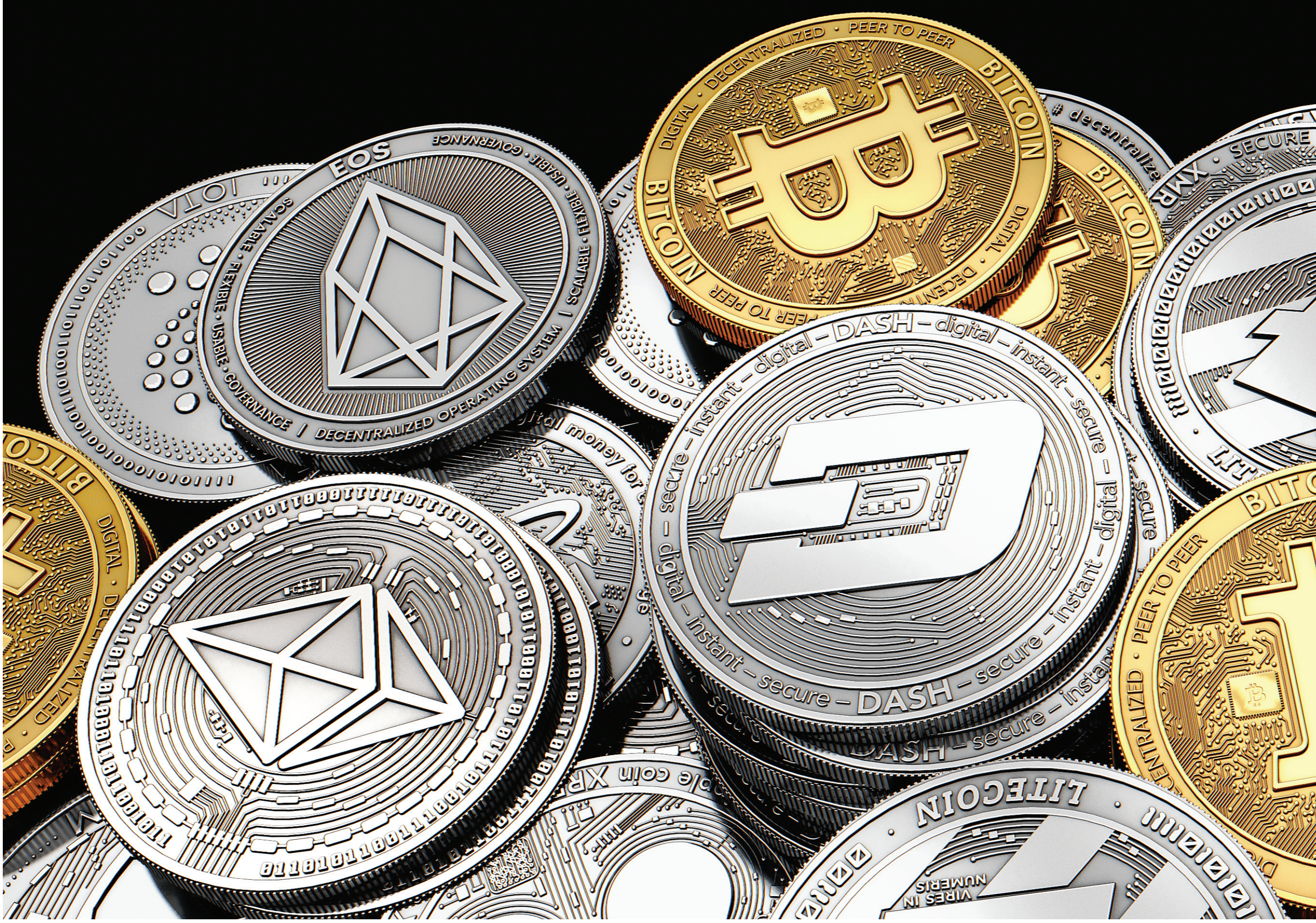
WHEN **YOUR** FINANCIAL INSTITUTION HOLDS CRYPTOCURRENCY IN TRUST



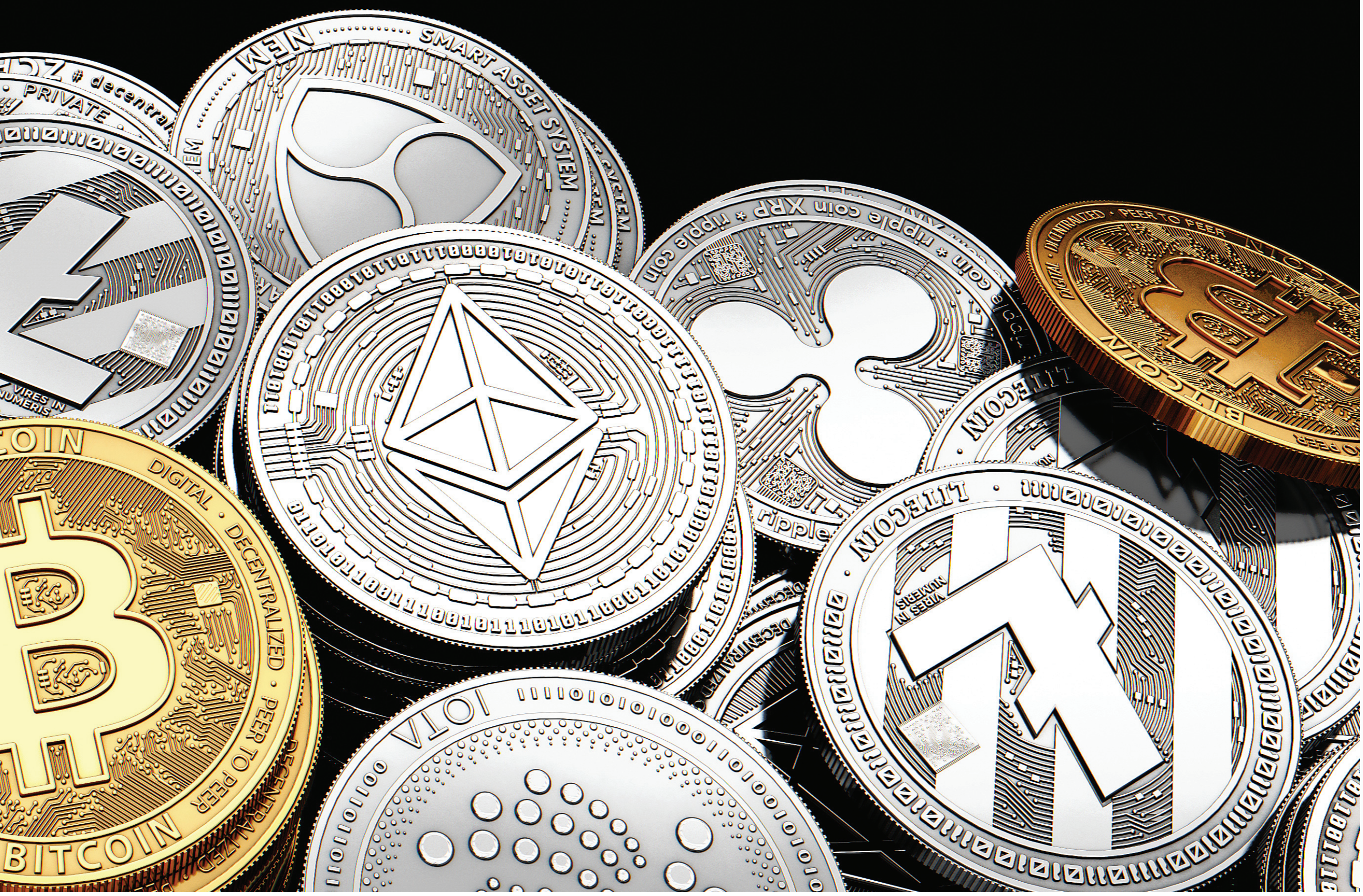
BY JOHN D. SHIRE, STANLEY S. JUTKOWITZ, AND JAMES BILLINGS-KANG

Imagine that your financial institution is the trustee of a testamentary trust you have been assigned to administer. Looking over the inventory of the trust, you notice that it owns a substantial amount—$50 million—of something called Gnosis.

You Google "Gnosis" and learn that it is a cryptocurrency. In fact, it is one of at least 1,500 cryptocurrencies in existence.[1] While you have heard about cryptocurrency, you personally have not, nor to your knowledge has your financial institution, ever administered cryptocurrency as part of a trust, an estate, or in any other capacity. As the trustee of this testamentary trust, you realize that you have no experience in managing this type of asset consistent with your fiduciary obligations. So what happens now?

Whether the trustee of a testamentary trust, a personal representative of a descendent's estate, or any other type of fiduciary, you must understand how to manage cryptocurrency consistent with your fiduciary obligations. This is a complex problem, since there is no natural market for the sale of these assets and no statutory or regulatory guidelines specific to administering cryptocurrency as part of a trust or an estate. Adding to the complexity is the reality that fiduciary obligations have been the subject of recent comprehensive rulemaking and litigation by the U.S. Department of Labor and the Securities and Exchange Commission.

With no primary market for selling large quantities of cryptocurrency, you will have to look to the secondary market to value and sell substantial amounts of it. This secondary market, however, is akin to the Wild West. Among many reasons, selling cryptocurrency on the secondary market can be a daunting task because of pricing, timing, and physical security issues.



You might be surprised to learn of the axiom, while counterintuitive, that the larger the crypto-asset holding, the more purchasers there are in the secondary market. For sellers or large holdings, that's a good thing. But how do you protect against fraud, theft, and price manipulation? As the trustee of the testamentary trust, you have a fiduciary obligation to manage and understand all these issues.

Fiduciary Duties of a Trustee

A trust is a legal arrangement in which title to property is held in the name of a trustee for the beneficial interest of those named in the trust instrument as the beneficiaries. Under the law, the trustee is considered a "fiduciary," someone who has a heightened responsibility to the beneficiaries of the trust. This heightened responsibility gives rise to a number of fiduciary duties, which include, among other things, a duty of loyalty to the beneficiaries and a duty to exercise reasonable care and skill in managing trust assets.

The duty of loyalty, at a minimum, requires the trustee to administer the trust estate solely in the interest of the beneficiary. Relatedly, the trustee must refrain from engaging in self-dealing. In broad terms, this means the trustee is not allowed to profit at the expense of the beneficiary and should not purchase trust assets.

The fiduciary duty most relevant for the handling of cryptocurrency is that of exercising reasonable care and skill in managing trust assets. That means that a trustee must deal with trust property in the same manner it would deal with its own property. An institutional trustee that is in the business of being a trustee is held to a higher standard than an individual appointed as trustee. For traditional assets such as stocks and bonds or real estate, there are established markets for purchases and sales. There are also established norms for managing such assets to generate income for the beneficiaries.

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As a trustee holding cryptocurrency, your fiduciary obligations to the trust will be to protect the asset value and liquidate the estate in a manner that maximizes price value and minimizes expense. This is an especially tricky business considering that there is no natural market for the resale of large blocks of cryptocurrency and that the cryptocurrency market has been decimated over the past year. To make matters worse, there are predators in the market who are interested in stealing cryptocurrency.

While there are electronic marketplaces for cryptocurrency, such as Coinbase, they are generally unsuitable for trading or disposing of large blocks of cryptocurrency. Moreover, since the rules on cryptocurrency are still being written, there are no established norms for managing and disposing of it.

What Is Cryptocurrency?

Cryptocurrency is a decentralized electronic or virtual currency not tied to a central bank or the government of any nation. As its name suggests, it uses various types of encryption to verify transactions and the creation of cryptocurrency units. The value of any cryptocurrency is dynamic and determined by its users. Each transaction becomes part of a block of a digital ledger that is validated and added sequentially to a chain of blocks—hence the term "blockchain technology." The holder of cryptocurrency keeps it in a virtual wallet and can use it in various types of transactions.

A transfer of cryptocurrency from the sender's virtual wallet to the recipient's virtual wallet through messages requires what are known as public keys and private keys (think bank account numbers and PINs). The transaction becomes part of a block that is sent to participants in a network. Once the block is validated, it is added to the chain of blocks—that is, the digital ledger. These are the very features that make cryptocurrency decentralized and secure.

Once a transaction is added to a block, it cannot be changed without modifying the entire blockchain comprised of the various blocks. If a transaction is not recognized by the blockchain, it is immediately expelled from the chain, thus preventing the unauthorized transaction from becoming a part of the chain.[2]

Within the United States, cryptocurrency is currently regulated by the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Internal Revenue Service, the Treasury Department, and several U.S. states. Outside of the United States, cryptocurrency is regulated by a large number of foreign countries.

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The IRS has taken the position that cryptocurrency is property, not currency, so the sale of cryptocurrency could generate gain or loss in much the same way that the sale of any other property could.

For its part, the SEC has taken the position that most cryptocurrency is a security (unless it is purely a utility token or currency), and therefore its initial coin offering, or ICO, must either be registered or be subject to an exemption from registration.[3]

Meanwhile, the CFTC has taken the position that, under certain circumstances, cryptocurrency is a commodity and subject to anti-fraud provisions, regulation, and oversight, just like any other commodity within the reach of the U.S. Commodity Exchange Act.

Finally, two offices within the Treasury Department—the Office of Foreign Asset Control, commonly known as OFAC, and the Financial Crimes Enforcement Network, or FinCEN—have taken an interest in cryptocurrency as a vehicle for laundering money and financing terrorist-related activities.

To the extent that it becomes important for the trustee to understand which type of cryptocurrency it is holding, knowledgeable counsel can help financial institutions navigate this regulatory framework. For most cryptocurrency listed for purchase and sale on an exchange, it is safe to say that it will be treated as a security.

Market Price and Timing Issues

In 2018, cryptocurrency pricing experienced a dramatic decline, with little evidence of a market accelerant. An array of factors are driving the current pricing, but a simple conceptual framework to consider is that cryptocurrencies and the technologies driving them are still in their infancy.

The global market is still factoring in how the technology will work and what it means for virtually every industry on the planet. A number of open questions and uncertainty remain about the application, utility, and security of cryptocurrency—and, until the technology behind it matures, about its efficacy.

Therefore, what options exist for an estate that needs to be liquidated? One option is to liquidate over time, essentially employing the strategy of dollar-cost averaging over a long time horizon. Of course, this strategy can be employed only if the estate can tolerate sales of the asset over a long time horizon.

A second option is to locate speculative buyers who see a big upside in future markets. These buyers have larger appetites for big blocks of the more mainstream cryptocurrencies. While these buyers are out there, it takes market knowledge and a savvy investor to find them.

A third option is to wait and see what happens to the market and essentially gamble that it will experience an uptick in the long term. This, however, may not be in the best interests of the estate.

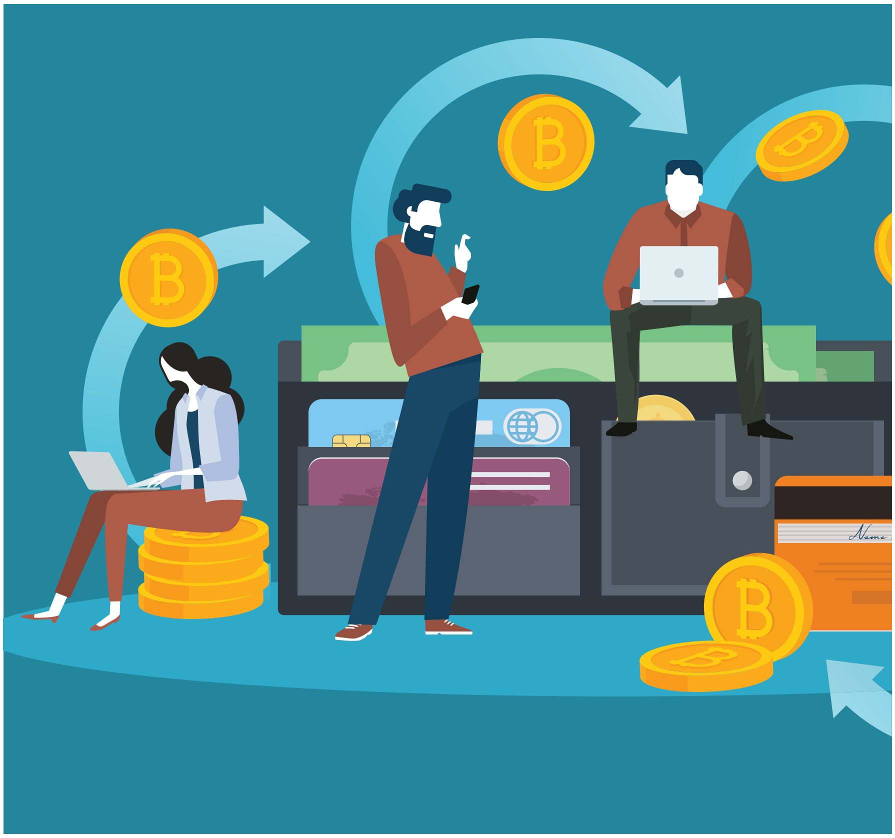
Finally, a fourth alternative would be to consign the assets to an existing fund that has the ability and presence to manage the assets pending a future sale.

Fraud, Theft, and Physical Security

Unfortunately, there have been numerous cryptocurrency thefts in recent years. For example, one of the world's largest cryptocurrency exchanges, Mt. Gox, had to declare bankruptcy after suffering a $473 million theft in February 2014. Subsequently, the cryptocurrency Tether succumbed to a loss of $31 million to hackers.

The year 2018 was a particularly bad year for cryptocurrency thefts:

1. In January, hackers successfully stole $400,000 in Stellar Lumen coins from the BlackWallet application. In the same month, hackers ran off with $530 million in digital tokens from the Japanese cryptocurrency exchange Coincheck.
2. In February, Italian exchange Bitgrail lost $195 million to hackers.
3. In May, Bitcoin Gold—an offshoot of the cryptocurrency Bitcoin—suffered a rare



attack that resulted in an $18 million loss.

4. In June, Korean exchange Bithumb lost $31.5 million to hackers. Coinrail, another Korean exchange, fell victim to a hack of $40 million.
5. In July, Israeli-Switzerland exchange Bancor was the target of a ruse that resulted in a loss of $23.5 million.
6. In September, the security parameters of Osaka-based cryptocurrency exchange Zaif could not prevent a heist of $60 million at the hands of cyber thieves.

By October 2018, crypto thefts had reached nearly $1 billion in heists for the year, according to a report issued by CipherTrace—three and a half times the amount of cryptocurrency stolen in 2017.

These thefts demonstrate that significant risk exists in the secondary market and that any buyer or seller of cryptocurrency in the secondary market must take every precaution to ensure that the parties involved in the buy-sell transaction are known, reliable, and able to execute.

Given these concerns, it is common for the most experienced cryptocurrency buyers and holders to use multiple sets of external "cold storage"—the term for physical storage of passwords and keys—to ensure the safety of their assets. Knowing which of these technologies to employ as "state of the art" is best left to professionals and experts in the industry. As a fiduciary, you will want to seek out professionals who are well aware of the best practices for safeguarding the trust's cryptocurrency.

Even assuming you have taken every precaution to safeguard the trust assets, the risk remains that your cryptocurrency can be stolen during a sale transaction. For that reason, it is advisable to procure insurance from an institution like Lloyd's of London. Of course, such an insurance product is going to be very expensive. The alternative, however, is not a viable option. If the trust is jeopardized by a fraudulent sale of cryptocurrency, the liability imposed on the trustee is going to be assumed.

Third-Party Experts

For all of the foregoing reasons, the safest route is to work with an established third-party broker that can liquidate the cryptocurrency for you. Specifically, a hedge fund with access to the secondary market and private buyers of large blocks of crypto around the world will be able to provide the safety and security your trust requires, as well as manage the procurement of insurance and obtain the optimal pricing.

Whether you determine that the trust is to be liquidated in a large block sale or pursuant to a time-phased sale, the third-party broker will likely be able to achieve the best value with the most efficient process. If the trust determines the need to leverage the holdings for cash, the third-party broker will also be able to achieve that outcome.

How do you choose the right hedge fund? One obvious way is to talk to one you have worked with previously. If such a fund has no history of cryptocurrency transactions, perhaps it can recommend one that does. You can also solicit recommendations from colleagues in the industry.

Once you have identified a hedge fund to work with, you will still need to do your due diligence. Does the hedge fund have a demonstrable knowledge and understanding of the cryptocurrency market? Does it have significant investments in this space? Does it have a positive track record with its cryptocurrency investments? As sophisticated as hedge funds are, the last thing you want is for a hedge fund to learn about the crypto market using your assets.

Conclusion

Considering these issues from the fiduciary's perspective, the safest and most efficient way to liquidate a cryptocurrency testamentary estate is to contract with a third-party hedge fund that is 1) already equipped to handle large-volume cryptocurrency trades, 2) has insurance sufficient to cover any losses due to theft or fraud or estate claims, and 3) has the ability to acquire better pricing for the trust.

As articulated above, there are multiple ways to handle the liquidation of these assets. In all cases, our conclusion is that third parties are far better equipped to handle the efficient movement of cryptocurrency and the management of decedent estates possessing such assets. ®

Notes

1. A list of most of these cryptocurrencies is available at coinmarketcap.com.
2. Since the blockchain is a decentralized distributed ledger, effecting a change is virtually an impossible task. One would have to change thousands of copies of the ledger distributed throughout the network.
3. The SEC's position on cryptocurrency is set out in full in "SEC Investor Bulletin: Initial Coin Offerings," July 25, 2017. Available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

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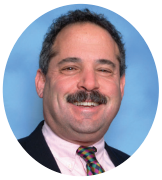

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