

Forming Special Purpose Entities to Gain Exposure to Private Cryptocurrency Funds

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With the expansion of cryptocurrency and the opportunities to capitalize on its growth, there has been a recent flurry of sponsors looking to raise capital in order to launch private funds primarily focused on cryptocurrency positions. With many large institutional investors often dissuaded by its volatility, still taking a very “wait and see” approach to the cryptocurrency market, the door may be open for certain smaller private investors. Often these smaller private investors are interested in pooling capital; creating special purpose entities (“SPEs”), such as a limited liability company (“LLC”); and collectively investing right alongside larger investors in cryptocurrency focused private funds. This presents a fantastic avenue for these smaller scale investors to gain exposure to cryptocurrency in a manner that is normally reserved for larger institutional investors and family offices. Many private funds and their sponsors are willing to accept these types of investments, provided that the SPEs and their investors comply with certain regulatory requirements under which such funds operate.

What these small private investors should understand is that many new U.S. based cryptocurrency private funds are operating under certain exemptions from registration under the Investment Company Act of 1940 (the “1940 Act”). One common exemption appears under Section 3(c)(1) of the 1940 Act. This exemption allows private funds to be exempt from the regulations and reporting requirements under the 1940 Act, provided that, at all times, the fund is not beneficially owned by more than 100 persons. Additionally, many private fund sponsors offer parallel funds that rely on another common exemption that appears under Section 3(c)(7) of the 1940 Act (often referred to as the “qualified purchaser” exemption). A “qualified purchaser” under the 1940 Act is an investor that falls within a set of general categories with the two most common being: (i) an individual that owns \$5 million or more in investments (either alone or jointly with their spouse); and (ii) an entity that invests at least \$25 million in private capital, on its own account or on behalf of other qualified purchasers. A private fund relying on Section 3(c)(7) may generally only sell its shares to qualified purchasers. It is important to note that, unlike a private fund relying on the Section 3(c)(1) exemption, there is no limit on the number of qualified purchasers that may invest in a private fund relying Section 3(c)(7). So, investors considering an investment in a private cryptocurrency fund may want to inquire with the fund’s sponsor as to whether there is a parallel 3(c)(7) fund being offered in the event they meet the applicable “qualified purchaser” threshold for such an investment. That said, at a smaller private investment level, qualified purchasers may not be too common. Additionally, many qualified purchaser investors may not need and/or desire to pool their capital and invest through an SPE as they are likely able to meet a private fund’s minimum investment threshold on their own.

Certain smaller investors looking to invest in a private cryptocurrency fund through an SPE, like an LLC, will likely be doing so through a private fund relying on the Section 3(c)(1) exemption and, therefore, will not be able to circumvent the 100-beneficial owner limit under Section 3(c)(1). Quite the contrary, because these SPEs are formed specifically for the purpose of investing in the private cryptocurrency fund, they will be subject to a “look through”

requirement meaning that, for purposes of complying with the 100-beneficial owner limit of Section 3(c)(1), the private cryptocurrency fund must “look through” a potential SPE investor to count all its underlying investors towards the investor limit. As an example, a group of 8 business associates (all of whom are accredited investors) are interested in forming an LLC to use as an SPE, within which to pool \$500,000 in investment capital. The SPE is being formed to serve as a limited partner investor in a private fund focused on cryptocurrency, structured as a limited partnership, and operating under the Section 3(c)(1) exemption. To comply with the 100-beneficial owner limit of Section 3(c)(1), the private fund is required to “look through” the SPE and count each of its 8 investors as 8 direct investors in the private fund. This is important because many private funds have minimum investment thresholds (e.g., \$500,000). Therefore, smaller investors considering pooling funds and forming an SPE for private fund investment reasons would be prudent to target potential co-investors that can commit a significant portion of funds. This serves to maximize investment while, minimizing the number of investor slots used for purposes of the 100-beneficial owner limit of the private fund. Under these circumstances, your business colleague who has \$200,000 in cash to commit towards the SPE is more desirable than your Uncle Louie looking to park \$10,000 after a successful Vegas vacation. Sorry Uncle Louie.

When structuring an SPE to invest in a private cryptocurrency fund, understanding the regulatory constraints on the fund is essential to targeting your investor pool and creating a structure that works for your investors, while maintaining good will with the private fund and helping it comply with its regulatory constraints. The proper advice and knowledge is essential for raising funds and creating effective governance policies within your investment vehicles.

For more information about structuring an SPE to invest in a private cryptocurrency fund please contact **Peter F. Cifichiello**.