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Rules and Regulations

SEC Releases FAQs on Liquidity Risk Management Reforms

In January 2018, the Division of Investment Management of the SEC released responses to certain frequently asked questions (the "**FAQs**") relating to the liquidity risk management program ("**LRMP**") requirements adopted in October 2016 under Rule 22e-4 ("**Rule 22e-4**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). For a detailed discussion of the LRMP requirements, please see the **October 31, 2016 Davis Polk Investment Management Regulatory Update**.

The FAQs provide guidance on several topics relating to sub-advised funds and exchange-traded funds ("**ETFs**") and their compliance with Rule 22e-4, including:

Sub-Advised Funds

- Rule 22e-4, according to the FAQs, requires a fund to adopt and implement a written LRMP, with a board-approved person designated to administer the program (the "**PA**"). According to the FAQs, a fund's sub-adviser may be designated as a fund's PA, and a PA may delegate specific responsibilities to a fund's sub-adviser. According to the FAQs, neither Rule 22e-4 nor its adopting release prescribe whether or how a PA may delegate LRMP responsibilities, but since the fund retains ultimate responsibility for complying with Rule 22e-4, and the PA is responsible for administering the fund's LRMP, a fund may consider implementing policies and procedures to address the scope of, conditions on and oversight of permitted delegation by a PA.

- According to the FAQs, a fund's adviser, including a sub-adviser, does not have an independent obligation to adopt and implement an LRMP, as Rule 22e-4 requires funds, not advisers, to adopt such programs. Nonetheless, Rule 22e-4, according to the FAQs, clearly contemplates a role for advisers and their personnel with respect to a fund's LRMP, such as, as discussed immediately above, administering specific responsibilities delegated by the PA.
- According to the FAQs, advisers, including sub-advisers, may have responsibilities under several LRMPs across multiple funds, including funds within the same fund complex, which may differ from one and another, and such advisers and sub-advisers need not reconcile the methodologies, assumptions, practices or outputs of those LRMPs, since advisers and sub-advisers often provide advisory services to multiple funds and assess, manage and review liquidity risk using different practices. In addition, according to the FAQs, funds, including funds within the same complex, may use different methodologies and assumptions with respect to the market, trading, and characteristics of a specific investment, as well as market depth and reasonably anticipated trade size, which may result in different liquidity classifications for the same investment.
- According to the FAQs, a fund's board-approved LRMP controls how an adviser or sub-adviser executes its responsibilities under Rule 22e-4, even if such adviser or sub-adviser has responsibilities under multiple LRMPs, either as PA or under specific delegated authority.
- According to the FAQs, if both an adviser and sub-adviser have responsibilities with respect to a fund's LRMP that result in different liquidity classifications, the fund's LRMP's policies and procedures could dictate how the fund would resolve such differences, such as, for example, specifying that a certain party's determination (e.g., the PA, adviser or sub-adviser) would control or by establishing a method whereby the most conservative (i.e., least liquid) classification would control.
- According to the FAQs, a fund operating under a manager-of-managers structure could have different sub-advisers managing distinct sleeves, which may result in the same investment being classified differently due to differing assumptions and methodologies. In such an event, according to the FAQs, there would be no need for the fund, PA, adviser or sub-adviser, as applicable, to resolve the differences in order to comply with Rule 22e-4, though a fund's policies and procedures could provide for a method for resolving such differences. Importantly, however, for manager-of-manager structures, since Form N-PORT does not permit a fund to report more than one liquidity classification for a single investment, according to the FAQs a fund's policies and procedures should address how to choose a single classification for purposes of Form N-PORT reporting. According to the FAQs, a fund may use any reasonable method for resolving classification differences, such as, for example, (i) adopting the classification of the sub-adviser with the largest position in the investment, (ii) calculating a weighted average (based on each sub-adviser's classification and its respective position size) and rounding to the nearest classification or (iii) using the most conservative classification, so long as the fund applies such method consistently. Finally, according to the FAQs, when a fund has differing liquidity classifications for an investment but one classification for purposes of Form N-PORT reporting, the fund is encouraged to note this fact in the form's explanatory notes section, which according to the FAQs is non-public if it relates to a non-public reporting item, such as the item requiring a fund to report its monthly position-level liquidity classification information.

ETFs

- According to the FAQs, Rule 22e-4's adopting release provides that an in-kind EFT may use cash to meet redemptions, and so long as the cash used is proportionate to the uninvested cash in the fund's portfolio, such redemption is an "in-kind" redemption and not considered cash that is subject to the *de minimis* amount requirement. Thus, according to the FAQs, an ETF may exclude cash in redemption proceeds that is proportionate to the ETF's uninvested cash for purposes of defining and testing compliance with the *de minimis* cash requirement.
- According to the FAQs, if an ETF falls out of compliance with the in-kind ETF exception, the SEC staff would not recommend enforcement action if such ETF again became compliant with the classification and highly liquid investment minimum requirements of its LRMP as soon as reasonably practicable after it no longer qualifies for the exception. In addition, according to the FAQs, an ETF must note in item E.5 of Form N-CEN its current status as an in-kind ETF for the reporting period.
- According to the FAQs, Rule 22e-4 and its adopting release provide that an in-kind ETF should define what constitutes a *de minimis* amount of cash in its policies and procedures, and as such what constitutes *de minimis* may differ among ETFs. Nonetheless, according to the FAQs, the SEC staff believes that (i) it would be reasonable for an in-kind ETF to conclude that 5% or less of its overall redemption proceeds being paid in cash (and subject to the permissible cash exclusions noted above) was *de minimis* and (ii) it would be unreasonable for an in-kind ETF to conclude that a percentage greater than 10% was *de minimis* for purposes of qualifying as an in-kind ETF. However, according to the FAQs, an in-kind ETF may determine that cash use of more than 5% in redemptions is *de minimis* after evaluating its particular facts and circumstances, including its LRMP and whether a redemption in cash in excess of 5% could raise liquidity risks substantially similar to those of mutual funds.
- According to the FAQs, a redemption consisting entirely of cash does not preclude an ETF from qualifying as an in-kind ETF if (i) such redemption transaction as a proportion of the ETF's aggregate redemption transactions does not exceed the *de minimis* amount of cash specified in the ETF's policies and procedures and (ii) any authorized participant receiving such redemption is not electing to receive cash redemptions as a standard practice.
- According to the FAQs, there are various reasonable approaches for an in-kind ETF to determine whether its cash use is *de minimis*, so long as the approach is applied consistently, including, for example, testing each redemption transaction to ensure that each has no more than a *de minimis* cash amount or testing all its redemption transactions over a reasonable period of time to ensure that its aggregate redemption transactions, on average, have no more than a *de minimis* cash amount. According to the FAQs, a reasonable period for a fund with frequent redemption activity may be a day or a week, whereas a reasonable period for a fund with less regular redemption activity may be up to a month; however, according to the FAQs, a period over a month would not be reasonable. Finally, according to the FAQs and regardless of the approach used, an ETF's policies and procedures should describe the methodology for testing compliance and the time period used, and such methodology should be applied consistently.
- According to the FAQs, if an ETF loses its status as an in-kind ETF, whether such ETF can requalify as an in-kind ETF is a facts and circumstances determination, and there is no specific time period that an ETF must wait before deciding that it again qualifies as an in-kind ETF. However, according to the FAQs and in light of Rule 22e-4's adopting release, such an ETF could potentially avail itself of the in-kind ETF exception again if it reasonably determines, based on its particular facts and circumstances, that the cause behind its loss of status was an extraordinary one-time event that is unlikely to occur again, and such an ETF

should describe the factors it would generally consider in making this determination in its policies and procedures.

- According to the FAQs, while backward-looking redemption history is usually relevant when determining whether an ETF can qualify as an in-kind ETF, such history alone is not dispositive. Rather, according to the FAQs, an ETF with no operating history may consider its policies and procedures and expected redemption practices in determining whether it qualifies for the in-kind ETF exception, and an ETF with an operating history could consider changes to its policies and procedures that would restrict its ability to meet redemptions using cash and whether it reasonably expects to maintain such levels going forward, notwithstanding its recent redemption transaction history, in making this determination.

► **See a copy of the FAQs**

► **See a copy of Rule 22e-4's Adopting Release**

SEC Adopts Amendments to Advisers Act Rules to Reflect Changes Made by FAST Act

On January 5, 2018, the SEC adopted final rules (the "**Final Rules**") amending the definition of "venture capital fund" under Rule 203(l)-1 and the private fund adviser exemption under Rule 203(m)-1 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to reflect changes made by Title LXXIV, Sections 74001 and 74002 of the Fixing America's Surface Transportation Act of 2015 (the "**FAST Act**"), which amended Sections 203(l) and 203(m) of the Advisers Act. For a detailed discussion of the amendments, please see the **May 25, 2017 Investment Management Regulatory Update**.

The Final Rules (i) amend the definition of "venture capital fund" to include "small business investment companies," as described in Section 203(b)(7) of the Advisers Act (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to Section 54 of the Investment Company Act) and (ii) amend the definition of "assets under management" in the private fund adviser exemption to exclude the assets of "small business investment companies."

The Final Rules will become effective on March 12, 2018.

► **See a copy of the Final Rules**

SEC Staff Permanently Extends No-Action Relief under Section 17(f) of the Investment Company Act to Chicago Mercantile Exchange, ICE Clear Credit LLC, LCH Limited and LCH.Clearnet LLC

On December 19, 2017, the SEC issued no-action letters (the "**Letters**") extending permanent relief to each of Chicago Mercantile Exchange ("**CME**"), ICE Clear Credit LLC ("**ICE**") and LCH Limited and LCH.Clearnet LLC (together, "**LCH**") allowing registered investment companies and their custodians to place and maintain cash and/or certain securities in the custody of CME, ICE and/or LCH, each a derivatives clearing organization registered with the Commodity Futures Trading Commission ("**CFTC**"), or a clearing member of CME, ICE and/or LCH that is a futures commission merchant ("**FCM**") registered with the CFTC, for purposes of meeting CME's, ICE's and/or LCH's margin requirements for certain swap transactions cleared by them, including interest rate swaps, credit default swaps, cash-settled commodity index swap contracts and foreign currency swap contracts.

According to the Letters, the SEC initially provided temporary no-action relief under Section 17(f) of the Investment Company Act based on the requirement in the Commodity Exchange Act ("**CEA**") that the CFTC adopt rules and issue interpretations with respect to the centralized clearing of swaps transactions. According to the Letters, in February 2012 the CFTC adopted final rules implementing the framework for central clearing of swaps and, as such, the SEC concluded that it is now appropriate to extend no-action relief permanently.

According to the Letters, if CME, ICE or LCH (or their respective clearing member that is a FCM) (together, a "**Clearing Member**") holds assets for an unaffiliated registered investment company (a "**Fund**") and wishes to clear certain swap transactions for such Fund, it must address each of the requirements of Rule 17f-6 under the Investment Company Act. Specifically, according to the Letters, a Clearing Member and a Fund must have a written contract between them governing the manner in which the Clearing Member will maintain the Fund's assets and specifically providing that:

- the Clearing Member will comply with the requirements relating to the separate treatment of customer funds and property of the Clearing Member and the CFTC segregation rules for swap collateral, under Part 22 of the CFTC's regulations, and specifying the substantive requirements for the treatment of cleared over-the-counter derivatives in the cleared swaps customer account and the cleared swaps account class prior to any bankruptcy;
- the Clearing Member may place and maintain the Fund's assets as appropriate to effect the Fund's cleared swap transactions through the Clearing Member and in accordance with the CEA and the CFTC's rules thereunder, and that the Clearing Member will obtain an acknowledgement, to the extent required under CFTC Rules 22.5 and 1.20(a), that such assets are held on behalf of the Clearing Member's customers in accordance with the provisions of the CEA;
- the Clearing Member will promptly furnish copies of or extracts from its records or such other information relating to the Fund's assets as the SEC may request;
- any gains on the Fund's transactions, other than *de minimis* amounts, may be maintained with the Clearing Member only until the next business day following receipt; and
- the Fund may withdraw its assets from the Clearing Member as soon as reasonably practicable if the custodial arrangement no longer meets the requirements of Rule 17f-6, as applicable.

According to the Letters, since maintaining assets in a Clearing Member's custody is not without risk, the SEC encourages Funds to carefully weigh the risks and benefits of doing so for the purpose of effecting swap transactions.

- **See a copy of the CME Letter**
- **See a copy of the ICE Letter**
- **See a copy of the LCH Letter**

Industry Update

SEC Issues Information Update on Applicability of Staff Accounting Bulletin No. 118 to Investment Companies Impacted by the Tax Cuts and Jobs Act

In December 2017, the Division of Investment Management of the SEC (the "**Division**") released an information update confirming that investment companies ("**Registrants**") that account for income taxes under Financial Accounting Standards Board Accounting Standards Codification Topic 740 ("**ASC 740**") may rely on the guidance in Staff Accounting Bulletin No. 118 (the "**Bulletin**") for purposes of calculating net asset values and reporting measurement period adjustments.

According to the Division, the Bulletin provides guidance for publicly traded companies, auditors and others concerning public disclosures of the accounting impacts of the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017 (the "**Tax Act**"). The Bulletin, according to the Division, addresses circumstances whereby the accounting for certain income tax effects of the Tax Act would be incomplete by the time financial statements are issued for a reporting period that includes the date of the Tax Act's enactment.

According to the Division, if a Registrant's financial statements include the reporting period in which the Tax Act was enacted, such Registrant must first reflect the income tax effects of the Tax Act for which the accounting under ASC 740 is complete, and such amounts would not considered to be provisional amounts. Such Registrant would then, according to the Bulletin, report provisional amounts for those specific income tax effects of the Tax Act for which the accounting under ASC 740 will be incomplete but for which a reasonable estimate can be determined. According to the Division, for any specific income tax effects of the Tax Act for which a reasonable estimate cannot be determined, a Registrant should not report provisional amounts and should continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to the Tax Act being enacted and should include such tax effects in the first reporting period in which a reasonable estimate can be determined.

Finally, according to the Division, Registrants must disclose relevant information to investors – by press release, website disclosure or some other reasonable manner – about the material impacts of the Tax Act to its calculation of net asset values and material provisions for which the accounting is incomplete, if applicable.

- **See a copy of the Information Update**
- **See a copy of the Bulletin**

SEC Expresses Concerns Over Cryptocurrency-Related Funds

Over the course of the last year, a number of proposals for bitcoin-backed ETFs have been either rejected by the SEC or withdrawn. For example, in March 2017, in a **release** denying a proposed rule change that would have permitted the listing of the Winklevoss Bitcoin Trust, the SEC pointed to the absence, at the time, of a liquid and regulated futures market in bitcoin. Accordingly, after the **launch** of listed bitcoin derivatives this past December, market observers had been questioning whether the SEC would be more receptive to proposals for cryptocurrency-related funds, particularly those related to bitcoin or bitcoin futures contracts.

On January 18, 2018, in a **letter** (the "**Letter**") to the Investment Company Institute and the Securities Industry and Financial Markets Association, the SEC's Division of Investment Management outlined several remaining concerns that sponsors will be expected to address when seeking approval for funds holding "substantial amounts" of cryptocurrencies or "cryptocurrency-related products." The questions, which are listed below, generally fall into one of five key areas: valuation, liquidity, custody, arbitrage and potential manipulation.

In the Letter, the SEC notes that these questions focus on specific requirements of the Investment Company Act and that entities with similar products and investment strategies might pursue registered offerings under the Securities Act of 1933 (the "**Securities Act**"). The Letter does not state whether each of the questions set forth would also need to be explicitly addressed by entities not subject to the Investment Company Act that are pursuing an offering under the Securities Act, although such entities would need to comply with the registration and prospectus disclosure requirements of the Securities Act, including a disclosure of risk factors relating to the investment.

Additionally, the Letter frequently addresses the broad universe of "cryptocurrencies" and "cryptocurrency-related products" in the same breath. However, it is worth considering how the answer to certain questions could vary based on the specific underlying cryptocurrency or product in question. For example, fragmentation risk—the risk of many trading venues competing for order flow in a particular asset—might be less of a concern for a fund that is solely interested in holding futures contracts because the number of trading venues for these contracts is actually quite limited.

Valuation

Mutual funds and ETFs must value their assets on each business day for purposes of determining a net asset value ("**NAV**"). In the Letter, the SEC noted that 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)." Interestingly, the SEC asks sponsors to consider what policies and procedures it would implement around "forks" and "airdrops." Forks and airdrops are two somewhat similar concepts that generally refer to a situation where, by virtue of holding a particular cryptocurrency at a given point in time ("**Coin A**"), a holder is automatically granted the right to receive a new cryptocurrency ("**Coin B**"). No exchange is required; the holder becomes a holder of both Coin A and Coin B. However, there is generally at least some effort required to obtain Coin B. One foreign bitcoin-backed ETN, for example, has a stated **policy** of "consider[ing] the appropriate action to take in light of each fork on a case-by-case basis."

The Letter raises the following valuation-related questions:

- 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 to determine eligibility for and acceptability of, 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?

Liquidity

Open-end funds, such as mutual funds and ETFs, are subject to daily redeemability. Accordingly, such funds must maintain sufficient liquidity in order to meet daily redemption demands. Under the new **fund liquidity rule**, funds will be required to (1) implement a liquidity risk management program, (2) classify their investments into one of four liquidity categories and (3) limit their investments in illiquid securities to 15% of the fund's assets. In the Letter, the SEC notes that a fund's liquidity classifications should be informed by the market depth of its holdings. In other words, the size of a fund's holdings could significantly affect those holdings' liquidity by limiting the fund's ability to manage that position. For example, a fund seeking to hold a particular cryptocurrency might find its liquidity significantly constrained if the size of the position relative to the volume in the relevant market impedes its ability to trade meaningful sizes of its portfolio.

The Letter raises the following liquidity-related questions:

- 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 (*i.e.*, rule 22e-4)? For example, would any of these products be classified as other than illiquid under the rule?
- 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 Investment Company Act imposes safeguards to ensure that registered funds maintain appropriate custody of their holdings. These safeguards include standards regarding who may act as a custodian and when funds must verify their holdings. In the cryptocurrency context, custody generally means control of the private key associated with a particular account because such control is necessary to effectuate a transaction. For that reason, holding the private key is tantamount to holding the digital currency itself. Accordingly, the most common attack vectors for malicious actors in this space relate to exchanges and wallet providers, which either custody cryptocurrency on behalf of the end user or provide the end user with a means to self-custody his or her own cryptocurrency. In less than a decade, hackers have stolen at least a **reported** $1.2 billion worth of bitcoin and ether alone, often by exploiting security vulnerabilities in the exchanges or wallet software.

The Letter raises the following custody-related questions:

- How would funds satisfy the custody requirements of the Investment Company Act and relevant rules?
- 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 Investment Company Act?
- 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

In the Letter, the SEC notes that ETFs 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. Notably, the SEC expressed concern over how service outages, such as the recent **service outage** at Kraken, would impact arbitrage. Kraken is one of the largest cryptocurrency exchanges based on volume and one of the constituent exchanges that feeds into the CME's bitcoin futures pricing mechanism. The exchange was reportedly down for nearly a

48-hour period, after discovering unforeseen difficulties during what was supposed to be a routine, scheduled two-hour maintenance.

The Letter raises the following arbitrage-related questions:

- 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?

Market Manipulation and Fraud

In the Letter, the SEC cites recent **concerns** voiced by Chairman Clayton that cryptocurrency markets, as they are currently operating, offer substantially less investor protection than traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. The Letter also refers to a number of recent media reports discussing the potential manipulation of cryptocurrency markets. While the Letter does not mention any specific reports or alleged manipulative activities, some commonly alleged manipulative practices in this space include (1) coordinated "pump-and-dump" schemes organized through chatrooms on the Tor network or through encrypted mobile messaging applications and (2) "painting the tape" manipulation executed by organized trading bots that buy and sell among themselves to create an appearance of substantial trading activity on a particular exchange. As noted below, the CFTC recently asserted its authority and intent to "prosecute fraud, abuse, manipulation or false solicitation in markets for virtual currency derivatives and underlying spot trading."

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

The Letter closes with a word of caution against utilizing 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, which the SEC would view "unfavorably" and would cause the SEC to "consider actions necessary or appropriate" to protect retail investors, "including recommending a stop order."

CFTC Releases Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets

On January 4, 2018, the CFTC issued a Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets (the "**Backgrounder**") with an accompanying statement from Chairman J. Christopher Giancarlo. The Backgrounder describes (1) federal and state oversight of and jurisdiction over virtual currencies; (2) the CFTC's approach to virtual currency regulation; (3) the self-certification process generally, as well as specifically the recent self-certification of new contracts for bitcoin futures products by designated contract markets ("**DCMs**"); (4) the CFTC's "heightened review" for virtual currency contracts; and (5) the constituencies the CFTC believes could be impacted by virtual currency futures.

In 2014, the CFTC declared virtual currencies to be a "commodity" subject to CFTC oversight under the Commodity Exchange Act (the "CEA"). Since then, the CFTC has taken action against unregistered bitcoin futures exchanges, enforced the laws prohibiting wash trading and prearranged trades on a derivatives platform, issued proposed guidance on what is a derivative market and what is a spot market in the virtual currency context, issued warnings about valuations and volatility in spot virtual currency markets and addressed virtual currency Ponzi schemes.

On December 1, 2017, the Chicago Mercantile Exchange and the CBOE Futures Exchange self-certified new contracts for bitcoin futures products, and the Cantor Exchange self-certified a new contract for bitcoin binary options. In the Backgrounder, the CFTC discusses the self-certification process, including the "heightened review" that the CFTC staff and DCMs have applied in their review of the terms and conditions of virtual currency futures. According to the CFTC, such heightened review includes "extensive visibility and monitoring of markets for virtual currency derivatives and underlying settlement reference rates," including determining that the CFTC has the means to police certain underlying spot markets for fraud and manipulation.

In addition, Commissioner Giancarlo noted that the CFTC's Market Risk Advisory Committee (the "**MRAC**"), will hold a meeting on January 31, 2018 "to consider the process of self-certification of new products and operational rules by DCMs under the CEA and CFTC regulations." The MRAC meeting is scheduled to take place the week after a January 23, 2018 meeting of the CFTC Technology Advisory Committee, which will consider the "related challenges, opportunities, and market developments of virtual currencies."

Litigation

Texas Securities Commissioner Issues Cease and Desist Order Against Cryptocurrency Promoter

On January 4, 2018, the Securities Commissioner of the State of Texas (the "**Commissioner**") issued an emergency cease and desist order (the "**Order**") against BitConnect, an England-based cryptocurrency producer and promoter, for violating securities registration requirements, making materially misleading and deceptive statements and making fraudulent statements. The Commissioner's findings echo the issues and concerns noted in the North American Securities Administrators Association's recent release (the "**NASAA Release**") regarding cryptocurrencies, initial coin offerings ("**ICOs**") and other cryptocurrency-related investment products.

According to the Order, BitConnect, via its website and sales agents, solicits Texas residents for the purpose of investing in the BitConnect Lending Program, a plan which allows potential investors to purchase BitConnect Coins and then lend them out through a dashboard on the BitConnect website. According to the Order, the BitConnect website represents that investors may earn up to 40% interest per month over a specified term, plus an additional rate of interest calculated on a daily basis. BitConnect, according to the Order, encourages sales agents to promote the BitConnect Lending Program through social media, blogs, websites, marketing materials and online advertisements, at times in conjunction with unique referral links that automatically credit a sales agent with the sale. In addition, according to the Order, the BitConnect website and BitConnect sales agents offer Texas residents the opportunity to invest in BitConnect's Staking Program. According to the Commissioner, investors in the program purchase BitConnect Coins, transfer them to the BitConnect online "wallet" and earn interest on all coins held there for more than fifteen days. The BitConnect website, according to the Order, represents that investors in the program can earn interest of up to 120% per year. Finally, according to the Order, BitConnect planned to hold an ICO on or around January 10, 2018.

According to an SEC public statement supporting the NASAA Release, despite previously being marketed as replacements for traditional currencies, cryptocurrencies lack important traditional currency characteristics, such as sovereign backing, and should be viewed more as investment opportunities. Nonetheless, according to the SEC, many promoters of ICOs and other cryptocurrency market participants are not abiding by state and federal securities laws, and while the SEC and state securities regulators are pursuing violations, there is a significant risk they may not be able to recover lost investments.

According to the Order, BitConnect and its investment programs violated multiple registration requirements in Texas, including failing to register investments in its investment programs, failing to register with the Commissioner as a dealer or agent and recruiting sales agents who are not registered with the Commissioner as dealers or agents. Further, according to the Commissioner, BitConnect's representations that its website does not constitute an offer to buy or sell securities is materially misleading and likely to deceive the public, since its website offers investments in its lending and staking programs and such investments constitute securities. In addition, according to the Order, BitConnect intentionally failed to disclose material facts in connection with its offer of investments in the BitConnect Lending Program and BitConnect Staking Program, including the identity of its principals, its principal place of business and information regarding the development of the business and its finances. In addition, according to the Order, BitConnect misrepresented material facts by representing that the BitConnect Lending Program was a safe and low risk way to earn a high rate of return because BitConnect acknowledges that there are significant risks associated with virtual currencies and its lending program, including legislative and regulatory changes, the irrevocability of transactions in virtual currencies and the inherent volatility of virtual currencies. Also, according to the Order, BitConnect intentionally failed to disclose financial information regarding its staking program and made materially misleading and deceptive statements by presenting investments in its staking program as safe.

In light of the above findings, the Commissioner ordered that BitConnect immediately cease and desist from (i) offering any security in Texas until the security is registered or offered pursuant to an exemption from registration, (ii) acting as a securities dealer in Texas until it is registered or acting pursuant to an exemption from registration, (iii) engaging in any fraud in connection with the offer for sale of any security in Texas and (iv) offering securities in Texas through an offer containing a statement that is materially misleading or otherwise likely to deceive the public. According to the Order, BitConnect may request a hearing within 31 days of the date the Order was served.

- **See a copy of the Order**
- **See a copy of the NASAA Release**
- **See a copy of the SEC's Public Statement**

SEC Charges Investment Adviser, Its President and Its Former Chief Compliance Officer with Violations of the Advisers Act and Safeguards Rule

On December 22, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Southwind Associates of NJ Inc., an investment adviser registered with the SEC ("**Southwind**"), Southwind's president (the "**President**") and Southwind's former Chief Compliance Officer (the "**CCO**") for violations under the Advisers Act and Rule 30(a) of Regulation S-P, 17 C.F.R. § 248.30(a) (the "**Safeguards Rule**").

According to the Order, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") conducted three separate examinations of Southwind in 2003, 2006 and 2013, each time issuing a deficiency letter. In May 2011, Southwind hired a compliance consulting firm (the "**Consultant**") to review its compliance program, and according to the Order, the Consultant identified 59 separate action items, including items relating to custody, electronic communications, books and records and compliance manual and policies, and assisted Southwind in conducting quarterly reviews to ensure such items were addressed. Nonetheless, according to the Order, Southwind failed to timely implement the majority of the Consultant's recommendations.

According to the Order, despite being aware of the requirements of Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**"), Southwind failed to conduct surprise examinations of those client accounts over which it had custody for every year but one, and Southwind failed to both provide certain of its private fund clients with audited financial statements within the required timeframe and to have an appropriate independent public accountant perform the audits. Further, according to the Order, Southwind failed to establish procedures related to the maintenance and preservation of client records until May 2012, and such procedures failed to be specifically tailored to Southwind's business and electronic storage media recordkeeping until May 2016. In addition, according to the Order, Southwind failed to preserve certain electronic communications and, during the 2013 OCIE examination, the CCO failed to inform OCIE that Southwind had previously determined that it may have had an issue with its preservation of electronic communications; only two months after OCIE's initial request did Southwind state that certain electronic communications could not be retrieved. As such, according to the Order, the CCO failed to ensure Southwind's compliance with certain books and records requirements under the Advisers Act, and the President did not take adequate steps to address this failure, despite being aware of the issue. Further, according to the Order, Southwind failed to timely update its compliance manual to reflect the amendment or adoption of relevant rules under the Advisers Act, including changes to the Custody Rule, and Southwind failed to implement certain written policies and procedures related to the Custody Rule and the maintenance and preservation of electronic records. Finally, according to the Order, the CCO failed to perform an annual review of Southwind's policies and did not ensure that they were adequately and effectively implemented, and the President failed to adequately address these issues despite being aware of them.

According the SEC, all of the violations in the Order were identified by OCIE in deficiency letters following OCIE examinations or after being highlighted in the Consultant's recommendations. According to the Order:

- Southwind violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which require registered investment advisers with custody of client funds or securities to have independent public accountants conduct surprise examinations of those client funds or securities, or to have any private fund clients timely distribute annual audited financial statements to their investors and to have that audit performed by an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board;
- Southwind violated Section 204(a) of the Advisers Act and Rule 204-2(a)(7) thereunder, which require registered investment advisers to create and maintain originals of all written communications received and sent relating to (i) client advice or recommendations, (ii) the receipt, disbursement or delivery of funds or securities, (iii) the execution of securities purchases or sales and (iv) with certain exceptions, the performance of managed accounts or securities recommendations;

- Southwind violated the Safeguards Rule, which requires registered investment advisers to adopt written policies and procedures that are reasonably designed to safeguard client records and information;
- Southwind violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, and to review at least annually the adequacy and implementation of such policies; and
- the President caused, and the CCO aided and abetted and caused, Southwind's violations of Sections 204(a) and 206(4) of the Advisers Act and Rules 204-2(a)(7), 206(4)-2 and 206(4)-7 thereunder and the Safeguards Rule

According to the Order, Southwind, the President and the CCO consented to the entry of the Order without admitting or denying the findings therein. Southwind agreed to retain an independent compliance consultant within 30 days of the date of the Order to undertake a review of Southwind's policies relevant to the violations identified in the Order, and Southwind agreed to adopt all recommendations made by such consultant within 60 days of the consultant issuing its findings. Further, Southwind agreed to preserve all records relating to its compliance with the Order for no less than six years and to notify all of its advisory clients of the entry of the Order. Finally, Southwind agreed to certify in writing to its compliance with all of the above undertakings.

According to the Order, Southwind was censured and the CCO may not act in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization. Further, according to the Order, Southwind and the President agreed to jointly and severally pay a civil money penalty of $50,000.

- ► **See a copy of the Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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