Client Alert

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SEC Staff Raises Concerns Related to Cryptocurrency ETFs and Mutual Funds

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On January 18, 2018, the Securities and Exchange Commission's (SEC) Division of Investment Management broke its relative silence regarding the recent growth of cryptocurrencies and cryptocurrency-related products. While signaling that registration of funds intending to invest substantially in cryptocurrency and related products is not on the immediate horizon, the guidance arguably provided the beginnings of a much-needed roadmap for the future development of registered open-ended funds ("mutual funds") and exchange-traded funds (ETFs) linked to cryptocurrencies and related products.

In a letter (the "Staff Letter" and the SEC staff, the "Staff")[1] addressed to the Investment Company Institute (ICI) and the Securities Industry and Financial Markets Association's Asset Management Group (SIFMA), the Director of the SEC's Division of Investment Management, Dalia Blass, said that it would not be appropriate to initiate registration of mutual funds and ETFs intending to hold substantial amounts of cryptocurrencies[2] and related products until there is clarity regarding how such funds could satisfy certain requirements of the Investment Company Act of 1940, as amended, and its related rules (collectively, the "1940 Act"). In the Staff Letter, Director Blass identified several key questions intended to "facilitate the start" of a dialogue between fund sponsors and the SEC Staff, stating, "we invite you and any interested sponsors to engage with us in detail on these [issues]."

Acknowledging the recent growth in the cryptocurrency markets and public interest in cryptocurrency, the Staff Letter recognized that many fund sponsors desire to provide—and many members of the investing public (including retail or "Main Street" investors) would like to participate in—registered funds linked to cryptocurrency. Indeed, with both the Cboe Global Markets and CME Group successfully launching bitcoin futures in December 2017, some had speculated that the next major cryptocurrency-related milestone would be the SEC's approval of the registration of certain funds linked to cryptocurrency and related products.

[1] Staff Letter (Jan. 18, 2018), available at: https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.
[2] A "cryptocurrency" is also commonly referred to as a "virtual currency," a "digital currency," or a "token." In FIN-2013-G001, FinCEN defines "virtual currency" as "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency." In contrast, FinCEN defines "traditional currency" as something that "[i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance." Similarly, in IRS Notice 2013-21, the IRS defines a "virtual currency" as a "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value" that in some environments would function "like 'real' currency … but does not have legal tender status in any jurisdiction." Common examples include Bitcoin, Ether, and Litecoin.

Rather than announcing any such approval, however, the Staff Letter highlighted several key investor protection issues that sponsors will need to address in order to satisfy the requirements of the 1940 Act.[3] The Staff's carefully articulated questions demonstrate that it has given significant thought to the novel challenges, risks, and potential rewards that the introduction of registered cryptocurrency funds and related products may present.

Valuation

By law, mutual funds and ETFs must value their assets on each business day in order to determine a net asset value (NAV). Appropriate valuation of fund assets is critical to calculating fund performance and determining what investors in mutual funds and authorized participants in ETFs pay to purchase fund shares (and what they receive when they redeem their holdings). The Staff Letter questioned whether funds holding substantial amounts of digital assets would have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products in light of "their volatility, the fragmentation and general lack of regulation of underlying cryptocurrency markets, and the nascent state and current trading volume in the cryptocurrency futures markets." In particular, the SEC posed the following questions to fund sponsors:

- How would funds develop and implement policies and procedures to value, and in many cases "fair value," cryptocurrency-related products? How would differences among various types of cryptocurrencies impact funds' valuation and accounting policies?

- How would funds' accounting and valuation policies address the information related to significant events relevant to cryptocurrencies? For example, how would they address when the blockchain for a cryptocurrency diverges into different paths (*i.e.*, a "fork"), which could result in different cryptocurrencies with potentially different prices?

- How would a fund identify, and determine eligibility and acceptability for, newly created cryptocurrencies offered by promoters (*e.g.*, an "air drop")? How might a fund account for those holdings if the fund chooses to claim such cryptocurrencies?

- How would funds consider the impact of market information and any potential manipulation in the underlying cryptocurrency markets on the determination of the settlement price of cryptocurrency futures?

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[3] In addition to the Staff Letter, the SEC and the CFTC enforcement directors issued the following joint statement on January 18, 2018, relating to investor protection:

> When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments.

Available at: https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors.

Liquidity

Mutual funds and certain ETFs are subject to new Rule 22e-4 (the "Liquidity Rule"), which requires funds to classify their investments into one of four liquidity categories, as well as to limit their investments in illiquid securities to a maximum of 15% of the fund's assets. Fund complexes with more than $1 billion in assets under management must come into compliance with the Liquidity Rule by December 31, 2018 and other funds must comply by June 1, 2019. The Staff questioned whether mutual funds and ETFs that propose to invest in a significant amount of cryptocurrencies would be able to maintain adequate liquidity to meet redemption requests and to comply with their obligations under the Liquidity Rule. Under the Liquidity Rule, among other things, a fund's liquidity classifications should be informed by the market depth of its holdings, as well as other relevant market, trading, and investment-specific considerations. The Staff noted that it is not convinced that funds would be able to meet the requirements of the Liquidity Rule, given the "fragmentation and volatility in the cryptocurrency markets" and encouraged fund sponsors to consider the following questions:

- What steps would funds investing in cryptocurrencies or cryptocurrency-related products take to assure that they would have sufficiently liquid assets to meet redemptions daily?

- How would funds classify the liquidity of cryptocurrency and cryptocurrency-related products for purposes of the Liquidity Rule? Would any such products be classified as other than illiquid under the Liquidity Rule, and if so, why? How would funds take into account the trading history, price volatility, and trading volume of cryptocurrency futures contracts, and would funds be able to conduct a meaningful market depth analysis in light of these factors? Would funds need to assume an unusually sizable potential daily redemption amount in light of the potential for steep market declines in the value of underlying assets?

- How would a fund prepare for the possibility that funds investing in cryptocurrency-related futures could grow to represent a substantial portion of the cryptocurrency-related futures markets? How would such a development impact the fund's portfolio management and liquidity analysis?

Custody

Not surprisingly, the Staff also raised concerns about custody. Specifically, how would a fund ensure the safekeeping of holdings in cryptocurrencies? The 1940 Act sets forth standards regarding who may act as a custodian of the assets held by a registered fund, as well as when funds must verify their holdings. Noting that it is unaware of a qualified custodian currently providing fund custodial services for cryptocurrencies, the Staff queried how a fund would satisfy the 1940 Act's custody requirements. The Staff also raised issues about physically settled derivatives related to cryptocurrencies and how a fund that takes delivery of cryptocurrencies in settlement would provide for the custody of the cryptocurrency. Specific issues identified in the Staff Letter that sponsors wishing to register a mutual fund or ETF should consider include:

- To the extent a fund plans to hold cryptocurrency directly, how would it satisfy the custody requirements of the 1940 Act?

- How would a fund intend to validate existence, exclusive ownership, and software functionality of private cryptocurrency keys and other ownership records? To what extent would cybersecurity threats or the potential for hacks on digital wallets impact the safekeeping of fund assets under the 1940 Act?

- To the extent a fund plans to hold cryptocurrency-related derivatives that are physically settled, under what circumstances could the fund have to hold cryptocurrency directly? If the fund may take delivery of cryptocurrencies in settlement, what plans would it have in place to provide for the custody of the cryptocurrency?

Arbitrage (for ETFs)

An ETF must obtain SEC permission (in the form of exemptive orders) to operate in a specialized structure that provides for both exchange trading of the ETF's shares throughout the day at market-based prices, and purchases and redemptions of "creation units" that are transacted at NAV by authorized participants. Additionally, in order to ensure fair treatment of investors, an ETF's market price is not permitted to deviate materially from its NAV. The Staff Letter questioned how ETFs would comply with these requirements, as well as whether ETFs, market makers, and authorized participants had adequately considered the feasibility of arbitrage for ETFs investing substantially in cryptocurrency and cryptocurrency-related products. Questions raised by the Staff include:

- How would volatility-based trading halts on a cryptocurrency futures market impact the arbitrage mechanism?

- How would the shutdown of a cryptocurrency exchange affect the market price or arbitrage mechanism?

Potential Manipulation and Other Risks

Previously, the SEC had raised concerns that cryptocurrency markets, as they currently operate, may provide less investor protection than traditional securities markets, while permitting potentially greater opportunities for fraud and manipulation. Perhaps as a result of this concern, the SEC has thus far denied exchange proposals to list and trade the shares of commodity-trust exchange-traded products that would hold cryptocurrency. For that reason, before submitting a registration statement for a mutual fund or ETF holding substantial amounts of cryptocurrencies, sponsors should address the following questions:

- How have concerns about fraud and manipulation in the market for cryptocurrencies informed a sponsor's responses to questions concerning, for instance, valuation and liquidity?

- Have the concerns about potential fraud and manipulation been adequately considered in light of the wide range of investors, including retail investors, who might invest in the fund? Would investors, including retail investors, have sufficient information to consider any cryptocurrency-related funds and to understand the risks?

- Has the sponsor discussed with any broker-dealers who may distribute the funds how those broker-dealers would analyze the suitability of offering the funds to retail investors in light of these risks? Are there particular challenges investment advisers would face in meeting their fiduciary obligations when investing in cryptocurrency-related funds on behalf of retail investors?

Our Take

While some may perceive the Staff Letter's message (*i.e.*, that registration of cryptocurrency funds and related products will not be approved in the immediate future) as a setback for the nascent cryptocurrency ETF/mutual fund industry, our view is that the Staff Letter provides the blueprint for a path forward to establish legally compliant cryptocurrency ETFs and mutual funds by addressing critical investor protection concerns.

Pending resolution of the issues identified in the Staff Letter, however, the Staff will not consider registration of cryptocurrency funds. In addition, the SEC has also requested that sponsors withdraw all previously filed registration statements for their respective funds. Indeed, during the first two weeks of January, several prospective issuers withdrew their applications in response to an SEC request.[4]

Despite its cautionary tone, the Staff Letter also expressed the Division's continuing commitment to the "flexibility to innovate," which the Staff noted is a key feature of the 1940 Act. By encouraging ICI and SIFMA, along with fund sponsors seeking to offer registered funds holding digital assets, to engage with the Staff to "foster innovation that benefits investors and preserves the important protections that Congress established in the 1940 Act," the Division arguably signaled that the Staff Letter was intended not to mark the end of registered cryptocurrency funds, but to serve as the beginning.

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[4] *See, e.g.,* Frank Chaparro, *ProShares and VanEck are withdrawing their requests for bitcoin ETFs,* Business Insider, Jan. 9, 2018, available at: http://www.businessinsider.com/proshares-and-vaneck-are-withdrawing-their-requests-for-bitcoin-etfs-2018-1.

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