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SEC Requests Comments On Bitcoin-Related ETF Rules

By *Diana E. McCarthy and Kellilyn Greco*

The Securities and Exchange Commission (SEC) recently called for public comment on two proposed rule changes to the Chicago Board Options Exchange that would allow the exchange to list the first Bitcoin-related exchange-traded funds (ETFs). The SEC shortly thereafter disclosed its plans to hire a technology company to assist the SEC staff with investigations that involve tracing cryptocurrency transactions, and to aid the staff with its continued activities related to the Cryptocurrency Tracing Project. This alert outlines recent developments relating to cryptocurrency in the fund industry and describes the SEC’s proposed engagement of the aforementioned cryptocurrency contractor.

Recent Cryptocurrency Developments in the Fund Industry

As of the date of this publication, no initial coin offerings have been registered with the SEC, and the SEC has not yet approved any exchange-traded products holding cryptocurrencies. However, ETF sponsors have filed registration statements for ETFs that would hold Bitcoin or obtain exposure to Bitcoin through futures contracts. Dalia Blass, director of the SEC’s Division of Investment Management, released a letter in January 2018 relating to fund innovation in the cryptocurrency space and cryptocurrency-related holdings. The letter acknowledged the SEC’s willingness to engage in dialogue with sponsors regarding the development of cryptocurrency funds but noted that there are a number of investor protection issues that will need to be examined before such funds may be offered to retail investors, including issues relating to valuation, custody, liquidity, potential manipulation and arbitrage for ETFs. The letter put the potential launch of such bitcoin funds on hold temporarily; as Ms. Blass noted, the staff “[does] 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 asked any sponsor with registration statements filed for such products to withdraw them. The letter also stated that the staff does not believe that such funds should utilize Rule 485(a) under the Securities Act of 1933, which allows a post-effective amendment to a previously effective registration statement for the registration of a new series to go effective automatically, which the staff would view “unfavorably” according to the letter.

The SEC has not yet, however, tabled all discussion around the topic of cryptocurrency funds, as it has now

put out a call for public comment on two proposed rule changes to the Chicago Board Options Exchange that would allow the exchange to list the first Bitcoin-related ETFs. The Bitcoin ETFs intend to invest substantially all of their assets in Bitcoin futures contracts and would also be able to invest in listed options on Bitcoin futures contracts and over-the-counter swap agreements referencing Bitcoin futures contracts. The SEC has thus far received one comment letter on the proposed rule changes, which expressed concerns that the funds’ attempts to replicate the bitcoin futures markets, which are related to underlying cryptocurrencies trading on unregulated exchanges, could lead to losses for retail investors.

Coinbase, a cryptocurrency firm, is also allegedly discussing the possible registration of its business as a licensed broker and trading venue with the SEC, which could allow the company to add to the four coins that it currently lists, including Bitcoin, Bitcoin Cash, Litecoin and Ethereum. If Coinbase becomes licensed with the SEC, it could encourage similar trading platforms to follow suit.

SEC’s Proposed Engagement of Cryptocurrency Tracing Firm

The SEC has also disclosed its intent to award a purchase order to CipherTrace Inc. (“CipherTrace”) for CipherTrace Software Support Services (the “CipherTrace Software”). According to the CipherTrace website, it is a “provider of security, compliance and enforcement solutions that make cryptocurrencies, crypto-tokens and private enterprise blockchains safe and secure” and was designed to “develop cryptocurrency and blockchain tracing and security capabilities.” According to the notification, CipherTrace will be hired to, among other functions, trace individual addresses, wallets and contracts provided by SEC staff and assist the SEC with performing cryptocurrency tracing and analysis. The deal may last up to nine months and will augment the SEC’s ability to monitor cryptocurrency markets.

Practice Points and Tips

Although the SEC’s approval of cryptocurrency ETFs and mutual funds appears to be on hold, the aforementioned developments may show that the SEC is seriously considering the underlying issues surrounding cryptocurrency funds. The staff has shown that it is willing to engage in dialogue with fund sponsors who are seeking to launch cryptocurrency funds and made

clear that it does not intend to cease consideration of such funds, but rather is looking for ways to protect investors before allowing fund sponsors to launch them. Fund sponsors that are interested in pursuing cryptocurrency products should stay apprised of any further developments on these issues by the SEC. For more information on these and related issues, see our prior alert, [Recent Developments in Cryptocurrencies and Blockchain Technology in the Fund Industry](#).

Developments in securities laws related to cryptocurrencies and in the fund industry's use of blockchain technology are occurring rapidly and the information in this alert is only accurate as of the date of publication.

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