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Retail Crypto Funds: An Introductory Guide to Structuring



There are several structuring options for creating a retail fund product that invests in digital assets (also referred to as crypto). With a focus on funds that seek to invest in digital assets as a primary investment strategy, we describe some of the pros and cons of four potential retail crypto fund structures:

- an open-end mutual fund or exchange-traded fund (ETF) registered under the Investment Company Act (an Open-End Fund)
- a closed-end fund registered under the Investment Company Act (a Closed-End Fund)
- a fund that is not registered under the Investment Company Act, interests of which are registered under the Securities Act of 1933 (a 33 Act Fund or 33 Act ETP)
- a commodity pool, interests of which are registered under the Securities Act (a Commodity Pool)

This piece discusses each of these structures and reviews some of the types of digital assets such funds might hold.

A BRIEF OVERVIEW OF THE DIGITAL ASSET LANDSCAPE

Digital assets are diverse and difficult to group into categories. Some assets are referred to as cryptocurrencies. These assets, such as bitcoin and ether, are intended to be used to purchase goods and services. It can be argued that some of these assets function more like fiat currency than like a security (as defined under the federal securities laws).¹

There is a broad swath of fungible digital assets issued as coins or tokens and sometimes traded on secondary markets that do not function as equity or debt and which may be categorized as securities under the investment contract analysis articulated in the classic *Howey* test.² In this regard, the SEC – and particularly its current chair, Gary Gensler, takes the view that most of these assets are securities because, among other things, the expectation of profits from owning these assets would be derived from the managerial and entrepreneurial efforts of another, i.e., the persons or entities that created the asset and/or the network on which the asset is utilized.³ In contrast, it appears to be a current consensus that another broad swath of digital assets – these non-fungible (i.e., NFTs) – are not securities because they are not investment contracts under *Howey*.

There are also assets that are not themselves digital assets but reference digital assets, specifically, crypto derivatives. In December 2017, both the Cboe Global Markets Inc. and CME Group Inc. went live with bitcoin

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futures, and other derivative contracts, particularly those referencing ether, have followed. In this respect, the Commodity Futures Trading Commission (CFTC) has generally deemed digital assets to be “commodities,” and, as a result, derivatives that reference digital assets are subject to regulation by the CFTC.

FOUR OPTIONS FOR RETAIL CRYPTO FUND STRUCTURES

What follows are some high-level thoughts on four potential retail fund structures through which a crypto fund might be offered.

Open-End Fund Structure

In January 2018, Dalia Blass, the then-Director of the SEC’s Division of Investment Management, issued a letter to two investment management industry groups entitled “Engaging on Fund Innovation and Cryptocurrency-related Holdings.”⁴ The letter stated that the SEC staff had “significant outstanding questions how funds holding significant amounts of cryptocurrencies and related products would satisfy the requirements of the 1940 Act and its rules.” The letter identified and invited comment on several cryptocurrency-related issues, including valuation, liquidity, custody, arbitrage for ETFs, potential manipulation and other risks. Significantly, the letter stated that, until such issues are addressed, the SEC staff does “not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products.” The letter also noted that the SEC staff had asked sponsors with cryptocurrency fund registration statements on file to withdraw them.

Given the approach of the SEC staff in the Blass Letter, the path forward for a crypto fund seeking registration as an Open-End Fund remains difficult. Assuming that a crypto fund falls within the definition of an investment company,⁵ an Open-End Fund’s sponsor, in order to register the fund, must be able to provide satisfactory responses to the concerns raised in the Blass Letter. Four years after the letter’s issuance, it still is not clear how long the process of responding to the SEC’s concerns may take or even if engaging with the SEC staff at the present time on the questions raised in the Blass Letter will ultimately result in any approvals to begin registrations of Open-End Funds. To date, only a handful of public responses to the Blass Letter have been submitted to the SEC, the most recent, as of the writing of this article, from November 2021.

Closed-End Fund Structure

The Blass Letter did not address the registration of Closed-End Funds that invest in digital assets. Nevertheless, many of the issues raised in the Blass Letter appear to apply in equal measure to a Closed-End Fund as to an Open-End Fund (for example, concerns about custody of digital assets). As a result, it appears that the SEC staff expects a Closed-End Fund sponsor to respond to some or all of the issues raised in the Blass Letter before submitting a registration statement. An additional question for the sponsor of a Closed-End Fund is whether to seek to have the fund’s shares traded on an exchange or, alternatively, to provide liquidity periodically through either a tender offer or interval fund structure.

Perhaps the biggest roadblock to date for crypto funds – whether seeking registration under the Investment Company Act or not – has been in obtaining the SEC approval needed pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder (the 19b-4 process) in order for a digital fund’s shares to trade on an exchange.⁶ Issues arising in the 19b-4 process are not limited to funds structured as Closed-End Funds. The press has been full of stories over the past several years of SEC denials of Rule 19b-4 requests in connection with funds formed as non-investment company exchange-traded products (ETPs), including the Winklevoss Bitcoin Trust⁷ and the Grayscale Bitcoin Trust.⁸ To date, the central issue that has emerged through these denials is the SEC’s concern that the exchanges seeking to list the ETPs lack “a comprehensive surveillance-sharing agreement with a regulated market of significant size related to the underlying or reference [digital] assets.”⁹ The SEC has granted a Rule 19b-4 request specific to a bitcoin futures ETP (the Teucrium Bitcoin Futures Fund), in part, because of the existence of a comprehensive surveillance-sharing agreement with the futures exchange on which the bitcoin futures trade.¹⁰

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In light of the SEC's rejection of exchange-trading proposals, a sponsor of a retail crypto fund, including a Closed-End Fund, may consider foregoing the listing and trading of its shares on an exchange. As an alternative, a Closed-End Fund could provide periodic liquidity to shareholders either by making periodic tender offers pursuant to Exchange Act tender offer rules (Tender Offer Fund) or could elect to operate as an interval fund under Investment Company Act Rule 23c-3 (Interval Fund). Importantly, although generally prohibited under Regulation M of the Exchange Act, a Closed-End Fund – whether a Tender Offer Fund or an Interval Fund – is permitted to continuously offer and redeem its shares simultaneously.¹¹ In fact, an Interval Fund additionally may allow its shares to trade on a secondary market, including an exchange or an ATS.

33 Act Fund/ETP Structure

As noted above, many of the crypto fund products that have sought approval to list and trade shares on an exchange to date have been non-investment company products. These products register their shares under the Securities Act, but because they have determined that they are not required to register under the Investment Company Act, they do not register the fund itself. Generally, the assets of these funds are not deemed to be securities for Investment Company Act purposes. For example, in the filings mentioned above, the funds are intended to hold only bitcoin or bitcoin futures.

For purposes of this article, assume that a 33 Act Fund/ETP only holds assets that are not securities and are not “commodity interests” (i.e., interests, including bitcoin futures, that would subject the fund's adviser to regulation as a commodity pool operator). An example would be a fund that only holds bitcoin (assuming bitcoin is not a security). What is the regulatory posture of such a fund? On the one hand, the sponsor of this fund does not have to respond to the issues set forth in the Blass Letter because the fund is not an investment company. However, on the other hand – just like with the exchange-trading issues discussed above – a fund structured as an ETP would have to go through the 19b-4 process and would likely face a roadblock. One remaining option might be to pursue registration of a 33 Act Fund that does not trade on an exchange; however, additional considerations, including state registration and tax concerns, would have to be addressed. The result of this situation is that, at present, there are no retail crypto funds that focus on holding spot digital assets.

Commodity Pool Structure

The last structuring option is the public Commodity Pool. Like the 33 Act Fund, this fund's shares are registered under the Securities Act. However, unlike the 33 Act Fund, the Commodity Pool holds “commodity interests,” which may include futures, options on futures, swaps and options on swaps, among other derivatives. Although the Commodity Pool itself is not registered or directly regulated, it is indirectly regulated through its adviser, which is required to register with the CFTC as a commodity pool operator. As with the 33 Act Fund, a Commodity Pool's sponsor would not have to address the issues in the Blass Letter, and, as discussed above, at least one Commodity Pool has successfully gotten past the 19b-4 process. Finally, with respect to a non-exchange-traded Commodity Pool, Regulation M contains a specific exemption from the prohibition on simultaneous offers and redemptions for non-traded commodity pools, and, as a result, providing periodic liquidity would not be an issue for such funds.¹²

IN REVIEW

While this article provided a high-level overview of structuring options for retail crypto funds, in addition to the above considerations, there is also tax structuring to explore and legislative proposals to watch, which could affect some of the above discussion. Notwithstanding these various challenges and considerations, an increasing number of fund sponsors (and their counsel) are innovating in this area in an effort to offer retail investors access to crypto in a fund format.

¹ Bitcoin and ether are the only cryptocurrency assets about which the SEC or SEC staff have definitively opined that the assets are not securities.

- ² See SEC v. W. J. Howey Co., 328 U.S. 293 (1946).
- ³ See, e.g., SEC Rel. No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017).
- ⁴ SEC Staff Letter (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm> (the Blass Letter).
- ⁵ For purposes of this article, put aside the question of whether an Open-End Fund that invests most or all of its assets in digital assets falls within the definition of an investment company under the Investment Company Act and therefore is entitled to register as such with the SEC. See the definition of “investment company” in Section 3 of the Investment Company Act.
- ⁶ A crypto ETF that is subject to the Investment Company Act generally would not need SEC approval through the 19b-4 process, provided it can rely on Investment Company Act Rule 6c-11.
- ⁷ See SEC Rel. No. 34-80206 (March 10, 2017) (Winklevoss Bitcoin Trust denial).
- ⁸ See SEC Rel. No. 34-95180 (June 29, 2022) (Grayscale Bitcoin Trust denial).
- ⁹ Id. (referring to the spot bitcoin market).
- ¹⁰ See SEC Rel. No. 34-94620 (April 6, 2022) (Teucrium Bitcoin Futures Fund approval).
- ¹¹ See Regulation M, Rule 102(b)(2)(i), (ii).
- ¹² Regulation M, Rule 102(b)(3).

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