges that:

- CAM violated Sections 5(a) and (c) of the Securities Act of 1933, as amended (Securities Act), by conducting an unregistered, non-exempt public offering of limited liability company interests in CAF;
- CAM caused CAF to violate Section 7(a) of the ICA, which prohibits an investment company not registered with the SEC from engaging in any business in interstate commerce, including offering, selling, purchasing, or redeeming interests in the investment company (unless, of course, the investment company is entitled to rely on an "exclusion" or exemption from registration);
- the respondents violated Section 17(a)(2) of the Securities Act, which prohibits any person in the offer or sale of securities from obtaining money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made not misleading; and
- the respondents violated Section 206(4) of the Investment Advisers Act of 1940, as amended, and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle.

The respondents agreed to the SEC's cease-and-desist order and censure without admitting or denying the findings against them, and agreed to pay a penalty of $200,000.

The CoinAlpha Action

Fast forward to December 7, 2018, when the SEC brings an enforcement action against CoinAlpha Advisors, LLC (CoinAlpha) for violating the registration provisions of Section 5 of the Securities Act by causing CoinAlpha Falcon LP (Falcon) – an investment fund that, like CAF, invested in "digital assets" – to offer and sell limited partnership interests in transactions that were not registered under the Securities Act and that did not qualify for an exemption from such registration. [5] However, the CoinAlpha Order did not allege that Falcon operated as an unregistered investment company, notwithstanding that Falcon, like CAF in the CAM Order, invested in a portfolio of "digital assets."

Specifically, according to the CoinAlpha Order:

- CoinAlpha formed Falcon for the purpose of investing in "digital assets." During the relevant period, CoinAlpha raised approximately $600,000 from 22 investors, residing in at least five U.S. states. Through this offering, the investors purchased limited partnership interests in Falcon in exchange for a pro rata share of any profits derived from Falcon's investment in digital assets.
- Falcon filed with the SEC a Form D Notice of Exempt Offering of Securities. (The CoinAlpha Order, however, did not note that in such Form D filing, Falcon indicated that it was relying on Rule 506(b) of Regulation D; nor did the CoinAlpha Order note that Falcon indicated in its Form D filing that it was relying on the "exclusion" from the definition of "investment company" provided by Section 3(c)(1) of the ICA.)
- CoinAlpha did not have pre-existing substantive relationships with nine of Falcon's investors.
- CoinAlpha engaged in a general solicitation of public interest in the securities offering through CoinAlpha's website, which was generally accessible without password protection. Further, CoinAlpha engaged in general

solicitation through blog postings, and media interviews and digital asset and blockchain conferences, accessible both via live attendance and through the Internet.

- Despite collecting accredited investor questionnaires and representations from investors certifying to their accredited investor status, CoinAlpha did not take reasonable steps to verify that investors in Falcon were accredited investors.

- CoinAlpha immediately halted the offering when contacted by the SEC staff and undertook a review of its website, social media postings, digital asset and blockchain conference marketing materials, and offering procedures. CoinAlpha further voluntarily reimbursed all fees it had already collected, surrendered all rights to future management and incentive fees, unwound Falcon, and made payments to ensure that no Falcon investor suffered a loss. During the SEC staff's investigation, CoinAlpha retained a third party who determined that all 22 investors were accredited investors.

CoinAlpha agreed with the SEC to cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act, and to pay a civil money penalty in the amount of $50,000.00.

Based on the activities described above, it is clear that, by virtue of CoinAlpha's engaging in activities that constituted "general advertising" and "general solicitation," Falcon was not entitled to rely on the exemption from Securities Act registration provided by Rule 506(b) of Regulation D, notwithstanding that Falcon indicated in its Form D that it was relying on that exemption. It also appears that, under the facts and circumstances, Falcon would not have been entitled to rely on Rule 506(c) of Regulation D (because, among other things, CoinAlpha did not take reasonable steps to verify that investors in Falcon were accredited investors ***prior to*** the time it admitted those investors into Falcon.).

But, even though Falcon indicated its Form D that is was relying on the "exclusion" from the definition of "investment company" provided by Section 3(c)(1) of the ICA, Falcon could not rely on that "exclusion" for the very reason that it could not claim reliance on Rule 506(b) or Rule 506(c) of Regulation D – namely, because it engaged in an unlawful "public offering" of its securities. The CoinAlpha Order, however, did not charge that CoinAlpha operated Falcon as an unlawful unregistered investment company.

Why? Presumably because Falcon did not exceed the Section 3(a)(1)(C) 40% Test – that is, either none of the crypto assets or other financial instruments held by Falcon were "securities," or the value of the crypto assets held by Falcon that were "securities," together with the value of all other "investment securities" held by Falcon, did not have a value that exceeded 40 percent of the value of Falcon's total assets (exclusive of Government securities and cash items) on an unconsolidated basis – with the result that Falcon was not an investment company within the definition of that term contained in Section 3(a)(1)(C) of the ICA to begin with, and therefore had no need to rely on an "exclusion" from that definition. For example, it is possible that the bulk of Falcon's portfolio of "digital assets" consisted of virtual currencies that were not "securities" (*e.g.*, Bitcoin and Ether, which certain high-ranking officials of the SEC have determined are not "securities").

However, as was the case in the CAM Order, the SEC in the CoinAlpha Order did not offer any analysis regarding the composition of the fund's underlying portfolio, so market participants are once again left to guess.

The Moral(s) of Our Story

Unless a crypto fund manager is certain that none of the crypto assets held by the fund are "securities" (and that no other assets held by the fund are "investment securities"), or that the value of the crypto assets held by the fund that are "securities," together with the value of all other "investment securities" held by the fund, will never exceed the Section 3(a)(1)(C) 40% Test (see note 3), it should structure the fund so that the fund is qualified to rely on the "exclusion" from the definition of "investment company" provided by Section 3(c)(1) (which generally provides that the fund's securities may not be held by more than 100 beneficial owners) or Section 3(c)(7) (which generally limits owners of the fund's securities to so-called "qualified purchasers") of the ICA. This will enable the manager to avoid operating an unlawful investment company.[6]

Of course, in order to rely on either of those Sections of the ICA, the manager must structure the offering and sale of the fund's securities to fund investors in a manner that does not involve a "public offering" of those securities. Most fund managers typically rely on Rule 506(b) or Rule 506(c) of Regulation D to ensure that their funds are not engaged in public offerings of their securities. If the manager determines to rely on Rule 506(b), then it may not employ any means of "general advertising" or "general solicitation" (*e.g.*, no use of websites, blogs, social media, etc.) in connection with offering the fund's securities, and the manager must (among other things) have a "reasonable belief" that ***all offerees*** of the fund's securities are "accredited investors" or meet the sophistication test set forth in Rule 506(b)(2)(ii).[7] A manager typically forms this "reasonable belief" by way of having a so-called "pre-existing substantive relationship" with each offeree. CAM not only engaged in "general advertising" and "general solicitation" on behalf of CAF, but it did not have "pre-existing substantive relationships" with CAF investors, and thus was not in a good position to argue that it had formed a reasonable belief that those investors were accredited or met the sophistication test. Thus, CAF was not entitled to rely on Rule 506(b). (Further, there did not appear to be any facts that would support the conclusion that CAF was entitled to Rely on Rule 506(c).) And CAF's inability to rely on Rule 506(b) (or Rule 506(c)) doomed any claim on its part that it was entitled to rely on the Section 3(c)(1) or Section 3(c)(7) "exclusion" from the definition of investment company.

If the manager selects Rule 506(c), it may engage in "general advertising" and "general solicitation" on behalf of the fund, but the price the manager pays for that privilege is that ***all purchasers*** of the fund's securities must be "accredited investors" (that is, there is no exception in Rule 506(c), as there is in Rule 506(b), that permits 35 (or fewer) sophisticated, non-accredited investors to invest) and the manager must take reasonable steps to verify that all purchasers are "accredited investors" (as required by Rule 506(c)(2)). In this regard, the manager may not simply rely on representations and warranties from investors to that effect. Although it was ultimately determined that all of the investors in Falcon were in fact "accredited investors," CoinAlpha did not take reasonable steps to verify that fact ***prior to*** the time it admitted those investors into Falcon. Thus, Falcon was not entitled to rely on Rule 506(c). (And it could not rely on Rule 506(b) because the manager engaged in "general advertising" and "general solicitation" on behalf of Falcon.) However, despite Falcon's inability to rely on Rule 506(b) or Rule 506(c) with respect to the offering of its own securities, it does not appear that this resulted in Falcon's becoming an unlawful unregistered investment company, for the reason that Falcon appears to have been outside that definition without the need to rely on Section 3(c)(1) or Section 3(c)(7) of the ICA.

Additional observations, not discussed in the CAM Order or the CoinAlpha Order:

- if any of the crypto assets held by a fund are securities, the manager must determine whether it is required to register as an investment adviser under the Investment Advisers Act of 1940, as amended; and
- depending on the types of crypto assets held by a fund, the manager must determine whether it is required to register as a commodity pool operator and commodity trading adviser under the commodities laws; for example, if the fund holds bitcoin futures, such registration is required (unless an exemption is available).

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[1] *In the Matter of Crypto Asset Management, LP and Timothy Enneking* (September 11, 2018) Securities Act Release No. 10544; Investment Advisers Act Release No. 5004; Investment Company Act Release No. 33222; Administrative Proceeding File No. 3-18740 (CAM Order); see also SEC Press Release No. 2018-186.

[2] Under Section 3(a)(2) of the ICA, the term "investment securities" includes all "securities," with certain limited exceptions. To the extent crypto assets are "securities," it is unlikely that they would ever qualify for any of those limited exceptions.

[3] Section 3(a)(1)(C) defines an "investment company" as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in "securities," and owns or proposes to acquire "investment securities" (see note 2) having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis (the "Section 3(a)(1)(C) 40% Test").

Section 3(a)(1)(A) of the ICA defines an "investment company" as any issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. The CAM Order does not discuss whether CAF met the definition of "investment company" contained in Section 3(a)(1)(A) of the ICA.

[4] CAF filed a Form D with the SEC indicating that it claimed reliance on Rule 506(b) of Regulation D in connection with its offering of limited liability interests. However, an entity that relies on Rule 506(b) is not entitled to engage in "general advertising" or "general solicitation," which CAF clearly did. In its Form D,

CAF did not claim reliance on any exemption from registration under the ICA.

[5] *In the Matter of CoinAlpha Advisors LLC* (December 7, 2018); Securities Act Release No. 10582; Administrative Proceeding File No. 3-18913 (CoinAlpha Order).

[6] If the manager determines that none of the crypto assets held by the fund are "securities" (and that no other assets held by the fund are "investment securities"), or that the value of the crypto assets held by the fund that are "securities," together with the value of all other "investment securities" held by the fund, will never exceed the Section 3(a)(1)(C) 40% Test, the manager might elect to forego compliance with Section 3(c)(1) or Section 3(c)(7). In that case, however, the manager would still need to be careful not to hold the fund out as being engaged primarily, or as proposing to engage primarily, in the business of investing, reinvesting, or trading in "securities," since simply holding the fund out in that way could (by operation of Section 3(a)(1)(A) of the ICA) trigger investment company registration in the absence of reliance on Section 3(c)(1) or Section 3(c)(7). Further, the manager would still need to register securities offered and sold by the fund or structure the fund's offers and sales of securities in a manner that is entitled to qualify for an exemption from such registration.

[7] Under the non-accredited investor sophistication test, each purchaser who is not an accredited investor must, either alone or with his purchaser representative(s), have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the fund must reasonably believe immediately prior to making any sale that such purchaser comes within this description.

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