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**ADVANCED TOPICS IN  
HEDGE FUND PRACTICES  
CONFERENCE**

**Manager and Investor Perspectives**

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# Digital Assets

## Speakers



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# Notable Digital Assets Bankruptcy Cases

- FTX/Alameda
- BlockFi
- Celsius Network
- Voyager Digital

## Custodian's General Business Model

### Pure Custody

Customers deposit digital assets with a custodian solely for safekeeping

### Earn Services

Customers deposit digital assets with a custodian that are then used by the custodian to generate high yields by investing the digital assets

### Lending Services

Customers obtain loans from the custodian in the form of digital assets

### Swap

Customer can swap digital assets with or through the custodian

### Purchase and Sale Services

Customers can buy or sell digital assets with or through the custodian in exchange for USD

### Mining

Miners can monetize new digital assets to pay off loans and generate revenue

### DeFi and Lending Protocols

Custodian may borrow money using digital assets as collateral

# Common Question

Are the digital assets maintained by the customer with the custodian property of the customer or property of the custodian's insolvency estate?

If property of the customer, the digital assets should be returned to the customer by the insolvency administrator (if they are there)

If property of the custodian's insolvency estate, the customer will have only a general unsecured claim to the value of the digital assets (value would likely be measured at the commencement of the insolvency proceeding)

# Obstacles for the Customer

- Digital asset deposits are not protected under any FDIC or other government insured program.
- It does not appear that the custodians complied with any custody-related procedures (e.g., UCC Article 8 opt-in) that could have protected its customers. See April 2023 issue of *Business Law Today*.
- To the extent that a custodian held cash on behalf of a customer pending investment in digital assets, it is likely that the customer will be a general unsecured creditor in the custodian's insolvency proceeding.
- The customer may have FDIC insurance if the cash was held in an FDIC-insured bank and the customer had "FDIC pass-thru" protection. But that protection requires that meaningful records be maintained by the custodian.
- To the extent that a customer purchased digital assets to be held by a custodian in a noncustodial wallet, the custodian may have used the digital asset for its own purposes and claiming a direct right to recover the digital assets will be difficult if not impossible.
- Legal theories related to recovering cash or digital assets through the assertion of a constructive or resulting trust will be difficult to prove.
  - The arguments are not usually successful when the customer has a contract in place with the custodian.
- It also does not appear that certain of the custodians kept meaningful records linking the assets it held on behalf of customers to those customers.

# Trend of Decisions So Far

Courts have looked to the account agreements – sometimes referred to as “terms of use.”

If there is pure custody and the account agreement is clear that the customer retains ownership of the digital assets, the digital assets are not part of the insolvency estate of the custodian.

If there is more going on than pure custody (e.g., the customer permitted the custodian to use the digital assets in exchange for a return), there is a greater likelihood that the digital assets will be viewed to be part of insolvency estate of the custodian.

# Possible Reforms

## State Law

- Wider use of the UCC Article 8 opt-in
- Impact of 2022 UCC amendments

## Federal Law: Bankruptcy Reform

- Property of the estate
  - Pure custody
    - UCC Article 8 model
    - Bankruptcy Code chapter 7, subchapter III model
    - SIPA model
  - Other services
    - SEC Rule 15c3-3 model



# Digital Asset Legislative Proposals

Focused on Investor Protection



Bankruptcy Protections  
Disclosures  
Advertising Rules



Significant legislative proposals  
are in “discussion draft” form.  
States are taking action in the  
meantime.

# Regulation by Enforcement

2014 to Present

1. Crypto Assets
2. Insider Trading
3. Market Manipulation/False Tweets/Fake Websites/Dark Web
4. Public Company Disclosure and Controls

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## Crypto Assets and Cyber Enforcement Actions

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### Crypto Assets

Action Name	Description	Date Filed
SEC v. Green United, LLC, et al.	The Securities and Exchange Commission charged Utah-based company Green United, LLC, its founder Wright W. Thurston, and one of its promoters, Kristoffer A. Krohn, with allegedly defrauding investors in connection with an unregistered offering of crypto asset securities.	3/8/2023
SEC v. Singh	The Securities and Exchange Commission charged Nishad Singh, the former Co-Lead Engineer of FTX Trading Ltd. (FTX), for his role in a multi-year scheme to defraud equity investors in FTX, the crypto trading platform started by Singh along with Samuel Bankman-Fried and Gary Wang. Investigations into other securities law violations and into other entities and persons relating to the alleged misconduct are ongoing.	2/28/2023
SEC v. BIKCoin Management,	The Securities and Exchange Commission announced	2/23/2023

# Regulation by Enforcement

## CFTC

- Is a decentralized autonomous organization (DAO) an unincorporated association that may be sued?
- Is it possible to engage in oracle manipulation?

## SEC

- Heightened regulatory risk
- Past enforcement actions involved the offering of unregistered securities
- More recent enforcement actions allege that digital asset exchanges are operating an unregistered exchange, broker, and clearing agency

# Other Regulatory Developments

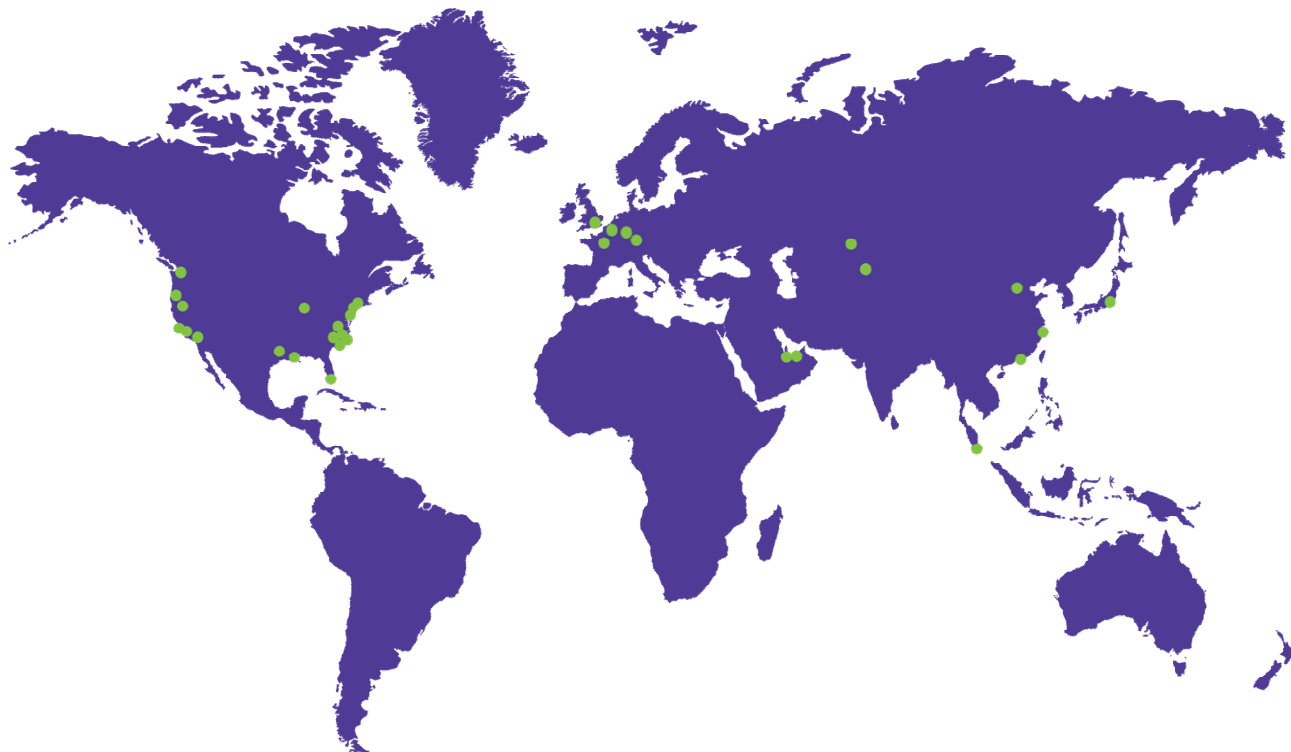
- Securities and Exchange Commission (SEC)
  - Proposed Amendments to the Custody Rule
- Commodity Futures Trading Commission (CFTC)
  - Staff Advisory to derivatives clearing organizations (DCOs) on importance of system safeguards, conflicts of interest, and physical settlement procedures when clearing digital assets products.
  - Amended Order of DCO Registration issued to Cboe Clear Digital, LLC, allowing it to offer margined futures on digital assets.
- National Futures Association (NFA)
  - Disclosure requirements in place since 2018
  - New Compliance Rule 2-51 (effective May 31, 2023)
    - Imposes antifraud, just, and equitable principles of trade, and supervision requirements on NFA members that engage in digital asset commodity activities
    - Currently applies only to Bitcoin and Ether

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