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SEC's New Message to the Cryptocurrency Market: Take the Lead, but Proceed with Caution

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As we have been reporting, cryptocurrency, as an asset class, is currently taking the world financial markets by storm. Total market capitalization of cryptocurrency is estimated to be in the hundreds of billions of dollars and new initial coin offerings (ICOs) seem to crop up every other day, while the United States and other country governments have been left scrambling to figure out how to best regulate this new asset class and protect market participants and end users.

The US Securities and Exchange Commission (SEC) has been a leader in taking affirmative steps toward exercising some oversight of the fragmented cryptocurrency market. On January 18, the SEC's Division of Investment Management published a staff letter detailing some of the Commission's concerns about how cryptocurrency-related products will comply with the Investment Company Act of 1940, including specific issues relating to valuation, liquidity, custody, arbitrage, and potential manipulation.

The Commission's letter demonstrates the cautionary manner in which it views the emerging cryptocurrency market. While the SEC seeks to engage with investors in this new technology product, it is just beginning to understand this new asset class and to highlight its specific concerns. To date, the Commission has been in a reactionary mode, choosing to intervene in the market only where it feels it's necessary to prevent potential fraud and/or abuse. At this time, the Commission seems to prefer engaging market participants and gatekeepers to develop new standards around the crypto asset class, instead of promulgating new regulations.

The staff letter notes that cryptocurrency's lack of regulation and its fragmentation and volatility distinguish it from traditional securities products. The letter addresses the valuation of cryptocurrency-related products, specifically mutual funds and exchange-traded funds (ETFs), and inquires as to how these products would be valued, given the numerous different types of cryptocurrency that are emerging and the various related issues that could arise when holding such cryptocurrencies (e.g., what happens “when the blockchain for a cryptocurrency diverges into different paths (i.e., a ‘fork’)”). The Commission also raised concerns about liquidity and daily redeemability, inquiring as to how advisers would ensure that mutual funds and ETFs have sufficient liquidity to meet daily redemption requirements. Additionally, the Commission raised concerns about how an investment fund would comply with the custody requirements under the 1940 Act if it were to hold cryptocurrency directly.

The staff letter also raised issues relating to the possibility of arbitrage opportunities within the cryptocurrency asset class for ETFs and expressed concern that ETFs would not be able to comply with the terms of their orders while pursuing such strategies (ETFs obtain orders from the Commission that allow them to operate).

Finally, the Commission reiterated its prior statements regarding potential manipulation in the market, and inquired as to how these concerns inform responses from market participants with respect to issues like valuation, liquidity, and suitability.

Takeaways

By raising a series of specific concerns instead of directly regulating the cryptocurrency market, the Commission has put the onus on market participants to flesh out issues relating to the cryptocurrency asset class as a means of developing standards and creating policies and procedures around this new asset class. This cautionary approach has been separately reinforced by SEC Chairman Jay Clayton, who has stated that it is incumbent upon market professionals (securities lawyers, accountants, etc.) to act as “gatekeepers” and provide sound advice and expertise for those investing in cryptocurrency. We are continuing to monitor this space and will report on new developments as they occur.

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