

SEC Sidelines Funds Focused on Cryptocurrencies

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In a January 18 letter to two of the fund industry's leading advocacy groups, the staff of the SEC's Division of Investment Management advised fund sponsors not to initiate registration of funds that intend to invest substantially in cryptocurrency and related products until the staff's questions, which the letter identified, are satisfactorily addressed. This applies to funds that are publicly offered as well as to registered funds that support variable insurance products. The letter identifies a host of "outstanding questions" regarding certain core requirements under Investment Company Act of 1940 (1940 Act) governing valuation, liquidity, and custody of fund assets. For example, the letter questions how funds can:

- value or "fair value" cryptocurrency products,
- assess and manage the liquidity of such products, and
- satisfy the applicable standards for safeguarding fund assets if they hold such products directly.

"In light of the fragmentation, volatility and trading volume of the cryptocurrency marketplace," the letter also questions, for ETFs, the efficacy of the arbitrage mechanism such funds rely on to ensure that their market price does not materially deviate from the fund's net asset value. The letter also highlights general concerns over the greater opportunities for fraud and manipulation within the cryptocurrency markets and asks how such concerns would factor into the sponsor's consideration of such matters as the fund's compliance with the requirements of the 1940 Act, as noted above, and whether a proposed fund is appropriate for retail investors. Finally, the letter queries whether sponsors understand how broker-dealers and investment advisers would discharge their suitability and fiduciary obligations when recommending or investing on behalf of retail investors in cryptocurrency-related funds.

According to the letter, due to the myriad questions and concerns, the staff has asked sponsors that have registration statements filed for cryptocurrency-related funds to withdraw them. The letter also advises that such funds should not use Rule 485(a), which allows post-effective amendments to previously-effective registration statements for a new series to go effective automatically. It is safe to say that sponsors aiming to launch a cryptocurrency-related fund have their work cut out for them as far as the SEC staff is concerned.