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SEC Rejects Grayscale's Proposed Spot Bitcoin ETF

July 27, 2022

On June 29, 2022, the Securities and Exchange Commission ("SEC") rejected a rule change application that would have allowed NYSE Arca, Inc. (the "Exchange") to list and sell shares of a "spot" bitcoin ETF. The application was made in connection with Grayscale Bitcoin Trust's (the "Trust") goal to convert the Trust—which generally purchases and holds bitcoin tokens—from an over-the-counter vehicle into an exchange-traded fund ("ETF").

The rejection is consistent with recent SEC history; it has never allowed an exchange to list shares of a spot bitcoin ETF.[1] However, the SEC has approved multiple ETFs based on bitcoin futures.[2] The SEC justifies approving futures bitcoin ETFs while rejecting spot bitcoin ETFs based on the differences in the underlying markets for the assets that each type of ETF holds or would hold. Futures bitcoin ETFs hold derivatives contracts to buy or sell bitcoin tokens at a predetermined price and specified time in the future. The underlying futures contracts are traded on the Chicago Mercantile Exchange, Inc. ("CME"), an exchange that is regulated by the Commodity Futures Trading Commission ("CFTC"). In contrast, spot bitcoin ETFs would generally hold actual bitcoin, and the underling spot bitcoin markets are largely unregulated in the United States. As a result, the SEC contends that spot bitcoin ETFs fail the SEC's standard for financial products being safe for investors and in the public interest.

ETFs are a popular investment vehicle for their low transaction costs and high liquidity. As compared with futures bitcoin ETFs, a spot bitcoin ETF would offer investors a more intuitive vehicle (i.e., it would hold actual bitcoin, instead of derivatives contracts, and the ETF performance would be more directly tied to the actual price of bitcoin) with lower fees. Spot bitcoin ETFs approved overseas have largely corroborated these benefits,[3] and many U.S. investors are eager to see spot bitcoin ETFs approved in the United States.

THE SEC'S RATIONALE FOR REJECTING SPOT BITCOIN ETFS

The SEC rejected the proposed rule to list the Trust as an ETF because it concluded the Exchange failed to show that the spot bitcoin ETF was "designed to prevent fraudulent and manipulative acts and practices". The SEC required the Exchange to show either (i) detection and deterrence of fraud manipulation provided by a comprehensive surveillance-sharing agreement ("SSA")[4] with a *regulated* market of sufficient size related to spot bitcoin or (ii) other means sufficient to justify dispensing with the first requirement.

The SEC stated that the Exchange failed to meet the first prong because of the lack of comprehensive SEC or CFTC regulation in underlying spot bitcoin exchanges and an insufficient relationship with regulated futures exchanges. The SEC's concern centered on the lack of existing SSAs with spot bitcoin exchanges and the absence of a path to operationalize future SSAs. The SEC stated that the lack of SSAs exacerbated bitcoin's susceptibility to wash trading, dominant position pricing, hacking, malicious network control and insider trading. These concerns were not assuaged by reference to regulated bitcoin futures markets because the SEC determined there was insufficient correlative analysis between the regulated bitcoin futures markets and the unregulated bitcoin spot markets.

The SEC argued the Exchange failed to meet the second prong—that the Trust would have "other means" sufficient to prevent fraudulent and manipulative practices—based on its conclusion that spot bitcoin markets lack sufficient inherent protections. The SEC contends that such protections must establish that the underlying market is "uniquely and inherently resistant to manipulation" and that such resistance "must be novel and beyond the protections that are utilized by traditional commodity or securities markets". Neither the unique aspects of bitcoin (i.e., blockchain's public ledger, large aggregate market valuation, etc.), nor industry practices, satisfy this high standard in the view of the SEC. Instead, the SEC argues some characteristics of bitcoin, such as purchaser anonymity, may require more—not less—regulatory oversight.

The SEC's rejection sets a very high standard for exchanges seeking to list spot bitcoin ETFs. The SEC essentially demands either the existence of a large spot bitcoin market regulated by the SEC or CFTC (of which there are currently none), or else that exchanges meet a vague and novel standard of being "uniquely and inherently resistant" to manipulation as compared to traditional markets, all while simultaneously failing to offer a path to meet that standard.

CRITICISM OF THE SEC'S APPROACH BY GRAYSCALE AND THE BITCOIN COMMUNITY

As part of the SEC's public comment process, Grayscale, Coinbase, the Blockchain Association and others (together, the "bitcoin community") sent in comments articulating their belief that the disparate treatment of spot-ETFs and futures-ETFs is illogical, unnecessarily harmful to the bitcoin investing public and potentially violative of U.S. administrative law.

The bitcoin community argues that industry-standard monitoring and surveillance practices in bitcoin exchanges satisfy the purpose behind the SEC's SSA requirement. Comments outline multiple machine-learning-based surveillance programs that effectively offer the same protection as SSAs achieve in regulated exchanges, such as same-day market analysis and retrospective data for investigations.

These same comments also contend that the underlying risks in both spot bitcoin ETFs and futures bitcoin ETFs are fundamentally the same. Grayscale observes that the reference rate for regulated bitcoin futures and the pricing indices used by the Trust (and other rejected bitcoin ETFs) both use trading prices reported by unregulated bitcoin exchanges. Therefore, they argue, any fraud or manipulation would affect both products in the same way. One commentator, providing CME data showing a correlation of 99.9% between the price of futures and spot market prices, argued that these data are consistent with arbitrageurs forcing price convergence by selling in one market (spot or futures) and buying in the other. Therefore, the bitcoin community claims, the SEC cannot support using risk in spot bitcoin markets to reject spot bitcoin ETFs while it approves bitcoin futures ETFs.

Additionally, those comments claim that the spot bitcoin market is comparable to other commodity markets with no direct regulation of spot trading. For instance, they claim that Bitcoin's spot markets' depth, market capitalization, liquidity and transparency compare favorably with other over-the-counter commodities such as silver, palladium and platinum.

GRAYSCALE'S APPEAL TO THE D.C. CIRCUIT

Grayscale petitioned the SEC's rejection of the proposed rule change to the D.C. Court of Appeals the same day that the SEC published its rejection order. Grayscale's petition centers on an administrative question: whether the SEC, in approving futures bitcoin ETFs while rejecting spot bitcoin ETFs, acted arbitrarily and capriciously. Critically, the initial standard of review is largely procedural. That is, the Court will generally be reviewing *how* the SEC came to its conclusion and not the substance of the ruling itself. Should the Court uphold the rejection by finding the SEC had a legitimate basis for its decision, Grayscale intends to appeal to the Supreme Court.

Absent a judicial ruling in Grayscale's favor, there is currently no clear path to SEC approval of a spot ETF for bitcoin or for any other digital token.

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[1] On June 30, 2016, Bats BZX Exchange filed the first proposed rule change to list and trade shares of a spot bitcoin ETF (the Winklevoss Bitcoin Trust). The SEC rejected their application on July 26, 2018.

[2] In April 2022, for example, the SEC approved the Exchange's proposal to list and trade shares of Teucrium Bitcoin Futures Fund (the "TBF Fund"). Prior to the TBF Fund, the SEC had approved the sale and listing of three similar futures bitcoin ETFs: (i) ProShares Bitcoin Strategy ETF launched in October 2021; (ii) Valkyrie Bitcoin Strategy ETF launched in March 2022; and (iii) VanEck Bitcoin Strategy ETF launched in March 2022.

[3] Germany, Canada and Jersey have each approved multiple digital-asset exchange-traded products ("ETPs"). In a comment letter to the SEC, Coinbase Chief Legal Officer Paul Grewal argued that analysis of non-U.S. spot bitcoin ETPs demonstrates both consumer safety and a sufficient connection between the ETP price and the price of the underlying digital token. Letter from Paul Grewal, Chief Legal Officer, Coinbase (Mar. 3, 2022) ("Coinbase Letter").

[4] SSAs are agreements between exchanges that allow those exchanges to share information about market trading, clearing and customer identity. In doing so, SSAs can help mitigate price manipulation across different related markets and provide data for investigations should manipulation occur.