PAUL HASTINGS

STAY CURRENT

January 2018

Follow @Paul_Hastings

SEC's Division of Investment Management Voices Concerns Over Registered Funds Investing in Cryptocurrencies & Cryptocurrency-Related Products

By The Investment Management Practice

Introduction

Over the last few years, various fund sponsors have been contemplating different ways to bring cryptocurrency exchange traded products to the masses. For these fund sponsors it has been an arduous journey, and with the recent pronouncements from the Securities and Exchange Commission's (the "Commission") Division of Investment Management, it appears that this journey is only beginning.

On January 18, 2018, the Division of Investment Management issued a staff letter ("Letter") to two industry groups, the Investment Company Institute (the "ICI") and the Securities Industry and Financial Markets Association (the "SIFMA"), posing questions on and voicing its concerns over registered investment companies that intend to invest in cryptocurrencies and cryptocurrency-related products. In the Letter, the Commission staff (the "Staff") notes that it has been approached by several fund sponsors that have recently taken steps to launch exchange traded funds ("ETFs") registered under the Investment Company Act of 1940, as amended (the "1940 Act") that would invest in financial instruments that provide exposure to movements in the value of bitcoin. However, the Staff has asked that the sponsors withdraw the filed registrations statements.[1] In the Letter, the Staff states that in order to "facilitate the start of [a] dialogue" the Staff has identified a number of "significant" questions that need to be answered prior to their approval of any cryptocurrency registered fund.[2]

Before discussing the questions outlined in the Letter, it is worthwhile to note the following points. First, while the Letter sets out numerous questions for aspiring cryptocurrency fund sponsors, it also appears to make the point that, to date, the Staff has not been convinced by the arguments presented in favor of launching cryptocurrency funds and presumably by the responses it has received to the questions outlined in the Letter. Second, it is not the first time the Commission has made the points outlined in the Letter. For example, Staff concerns regarding the lack of regulation associated with cryptocurrencies, manipulation of cryptocurrencies, lack of liquidity, and custody concerns have all been previously discussed by the Commission.[3] In addition, points made in the Letter with respect to manipulation, appear to echo similar concerns voiced by others.[4] Third, while it appears that registered funds investing in cryptocurrencies are a recent phenomenon,[5] other non-1940 Act registered products[6] have been trying to get Commission approval for some time.[7] The Commission's reluctance to approve these investment products underscores the point that the Commission is struggling to get comfortable with the notion of registered investment fund products providing cryptocurrency exposure to retail investors. Finally, while the Commission appears to have several concerns with registered-cryptocurrency-funds, it has not disapproved of all types of exposure to cryptocurrencies (even though the Commission appears to have had some issues with the names for those funds[8]), nor has it barred other registered funds from gaining some exposure to cryptocurrencies through the sole exchange traded product that has been able to make it to the market.[9]

Questions Raised in the Staff Letter

In the Letter the Staff noted that because cryptocurrencies and cryptocurrency-related products are unlike the types of investments that registered funds currently hold and offer to retail customers, the Staff has certain questions concerning how funds holding substantial amounts of cryptocurrencies and cryptocurrency-related products would satisfy the requirements of the 1940 Act and rules thereunder. The questions are divided into five categories: Valuation, Liquidity, Custody, Arbitrage, and Potential Manipulation and Other Risks.

I. Valuation

Under this section, acknowledging that mutual funds and ETFs must value their assets each business day to determine a net asset value ("NAV"), the Staff presented the following questions:

- Would funds have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products, given 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?
- How would funds develop and implement policies and procedures to value, and in many cases "fair value," cryptocurrency-related products?
- 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"),[10] which could result in different cryptocurrencies with potentially different prices? How and when would funds recognize such information in their NAV?
- What policies would a fund implement to identify, and determine eligibility and acceptability for newly created cryptocurrencies offered by promoters (*e.g.*, an "air drop")?[11] How might a fund account for those holdings if the fund chooses to claim such cryptocurrencies?[12]
- How would differences among various types of cryptocurrencies impact funds' valuation and accounting policies?
- 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?

II. Liquidity[13]

The Staff notes that funds must maintain liquid assets in order to satisfy daily redemptions. Under the new liquidity risk management rule 22e-4,[14] funds will be required to implement a liquidity risk management program. Accordingly, the Staff noted the following:

- 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 new fund liquidity rule, rule 22e-4? For example, would any of these products be classified as other than illiquid under the rule? 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? Similarly, given the fragmentation and volatility in the cryptocurrency markets, 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?

III. Custody

With respect to custody, the Staff notes that the 1940 Act imposes requirements that registered funds maintain their holdings with a qualified custodian. As such, the following questions have been posed by the Staff:

- To the extent a fund plans to hold cryptocurrency directly, how would it satisfy the custody requirements of the 1940 Act and relevant rules? In addition, 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?
- While the currently available bitcoin futures contracts are cash settled, the SEC noted that other derivatives related to cryptocurrencies may provide for physical settlement, and physically settled cryptocurrency futures contracts may be developed. To the extent a fund plans to hold cryptocurrency-related derivatives that are physically settled, under what circumstances could the fund be required 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?

IV. Arbitrage (for ETFs)

Arbitrage—or the practice of taking advantage of a price difference among two or more markets—has been a significant area of concern around the cryptocurrency marketplaces. In this section, the Staff has raised the following questions:

- ETFs obtain Commission orders that enable them to operate in a specialized structure that provides for both exchange trading of their shares throughout the day at market-based prices, and "creation unit" purchases and redemptions transacted at NAV by authorized participants. In order to promote fair treatment of investors, an ETF is required to have a market price that would not deviate materially from the ETF's NAV. In light of the fragmentation, volatility and trading volume of the cryptocurrency marketplace, how would ETFs comply with this term of their orders?

- Have funds engaged with market makers and authorized participants to understand the feasibility of the arbitrage for ETFs investing substantially in cryptocurrency and cryptocurrency-related products? How would volatility-based trading halts on a cryptocurrency futures market impact this arbitrage mechanism? How would the shutdown of a cryptocurrency exchange affect the market price or arbitrage mechanism?

V. Potential Manipulation and Other Risks

Finally, due to investor protection being a major concern, the following questions have been raised:

- How have recent concerns about fraud or manipulation[15] in the cryptocurrency market informed a fund sponsor's responses to the foregoing questions concerning, for instance, valuation and liquidity?

- How would a fund sponsor weigh these concerns in considering whether offering a proposed fund is appropriate for 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?

- Have fund sponsors discussed with any broker-dealers who may distribute the funds how they would analyze the suitability of offering the funds to retail investors in light of the risks discussed above?[16] Are there particular challenges investment advisers would face in meeting their fiduciary obligations when investing in cryptocurrency-related funds on behalf of retail investors?

Furthermore the Staff noted that this Letter is only meant to address exchange traded funds registered under the 1940 Act and that there may be similar offerings registered under the Securities Act of 1933, as amended (the "1933 Act"). However, the Staff noted that those offerings would have to comply with the registration and prospectus disclosure requirements of the 1933 Act and this Letter does not appear to cover such products.

Finally, the Staff noted that it is not appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrencies and cryptocurrency-related products. In addition, the Staff believes that such funds should not utilize Rule 485(a) under the 1933 Act, which allows post-effective amendments to previously effective registration statements for registration of a new series to go effective automatically. And that if a fund sponsor were to file a post-effective amendment under rule 485(a) to register a fund that invests substantially in cryptocurrency or related products, the Commission would view that action unfavorably and would consider actions necessary or appropriate to protect investors, including recommending a stop order to the Commission.

A copy of the Letter can be found here.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Yousuf I. Dhamee
1.213.683.6179
yousufdhamee@paulhastings.com

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

New York

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Vadim Avdeychik
1.212.318.6054
vadimavdeychik@paulhastings.com

Jacqueline A. May
1.212.318.6282
jacquelinemay@paulhastings.com

Gary D. Rawitz
1.212.318.6877
garyrawitz@paulhastings.com

Bill Belitsky
1.212.318.6097
billbelitsky@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com

Washington, D.C.

Wendell M. Faria
1.202.551.1758
wendellfaria@paulhastings.com

Tram N. Nguyen
1.212.318.6848
tramnguyen@paulhastings.com

[1] *See* UPDATE: The prospects for a bitcoin ETF look dead in the water (Jan. 11, 2018), available at https://www.morningstar.com/news/market-watch/TDJNMW_20180111602/update-the-prospects-for-abitcoin-etf-look-dead-in-the-water.html.

[2] The SEC has noted that the cryptocurrency market is consistently developing and as a result, it may have additional questions in the future.

[3] *See* Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust (Mar. 10, 2017), available at https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1, Relating to the Listing and Trading of Shares of the SolidX Bitcoin Trust under NYSE Arca Equities Rule 8.201 (Mar. 28, 2017), available at https://www.sec.gov/rules/sro/nysearca/2017/34-80319.pdf. *See also* Speech by Chairman Jay Clayton, Governance and Transparency at the Commission and in Our Markets (Nov. 8, 2017), available at https://www.sec.gov/news/speech/speechclayton-2017-11-08. *See also* Investor Alert: Public Companies Making ICO-Related Claims (Aug. 28, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_icorelatedclaims.

[4] Gandal, Neil; Hamrick, JT; Moore, Tyler; Oberman, Tali. Price Manipulation in the Bitcoin Ecosystem (2017), available at http://weis2017.econinfosec.org/wp-content/uploads/sites/3/2017/05/WEIS_2017_paper_21.pdf.

[5] *See e.g.,* Direxion Bitcoin ETF, ProShares Trust, and VanEck Vectors ETF Trust. *See also supra* note 1.

[6] The Staff Letter does not address the question of whether cryptocurrencies or cryptocurrency-related products are securities or whether investment in such by a fund impacts qualification as an "Investment Company" as defined under Section 3(a) of the 1940 Act.

[7] *See* Winklevoss Bitcoin Trust and SolidX Bitcoin Trust supra note 3.

[8] *See* 2 blockchain ETFs are launching—but the SEC asked them to take blockchain out of their names (Jan 17, 2018), available at http://www.businessinsider.com/two-blockchain-etfs-are-launching-but-blockchain-wont-be-in-their-names-2018-1.

[9] *See e.g.*, Bitcoin Investment Trust (GBTC), https://finance.yahoo.com/quote/GBTC/; A Bitcoin Boost for ARK ETF (Oct. 18, 2017), available at http://www.nasdaq.com/article/a-bitcoin-boost-for-ark-etf-cm861455.

[10] *See e.g.*, Latest Bitcoin 'Hard Fork' Causing Concern in Cryptocurrency Community (Dec. 29, 2017), available at https://www.thestreet.com/story/14431175/1/crypto-community-segwit2x-hard-fork.html. *See also* Bitcoin Cash Developers Propose Date for November Hard Fork (Oct. 31, 2017), available at https://www.coindesk.com/bitcoin-cash-developers-set-date-november-hard-fork/.

[11] "Air drop" for a cryptocurrency is a procedure of distributing tokens by awarding them to existing holders of a particular blockchain currency.

[12] In the United States, this practice of air dropping has raised questions about tax liabilities and whether they amount to capital gains.

[13] It appears that other applicants have also been unsuccessful in addressing liquidity concerns. *See e.g.*, SEC Release No. 34-82429, at 19 and 23 (where the applicant represented that the fund would limit its investment to no more than 15% in illiquid assets. Furthermore, applicants argued that they "expect" liquidity to exist in the market for listed bitcoin derivatives. However, the support for this argument does not appear to be self-evident to the Staff.)

[14] For more information about the liquidity risk management rule please see our previous release here or reach out to one of the attorneys listed above. *See also* Investment Company Liquidity Risk Management Programs, Inv. Co. Act Rel. No. 32315 (Oct. 13, 2016), available at https://www.sec.gov/rules/final/2016/33-10233.pdf.

[15] *See supra* note 3.

[16] In addition to the SEC, FINRA is also looking into initial coin offerings (ICOs) and cryptocurrency-related developments. *See* FINRA's 2018 Regulatory and Examination Priorities Letter (Jan. 8, 2018), available at http://www.finra.org/industry/2018-regulatory-and-examination-priorities-letter.