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Includes *Grayscale vs. SEC* Ruling

What You Need To Know About Spot Bitcoin ETFs

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Snapshot

- Spot bitcoin ETFs are not yet available to U.S. investors, but they might become available any day, as the SEC is evaluating requests from several ETF sponsors.

- By investing in a spot bitcoin ETF, investors would be able to own bitcoin without having to buy, store or secure it themselves. Such an ETF thus offers investors easier access to bitcoin and better investor protection when they're buying it, compared to other methods that are currently available.

- Only 12% of financial advisors currently recommend bitcoin to clients, but more than three-fourths of advisors (77%) say they will recommend a spot bitcoin ETF when they become available. It is also widely expected that there will be significant institutional demand for these ETFs, suggesting that hundreds of millions of dollars, and perhaps billions of dollars, will be allocated to these funds when they become available. Since the supply of bitcoin is fixed, such increased demand would likely cause bitcoin's price to rise significantly. The attendant increase in engagement by so many investors is also likely to lead to further innovation and product development in the crypto sector, creating more opportunities and choices for both individual and institutional investors.

- Nearly 50 applications for a spot bitcoin ETF have been submitted to the U.S. Securities and Exchange Commission over the past eight years, and the SEC has rejected each one. SEC Chair Gary Gensler has made his opposition to crypto clear, and by early 2023, the crypto community generally concluded that applications for a spot bitcoin ETF would never be approved under his tenure. Gensler's term ends in 2026, suggesting that it would be years before a spot bitcoin ETF would become available to investors – and that assumes that Gensler's successor will have a different viewpoint (which is by no means certain). As a consequence of this environment, every ETF sponsor that had submitted applications in the past indicated by early 2023 that they had no interest in submitting a new application – a "waste of time" as one wryly put it.

- But on June 15, BlackRock, the world's largest money manager with $9 trillion in assets under management, submitted a spot bitcoin ETF application to the SEC. It is the first time BlackRock did this. Sensing the SEC might view BlackRock's application differently, eight other fund companies quickly filed similar spot bitcoin ETF applications. The SEC could approve or reject each application at any time, but it must act on all of them within 240 days of submission (by late March 2024 for the application filed most recently). There is speculation that the agency will approve or reject several (and perhaps all) applications simultaneously. Approval of even a single spot bitcoin ETF is expected to cause bitcoin's price to rise 25% and possibly substantially more (the price rose 20% when BlackRock submitted its application), while rejection of every application could cause bitcoin's price to fall as much as 25%, back to where it was before BlackRock's application was filed.

- Investing in bitcoin today thus offers a significant investment opportunity, but with considerable risk.

Overview

A spot bitcoin ETF is an exchange-traded fund that buys bitcoin.

The ETF's share price would reflect the actual current price of bitcoin ("on the spot", so to speak). A spot bitcoin ETF differs from other bitcoin funds in that its Net Asset Value, or share price, is directly based on bitcoin's price and is always current. By contrast, other bitcoin-related funds often reflect prices that are updated only monthly, quarterly or annually, or reflect prices that are provided by indirect sources (such as futures contracts or stock prices). Furthermore, by investing in a spot bitcoin ETF, investors would have direct exposure to bitcoin without having to buy, store or secure it themselves.

Investors buying shares of a spot bitcoin ETF would also enjoy greater investor protection, since these ETFs would be regulated by the SEC, FINRA and state securities regulators – exactly the same way that stocks, bonds, mutual funds and other ETFs are regulated. (Many other avenues for buying bitcoin are outside regulators' jurisdiction, and concerns about crypto fraud are frequently raised by the SEC, Federal Bureau of Investigation, Federal Trade Commission, Consumer Financial Protection Board, Commodity Futures Trading Commission and other agencies.) As part of this strong regulatory regime, investors would access spot bitcoin ETFs via sponsoring fund companies as well as every major brokerage firm and custodian in the country. These firms have the most robust compliance and risk management programs in the financial services industry, supporting investor confidence.

Spot bitcoin ETFs are already available to investors in Canada, Brazil, Dubai and Europe. But they are not available to U.S. investors. As a result, Americans interested in adding bitcoin to their portfolios must seek alternative avenues.

These include:

- establishing accounts with (sometimes offshore) crypto exchanges
- creating their own crypto wallets to trade via DeFi (decentralized finance) platforms
- investing in hedge funds or venture capital funds
- purchasing shares of Grantor Trusts.

All those options have significant drawbacks compared to ETFs: larger account minimums, higher fees, less liquidity, reduced transparency, more complicated tax recordkeeping and reporting requirements, out-of-date pricing, and even (in the case of Grantor Trusts) share prices that can be as much as 60% lower than the actual price of bitcoin.

All this explains why 77% of the nation's financial advisors say they won't allocate any portion of their clients' portfolios to bitcoin unless they can do so via a spot bitcoin ETF.

It's worth noting that two-thirds of the nation's investors rely on financial advisors for investment recommendations – and since three-fourths of those advisors are not recommending bitcoin at present, the result is that most investors are not allocating to this new asset class – and won't until the spot bitcoin ETF is available.

What will the price of bitcoin be by the time spot bitcoin ETFs become available? The delay could cause investors to miss substantial investment gains simply because the SEC has refused to allow these ETFs onto the market. (This has already happened; bitcoin is the most successful asset in history, with a 400 million percent increase since inception in 2009. How much more of bitcoin's gains will investors miss out on while they – and their advisors – wait for a spot bitcoin ETF?)

Of course, some investors aren't waiting. When their requests for bitcoin are denied by their advisors, many investors proceed on their own, often by searching the internet for ways to buy bitcoin. The too-common result is that these investors, unaccustomed to conducting their own due diligence, become victims of fraud or scams. Indeed, the FBI says 46,000 U.S. investors have lost more than $1 billion to crypto scams since 2021. The bulk of these losses likely would have been avoided if consumers had been able to obtain the assistance of financial advisors.

Prohibiting advisors from helping their clients engage in crypto is reminiscent of Prohibition. Rather than stopping Americans from drinking alcohol, the 1930s ban on booze merely chased adults into speakeasies where they overpaid for "rotgut" that often led to illness – all while states lost large amounts of tax revenue. Bans of this sort never serve society, and yet that's the current state of crypto today vis-a-vis the investment advisory field.

This is why the SEC's approval of a spot bitcoin ETF would be such a significant event. However, there is no indication yet that the SEC will approve any spot bitcoin ETF application – even though the SEC has approved other ETFs related to bitcoin, including:

- bitcoin futures ETFs, which buy futures contracts (essentially, bets about the future price of bitcoin)
- inverse bitcoin futures ETFs (which buy futures contracts that profit if bitcoin's price declines)
- 2x bitcoin futures ETFs (which borrow money to double the amount invested, so that investor returns are twice as high, or twice as low as the futures contracts themselves)
- crypto ETFs (which invest in stocks of companies engaged in the bitcoin industry)

How much more of bitcoin's gains will investors miss out on while they – and their advisors – wait for a spot bitcoin ETF?

Many are perplexed that the SEC has been willing to approve ETFs that buy derivatives of bitcoin but not bitcoin itself. Congress has asked SEC Chair Gensler to explain his rationale (and a bill has even been introduced to fire him), and Grayscale, manager of the Grayscale Bitcoin Trust (the largest grantor trust with $18 billion in assets), has filed a lawsuit against the SEC over its refusal to allow Grayscale to convert GBTC to an ETF.

Grayscale says the SEC has acted arbitrarily and capriciously, and in violation of its own procedures, and notes that if it is permitted to convert GBTC into an ETF, of Holders of the fund would immediately receive $7 billion in value (because the current discount in NAV would be eliminated) and fund expenses would fall 80%. The court is expected to rule by early Fall.

Some speculate that the SEC won't rule on any of the spot bitcoin ETF applications before then (on the assumption that a Grayscale victory would force the SEC to approve all the applications while an SEC victory would allow it to reject them all). Others speculate that the SEC will approve at least one spot bitcoin ETF before the court rules, giving Gensler the opportunity to claim that he's changed his viewpoint without being forced by the court.

Why BlackRock, and Why Now?

Given the history of the crypto community's failed quest to bring a spot bitcoin ETF onto the market – a quest widely considered to be the "holy grail" for achieving broad crypto ownership in the U.S. – one question is frequently asked: why would the world's largest money manager file an application to bring a spot bitcoin ETF onto the market – and why now?

For years, BlackRock CEO Larry Fink has expressed negative views about crypto (in 2017, he said, "Bitcoin just shows you how much demand for money laundering there is in the world.") Even if its spot bitcoin ETF is as successful as GLD, the largest gold ETF with $55 billion in assets, it would amount to only 0.6% of BlackRock's assets. Given that so many consider crypto to be controversial, why would BlackRock risk its reputation by filing a spot bitcoin application – especially considering the chilly reception that the SEC has given every other application?

There are two answers to this question – one certain, the other speculative.

The certain answer is that Larry Fink has changed his views about bitcoin. Appearing on CNBC in July, he said crypto is "going to transcend any one currency," and "has a differentiating value versus other asset classes." As for why he felt it was appropriate for BlackRock to file its spot bitcoin ETF application, he said, "We believe we have a responsibility to democratize investing. Over the last five years, more and more global investors are asking us about the role of crypto – and like I said, I do think a lot of crypto is an international asset. More importantly, because it's so international, it's going to transcend any one currency in currency valuation." He added that an "international crypto product" can "transcend" the problem of dollar devaluation. Clearly, Fink is now a strong advocate of crypto.

But why file the application now, given that SEC Chair Gensler strongly opposes the idea? There is speculation that Gensler realizes he has backed himself into a corner: the SEC largely lost its lawsuit against Ripple (where the SEC argued that Ripple's XRP token is a security); the SEC is widely expected to lose in the Grayscale case; he has refused to issue new regulations governing crypto, causing members of both parties in Congress to criticize him; and his obstinance has caused the U.S. to fall behind other nations, where more favorable regulatory environments have attracted many crypto companies. (The European Union, for example, has approved its landmark MiCA – Markets in Crypto-Assets – regulation, and the French finance minister said, "We want to make the European Union the world's leading economic zone for structuring and organizing the crypto market, and we want France to be the European hub of the crypto asset ecosystem.")

Yet, speculators contend, Gensler remains loathe to concede defeat by approving applications from companies he's previously denied. Thus, this line of thinking goes, SEC staff have engaged in an unofficial back-room, wink-wink acknowledgement to BlackRock that if it files an application, it'll get approved. After all, how could the SEC say no to the world's largest issuer of ETFs, which has almost never had an ETF application denied?

There's no evidence that this quiet conversation ever occurred. It's even silly to contemplate, since any such communication would probably be illegal. Nevertheless, several ETF sponsors took note of BlackRock's application and quickly filed new applications of their own. There are now applications before the SEC, from ARK/21Shares, Bitwise, Fidelity, Global X, Invesco, Galaxy, Valkyrie, VanEck and WisdomTree, plus Grayscale's request to convert GBTC into a spot bitcoin ETF.

What Makes These New Applications Different from Prior Applications?

Over the years, in rejecting the dozens of spot bitcoin ETF applications, the SEC has regularly said that the applications do not meet the SEC's standards to prevent fraudulent and manipulative practices and protect investors and the public interest. The major concerns the SEC has raised about the crypto market include:

- The market is small. This denies investors the liquidity necessary to sell anytime at current market prices.
- Custody is unstable. Many crypto providers operate overseas, outside the reach of U.S. regulators and law enforcement agencies. This contributes to excessive opportunity for fraud and investor abuse. There have been many instances, from Mt. Gox to FTX, where custodians responsible for safeguarding investor assets have stolen money or gone out of business, resulting in massive investor losses.
- Prices are unreliable. Crypto trades 24/7/365 globally. Each crypto custodian and exchange post their own prices for crypto coins and tokens, and there are often wide spreads.

Since the first spot bitcoin application was rejected in 2007, the crypto community has worked to resolve the SEC concerns. There is consensus that the market's size and liquidity (now $1 trillion) and well-regarded custody providers (including Fidelity and BNY Mellon) now satisfy the SEC. The remaining issue, many believe, is pricing.

BlackRock's application, for the first time, offers an approach to pricing that many believe will satisfy the SEC. It's called a surveillance-sharing agreement. This directly responds to previous SEC statements that an ETF sponsor must show that it "has a comprehensive surveillance-sharing agreement with a regulated market of significant size related to the underlying or reference bitcoin assets."

So, BlackRock has told the SEC that it has struck a surveillance-sharing agreement with Coinbase. All the other spot bitcoin ETF applications now include their own surveillance-sharing agreements as well, with Coinbase, Nasdaq or CBOE.

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"Surveillance-sharing" is designed to avoid price manipulation of spot bitcoin ETFs. They do this by coordinating with a regulated market of significant size (such as the New York Stock Exchange, Nasdaq or CBOE). The SEC has said that "such agreements have previously provided the basis for… exchange-traded products to meet those obligations, and the commission has historically recognized their importance." For example, the SEC approved bitcoin futures ETFs in part because the futures contracts purchased by those ETFs are traded on the Chicago Mercantile Exchange – and the CME provides surveillance services that are satisfactory to the regulator.

If the SEC agrees that the surveillance-sharing agreements that the spot bitcoin ETFs would put in place are sufficient, then perhaps these applications will have overcome the final obstacle to getting approval.

What Would SEC Approval of a Spot Bitcoin ETF Application Mean for Investors?

SEC approval of any spot bitcoin ETF means the fund would be available to investors.

Almost immediately, the fund would be available to independent financial advisors. The nation's largest custodians, including Schwab, Fidelity, Pershing and others, would also likely make the fund available to investors using their platforms. Major brokerage firms probably won't immediately make the funds available to their clients, as these firms generally wait to offer new ETFs until after they reach $100 million in assets. However, a spot bitcoin ETF would presumably reach this level quickly, so availability by big brokerage firms would likely occur not long after their launch.

Whether or not the launch of spot bitcoin ETFs would cause the price of bitcoin to rise is uncertain and will be determined by market demand. It's worth noting that this entire conversation is of direct interest only to U.S. investors, many of whom are delaying their investment in crypto until these ETFs are available. But investors overseas already have access to these funds; thus, the U.S. launch would not directly impact anyone outside the United States. That said, the U.S. is the global economic leader, and a launch of these funds in this country could generate new levels of interest around the world – creating new demand for bitcoin, which in turn could lead to higher prices.

It's also worth noting that it often takes years for new categories of ETFs to gain substantial market traction. So even though spot bitcoin ETFs might enter the market within days, the impact on bitcoin prices could take years.

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The Risks of Investing in a Spot Bitcoin ETF

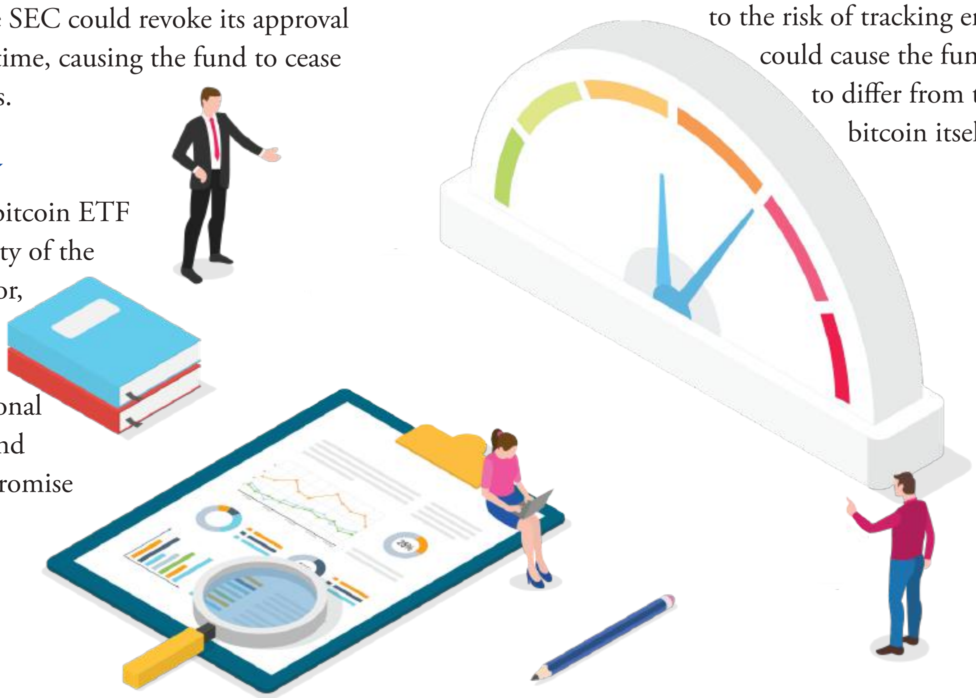
1. Market risk
The price of bitcoin is highly volatile and influenced by investor demand, which itself is affected by regulation, competition, security breaches, media attention, and investor sentiment. Investing in a spot bitcoin ETF would expose investors to the fluctuations of the bitcoin market, which could result in significant losses.

2. Regulatory risk
The legal and regulatory status of bitcoin and crypto-related activities varies by jurisdiction and is subject to change. Investing in a spot bitcoin ETF would entail compliance with all applicable laws and regulations. Authorities could impose restrictions, limitations or sanctions on the fund or its investors. Additionally, the SEC could revoke its approval of a spot bitcoin ETF at any time, causing the fund to cease trading and liquidate its assets.

3. Operational risk
Effective operation of a spot bitcoin ETF would depend on the reliability of the fund's custodian, administrator, auditor, distributor and its vendors. Investors would be exposed to the risk of operational failures, errors, fraud, theft, and cyberattacks that could compromise the fund's assets, records, or transactions.

4. Liquidity risk
The ability for an investor to liquidate their investment in a spot bitcoin ETF would depend on the bitcoin market and the secondary market for the fund's shares. Investing in a spot bitcoin ETF would expose investors to the risk of low trading volume, wide bid-ask spreads, or market disruptions that could affect the fund's ability to buy or sell bitcoin or its shares at desirable prices.

5. Tracking risk
A spot bitcoin ETF would strive to track the price of bitcoin as closely as possible, but there could be deviations or discrepancies due to fees, expenses, taxes, premiums, discounts or other factors. Investors would thus be exposed to the risk of tracking error, which could cause the fund's returns to differ from those of bitcoin itself.



Remember: It's Not All About Bitcoin

For all the attention being devoted – rightly so – to spot bitcoin ETF applications, let's remember that there's a lot more to crypto than just bitcoin. Although it's the first and still largest digital asset, bitcoin is only 49% of crypto's total market cap – down from 100% in 2009. Many regard Ethereum, the second-largest digital asset with a 40% market share, to be considered by many as an investment-as worthy as bitcoin. (In fact, several Ethereum futures ETF applications have been filed with the SEC.) There are a number of other digital assets and tokens that also have a significant market share.

Stock investors are routinely admonished to own dozens, hundreds, even thousands of stocks – because diversification reduces investment risk. Likewise, many believe that investors should diversify their crypto allocation. So, although there is a richly deserved focus on bitcoin, and the spot bitcoin ETFs everyone is waiting for, let's remember that bitcoin is only one digital asset.

For this reason, it is expected that while investors who are new to crypto will start their journey with the spot bitcoin ETF, they won't stop there. They'll soon discover that, for all its virtues, bitcoin has limitations in its usage in global commerce. They may also discover they like investing in this asset class more than they expected. As a result, many are likely to eventually consider making additional investments in crypto, in coins or tokens beyond bitcoin. And this will translate into interest in the many other ways to invest in crypto.

This is why it's essential that financial advisors learn about the complete crypto ecosystem. It's not enough to "check the box" by recommending shares of a spot bitcoin ETF to a client. As an advisor, you also need to know:

- what blockchain technology is and how it works
- the different coins, tokens and funds that are available – including IRAs, SMAs, funds for accredited investors, and thematic ETFs that invest in crypto stocks
- the new big thing in crypto: tokenization
- the next big thing in crypto: the metaverse
- crypto taxation
- how to explain it all to clients

Thousands of financial advisors and back-office professionals have attained their CBDA – Certified in Blockchain and Digital Assets – listed by FINRA as a professional designation. The online, self-study course grants you up to 18 CE credits and is taught by a world-class faculty, including Scott Stornetta, co-inventor of blockchain technology, and Anders Brownworth of the Boston Fed.

By attaining your CBDA designation, you show your clients that are you are staying current in the latest developments in the investment management field, and as they respond to the massive media attention and advertising activities that approval of a spot bitcoin ETF is sure to generate, you'll be able to demonstrate that you are the one they should be relying on. Achieving your CBDA designation can help you distinguish yourself while giving you the knowledge and skills you need to better serve your clients.

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AUG 29 UPDATE: Court Rules in Favor of Grayscale

As explained in the whitepaper, which was published on August 21, the crypto community has been anxiously waiting for the Circuit Court of Appeals to rule in the case of Grayscale vs. SEC. In that case, Grayscale complained that the SEC has approved of bitcoin futures ETFs but rejected spot bitcoin ETFs – a position that nobody in the crypto community believes makes any sense.

On August 29, the court sided with Grayscale, saying, “The denial of Grayscale’s proposal was arbitrary and capricious because the Commission failed to explain its different treatment of similar products.”

The court noted that the SEC Commission must not permit “unfair discrimination between customers, issuers, brokers or dealers” and since Grayscale’s bitcoin ETF would be similar to bitcoin futures ETFs, the SEC is obligated to explain why a bitcoin ETF is materially different from a bitcoin futures ETF, since it has said yes to the futures ETF but no to the spot ETF. The SEC has failed to do this – in fact, the court noted that Grayscale provided the SEC with substantial evidence that its proposed bitcoin ETF was similar to bitcoin futures ETFs that the SEC had already approved – and therefore, the court said, should have received the same regulatory treatment. So for the SEC to say that Grayscale’s application is denied while the others are approved is, at its core, inconsistent treatment of similar products. And the court noted that, in fact, the SEC did not dispute Grayscale’s evidence that the spot market and the futures market for bitcoin are 99.9% correlated.

“The denial of Grayscale’s proposal was arbitrary and capricious because the Commission failed to explain its different treatment of similar products.”

Ruling by the Circuit Court of Appeals

The court blasted the SEC, calling its actions “unreasonable.” You see, the SEC has been claiming that bitcoin prices are impossible to verify, but if the bitcoin prices can’t be verified, then how can you verify bitcoin futures prices? After all, the prices of the futures contracts are based on the spot prices – so if the spot prices are questionable, how can the futures prices be certain? The SEC’s position doesn’t make any sense – and the court raised that exact point. In the ruling, Judge Neomi Rao wrote that “Because the spot bitcoin market and the bitcoin futures market are so tightly correlated, a price distortion in the spot market will be reflected in the price of the futures market. After all, futures are derivatives of the spot market.” The SEC failed to explain why a bitcoin futures ETF protects investors from potential fraud, but not Grayscale's proposed bitcoin ETF.

The court also said the SEC offered no compelling reason why it felt that a measure for assessing the potential for fraud and manipulation was necessary for bitcoin ETFs but unnecessary for bitcoin futures ETFs.

Bottom line, the court said, "The SEC failed to reasonably explain why it approved the listing of two bitcoin futures ETFs but not Grayscale's similar proposed bitcoin ETF. Without such an explanation, inconsistent treatment of similar products is arbitrary and capricious. This unlike regulatory treatment of like products is unlawful. We therefore grant Grayscale's petition and vacate the SEC's order."

Cheers immediately erupted throughout the crypto community. Within minutes, bitcoin's price rose 5%. And the discount in Grayscale's Bitcoin Trust – which has been as large as 60% - also shrunk, as investors expect GBTC to soon convert to ETF status (at which time the discount will completely evaporate).

The court's ruling is the most bullish signal for crypto in years.

The story isn't over yet.

The SEC could appeal the ruling – an action it often takes when it doesn't get the ruling it wants. That could add months or years to a final decision. The agency has 45 days to file an appeal.

Or the SEC could stall. It could delay approval of the pending applications for six months, during which time it could think of other strategies that might let it squirm out of defeat.

Or the SEC could acquiesce. That doesn't mean that the SEC will approve Grayscale's spot bitcoin application. The court didn't order the SEC to do that; it merely said the SEC's rejection was invalid because the SEC failed to explain why it rejected the application. So, the SEC might decide to issue those explanations along with a new rejection letter to Grayscale. That would restart this entire process.

Or the SEC could admit it is wrong – and approve not only Grayscale's spot bitcoin ETF application, but many of the others as well. That would unleash hundreds of thousands of financial advisors into action, potentially allocating hundreds of millions of dollars – and perhaps tens of billions – into bitcoin and other digital assets. The price of bitcoin would be expected to surge. The fact that it rose 5% within minutes of the court ruling is an early indication of the results of SEC approval of the spot bitcoin ETF applications.

The crypto community is both excited about this ruling and hopeful that it will soon lead to spot bitcoin ETFs becoming available to U.S. investors. While nothing is certain, the court's ruling is the most bullish signal for crypto in years.