

Financing of Bitcoin and Other Crypto Assets: Structuring, Regulatory, Valuation, and Hedging Issues

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The Digital Asset Economy

- Two types of companies: Crypto Native & Traditional.
- Before the recent crash, cryptocurrency and blockchain companies were growing fast. In 2021, venture and other firms invested \$25-33B into startups in this space. 8x increase YoY 2020-2021.
- While we just experienced a market crash in the cryptocurrency industry that many are calling the “crypto winter,” there are signs that winter has begun to thaw into spring, as prices appear to have plateaued in recent weeks.
- The key takeaway is that digital assets are not going away.

Future Outlook

- Even with the recent market crash, there are still a wide range of digital assets from Bitcoin (digital store of value like gold) to Meme coins (like Tulips in the 1800s).
- These assets are likely to become more important to balance sheets in the coming years.

The “Proceeds” Rule

- Secured lenders may find themselves with digital asset collateral under the proceeds Rule
- UCC § 9-315(a)(2) provides that upon the disposition of collateral, the security interest continues in the identifiable proceeds of the collateral.
- So, if a borrower uses collateral to purchase digital assets, then the lender’s security interest will cover those digital assets

Structural Considerations

LTV

**Bankruptcy
Code Safe
Harbors**

24/7 Trading

**Liquidation
Considerations**

Custody Considerations

- There are multiple ways to custody digital assets:
 - Self-hosted wallet and private key
 - Third-party custodian
- If using a custodian, what is the custodial arrangement?
 - Omnibus wallet
 - Cold storage for dealer's specific digital assets
- Various issues to consider for custody arrangements
 - Commercial law treatment
 - Allocation of risk for adverse technological or operational events

What Happens if the Custodian Goes Bankrupt?

- Whether digital assets are property of the bankruptcy estate is a question of both (1) the language of the agreement and (2) the intent of the parties
- Some indicia of intent include:
 - How the parties label their relationship
 - Whether the debtor segregates customer assets from its own and those of other clients
 - Whether the customer retains all the incidents of ownership
 - Whether the debtor charges a fee for certain custodial services
 - Whether the debtor pays interest to customers
 - Whether the debtor can reuse the digital assets
 - Whether the debtor is required to act upon the instructions of customers
 - Whether the debtor treats the digital assets as its own for account purposes

Existing Commercial Law Treatment of Digital Assets for Security Interest Purposes

How does one determine which UCC category applies?

The starting place is Section 9-102 of the UCC, which sets forth many definitions applicable under Article 9

However, the UCC does afford the parties some leeway to structure an asset or arrangement to fit within a particular category

The most notable example of this is the financial asset definition under Article 8 of the UCC

Describing the collateral can be challenging with digital assets.

Existing Commercial Law Treatment of Digital Assets for Security Interest Purposes (including certain sale transactions)

Digital assets could fall into a wide array of UCC categories, including:

General intangible

Investment property

Money

Account

Deposit account

Electronic chattel paper

The applicable characterization will affect how (and if) a creditor can obtain a perfected security interest in the asset, as well as the rights of third parties to assert claims to such asset and **the right of a purchaser to take such assets free of prior claims**

A Few Examples: General Intangibles

Perfecting a security interest in a **general intangible** requires **filing** a UCC financing statement

To have priority in a general intangible, the secured party must generally be **the first to file** (which necessitates conducting and relying on UCC searches)

There are generally **no** UCC rules addressing whether a transferee of a general intangible takes free of adverse claims

A Few Examples: Money

Perfecting a security interest in **money** requires obtaining possession of the money

A transferee of money **takes free of a security interest** as long as it does not act in collusion with the debtor in violating the secured party's rights

A Few Examples: Investment Property

A secured party may perfect a security interest in **investment property** by “**control**” or by filing a financing statement*

Control generally affords priority over a secured party that files a financing statement

A party with control **takes free** of adverse claims so long as it took for value without notice of the adverse claim

— However, this take-free rule does not apply to any adverse claims before the financial asset became such

Relevant types of investment property:

Uncertificated securities

Security entitlement to a
financial asset

*Certificated securities may be perfected through possession.

What Is a Financial Asset and Why Is It So Popular?

Main Definition

UCC Section 8-102(a)(9) defines “financial asset” as:

- i. a security;
- ii. an obligation of a person or a share or participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on financial markets or which is recognized in any area in which it is issued or dealt in as a medium for investment; or
- iii. **any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article.**

Securities Intermediary

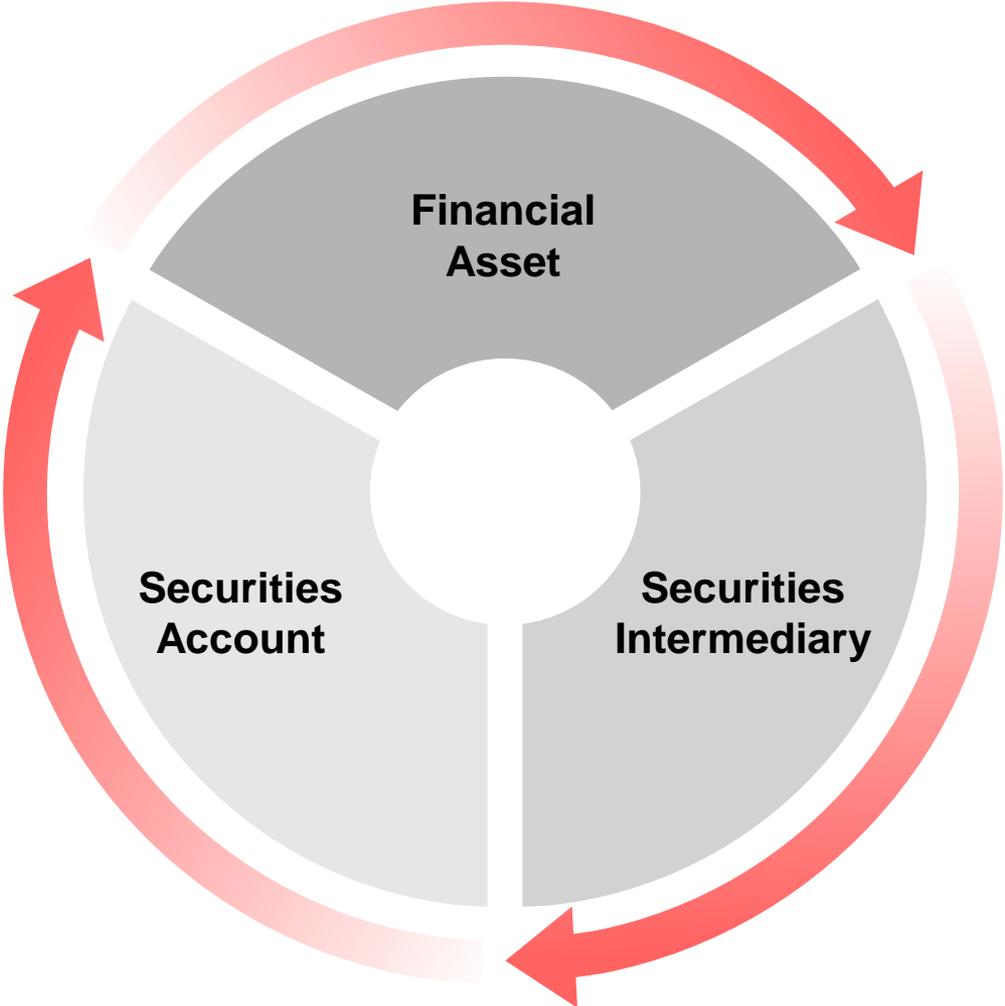
UCC Section 8-102(a)(14) defines “securities intermediary” as:

- i. a clearing corporation; or
- ii. a person, including a bank or broker, who, in the ordinary course of their business, maintains securities accounts for others and is acting in that capacity.

Securities Account

UCC Section 8-501 defines “securities account” as “an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.”

Is This Not All Circular?



Why Such Circularity?

The circularity is designed to provide flexibility: If the relationship between an intermediary and its customer is akin to the relationship of a broker indirectly holding “security entitlements” for a customer, the assets can—on the parties’ agreement—be financial assets

[O]ne must analyze whether the relationship between an institution and a person on whose behalf the institution holds an asset falls within the scope of the term securities account as defined in Section 8-501. That question turns in large measure on whether it makes sense to apply the Part 5 rules to the relationship.

— UCC § 8-102, cmt. 9.

What Are The Part 5 Duties?

8-504(a)

A securities intermediary must maintain a quantity of financial assets corresponding to the aggregate of security entitlements it has established for its customers

8-505(a)

A securities intermediary must obtain any payments or distributions made by the issuer of a financial asset

8-506(a)

A securities intermediary must exercise rights with respect to a financial asset if directed to do so by a customer

8-507

A securities intermediary must comply with its customers' orders to transfer or redeem the financial asset

8-508

A securities intermediary must, at the direction of the customer, change the security entitlement into another available form of holding for which the customer is eligible or cause the financial asset to be transferred to a securities account of the customer at another intermediary

Does It Make Sense to Apply the Part 5 Duties to Digital Assets?

If a customer and its intermediary agree to treat digital assets maintained with the intermediary as “financial assets,” many of the duties of Part 5 may reasonably be applied to the intermediary in respect of the digital assets:

8-504(a)

The intermediary could maintain an amount of each digital asset corresponding to each customer’s entitlement.

8-507

The intermediary could comply with a customer’s orders to transfer the digital asset to another customer or third party.

8-508

The intermediary could comply with a customer’s instruction to convert the intermediated digital asset (i.e., a digital asset held strictly by the intermediary) to a digital asset held directly by the customer on the distributed ledger.

Does It Make Sense to Apply the Part 5 Duties to Digital Assets?

Depending on the attributes of the particular digital asset, it may not be clear how an intermediary could exercise certain Part 5 duties in relation to that asset, such as the duty to obtain distributions from the issuer* (UCC § 8-505(a)) or the duty to exercise rights (UCC § 8-506)

8-505(a)

The intermediary could obtain “distributions” in the form of forks or airdrops

8-506

The intermediary could comply with a customer’s orders to stake, stack, vote, or otherwise exercise governance rights associated with digital assets, if such rights exist

- Even if certain Part 5 duties are not applicable to certain digital assets, on a whole, it would seem to make sense to apply them to intermediaries who agree with their customers to treat digital assets as “financial assets”
- The official comments to the recent UCC digital asset amendments make clear that “[i]t is not necessary for all of the Part 5 rules to be relevant to a particular financial asset for the relevant property to qualify as a ‘financial asset’ credited to a securities account”

*The concept of an “issuer” will not always apply to digital assets. The official comments to the recent UCC digital asset amendments make clear that this duty can apply by analogy even when there is no true “issuer” of a digital asset and related distributions

Other Benefit of Financial Assets – Bankruptcy Certainty

The UCC makes clear that “financial assets” are not part of a securities intermediary’s estate.

*To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, **are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511 [of the UCC].***

- UCC § 8-503 (emphasis added)

A limited exception applies under Section 8-511. Creditor claims have priority over an entitlement holder only if:

- i. The securities intermediary has pledged a financial asset held for an entitlement holder to a creditor; and
- ii. The creditor has control over the financial asset
 - *This factor is not required when the securities intermediary is a clearing corporation*

In the absence of Article 8, market participants will need to look to the common law to determine whether custodied digital assets form part of the custodian’s estate

Some Limitations

Although we think it is possible for an intermediary and its customer to elect to treat digital assets as “financial assets,” there are a number of important limitations to bear in mind:

- A court may only respect the parties’ financial asset election if the securities intermediary acts as a traditional intermediary by holding the digital assets on an omnibus basis
 - If the digital assets are subject to individual segregation, a court may be less inclined to respect the parties’ financial asset election
- There is no case law on this issue, and it is hard to know how a court will interpret the “financial asset” definition
- Article 8’s take-free rules do not apply to claims that arose before the digital asset became a financial asset
- This analysis only applies if the assets at issue are intermediated

Thus, while existing law may provide paths to achieve legal certainty and workable commercial law rules, there is clearly a need for new legislation that directly addresses digital assets

Market practice differs widely; while some parties have sought to include financial asset elections, others have resisted this approach

Proposed Article 12 of the UCC

- Article 12 introduces the concept of a “controllable electronic record” or “CER,” which is defined at Section 12-102(a)(1) as “a record stored in an electronic medium that can be subjected to control under Section 12-105. The term does not include a controllable account, a controllable payment intangible, a deposit account, an electronic copy of a record evidencing chattel paper, an electronic document of title, electronic money, investment property, or a transferable record.”
- CERs are general intangibles under Article 9.
- Article 12 also introduces “controllable accounts” and “controllable payment intangibles,” and new choice-of-law rules with respect to CER.
- The Article 12 amendments also introduce the concepts of “electronic money” and “tangible money.”

Controllable Electronic Record

- What qualifies as a “controllable electronic record” is straight forward: an electronic record that is subject to control as defined under Section 12-105.
- Pursuant to Section 12-105(a), an electronic record is subject to control if the electronic record, a record attached to or logically associated with the electronic record, or the system in which the electronic record is recorded:
 - 1) Gives the person
 - A. Power to avail itself of substantially all of the benefits from the electronic record; and
 - B. Exclusive power, subject to subsection (b), to:
 - i. Prevent others from availing themselves of substantially all the benefits from the electronic record; and
 - ii. Transfer control of the electronic record to another person or cause another person to obtain control of another electronic record as a result of the transfer of the electronic record; and
 - 2) Enables the person readily to identify itself in any way, including by name, identifying number, cryptographic key, office, or account number, as having the powers specified in paragraph (1).

Elements of Control

- Four key elements of control:
 1. Power to avail oneself of substantially all of the benefits of the record;
 2. Exclusive power to prevent others from doing the same;
 3. Exclusive power to prevent others from transferring control to another; and
 4. Ability to identify oneself as having these powers with respect to the record.

Controllable Electronic Record

- Section 12-105(a) makes clear that a power is “exclusive” even the power is shared with another person.
- Power is also exclusive even if the electronic record, or the system in which it is recorded limits the use of the record or has a protocol programmed to cause a change, including a transfer, loss, or modification of the benefits of the record.
- Power is not shared, and therefore not exclusive, if (a) the person can exercise the power only if the power also is exercised by the other person **and** (b) the other person can exercise the power without the exercise of the power by the person or the other person is the transferor to the person.

Control Through Another

- Section 12-105(e) provides that a person has control of a CER if another person, other than the transferor to the person:
 - 1) Has control of the electronic record and acknowledge that it has control on behalf of the person; or
 - 2) Obtains control of the electronic record after having acknowledged that it will obtain control of the electronic record on behalf of the person.
- A person that obtains control on behalf of another is not required to acknowledge that it has control on behalf of another person.

Perfection in Controllable Electronic Records

- A security interest in CERs may be perfected by control or filing.
- Similar to security interests in investment property, i.e. securities, a security interest in a CER perfected by control has priority over a security interest in the same CER perfected by filing..

Controllable Accounts and Payment Intangibles

- The Article 12 amendments also introduce the concepts of controllable accounts and controllable payment Intangibles, which are accounts or payment intangibles, respectively, that are evidenced by a CER and under which the account debtor undertakes to pay the person that has control of the CER.
- Pursuant to new section 9-107A(b), a secured party obtains control over a controllable account or a controllable payment intangible by obtaining control over the CER evidencing the account or payment intangible.
- To discharge its liability on the underlying account or payment intangible, the account debtor under a controllable account or controllable payment intangible must pay the party with control of the controllable account or payment intangible, provided that it has received an authenticated notice identifying the party with control and a commercially reasonable method by which the account debtor may pay the person with control.

Choice of Law

- The “local law of the [CER’s] jurisdiction governs a matter covered by” Article 12.
- For controllable accounts and controllable payment intangibles, the local law of the CER’s jurisdiction governs unless an effective agreement designates that another jurisdiction’s law to apply.
- The CER’s jurisdiction is determined in the following priority:
 1. First, the jurisdiction expressly identified in the CER or records attached to or logically associated with the CER as the jurisdiction for purposes of Article 12 or the UCC, if any;
 2. Second, the jurisdiction expressly identified in the rules of the system in which the CER is recorded as the jurisdiction for purposes of Article 12 or the UCC, if any;
 3. Third, the jurisdiction expressly identified in the CER or records attached to or logically associated with the CER, if any;
 4. Fourth, the jurisdiction expressly identified in the rules of the system in which the CER is recorded, if any; or
 5. Fifth, the District of Columbia.

New “Money”

- The Article 12 amendments modify the definition of “Money” expressly to exclude cryptocurrencies such as Bitcoin and Ethereum.
- Specifically, section 1-201(b)(24) now defined “money” to mean:
“a medium of exchange that is currently authorized or adopted by a domestic or foreign government. The term includes a monetary unit of account established by an intergovernmental organization, or pursuant to an agreement between two or more countries. The term does not include an electronic record that is a medium of exchange recorded and transferable in a system that existed and operated for the medium of exchange before the medium of exchange was authorized or adopted by the government.””
- The Article 12 amendments add new definitions for “Electronic money,” which is defined to mean “money in an electronic form” (UCC § 9-102(a)(31A)) and “Tangible money,” which is defined to mean “money in a tangible form.” (UCC § 9-102(a)(79A).

Control of “Electronic Money”

- New section 9-105A governs obtaining control of Electronic Money, essentially mirroring the requirements for obtaining control over CERs under Section 12-105(a).
- Under section 9-312(b)(4), a security interest in electronic money may only be perfected by control—not filing.
- A security interest in tangible money still may only be perfected by possession.

Regulatory Considerations

**Commodities
Regulation**

**Securities
Regulation**

Bank Powers



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Thank You

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