Securities Regulation Daily Wrap Up, TOP STORY—SEC rejects listing of Winklevoss bitcoin ETF, (Jul. 27, 2018)

Securities Regulation Daily Wrap Up

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The bitcoin derivatives markets are not large enough to permit an exchange-traded fund, the SEC suggested in rejecting an exchange's bid to list shares in the Winklevoss Bitcoin Trust. Bats BZX Exchange, Inc., failed to convince three members of the Commission that its surveillance-sharing agreement with the Winklevoss twins' Gemini Exchange was sufficient to prevent fraud and manipulation, as required by the Exchange Act. Dissenting, Commissioner Peirce argued that allowing the product to be listed would help ameliorate the majority's concerns about manipulation by helping to stabilize the bitcoin market (Release No. 34-83723, July 26, 2018).

The three-member majority clarified that its disapproval was not a comment on bitcoin's "utility or value as an innovation or an investment." But Commissioner Peirce wrote that the concerns underlying the order do go to the merits of bitcoin. "Moreover, because it opines at length about the quality of the bitcoin spot market, the disapproval order suggests that, when we do finally approve an ETP on bitcoin (or any other product traded in a non-traditional market), investors may reasonably—but incorrectly—conclude that the investment carries with it the SEC's imprimatur."

Exchange rules must deter fraud and manipulation. The SEC originally disapproved the proposed rule change by the exchange, then known as Bats BZX Exchange, Inc. and since acquired by Cboe, in March 2017. The SEC granted BZX's petition for review of this disapproval and sought public comments. Following a de novo review of the proposal, the SEC again disapproved it, three commissioners to one (the vote occurred after Commissioner Piwowar's departure earlier this month). The crux of the order is Exchange Act Section 6(b)(5), which requires that an exchange's rules be "designed to prevent fraudulent and manipulative acts and practices."

In seeking review, BZX's primary argument was that a surveillance-sharing agreement between the listing exchange and significant regulated markets is not the only way to satisfy the Exchange Act requirement that the exchange's rules be designed to prevent fraud and manipulation. In the case of a bitcoin commodity-trust exchange-traded product (ETP), it argued, traditional measures to detect and deter manipulation are sufficient.

Bitcoin is susceptible to manipulation. The Commission agreed with BZX that surveillance-sharing agreements, whose function is to detect and deter fraud and manipulation, would not be required if bitcoin and bitcoin markets were inherently resistant to fraud and manipulation. However, the SEC rejected that premise.

The SEC considered arguments from BZX and certain commenters regarding the susceptibility of bitcoin and bitcoin markets, including Gemini Exchange, to manipulation and the availability of traditional means to detect and deter fraud and manipulation. Some of these comments presented the idea that bitcoin's unique characteristics, such as the lack of a single market-close and the fungibility of bitcoin across exchanges, made manipulation less likely and constrained prices within the bounds of arbitrage. Commenters also pointed out the improbability of any one actor obtaining a dominant market share.

The SEC rejected many of these arguments, including the suggestion that there is no concern about inside information or the dissemination of false or misleading information with respect to bitcoin. Even if there is no inside information about earnings or revenue, the Commission reasoned, there may be material nonpublic information about the actions of regulators; order flow; new sources of demand; or how an ETP, venue, or other service provider would deal with a fork in the blockchain.

Futility of seeking a surveillance-sharing agreement. The agency concluded that the underlying market was not demonstrably resistant to manipulation, necessitating a surveillance-sharing agreement with at least one significant, regulated market relating to bitcoin. The order hints at the impossibility of securing such an agreement to the Commission's satisfaction at this stage of bitcoin's development, because not only does Gemini Exchange fail to satisfy the requirement of a "regulated market of significant size," but BZX failed to demonstrate that *any* of the current trading venues in the worldwide bitcoin spot market could be a party to a satisfactory surveillance-sharing agreement. "While the record does not support a conclusion that bitcoin derivatives markets have attained significant size," the majority writes:

> Over time, regulated bitcoin-related markets may continue to grow and develop. For example, existing or newly created bitcoin futures markets may achieve significant size, and an ETP listing exchange 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.

Dissent. Commissioner Peirce would have approved the proposed rule change as satisfying the requirements of Exchange Act Section 6(b). In the commissioner's view, disapproving the listing inhibits institutionalization of the bitcoin market, and institutionalization could ameliorate some of the very problems that the majority identified as reasons to deny listing. The dissent also said that the order dampens innovation by comparing the underlying market to the markets for other commodities, making the SEC "the gatekeepers of innovation." Peirce "would rather we err on the side of approving products so that investors, who are generally better judges about these things than we are, can form their own views about a particular innovation and act on those views in the market."

Peirce believes that the majority misread Section 6(b)(5) by focusing on the characteristics of the bitcoin spot market, rather than on BZX's ability to detect and deter manipulation in the shares listed on its exchange. The proposal details how the shares would trade under an exchange rule that imposes initial and continued listing standards, as well as obligations on registered market makers. BZX would also be able to halt trading if necessary. More broadly, the commissioner states that the order, by focusing on the bitcoin spot market, gives insufficient weight to the function that self-regulatory organizations such as BZX perform under the SEC's regulatory framework. Nothing in the record suggests that BZX is unwilling or unable to fulfill its responsibility to monitor trading and ensure the integrity of its listed products, with Commission oversight.

Even if Peirce were to focus on the underlying markets, she would allow the product to be listed. The commissioner is unpersuaded that the disapproval order's "regulated market of significant size" test is the appropriate one, and private regulation can achieve well-functioning markets even absent government regulation. Moreover, the Gemini Exchange is regulated by the state of New York.

Peirce also argues that the disapproval order inhibits institutionalization of bitcoin products. The order "suggests that approval for bitcoin ETPs will come only when bitcoin spot and derivatives markets have matured substantially, yet, at the same time, contributes to further delay in their maturation." This undermines investor protection by relegating bitcoin investors to the spot market, denying them the opportunity to access bitcoin through an exchange-listed avenue.

Finally, the order dampens innovation by suggesting that a novel financial product based on a novel technology, that trades on a non-traditional market, cannot be the basis of an ETP. Peirce expressed concern that by withholding approval because the underlying market insufficiently resembles the markets for other commodities, the SEC sets itself up as the gatekeeper of innovation, a role for which it is ill-equipped. Rather than considering the unique opportunity presented by bitcoin's innovative characteristics—electronic trading, geographic neutrality, fungibility—the order derives its legal and regulatory approach from prior approval orders for commodities with very different characteristics.

Companies: Bats BZX Exchange, Inc.; Winklevoss Bitcoin Trust; Gemini Trust Company LLC; Digital Asset Services LLC

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