

Inflation and Cryptocurrency: Challenges and Opportunities in Digital Assets

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Thursday, Oct 29th, 2020 at 2 PM EST/ 11 AM PST



POINTS TO BE DISCUSSED

1

Challenges and opportunities in digital assets, including cryptocurrency, blockchain, and smart contracts

2

Recent developments with legal, reporting and tax ramifications of cryptocurrency and the underlying technology

3

Current events of crypto/blockchain and applications, potential implications from the pandemic

4

Updates on tax-related trends on Cryptocurrency

Because We Are Lawyers:

Disclaimer:

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What is Blockchain and Why are Many Venture Capital Investors Focused on it?

- Blockchain is software that provides a general “distributed ledger” that allows for the recording of information across a network of connected devices to enable people and enterprises to engage in transactions and information storage
- Within the last 10 years, there has been a lot written about the “Blockchain Revolution”; In our experience, the adoption of Blockchain has been more “evolution” than “revolution”
- The adoption of Blockchain is another important step in the digital transformation of our personal and business lives and is poised to be key driver of this continued evolution

What Opportunities are our Venture Capital fund Clients Seeing in the Space?

- Our firm saw the Blockchain wave coming early on and formed our Blockchain, Smart Contracts and Digital Currencies Practice to help our venture capital and early-stage technology company clients fully realize the potential of this technology
- We work with several early-stage venture capital firms that are betting that Blockchain technology will be globally adopted by nearly all companies and industries within the next decade

What Opportunities are our Venture Capital Fund Clients Seeing in the Space? (cont'd)

- Our client Tessera Venture Partners has deep expertise in the field and has clearly articulated their Blockchain investment thesis in a white paper appropriately titled “Blockchain Demystified” that is available for download at tesseravp.com
- Tessera’s view is that the adoption of Blockchain is analogous to how many companies migrated to cloud environments over the past ten years; Just as today we take cloud services for granted as our phones, tablets and computers all sync together, Blockchain will be widely adopted to:
 - unleash the power of data
 - improve the transparency, security and accuracy of transactions
 - improve the speed and efficiency of transactions through disintermediation, i.e., reducing the use of intermediaries

Solution in Search of a Problem?

- While the widespread adoption of Blockchain solutions is still early, our venture capital clients are sure that a wave of value creation has been kicked off
- We have represented several of our early-stage venture fund clients on the investor side in their investments in Blockchain companies recently and some consistent themes have been:
 - Companies that have developed Blockchain applications to reduce inefficiencies in transactions by removing non-core pieces of transactions
 - Blockchain companies that fully recognize that information is power and have developed applications that allow enterprises to make better decisions based on data
 - Companies with Blockchain applications that reduce and sometimes eliminate the need for human intervention in business processes or transactions
 - Companies with Blockchain applications that help enterprises – particularly in banking and finance – meet their compliance obligations

Challenges: From the Perspective of Venture Investors

- Many of us first became familiar with Blockchain as the underlying software used for cryptocurrencies such as Bitcoin, Ethereum and the myriad of other cryptocurrencies created over the last seven years or so
- Several of our venture capital clients were very circumspect about the explosion (and subsequent screeching halt!) of companies using Initial Coin Offerings (ICOs) to raise capital via the sale of tokens

Challenges: From the Perspective of Venture Investors

- We counselled our venture fund clients to be cautious about ICOs, and in 2016, we began incorporating protective provisions into certificates of incorporation that required portfolio companies to seek and obtain the consent of at least a majority of their preferred stock investors before they could engage in an ICO or other token offering in an effort to keep companies from running afoul of federal securities laws
- The National Venture Capital Association (“NVCA”) subsequently incorporated a similar protective provision into its standard form of venture capital financing term sheet and it has become a standard investor protection in venture deals since
- Our venture fund clients’ concerns about ICOs have proven to be well-founded as the SEC has brought dozens of enforcement actions related to ICOs in the last three years alone

Challenges: From the Perspective of Venture Investors

- The SEC now has a page on its website titled “Spotlight on Initial Coin Offerings (ICOs)”
- There is no shortage of headlines related to the SEC’s enforcement efforts in this space:
- “Telegram to Return \$1.2 Billion to Investors and Pay \$18.5 Million Penalty to Settle SEC Charges”
- “SEC Charges Issuer and CEO With Misrepresenting Platform Technology in Fraudulent ICO”
- “SEC Charges John McAfee With Fraudulently Touting ICOs”
- And just last week, “SEC Obtains Final Judgement Against Kik” for unregistered offering of “Kin” tokens in 2017 leading to a \$5 million penalty for the company

Investor Due Diligence

- One of the takeaways for venture investors has been that, despite the promise of decentralization, the adoption and use of Blockchain technology does not eliminate the business rules that enterprises are subject to
- As part of our due diligence work on behalf of venture capital investor clients, we dig in to the many questions raised by investing in Blockchain companies including:
- When ledgers comprising the blocks in the chain are distributed on computers located all over the world, what jurisdiction controls when disputes arise?
- When personal information is stored in a Blockchain, how will that information be protected and what rules will apply? The European Union's General Data Protection Regulation (GDPR), California's Consumer Protection Act (CCPA), China's Data Protection Directive?
- Who owns the data residing on the Blockchain?
- Does the company own the intellectual property that incorporates open source Blockchain technology platforms?

Evolving Legal Landscape

- Every major U.S. financial regulatory agency and others are looking closely at Blockchain and digital assets:
- Internal Revenue Service (IRS)
- U.S. Department of Justice (DOJ)
- Securities and Exchange Commission (SEC)
- Office of the Comptroller of Currency (OCC)
- Financial Crimes Enforcement Network (FinCEN)
- Commodity Futures Trading Commission (CFTC)
- States

Cryptocurrency: Viable, Sustainable, Alternative Capital Raising Mechanism?

Debt v. Equity → Debt v. Equity v. Tokenization

- Debt (temporary capital) / Equity (permanent capital) / Tokens (hybrids and may have both debt and equity security characteristics)
- Lure of raising money non-dilutively, quickly, easily, **seemingly** without the constraints imposed by federal and state securities laws and other regulatory requirements
- Democratization of access to these investments empowered by crowdfunding and Regulation A+

Cryptocurrency: Viable, Sustainable, Alternative Capital Raising Mechanism? (cont'd)

Utility v. security tokens

- Utility tokens permit the holder to buy the issuer's products, goods, services or solutions
- Security tokens are broader and more generalized in their uses
- When in doubt, **treat tokens (including cryptocurrencies) as securities!**
- Howey and recent NALs add some clarity, but utility tokens remain the **rare** exception, *not* the rule
- SEC stepping up enforcement actions of unregistered (or otherwise non-exempt) token sales, even for relatively small offerings

Cryptocurrency: Viable, Sustainable, Alternative Capital Raising Mechanism? (cont'd)

- Characteristics of “successful” security tokens – *broad dissemination and free tradability*
 - Regulation A+
 - Initial public offering
- Can be combined with traditional and other fundraising mechanisms (Regulation D, Regulation Crowdfunding, Regulation S)

Currency

- Medium of exchange
- Replaced barter system
- Generally backed by governments
- Centralized

Cryptocurrency

- Digital asset
 - File
- Medium of exchange
- Store of value
- Utility
- Decentralized and centralized
- Volatile

Distributed Ledger Technology and Blockchain

- Cryptocurrency utilizes a peer-to-peer network to transact known as distributed ledger technology (DLT)
- Distributed ledger technology is a decentralized database that is shared and replicated
- Blockchain is a subset of DLT that uses proof-of-work to validate transactions known as consensus
- Each validated transaction is added to the blockchain with a hash referencing the previous and current block
- Proof-of-work is a mechanism that rewards miners for solving cryptographic algorithms based on computing power
- Immutability is preserved as the blockchain ages

Tax



Internal Revenue Service treats cryptocurrency as property yielding capital gain/(loss) tax treatment for investors



Trades or businesses involving cryptocurrency may have ordinary income tax treatment (i.e. mining, remuneration in cryptocurrency)



Hard forks followed by airdrops may be taxable



Foreign Account Tax Compliance Act (FATCA) has not yet provided guidance regarding the Form 8938 for cryptocurrency accounts abroad



Financial Crimes Enforcement Network (FinCEN) has not yet provided guidance regarding the Form 114 Foreign Bank Account and Reporting (FBAR)

Tax (cont.)

- Virtual currency question on Schedule 1 from 2019 tax return has been moved to Form 1040 page 1 as the first question for all taxpayers following name and address
- The IRS is strictly monitoring cryptocurrency tax compliance

Form 1040 Department of the Treasury—Internal Revenue Service (99) **2020** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial _____ Last name _____ Your social security number _____
If joint return, spouse's first name and middle initial _____ Last name _____ Spouse's social security number _____

Home address (number and street). If you have a P.O. box, see instructions. _____ Apt. no. _____
City, town, or post office. If you have a foreign address, also complete spaces below. _____ State _____ ZIP code _____
Foreign country name _____ Foreign province/state/county _____ Foreign postal code _____
Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.
☐ You ☐ Spouse

At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? ☐ Yes ☐ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1956 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1956 ☐ Is blind

Dependents (see instructions):
If more than four dependents, see instructions and check here ▶ ☐

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

1 Wages, salaries, tips, etc. Attach Form(s) W-2	1 _____
2a Tax-exempt interest	2a _____
3a Qualified dividends	3a _____
4a IRA distributions	4a _____
5a Pensions and annuities	5a _____
6a Social security benefits	6a _____
b Taxable interest	2b _____
b Ordinary dividends	3b _____
b Taxable amount	4b _____
b Taxable amount	5b _____
b Taxable amount	6b _____
7 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>	7 _____
8 Other income from Schedule 1, line 9	8 _____
9 Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your total income ▶	9 _____
10 Adjustments to income: a From Schedule 1, line 22 10a _____ b Charitable contributions if you take the standard deduction. See instructions 10b _____ c Add lines 10a and 10b. These are your total adjustments to income ▶	10c _____
11 Subtract line 10c from line 9. This is your adjusted gross income ▶	11 _____
12 Standard deduction or itemized deductions (from Schedule A)	12 _____
13 Qualified business income deduction. Attach Form 8995 or Form 8995-A	13 _____
14 Add lines 12 and 13	14 _____
15 Taxable income. Subtract line 14 from line 11. If zero or less, enter -0-	15 _____

Standard Deduction for—
• Single or Married filing separately, \$12,400
• Married filing jointly or Qualifying widow(er), \$24,800
• Head of household, \$18,650
• If you checked any box under Standard Deduction, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2020)

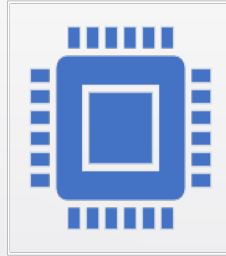
Store of value

- Cryptocurrency is being used as a store of value
 - Like gold
 - Hedge against inflation
 - Government stimulus
 - Political tension
 - Exchange rates
 - National debt
- ❖ Bitcoin was created as a result of the 2008 global financial crisis

Utility



There are approximately 7,500 cryptocurrencies and a \$400B market cap today



An internet 2.0 is being developed known as the internet of value

Transfer value directly between two parties



Applications of cryptocurrencies will play an instrumental role in their survival by solving real world problems:

Micropayments

Bank settlement (domestic/international)

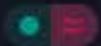
Exchange rate friction minimization

Decentralized finance

COVID-19 Pandemic

- Increased economic uncertainty as pandemic continues to exacerbate the financial crisis
- Governments have been using quantitative easing monetary policy to mitigate effects of the global financial crisis
 - Injection of money supply decreased the value of fiat
 - Cryptocurrency value increases

U.S. Dollar Currency Index · 1D · TVC



93.126 +0.032 (+0.03%)

93.126

0.000

93.126



93.126

19:51:38

92.000

4

2020

Mar

May

Jul

Sep

Nov







Inverse Relationship



Total Market Capitalization

Linear Scale

Log Scale



Zoom 1d 7d 1m 3m 1y YTD ALL

From Oct 28, 2019 To Oct 28, 2020



coinmarketcap.com

Total Market Capitalization (Excluding Bitcoin)

Linear Scale

Log Scale



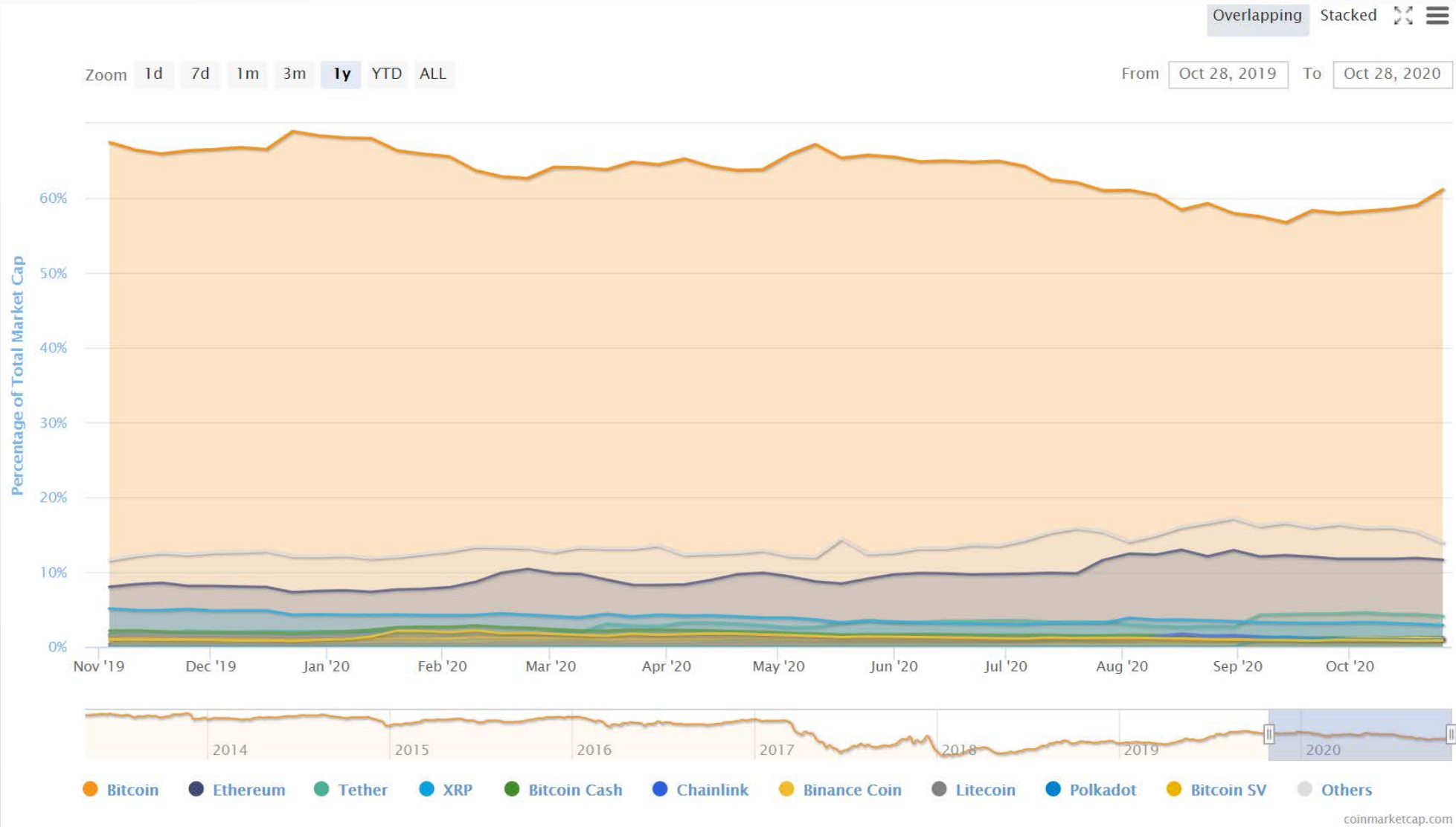
oom 1d 7d 1m 3m 1y YTD ALL

From Oct 28, 2019 To Oct 28, 2020



coinmarketcap.com

Percentage of Total Market Capitalization (Dominance)



Comments

- The digital asset space is still nascent even after being around for over a decade
- The space is industry agnostic and is on a path to mainstream adoption
 - Paypal/Venmo announced using crypto wallets on their platform, occ letter permits banks to provide custodial services for cryptocurrency
- Decentralized finance (DeFi) is a catalyst for mainstream adoption
 - Bank the unbanked
 - Loans
 - Stablecoins
 - Tokenization
- There are parallels between the initial coin offering (ICO) craze and DeFi
 - Surge of new cryptocurrencies and major market movements
- Regulatory clarity is imperative for the long-term success of the space
- Governments are experimenting with central bank digital currencies (CBDCs) to compete in the digital asset space

Defi or Decentralized Finance: Will it change the future of finance?

What is Defi?

- Open Source Financial Code
- Financial Services with no central authority
- Billions of dollars currently locked up in Defi and growing
- Current financial system centralized (i.e. bank, stock market, insurance, etc.)
- Permission less and no account needed to set up

Defi – How Does it work

Defi Infrastructure

- DIY Platform for writing Dapps (i.e. Ethereum)
- Open Source Code
 - Smart Contract
 - immutable

Defi - Currency

Cryptocurrencies:

- Bitcoin – non compatible/ Ether – compatible but volatile
- Stable coins – crypto currency which is pegged to a real asset (i.e. the US dollar)

DAI

- Decentralized backed by crypto collateral
- Overcollateralized 1eth =66c of Dai.
- Overcollateralization covers for eth volatility
- Smart contract on Ethereum blockchain

DEX – Decentralized Exchange

- Built on Ethereum platform
- Non Custodial
- No account sign up or ID verification
- Autonomous and free for all

Decentralized Money Markets

- Connect borrowers with lenders
- Deposit crypto against collateral and borrow against it
- Interest earned for lenders
- Tokenized derivatives using decentralized synthetics
- Defi Insurance

Defi: Use Case

Advantages

- Access to financial products
- Permission-less
- Cheaper (removing middleman)

Disadvantages

- General volatility of crypto
- Potential for bugs
- Miner interference

Accounting & Auditing: Update

Digital Asset Classification

- AICPA practice aid (non-specialized accounting)
- Indefinite lived intangible asset
- Subject to impairment analysis
- Highly judgmental/Evolving guidance

Herbert P. Moore, Special Counsel

McCarter & English, LLP

Herb “JR” Moore is Special Counsel in the firm’s Venture Capital & Emerging Growth Companies practice. He focuses his practice on advising entrepreneurial clients and venture capital investors on a full range of transactional, securities law and corporate governance matters. Herb counsels early stage, emerging growth and middle market tech and tech-enabled companies on a diverse range of corporate matters, including venture capital financings, technology transfer agreements, mergers and acquisitions, protection of intellectual property, complex commercial agreements, licensing, entity formation and general corporate matters.

Prior to joining McCarter & English, Herb was in-house counsel at a leading New York seed- and early-stage venture capital firm investing in some of the strongest growth areas to date, including cybersecurity, artificial intelligence, machine learning, drones, enterprise cloud software, and crowdfunding. Herb represents several early stage venture capital funds in both fund formation and investment transactions as the firms identify and invest in technology and technology-enabled companies – across geographies and emerging industries.



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Matthew E. Uretsky advises entrepreneurial clients in technology-driven industries at every stage of the business lifecycle, from initial formation and funding to exit strategy. He combines industry knowledge with extensive deal experience to deliver smart solutions for tech, tech-enabled, and life sciences companies with respect to choice of business entity, intellectual property protection, internal governance, private and public debt and equity financings, securities law compliance, mergers and acquisitions, and beyond.

Innovators and investors regularly seek Matt's depth of knowledge and practical guidance for pre-seed, seed, and early stage to expansion and growth stage capital raising transactions and ultimate liquidity events. He works closely with venture capital funds, family offices, private equity and hedge funds, and angel networks and funds to understand and meet their individual business needs. He keeps up with the rapid pace of the emerging technologies and techniques that are disrupting every industry, advising clients on cryptocurrencies, SAFEs, KISSes, and other innovative fintech solutions.



AREAS OF EXPERTISE

Proptech
Venture Capital & Emerging Growth Companies
Blockchain, Smart Contracts & Digital Currencies
Cannabis
Corporate
Debt Financings
Mergers & Acquisitions
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Peter Goodrich is a Manager in the Tax Department of Prager Metis CPAs, a member of Prager Metis International LLC. He has been working in the industry for over 5 years.

Peter specializes in tax planning, consulting, and structuring with domestic and international businesses, whether they are mature or startups, high net worth individuals, and trusts and estates tax planning. He assists and advises on complex business transactions.

Peter has an expertise in several industries including blockchain/cryptocurrency, entertainment, manufacturing, defense contracting, technology, hedge funds, automotive, hospitality and real estate. He believes in working with clients to ensure they are 100% paperless and ensures their cybersecurity is in place.

Peter is a noted expert in a variety of tax issues and has been published in Dealer Magazine. In his free time, he enjoys building computers, playing guitar, running chartable 5Ks, and spending time with his son.



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Brian Goldblatt is a Partner in the Audit and Accounting Department of Prager Metis CPAs, a member of Prager Metis International Group. He has over 14 years of accounting and assurance experience. Prior to joining Prager Metis Brian worked at a Big 4 Accounting firm.

Brian specializes in a full range of audit and accounting services. This includes experience in various industries, including hedge funds and private equity. He has extensive experience with private companies, investment companies, valuation, financial products, internal controls, and financial reporting. Brian is an expert in his field and believes in a proactive and personal approach to working with his clients.



AREAS OF EXPERTISE

Advisory
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Thank You!

