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FAIR VALUE MEASUREMENT BEST PRACTICES FOR IMPLEMENTATION UNDER ASC 820: CRYPTOCURRENCY

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Fair Value Measurement Best Practices for Implementation Under ASC 820: Cryptocurrency

Overview

Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC" or the "Codification") Topic 820, Fair Value Measurement ("ASC 820") is the sole source for authoritative guidance on how entities should measure and disclose fair value in their financial statements under U.S. generally accepted accounting principles ("U.S. GAAP"). The experts at Richey May have created the following reference to provide practical guidance on certain provisions in the Codification that affect crypto valuation.

Fair Value Hierarchy

One of the most significant elements of ASC 820 is the use of a three-level fair value hierarchy for the classification of inputs in fair value measurement. The three levels of the fair value hierarchy and the significant valuation inputs under ASC 820 are:

Level 1 Inputs are the most observable inputs to arrive at fair value (e.g. liquid investments), including unadjusted quoted prices for identical assets or liabilities in active markets (e.g. exchange-traded securities). *ASC 820 defines an "active market" as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.*

Level 2 Inputs are observable inputs other than quoted prices used to value Level 1 securities, such as quoted prices for identical assets and/or liabilities in markets that are inactive, quoted prices for similar assets and/or liabilities, private investments in public companies, or market inputs other than the directly observable quoted price. These "other market inputs" are often used in conjunction with valuation models and generally include interest rates and yield curves observable at commonly quoted intervals, implied volatilities, and other market-corroborated inputs. Level 2 securities typically include digital assets with a public market and most OTC derivatives. For certain OTC securities, this may include the bid/ask levels from market participants. Additionally, certain assets and securities with observable process, but which are thinly traded or otherwise illiquid, may be categorized as Level 2.

Level 3 Inputs are those not currently observable, as when there is historical volatility in an option-pricing model or a fund's own data or assumptions.

> *ASC 820 emphasizes the need to prioritize the use of observable inputs whenever possible. However, the more illiquid an investment, the greater the need to use multiple valuation techniques to arrive at fair value.*

The level designation in the fair value hierarchy is based on the lowest level input that is significant to the fair value measurement.

Funds must consider the sensitivity of the financial instrument's fair value when assessing the significance of an input. Assessing the significance of an input requires consideration of factors specific to the financial instrument being valued. Ultimately, determining the significance of an input is a matter of judgment. Consequently, two unrelated funds assigning level designations to the same investment using similar unobservable inputs may reach different conclusions. Level 3 digital assets are those without a public market, complex OTC derivatives (including certain foreign currency options, long-dated commodity options and swaps, certain

mortgage- related credit default swaps, derivative interests in mortgage-related CDOs, and basket credit default swaps), Pre-ICO SAFTs, SAFEs, etc.
For Level 2 designations, any model used must be widely accepted, non-proprietary and the data used must be observable. Any significant judgment or adjustments to the model or data will likely result in a Level 3 designation. In addition, quotes from brokered markets should represent a firm commitment to transact or be developed from other observable market data.

Considerations When Determining Fair Value

Level 2 Liquidity Discounts

Level 2 inputs are observable inputs other than quoted market prices included within Level 1. The fair value of these types of investments is generally based upon the price of the actively traded public equity price on an "as-if" converted basis, less any discounts applied to take legal restrictions into consideration, liquidity risk, price volatility, and other risk assumptions. In practice, we have seen discounts typically range from five to thirty percent. In situations where the discount is significant or when convertible securities are not in the money, then these positions typically move into Level 3.

Funds must consider the assumptions used to arrive at fair value from the perspective of a market participant when applying liquidity discounts. Neither the quantity of the investment held by a fund, nor a fund's intention to hold an investment are relevant in estimating fair value on the measurement date.

Level 3 SAFTs & ICOs

Due to their lack of observable inputs, SAFT's, ICO's and other digitized equity ownership interests are generally categorized as Level 3 investments.

Many funds that invest in the above positions traditionally record the fair value of those investments at their initial transaction cost, and subsequently make adjustments when there is a new round of financing. While the initial transaction cost is not fair value, fair value can approximate the initial transaction cost. A fund's valuation policy should document the fair value of private equity investments and digital assets through its use of internal analysis, review of portfolio company financial statements, and comparison of the fair value of public securities to the fair value of its investment in the private equity. When considering whether the transaction price from a new round of financing is a suitable input for fair value measurement, the following factors should be considered:

- Attributes and characteristics of the transaction
- Complexity of the capital structure
- Proximity to reporting date
- Extent of participation of additional third-party investors in the round of financing
- Any changes in the portfolio company in the intervening period between transaction date and reporting date

Again, the initial transaction cost can be considered (but not on its own) since it cannot be presumed to be fair value. As a best practice, a fund's financial reporting team should document the fair value measurement of its private equity investments. Private equity funds should include the use of multiple valuation techniques to supplement and corroborate the fair value based on the transaction price in a recent round of private equity financing.

Disclosures of Significant Accounting Policies

SAFTs

The General Partner has determined to value certain digital assets that are Simple Agreements for Future Tokens, Simple Agreements for Future Equity, Service Token Presale Prepayment Agreements, or Initial Coin Offerings at cost. Management has determined that there have been no material developments related to these digital assets and therefore cost is representative of fair value. The General Partner has determined the value of certain digital assets by applying a discount for the lack of marketability to an observable last reported sales price of a contract, representing a commitment for the future purchase or sale of the digital asset at a specific date. To support the discount for lack of marketability, management may take into consideration the use of an option pricing model that is sensitive to certain key assumptions, such as volatility and time to exit, that are unobservable. The General Partner has also determined to value certain digital assets based on additional financing rounds, market transactions, or public offerings.

Digital Currency

The Fund values investments in digital assets at the last reported value using CoinMarketCap (coinmarketcap.com, in United States Dollars) which derives its prices by aggregating the prices from various exchanges. Such investments are classified as Level 2 in the fair value hierarchy.

The Fund's investments in digital assets are stated at fair value. Digital assets are generally valued using the price reported by CoinMarketCap as of 11:59 pm UTC on the valuation date, although the General Partner has substantial discretion in determining the value of the Fund's assets. CoinMarketCap is a well-known cryptocurrency market capitalization source in the industry that provides prices for cryptocurrencies using a volume weighted average of prices across the varying exchanges on which they are traded.

Exchange Traded Assets

For digital assets traded on exchanges, the fair value on any given day will be calculated as the Closing Price (defined as the price at fund-specific Universal Coordinated Time (UTC)) displayed on Coinmarketcap.com or other applicable pricing source in the case of assets listed on the website. The only exception to this policy will be made in the case of assets traded at de minimis levels of liquidity, such that a single large order can cause a material change in the reported price; in these instances, the Fund may, at its sole discretion, apply a discount to the reported price.

For digital assets that are traded on an exchange but at de minimis levels of liquidity such that a single large order can cause a material change in the price, the Fund may apply a discount to the reported price. For futures contracts, exchange traded options contracts or other exchange traded digital assets not appearing on Coinmarketcap.com, the closing price from the exchange on which the asset trades (or in the instance of digital assets trading on multiple exchanges, the closing price from the exchange in which it trades in the greatest volume) shall be utilized.

In the case of otherwise liquid assets that are subject to resale restrictions (i.e. a lock-up), the Fund may discount the market value of the asset to reflect fair and current market values, and, in good faith, maintain the ability to change the valuation of a digital asset based on many factors including, but not limited to, liquidity, trading volume and price movements of the underlying digital asset. Discounts may be applicable from 5%-25% based on marketability or liquidity.

Other than Publicly Traded Assets

Any digital assets without market valuation information are to be reviewed and priced by management in good faith to reflect the asset's fair and current market value, and supporting documentation maintained. Management will arrange for periodic and frequent reviews of valuation information from whatever source to promptly identify any incorrect, stale, or mispriced digital assets.

Generally speaking, illiquid digital assets such as those acquired via an Initial Coin Offering will be held at the lesser of cost or fair value. There will be a bias to hold these digital assets at cost provided no credible negative information regarding the associated project has been publicized or otherwise come to the Fund's attention that would lead it to conclude the cost of acquiring the digital asset is no longer an

appropriate reflection of its value. In the event that management determines it is necessary to adjust the valuation of one of these digital assets, they shall use one or a combination of industry comparable or inputs from a third-party valuation firm to do so.

Cryptocurrency Specifics

Note Regarding Risk Consideration in Valuation

The Fund is subject to various risks including market risk, liquidity risk, and other risks related to its investments in digital assets. Investing in digital assets is currently unregulated, highly speculative, and volatile.

The net asset value of the Fund relates directly to the value of the digital assets held by the Fund, and fluctuations in the price of digital assets could materially and adversely affect an investment in the Fund. The price of digital assets has a limited history. During such history, digital asset prices have been volatile and subject to influence by many factors including the levels of liquidity. If digital asset markets continue to experience significant price fluctuations, the Fund may experience losses. Several factors may affect the price of digital assets, including, but not limited to, global digital asset supply and demand, theft of digital assets from global exchanges or vaults, and competition from other forms of digital asset or payments services.

Digital assets are loosely regulated and there is no central marketplace for currency exchange. Digital assets are decentralized and do not rely on either governmental authorities or financial institutions to create, transmit, or determine the value of the cryptocurrency issued by them. Supply is determined by a computer code, not by a central bank, and prices can be extremely volatile. Digital asset exchanges have been closed due to fraud, failure, or security breaches. Any of the Partnership's assets that are maintained on an exchange may be lost.

Several factors may affect the price of digital assets, including, but not limited to, supply and demand, investors' expectations with respect to the rate of inflation, interest rates, currency exchange rates or future regulatory measures (if any) that restrict the trading of digital assets or the use of digital assets as a form of payment. Ultimately, digital assets can be purchased and exchanged for conventional currency on exchanges, can be used for consuming resources per their respective protocols, or used to purchase goods and services online or at physical locations. However, there is no assurance that digital assets will maintain their long-term value in terms of purchasing power in the future, or that acceptance of digital assets payments by mainstream retail merchants and commercial businesses will grow.

Digital assets represent a speculative investment and involve a high degree of risk. As relatively new products and technologies, digital assets have not been widely adopted as a means of payment for goods and services by major retail and commercial outlets. Conversely, a significant portion of the demand for digital assets is generated by speculators and investors seeking to profit from the short or long-term holding of digital assets. The relative lack of acceptance of digital assets in the retail and commercial marketplace limits the ability of end-users to pay for goods and services with digital assets. A lack of expansion by digital assets into retail and commercial markets, or a contraction of such use, may result in increased volatility.

Digital assets are controllable only by the possessor of a unique private cryptographic key controlling the address in which the digital asset is held. The theft, loss or destruction of a private key required to access a digital asset is irreversible, and such private keys may not be capable of being restored by the Fund. The loss of private keys relating to digital wallets used to store the Fund's digital assets could result in the loss of the digital assets and a limited partner could incur substantial, or even total, loss of capital.

The Fund must adapt to technological change in order to secure and safeguard client accounts. While the General Partner believes it employs an appropriate proprietary security system reasonably designed to safeguard the Fund's digital assets from theft, loss, destruction, or other issues relating to hackers and technological attack (including through the use of third party custodians), such assessment is based upon known technology and threats. To the

extent that the Fund is unable to identify and mitigate or stop new security threats, the Fund's digital assets may be subject to theft, loss, destruction, or other attack, which could adversely affect the performance of the Fund or result in loss of the Fund's digital assets.

Many digital assets are open source projects with a core group of developers; however, there is no developer or group of developers with formal control. Any individual with the open source network software can make software modifications, which users and miners may consent to by downloading the altered software or upgrade that implements the changes. If a modification is not accepted by a vast majority of users and miners but is accepted by a substantial population of participants in the project, a "hard fork" in the blockchain can develop two separate networks, one running the pre-modification software and the other running the modified version. This kind of split could materially and adversely affect the value of the Fund's investments and in the worst-case scenario, harm the sustainability of the affected digital assets.

The Fund generally records receipt of a new digital asset created due to a hard fork at the time the hard fork is effective. Some custodians and exchanges do not honor hard forks or may honor hard forks in the future. In such cases, the Fund will record receipt of the new digital asset at the time the custodian or exchange announces it will credit the Fund's account. The Fund does not allocate any of the original digital asset's cost to the new digital asset and recognizes unrealized gains equal to the fair value of the new digital asset received. The Fund may receive "airdrops" of new digital assets. The use of airdrops is generally to promote the launch and use of new digital assets by providing a small amount of such new digital assets to the private wallets or exchange accounts that support the new digital asset and that hold existing related digital assets. Unlike hard forks, airdropped digital assets can have substantially different blockchain technology that has no relation to any existing digital asset. The Fund records receipt of airdropped digital assets when received. Digital assets received from airdrops have no cost basis and the Fund recognizes unrealized gains equal to the fair value of the new digital asset received.

Some of the markets in which the Fund may execute its transactions are "over-the-counter" or "interdealer" markets. The participants in such markets are typically not subject to credit evaluation and regulatory oversight as are members of "exchange-based " markets. This exposes the Fund to the risk that a counterparty will not settle a transaction in accordance with its terms and conditions because of a dispute over the terms of the contract (whether or not bona fide) or because of a credit or liquidity problem, thus causing the Partnership to suffer a loss. Such "counterparty risk" is accentuated for digital assets where the Fund has concentrated its transactions with a small group of counterparties. The Fund is not restricted from dealing with any particular counterparty or from concentrating any or all of its transactions with one counterparty. Moreover, the Fund has no separate credit function that evaluates the creditworthiness of its counterparties. The ability of the Partnership to transact business with any one or number of counterparties, the lack of any meaningful and independent evaluation of such counterparty's financial capabilities and the absence of a regulated market to facilitate settlement may increase the potential for losses by the Fund.

The Fund engages in the speculative trading of various financial instruments including digital assets, futures contracts, and option contracts (if applicable). Such trading activities expose the Fund to market risk. Market risk is the potential for changes in fair value of financial instruments from market changes, inducing fluctuations in market prices. Market risk is directly affected by the volatility and liquidity in the markets in which the related underlying assets are traded. The Fund manages its exposure to market risk related to trading instruments on an aggregate basis combining the effects of cash instruments, digital assets, and derivative contracts.

Digital Asset Regulation

As Digital Assets have grown in popularity and market size, various countries and jurisdictions have begun to develop regulations governing the Digital Assets industry. Regulators are concerned such a large unregulated person-to-person global economy could potentially enable criminals to evade taxes and launder money. To the extent that future regulatory actions or policies limit the ability to exchange Digital Assets or utilize them for payments, the demand for Digital Assets will be reduced. Furthermore,

regulatory actions may limit the ability of end-users to convert Digital Assets into fiat currency (e.g., U.S. dollars) or use Digital Assets to pay for goods and services. Such regulatory actions or policies would result in a reduction of demand, and in turn, a decline in the underlying Digital Asset unit prices. The effect of any future regulatory change on the Fund or Digital Assets in general is impossible to predict, but such change could be substantial and adverse to the Fund and the value of the Fund's investments in Digital Assets.

No FDIC or SIPC Protection

The Fund is not a banking institution or otherwise a member of the Federal Deposit Insurance Corporation ("FDIC") or the Securities Investor Protection Corporation ("SIPC"). Accordingly, deposits or assets held by the Fund are not subject to the protections enjoyed by depositors with FDIC or SIPC member institutions. The undivided interest in the Fund's Digital Asset investments and other assets represented by units in the Fund are not insured.

Frequently Asked Questions

1. Fund assets carried at fair value should be classified and disclosed in one of three levels (1, 2 or 3) in the fair value hierarchy table. What would be the correct fair value classification for digital assets with a liquid market?

The difference between Level 1 versus Level 2 is that in Level 1 there's an active market for an exact asset. In Level 2 there's an active market with data obtained from external, independent sources. Data could include quoted prices for similar assets and liabilities in active markets, prices for identical or similar assets and liabilities in inactive markets, or models which have observable inputs. Digital assets typically trade on a number of exchanges and OTC desks where, although there is an active market, there are also observable spreads in pricing based on the individual and specific valuation inputs at each counterparty, therefore making digital assets a level 2 classification

2. Are transaction fees considered for fair value measurement of cryptocurrencies or digital assets?

Although transaction fees are capitalized into cost, per current accounting standards, transaction fees are generally not a component of fair value. Therefore, usually, transaction fees are not considered while determining the fair value of cryptocurrencies.

3. When a Fund uses a custodian with access to private keys, are SOC reports needed?

SOC 1 Type 2 and SOC 2 Type 2 reports of the custodian would generally provide evidence of consistent, and more reliable existence of digital transactions/assets when a portion of the processes and controls are performed by a third-party service organization.

4. What are the best practices crypto funds should implement to aid in the audit?

Best practices that aid in the audit include:

- Clear up-to-date information regarding all exchanges and wallets including API keys
- Clear identification of in-kind contributions
- Consistent valuation Policy

If you have any questions about valuation for digital assets or the accounting services Richey May provides to the alternative investments industry, please contact Stephen Vlasak.

ABOUT RICHEY MAY & CO.

As a public accounting firm with hundreds of Alternative Investment clients, and relationships with many of the top service providers and specialists in the country, Richey May has a depth of specialized knowledge that few firms can claim.

Our team combines the dedicated expertise found in a national accounting firm with the hands-on approach to client service you'd expect from a boutique provider – a unique model that allows us to bring expert solutions and strategies to your specific business needs.

National Client Representation

We serve alternative investment clients that range in size from $1M to $4.2B. We work with funds utilizing a wide variety of strategies, including, but not limited to, the following: arbitrage, ABS, catastrophic bonds, convertible arbitrage, cryptocurrency, currency, day trading, derivative funds of funds, distressed debt, emerging markets, energy trading, event driven, fixed income, foreign currency, global macro, funds of funds, high yield, long/short, merger arbitrage, mortgage backed securities, real estate, reinsurance, risk arbitrage, situational and structured finance.

We Work with Several Entity Types

We assist investors in several types of funds with accounting and tax services. Our expert team can assist you at any stage of your business, from new entrants into the market to veteran investors looking for new growth opportunities.

Industry Services

- Audits, reviews, compilations, agreed upon procedures and other assurance services
- Initial fund structuring and consulting
- Federal and state tax returns
- Individual tax returns
- Tax estimate
- Valuation consulting
- Surprise exams
- Fund document reviews
- Performance examinations
- Management company, general partner tax returns
- Offshore Cayman filing requirement (FAR form) assistance

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