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Bitcoin ETF
Substance over form, please

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

Since the first postponement of the decision to authorise trading in a bitcoin spot Exchange Traded Fund (ETF) – in March 2019 (proposal by VanEck and SolidX) – the Securities and Exchange Commission of the United States (SEC) has rejected eleven bitcoin spot ETFs consecutively and has not approved any. The rejections have been substantiated by the argument of insufficient compliance with Section 6(b)(5) of the Securities Exchange Act of 1934 and by insufficient evidence that the relevant bitcoin market is resistant to manipulations beyond that of traditional security or commodity markets. The SEC, however, authorised the first bitcoin futures ETF on 18 October 2021, which seems to be a situation of 'form over substance'. A bitcoin futures ETF, being based on derivatives, is inherently riskier than a bitcoin spot ETF, and the arguments supporting the rejection of a spot ETF logically carry over the bitcoin futures ETF. The Commodity Futures Trading Commission's (CFTC) formal overseeing of the bitcoin futures cannot alleviate the substantial concerns. The sense is that by privileging form over substance, the SEC tries to risk control the access to bitcoin by retail investors. However, given the increasingly easy access to bitcoin and other cryptos through products and services offered by the (often unregulated) market, the SEC stance may increase the risks for investors rather than provide effective protection.

Other notable regulatory developments over the last few weeks include the release of the report on stablecoins (recognising their economic value in principle) by the US Treasury, the passing of the controversial infrastructure bill (taxing cryptobrokers) by the Congress, and the decision of the Basel Committee on Banking Supervision (BCBS) to issue an updated version of its consultative document on the prudential treatment of banks' exposures to cryptoassets (taking stock of the comments received by the industry).

On 15 October 2021, the Securities and Exchange Commission (SEC) of the United States allowed trading in the ProShares bitcoin futures Exchange Traded Fund (ETF).

On 12 November 2021, the SEC rejected the bitcoin spot ETF proposal submitted by VanEck. Authorising the futures and rejecting the spot is 'form over substance' that increases the overall risk for investors.

1. US Bitcoin futures and spot ETFs: The case for 'form over substance'

The decision by the SEC to authorise trading in the bitcoin futures ETF based on the proposal submitted by ProShares took many analysts and policy makers by surprise because the SEC has consistently rejected up to ten bitcoin spot ETF applications in a row and never approved any so far. What follows recaps briefly the SEC's handling of bitcoin spot ETF applications since 2019, deep-dives into the rationale underpinning the rejections, recalls the circumstances surrounding the recent approval of a bitcoin futures ETF, and speculates the reasons why the SEC seems to privilege form over substance and what the result may be from an investor protection perspective.

The US bitcoin spot ETF saga

The SEC has received several bitcoin spot ETF applications during the last three years. It has never authorised any. It has always rejected the applications, sometimes after postponing the decision several times. Without claiming completeness, the SEC postponed the decision on the bitcoin spot ETF submitted by VanEck and SolidX in March 2019 and then again in August 2019. During the same month, it also postponed the decision on two other bitcoin spot ETF proposals (Wilshire Phoenix and Bitwise). Wilshire Phoenix's proposal was rejected by the SEC on 26 February 2020. In 2021, the SEC delayed the decision on the proposal by WisdomTree on 14 July and on 2 October. It postponed the decision on the proposal by Kryptoin on 14 June and on 2 October and that by GlobalX on 2 October. Finally, the SEC rejected the proposal by VanEck on 12 November and by WisdomTree on 1 December. At the time of writing, two bitcoin spot ETF applications are awaiting SEC's decision.

The rejection of the bitcoin spot ETF

The SEC has rejected all bitcoin spot ETF applications on the basis that none of them guarantee compliance with Section 6(b)(5) of the Securities Exchange Act of 1934. The provision was designed to prevent fraudulent and manipulative market acts and practices, and to protect investors and the public interest. When analysing bitcoin spot ETF applications, the SEC proxies the proposals with commodity ETPs, where each exchange listing the ETP enters a surveillance-sharing agreement with a regulated, significant, market that trades the underlying commodity. Such an agreement is meant to deter manipulations because it facilitates the investigation of manipulations and violations of exchange rules through sharing of information about market trading and clearing activity, and customer identity. Accordingly, the SEC has consistently argued that it will authorise a bitcoin spot ETF only if the applicants establish a comprehensive surveillance-sharing agreement with a regulated and sizeable market, trading the underlying assets that will ensure compliance with the provision of the Securities Exchange Act of 1934. All applicants have sought to demonstrate that means other than surveillance-sharing agreements will effectively prevent fraudulent and manipulative activities and practices, such as, for instance, the concept that the bitcoin market is resistant to fraud and manipulation. The SEC has, however, always deemed such arguments as insufficient and has concluded that the proposed bitcoin spot ETFs have not established that the relevant bitcoin market is resistant to manipulations beyond that of traditional security or commodity markets. The reader willing to examine the SEC reasoning may consult, for instance, the order disapproving the Wilshire-Phoenix's bitcoin spot ETF proposal or the more recent order disapproving the VanEck bitcoin spot ETF proposal.

The approval of the bitcoin futures ETF

On 18 October 2021, the SEC approved the trading of the bitcoin futures ETF application submitted by ProShares. The trading commenced on 19 October 2021. The SEC argued that bitcoin futures have been overseen by the Commodity Futures Trading Commission (CFTC) for four years under the provisions of the Investment Company Act of 1940 and that this fact provides the necessary comfort for investor protection. The decision to approve a bitcoin futures ETF before approving a bitcoin spot ETF has triggered several reactions by analysts and policy makers, including from two members of the Congress, who requested a formal statement by the SEC on 3 November 2021 on the argument that a bitcoin futures ETF is inherently riskier than a bitcoin spot ETF. The argument is that a bitcoin spot ETF, being based directly on the asset, provides more protection to investors than a bitcoin futures ETF. A bitcoin futures ETF, which is based on derivatives, is potentially much more volatile than a bitcoin spot ETF and may impose substantially higher fees on investors due the premium at which bitcoin futures typically trade. The congressmen further argued that the perceived potential for fraud and manipulation in the bitcoin markets carries over the bitcoin futures ETF, and that it is counterintuitive that the SEC is more comfortable allowing trading in a bitcoin futures ETF than in a bitcoin spot ETF. Finally, accepting that a bitcoin futures ETF is inherently riskier than a bitcoin spot ETF also means that the permission to trade bitcoin futures ETF while disapproving trading in bitcoin spot ETF overall exposes investors to enhanced risks–complicating the SEC's mission of protecting investors.

By approving the trading of a bitcoin futures ETF while perpetuating the rejection of bitcoin spot ETFs, the SEC seems to privilege a regulatory form over an economic substance. Why does the SEC seem to privilege form over substance, which is fundamentally an unstable position bound to evolve? One possible explanation is that by favouring a bitcoin futures ETF, the SEC is trying to risk control the access to bitcoin by retail investors. Allowing trading in a bitcoin spot ETF would immediately multiply retail investments in the major cryptocurrency, well above the retail involvement in a bitcoin futures ETF. As a case in point, the spot-based gold ETF SPDR Gold Trust has traded over USD 55.5 billion in the last 15 years, compared to only USD 50.4 million from the futures gold ETF DB Gold Fund. Such a controlled access would be effective if consumers' access to bitcoin and other cryptos did not rapidly increase via the rather unregulated market (exchanges etc.). Hence, the SEC's stance may increase the risks for investors rather than provide them with effective protection.

2.
Other Noteworthy Developments

In the US, the Treasury released its report on stablecoins, which recognises their potential benefits, while the Congress passed the controversial infrastructure bill, taxing cryptobrokers.

- The report on stablecoins released by the US Treasury recognises that, if well-designed and appropriately regulated, stablecoins can support faster, more efficient, and more inclusive/beneficial payments options. The report enlarges on the risks of stablecoins. These include risks related to market integrity and investor protection, illicit finance concerns and risks to financial integrity, and prudential and systemic risk concerns. The US Treasury sees the SEC and the CFTC in charge for market integrity and investor protection, the Treasury in lead for AML/CFT aspects, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency for prudential/systemic risk concerns.
- The Congress has passed the USD 1.2 trillion bill to improve America's infrastructure through a variety of measures. Amongst the measures is a tax imposed on crypto brokers, that is, organisations that trade crypto assets. Analysts are concerned that such tax imposition will slow down crypto adoption and, more importantly, favour decentralised finance.

In the UK, authorities are, on the one hand, concerned about risks embedded in the use of cryptocurrencies, and, on the other hand, they are taking concrete steps towards developing a CBDC.

- The Bank of England (BoE) expressed fresh concerns that the rise of cryptocurrency is stimulating illegal activities. The BoE is also worried that the increasing integration of cryptocurrencies in traditional finance may pose an imminent threat to the traditional financial system.
- On the contrary, the BoE plans to launch a consultation in 2022 on the possible rollout of a CBDC. The results will determine whether the UK will move forward with a CBDC. https://cointelegraph.com/news/uk-treasury-and-central-bank-will-consult-on-cbdc-potentially-launching-by-2030.

The BCBS will issue an updated version of its consultative document on the prudential treatment of banks' exposures to cryptoassets.

- The BCBS took stock of the comments received regarding its consultation on the prudential treatment of banks' exposures to cryptoassets. It reiterated the commitment to develop conservative risk-based global minimum standards to prevent such exposures and plans to further specify its proposals to issue a further consultative document by mid-2022.

Further progress on CBDC analyses and developments in France and Peru.

- The central bank of France published the results from its wholesale CBDC experiment. The experiment indicated ways in which central banks can implement securities settlement using DLT-based platforms and how a wholesale CBDC can be used to complete cross-border transactions within the EU.
- The central bank of Peru announced that it is joining forces with India, Singapore, and Hong Kong to develop a CBDC.

3. Conclusion

The decision by the SEC to authorise trading in the bitcoin futures ETF proposed by ProShares was surprising for analysts and policy makers, given that the Commission has consistently rejected up to ten bitcoin spot ETF applications and never approved any so far. A bitcoin futures ETF is based on derivatives and is, therefore, inherently riskier than a bitcoin spot ETF. The arguments put forward by the SEC when rejecting bitcoin spot ETFs carry over the bitcoin futures ETF. The decision by the SEC could be explained as an effort to risk control the retail access to bitcoin. This strategy would work effectively if consumers did not have easy access to bitcoin and other cryptos via the rather unregulated market.

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