

Client Alert

Part 2 – Blockchain and the Volcker Rule: Are Cryptocurrency Companies Covered Funds?

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Contact

Douglas Landy, Partner
+1 212.530.5234
dlandy@milbank.com

Catherine Leef Martin, Partner
+1 212.530.5189
cmartin@milbank.com

Jonathan Edwards, Associate
+1 212.530.5476
jedwards@milbank.com

James Kong, Associate
+1 212.530.5244
jkong@milbank.com

We last wrote about how the Volcker rule's¹ ban on proprietary trading impacts the ability of banking entities to buy and sell certain cryptocurrencies.² We now turn to how the other primary component of the Volcker rule – the limitation on investing in, or sponsoring, “covered funds” – may impact the ability of banking entities to make equity investments in certain financial technology (“FinTech”) companies. The covered fund prohibitions of the Volcker rule can be seen as an attempt to achieve indirectly what the proprietary trading ban achieves directly: where the proprietary trading provisions prohibit banking entities from engaging in certain trading activities on their own behalf, the covered funds provisions restrict the ability of banking entities to invest in entities that either trade securities themselves or act as private equity managers.

As discussed further below, the Volcker rule's broad definition of “covered fund” has the potential to capture a range of entities other than traditional hedge funds or private equity funds. The question of whether certain FinTech companies may be inadvertent covered funds is a critical one, as a wide range of bank holding companies (“BHCs”) are reported to have made investments in such companies over the past several years. Their reasons for making these investments are varied, but the benefits are easily discernible: the BHC may, for example, gain priority access to the software or other solutions being developed (or keep such technology out of the hands of its competitors), or may simply find the technology promising and expect a handsome profit on its investment.

Even though FinTech companies are, by definition, “financial” technology firms, many of their activities, such as blockchain-based software development, likely fall outside of the realm of traditional financial or banking activities.³ As a result, the most likely investment authorities under which a BHC (including those

¹ The Dodd-Frank Act, enacted on July 21, 2010, added a new Section 13 to the Bank Holding Company Act of 1956 (the “BHC Act”). Section 13 is commonly referred to as the “Volcker rule”. The BHC Act is codified at 12 U.S.C. § 1841 et seq., and Section 13 is codified at 12 U.S.C. § 1851.

² <https://www.milbank.com/en/news/bitcoin-and-the-volcker-rule-are-banks-banned-from-cashing-in-on-the-crypto-craze.html>.

³ See 12 C.F.R. § 225.28 (the “laundry list” of nonbanking activities considered “closely related to banking”) and 12 U.S.C. § 1843(k)(4) (the list of activities considered “financial in nature”).

BHCs that have elected to be treated as financial holding companies, or “FHCs”) might invest in a FinTech company are the authorities available for investing in *non*-financial companies. In particular, Section 4(c)(6) of the Bank Holding Company Act of 1956, as amended (the “BHC Act”), allows BHCs to make passive, non-controlling investments in up to five percent of the voting equity (or up to 25 percent of the total equity)⁴ of any nonbanking company, while the merchant banking authority available to FHCs under Section 4(k)(4)(H) of the BHC Act allows FHCs to make investments in any amount of the shares of a nonfinancial company, provided the FHC does not “routinely manage or operate” the company.⁵

If not for the Volcker rule, these investment authorities would allow a BHC or FHC to invest at least *some* amount in virtually any nonbanking technology company. The one exception lies in the Volcker rule’s covered fund prohibitions: if a FinTech company is a covered fund, then a banking entity⁶ may not hold *any* shares of that company, unless an exemption or exclusion is available. Therefore, this article investigates whether the positions taken by banking entities in certain FinTech and cryptocurrency companies, such as Ripple Labs Inc. (“Ripple”), Coinbase, Inc. (“Coinbase”) and Circle Internet Financial, Inc. (“Circle”), may constitute ownership interests in covered funds that may be prohibited under the Volcker rule.⁷

Section I of this article provides an overview of how covered funds are defined under the Volcker rule. Section II provides an overview of how an investment company is defined under the Investment Company Act of 1940 (“1940 Act”). Section III discusses applicable exemptions to the 1940 Act. Section IV discusses whether certain FinTech companies are covered funds. Section V discusses the ramifications of FinTech companies investing in start-up FinTech companies in a venture capital role, and Section VI concludes by discussing how FinTech companies can best avoid becoming an inadvertent investment companies and how banking entities can best manage their investments in FinTech companies to ensure compliance with the Volcker rule.

I. What are Covered Funds?

The Volcker rule generally prohibits banking entities from acquiring “ownership interests” in “covered funds,” subject to a number of exclusions and exemptions.⁸ A “covered fund” generally includes (among others⁹) any issuer that would be an “investment company,” as defined in the 1940 Act, *but for* Section 3(c)(1) or 3(c)(7) of that Act (the exceptions typically relied on by private funds). As noted in our

⁴ 12 U.S.C. § 1843(c)(6); 12 C.F.R. § 225.22(d)(5). *See also* https://www.federalreserve.gov/boarddocs/legalint/bhc_changeincontrol/2007/20070822.pdf.

⁵ 12 C.F.R. Part 225, Subpart J.

⁶ A “banking entity” includes a U.S. insured depository institution, its holding company, any foreign banking organization regulated as if it were a U.S. bank holding company, and any affiliates or subsidiaries of the foregoing, subject to certain exceptions. 12 C.F.R. § 248.2(c).

⁷ We chose to analyze Ripple, Coinbase and Circle because publicly available information and public statements by the companies indicate that they have bank investors and that they are engaging in activities that may implicate the Volcker rule. We assume, for purposes of this article, that these investments constitute equity interests under the BHC Act.

⁸ 12 C.F.R. § 248.10.

⁹ The Volcker rule definition also includes two other types of “covered funds”: certain foreign funds that raise money from investors primarily for the purpose of investing in securities for resale, and “covered commodity pools” – certain commodity pools, as defined in the Commodity Exchange Act (CEA), with respect to which there is a commodity pool operator that (1) is registered with the Commodity Futures Trading Commission and (2) has claimed, or meets the requirements for, an exemption from certain CFTC requirements otherwise applicable with respect to the commodity pool. Although the CFTC has asserted that virtual currencies are “commodities” (as discussed more fully in our prior Client Alert, available at <https://www.milbank.com/images/content/1/0/v2/101951/Financial-Institutions-Regulatory-Bitcoin-and-the-Volcker-Rule-M.pdf>), an issuer is not a “commodity pool” as defined in the CEA unless it trades in “commodity interests,” which include futures and other derivatives on commodities but not commodities themselves. Therefore holdings of virtual currencies would not in themselves cause a company to be a “covered commodity pool.”

previous Client Alert, this definition was originally used in the Volcker rule statute as a means of identifying a hedge fund or private equity fund, but has notably captured a wide range of additional entities that bear little resemblance to such entities.

An issuer is generally not at risk of falling within the covered fund definition unless it also falls within the basic definition of “investment company” under the 1940 Act, because such an issuer may find it necessary to rely on the 1940 Act exclusions for private funds that trigger characterization as a covered fund. FinTech companies are not commonly viewed as private funds, and at first glance, the Volcker rule’s covered fund prohibitions may appear to have little bearing on the ability of a banking entity to invest in a FinTech company. However, for reasons we discuss below, certain FinTech companies may be at risk of inadvertently falling within the “investment company” definition.

II. What is an Investment Company?

The definition of investment company in Section 3(a)(1) of the 1940 Act is notoriously broad. It includes two main tests of investment company status, contained in Sections 3(a)(1)(A) and (C). Any issuer that is captured by either of the two tests is a *prima facie* investment company.

Section 3(a)(1)(A), which provides that an investment company includes any issuer that “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities,” generally describes “orthodox” investment companies—true funds, such as mutual funds, hedge funds and private equity funds, whose primary business is investing in securities for gain. Section 3(a)(1)(A) is sometimes called the “subjective test,” because it describes “a company that knows it is an investment company and does not claim to be anything else.”¹⁰ However, the subjective test can also capture companies that do not believe themselves to be investment companies—for example, companies that primarily invest or trade in assets that are not conventional securities but may be viewed as securities by the Securities and Exchange Commission (“SEC”).

More commonly, a company may become an inadvertent investment company by triggering the second or “objective” test, which is contained in Section 3(a)(1)(C). Under the objective test, any company, including a company that is not in an investing business, may be an investment company as a *prima facie* matter if more than 40 percent of the fair value of its total assets on an unconsolidated basis (excluding certain cash items and government securities) consists of investment securities. Rule 3a-1 under the 1940 Act provides an alternative objective test: an issuer that “fails” the 40 percent test in Section 3(a)(1)(C) is nonetheless deemed to “pass” the objective test if no more than 45 percent of the value of its total assets (excluding certain cash items and government securities), and no more than 45 percent of its net income for the preceding four fiscal quarters combined, are attributable to securities, subject to various conditions and calculated in the manner provided in the rule and the SEC staff’s interpretations. Assets that count as securities for purposes of the 1940 Act tests are sometimes referred to as “bad assets.”¹¹

The scope of “bad assets” under the 1940 Act is itself broad and, in many cases, non-intuitive. As is the case under the other federal securities laws, the definition of “security” under the 1940 Act includes a litany of instruments, including any “investment contract.”¹² Whether a given asset or instrument is an “investment contract” is generally determined by reference to the test established by the Supreme Court

¹⁰ SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968).

¹¹ Securities of majority-owned subsidiaries that are not themselves investment companies are not generally “bad assets” for purposes of either the subjective or the objective test. Other securities that are not generally “bad assets” include, for purposes of the objective but not the subjective test, certain cash items, U.S. government securities and, for purposes of Rule 3a-1 only, securities of certain companies that are minority-owned but controlled primarily by the issuer.

¹² 15 U.S.C. § 80a-2(a)(36).

in the 1946 *SEC v. Howey* decision (the “*Howey*” test).¹³ In the past year, it has become clear that the staff of the SEC considers certain virtual currencies to be investment contracts under the *Howey* test, and therefore securities within the meaning of the Securities Act of 1933 (the “1933 Act”) and the Securities Exchange Act of 1934 (the “1934 Act”). To the extent some virtual currencies may *not* be investment contracts under the *Howey* test, as suggested in a recent speech by the Director of the SEC’s Division of Corporate Finance,¹⁴ it is worth bearing in mind that, depending on the facts and circumstances, an asset may be a security under the 1940 Act but not under the 1933 or 1934 Acts, despite the nearly identical language of the definition across the three statutes. For example, the SEC staff has consistently maintained that the “commercial/investment dichotomy”—the principle that notes or other instruments used for commercial purposes generally are not securities for purposes of the 1933 and 1934 Acts—does not apply to the 1940 Act, and that in certain cases the protection of investors requires that such instruments be treated as securities for purposes of investment company status determination.¹⁵ (Note that the remaining discussion in this Client Alert assumes, for the sake of argument, that tokens sold pursuant to an initial coin offering (“ICO”) are securities—“bad assets”—for purposes of the 1940 Act, notwithstanding that, for certain tokens in certain circumstances, this may not be the case.)

One can readily imagine how certain companies in the cryptocurrency space might inadvertently fall within the investment company definition. The outcome of the objective test at any time depends on the value of the securities the company owns at that time, relative to the value of its total assets. The “value” of a security or other asset for these purposes, under the 1940 Act definition, is generally its value as of the last day of the prior fiscal quarter; a company may not value an asset at its historic cost unless the asset was acquired during the quarter in which the test is being conducted.¹⁶ Moreover, if the asset is a security for which “market quotations are readily available,” it must be valued at its market price.

Because the outcome of the objective test will vary as market values change, a company may not be able to control its investment company status. The risk is particularly acute for companies that hold volatile securities, or securities of issuers that go public at prices far exceeding the prices at which the company had valued them.¹⁷ Given the extraordinary volatility of some virtual currencies, a company holding tokens representing a relatively minor portion of its assets could fairly easily trigger the 40 percent threshold without any change in its asset composition. For example, a company that held ten percent of its total assets in any number of virtual currencies at the end of the third quarter of 2017 might well have failed the balance sheet test months later as a result of the large spike in virtual currency prices that occurred at the end of last year.

¹³ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under the test established in *Howey*, an “investment contract” exists if there is (1) an investment of money, (2) in a common enterprise and (3) with an expectation of profits predominantly from the efforts of others.

¹⁴ See <https://www.sec.gov/news/speech/speech-hinman-061418>.

¹⁵ Compounding the breadth of the investment company definition is the fact that an investment company need not be a “company” in the traditional sense, and may include an unincorporated pool of assets or group of persons, if it is an “issuer” of securities. In a July 2017 Report of investigation on “The DAO,” the SEC found that a decentralized organization “embodied in computer code and executed on a distributed ledger” was an “issuer” for purposes of the 1933 and 1934 Acts. In a footnote, the SEC cautioned “virtual organizations” to “consider their obligations under the Investment Company Act of 1940.” SEC Release No. 81207 (July 25, 2017).

¹⁶ “Value” refers (1) with respect to securities for which “market quotations are readily available,” the market value, and (2) with respect to other assets, at their “fair value as determined in good faith” by the company’s board. It is not clear whether quotations from unregistered digital asset exchanges would be “market quotations” for these purposes. In either case, however, “value” should reflect what a third-party would be expected to pay for an asset in an arm’s-length transaction at the relevant time.

¹⁷ Yahoo! Inc., for example, most likely triggered the balance sheet test when Alibaba Group, in which Yahoo held a minority interest, went public in 2014. Although Yahoo sold about one third of its holdings in the IPO, its remaining shares, in which Yahoo’s basis was \$2.7 billion, had a market value of approximately \$40 billion (out of Yahoo’s total consolidated assets of approximately \$62 billion) at the end of 2014. Yahoo! Inc. eventually registered as an investment company (re-named Altaba Inc.) in June 2017 following the sale of the operating portion of its business to Verizon.

Certain novel questions are presented where a FinTech company holds digital tokens that the company itself has issued.¹⁸ If such tokens are treated similarly to treasury stock and not as assets of the company, they will not affect the balance sheet test, which looks solely to the asset side of the balance sheet. Under GAAP, treasury stock is carried on the balance sheet as a negative adjustment to shareholders equity and not as an asset of the company. Although the 1940 Act treatment does not necessarily follow the accounting treatment, treasury stock would not in any event affect the balance sheet test because it has no value in the hands of the issuer; an issuer cannot own interests in itself. The same is not necessarily true, however, of digital tokens; although some may be viewed as interests in their own issuer, they are also in some measure currencies, commodities, or other forms of property, and as such may have value even when held by their own issuer. To the extent they do, it would be appropriate to treat them as assets for 1940 Act purposes.

III. Exceptions from the Definition of Investment Company

An issuer that falls within the investment company definition as a *prima facie* matter will nonetheless not be required to register under the 1940 Act if it qualifies for an exception from the investment company definition or an exemption from the requirement to register. For many private companies, becoming a *prima facie* investment company is of little consequence, because they have a small number of security holders (and therefore qualify for the Section 3(c)(1) exception from the investment company definition for certain issuers with no more than 100 security holders), or because all of their security holders have substantial holdings of investments (and therefore they qualify for the Section 3(c)(7) exception for certain issuers whose securities are owned exclusively by “qualified purchasers,” as defined in the 1940 Act). An issuer’s reliance on these exceptions may have significant consequences for its investors, however, if any such investor is a banking entity subject to the Volcker rule, because an issuer that relies exclusively on Section 3(c)(1) or 3(c)(7) to avoid registration under the 1940 Act will fall within the covered fund definition. An issuer that qualifies for Section 3(c)(1) or 3(c)(7) will not be a covered fund, however, if any other 1940 Act exemption or exclusion is available to it.¹⁹

Section 3(b)(1) – Exception for companies primarily engaged in a non-investment company business

A FinTech company that fails the objective test in Section 3(a)(1)(C) might assert, for example, that it qualifies for the exception provided by Section 3(b)(1) of the 1940 Act. Section 3(b)(1) provides that, notwithstanding Section 3(a)(1)(C), an issuer is not an investment company if it is “primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.”²⁰ By its terms, Section 3(b)(1) is not available to companies that conduct a substantial portion of their activities through one or more subsidiaries that are not wholly owned.

To determine whether a company is primarily engaged in a non-investment company business for purposes of Section 3(b)(1), the SEC and the courts have looked to a highly fact-specific five-factor test first set forth by the SEC in the 1947 *Tonopah Mining* decision.²¹ The SEC stated in *Tonopah Mining* that the determination of an issuer’s primary business is a question of fact that must be resolved by review of the specific circumstances of the particular case based on the following principal considerations: (1) the issuer’s historical development; (2) its public representations of policy; (3) the activities of its officers and

¹⁸ Ripple, for example, holds billions of dollars’ worth of its own XRP tokens in a series of escrows implemented on the XRP ledger. See <https://ripple.com/dev-blog/explanation-ripples-xrp-escrow/>.

¹⁹ An issuer can also avoid being a covered fund if it qualifies for any available exception or exemption under the Volcker rule.

²⁰ Although Section 3(b)(1) technically excepts an issuer from only Section 3(a)(1)(C), a finding that an issuer is primarily engaged in a non-investment company business pursuant to Section 3(b)(1) necessarily means that it is not primarily engaged in an investment company business under Section 3(a)(1)(A). See, e.g., SEC Release No. IC-26077 n.9 (June 16, 2003).

²¹ *Tonopah Mining Co.*, 26 S.E.C. 426 at 427 (1947).

directors; (4) the nature of its present assets; and (5) the sources of its present income. The SEC has not offered guidance on exactly how these factors are to be applied, but has historically said that the two most important factors are the composition of the issuer's assets and the sources of its income.²² At least one court has pointed out that this is a surprising interpretation, given that an issuer only turns to Section 3(b)(1) if it has failed the objective tests that look to its assets (in the case of the Section 3(a)(1)(C) balance sheet test) or its assets and income (in the case of the Rule 3a-1 alternative test).²³

Because the *Tonopah Mining* analysis is abstract and fact-specific, it may be difficult for an issuer to determine with certainty whether it satisfies Section 3(b)(1). The determination may be all the more difficult for a banking entity that has invested in such an issuer, as investors may not have complete information regarding all the facts and circumstances that bear on the analysis.

Section 3(c)(2) – Exception for companies primarily engaged in brokerage and certain related customer-based activities

Certain FinTech companies may alternatively be able to rely on Section 3(c)(2), which provides an exclusion from the investment company definition for certain brokers, underwriters and swap or repo intermediaries, provided they are primarily engaged in, and derive their gross income principally from, such businesses and related activities.²⁴ A limited amount of proprietary trading is generally permitted, provided the broker-dealer's primary activity is customer-based, but dealers that primarily trade for their own account are not eligible for Section 3(c)(2).

Section 3(c)(3) – Exception for banks

A number of cryptocurrency companies are reported to have met with U.S. banking regulators to discuss the possibility of obtaining banking licenses.²⁵ Any issuer that is a "bank," as defined in the 1940 Act, is excluded from the investment company definition by Section 3(c)(3) of the 1940 Act; "bank" is defined broadly and includes any FDIC-insured depository institution as well as certain state-chartered and supervised trust companies. Unlike most business-related exceptions under the 1940 Act, which require that an issuer demonstrate "primary engagement" through various asset and/or income-related metrics, the Section 3(c)(3) exception is virtually automatic for issuers that meet the 1940 Act bank definition.

IV. Are Fintech Companies Covered Funds?

The remainder of this Client Alert considers whether the few prominent FinTech companies that have publicly identified banking entity investors could be considered inadvertent covered funds.

Ripple

Ripple has developed and maintains RippleNet, a decentralized network of banks and payment providers that operate on Ripple's technology and that provide messaging, clearing, and settlement services with respect to financial transactions.²⁶ Ripple also operates a blockchain-based digital payment processing system that incorporates the use of Ripple's own proprietary cryptocurrency ("XRP tokens").²⁷ In addition to RippleNet, Ripple has developed and offers a range of software to banks and companies intended to

²² See, e.g., Hallwood Industries, SEC No-Action Letter (Jun. 19, 1991).

²³ S.E.C. v. National Presto Industries, 486 F.3d 305 (7th Cir. 2007).

²⁴ If a FinTech company is not properly registered or licensed as a broker or market intermediary, this would generally call into question whether it can avail itself of the Section 3(c)(2) exception.

²⁵ See, e.g., notes 38 and 50 below.

²⁶ See, e.g., https://ripple.com/files/rippletnet_brochure.pdf.

²⁷ See <https://ripple.com/xrp/>.

speed up cross-border payments. A number of BHCs – including Santander and Standard Chartered – have invested in Ripple.²⁸

Ripple: A prima facie investment company?

Ripple has created approximately 100 billion XRP tokens, of which it has sold approximately 40 billion and retains the remainder. This cache of approximately 60 billion XRP tokens corresponds to a market value of over \$34 billion.²⁹ Assuming, as noted, that XRP tokens would be bad assets³⁰ and would be valued at their market price for purposes of the objective test, Ripple would need over \$23 billion in “good assets”—i.e., assets other than its XRP tokens, other securities and cash—in order not to fail the objective test. While Ripple’s financial statements are not publicly available, it is hard to conceive that it has non-XRP assets on anywhere near this scale, and it seems quite plausible therefore that Ripple is a *prima facie* investment company under the Section 3(a)(1)(C) objective test.

Ripple: Section 3(b)(1)

As noted above, an issuer that “fails” the objective test will nonetheless not be an investment company if it qualifies for Section 3(b)(1), the exception for certain issuers that are primarily engaged “in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.” To qualify for Section 3(b)(1), Ripple would have to pass the five-factor *Tonopah Mining* test described above.

Ripple would most likely assert that its primary business is developing and operating a payment settlement system and remittance network and not holding or investing in securities, and some of the *Tonopah Mining* factors would likely support this conclusion. For example, the development and operation of the network and system could occupy more of the officers’ and directors’ time than the business of holding XRP tokens. Regarding its public representations of policy, Ripple might further argue—perhaps citing its website, which primarily advertises its payment services—that it has never publicly held itself out as being in the business of investing.³¹

That said, the two *Tonopah Mining* factors that are arguably most important are likely to be problematic for Ripple: composition of assets and sources of income. Ripple’s asset composition, as discussed, is most likely dominated by its large cache of XRP tokens. This factor would appear to weigh toward a finding of primary engagement in holding or investing in securities, although Ripple might argue that its holdings serve as inventory for its payment and remittance network business and are not indicative of investment purpose. As regards sources of income, a complaint filed against Ripple in May 2018 alleges that “Ripple Labs’ primary source of income is, and has been, the sale of XRP. Defendants earned over \$342.8 million through XRP sales in the last year alone.”³² If this is correct, Ripple would have a heavy burden to overcome if it were to demonstrate that its primary source of expected profit is in fact fees for settlement services and usage of its network and not gains from sales of XRP.

At best, the *Tonopah Mining* factors appear to yield mixed indications regarding Ripple’s area of primary engagement.

²⁸ See https://www.crunchbase.com/organization/ripple-labs/investors/investors_list.

²⁹ See <https://coinmarketcap.com/currencies/ripple/>.

³⁰ Ripple is currently the subject of three pending class action lawsuits, each of which allege that Ripple’s creation and ongoing sale of XRP tokens constitutes an illegal, unregistered securities offering. See <https://www.coindesk.com/third-ripple-lawsuit-claims-xrp-is-a-security/>.

³¹ Ripple’s website states that it “provides one frictionless experience to send money globally using the power of blockchain” and also promotes its payment services, none of which appear to be investment focused. See <https://ripple.com/solutions/>.

³² See <https://static1.squarespace.com/static/5938711a9de4bb74f63b4059/t/5aebc4112b6a28e0ef4a0381/1525400594617/Coffey+v+Ripple+Labs+Complaint.pdf> at page 5.

Ripple: A Covered Fund?

If Ripple were to be considered an investment company that would not qualify for an exemption under Section 3(b)(1) (or any other exemption, other than under Section 3(c)(1) or 3(c)(7)), it would only escape characterization as a covered fund if were otherwise excluded from that definition by the Volcker rule. Specifically, the Volcker rule excludes a number of entities that would otherwise be considered covered funds from the scope of the definition, including joint ventures, wholly-owned subsidiaries, foreign public funds, and certain loan securitizations.³³ None of these exclusions appears to be available to Ripple. As a result, current bank investors may want to review Ripple's status to ensure that any investments continue to be permissible under the Volcker rule.

Coinbase

Coinbase is the largest digital currency wallet provider in the United States. It reportedly stores more than \$20 billion in cryptocurrency assets for retail customers, and has begun to offer custody solutions for institutional clients.³⁴ Coinbase also operates Coinbase Pro, one of the world's largest cryptocurrency exchanges,³⁵ and offers a suite of institutional-investor-focused services.³⁶ Coinbase has announced the acquisition of a registered broker-dealer that is also licensed to operate as a registered investment adviser and to run an alternative trading system (an "ATS").³⁷ Coinbase is also reported to have met with officials at the Office of the Comptroller of the Currency (the "OCC") about the possibility of obtaining a federal banking charter.³⁸

Coinbase has a number of banking entity investors, including USAA Bank,³⁹ BBVA Ventures⁴⁰ (the San Francisco-based investment arm of Banco Bilbao Vizcaya Argentaria SA), and MUFG Bank.⁴¹

Coinbase: A prima facie investment company?

Coinbase most likely has a complicated 1940 Act profile. It reportedly holds some \$20 billion of cryptocurrency assets, but those assets are held on behalf of customers that utilize its wallet, storage and exchanges services, and as such would not generally be bad assets of Coinbase itself. Coinbase's other businesses, however—operation of an exchange, and potentially a broker-dealer and ATS—are of a type that often requires their operators to hold significant cash and securities, although typically not for investment purposes. Many "financial market utilities" such as exchanges and trading and settlement systems are *prima facie* investment companies, as noted by commenters to the initial Volcker rule proposed regulation, who urged the Agencies to include an exception for such businesses in the Volcker rule covered fund provisions.⁴²

³³ 12 C.F.R. § 248.10(c).

³⁴ See <https://www.bloomberg.com/news/articles/2018-07-02/coinbase-adds-10-customers-as-crypto-custody-service-goes-live>.

³⁵ See <https://www.coinbase.com/about>.

³⁶ See <https://medium.com/m/global-identity?redirectUrl=https://blog.coinbase.com/announcing-coinbase-pro-6773bc3bf99c>.

³⁷ See <https://www.wsj.com/articles/coinbase-expands-with-deal-for-broker-dealer-keystone-capital-1528321468>.

³⁸ See <https://www.wsj.com/articles/cryptocurrency-firms-explore-getting-bank-licenses-1526635800>.

³⁹ See <https://www.wsj.com/articles/coinbase-raises-75-million-in-funding-round-1421762403>.

⁴⁰ *Id.*

⁴¹ See <https://www.coindesk.com/coinbase-10-million-mitsubishi-japan/>.

⁴² Preamble, at nn. 2015-2018, and accompanying discussion ("...the Agencies believe that [financial market utilities] are not investment vehicles of the type section 13 of the BHC Act was designed to address, but rather entities that generally engage in other activities...").

Moreover, Coinbase announced earlier this year that it plans to invest in blockchain start-up companies and to “provide financing to promising early stage companies.”⁴³ Coinbase appears to be investing its own funds in such investments rather than raising money from investors.⁴⁴ Although it is unlikely such activities are extensive relative to Coinbase’s core businesses, any debt or equity investments Coinbase makes in other companies will generally constitute further bad assets on its balance sheet, unless Coinbase acquires majority or primarily controlling interests.

Coinbase: Sections 3(b)(1), 3(c)(2) and 3(c)(3)

Even if Coinbase is a *prima facie* investment company based on its balance sheet, it appears likely that one or more exceptions other than Section 3(c)(1) or 3(c)(7) would be available to it. The Volcker rule Agencies recognized that the business of operating an exchange or trading platform is not an investment company business and that a company primarily engaged in one or more such businesses should be able to rely on Section 3(b)(1) if necessary.⁴⁵ Nor is provision of “wallet” or custody services an investment company activity and, to the extent Coinbase operates through a broker-dealer subsidiary, this aspect of its business would generally be eligible for Section 3(c)(2) if it is primarily customer-oriented—that is, focused on effecting transactions in securities for the account of others and not for its own proprietary investment purposes. If Coinbase forms a qualifying bank within the meaning of the 1940 Act, this portion of its business would be eligible for the Section 3(c)(3) exception.

The portion of Coinbase’s business that is devoted to financing start-up companies is indeed an investment company business, but should not in itself disqualify Coinbase from reliance on the potential exceptions described above unless it overtakes the core businesses in relevant respects (in particular in assets employed and income generated). Although reports suggest that Coinbase derives a large amount of its revenue from its core non-investment businesses (custody and trading services),⁴⁶ determination of its 1940 Act status would require close analysis based on complete information regarding its asset and income composition and organizational structure, among other factors.

Circle

Circle brands itself primarily as a payments company that offers mobile applications that enable users to send and receive money and make online payments. It also offers a variety of other services, including: (1) buying, selling and storing various virtual currencies for customers’ accounts,⁴⁷ (2) an over-the-counter cryptocurrency trading desk called Circle Trade and (3) access to a cryptocurrency exchange called Poloniex.⁴⁸ In 2015, Goldman Sachs was the lead investor in a funding round that raised \$50 million for Circle.⁴⁹ In a June 2018 interview with Bloomberg, Circle announced that it intends to seek registration as a broker-dealer and has had conversations with the OCC about potentially pursuing a banking license.⁵⁰

⁴³ See <http://fortune.com/2018/04/06/coinbase-ventures-cryptocurrency-startups/>.

⁴⁴ If Coinbase does pool money from third-party investors (including its existing investors) to make investments in other companies, the pool itself would be a separate issuer from Coinbase and would likely be a covered fund.

⁴⁵ Preamble, at nn. 2018-2019, and accompanying discussion (“...if [a financial market utility] is primarily engaged in a business other than those that would make it an investment company...[it] could rely on the exclusion to the definition of investment company provided by section 3(b)(1) and would not need to rely on section 3(c)(1) or 3(c)(7) and, as such, would not be a covered fund.”).

⁴⁶ See e.g. <https://news.bitcoin.com/coinbase-making-2-7-million-day/>.

⁴⁷ See <https://www.circle.com/en/invest>.

⁴⁸ See <https://www.circle.com/en/>.

⁴⁹ See <https://www.crunchbase.com/organization/circle-2#section-funding-rounds>.

⁵⁰ “See <https://www.bloomberg.com/news/articles/2018-06-06/circle-in-talks-with-u-s-to-become-licensed-bank-trading-venue>.”

Circle: A prima facie investment company?

Circle claims to be the world's second-largest trader of virtual currencies, and to make markets on all of the world's major virtual currency exchanges.⁵¹ Assuming that Circle must buy and sell as principal in order to make markets, and given the reported volume of its virtual currency trading activities (reportedly over \$2 billion a month as of March 2018),⁵² its virtual currency holdings are likely to be significant and may possibly cause it to be a *prima facie* investment company. Additionally, Circle reportedly does not make money from its payments services, but rather, "makes money by trading bitcoin and other cryptocurrencies, both on digital currency exchanges and over the counter."⁵³

Circle: Sections 3(b)(1), 3(c)(2) and 3(c)(3)

"Primary engagement" determination arguably boils down to the question of what business a company looks to for its greatest expectation of potential profit.⁵⁴ If Circle is found to be a *prima facie* investment company, given its public statements regarding trading as its primary source of profit, it may be difficult for it to make a case that it qualifies for the Section 3(b)(1) exception because it is primarily engaged in providing payment services.

Circle may, however, be eligible to rely on the Section 3(c)(2) exception for persons primarily engaged in acting as broker, selling securities to customers, and certain related activities. Circle's statements indicate that a key component of its trading activities consists of making markets in virtual currencies. Although market-making involves buying and selling as principal and is not specifically referenced in Section 3(c)(2) as a qualifying activity, the SEC staff has said that "dealers who are primarily market makers, even those who are not brokers, are excluded from the definition of investment company" because they are considered to be primarily engaged in "selling securities to customers," a qualifying activity for the purpose of Section 3(c)(2).⁵⁵ Trading as principal *other than* as a market-maker is not a qualifying 3(c)(2) activity and, if Circle engages in such activity on an extensive basis it may not meet the primary engagement standard for reliance on Section 3(c)(2).

The formation of a bank, should Circle take this step, would not hurt its 1940 Act profile, but also would not necessarily "cleanse" the status of any non-bank entities in the group if they invest or trade in cryptocurrencies in a manner that does not fit within Section 3(c)(2) or another exception. If Circle is structured as a holding company owning multiple businesses (bank, broker-dealer, other), its status will depend on the relative value of its interests in its "good" (non-investment company) and "bad" (investment company) subsidiaries (if any).

Circle: A Covered Fund?

If Circle is determined to be an investment company with no available exclusion other than Section 3(c)(1) or 3(c)(7), it is unlikely to qualify for any exclusions from the definition of covered fund. While Circle's business model does appear to be distinguishable in certain respects from that of a typical "investment company," the uncertainty of Circle's characterization under the 1940 Act illustrates how banking entities may need to reassess their investments in certain FinTech companies to ensure that they do not own inadvertent covered funds.

⁵¹ See <https://www.cnbc.com/2017/06/15/circle-launches-an-international-money-transfer-service.html>; <https://bitcoinexchangeguide.com/circle-trade/>.

⁵² See <https://techcrunch.com/2018/05/16/circle-raises-110-million-or-13300-btc/>.

⁵³ <https://www.fastcompany.com/40544577/why-circle-could-become-coinbases-biggest-rival>.

⁵⁴ See, e.g., the SEC staff's response in Peavey Commodity Futures Fund, SEC No-Action Letter (June 2, 1983) ("we should consider of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss").

⁵⁵ M.J. Post, SEC No-Action Letter (Apr. 30, 1982).

V. Fintech Companies Forming or Investing in Venture Capital Funds

Under the Volcker rule, even if a FinTech company is not itself a covered fund, creating a company that falls under the covered fund definition could potentially limit the ability of banking entities to hold investments in the FinTech company as a whole. Even if a banking entity does not invest in the separate covered fund company, there could be an issue if the FinTech company's investment in the separate covered fund company is significant enough to cause the FinTech company to become a covered fund. Both Coinbase⁵⁶ and Ripple,⁵⁷ for example, have announced plans to create "venture" funds or other investment arms of their companies.

Coinbase Ventures

Coinbase formed Coinbase Ventures to finance "early stage companies" in the blockchain and cryptocurrency space.⁵⁸ While Coinbase has confirmed few public details regarding the size and scope of Coinbase Ventures, Coinbase has indicated that its investments will likely take the form of traditional equity or debt financing rather than, for example, ICO tokens.⁵⁹

Ripple – Xpring

Similarly to Coinbase Ventures, Ripple launched Xpring as a way to "invest in, incubate, acquire and provide grants to companies and projects."⁶⁰ However, Ripple has provided slightly more guidance around its investment plans, noting that: (1) it will be providing funding from its own money, (2) each investment will operate as its own separate entity under Xpring, and (3) it may seek representation on the boards of its target companies.⁶¹

Volcker rule implications

While neither Coinbase nor Ripple has indicated that they plan to raise money from investors in order to fund ventures described above, both they (and any banking entities invested in Coinbase, Ripple, or other companies launching similar ventures) should closely monitor the portfolio of investments. If an early investment should mushroom in size and value, for example, this could cause the company holding the stake to fail the balance sheet test and become a prima facie investment company and, possibly, a covered fund.

This concern may be exacerbated by the essentially passive nature of bank investments made pursuant to Section 4(c)(6) or 4(k)(4)(H) of the BHC Act. While banking entities may take care to restrict the companies they invest in from engaging in activities or making investments that the bank investors themselves cannot, in the quickly changing world of blockchain, FinTech companies, and ICOs, bank investors may find themselves in a situation where an investment in what had been a software company quickly morphs into an investment in a company engaged in issuing, trading, and investing in securities. If these companies should become covered funds, the banking entities would likely have to divest their ownership stakes, notwithstanding the investment authorities available under Sections 4(c)(6) or 4(k) of the BHC Act.

⁵⁶ <https://blog.coinbase.com/introducing-coinbase-ventures-c67865a1d2fe>.

⁵⁷ <https://www.cnbc.com/2018/04/11/ripple-invests-25-million-worth-of-xrp-in-blockchain-capital-fund.html>.

⁵⁸ <https://medium.com/m/global-identity?redirectUrl=https%3A%2F%2Fblog.coinbase.com%2Fintroducing-coinbase-ventures-c67865a1d2fe>.

⁵⁹ See, e.g., <https://www.cnbc.com/2018/04/05/bitcoin-exchange-coinbase-launches-early-stage-investment-venture.html>.

⁶⁰ <https://xpring.co/faq/>.

⁶¹ <https://xpring.co/faq/>.

VI. Conclusion

Given how unique the business models of FinTech companies can be and how fast they can change, banking entities should take particular care in ensuring that their equity investments do not constitute ownership interests in covered funds. To do so, banking entities should proactively examine their existing investments to verify that companies they have invested in are not holding an outsize amount of virtual currencies or engaging in the proprietary trading of virtual currencies or other securities. Banks making new investments in FinTech companies should tailor provisions in the funding or financing documentation (for example, inserting regulatory out provisions or imposing specific notice and reporting requirements) to protect against the possibility that those companies could become covered funds.

Similarly, the companies themselves should ensure that they have not become inadvertent investment companies. FinTech companies that hold virtual currencies should closely monitor the value of their holdings and should likely treat the vast majority of virtual currencies as investment securities for purposes of the balance sheet test. Such companies should also exercise extreme caution with respect to any public statements they make regarding what the company does and the investment value of any tokens they issue to avoid unwanted scrutiny from regulators.

This list of FinTech companies discussed in this Client Alert is by no means exhaustive, and the onus ultimately falls on banking entities and FinTech companies to have the necessary compliance infrastructure in place to avoid any unintended violations of the Volcker rule.

Wayne Aaron	waaron@milbank.com	+1-212-530-5284
Joel Harrison	jharrison@milbank.com	+44-20-7615-3051
Douglas Landy	dlandy@milbank.com	+1-212-530-5234
Catherine Leef Martin	cmartin@milbank.com	+1-212-530-5189
Nicholas Smith	nsmith@milbank.com	+1-202-835-7522
John Williams	jwilliams@milbank.com	+1-212-530-5537
Melissa Ferraro	mferraro@milbank.com	+1-212-530-5332
James Kong	jkong@milbank.com	+1-212-530-5244

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