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Insights

AT LONG LAST: WHAT CRYPTO'S FIRST SPOT ETFS MEAN FOR THE DIGITAL ASSET INDUSTRY

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SUMMARY

After years of denials, the SEC has finally approved its first Bitcoin spot ETFs. Reaching this point has involved legal battles, repeated reviews of applications, and much more. That said, the SEC's approval of a Bitcoin spot ETF represents a huge leap forward for the digital asset industry: it further solidifies the primacy of Bitcoin and other cryptocurrencies as an asset class. However, these approvals were not straightforward—and at times, seemed improbable. Nevertheless, approval now deals an even greater blow to the SEC's regulation by enforcement approach. Given that Bitcoin spot ETFs have now been approved, digital assets will only be further legitimized as an asset class.

WHY ETFS MATTER

ETFs have been around for thirty years, presenting investors with a unique opportunity: an investment vehicle that looks like a mutual fund, but with the ease of trading on an exchange. Whereas mutual funds tend to require a larger amount of capital to invest in, ETFs can be traded for comparably less. For the vast majority of investors, this difference makes purchasing shares of an ETF much more accessible. A number of ETFs, such as the SPDR S&P 500 Trust ETF, are indexed to track the market, whereas others are indexed to track a specific portion of the market.

With regard to crypto, today's approval by the SEC is the first crypto spot ETF to be greenlit. Spot ETFs invest in the product immediately, as opposed to futures ETFs which invest in futures contracts of a product—an agreement to buy or sell at a given price. The SEC, also charged with approving futures ETFs, has already given the green light to a number of these ETFs in crypto. Now, the SEC's approvals enable Bitcoin spot ETF investing, lending further legitimacy to digital assets.

THE LONG ROAD TO APPROVAL

Beginning in July of 2013, the Winklevoss Bitcoin Trust filed the first proposal for a Bitcoin ETF with the SEC. The SEC would not touch this application for nearly four years, denying it in March of 2017. In its rejection, the SEC cited—somewhat paradoxically—a lack of regulation in the digital asset market, which raised "concerns about the potential for fraudulent or manipulative acts and practices in this market." Again rejecting the Winklevoss ETF in 2018, the SEC concluded that:

> regulated bitcoin-related markets are in the early stages of their development. . . . [E]xisting or newly created bitcoin futures markets may achieve significant size, and an ETP lifting may be able to demonstrate in a proposed rule change that it will be able to address the risk of fraud and manipulation by sharing surveillance information with a regulated market of significant size related to bitcoin, as well as, where appropriate, with the spot markets underlying relevant bitcoin derivatives. Should these circumstances develop, or conditions otherwise change in a manner that affects the Exchange Act analysis, the Commission would then have the opportunity to consider whether a bitcoin ETP would be consistent with the requirements of the Exchange Act.[1]

The SEC's concerns regarding market manipulation, lack of regulation, and market size would be mirrored across all other rejections.[2] However, the SEC's series of rejections came to a head when it rejected Grayscale's ETF application, again concluding that Grayscale "has not established that other means to prevent fraudulent and manipulative acts and practices are sufficient to justify dispensing with the detection and deterrence of fraud and manipulation provided by a comprehensive surveillance-sharing agreement with a regulated market of significant size related to spot bitcoin."[3] Following this rejection, Grayscale initiated a lawsuit to review the SEC's order, alleging that "the commission violated the Administrative Procedure Act and the Securities Exchange Act of 1934 by discriminating between issuers of the two types of ETFs [futures and spot] on an 'arbitrary and capricious' basis."

GRAYSCALE'S LAWSUIT

In June of 2022, Grayscale petitioned the D.C. Circuit for review of the SEC's rejection of Grayscale's Bitcoin ETF under the Administrative Procedure and Exchange Acts.[4] Grayscale contended that the SEC's rejection was "not in accordance with law," and asked the D.C. Circuit to examine whether the SEC's rejection was "arbitrary, capricious, an abuse of discretion, or in excess statutory authority under the Exchange Act[.]"[5] At the core of Grayscale's argument was the notion that the SEC was treating Bitcoin futures and spot ETFs differently on an arbitrary basis—that these two indexed exchange-traded products were "exposed to the same risks of fraud and manipulation" under the SEC's logic.[6] The SEC rejected Grayscale's contention, arguing that its application of the significant-market framework—*i.e.*, the inquiry into whether an exchange seeking to list a bitcoin ETP has a surveillance-sharing agreement in place with a regulated market of significant size relating to the

ETP's underlying assets as a means to ensure that the exchange's rules are designed to prevent [fraud]—was reasonable.[7]

Grayscale then continued to assert that the SEC's significant-market test was arbitrary and capricious in its application, unreasonably favoring only Bitcoin futures ETFs.[8] While the D.C. Circuit formulated its decision, the SEC denied still more Bitcoin spot ETF applications. Then, in August of this year, the D.C. Circuit granted Grayscale's petition for review, vacating the SEC's order denying their spot ETF.[9] The SEC then chose not to appeal the D.C. Circuit's ruling, which placed the onus on the SEC to either approve Grayscale's ETF or deny it on other grounds.

APPROVAL AT LAST: AN ANALYSIS

After a misfire a day prior to approval, the SEC's real announcement displays new logic as a result of the *Grayscale* suit. In its approval, the SEC states that it has found "sufficient 'other means' of preventing fraud and manipulation[.]"[10] Moreover, the Commission undertook its own analysis of the correlation between Bitcoin futures and spot markets, and having found that the two were sufficiently correlated, noted that the exchanges' surveillance-sharing agreements with the Chicago Mercantile Exchange "can be reasonably expected to assist in surveilling for fraudulent and manipulative acts and practices[.]"[11] As such, the SEC's own analysis bears out that there are measures in place to ensure prevention of fraud and manipulation.

Earlier last year, Commissioners Hester Peirce and Mark Uyeda dissented regarding the SEC's disapproval of a proposed rule change to list and trade shares of the VanEck Bitcoin Trust. Lambasting the Commission's uneven handling of Bitcoin ETFs, Commissioners Peirce and Uyeda stated that "we believe that spot bitcoin ETPs should be subject to the same standards the Commission has used for every other type of commodity-based ETP and because we believe the poorly designed test being used here is not fit for purpose and will inhibit innovation—and thereby harm investors—in our markets, we dissent." Today's approval shows that Peirce and Uyeda were ultimately correct, and Bitcoin ETFs are no longer treated differently under the SEC's analysis.

Finally, before addressing several miscellaneous comments, the Commission notes that it:

> believes that the Proposals . . . are reasonably designed to promote fair disclosure of information that may be necessary to price the shares of the Trusts appropriately, to prevent trading when a reasonable degree of transparency cannot be assured, to safeguard material non-public information relating to the Trusts' portfolios, and to ensure fair and orderly markets for the shares of the Trusts.[12]

Ultimately, this approval is a complete reversal in the SEC's prior logic, no doubt ushered by its rebuke in the *Grayscale* suit.

TAKEAWAYS

With the approval of Bitcoin spot ETFs, there is even greater potential for digital assets moving forward. As such, a few things are immediately clear: first, the SEC's regulation by enforcement approach does not have support in the judiciary; second, digital assets will be further legitimized in the eyes of the public; and third, digital assets will be afforded greater stability.

THE SEC TWICE REBUKED: TIME FOR A CLEARER REGULATORY PATH?

Coming off the heels of losses in both its suit against Ripple Labs and Grayscale's suit against the agency, the SEC has been forced to reckon with the staying power and legitimacy of digital assets.[13] Critically, the SEC's approval here underscores that the agency's regulation by enforcement approach is no longer suitable. As we see increased risks of digital asset protocol developers leaving crypto altogether as a result of the SEC's approach, it becomes much clearer that a straightforward regulatory path, ideally in partnership or totally run by the CFTC, is necessary. A lack of clear regulation held up Bitcoin spot ETFs for far too long, and the same can be said about the SEC's approach to crypto writ large.

MAINSTREAMING CRYPTO: LEGITIMACY MATTERS

In the words of Ethereum co-founder Vitalik Buterin, "legitimacy turns out to be quite important indeed." With the SEC's long-awaited Bitcoin spot ETF approval, the industry has proved that digital assets are here to stay. Detractors who have baselessly claimed that digital assets are vaporware have been repeatedly proven wrong, and now, this Bitcoin ETF represents even more true staying power for cryptocurrencies. Moreover, the SEC's Bitcoin spot ETF approval further legitimizes crypto in the eyes of the public. In the past, a lack of confidence in cryptocurrency amongst Americans has been noted, but ETFs present a clearer, regulated alternative for traditional investors.

CREATING DIGITAL ASSET STABILITY: ENDING CYCLES OF VOLATILITY?

Taming market volatility will also be made easier by the approval of this Bitcoin spot ETF. Those involved in crypto now are no strangers to the boom-bust cycles of crypto winters, but perhaps with Bitcoin spot ETF approval, volatility can be stayed. Although a number of industry members see crypto winters as a tool for pruning out non-viable protocols, price stability ensured by an ETF could stimulate continuous growth and allow investors to feel more comfortable about "holding" Bitcoin, even if through an ETF.

In sum, approval of a spot bitcoin spot ETF is a significant victory for the digital asset industry, providing even greater legitimacy to an already-established market. This decision may very well pave the way for other digital asset ETFs in the near future, giving digital asset providers much to be excited for.

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FOOTNOTES

[1] S.E.C., Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to List and Trade Shares of the Winklevoss Bitcoin Trust, Exchange Act Release No. 34-83723 (July 26, 2018).

[2] *See* Nelson Wang, SEC Rejects VanEck's Spot Bitcoin ETF Proposal, CoinDesk, (May 11, 2023 12:51 PM); S.E.C., Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, to List and Trade Shares of Grayscale Bitcoin Trust under NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares), Exchange Act Release No. 34-95180 (June 29, 2022).

[3] S.E.C., *supra* note 9, at 11.

[4] Petition for Review, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. June 29, 2022).

[5] Petitioner's Statement of Issues to Be Raised at 2, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Aug. 1, 2022).

[6] Brief of Petitioner Grayscale Investments, LLC, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Oct. 11, 2022).

[7] Final Brief for Respondent Securities and Exchange Commission at 34–35, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Feb. 3, 2023).

[8] Final Reply Brief of Petitioner Grayscale Investments, LLC at 1, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Feb. 3, 2023).

[9] Judgment at 1, *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Aug. 29, 2023).

[10] S.E.C., Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units at 6, Exchange Act Release No. 34-99306 (Jan. 10, 2024).

[11] *Id.* at 3.

[12] S.E.C., *supra* note 21, at 12.

[13] *See S.E.C. v. Ripple Labs*, No. 20-CV-10832, 2023 WL 4507900, at *1 (S.D.N.Y. July 13, 2023); *Grayscale Investments, LLC v. S.E.C.*, No. 22-1142 (D.C. Cir. Feb. 3, 2023).

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