U.S. Securities and Exchange Commission

Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings

January 18, 2018

Paul Schott Stevens
President & CEO
Investment Company Institute
1401 H St., NW, Suite 1200
Washington, DC 20005

Timothy W. Cameron
Asset Management Group – Head
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1101 New York Avenue, NW, 8th Floor
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Re: Engaging on Fund Innovation and Cryptocurrency-related Holdings

Dear [Mr. Stevens/Mr. Cameron]:

As you know, the U.S. investment fund market is one of the most robust, varied and successful markets for investment products in the world. Its success can be attributed, in significant part, to the commitment of fund sponsors to responsible innovation and continuous improvement of the products they offer. This commitment is especially important because many of America's Main Street investors rely on registered funds to help them build toward education, retirement and other important goals.

Flexibility to innovate is also a key feature of the Investment Company Act of 1940. As the Division with primary responsibility for regulatory policy regarding registered funds, we seek to foster innovation that benefits investors and preserves the important protections that Congress established in the 1940 Act. Over the years, dialogue between fund sponsors and the Division has facilitated the development of many new types of investment products that have expanded choice for investors. Exchange-traded funds and money market funds are notable examples.

Recently, the growth in cryptocurrencies and cryptocurrency-related products has attracted significant attention, and we have seen interest among sponsors in offering registered funds that would hold these new digital products. As we have in the past, the Division stands ready to engage in dialogue with sponsors regarding the potential development of these funds. We believe, however, that there are a number of significant investor protection issues that need to be examined before sponsors begin offering these funds to retail investors.

We appreciate that proponents of cryptocurrencies and related products have identified a range of potential benefits. We are also aware that critics of cryptocurrencies have raised various concerns regarding transparency of information, trading, valuation and other matters related to the nature of the underlying assets. In addition, the innovative nature of cryptocurrencies and related products, as well as their expected use and utility in our financial markets, means that they are, in many ways, unlike the types of investments that registered funds currently hold in substantial amounts. In light of these considerations, we have, at this time, significant outstanding questions concerning how funds holding substantial amounts of cryptocurrencies and related products would satisfy the requirements of the 1940 Act and its rules. To facilitate the start of our dialogue, we have identified below a number of these questions, and we invite you and any interested sponsors to engage with us in detail on these. While we have identified the questions below, we note that the cryptocurrency markets are

developing swiftly. Additional questions may arise from these developments.[1]

Valuation

Mutual funds and ETFs must value their assets on each business day in order to strike a net asset value ("NAV"). Appropriate valuation is important because, among other things, it determines fund performance, what investors pay for mutual funds and what authorized participants pay for ETFs (and what they receive when they redeem or sell). 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"), 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")? How might a fund account for those holdings if the fund chooses to claim such cryptocurrencies?

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?[2]

Liquidity

A key feature of open-end funds, such as mutual funds and ETFs, is daily redeemability. Funds must maintain sufficiently liquid assets in order to provide daily redemptions. Under the new fund liquidity rule, rule 22e-4, funds will be required to implement a liquidity risk management program.[3] Under the rule, among other things, funds must classify their investments into one of four liquidity categories and limit their investments in illiquid securities to 15% of the fund's assets.[4] A fund's liquidity classifications should be informed by the market depth of its holdings (that is, whether trading varying portions of a position in a particular portfolio asset is reasonably expected to affect the liquidity characteristics of that investment) as well as other relevant market, trading and investment-specific considerations.

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?

Custody

The 1940 Act imposes safeguards to ensure that registered funds maintain custody of their holdings. These safeguards include standards regarding who may act as a custodian and when funds must verify their holdings. To the extent a fund plans to hold cryptocurrency directly, how would it satisfy the custody requirements of the 1940 Act and relevant rules? We note, for example, that we are not aware of a custodian currently providing fund custodial services for cryptocurrencies. 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, we understand 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 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)

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?[5]

Potential Manipulation and Other Risks

In a recently issued statement, Chairman Jay Clayton noted that concerns have been raised that cryptocurrency markets, as they are currently operating, feature substantially less investor protection than traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.[6] The Commission has also discussed concerns relating to the risk of fraud and manipulation in cryptocurrency markets in orders denying exchange proposals to list the shares of commodity trusts that would hold cryptocurrency.[7] In addition, a number of recent media reports have highlighted a range of possible vectors for potential manipulation of cryptocurrency markets. Although some funds may propose to hold cryptocurrency-related products, rather than cryptocurrencies, the pricing, volatility and resiliency of these derivative markets generally would be expected to be strongly influenced by the underlying markets.

How have these concerns informed your responses to the foregoing questions concerning, for instance, valuation and liquidity?

How would you 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 you 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? Are there particular challenges investment advisers would face in meeting their fiduciary obligations when investing in cryptocurrency-related funds on behalf of retail investors?

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The resolution of many of the questions we have raised in the context of a product seeking to register under the 1940 Act will also be important to the ongoing analysis of filings for exchange-traded products and related changes to exchange listing standards by the Division of Corporation Finance, the Division of Trading and Markets and the Office of the Chief Accountant. In addition, questions concerning what regulatory structure or structures apply to the market for the underlying instrument will be relevant to the requirements of both the 1940 Act and the Securities Exchange Act of 1934, including applicable accounting, audit and reporting implications. We have been and will continue working closely with the other Divisions and Offices as we analyze these significant issues.

The preceding questions have focused on specific requirements of the 1940 Act and its implications for registered offerings of funds intending to hold cryptocurrency or related products. There may be registered offerings under the Securities Act of 1933 by entities holding similar products and pursuing similar investment strategies. Those entities would have to comply with the registration and prospectus disclosure requirements of the Securities Act.

Until the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and we have asked sponsors that have registration statements filed for such products to withdraw them. In addition, we do not believe that such funds should utilize rule 485(a) under the Securities Act, which allows post-effective amendments to previously effective registration statements for registration of a new series to go effective automatically. If a sponsor were to file a post-effective amendment under rule 485(a) to register a fund that invests substantially in cryptocurrency or related products, we would view that action unfavorably and would consider actions necessary or appropriate to protect Main Street investors, including recommending a stop order to the Commission.

I appreciate your assistance in sharing our views on this subject with your members. We look forward to engaging with you and your members on these important questions, and we invite you to contact Barry Miller at (202) 551-6725.

Sincerely,

Dalia Blass
Director
Division of Investment Management
U.S. Securities and Exchange Commission

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[1] This letter addresses issues arising from funds potentially focused on cryptocurrency-related products. We note, however, that other types of digital assets and related products could present similar issues.

[2] See, e.g., http://www.businessinsider.com/ico-cryptocurrency-pump-and-dump-telegram-2017-11; http://fortune.com/2017/12/10/bitcoin-whales-market-manipulation/.

[3] See 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.

[4] The 15% illiquidity standard is consistent with past Commission statements regarding funds' liquidity standards. However, the Commission's new rule strengthened the compliance controls under the standard, including requiring reporting to a fund's board and to the Commission regarding breaches of the 15% illiquid limit. Most funds would be required

to comply with the new rule's liquidity risk management program requirements on Dec. 1, 2018, while fund complexes with less than a $1 billion in net assets would be required to do so on June 1, 2019.

[5] See, e.g., https://www.bloomberg.com/news/articles/2018-01-12/crypto-exchange-kraken-goes-dark-and-user-anxiety-surges.

[6] SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[7] See, e.g., Securities and Exchange Commission, Order Disapproving a Proposed Rule Change (Mar. 28, 2017), available at https://www.sec.gov/rules/sro/nysearca/2017/34-80319.pdf.

http://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm

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