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Blockchain and Virtual Currencies Briefing

By Jay G. Baris* and Joshua Ashley Klayman**

In Pursuit of Perfection? A Primer on Digital Asset-Related ETPs

In May 2019, the road to a digital asset-based exchange-traded product (“ETP”) appeared to grow a bit longer when the Securities and Exchange Commission (the “SEC”) published notices to solicit public comments on a proposed “rule change” that would allow two national securities exchanges – NYSE Arca, Inc. (“NYSE Arca”) and Cboe BZX Exchange, Inc. (“BZX”), respectively – to list and trade certain bitcoin-based ETPs. What does that mean? And why should we care?

While many investors have heard of ETPs, or have seen headlines about the SEC’s denial of certain “rule change” applications for bitcoin or other, ether-based ETPs, there is often uncertainty about what ETPs are or do, or the process they must follow for a digital asset-based ETP to become a reality.

Our goal here is to demystify digital asset-related ETPs, while attempting to address certain challenging questions facing the digital asset market participants and regulators, including:

- What are digital asset-related ETPs, and why do investors want access to them?
- Why do many believe that the availability of digital asset-related ETPs is important to the digital asset market’s development and growth?
- When will a digital asset-related ETP hit the market, and why has the SEC continued to disapprove, or defer its consideration of, trading of ETP shares on U.S. national exchanges?
- What are some of the practical implications for delaying approval of the trading and listing digital asset-related ETPs?
- And, finally, as the SEC attempts to structure a regulatory model that will balance the need to protect Main Street investors with the desire to encourage market innovation, will investors seeking exposure to digital assets invest in less-regulated alternatives that may provide *fewer* investor protections and greater *risks* than even imperfectly proposed digital asset-related ETPs might?

The Hunger to Invest in Digital Assets

Although the market values of certain popular digital assets (including some certain so-called “cryptocurrencies,” such as bitcoin) appeared to peak in December 2017,

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many would-be investors – including both “Main Street” and highly sophisticated purchasers – continue to seek ways to gain exposure to this new asset class. While some may wish to purchase and hold, directly and individually, their own bitcoin (or other digital asset) or related derivative product, many would prefer to invest in pooled investment vehicles – like mutual funds or ETPs -- that provide either direct or derivative exposure to particular digital assets.

Why might some investors prefer to invest in digital asset-related ETPs? ETPs arguably would provide a “more liquid” path by which investors of various types could participate in the digital asset market, because ETP shares may be traded freely on a national stock exchange. Moreover, ETPs would bear the responsibility for buying, selling and maintaining custody of the actual digital assets or related derivatives owned by such ETPs. For those prospective investors with less technological sophistication, investing in digital asset-related ETPs may provide a seemingly simpler route to gaining portfolio exposure to digital assets.

Indeed, some believe that the availability of such ETPs would broaden the overall market for such assets, potentially increasing public awareness and acceptance of investment in digital assets as a legitimate investment strategy, as well as contributing to increased liquidity of the digital assets and related derivatives themselves.

ETP Versus ETF: What's the Difference?

An exchange-traded product, or ETP, generally refers to any pooled investment vehicle that tracks a particular benchmark, which can be an index or a particular asset. Although ETPs can include any pooled asset vehicle that invests in any kind of asset, in this article, we refer to ETPs as pooled investment vehicles that invest in commodities, or other assets (including digital assets or related derivatives) that are not securities. In contrast, we refer to pooled investment vehicles that achieve their objectives by investing primarily in securities as exchange-traded funds (“ETFs”), which are a subset of ETPs.

ETFs are registered with the SEC as investment companies under the Investment Company Act of 1940, as amended (the “1940 Act”). ETPs that invest in commodities and digital assets that are not securities are registered as commodity pool operators with the Commodity Futures Trading Commission (“CFTC”) and are not regulated by the SEC as investment companies. Either way, the SEC regulates trading and listing of all ETPs that are listed and traded on a national securities exchange.

Current Investment Opportunities Create a Strange Result for Retail Investors

For now, with some limited exceptions, the only pooled investment vehicles investing in digital-related assets are privately-offered funds. These funds, however, have their limitations. First, they generally are not available to “Main Street,” or retail, investors. Instead, only certain qualified sophisticated investors (such as “accredited investors” (as defined in Regulation D under the Securities Act of 1933, as amended (the “Securities Act”)) may invest in them. Accredited investors, by definition, must have a net worth or income level that exceeds a particular threshold. Second, privately offered funds generally restrict the investor’s ability to freely sell their ownership interests, essentially making them illiquid investments.

Thus, U.S. retail purchasers wishing to gain investment exposure to digital assets currently are limited to comparatively few investment options. With few exceptions, the digital asset investment alternatives for which Main Street purchasers currently are legally eligible involve purchasing certain digital assets via (i) a cryptocurrency exchange (such as Coinbase or Poloniex, among others), (ii) a peer-to-peer transaction, or (iii) the so-called cryptocurrency over-the-counter market (the “OTC market”).

This limited access to digital asset investment alternatives arguably creates a strange result: Main Street investors can purchase directly certain digital assets through cryptocurrency exchanges, peer-to-peer transactions and on the OTC market, each of which argu-

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ably provides less investor protection than would a registered ETP.

Retail investors purchasing digital assets, such as bitcoin, participate in a market characterized by relative illiquidity, significant volatility, and a large degree of risk – including risk of loss related to self-custody or, in the case of those holding digital asset on a cryptocurrency exchange, such exchange's own vulnerabilities and terms of service. Moreover, potential investors who are less technologically sophisticated or unfamiliar with certain popular communication channels, such as the Telegram messaging app, may find aspects of the digital asset market to appear relatively opaque.

The SEC Has Not Yet Allowed Any Digital Asset Related ETP Structures to Come to Market

To date, digital market participants have proposed various ETP structures, each with a similar goal: to enable both accredited and retail investors to gain exposure to bitcoin and, in certain cases, ether (the native token of the Ethereum blockchain) by investing in ETPs. Some ETPs have proposed to invest directly in digital assets (i.e., hold bitcoin or ether directly). Other proposed ETPs would provide investors with indirect digital asset market exposure, for example, by investing in bitcoin futures contracts, rather than holding bitcoin directly.

As we explain below, for a digital asset-related ETP to become a reality in the U.S., such an ETP must comply with the listing and trading rules of the securities exchange on which such ETP will be traded. Given the arguably novel characteristics of digital assets (as compared to traditional debt or equity securities, such as stock), a national securities exchange seeking to list and trade digital asset-related ETP must obtain a rule change under Rule 19(b)-4 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

In the past year, multiple national securities exchanges have proposed to the SEC such a rule change to enable a digital asset-related ETP to be publicly listed and traded on such exchange (i.e., thereby permitting both accredited and unaccredited investors to invest in them). In each case, however, the SEC has delayed or disapproved the proposed rule change, concluding that the applicable securities exchange did not meet requisite statutory requirements.

As of the date of this writing, the SEC has not yet approved *any* rule change proposed by a national securities exchange to allow a digital asset-related ETF. Most recently, in May 2019, the SEC published two notices to

solicit public comments on a proposed rule change and to initiate proceedings to determine whether the SEC should approve or disapprove the proposed rule changes.

The first notice related to an application by NYSE Arca for a rule change to list and trade shares of Bitwise Bitcoin ETF Trust. Rel. No. 34-85854 (May 14, 2019), available at <https://www.sec.gov/rules/sro/nysearca/2019/34-85854.pdf>

The second notice related to an application filed by BZX for a rule change to list and trade shares of SolidX Bitcoin Shares, issued by the VanEck SolidX Bitcoin Trust. Rel. No. 34-85896 (May 20, 2019), available at <https://www.sec.gov/rules/sro/cboebzx/2019/34-85896.pdf>.

We believe that, as the markets for digital assets and related derivatives grow and mature, it is only a matter of time before the SEC determines that one or more sponsors of innovative digital asset-related ETPs have satisfied applicable statutory requirements and approves rule changes to allow national exchanges to list and trade them.

ETP Approval Process Basics

Rather than predict or anticipate how the SEC will approach any one application, we will attempt to explain, at a high level, both the rule change application process itself and a non-exhaustive list of issues that the SEC likely is considering, which may provide insight as to what products the SEC may approve in the future.

Digital Asset-Related ETFs Require Rule Changes

For any ETP to be publicly listed and traded on a U.S. national securities exchange, the ETP must first file with the SEC a registration statement, and the registration statement must become effective. In addition, the ETP must comply with the listing rules of the national securities exchange on which its shares will trade. If the ETP cannot comply with the exchanges existing, or "generic," listing standards, then the exchange must ask the SEC to approve a rule change under Section 19b-4 of the Exchange Act that would permit the listing.

At present, an ETP that provides returns linked to bitcoin or other digital assets cannot meet the SEC-recognized "generic listing standards" described below. Practically speaking, this means that every national securities exchange wishing to list and trade a digital asset-related ETP first would need to obtain a rule change that would specify the particular listing and trading standards applicable to such proposed ETP.

Generic listing standards.

In general, a national securities exchange (as defined under the [Exchange Act]) can list and trade shares of an ETP that meets certain pre-approved “generic listing standards.” Generic listing standards include specific guidelines and limitations relating to, among other things:

- Minimum market value of the ETP’s underlying holdings;
- Minimum trading volume of the underlying issuers of the assets in which the ETP is investing;
- Specific weightings of types of stocks and bonds held in the ETP’s portfolio;
- Minimum number of portfolio components (e.g., U.S.-component, non-U.S. component) of the ETP;
- Listing requirements for the ETP’s underlying portfolio holdings;
- Limitations on the ETP’s ability to leverage its investment returns of its underlying benchmark index or asset, or to provide exposure that is inverse to the value of the investment returns of the underlying benchmark index or asset class (that is, an investment return that moves in the opposite direction from the returns of the benchmark);
- Minimum number of holdings by the ETP of fixed income securities; and
- Requirements concerning diversification of individual ETP portfolio holdings (that is, the minimum number issuers that the ETP must hold).

Until recently, generic listing standards were available only to ETPs that tracked a specific benchmark. These ETPs are known as “passively managed” ETPs because they invest passively in the assets that comprise the underlying index and no investment discretion is involved.

In 2016, the SEC adopted generic listing standards for fully transparent “actively managed” ETPs. Actively managed are ETPs that attempt to achieve an investment return in excess of a benchmark’s performance based on the investment adviser’s investment skills. Actively managed ETPs that can comply with these generic listing standards can more easily list and trade their shares on the national securities exchange.

A national securities exchange that wishes to list and trade shares of an ETP that cannot comply with the generic listing standards must apply to the SEC to obtain a rule change that would contain bespoke, or specific, standards for the new type of ETP. No bitcoin or other digital asset-related ETP can satisfy the generic listing requirements, and a national securities exchange therefore must apply to the SEC for a rule change to allow the listing. For that reason,

until the SEC grants its approval, registered bitcoin and other cryptocurrency-linked ETPs cannot become a reality.

Rule 19b-4 – the Rule Change Process

As explained above, a national securities exchange that wishes to list and trade a bitcoin or other digital asset-related ETP must file, for the SEC’s consideration, an application for a rule change under Rule 19b-4 of the Exchange Act that would include specific standards (that is, listing standards that differ from the pre-approved generic listing standards).

Rule 19b-4 provides that a self-regulatory organization (an “SRO”), including a national securities exchange, proposing to list and trade a “new derivatives securities product” must have established trading rules, procedures and listing standards for the product class.

Rule 19b-4 defines a “new derivatives securities product” to mean “any type of option, warrant, hybrid securities product or any other security (other than a single equity option or a security futures product) whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument. An ETP that seeks to provide returns equivalent or related to the value of bitcoin, or any other cryptocurrency or digital asset, for that matter, would be a “new derivatives securities product” for purposes of Rule 19b-4. A digital asset-related ETP, however, cannot comply with a national securities exchange’s pre-approved generic listing standards.

Section 19(b)(2) of the Exchange Act provides that within 45 days after the publication of a notice of the proposed rule change (or up to 90 days if the SEC indicates that it needs additional time for consideration), the SEC either must approve or disapprove an SRO’s proposed rule change, or the SEC must institute proceedings to determine whether it should approve or disapprove it.

If the SEC does not approve or disapprove the proposed rule change within the 45 day deadline (or 90 day extended deadline), it must notify the applicable SRO of the grounds for disapproval and provide the SRO with an opportunity for a hearing. If elected by the SRO, such a hearing generally must be concluded within 180 days after the date of publication of the notice of the proposed rule change, although the SEC may, at its option, extend this deadline for an additional 60 days.

If the SEC fails to approve or disapprove the proposed rule change within 180 days (or 240 days, if such review period

is extended) after its publication, the proposed rule change automatically becomes effective. In essence, the Exchange Act effectively forces the SEC either to take some action or the application automatically becomes effective.

When the SEC approves an application by a national securities exchange for a rule change, that approval relates only to a particular listing. That is, unless an ETP can satisfy the generic listing requirements, the exchange on which it would be listed must apply for a separate and distinct rule change.

The SEC's Standard of Review for a Proposed Rule Change

When reviewing a proposed rule change, the SEC considers whether the national securities exchange's proposal is consistent with Section 6(b)(5) of the Exchange Act. Section 6(b)(5) generally requires that the rules of a national securities exchange be designed "to prevent fraudulent and manipulative acts and practices" and "to protect investors and the public interest."

An exchange proposing a Section 19b-4 rule change must describe the purpose of the proposed rule change and how it would operate, and it must provide to the SEC a legal analysis of how the proposed rule is consistent with the requirements of Section 6(b)(5).

As of this writing, the SEC has denied multiple digital asset-related rule change applications, based on the SEC's determination that the proposed listing and trading standards and procedures were insufficient to "prevent fraudulent and manipulative acts and practices."

While it has not approved a digital asset-related ETP or proposed rule change under Rule 19b-4, the SEC [staff] has provided publicly certain insights concerning its views about Section 6(b)(5) compliance in such context.

For instance, although the SEC has acknowledged that there may be more than one way in which a national securities exchange could meet its obligations under Section 6(b)(5), the SEC nevertheless has emphasized, its view that surveillance-sharing agreements form a critical component of any such compliance. Surveillance sharing agreements are arrangements between the exchange and other markets (typically non U.S.-markets) to provide information about that other market that may help the U.S. exchange to enforce its laws and prevent fraud. (See, e.g., Intermarket Surveillance Group No-Action Letter, June 3, 1994, available at <https://www.sec.gov/divisions/marketreg/mr-noaction/isg060394.htm>

Selected History of, and Context for, Digital Asset-Related ETPs Disapproved by the SEC

Winklevoss Bitcoin ETF Trust.

The Winklevoss Bitcoin ETF Trust was a high-profile proposed ETP designed with the goal of tracking the price of bitcoin on the Gemini Exchange. See <https://www.sec.gov/Archives/edgar/data/1579346/000119312517034708/d296375ds1a.htm>. The Gemini Exchange is a digital-asset exchange owned and operated by the Gemini Trust Company, a limited liability, limited purpose trust company chartered in New York, which is an affiliate of the ETP's sponsors. The proposed Winklevoss ETP contemplated that bitcoin would be the only asset held by it and that Gemini Trust Company would provide custody services for the ETP's bitcoin holdings. As proposed, the Winklevoss ETP would have operated much like any other ETP, buying and selling "creation units" (consisting of 100,000 bitcoin) and publishing an Intraday Indicative Value (IIV) every 15 seconds during the regular trading session of BZX, the would-be listing exchange.

The SEC's Division of Trading and Markets, acting on "delegated authority" from the SEC, disapproved a proposed rule change filed by BZX that would have permitted BZX to list and trade shares of the Winklevoss ETP. Release No. 34-80206 (March 10, 2017), available at <https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf>

BZX subsequently petitioned the SEC to review the disapproval by delegated authority. The SEC granted BZX's petition for review and sought public comments in favor of, or opposed to, the application.

The SEC set aside the Division's Disapproval Order, and itself disapproved BZX's proposed rule change, concluding that the underlying bitcoin market in which the ETP would participate "is not demonstrably resistant to manipulation," such as front running. Release No. 34-83723 (July 26, 2018), available at <https://www.sec.gov/rules/other/2018/34-83723.pdf>

To address potential manipulation concerns, the SEC insisted, BZX, as the listing exchange, "must enter into surveillance-sharing agreements with, or hold Intermarket Surveillance Group membership in common with, at least one significant, regulated market relating to bitcoin."

The SEC rejected BZX's arguments that bitcoin and bitcoin markets are "inherently resistant to manipulation," as well as that a surveillance-sharing agreement

was not the only way that BZX could satisfy the statutory requirement that its rules be designed to prevent fraudulent and manipulative activity. The SEC's denial order detailed, at length, ways in which BZX had failed to demonstrate that the bitcoin markets were manipulation-resistant.

The Peirce dissent.

Not all SEC staff agreed with the SEC's denial of the Winklevoss Bitcoin ETP and related rule change, however, and some disagreed quite publicly.

For instance, SEC Commissioner Hester M. Peirce published a lengthy dissent from the SEC's order disapproving the BZX proposed rule change, explaining that, in her view, the proposed rule change satisfied Section 6(b)(5)'s statutorily mandated standards. Dissent of Commissioner Hester M. Peirce to Release No. 34-83723 (July 26, 2018), available at <https://www.sec.gov/news/public-statement/peirce-dissent-34-83723>

Peirce argued that the SEC's focus on the potential manipulation of the underlying bitcoin spot market was improper, positing, instead, that the SEC should have focused on the ETP's shares proposed to be listed on the exchange. In Commission Peirce's view, to determine whether the Winklevoss Bitcoin ETP satisfied the relevant statutory requirements, the SEC should evaluate whether BZX's own rules were sufficient to surveil trading of, and deter manipulation in, the ETP's shares that would be listed and traded on the exchange.

Perhaps more significantly, Commissioner Peirce asserted that the SEC's analytical approach when consideration of the Winklevoss Bitcoin ETP "undermines investor protection by precluding greater institutionalization of the bitcoin market" and "sends a strong signal that innovation is unwelcome in our markets, a signal that may have effects far beyond" the fate of bitcoin ETFs and other ETPs.

Commissioner Peirce's dissent, and her subsequent speech on May 9, 2019 to the Securities Enforcement Form spotlights an ongoing, broader and, arguably, fundamental debate about how the SEC should balance what appear to be competing and, at times, conflicting SEC mandates: investor protection and encouraging open and efficient U.S. markets. Remarks of Commissioner Hester M. Peirce (May 9, 2019), available at <https://www.sec.gov/news/speech/peirce-how-we-howey-050919>

Subsequent rule change application denials.

On August 22, 2018, the SEC disapproved two applications from NYSE Arca and one from BZX. Rel. 34-83913 (August 22, 2018), available at <https://www.sec.gov/rules/sro/cboebzx/2018/34-83913.pdf>; Rel. 83904 (August 22, 2018), available at <https://www.sec.gov/rules/sro/nysearca/2018/34-83904.pdf>; and Rel. 83912 (August 22, 2018); available at <https://www.sec.gov/rules/sro/nysearca/2018/34-83912.pdf>

The disapproved applications would have allowed the applicable exchange to list and trade shares of multiple proposed ETPs that would enable indirect investment exposure to bitcoin, via bitcoin futures and other bitcoin-related derivatives, including swaps, rather than by holding bitcoin directly. In each case, the proposed ETPs would provide direct or inverse exposure to the performance of a benchmark futures contract for a single day. In addition, one of the rule change applications would have permitted the listing and trading of geared, or leveraged, versions of a similar ETP.

In connection with each such application denial, the SEC repeated its view that having a surveillance-sharing agreement with a regulated market is *required* to ensure that the proposed rule change meets the Section 6(b)(5) standard of "preventing fraudulent and manipulative acts and practices."

The SEC's repeated denials of rule change applications for digital asset-related ETPs mean that U.S. investors seeking to obtain bitcoin exposure must look to available alternatives. As explained earlier, such alternatives have their own significant risks – and, as compared to the proposed digital asset-related ETPs, arguably provide investors with *less*, not greater, protection from market manipulation.

Pending Digital Asset-Related ETP Rule Change Applications

SEC Commissioner Robert Jackson reportedly stated, on February 18, 2019, that, in his view, "eventually" a proposed ETP would satisfy the SEC's standards for approval. As of today, it still remains to be seen how, and when. Yet, despite the SEC's stated concerns about digital asset-related ETPs, many market participants continue to press forward.

USCF Crescent Crypto Index Fund

On May 9, 2019, United States Commodity Index Funds Trust filed a registration statement on Form S-1 to register

shares of an ETP (the USCF Crescent Crypto Index Fund) that seeks to match the daily changes in percentage terms of its net asset value to reflect the daily changes in percentage terms of an affiliated index that tracks the performance of bitcoin and ether. https://www.sec.gov/Archives/edgar/data/1479247/000117120019000215/i19283_xbet-s1.htm

Notably, the proposed USCF Crescent Crypto Index Fund would not register as an investment company. Instead, its sponsor is a commodity pool operator subject to regulation by the CFTC and the National Futures Association.

With this filing, the USCF Crescent Crypto Index Fund joins multiple proposed bitcoin-related ETFs – and attendant rule changes – under the SEC’s current consideration, including one filed by Bitwise Asset Management and NYSE Arca and another filed by VanEck, SolidX and the Cboe BZX Exchange.

Bitwise Bitcoin ETF Trust and Van Eck SolidX Bitcoin Trust.

Bitwise Bitcoin ETF Trust filed a registration statement on Form S-1 on January 10, 2019. <https://www.sec.gov/Archives/edgar/data/1763415/000149315219000408/forms-1.htm>

The Bitwise ETP’s stated investment objective is to “provide exposure to bitcoin at a price that is reflective of the actual bitcoin market where investors can purchase and sell bitcoin, less the expenses of the Trust’s operations.” The proposed Bitwise ETP would hold bitcoin directly and would value its shares “based on prices drawn from exchanges representing substantially all of the economically significant spot trading volume on bitcoin exchanges around the world.”

The Bitwise ETP did not register as an investment company under the 1940 Act and, thus, would not be subject to regulation as a mutual fund. The registration statement also disclosed that the Bitwise ETP would not be a commodity pool for purposes of the Commodity Exchange Act. For that reason, the sponsor would not be subject to regulation by the CFTC as a commodity pool operator or a commodity trading advisor.

On January 28, 2019, NYSE Arca filed a notice of filing of a proposed rule change to list and trade shares of the Bitwise ETP. Release No. 34-85093, 84 FR 4589 (Feb. 15, 2019), available at <https://www.sec.gov/rules/sro/nysearca/2019/34-85093.pdf>

Bitwise filed an amended registration statement on April 16, 2019, available at <https://www.sec.gov/Archives/edgar/data/1763415/0001493152190005505/forms-1a.htm>

On May 14, 2019, the SEC published a notice and order to solicit comments on a proposed rule change that would allow NYSE Arca to list and trade shares of Bitwise Bitcoin ETF Trust. SEC Release No. 34-85854 (May 14, 2019), available at <https://www.sec.gov/rules/sro/nysearca/2019/34-85854.pdf>

On March 29, 2019, the SEC extended the deadline by which it must either approve, disapprove, or institute hearings to consider, NYSE Arca’s proposed “rule change.” <https://www.sec.gov/rules/sro/nysearca/2019/34-85461.pdf>

VanEck SolidX Bitcoin Trust.

Similar to Bitwise, VanEck SolidX Bitcoin Trust filed a registration statement on Form S-1, as amended on June 5, 2018, to register shares of an ETP that would buy and sell bitcoin directly, with a goal of tracking the bitcoin’s price. https://www.sec.gov/Archives/edgar/data/1668039/000110465918038369/a18-2298_1s1a.htm. Like the Bitwise ETP, the VanEck SolidX ETP did not register as an investment company under the 1940 Act.

In February 2019, the SEC published a notice of a proposed rule change by BZX with respect to the shares of the VanEck SolidX ETP. Rel. No. 34-85119, available at <https://www.sec.gov/rules/sro/cboebzx/2019/34-85119.pdf>. A few weeks later, the SEC extended the date by which it was required to approve, disapprove, or institute proceedings to determine whether to approve or disapprove, BZX’s proposed rule change. Rel. No. 34-85475 (March 29, 2019), available at <https://www.sec.gov/rules/sro/cboebzx/2019/34-85475.pdf>. Finally, on May 20, 2019, the SEC instituted proceedings under Section 19(b)(2)(B) of the Exchange Act to determine whether to approve or disapprove BZX’s proposed rule change. Rel. 34-85896 (May 20, 2019), available at <https://www.sec.gov/rules/sro/cboebzx/2019/34-85896.pdf>.

As of the date of this writing, we do not know what the results of the SEC’s Section 19(b)(2) proceedings will be, or whether the SEC eventually will approve digital asset-related ETP, as Commissioner Jackson predicted.

It’s Not Just Market Manipulation Concerns: The Blass Letter

SEC’s Division of Investment Management identified additional risks that must be addressed before the SEC’s

staff will not object to the registration of a digital asset-related investment company. We note that some proposed digital asset-related ETPs have been structured in way that would require them to register as investment companies under the 1940 Act.

In January 2018, Dalia Blass, Director of the Division of Investment Management, in a letter to the Securities Industry and Financial Markets Association and the Investment Company Institute (the “Blass Letter”), raised publicly numerous regulatory concerns raised by ETFs proposing to invest in digital assets, whether by holding directly such digital assets or related derivatives. Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>

The Blass Letter posed a number of specific questions, and identified several issues relevant for registered funds. It also invited comments from, and discussion with, relevant market participants. Among other things, the Blass Letter raised the following concerns:

- *Valuation.* Director Blass asked, among other things, how registered funds could fairly value cryptocurrency-related products, especially those that involve characteristics that appear to be unique to such asset class. For example, how would a fund value a cryptocurrency that diverges in the case of a “fork”?
- *Liquidity.* A registered open-end fund is required to limit its investments in illiquid securities to no more than 15 percent of such fund’s net assets. A registered open-end fund also must classify all of its assets into one of four liquidity categories (or “buckets”). The Blass Letter expressed concerns about how funds that invest in cryptocurrencies and related assets would comply with the limitations on liquidity and the requirements of Rule 22e-4 under the Investment Company Act of 1940, also known as the liquidity risk management rule, which it adopted in 2016. Release No. IC-32315 (Oct. 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10233.pdf>.
- *Custody.* Many believe that the most vexing question affecting registered funds is how the SEC should regulate custody (i.e., safekeeping) of cryptocurrency and related assets. The SEC and members of its staff repeatedly have emphasized the mandate to protect Main Street investors and have identified custody as a key issue.
- *Arbitrage for ETFs.* Given the typically volatile nature of the markets for cryptocurrencies and related assets, the Division of Investment Management’s staff has concerns that market makers may not fully understand

the feasibility, or lack thereof, of arbitrage for cryptocurrency-related ETFs. As Blass Letter noted, efficient arbitrage ensures that the deviation between net asset value and market price is minimal.

- *Potential market manipulation.* The Blass Letter reinforced views expressed by SEC staff and certain commissioners that cryptocurrency markets feature substantially less investor protection than do traditional securities markets. This concern, again, relates to the Commission’s oft-stated goal of protecting “Main Street” investors from significant losses due to potential fraud or market manipulation.

The Blass Letter made clear that, until the regulatory questions identified in the Blass Letter were capable of being addressed satisfactorily, “we do 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 we have asked sponsors that have registration statements filed for such products to withdraw them.”

Similarly, the Blass Letter discouraged registered funds from amending their existing registration statements to permit such funds to “invest substantially in cryptocurrency or related products.”

Notwithstanding the Blass Letter’s cautionary statement, on March 13, 2019, a new bitcoin-related closed-end fund filed a registration statement on Form N-2. Cipher Technologies Bitcoin Fund, Registration Statement on Form N-2 (May 13, 2019), available at https://www.sec.gov/Archives/edgar/data/1776589/000114420419025611/tv521304_n2.htm.

The fund, which registered as an investment company under the 1940 Act, seeks to provide the total returns available to direct investors in bitcoin, less operating expenses of the fund. The fund would endeavor to achieve its investment objective by investing substantially all of its total assets in a portfolio of bitcoin or futures contracts or other derivatives providing similar economic exposure, as well as certain liquid securities to satisfy certain requirements of Rule 23c-3 under the 1940 Act, which requires interval funds periodically to maintain a minimum degree of liquidity.

The fund would be structured as an “interval fund,” which means that it would provide liquidity by offering to repurchase between five percent and 25 percent of its outstanding shares each quarter at net asset value.

Two weeks later, the SEC staff responded to the filing with a letter, indicating that as a threshold matter, it is “unclear

whether the proposed fund would meet the definition of an investment company,” and that the proposed fund does not satisfactorily address the issues raised in the Blass Letter. The staff asked that the fund’s sponsor withdraw the registration statement. Letter dated May 28, 2019 of Brent J. Fields, Associate Director, Disclosure Review and Accounting office, available at <https://www.sec.gov/Archives/edgar/data/1776589/999999999719005113/filename1.pdf>

Although the Blass Letter identified issues specifically concerning registered investment companies, many such concerns – particularly those related to valuation, liquidity, market manipulation and custody – arguably may be equally relevant for those ETPs that are not registered investment companies. While the Blass Letter refers specifically to “cryptocurrency,” it is reasonable to read the letter to refer to digital assets more generally.

The Custody Letter.

On March 12, 2019, the SEC’s Division of Investment Management published a letter (the “Custody Letter”) seeking public input to help it better understand how the characteristics of digital assets affect compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Custody Rule”). Engaging on Non-DVP Custodial Practices and Digital Assets (March 12, 2019), available at <https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206>.

The Custody Rule was designed generally to prevent misappropriation or misuse of assets when investment advisers have “custody” of client assets. While the Custody Rule does not expressly define what constitutes adequate custody, it specifies certain requirements for those investment advisers who are authorized or permitted to withdraw, upon instruction to the applicable custodian, client funds or securities maintained with such custodian.

While, at first glance, the Custody Letter appears to be limited in scope to issues raised under the Investment Advisers Act, it raises concerns that arguably are common to, or are similar or otherwise analogous to other issues affecting, a variety of kinds of digital asset-related ETPs.

Current Alternatives for Investors to Obtain Digital Asset Exposure

As noted previously, U.S. persons that do not satisfy the definition of “accredited investor” (under Regulation D

of the Securities Act) are limited in the ways in which they can gain investment exposure to digital assets, such as bitcoin. Main Street investors generally can purchase bitcoin (or certain other digital assets that deemed to be securities) on a cryptocurrency exchange, via a cryptocurrency OTC market or peer-to-peer. Indeed, even bitcoin futures, which enjoyed immense popularity immediately after their launch in late 2017, by the Cboe and the Chicago Mercantile Exchange, and which enable investors to gain investment exposure to bitcoin without holding bitcoin itself, have been off-limits to most retail investors.

Accredited investors have greater investment options than Main Street investors. For instance, in addition to taking positions in bitcoin futures, accredited investors may access investment alternatives that generally are unavailable to retail purchasers, such as purchasing certain digital assets directly in offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act.

In addition, accredited investors may elect to invest in Grayscale Bitcoin Trust (“GBTC”), formerly known as Bitcoin Investment Trust, which many believe to be the closest thing that currently exists to a digital asset-related ETF. Generally, investment in Grayscale Bitcoin Trust is limited to accredited investors, unless the restrictions on secondary trading have been removed pursuant to rules under the Securities Act.

Grayscale Bitcoin Trust.

GBTC is a privately offered “grantor trust” that attempts to track bitcoin’s “market price,” minus fees and expenses, by reference to a bitcoin-related index. GBTC, which is quoted on OTCQX[®], an over-the-counter trading market, is a hybrid of sorts. While investors can trade interests in the trust in the over-the-counter market, such investors must satisfy either the definition of “accredited investor” or another kind of sophisticated investor as specified in Regulation D under the Securities Act.

In 2017, Bitcoin Investment Trust attempted to register its shares with the intention of listing them on NYSE Arca. On January 20, 2017, it filed a registration statement on Form S-1. Registration Statement of Bitcoin Investment Trust on Form S-1 (January 20, 2017), available at <https://www.sec.gov/Archives/edgar/data/1588489/000119312517013693/d157414ds1.htm>

In 2017, NYSE Arca filed an application for a rule change that would allow it to list and trade shares of

Bitcoin Investment Trust. Rel. 34-79955 (February 3, 2017), available at <https://www.sec.gov/rules/sro/nyse-arca/2017/34-79955.pdf>.

After filing two post effective amendments, on July 7, 2017, representatives of Bitcoin Investment Trust's sponsor, Grayscale Investments, LLC, met with the SEC to discuss the filing. See presentation to U. S. Securities and Exchange Commission (July 7, 2017), available at <https://www.sec.gov/Archives/edgar/data/1588489/000119312517228591/d411511dfwp.htm>

Reportedly facing resistance, Bitcoin Investment Trust withdrew its registration statement on October 25, 2017. Bitcoin Investment Trust, Application for withdrawal of Registration Statement (Oct. 25, 2017), available at https://www.sec.gov/Archives/edgar/data/1588489/000095010317010239/dp81942_rw.htm

For that reason, although GBTC arguably is the investment alternative that is most like a bitcoin-related ETF, it differs in at least one key way: It is off-limits to most Main Street investors.

Conclusion

Investor interest in digital asset-related ETPs appears to continue to grow, while the U.S. regulatory landscape is evolving rapidly. U.S. regulators, including the SEC, the CFTC, the Financial Industry Regulatory Authority ("FINRA"), and the 50 states, not to mention the U.S. Congress, are struggling to develop a regulatory framework that will satisfy the U.S. market's desire for digital asset-related ETPs, while simultaneously protecting Main

Street investors from fraud, market manipulation and inadequate custody procedures.

Adding to this challenge, swiftly moving technological development may provide opportunities for both market innovation, and opportunities for would-be malfeasors to disrupt those markets. Moreover, market participants are potentially subject to multiple laws regulated by multiple federal and state regulators, each with different constituencies and goals. But too much regulation may inadvertently chill the U.S. markets or allow non-U.S. markets to overtake – or even eclipse – the ability of U.S. markets to offer new products.

When will the SEC permit digital asset-related ETPs? Our best guess is "eventually." Admittedly, the digital asset-related ETP is not an easy puzzle for U.S. regulators, market participants or their lawyers to solve.

The SEC and other regulators, including the CFTC, have repeatedly warned Main Street investors about the potential dangers inherent in digital asset purchases and related investments. Yet, retail purchasers continue to purchase digital assets and to clamor for new digital asset-related investment products.

As U.S. regulators move cautiously to protect Main Street investors, it is important to remember that many of those same retail purchasers are – today – gaining direct investment exposure to digital assets, sometimes with little to none of the protections that even an imperfectly designed digital asset-related ETP might provide. When regulating digital asset-related ETPs, perhaps we should be equally cautious not to lose sight of the good, while in pursuit of the perfect.