

Retirement Plan and IRA Investment in Bitcoin and Other Cryptocurrencies

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Introduction

- 2013 saw the emergence of cryptocurrency, predominantly Bitcoins, as a financial instrument
- A rollercoaster ride: according to CoinDesk.com, the Bitcoin Price Index was
 - \$13.28 on January 2, 2013;
 - \$1,147.25 on December 4, 2013; and
 - \$534.71 on February 25, 2014
- Substantial uncertainties
 - Will cryptocurrency reach a critical mass of acceptance and become a lower cost and faster method of effecting global transfers of money?
 - Will cryptocurrency become an investment alternative, and will cryptocurrency be able to be held by retirement plans and IRAs?
 - Will cryptocurrency fade away because of inherent flaws in structuring, because of the potential for use in money laundering or fraud, or for other reasons?
 - Keep in mind, *“Bitcoins may crash, but Hanukkah gelt always will remain a steady hedge against inflation”*

Agenda

■ Cryptocurrency Basics

- What are cryptocurrencies? How do you buy and sell them? What financial functions can they serve?

■ Code Considerations

- What type of asset is a cryptocurrency for purposes of the Code's retirement plan provisions?
- How can cryptocurrency be held in a manner that satisfies the Code's custodial requirements?
- Are the prohibited transaction rules of Code section 4975 (and the corresponding provisions of ERISA) applicable to transactions in cryptocurrency and if so how?

■ ERISA Considerations

- Would an investment in cryptocurrency satisfy ERISA's prudence standard?
- What is the indicia of ownership of cryptocurrency?

■ Securities Law Considerations

- Are interests in funds that invest in Bitcoin securities?
- Can a cryptocurrency fund be included as an investment alternative for a 401(k) plan?

Introduction to Cryptocurrencies

- Cryptocurrencies (currencies whose security is maintained by public key / private key cryptography) are a new form of decentralized digital currencies
- Bitcoin is the oldest and best known cryptocurrency. We will use 'Bitcoin' interchangeably with cryptocurrency in this presentation
- The basis for cryptocurrencies was a white paper released in 2008/2009 under the pseudonym 'Satoshi Nakamoto'
 - This paper presented a new, improved solution to the so-called "Byzantine General's Problem," a well known problem in computer science
- At the highest level, solving the Byzantine General's Problem, allows a group of decentralized parties who do not necessarily trust or know each other to reach a trusted 'consensus.' This occurs through a process known as 'mining' but probably more accurately described as 'competitive bookkeeping,' where computers worldwide compete to update the ledger in exchange for rewards (in Bitcoins)
- What this means in practice is that for the first time in history, it is possible to have a decentralized 'asset ledger', the 'blockchain' that is currently distributed across 250,000 computers worldwide
- It is hard to overstate how broad the applications of this will be. 'Currency' is a logical starting point but there is no reason why the blockchain could not be used to track ownership of other assets (real property, stock, bonds, intellectual property and so on)

Bitcoin, the Currency

- Though Bitcoin (as a protocol for asset register) can have many uses beyond currency, most of the popular attention is on Bitcoin (the currency). This presentation will focus on the latter.
- Bitcoin the currency mostly closely resembles a form of commodity money. It shares with older forms of commodity money the characteristic that supply is fixed. Only 21M bitcoins will ever be issued on a declining scale that will end in 2140.
- Bitcoin however introduces several characteristics that are new to commodity money:
 - It is fairly invulnerable to being shut down as there is no central clearinghouse. There are hundreds of thousands of computers that support the blockchain right now, following a series of mathematical formulas.
 - It is infinitely divisible
 - It is natively digital meaning that it is the first form of money that is extremely well-suited to the internet era
 - It is extremely secure cryptographically, built on 40 years of public key / private key cryptographic research
 - It is programmable, meaning that advanced financial instruments (e.g. derivatives) or contracts (e.g. escrow services) can be built 'on top of' the bitcoin scripting language

State of the Market Today

- The 'market cap' or 'money supply' of Bitcoin over the last three months has ranged from about \$6B to \$10B, up 10x from last year. All other cryptocurrencies represent about an additional \$1B in 'money supply'.
 - By this metric, it is a small, but rapidly growing asset class
- The initial usages in practice are:
 - International remittances (can happen in seconds, worldwide, without a clearinghouse, for fractions of a penny)
 - Merchant processing (where the goal is to provide electronic payments with lower interchange fees)
- From an asset class perspective, the infrastructure is still immature, but changing rapidly
 - The United States still has no definitive exchange for exchanging Bitcoins into USD and vice versa, though Second Market announced the formation of one this week
 - Most of the US and Europe is served by an exchange called BitStamp (a small firm based in Slovenia)
 - Mt. Gox (the original Bitcoin exchange) collapse reported in the media this week as due to possible fraud or technical incompetence
- There is VC interest in building out the financial services infrastructure needed to serve Bitcoin. Over the next 6-18 months, one may expect a new class of professionalized exchanges, merchant processors and online wallets to emerge. Some of the initial firms in the space will survive; other, like Mt. Gox, will not make the transition from the 'enthusiast' phase to the 'financial services professionals' phase

Tax Considerations: Characterization of Bitcoin

- The Internal Revenue Code contains prohibitions on the types of investments that can be made by IRAs and qualified plans
- Code section 408(m): “The acquisition by an individual retirement account or by an individually-directed account under a plan described in section 401(a) of any collectible shall be treated (for purposes of this section and section [402](#)) as a distribution from such account in an amount equal to the cost to such account of such collectible. . . . For purposes of this subsection, the term “collectible” means (A) any work of art, (B) any rug or antique, (C) any metal or gem, (D) any stamp or coin, (E) any alcoholic beverage, or (F) any other tangible personal property specified by the Secretary for purposes of this subsection.”
 - A collectible does not include any coin that is: a fifty dollar gold coin, a twenty-five dollar gold coin, a ten dollar gold coin or a five dollar gold coin that in each case is issued by the Secretary of the Treasury; a silver coin that is issued by the Secretary of the Treasury; a platinum bullion coin and a proof platinum coin issued by the Secretary of the Treasury; or a coin issued under the laws of any State.
 - Code section 408(m) does not prohibit investments in commodities contracts such as futures contracts on gold

Tax Considerations: Characterization of a Bitcoin

- As of February 2014, the IRS has not issued any guidance under Code section 408(m) as to whether Bitcoins are “coins” or are otherwise “collectibles” for purposes of § 408(m) or whether a purchase of shares in a trust holding Bitcoins by an IRA, or by a participant-directed account under a Code section 401(a) plan, will be treated as an acquisition of Bitcoins.
- According to its most recent Registration Statement on Form S-1, the Winklevoss Bitcoin Trust has taken the view that:

Bitcoins should not be regarded as coins, or otherwise as collectibles, for purposes of section 408(m), because Bitcoins are a virtual, rather than a fiat currency . . . and, as such, do not take the form of tangible personal property, in contrast to a coin or any of the other items defined as a “collectible” under Section 408(m). Rather, it is the Registrant’s view that Bitcoins are in the nature of other Intangible investments such as commodity futures.

Tax Considerations: Unrelated Business Taxable Income

- Qualified plans and IRAs that are generally exempt from U.S. federal income tax pay tax on “unrelated business taxable income” – generally, for a retirement plan or IRA, a business activity other than a passive investment and certain debt-financed income
- It does not appear that UBTI would be triggered by a plan investing directly in Bitcoins or investing indirectly through a Bitcoin fund

Tax Considerations: Custody Issues

- Who can be a trustee or custodian for an IRA?
 - Code section 408(a) and its regulations require an IRA to be created or organized in the U.S. and to be maintained at all times as a domestic trust or custodianship so as to ensure the U.S. courts have jurisdiction over the IRA assets
 - Generally, IRA trustees will be banks, but non-bank entities can serve as IRA trustees or custodians under the Code if they make a written application to the IRS that demonstrates that the trust will be administered in a manner consistent with the requirements of Code section 408. According to the regulations, the applicant must be able to demonstrate:
 - Fiduciary ability, which encompasses continuity, an established place of business in the U.S., fiduciary experience/expertise, responsibility,
 - Capacity to account for the interests of a large number of individuals,
 - Fitness to handle retirement funds
 - Compliance with the rules of fiduciary conduct
 - Certain minimum net worth (at least \$250,000 to obtain initial IRS approval as a nonbank trustee)

ERISA Considerations: Duty of Prudence

- ERISA does not exclude investments in any particular asset classes – “portfolio theory”
 - A plan fiduciary decision to invest in Bitcoins is not a per se violation of ERISA
 - However, the fiduciary must ensure selecting Bitcoins as a plan investment is “prudent”
- ERISA section 404(a) requires plan fiduciaries to act with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. A fiduciary’s conduct is evaluated according to the result of a decision as well as the process used to make the decision. It entails both substantive and procedural prudence.
- A fiduciary must give “appropriate consideration” to the facts and circumstances that, given the scope of the fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action. Appropriate consideration includes a determination by the fiduciary that a particular investment or investment course of action is reasonably designed to further the purposes of the account, taking into account the risk of loss and the opportunity for gain and considering the composition of the investment portfolio with respect to diversification, the liquidity and returns of the portfolio relative to anticipated cash flow requirements with respect to the account under management and the projected return relative to the funding objectives of the plan (to the extent applicable).

ERISA Considerations: Indicia of Ownership

- ERISA § 404(b) provides that no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the District Courts of the United States.
 - There are exceptions applicable to foreign securities or foreign currency incident to the purchase, sale or maintenance of foreign securities.
 - Congress' intent is to prevent so-called "runaway assets":
 - the basic objective of the indicia of ownership requirement is to preclude frustration of adequate fiduciary supervision and remedies for breach of trust.
- What is the indicia of ownership of a Bitcoin and where is it located?

ERISA Considerations: Prohibited Transactions

- A fiduciary has an obligation not to cause the plan to engage in prohibited transaction, including any sale, exchange, or leasing of any property between the plan and a party in interest or any furnishing of goods, services, or facilities between the plan and a party in interest.
- Would the acquisition, holding or sale of Bitcoins in the market as it functions today involve any prohibited transaction?
 - The answer may depend on what kind of an asset a Bitcoin is for ERISA purposes:
 - Is it a tangible asset, such as a physical currency?
 - Is it an intangible asset such as a contract right? If so, who is the counterparty?
 - Are secondary market acquisitions of Bitcoin conducted on an exchange in blind transactions? Is it a principal or agency market?
 - PTCE 98-54: “A *foreign exchange transaction* means the exchange of the currency of one nation for the currency of another nation.”

Securities Law Considerations: Definition of “Securities”

- According to SEC Chairman Mary Jo White in a August 30, 2013 letter addressed to the Chairman Thomas R. Carper of the Senate Committee on Homeland Security and Governmental Affairs,
 - *“Whether a virtual currency is a security under the federal securities laws, and therefore subject to our regulation, is dependent on the particular facts and circumstances at issue. Regardless of whether an underlying virtual currency is itself a security, interests issued by entities owning virtual currencies or providing returns based on assets such as virtual currencies likely would be securities and therefore subject to our regulation.”*
- The SEC brought an enforcement action against Trendon T. Shavers in 2013, who offered and sold Bitcoin-denominated investments over the Internet using his company, Bitcoin Savings & Trust (BTCST). The SEC’s complaint charged Shavers and his trust with offering and selling investments in violation of the anti-fraud and registration provisions of the securities laws.
 - Shavers moved to dismiss on the ground that the BTCST investments were not securities as defined by federal securities laws because Bitcoin is not money and that no money ever exchanged hands. In response, the SEC argued that the investments are both investment contracts and notes, and therefore, are securities.

Securities Law Considerations: Definition of “Securities”

- The U.S. District Court for the Eastern District of Texas ruled in favor of the SEC (SEC v. Shavers, E.D. Tex., No. 4:13-CV-416, 8/6/13).
 - Using the test articulated by the U.S. Supreme Court in SEC v. W.J. Howey & Co., 328 U.S. 293, 298-99 (1946), the court explained that an investment contract is “any contract, transaction, or scheme involving (1) an investment of money, (2) in a common enterprise, (3) with the expectation that profits will be derived from the efforts of the promoter or a third party.”
 - The court noted how Bitcoin can be used as money to purchase goods or services, and it can also be exchanged for “conventional currencies,” including the U.S. dollar, Euro, Yen, and Yuan.
 - Next, the court determined there was a common enterprise due to the interdependence between the investors and Shavers stemming from his alleged “expertise in Bitcoin markets” and Shavers' promises of “substantial return.”
 - Finally, the court said the investors were expecting profits from Shavers' efforts since Shavers allegedly promised up to 1% interest daily.

Securities Law Considerations: Can a Bitcoin Fund Be an Investment Option for a 401(k) Plan?

- Section 3(c)(11) of the Investment Company Act exempts from the definition of “investment company” any “employee’s stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section [401](#) of title [26](#) . . . or any collective trust fund maintained by a bank consisting solely of assets of one or more of such trusts . . . or any separate account the assets of which are derived solely from (A) contributions under pension or profit-sharing plans which meet the requirements of section [401](#) of title [26](#) or the requirements for deduction of the employer’s contribution”
- Section 3(c)(7) of the Investment Company Act exempts from the definition of “investment company” any “issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers.”
 - **H.E. Butt Grocery Co.** In the SEC No-Action Letter, H.E. Butt Grocery Co. (2001 CCH Dec. ¶ 78,124), the staff did not recommend enforcement under Investment Company Act Section 7(a) against Section 3(c)(7) funds in which a grocery company’s retirement plan invested a portion of its assets, if those Section 3(c)(7) funds treated the plan as a “qualified purchaser” for Section 3(c)(7) purposes.
- CFTC Regulation 4.5 excludes certain employee benefit plans from being construed to be commodity pools and generally excludes a fiduciary of a qualified plan from being a commodity pool operator