diffusetap
Virtual Event Series

Digital Asset Bets

Guest Speaker:

Matt Lisle
Director-Legal
Galaxy Digital

Hosts:

Kenny Estes
CEO and Founder
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DiffuseTap: Digital Asset Bets

Last time on DiffuseTap, **Matt Lisle, Director-Legal at Galaxy Digital**, discussed the problems facing the SEC in setting up a tax structure for crypto, in-kind investments and how they work, and the age-old question on when we can expect ETFs in the crypto space.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speaker

MATT LISLE is an experienced lawyer specialized in the crypto and digital assets space. He co-founded and was General Counsel at DrawBridge Lending, a member of the National Futures Association that facilitates USD loans secured by crypto assets and operates commodity pools offering crypto asset derivative strategies.

DrawBridge was recently acquired by financial services and investment management innovator Galaxy Digital, which is dedicated to digital assets, cryptocurrency, and blockchain tech, where Matt now serves as Director-Legal.

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About Diffuse®

We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information, visit www.diffusefunds.com.

KENNY ESTES: Today's speaker is Matt Lisle. Matt, do you want to do a quick introduction of yourself for the crew here?

MATT LISLE: Thanks for having me, Kenny. I am Matt Lisle. I'm currently an in-house attorney for Galaxy Digital. Prior to Galaxy Digital, I founded along with three other partners a very small company called DrawBridge Lending based in Chicago. All four of us are from the derivatives industry. My specialty was legal regulatory compliance in the futures space, and derivatives as well.

We started that company in 2018 with the aim of providing a lending solution against crypto collateral. We developed a fairly sophisticated product that I will go into a little bit down the road. Eventually, we morphed and we also became a commodity pool operator and a commodity trading advisor under Commodity Futures Trading Commission (CFTC) rules. We launched a couple of commodity pools, and I'm sure I will be talking about those as well.

Prior to that, my experience extends all the way back with a couple of startup exchanges, but none of them survived. But if you're old enough, you may recall Euronext US, which was Euronext's venture into the US market space. I also was associated with NYSE Liffe's initiative into the futures markets. Before that, I held a couple of jobs in Washington DC. The first one was as a staff attorney at the CFTC. The second one was as general counsel on the National Grain and Feed Association,.

In a nutshell, that is what I've been doing. I should probably sum it up by telling you that my little startup company was bought by Galaxy Digital back in November, with the primary objective of adding an arm of the company that had expertise in derivatives, derivatives trading, and so forth.

One of my partners, Jason Urban came from DRW, which is a significant market maker in the futures and security space. He is very, very experienced in the world of options and options trading, which is central to both our cool strategies, as well as our long-term product.

That's my background. I'm very happy to be here, Kenny and Ayla, because I have come to know Diffuse through my side job as chairman of the Global Digital Asset and Cryptocurrency Association, or what we refer to as the Global DCA, which is a startup self-regulatory initiative that's based here in Chicago. But we have global aspirations, and we're just getting started.

That's how I know Diffuse. I have been extremely impressed by their expertise and professionalism, which I think far exceeds their age. I think that probably speaks for itself to most people here, and that is why a lot of people are here. I think that they are the future of the industry, as well as shops like them who are really out front and innovative, and who are exactly what we're looking for, especially in the crypto and digital assets space. So, kudos to you both. I think I'm going to see you do big things.

AYLA KREMB: That's very touching. Thanks so much, Matt. You mentioned something interesting in your introduction, which was around in-kind investments. We'd love to touch on that as our first topic.

How does it work when somebody wants to make an in-kind investment into a fund, or any other investment vehicle that is sitting on crypto, and they're hoping that they can smoothly transition that into another investment? How does that work? And is that even possible?

MATT: Yes, it's possible. Perhaps there is more of a limited choice than you would find in a typical securities marketplace, but I think that is going to be growing. When you consider in-kind investments, it’s important to think about it in two respects, you think about it in terms of the rails, the how-to of the actual process. And also, you can think about it from the regulatory standpoint.

Let's take a look at the second one first. From a regulatory standpoint, they are allowed into certain vehicles. Like I said, we run commodity pools and a lending product. Both of those will accept and are certainly looking for in-kind investments.

The way it works is, if you're interested in one of our commodity pools, we would provide you with the standard legal documentation that you would see for any pool, which would include a PPM and a subscription agreement, as well as a limited liability company agreement. Typically, the rails of it is that an investment is passed from your wallet, into where we keep custody of our investment assets, usually with a third party custodian like Gemini. We also use Fireblocks.

If you're well aware of what's going on in the crypto industry or the crypto space, you might have heard that Galaxy just announced in the last month a proposed combination with BitGo. Going forward, in q3, or q4, Galaxy will be one with BitGo, and we'll probably look to custody all our assets over there. That's where you know that our assets are in custody. We will then operate or manage our fund strategies on top of that.

In terms of our fund, we're primarily interested in producing returns based upon the volatility in this asset class. So, if you're familiar with the VOLs in this asset class, they are through the roof. You cannot find volatility at this time in any traditional space. Traditionally, the highest is probably in energy. You're looking in the 10s.

From a VIX measurement standpoint, you can get into the hundreds with crypto when it moves. So, for those who understand the options world, that's a lot of premium that you can harvest just by having in-kind collateral in there, collateralizing your investments. We typically look for investments in the OTC options space, and there's plenty of liquidity out there for that. That's what you can do from a commodity pool standpoint.

As you probably are aware, the standard closed-end funds, the Grayscales and so forth, will take in-kind investments. Loan products and similar products are some of the ways to put in-kind assets into a position where you can realize at least some fiat capacity while keeping your assets high and dry. And we can produce structures where interest rates become very close to zero. Those are interesting products as well. That's it, in a nutshell.

KENNY: There's a question about what Galaxy Digital does, and I think you touched on some of the main parts there, such as fund management. Not many people have a direct background working at the SEC and are now spinning up funds. So, I guess the hot topic now in the space is ETFs. What's going on there? Are we ever going to have an ETF?

MATT: Yeah, good question. Great question. It's on everybody's mind, and it's the most important thing in the crypto space right now. But unfortunately, I cannot give you an answer. And the reason I can't give you that answer is because the SEC has been sitting on this for a very long time.

There are probably dozens of applications now from various providers looking to list an ETF. But the SEC has not approved any because they have substantial questions around the pricing of the underlying spot cryptocurrencies, which informs the settlement of the ETF price. It's a space where there are a lot of questions around the legitimacy of the liquidity in the spot cryptocurrency exchanges.

Such exchanges are not regulated under a standard regulatory regime. As a result, the SEC has some issues surrounding the fairness and accuracy of the underlying market pricing mechanisms, not to mention their unease with the volatility of the asset class, the questions around anti-money laundering that continue to circle around it, and where the assets are custodied.

So, there's a lot of questions that they have there. And there are other forces of friction at play. There is the transition from the Trump administration to the Biden administration. And with that, we're going to see a philosophic change. Gary Gensler is now in the SEC chairman spot. And the SEC, like all the regulators here in the United States, have very heavy burdens in their "day jobs" policing the traditional financial markets.

I think crypto, being an asset class that is still dwarfed by traditional markets, is a very unstable space, and there's quite a bit of fraud that can go on. The SEC has to spend most of their resources on traditional asset classes. And therefore, an asset class like crypto or digital assets gets shunted and left aside a bit. We do have a bandwidth question, that said, we're starting to see some activity on this. But unfortunately, what's coming out is somewhat negative.

I can't point to any smoking guns, but the suspicion amongst those who watch the DC shenanigans going on is that there has been a big effort in DC since the administrative change to raise issues about the instability and other concerns of the asset class and urging regulators and legislators to be cautious.

Senator Elizabeth Warren, recently expressed skepticism about the legitimacy of the asset class and about the environmental suitability of this asset class. These are of course legitimate concerns but there are other considerations which would tend to balance out the perspective on this asset class and for whatever reason those considerations have taken a little bit of a back seat in the public debate. It will be up to the industry to educate Congress and the Administration going forward about the benefits of the new asset class.

AYLA: The audience raised a few really interesting points, and I'm picking up some good questions from here. One of them was on taxes, specifically, DeFi. DeFi is a very new and complex environment. Nobody really knows how to treat it from a tax perspective. What are your thoughts on these emerging new investment vehicles? And also, how do you manage taxes on that?

MATT: Yeah. Let's start with the standard questions around DeFi. De-Fi can be hard to generalize but roughly speaking, DeFi refers to protocols based on a blockchain, and which are set up to provide or support a certain function or functions using digital tokens. In many cases, the digital tokens are sold in what looks like an initial offering and typically funds that are raised are used for the development and support of the blockchain based protocols. Once operational, the blockchain forms a network of nodes that will verify transactions on a particular black blockchain, with node operation and verification incentivized by the receipt of some form of token compensation.

We're seeing the whole 360-degree spectrum of various enterprises, which shows that the potential uses of blockchain are almost infinite. You've got this wide-open green field, with operators and developers looking for investment and capital into their enterprises. That brings into focus the regulatory questions around whether these things that are being sold look like securities, and whether or not they have to be registered under SEC rules.

There is always a threshold question in the United States as to whether United States persons are actually able to invest in one of these enterprises. Because the enterprises are so bespoke or unique from each other, you have to go through a fairly involved legal analysis (the so-called Howey analysis) as to whether it would be okay to invest or not. There are certainly some black lines that you can depend upon, but no enterprise is entirely without risk, in terms of what the SEC is going to do.

Again, De-Fi is another area that the SEC has yet to provide specific guidance, instead preferring to stand on the customary Howey analysis requirements. There is no definitive black line guidance or test that can be relied on and thus all De-Fi projects present some level of regulatory and legal risk.

But for the sake of discussion, let's assume that a US person can safely invest in certain De-Fi tokens. I am not a tax expert, far from it but generally a de-fi investment should be treated like any other capital investment, so it's a matter of tracking your investments and then reporting the results of those investments when they're sold. The IRS will then treat these investments as capital investments.

The complexities come when you start to use your assets to participate in the lending and borrowing markets, in order to produce returns on assets that you have while you're holding them. That's certainly allowed.

But then, you have more complex, maybe even gray areas in the tax world. It is still unsettled as to whether lending out a digital asset is considered a loan, which is not taxed, as compared to a sale. Some of it will depend upon how the loan is characterized. There is still just no little guidance from the IRS as to how that is treated.

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