Understanding Cryptocurrencies: Audit Considerations and Potential Regulations

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Over the past six months, our Alternative Investment industry professionals at Richey May have seen a rapid uptick in activity in the cryptocurrency, or digital currency, space. Having been involved with these digital assets for a few years now, our tax and audit teams have developed insights into the unique challenges these assets present to both funds and investors – particularly key considerations that fund managers should understand prior to an audit, and how to mitigate risk to encourage investors.

With a combined market capitalization already exceeding $120 billion, Richey May projects continued growth in the crypto space. And it's no secret that investors are seeking increased exposure to these digital assets, including digital currencies such as bitcoin and ethereum. Conservative investors have historically shunned digital assets due to lack of clear authoritative guidance from industry regulators as well as perceived risks, but as the technology becomes more widely understood and usable, so too do the assets' future value.

Understanding Digital Currencies

According the United States Securities and Exchange Commission, digital currencies and other digital assets are "a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account, or store of value. Virtual tokens or coins may represent other rights as well."

Investment funds can be set up using any mix of traditional fund structures. Since cryptocurrencies and other digital assets experience increased volatility and reduced liquidity, closed-end funds and open-end funds with side-pockets are both common among investment funds for this asset class. More liquid assets, such as bitcoin, may not require a lock-up period or to be side-pocketed into a separate account. On the other hand, tokens that are not easily or profitably disposable in the short-term should have terms disallowing withdrawals at the limited partners' discretion. An investment fund's structure should be tailored to its investment strategy.

Mitigating Risk to Attract Investors

Security of assets is a major concern both for investment managers and investors in the digital asset class. News about hacking and theft have caused investors to become wary of investing, but there are ways to mitigate loss and appeal to investors. Managers should consider holding a certain percentage of fund net asset value in old-fashioned fiat currency in commercial bank accounts. A portion of the cash held is insured by the FDIC and all amounts held with commercial banks are protected by the bank's controls, minimizing risk of loss. Any loss due to hacking and theft would be limited to the value of the digital assets held.

Externally, digital currency exchanges are also taking steps to mitigate risk in order to attract investors. Exchanges are now beginning to perform "proof of reserves" testing whereby they prove that the total amount of coins/tokens held by the exchange matches the amount required to cover an anonymized set of customer balances. With these audits, exchanges hope to provide transparency as a means to reassure investors of the security of their digital assets, as well as to assure the going concern for the exchange following the bankruptcy of the Mt. Gox exchange in 2014.

Investment managers should also take steps to mitigate risk of loss on digital assets themselves. This can be accomplished through storing the investments in offline wallets, known as “cold-storage,” holding the assets through a qualified custodian or insuring the investments. At a recent cryptocurrency fund conference, one fund manager noted insurance on digital assets could cost up to 10%, a fee difficult for investors to swallow. Funds should also focus on their internal controls, particularly multi-signature technology, as a means of limiting internal theft. Managers must limit access to assets’ security keys to only necessary and qualified individuals.

Audit Considerations

If the fund will be getting audited, there are a couple unique considerations for digital assets. Typically, auditors obtain proof of existence of assets and the rights to control these assets from third parties, such as banks, brokers, or the private investee itself. Unless your digital assets are held with an exchange or custodian, this typical procedure must be circumvented. Although this may be more time-consuming, auditors can perform alternative procedures to obtain proof that these assets exist and that the asset manager controls them. Blockchain explorers are an important tool in the audit process when alternative procedures are used.

Valuation is another assertion requiring unique procedures. As digital assets become more freely tradeable on exchanges, the gap between typical investment funds and digital asset funds is becoming smaller. That said, an investment manager should always have a well-defined investment valuation policy, incorporating data from several different exchanges. As the market for individual digital assets is still relatively small, a single transaction on any exchange could affect the pricing of that asset on that particular exchange.

Depending on the firm’s investment strategy, the manager and the fund may be subject to regulation by CFTC, FINRA and/or the SEC. Given their broad legal definition, digital currencies qualify as commodities. Managers of digital currency funds will be subject to regulation by the Commodity Futures Trading Commission, unless they qualify as exempt organizations. Qualified advisors should be consulted to determine the appropriate course of action in these cases.

Current State of Regulation

Digital assets may be considered highly regulated by various agencies and jurisdictions, but to date, little specific guidance has been provided. The IRS, presumably eager to collect taxes from the assets, issued Notice 2014-21 designating that virtual currency be treated as property for U.S. federal tax purposes and that the general rules for property transactions apply. Although the IRS has not issued any guidance on token exchanges, many tax professionals agree that such an exchange would probably not qualify for §1031 treatment, which provides for deferral of gains or losses arising from the transaction. Traders in the digital asset space can also elect to use mark-to-market 475 election, causing investment gains and losses to be recognized in the current period, rather than upon occurrence of a taxable event, which is the default.

From a legal standpoint, the status of cryptocurrencies like bitcoin has not been agreed upon. In the case SEC v Trendon Shavers, a Texas magistrate judge ruled that, “bitcoin can be used as money…to purchase goods or services, and used to pay individual living expenses. Therefore, bitcoin is a currency or form of money.” Further support of this ruling can be seen as numerous commercial retailers have begun to accept bitcoins as a means of payment for goods and services, including Overstock.com and Subway restaurants. Contrary to the previous ruling, a Miami-Dade judge cited, in a money laundering case involving bitcoin, that the cryptocurrency, “is not backed by anything…and is certainly not tangible wealth and cannot be hidden under a mattress like cash and gold bars.” As further legal cases and regulation are decided, the exact definition and legal standing of cryptocurrencies will be established.

To date, the Financial Accounting Standards Board has provided little guidance on how to account for digital assets. In a comment letter to the FASB dated June 8, 2017, the Chamber of Digital Commerce outlined four potential methods to account for digital currencies under the following ASC topics:

1. ASC 305, Cash and Cash Equivalents.
2. ASC 825, Financial Instruments.
3. ASC 350, Intangibles – Goodwill and Other.
4. ASC 330, Inventory.

The comment letter proceeds to suggest that none of the options is suitable, and that a new ASC subtopic be drafted. To date, the Board has not publicly responded to the letter, and the issue has not been seen on any agendas. From an investment fund perspective, assets are measured and reported at their fair market value, with changes in fair value recorded in earnings during the period.

During July 2017, the SEC issued a report on a single token issued by an entity, citing that, “whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances… Those who offer and sell securities in the United States must comply with the federal securities laws.” Another token issuer which raised ethereum during August 2017 through an initial coin offering, Protostarr, announced that it would shut down and return funds after receiving a call from SEC investigators. In September 2017, the SEC announced the creation of the Cyber Unit within the Enforcement Division. The unit will focus efforts on targeting cyber-related misconduct and specifically calls out distributed ledger technology and initial coin offerings. Shortly after release of the Cyber Unit press release, SEC Chairman Jay Clayton testified that he expects, “the SEC’s near-term rulemaking objectives to be fully reflected in our upcoming Regulatory Flexibility Act Agenda.” To avoid potential regulation by the SEC, some issuers of initial coin offerings (ICO) are disallowing US-domiciled purchasers, but it is important to note that circumventing one country’s regulations does not protect against regulation and enforcement from other jurisdictions and agencies.

In the wake of ICO crackdowns, new documentation may hold direction for future token issuances. A Simple Agreement for Future Tokens (SAFT), similar to a SAFE but for tokens, can provide a framework for startups to generate funding prior to the development of the token’s functional network and/or sale of any tokens. SAFTs are a fairly new concept in the digital asset arena and should be considered investment contracts for legal purposes. That being said, all SAFTs would have to be qualified by the Howey Test created by the U.S. Supreme Court to judge whether the offerings are securities. Through implementation of the Howey Test, SAFTs could provide definition to token offerings going forward. Issues related to the adoption SAFTs and their ability to reflect the needs of the developing market still pose concerns for the framework as compared to the ICO model, which is more retail investor-focused. Potentially, SAFTs afford venture capitalists a means to work within existing statutes and reduce risks while democratizing access to an expansive secondary market.

Earlier this year, the SEC denied a request to list a bitcoin exchange traded product (ETP), citing a lack of surveillance-sharing agreements between the national securities exchange listing and trading the ETP, and more recently, another fund seeking to list a bitcoin ETP withdrew its request with the SEC. With new developments, including the launch of a bitcoin futures product, it is only a matter of time before a legitimate bitcoin ETP is listed.

In international regulation, China has banned ICO’s, although the ban is widely considered temporary. Later this fall, Russia plans to pass new laws regulating the exchange of cryptocurrencies, and Japan has recently announced plans to require bitcoin exchanges to register with authorities. As the digital asset space continues to grow, more foreign regulations will emerge and we can expect more regulation and enforcement in the future.

Richey May is dedicated to sharing best practices and trends in the industry to help you stay competitive in the local and national marketplace. For more information on Richey May, please contact **Stephen Vlasak** at **svlasak@richeymay.com** or visit our website at **www.richeymay.com**.

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