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FUND DIRECTORS' OVERSIGHT OF INVESTMENTS IN CRYPTOCURRENCIES AND OTHER DIGITAL ASSETS

Fund investments in cryptocurrencies and other digital assets present oversight challenges for fund directors. In this article, after noting the absence of tested market infrastructure and of regulation for this new asset class, the authors focus first on technical considerations of blockchain technology and the limited regulatory jurisdiction of the SEC, the CFTC, and federal banking regulators. They then turn to the implications that the absence of infrastructure and regulation has for boards, including oversight of new service providers, and issues surrounding custody, valuation, and liquidity of digital assets. Consequently, their closing thought is that, as digital assets find their way into registered products, boards will need to be more diligent and sophisticated in their scrutiny and oversight of this new asset class.

By Paulita Pike and David M. Geffen *

Hardly a week goes by without several stories in the financial press about burgeoning investor interest in digital assets, especially cryptocurrencies. In July 2021, U.S. Senator Elizabeth Warren sent a letter to SEC Chair Gary Gensler regarding the SEC's "authority to properly regulate cryptocurrency exchanges" and to determine whether Congress "needs to act to ensure that the SEC has the proper authority to close existing gaps in regulation" that leave investors vulnerable. In her letter, Senator Warren asserted that, during the six-month period ending March 2021, nearly 7,000 people reported losses from cryptocurrency scams, "resulting in a cumulative $80 million lost — about 12 times the number of reports and nearly 1,000% more in reported losses compared to the same period a year earlier."

Driving investors' interest in cryptocurrencies is the fact that the price of Bitcoin, the most popular cryptocurrency, more than tripled in value during 2020. Indeed, in the quarterly report of a headline-making ETF — headline-making because its March 31, 2021 *one-year performance was +183%* — the CIO listed the ETF's indirect Bitcoin exposure among the top contributors to the ETF's performance.

As recently as May 2021, the SEC's Division of Investment Management issued a statement warning investors that Bitcoin is a "highly speculative investment," and that investors should consider Bitcoin's volatility and "the lack of regulation and potential for fraud or manipulation in the underlying Bitcoin market."

Despite the SEC staff's warnings, there appears to be significant investor appetite for registered funds that invest directly or indirectly in cryptocurrencies. Not surprisingly, a large number of fund sponsors are

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seeking to launch registered funds that meet this demand. Registered funds that focus on cash-settled Bitcoin futures contracts are in the pipeline and, notwithstanding the SEC's current bar to registered funds holding cryptocurrencies directly, funds are looking for exposure through a variety of means. This is an opportune moment for fund directors to explore the unique fiduciary and oversight issues presented by registered funds investing directly and indirectly in cryptocurrencies. The discussion below focuses on cryptocurrencies, but it applies equally to any other digital asset similarly relying on distributed ledger technology.

PRIOR TREATMENT OF NEW ASSET CLASSES

Since the inception of registered funds, asset management firms — which are highly entrepreneurial — have ventured into new or non-traditional asset classes that, at the time, carried implications under the Investment Company Act. Every such venture has confronted regulatory challenges and required fund directors to reconsider how to best oversee the asset class. As examples, consider the challenges arising from (1) investments in emerging markets that had underdeveloped payment and settlement systems, and fewer investor protections generally, (2) the emergence of money market funds in the 1970s leading to Rule 2a-7, requiring particularized board oversight, and (3) the emergence of the markets for overnight repurchase agreements and bilateral OTC swaps, each relying on new standardized documentation and enhanced oversight of counterparty risk.

While each foray into these asset classes faced hurdles, the then-existing market infrastructure, including established financial intermediaries, underwriters, custodian banks, central depositories, and exchanges, was largely able to accommodate the new investment exposures. Moreover, the entities underlying this infrastructure in the U.S. were typically regulated directly by the SEC, the CFTC, bank regulators, or another federal regulator. Outside the U.S., the infrastructure was overseen by analogous sets of non-U.S. regulators. In the U.S. and abroad, infrastructure also was provided indirectly by self-regulatory organizations or centralized trade organizations that provided uniform documentation and trading practices (e.g., the Bond Market Association and the International Swaps and Derivatives Association). As registered funds ventured into new or non-traditional asset classes, pre-existing market infrastructure was rarely absent.

This stands in sharp contrast to the many structural issues laid bare as the asset management industry explores how to add digital asset exposure to registered products. The industry is confronting new challenges in addition to familiar ones. For fund directors, this means that the oversight bar is about as high as it can be. Complicating the landscape are the many unique aspects of this new asset class.

UNIQUE STRUCTURAL ELEMENTS

Technical Considerations. A key practical consideration related to cryptocurrencies is the lack of a regulated central depository that records their ownership. Instead, a distributed, immutable record of transactions (frequently referred to as a blockchain), relying on blockchain technology, "makes it possible to create a digital ledger of transactions and share it among a distributed network of computers. It uses cryptography to allow each participant on the network to manipulate the ledger in a secure way without the need for a central authority."

Relying upon a non-central distributed ledger is considered by many to be a benefit because it eliminates participation of regulated intermediaries and scrutiny by government authorities. Instead, a blockchain relies on cryptography to permit any person to access the distributed ledger and to manipulate the ledger in a secure manner. When a person wants to transact, other network participants verify the transaction to assure that the transaction is legitimate and consistent with the history of the blockchain. After a proposed transaction is verified, it is broadcast to all other network participants and added to the blockchain's distributed ledger. Without a central figure maintaining a ledger, such as a securities depository or transfer agent, all participants maintain copies of the same distributed ledger. Cryptocurrencies are thus digital records that are represented on a distributed ledger by the software protocols used to secure and maintain the ledger.

Bitcoin can be acquired on so-called cryptocurrency exchanges or directly from others. Note that it is more accurate to call these exchanges "platforms" because they are unregulated. Anyone transacting in Bitcoin must set up a "wallet" to hold their bitcoins. The wallet can be provided by the exchange platform or by a third-party provider. A wallet maintains the string of characters representing acquired bitcoins, as well as a unique password or private key. If a participant loses its private key, it loses its ability to access its bitcoins permanently.

The fact that network participants maintain copies of the same distributed ledger makes unauthorized changes to the ledger difficult. Some maintain that this feature makes a distributed ledger less susceptible to fraud. While this may be true for transaction security, it does not protect individual wallet or account security, which may be compromised by the theft or loss of a private key. Once a transaction occurs on the distributed ledger, even if procured by a breach in a wallet or account security, it cannot be reversed.

Where Are the Regulators? There currently are an array of postures among traditional regulators relating to whether the regulation of cryptocurrencies falls within their purview. Consider, for example, that according to the SEC staff, Bitcoin is not a security. Yet, the SEC staff has taken the position that other cryptocurrencies amount to unregistered offerings of securities or "initial coin offerings" (e.g., Meta 1 Coin, BCT Token). Whether a digital asset is a "security" depends on a complicated multi-factor analysis that can be as fluid as the facts. The SEC staff's differing conclusions on whether it can or cannot regulate a particular cryptocurrency reflects the complexity of the issue. SEC Chair Gary Gensler has recognized the variability of regulatory oversight and cautioned about its potential pitfalls. He testified in May 2021 before a Senate committee that:

> "[t]here are many challenges and gaps for investor protection in these markets. Tokens currently on the market that are securities may be offered, sold, and traded in non-compliance with the federal securities laws. Furthermore, none of the exchanges trading crypto tokens has registered yet as an exchange with the SEC. Altogether, this has led to substantially less investor protection than in our traditional securities markets, and to correspondingly greater opportunities for fraud and manipulation."

Another likely federal regulator, the CFTC, has asserted that cryptocurrencies are commodities within its jurisdictional reach. However, the CFTC's assertion triggers only the CFTC's anti-fraud authority because the CFTC lacks authority to adopt rules regulating trading in the cash markets (i.e., spot contracts or forward contracts that settle in cash) of transactions in commodities. Consequently, the CFTC cannot set rules or regulations regarding how cryptocurrencies can be sold publicly in these cash markets or regulate the cash market infrastructure and so-called exchanges.

Instead, the CFTC has jurisdiction over futures and options on futures, which are required to be traded on a futures exchange registered with the CFTC. This means that the full regulatory weight of the CFTC applies only with respect to U.S. transactions in futures contracts and options on futures contracts of cryptocurrencies. These markets are much smaller than the cash markets for cryptocurrencies.

The U.S. Treasury views Bitcoin as a virtual decentralized currency but not as legal tender. Entities that process Bitcoin transactions are viewed as Money Services Businesses ("MSBs") and are subject to the AML and KYC supervision of the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN"), including requirements to file suspicious activity reports. Otherwise, there has been no rulemaking of cryptocurrencies by federal banking regulators.

Cryptocurrencies lack a regulated central depository and regulated transfer agents. The exchange platforms on which cryptocurrencies trade are unregulated. Intermediaries providing services to transact in cryptocurrencies are unregulated and lack significant operating histories or track records. Fraudulent transactions cannot be unwound. The SEC, the CFTC, and bank regulators do not have jurisdiction over much. A pre-existing market infrastructure, which has been a hallmark of virtually every other asset class in which registered funds have invested, is virtually non-existent when it comes to cryptocurrencies.

PINCH POINTS FOR FUNDS AND DIRECTORS

Vendor Oversight. The absence of market infrastructure increases the onus on directors and advisers. Any investment in cryptocurrencies could involve a range of new service providers to the fund, including with respect to custody, valuation, and liquidity. Additional entities, such as counterparties, could also be part of the mix. As with any service provider or counterparties, the role of the board is oversight. To the extent, however, that the entities in question are new to the asset management industry (which is not only possible, but likely), the board's

oversight and scrutiny grow in importance. This suggests that more frequent and robust diligence will likely be the norm. Understanding the compliance, operational, and technological infrastructure of fund service providers will be key, as will ensuring that contracts between the fund and the service providers address novel aspects of the relationship to ensure that the fund is protected. Fund insurance arrangements also should be considered in conjunction with service provider contracts to be sure the board understands the interplay between potential liability of the fund that would result from those contracts and the extent to which that liability would be covered by the fund's insurance policies.

Custody. The Investment Company Act mandates safeguards regarding how registered funds maintain custody of their assets. This role is usually filled by a custodian bank. At present, none of the major custodian banks provides custody services for cryptocurrencies. If a registered fund intends to hold cryptocurrencies, the board will likely have numerous questions about how the custody requirements of the Investment Company Act and its rules will be satisfied. In particular, custody of fund assets requires the ability to validate the existence and exclusive ownership of a digital asset. Therefore, a board might logically want to ask about the security of private software-based cryptocurrency keys. In turn, this raises additional questions about the new or unique cybersecurity threats, not present with respect to traditional assets, arising from the use of digital wallets and other software-based controls that affect the safekeeping of a fund's assets. Here, as in any area that requires technical or specialized knowledge, fund directors (1) may reasonably rely on the written and oral reports of the adviser and experts and (2) because their reliance must be reasonable, should consider the expertise and experience of the persons providing any report.

Valuation. Mutual funds and ETFs are required to value their assets each business day to calculate their NAV. Cryptocurrencies trade 24 hours a day every day of the year. There is no consolidated tape reporting the 4:00 p.m. closing price from the exchange platforms on which cryptocurrency trades, and these platforms are unregulated. Moreover, cryptocurrencies may trade on multiple platforms, not all of which handle institutional-sized transactions in which a fund is likely to trade. Valuing cryptocurrencies may require a methodology to deal with situations when two different platforms report different prices.

A fund holding a cryptocurrency will likely need bespoke additional procedures and controls to assure that the observed market transaction price used to calculate the fund's NAV is a readily available quotation. If not, the cryptocurrency's value must be its "fair value as determined in good faith by the board." Here, the board may rely on a reasonable methodology, perhaps the average of several venues' 4:00 p.m. transaction prices, to determine the fair value. As is true with any new asset class, it would be prudent to test relevant procedures and controls before the fund acquires exposure that requires new or different procedures and controls. It is also important to remember that the new valuation rule, Rule 2a-5, goes into effect on September 22, 2022. The rule provides, for the first time, a definition of "readily available." Under the rule, for a market quotation to be deemed "readily available," a security's value must be determined solely by reference to level 1 inputs under U.S. GAAP, which will require "quoted prices (unadjusted) in active markets for identical assets . . . that the reporting entity can access at the measurement date." In light of this, a question from directors might relate to whether the valuation of any digital asset would be a fair valuation. If the answer is "yes," understanding the interplay between the valuation of those assets and liquidity of the fund will be important (more on this below).

In view of the fact that cryptocurrencies continue to trade around the clock, the procedures for valuing cryptocurrencies must be sensitive to significant events that become public after 4:00 p.m. These procedures are similar to the procedures that funds have in place to make adjustments to the value of a security to reflect certain post-closing news events (e.g., an issuer unexpectedly announces that its earnings had been substantially overstated in prior periods due to accounting irregularities). The historic price volatility of cryptocurrencies means that cryptocurrencies will require their own unique procedures and controls to deal with significant events that may become public after 4:00 p.m.

To the extent that a fund will rely on pricing vendors, disclosure to the board of any conflict of interest by a pricing vendor will be paramount (e.g., the vendor has an affiliate that is a market-maker in a cryptocurrency covered by the vendor).

All of the foregoing demonstrates the greater difficulty in valuing cryptocurrencies. The board's goal will be to assure that these valuation difficulties do not make a fund more prone to NAV calculation errors. Fund directors should ask whether funds have the information, policies, control, and expertise necessary to value cryptocurrencies, especially in view of the fragmentation of trading venues and general lack of

regulation of underlying cryptocurrency markets, as well as the volatility of cryptocurrency prices. This includes procedures to fair-value the assets when a relied-upon platform's transactions are no longer deemed readily available.

Liquidity. The fund liquidity rule, Rule 22e-4, requires funds to have a liquidity risk management program. Among other things, the rule requires a fund to classify its portfolio holdings into one of four liquidity categories, and to limit its investments in illiquid securities to no more than 15% of the fund's net assets. A fund must review the liquidity classifications of each of its investments and periodically assess the fund's liquidity risks. Naturally, these classifications and assessments entail information about the market depth or trading volume of each investment class. In the case of cryptocurrencies, this information by necessity is based on limited data, due to the relative lack of transparency of the market for cryptocurrency. Boards are required to approve a fund's liquidity risk management program and any material changes thereto.

In view of the relative paucity of information concerning cryptocurrency markets, it would be prudent for boards to exercise particular scrutiny and ask the liquidity risk program administrator how it has informed itself regarding the characteristics of the cryptocurrency markets. Among other questions, directors could ask how the program administrator has arrived at its estimates of the trading history, volatility, and market depth of each cryptocurrency, especially in light of the non-centralized structure of the market. Here again, a board may rely on the written and oral reports of the adviser and experts, provided the board considers the expertise and experience of the persons providing any report.

Disclosure. As signatories of a fund's registration statement, directors are potentially on the front lines of prospectus liability. They can be held liable for losses caused by material misstatements in, or omissions from, a fund's registration statement. The volatility of cryptocurrencies may lead to substantial fund losses and after-the-fact scrutiny by the registration statement regulators and plaintiffs' attorneys. The challenges that fund investments in cryptocurrencies present are adequately disclosing identifiable risks, as well as adequately disclosing that there is a larger-than-normal space occupied by risks that cannot be identified, due to the relative immaturity of the asset class and its infrastructure. At least for now, and for as long as cryptocurrencies continue to be an emerging class, crafting disclosures that are appropriate and are also protective of the board takes a good deal of ingenuity and focus on the part of attorneys. Directors will want to discuss those disclosures with counsel and satisfy themselves that the disclosures are robust.

CLOSING THOUGHTS

At present, the SEC effectively prohibits funds registered under the Investment Company Act from owning cryptocurrencies directly. In view of this direct prohibition, the SEC staff observed in May, "a number of registered funds have particularly focused on cash-settled Bitcoin futures, traded on an exchange regulated by the U.S. Commodity Futures Trading Commission . . . believing it to be a potential method of gaining cryptocurrency exposure." The SEC staff's willingness to permit registered funds to invest in Bitcoin futures is driven by the staff's conclusions that the Bitcoin futures market is sufficiently mature, including trading volumes and open-interest positions, and that the CFTC-regulated market "consistently has produced a reportable price for Bitcoin futures [and] not presented the custody challenges associated with some cryptocurrency-based investing because the futures are cash-settled." As noted above, a number of fund sponsors have in the pipeline registered funds that focus on cash-settled Bitcoin futures. These pipeline funds, because they rely on existing infrastructure, obviate many, but not all, of the issues described in this article.

The Investment Company Act's underlying philosophy is that investors should know what investments they are buying and that, at the same time, sponsors of registered funds are free to offer the public a wide array of investment options, provided that all material facts are disclosed. Digital assets are here to stay. There is no question that they will increasingly and more directly find their way into registered products. The only question is when. As that begins to happen, boards will need to be more diligent and sophisticated in their oversight. Digital assets are not so much a new asset class as they are a new frontier. Directors will play an important part in confirming that, before this frontier is open for mass consumption, investor interests will be protected. The SEC is certain to view it this way. ■