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TECHNOLOGY

Business and Legal Issues in Raising Capital for Cryptocurrency Funds

By Vincent Pitaro, The Hedge Fund Law Report

A recent installment of the Cryptocurrency Fund Workshop Series presented by the Capital Fund Law Group offered a capital-raising primer for funds that seek to invest in cryptocurrencies and cryptocurrency-related strategies. The program, which covered both legal and business issues in setting up a cryptocurrency-focused fund, featured John S. Lore and Beth-ann Roth, managing partner and partner, respectively, at Capital Fund Law Group, along with Alex Mascioli, CEO of North Street Global. This article summarizes their insights.

For a look at the technology underlying cryptocurrency, see our three-part series on blockchain and the financial services industry: "Basics of the Technology and How the Financial Sector Is Currently Employing It" (Jun. 1, 2017); "Potential Uses by Private Funds and Service Providers" (Jun. 8, 2017); and "Potential Impediments to Its Eventual Adoption" (Jun. 15, 2017).

State of the Law on Cryptocurrency

No one should be surprised by the SEC's recent issuance of dozens of subpoenas to cryptocurrency firms, Roth said. The agency has signaled that initial coin offerings (ICOs) may constitute offerings of securities (e.g., in guidance issued roughly one year ago); stated that cryptocurrencies must be issued in the context of existing law; and formed its cryptocurrency group within the Division of Enforcement. See "Co-Director of SEC Enforcement Division Champions New Retail Strategy Task Force and Cyber Unit" (Nov. 16, 2017).

While market participants have offered various explanations as to why ICOs do not involve the issuance of securities, these arguments "really [don't] make any sense," Roth noted. The safest approach is to assume that ICOs involve securities and to plan accordingly. Still, the determination as to whether a financial instrument is a security will always be fact-specific.

See "SEC Halts Registration of Cryptocurrency Mutual Funds, Calling for Dialogue Regarding Valuation, Liquidity, Custody, Arbitrage and Manipulation Risk" (Feb. 15, 2018); and "SEC Cyber Unit Files Charges Against Allegedly Fraudulent ICO" (Jan. 11, 2018). For the IRS perspective, see "IRS Clarifies that Bitcoin and Other Virtual Currencies Are Treated As Property for U.S. Federal Tax Purposes" (Mar. 28, 2014).

Raising Money

A number of business factors affect a cryptocurrency fund's ability to raise capital, Lore explained. These include:

- performance and track record;
- management team credentials and whether those credentials are tailored to the proposed strategy;
- a compelling fund strategy that pairs the manager's experience with a specific investment opportunity; and
- the amount of initial capital.

Initial fund capital is the best predictor of success in raising capital, Lore noted, because it inspires confidence in subsequent investors, spreads costs and provides "outside viability." A manager starting a small fund should have at least $1 million to $5 million committed to ensure success in raising additional capital. Sources of initial capital often include the managers themselves; professional associates; and family and friends (although, outside investors may not see family-based investor assets as "merit-based").

Another key to successful capital raising is a narrow strategy; a manager can always branch out later if it finds initial success, Lore said. While a positive track record may prove dispositive for other asset classes, Mascioli observed that it may not be terribly helpful with cryptocurrencies given their relative infancy and the bull market.

See "Capital-Raising Issues Hedge Fund Managers Must Consider" (Jan. 7, 2016).

Legal Considerations in Raising Capital

As a threshold matter, new managers must determine the permissible investor base in the jurisdiction(s) where they plan to market the fund, Lore said. Generally, private fund managers must market only to "accredited investors" or, in some cases, only to "qualified clients."

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An accredited investor is an individual with (1) net income of at least $200,000 per year ($300,000 with a spouse) for the past two years and a reasonable expectation of earning that income in the current year; or (2) a net worth of at least $1 million (exclusive of his or her primary residence). See "SEC Commissioners and Staff Discuss Possible Amendments to Definition of Accredited Investor" (Jun. 2, 2016).

A qualified client is an individual with (1) a net worth of at least $2.1 million (exclusive of his or her primary residence); or (2) at least $1 million in assets under management (AUM) with the investment adviser at the time of entering into the advisory contract. Investment advisers may only charge performance fees to qualified clients. See "Steps an Exempt Reporting Adviser Must Take to Transition to SEC Registered Investment Adviser Status: Regulatory Filings, Updates to Fund Documents and Preparation for SEC Examination (Part Three of Three)" (Oct. 19, 2017); and "SEC Adopts Final Rules Governing the Payment of Performance Fees to Registered Hedge Fund Managers" (Mar. 1, 2012).

Cryptocurrencies are subject to the concurrent jurisdiction of the CFTC and the SEC, Lore added. Managers subject to CFTC regulation may also have to consider whether an investor is a "qualified eligible person" (QEP).

For more on CFTC regulation, see "What Fund Managers Investing in Virtual Currency Need to Know About NFA Reporting Requirements and the CFTC's Proposed Interpretation of 'Actual Delivery'" (Mar. 1, 2018); and "Virtual Currencies Present Significant Risk and Opportunity, Demanding Focus From Regulators, According to CFTC Chair" (Feb. 8, 2018).

Private fund advisers with less than $150 million in AUM are generally not required to register with the SEC as investment advisers. Those managers must still comply with state laws and regulations, however, Lore said. In certain eastern states – generally New York to Florida – if a manager only has accredited investors, does not hold itself out as a fund manager and does not have any separately managed accounts, then nothing further is required.

In other states, including California, Texas, Massachusetts and some in the Midwest, a fund manager that invests in cryptocurrency must register as an investment adviser and may only take in money from qualified clients, he cautioned.

Private fund offerings are usually done in accordance with Regulation D under the Securities Act of 1933, Lore said. Most emerging managers also rely on the exemption found in Section 3(c)(1) of the Investment Company Act of 1940, which is available to funds with no more than 99 beneficial owners, to avoid registering their funds as investment companies.

Advisers can get into trouble in two common ways, Lore cautioned. First, they may make a technical mistake in the registration or filing process, a risk that can be mitigated by using good legal counsel. Second, they may make a material misstatement or omission to an investor. Offering documents must disclose all relevant information and risks. Risk factors should be updated to take into account recent SEC releases, including the March 7 release that discusses regulation of cryptocurrency exchanges. Fund-specific risk factors are the most useful and overuse of non-applicable risk factors can draw SEC scrutiny. Fund strategy disclosures must be clear and current.

See "Marketing and Reporting Considerations for Emerging Hedge Fund Managers" (Jun. 16, 2016).

To minimize risks associated with cybersecurity, custody, fraud and regulatory compliance, a manager should choose only highly reputable cryptocurrency exchanges, Lore said. Exchanges employ different know your customer and security standards. Established exchanges are most likely to quickly and effectively comply with regulatory changes. For "cold storage," there are companies that serve in a "quasi-custodial" capacity, he said.

The greatest regulatory uncertainty involves ICOs, Lore said. A manager should consider using investment limits or very clear disclosure as to why it is investing in a particular class of ICO. In his experience, managers are putting no more than 20 percent of their portfolios into ICOs.

See "How Advisers to Private Funds Can Prepare for Challenges and Opportunities in 2018: Tax Reform, Blockchain Technology and Alternative Fee Structures" (Feb. 1, 2018); and "Securities Docket Webinar Analyzes SEC Focus on Cybersecurity and Cryptocurrencies, Along With Implications of Court Decisions on the ALJ Regime and Attorney-Client Privilege (Part Two of Two)" (Mar. 1, 2018).

Business Considerations

A manager must decide on a minimum investment amount, Lore said. The minimum investment for traditional emerging hedge funds is often $250,000 or $500,000. The minimum investment has been lower for cryptocurrency funds – often

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just $50,000 or $100,000. See "Why and How Do Hedge Fund Managers Set Minimum Subscription Amounts?": Part One (Jun. 6, 2013); and Part Two (Jun. 13, 2013).

This is the first year that cryptocurrency funds are considered a separate asset class, Mascioli noted. At present, high net worth individuals and family offices are most likely to invest in cryptocurrencies; they may use these investments to diversify or hedge. An audience member noted that investors interested in volatile investments like cryptocurrency often look for "unique low correlation." See "How Blockchain Will Continue to Revolutionize the Private Funds Sector in 2018" (Jan. 4, 2018).

In contrast, endowments, pensions and other institutional investors are interested, but they are "sitting on the sidelines waiting for the CFTC and SEC to make up their minds" and create rules, Mascioli continued. Regulation will give institutional investors confidence and should bring more – not less – investment in the area, he said. Regulators must address both issuers and exchanges, Lore added, including providing guidance as to whether registration will be required and, if so, what that registration will look like.

Regulated securities are desirable because they can be packaged and sold as products with which investors can be comfortable, Mascioli said. Some investors see cryptocurrency as a hedge against inflation, like gold. As the 10-year treasury rate rises, investors will be looking for additional outlets.

See "Opportunities and Challenges Posed by Three Asset Classes on the Frontier of Alternative Investing: Blockchain, Cannabis and Litigation Finance" (Dec. 14, 2017).

A new manager should "institutionalize" its fund by hiring three qualified service providers, Mascioli recommended. First, appropriate counsel will help to mitigate risk both for investors and the manager and will create a "Bible" that sets the rules that all other service providers must follow. Second, a fund administrator can provide third-party financial reporting and accounting services to ensure accuracy. Finally, a fund must have an experienced auditor. The fund's service providers are critical to investors, who rely on them to help protect their investments.

See "Investor Gatekeepers Advise Emerging Managers on How to Stand Out When Pitching and Marketing Their Funds" (Dec. 15, 2016); and "Establishing a Hedge Fund Manager in Seventeen Steps" (Aug. 27, 2015).

A manager must also develop a marketing plan and budget wisely, Mascioli continued. The sales cycle can take six to eighteen months from introduction to actual investment, so managers should plan accordingly. A good customer-relationship-management system is essential because the business is "all relationship-based," he said.

Finally, a manager must understand how to interact with the various types of potential investors, Mascioli noted. If the manager is successful, its investors will refer other investors, which is one of the greatest sources of capital for managers. It is critical for a manager to get it right the first time, he stressed. If not, the manager will lose credibility and access to investors.

See "How Emerging Hedge Fund Managers Can Raise Capital in a Challenging Market Without Overstepping Legal Bounds" (Aug. 4, 2016).

Capital Introduction

There are differences between capital introduction groups, third-party marketers and placement agents, Mascioli explained. Marketers and placement agents receive commissions based on their success in raising capital. Capital introduction groups within prime brokers and other firms provide a value-added service for which clients do not pay extra.

See "PLI Panel Addresses Marketing and Brokerage Issues Impacting Hedge Fund Managers, Including Marketing to State Pension Plans, Capital Introduction and Broker Implications of In-House Marketing Activities" (Jun. 27, 2013).

SEC and state rules prohibit a firm from taking a percentage of an investment as a finder's fee or for capital introduction, Lore said. What matters is whether someone receives "transaction-based compensation" – i.e., compensation that is either a percentage of the capital introduced or contingent on whether capital is committed. Transaction-based compensation can only be paid to a FINRA-registered broker-dealer or to a registered investment adviser. A manager should never try to disguise a success fee as a "deferred consultation fee," Mascioli added.

For more on FINRA, see "FINRA Outlines Its Regulatory and Examination Priorities for 2018" (Feb. 8, 2018).

See also our three-part advertising compliance series: "Ten Best Practices for a Fund Manager to Streamline Its Compliance Review" (Sep. 14, 2017); "Five High-Risk Areas" (Sep. 21, 2017); and "Six Methods for a Fund Manager to Test Its Advertising Review Procedures" (Sep. 28, 2017).

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