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asset management group

May 14, 2018

Ms. Dalia Blass
Director
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Fund Innovation and Cryptocurrency-Related Holdings

Dear Ms. Blass:

I am writing on behalf of the Asset Management Group ("AMG")[1] of the Securities Industry and Financial Markets Association in response to your letter of January 18, 2018.[2] Your letter expressed the desire of the Division of Investment Management (the "Division") of the U.S. Securities and Exchange Commission (the "SEC") to begin a dialogue regarding the development of registered funds designed to invest substantially in cryptocurrencies and related assets. Like others in the financial services industry, many AMG members believe that over time blockchain-enabled technology could have a transformative effect in the provision of certain financial services, and many are interested in exploring the potential of this technology. Certain AMG members also have experience trading in cryptocurrency assets on a limited basis and are considering the implications of making investments for institutional clients through separate account mandates or institutionally-oriented private funds.

Our membership recognizes the desire of certain registered investment fund sponsors to incorporate blockchain-related digital assets into their portfolios, potentially including certain cryptocurrency assets. Our membership also acknowledges the Division's prudential concerns about investor protection and the concerns recently expressed by the SEC Divisions of Enforcement and Trading and Markets regarding cryptocurrency exchanges.[3] As a threshold matter, AMG perceives that many of the questions posed in your letter touch upon the viability of cryptocurrency trading venues as reliable price discovery mechanisms. Although many venues can have the "look and feel" of conventional stock exchanges, they may be opaque in

[1] SIFMA's Asset Management Group (SIFMA AMG) brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.
[2] *See Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings* (January 18, 2018), *available at* https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.
[3] *See Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (March 7, 2018), *available at* https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

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functionality, underlying technology, operations and compliance with applicable laws. Particular concerns have been identified as to regular trading hours, circuit-breaker protections to curb panic-selling and excessive volatility and lack of counterparty risk mechanisms via a central clearing house. Such opacity and other issues also undermine some venues' ability to serve as reliable price discovery mechanisms and present a challenge to registered products trading substantially in cryptocurrencies.[4]

AMG believes that, as the regulatory framework continues to evolve, with regulatory guidance that is appropriately tailored to cryptocurrencies and cryptocurrency exchanges, United States-based funds comprised substantially of cryptocurrency assets may in the future offer investors opportunities that are not currently available within regulated structures. AMG looks forward to facilitating a collaborative dialogue with you and your colleagues within the Division. To that end, in response to your letter, we have included some preliminary observations based on a series of consultations with our membership over the last several weeks.

I. Valuation of Cryptocurrency Assets

As you noted in your letter, cryptocurrency markets have been characterized by volatility, market fragmentation and an absence of comprehensive regulation. These factors present challenges to fund sponsors seeking to offer access to cryptocurrency holdings through open-end mutual funds and other funds registered under the Investment Company Act of 1940 (the "1940 Act") that must reliably establish a net asset value ("NAV") on a daily basis.[5]

We note that these challenges are not unique to daily-valued funds such as mutual funds and ETFs but also apply to any collective investment vehicle that depends on accurate pricing sources for harder-to-value assets included in NAV calculations at times when shareholder investments and redemptions are being processed (whether daily, weekly, monthly or otherwise). In this respect, AMG members have seen volatility and market fragmentation impact other types of assets in which funds invest and believe these factors can be taken into account in pricing and fair valuation decisions (*e.g.*, as is the case with certain non-U.S. small capitalization equity securities).[6]

In consultation with AMG's membership, we have learned that some leading asset management organizations and service providers involved in administration, custody and accounting for private and registered funds are actively developing principles to apply to the

[4] In discussing cryptocurrency asset and trading venues, we are excluding derivatives exchanges and clearinghouses, and other derivatives markets regulated by the Commodity Futures Trading Commission in the U.S. and by other regulators abroad. The perspectives expressed in this letter do not address, for example, futures contracts referencing cryptocurrencies that are listed on futures exchanges. To the extent the Division would like feedback on the use by registered funds of derivatives that reference cryptocurrency, we can respond by a follow-up submission.

[5] Some AMG members see volatility and market fragmentation as less problematic to the launch of regulated investment funds than the unregulated activity and opacity of cryptocurrency exchanges, including in some cases risks associated with proprietary trading by exchange affiliates. We believe that current regulatory inquiries into these matters will foster a better understanding of the operations, infrastructure and compliance environment of the various exchanges that host trading in cryptocurrency assets.

[6] We note that while firms active in direct proprietary trading on cryptocurrency exchanges have developed sophisticated valuation practices for their direct investments in Bitcoin and other cryptocurrency assets, the level of precision acceptable for proprietary trading is lower than what would be anticipated for funds registered under the 1940 Act.

valuation of cryptocurrency assets. We understand a range of valuation ideas have been identified, including for example: (i) systems designed to generate indices of prices across multiple exchanges, including tolerances and limits for pricing variations between exchanges where pricing data is sourced; (ii) mechanisms to manage extreme movements in pricing data caused when cryptocurrency exchanges may stop trading in certain assets from time to time; (iii) in some cases, the use of weighted average prices that seek consistency in process and fair valuations over time, including in volatile conditions; (iv) fair valuation techniques that may take into account the risks of price manipulation and the absence of regulation in certain sectors; and (v) the need for clear disclosure to investors that addresses the principles and methods employed in establishing valuation protocols for cryptocurrency holdings. We believe it will be valuable for the staff of the Division to join with us and with other investment industry groups in discussing these matters further.

II. Liquidity Considerations

Your letter notes that daily redemption is a key feature of mutual funds and exchange-traded funds ("ETFs") and that under the SEC's new liquidity rule, Rule 22e-4, funds will be required to adopt liquidity risk management programs. You have asked how funds would classify the liquidity of cryptocurrency and cryptocurrency-related products for purposes of the liquidity "bucketing" requirements under Rule 22e-4, and how funds that invest in these assets would ensure sufficient liquidity to meet daily redemption requests in compliance with the rule.[7] In this regard, we note that that amendments have been proposed to certain elements of the rule and that the Division's staff has also acknowledged the expected diversity in and evolution of liquidity risk management practices under Rule 22e-4 as these are appropriately tailored by funds and the managers of their liquidity risk management programs over time.

In considering these issues, some AMG members have pointed to the dramatic increase in the volume of transactions in Bitcoin, Ether and certain other leading cryptocurrencies since the middle of 2017, noting that these transaction volumes can significantly exceed those for certain other investments held by registered funds. One could even argue that there may already be sufficient overall liquidity in certain cryptocurrency assets such that holding a position in such assets would not in itself compel a fund to assume larger potential daily redemptions in calibrating its liquidity program.[8] Over time, liquidity could also be enhanced by other factors, such as the establishment of trading venues with characteristics similar to 'dark pools' facilitating larger transactions in a manner intended to reduce price action and mitigate the potential for manipulative practices. We believe that all of these aspects require examination and AMG's membership looks forward to facilitating a productive and continuing dialogue with the Division.

[7] ETFs that qualify as "In-Kind ETFs" are exempt from the "bucketing" requirement.

[8] AMG's members also recognize, however, that liquidity determinations may take into account not just measures of market volume or depth but also market breadth, such as variation in the types of retail and institutional investors active in a market and their investment approaches. More limited market breadth may undermine liquidity in stressed conditions.

III. Custody

Your letter includes important questions as to the specific custody requirements of the 1940 Act and its rules that would need to be addressed if registered funds were to hold cryptocurrencies directly. AMG and its membership share a strong interest in supporting reasonable safeguards to protect fund investors, including shareholders of registered funds in particular, and expect that blockchain technology will continue to be enhanced both in relation to cryptocurrencies and in other distributed ledger applications. As many cryptocurrencies were designed to be pseudonymous and freely transferable on a peer-to-peer basis without the intervention or oversight of trusted market intermediaries, such assets are inherently susceptible to cybersecurity risks. In this respect, we have discussed recent developments in verification of ownership and approaches to operational security around private cryptographic keys used by institutional investors holding cryptocurrency investments (*e.g.*, cold storage with multi-signature and other protocols) and have also identified AMG members who are in dialogue with providers of custody services regarding their initiatives to satisfy both regulatory requirements and cybersecurity considerations. AMG believes that such efforts may in part reduce the cybersecurity risks associated with cryptocurrencies.

We look forward to working with the Division and other regulators in your ongoing efforts to clarify compliance requirements with rules and regulations related to, among other things, custody and cybersecurity requirements, in light of rapidly developing technology. Our membership also remains interested in further guidance from the SEC as to when a particular cryptocurrency or digital token is a security or other type of asset, permitting them to reliably determine the applicability of custody requirements and to assess the compliance of cryptocurrency exchanges. [9]

IV. Arbitrage (for ETFs)

Like the Division itself, AMG members support the innovation and flexibility in the application of regulatory rules that permits registered ETF structures, and generally consider the overall structure of the market forces that determine arbitrage activity in ETFs to be very robust. Accordingly, we appreciate the Division staff's emphasis on the importance of an efficient arbitrage mechanism to ensure that ETF trading prices do not materially deviate from NAV. Indeed, on the one hand, ETFs that elect to invest exclusively in futures products based on Bitcoin are arguably similar in structure to other futures-based ETFs whose underlying asset is a commodity. On the other hand, we recognize the Division's interest in exploring the challenges of fragmentation, volatility and trading in the underlying cryptocurrency marketplace and the

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[9] If an exchange hosts trading in cryptocurrency or digital token assets that are securities, the exchange would need to register under Section 6 of the Securities Exchange Act of 1934 or file an application under Regulation ATS. On this point, AMG notes the Statement on Potentially Unlawful Online Platforms for Trading Digital Assets by the SEC's Divisions of Enforcement and Trading and Markets (March 7, 2018) (available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading). We have also noted the Feb. 13, 2018 letter from the Assistant Secretary for Legislative Affairs at the Financial Crime Enforcement Network ("FinCEN") to U.S. Senator Ron Wyden, stating FinCEN's position that "virtual currency exchangers and administrators are money transmitters and must comply with the [Bank Secrecy Act] and its implementing regulations." (available at https://coincenter.org/files/2018-03/fincen-ico-letter-march-2018-coin-center.pdf).

stresses that such challenges could potentially impose on ETF arbitrage infrastructure. AMG would be pleased to facilitate further discussion of this issue with you.

V. Potential for Market Manipulation and Other Considerations

As we have noted above, AMG shares the Division's broad-based concern for the potential for fraud and manipulation in cryptocurrencies. AMG is diligently following developments in this area, and looks forward to the opportunity to cooperate with the SEC and other federal agencies in evaluating appropriate frameworks for regulation.

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On behalf of SIFMA AMG and its membership, we trust that the Division finds our observations helpful and constructive. We look forward to a continuing engagement with you in these matters.

Yours very truly,

Timothy W. Cameron
Managing Director

cc: Jay Clayton, Chairman
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner
Robert J. Jackson, Jr., Commissioner
Hester M. Peirce, Commissioner
William Hinman, Director (Corp Fin)
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