International
Comparative
Legal Guides

Public Investment Funds

2024

Seventh Edition

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The Current State of U.S. Public Cryptocurrency Funds

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Introduction

As cryptocurrency[1] (particularly Bitcoin) adoption has gained momentum within the global financial markets in recent years, notwithstanding recent volatility, fund sponsors continue to indicate enthusiasm in bringing exchange-traded cryptocurrency-related funds ("**cryptocurrency ETFs**") to the U.S. investing public. In January 2024, in a significant development for the U.S. market, the U.S. Securities and Exchange Commission (the "**SEC**") approved the first 11 Bitcoin spot-based ETFs.[2] The SEC's approval of Bitcoin spot-based ETFs had been anticipated since October 2021, when the SEC allowed the first Bitcoin futures-based ETF registered under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") to begin trading.[3] Then, in April 2022, the SEC approved the first Bitcoin futures-based ETF not registered under the Investment Company Act and instead registered only under the Securities Act of 1933, as amended (the "**Securities Act**"),[4] and, in October 2023, the SEC allowed the first nine Ethereum futures-based ETFs registered under the Investment Company Act to begin trading.[5] Although no other types of cryptocurrency ETFs have been permitted by the SEC to date, proponents continue to assert the benefits that cryptocurrency ETFs would bring, including: (1) improving the existing means by which retail investors obtain exposure to cryptocurrencies (for example, by simplifying asset acquisition and custody); and (2) providing structural benefits to the existing cryptocurrency markets (for example, by deepening the pool of available liquidity). To date, the SEC has expressed a few key concerns – primarily around the integrity of the cryptocurrency spot market, including the online exchanges where such assets trade. This chapter describes the general features of the cryptocurrency ETFs that the SEC has so far considered, along with the SEC's principal reasons for declining to approve any such funds, other than Bitcoin ETFs and Ethereum futures-based ETFs. Finally, it will consider what 2024 may hold for these products, including a review of the latest cohort of potential cryptocurrency ETFs that will be under review by the SEC in 2024.

A Tight Spot and Murky Futures

Over the past few years, the SEC considered various registration statements and rule change applications[6] that would allow for cryptocurrency ETFs of two different varieties: (1) funds intending to transact in the cryptocurrency spot market and to hold cryptocurrencies directly ("**spot-based ETFs**"); and (2) funds intending to gain cryptocurrency exposure through futures ("**futures-based ETFs**"). Further, futures-based ETFs can be divided into long funds, which seek to mirror the performance, both daily and over time, of leading cryptocurrency futures contracts listed and traded on regulated U.S. national futures exchanges, and short funds, which seek to do the opposite. The approved futures-based ETFs only pertain to Bitcoin and Ethereum at the moment. Additionally, the approved spot-based ETFs focus solely on Bitcoin, and most proposed spot-based ETFs would focus solely on Bitcoin or Ethereum, although at least one proposed spot-based ETF would invest in a basket of cryptocurrencies.

The SEC, in declining to approve any such ETF – whether spot-based or futures-based – other than Bitcoin ETFs and Ethereum futures-based ETFs, has primarily cited concerns around the cryptocurrency spot market, including the online exchanges where such assets trade. The reason for this concern is that the market price for a cryptocurrency ETF's shares would be heavily influenced by trading activity in the lightly regulated, underlying cryptocurrency spot markets. Specifically, the arbitrage mechanism underpinning all ETFs causes an ETF's share price to be particularly sensitive to changes in the price of the ETF's underlying assets. This arbitrage mechanism – effected through the in-kind creation and redemption process undertaken by authorised participants – is intended to ensure that an ETF's share price closely tracks the ETF's net asset value per share ("**NAV**"). For example, if the ETF's shares are trading at a premium to NAV, authorised participants will create new shares at NAV ("**creation units**") and sell them on the open market. If the fund's shares are trading at a discount to NAV, authorised participants will buy shares on the open market and redeem them at NAV. Although this mechanism generally keeps an ETF's share price in line with its NAV, it also means that an ETF's share price is invariably vulnerable to issues in the markets for the underlying asset (and, in the case of a futures-based ETF, the assets underlying the futures contracts in the ETF's portfolio).

In that regard, the SEC has noted that the low liquidity of cryptocurrency exchanges could inhibit an ETF's arbitrage mechanism by limiting the ability of authorised participants to obtain sufficient quantities of the underlying asset to support creation transactions without affecting the underlying market price. The SEC has also noted that less liquid markets are more susceptible to manipulation and that, moreover, much of the volume in cryptocurrency trading occurs in venues outside the U.S. that are suspected to experience significant manipulation. For these reasons, the SEC has expressed concern that manipulation in the spot markets could ultimately adversely affect the integrity of the price of a cryptocurrency ETF's shares or even permit the shares themselves to be manipulated. In addition, the SEC has noted that cybersecurity, theft, hacking and operational issues, which have plagued cryptocurrency exchanges, could also inhibit the operation of a cryptocurrency ETF by reducing liquidity or permitting price manipulation.

Unfortunately for the ETF industry, the recent history of cryptocurrency exchanges offers several examples from which the SEC can draw to support its concerns. Over their decade-plus history, several cryptocurrency exchanges have been closed or impaired due to cybersecurity breaches and theft, in amounts totalling billions of USD. For instance, the now infamous Mt. Gox exchange filed for bankruptcy in 2014, claiming $63.6 million (USD) of outstanding debt, in connection with losing 750,000 of its customers' Bitcoins, along with 100,000 of its own.[7] In 2022, hackers stole more than $570 million (USD) worth of cryptocurrency from the Binance exchange[8] and more than $600 million (USD) worth of cryptocurrency from the FTX exchange, hours after it filed for bankruptcy.[9] In 2023, hackers stole more than $120 million (USD) worth of cryptocurrency from the Poloniex Exchange[10] despite a 50% decline in overall losses from cryptocurrency hacks compared to 2022.[11]

The FTX bankruptcy was precipitated by a November 2022 report that prompted concern across the cryptocurrency industry regarding FTX's financial health.[12] Shortly thereafter, FTX's chief executive officer appointed as part of the bankruptcy process, who had overseen some of the largest bankruptcies in history, including Enron's, said that "[n]ever in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here".[13] Sam Bankman-Fried, the founder of FTX, was subsequently charged by the U.S. Department of Justice, the SEC, and the U.S. Commodity Futures Trading Commission (the "**CFTC**") with fraud-related charges,[14] and was found guilty of seven criminal counts of fraud in November 2023.[15] In addition, the U.S. Department of Justice is reportedly investigating whether Sam Bankman-Fried and an FTX-affiliated trading firm manipulated the market for the stablecoin TerraUSD ("**UST**") and its companion token Luna, which was supposed to stabilise UST's $1 (USD) price, in a way that led to the collapse of the two cryptocurrencies, and a loss of $40 billion (USD) in investor funds, in May 2022.[16]

Additionally, in early 2019, one of the largest Canadian exchanges was unable to retrieve at least $190 million (USD) worth of customer funds.[17] After the mysterious death of its founder, customers quickly learned that this individual had the sole power to authorise movement of customer funds – fiat and cryptocurrency alike. With the defunct exchange now bankrupt,[18] this episode highlights the lack of appropriate operational risk management at some cryptocurrency exchanges, even large exchanges located in countries with robust financial regulatory systems.

Furthermore, in late 2017, an anonymous blogger cited publicly available trading data to conclude that a trading bot, aptly nicknamed "Picasso", was engaging in paint-the-tape-style manipulation on one of the largest and most prominent U.S. exchanges.[19] This strategy involved the alleged buying and selling of Bitcoin and Bitcoin Cash between affiliated accounts in order to create the appearance of substantial trading activity and, ultimately, to influence the price of such assets. Other reports of manipulative practices include so-called "banging the close"[20] and "spoofing"[21] and have been the subject of a high-profile criminal investigation by the U.S. Department of Justice.[22]

More broadly, these episodes illustrate the SEC's general observation that no cryptocurrency spot market, whether in the U.S. or abroad, is subject to governmental oversight on par with U.S. national securities exchanges, which are held to high cybersecurity and operations standards, and are required to take steps to detect and deter price manipulation and fraud. For example, the SEC rejected arguments that Gemini Exchange was a sufficiently regulated market simply by virtue of its New York State trust charter and supervision by the New York State Department of Financial Services (the "**NYDFS**").

While it is too early to anticipate what effect they will have in the long term, several trends have helped the industry begin to overcome the SEC's concerns with the state of the spot markets. First, not all SEC commissioners are convinced that the market issues are so grave that they should prevent the launch of cryptocurrency ETFs. In particular, Commissioner Peirce made waves with her dissent from the SEC's order disapproving the listing of one such fund, arguing that such disapprovals effectively preclude greater institutionalisation of cryptocurrency markets, and accordingly, raise even greater investor protection concerns.[23] Consider, for example, price fragmentation – i.e., the tendency of cryptocurrencies to vary in price, from time to time, across different exchanges. Commissioner Peirce notes that authorised participants would minimise fragmentation because, in the process of composing creation units, such participants could obtain cryptocurrency from any source. Because authorised participants have an incentive to buy at the lowest prices available, such authorised participants would effectively keep prices close together by "bidding up" the price on certain exchanges where the price started to diverge downward from the market.

Second, industry participants have joined forces in an effort to allay concerns of the SEC and the broader market related to issues of market integrity. For example, several large cryptocurrency companies – including prominent exchanges, OTC dealers and investment and trading firms – formed the Global Digital Asset & Cryptocurrency Association ("**Global DCA**").[24] Global DCA's stated goal is to provide a framework for self-regulation in the cryptocurrency spot market, in the form of a Code of Conduct, which would deter market manipulation and promote market integrity, risk management and data protection, among other things. Global DCA holds its members accountable via enforcement mechanisms such as surveillance and a legally binding dispute resolution forum.

Third, well-established and trusted financial services companies are beginning to offer custody solutions, which include robust security procedures and large insurance policies. For example, in 2019, Fidelity Investments launched Fidelity Digital Asset Services ("**FDAS**"), a full-service, enterprise-grade platform for securing, trading and supporting digital assets, such as Bitcoin.[25] In November 2019, the NYDFS announced that it had granted FDAS a charter under New York banking law to operate as a limited liability trust company.[26] In 2022, BNY Mellon became the first large U.S. bank to offer cryptocurrency custody services.[27]

Finally, fund sponsors have received approval to bring cryptocurrency ETFs, including Bitcoin spot-based ETFs, to market. Most of the approved Bitcoin spot-based ETF structures appear to be responsive to earlier SEC commentary that favoured pricing mechanisms that rely on multiple exchanges. Although such ETFs derive their prices from different index providers, many of the indexes are calculated based on prices contributed from the same six spot market exchanges: Bitstamp; Coinbase; Gemini; itBit; Kraken; and LMAX Digital. The sponsors of the approved Bitcoin spot-based ETFs also addressed one of the lingering issues that the SEC had previously identified – the lack of surveillance-sharing agreements with regulated markets of significant size – by leading the SEC to conclude that a surveillance-sharing agreement with the Chicago Mercantile Exchange ("**CME**") with respect to the CME Bitcoin futures market can reasonably be expected to assist in surveilling for fraudulent and manipulative acts and practices in the context of Bitcoin spot-based ETFs because the CME Bitcoin futures market is consistently highly correlated to the Bitcoin spot markets.[28]

The SEC's approval of Bitcoin spot-based ETFs is the latest evolution in the SEC's engagement with cryptocurrency products. In a May 2021 statement, the SEC staff acknowledged that some non-exchange-traded mutual funds were investing in Bitcoin futures, and stated that investment in Bitcoin futures should be pursued only by mutual funds with appropriate strategies that support this type of investment and full disclosure of material risks.[29] The statement noted that the SEC staff would consider whether, in light of the experience of mutual funds investing in the Bitcoin futures market, the Bitcoin futures market could accommodate ETFs, which, unlike mutual funds, cannot prevent additional investor assets from coming into the ETF if the ETF becomes too large or dominant in the market, or if the liquidity in the market starts to wane.[30] Then, in an August 2021 speech, SEC Chair Gary Gensler suggested that the SEC would permit Bitcoin futures-based ETFs registered under the Investment Company Act.[31] Shortly after the speech, multiple fund sponsors filed registration statements for Bitcoin futures-based ETFs that automatically became effective after 75 days without the need for affirmative SEC action. The first such registration statement to become effective was for the ProShares Bitcoin Strategy ETF, which began trading in October 2021.[32]

In April 2022, the SEC approved a rule change application for the first Bitcoin futures-based ETF registered under the Securities Act, but not the Investment Company Act, to list and trade on NYSE Arca.[33] In approving the rule change application, the SEC noted the experience of the Bitcoin futures-based ETFs registered under the Investment Company Act in finding, among other things, that NYSE Arca had entered into a comprehensive surveillance-sharing agreement with a regulated market of significant size (the CME) related to the ETF's underlying Bitcoin assets (CME Bitcoin futures contracts).

Although exchanges had likewise sought to list Bitcoin spot-based ETFs in reliance on their surveillance-sharing agreements with the CME, the SEC had, prior to its Bitcoin spot-based ETF approvals, not found that an exchange had met its burden of demonstrating that surveillance of the CME Bitcoin futures market would detect and deter fraud and manipulation targeting the Bitcoin spot markets. When, in June 2022, the SEC thus denied a proposal for shares of the Grayscale Bitcoin Trust to list and trade on NYSE Arca, Grayscale immediately sued the SEC, claiming that the SEC's denial was arbitrary in light of its approval of Bitcoin futures-based ETFs.[34] In August 2023, the U.S. Court of Appeals for the D.C. Circuit held that the SEC failed to provide a "coherent explanation" as to why it approved Bitcoin futures-based ETFs, but not the proposed Bitcoin spot-based ETF, and ordered the SEC to reconsider the decision.[35] When the SEC determined not to appeal the ruling, the stage was set for the SEC's approval of Bitcoin spot-based ETFs.[36] And now that the SEC has approved Bitcoin spot-based ETFs, sponsors are hopeful that the SEC will soon approve Ethereum spot-based ETFs[37] and leveraged and inverse Bitcoin spot-based ETFs.[38]

Additional Core Concerns

The SEC's disapprovals of various proposed cryptocurrency ETFs, as described above, were foreshadowed by a January 2018 letter from Dalia Blass, the then Director of the SEC's Division of Investment Management.[39] This letter was addressed to industry sponsors and pertained to cryptocurrency-holding registered funds, both ETFs and public, non-exchange-traded funds, and offered a list of questions that sponsors would be expected to address when attempting to bring these products to market. In particular, in addition to the manipulation concerns cited by the SEC in its disapproval orders, the letter highlighted the apprehensions of SEC staff about valuation, liquidity, custody and arbitrage.

A. Valuation

The letter first addressed staff concerns about valuation challenges in calculating cryptocurrency ETFs' NAV. In general, public mutual funds and ETFs in the U.S. are required to value their assets each business day to calculate an NAV. This is important for determining fund performance and the price at which investors may purchase or redeem shares. In particular, SEC staff expressed concerns about whether cryptocurrency ETFs would have the information necessary to appropriately value cryptocurrencies, given their volatility, the fragmentation and general lack of regulation of underlying cryptocurrency markets and the nascent state of and current trading volume in the cryptocurrency futures markets. SEC staff also questioned how and which policies would be instituted in order to properly establish the "fair value" of a cryptocurrency fund's portfolio. For instance, SEC staff expressed concern over how funds' valuation and accounting policies might be designed to address cryptocurrency-specific risks, such as when a blockchain diverges into different paths (a so-called "fork"), which can produce different cryptocurrencies with differing prices, and how this possibility would be recognised in the fund's NAV.

B. Liquidity

The letter next discussed staff concerns about liquidity – specifically, the importance of funds maintaining sufficient liquidity such that daily redemptions would be possible, given that an essential feature of most U.S. ETFs and other public open-end funds is daily redeemability. The SEC staff also expressed doubt over digital currency funds' ability to adhere to fund liquidity requirements, which generally necessitate that most types of U.S. ETFs and other public open-end funds implement a liquidity risk management programme, to be able to classify investments into liquidity categories and limit the fund's investments in illiquid securities to 15% of the fund's total assets.

C. Custody

The letter also raised staff concerns relating to requirements applicable to certain U.S. public funds regarding custody of their holdings, and inquired as to how funds that planned to directly hold cryptocurrencies would satisfy such custody requirements. The letter asked these questions in light of the underlying novel technical aspects of cryptocurrencies and related cybersecurity threats, as well as in connection with funds that plan to hold public cryptocurrency derivatives.

D. Arbitrage

Next, the letter discussed SEC staff concerns related to how well a cryptocurrency ETF's arbitrage mechanism would be able to function in light of the fragmentation, volatility and trading volume of the cryptocurrency marketplace. As discussed above, an ETF's arbitrage mechanism is the fundamental means by which the market price of the ETF's shares is kept in line with its NAV. SEC staff inquired whether cryptocurrency ETF sponsors had engaged with market makers and authorised participants in order to understand the feasibility of arbitrage in relation to cryptocurrency ETFs.

Conclusion

Given the SEC's persisting qualms, no sponsor of either a spot-based ETF or futures-based ETF, other than Bitcoin ETFs and Ethereum futures-based ETFs, has succeeded yet in convincing the SEC to let it offer cryptocurrency ETFs to U.S. retail investors. As evidenced by the numerous spot-based ETF registration statement filings in recent years, however, sponsors remain steadfast in their pursuit of SEC approval. As the underlying spot markets continue to mature, we believe that these sponsors' chances for success will improve accordingly, although whether the SEC approves any additional types of cryptocurrency ETFs this year remains to be seen.

Endnotes

1. In this chapter, "cryptocurrency" is used to refer to all decentralised digital assets, whether they are intended to be used in a currency-like manner (e.g., Bitcoin), or as part of a larger platform (e.g., Ethereum). In addition to pure cryptocurrencies and privacy-focused coins, the broad range of general-purpose digital assets ("**platform coins**") includes NEO and Ravencoin, for instance. These platform coins also enable the creation of new digital assets called "tokens", which are usually developed for a particular purpose or application.
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5. Lucy Brewster, SEC Approves 9 Ether Futures ETFs, *ETF.com* (2023), https://www.etf.com/sections/news/sec-approves-9-ether-futures-etfs (last visited Feb. 1, 2024).
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31. Gary Gensler, U.S. Securities and Exchange Commission, Remarks Before the Aspen Security Forum (2021), https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03 (last visited Feb. 1, 2024). Although an ETF that invests solely in Bitcoin futures would not be required to be registered under the Investment Company Act, Chair Gensler expressed a preference for Bitcoin futures-based ETFs registered under the Investment Company Act because of the significant investor protections provided by the Investment Company Act. In order to qualify for Investment Company Act registration, the Bitcoin futures-based ETFs registered under the Investment Company Act hold significant amounts of fixed-income securities in addition to Bitcoin futures. The fixed-income security holdings, however, increase the costs of managing the Bitcoin futures-based ETFs' portfolios, and may reduce the correlation between the performance of the Bitcoin futures-based ETFs and the performance of Bitcoin. Such inefficiencies are among the reasons that sponsors continued to seek approval for Bitcoin spot-based ETFs and Bitcoin futures-based ETFs that are not registered under the Investment Company Act.
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