



OUR LEGAL CHALLENGE TARGETS SEC'S REGULATORY INCONSISTENCY AND ITS IMPACT ON INVESTORS

by Craig Salm

In failing to provide a framework for cryptocurrency and digital assets, the U.S. Congress has left a regulatory void, one which the Securities and Exchange Commission (SEC) has unfortunately filled with enforcement actions. Yet, this pattern of regulation by enforcement is inconsistent, causing uncertainty within the digital assets industry and sparking criticism that the SEC has overstepped its statutory bounds.

This statutory authority is the focal point of Grayscale's suit against the SEC, *Grayscale Investments, LLC v. SEC*, in which Grayscale argues that the SEC's denial of its application to convert its flagship fund Grayscale Bitcoin Trust (symbol: GBTC) to a spot Bitcoin ETF* violated the Administrative Procedure Act (APA) and the Securities and Exchange Act of 1934 (Exchange Act). While Grayscale's success would bring significant investor protection benefits for those looking to invest in crypto, in certain ways Grayscale's lawsuit is not about crypto at all, but rather challenging the inconsistent regulatory approach of the SEC.

Founded in 2013, Grayscale is a U.S.-based asset manager that's committed to ensuring Americans can confidently and securely access crypto. GBTC is the largest Bitcoin investment fund in the world, holding ~3.4% of all outstanding Bitcoin. GBTC has been publicly traded via the over-the-counter (OTC) market since 2015, and it was the first digital currency investment vehicle to become an SEC reporting company in January 2020. For a time, other similar products operated with a similar regulatory status, whether they offered exposure to Bitcoin directly or via futures contracts. That all changed in October 2021, when the SEC permitted an ETF that held Bitcoin futures to list on the NYSE.

Grayscale simultaneously filed with the SEC to convert GBTC to a spot Bitcoin ETF. The filing of its application started a standard 240-day open review period, during which more than 11,500 investors, academics, and other key stakeholders submitted comments in support of Grayscale to the SEC. Despite broad public support, the SEC denied Grayscale's application in June 2022, citing that the application did not meet the standards designed to prevent fraudulent and manipulative practices and protect investors. In response, Grayscale filed a lawsuit against the SEC currently being considered by the U.S. Court of Appeals for the D.C. Circuit.

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Both futures-based and spot Bitcoin ETFs reference the same underlying cash market; for this reason and because administrative procedure and the APA require an agency to treat like cases alike, Grayscale believes the approval of a Bitcoin futures ETF should have cleared the way for a spot Bitcoin ETF. Despite futures-based ETF approvals, the SEC's denial of Grayscale's application was one of over a dozen spot Bitcoin ETF applications denied in 2022.

Grayscale's legal argument is two-pronged: in its decision to disapprove Grayscale's application for a spot Bitcoin ETF, the SEC (1) acted arbitrarily and capriciously because it failed to treat like cases alike (i.e., it failed to treat spot Bitcoin ETF applications like futures-based Bitcoin ETF applications), violating the APA, and (2) unlawfully disapproved Grayscale's application based solely on an inability to satisfy a test that is not required by the Exchange Act.

To justify denying Grayscale's application, the SEC cited a failure to identify a regulated "market of significant size" related to GBTC's underlying bitcoin assets for which the listing exchange has surveillance sharing agreements. This "significant market test" has no basis in the applicable provision of the Exchange Act, Section 6(b)(5). The closest it comes is requiring that relevant products "[must be] designed to prevent fraudulent and manipulative acts and practices" 15 U.S.C. § 78f(b)(5). Setting aside the extra-textual requirement, Grayscale's application meets the requirements of the law.

Like a futures-based Bitcoin ETF, a spot Bitcoin ETF is designed to prevent fraud and manipulation and to protect investors and the public interest. Spot Bitcoin ETFs and Bitcoin futures ETFs are subject to the **exact same** risks of fraud and manipulation because they are equally dependent on spot-market pricing data, deriving their pricing from the same underlying spot Bitcoin markets. In [his letter to the SEC](#), Vanderbilt Professor Robert Whaley noted that the market that underlies Bitcoin futures and the market that underlies GBTC are "near perfect substitutes." The conclusions of this study were the basis of an [Amicus Brief](#) submitted by the Investor Choice Advocacy Network and joined by former SEC Chairman Harvey Pitt, former SEC Commissioner Joseph Grundfest, former CFTC Commissioner Brian Quintenz, as well as academics from business, economics, and law schools. Additionally, in [their letter to the SEC](#) and [Amicus Brief to the court](#), Coinbase Inc. showed there was a 99.9% correlation between the prices of Bitcoin futures on the Chicago Mercantile Exchange and Bitcoin on the spot market. By ignoring these similarities, the SEC has arbitrarily and capriciously exercised its authority and in doing so has violated the APA.

In 2022, [the Biden White House issued an executive order](#) stating that "[t]he United States has an interest in ensuring that it remains at the forefront of responsible development and design of digital assets and the technology that underpins new forms of payments and capital flows in the international financial system." Maintaining an inconsistent approach to regulating an industry of massive economic importance without guidance from Congress, is contrary to the spirit of this executive order, and contrary to the interests of everyday investors. Thankfully, the APA provides an avenue for U.S. companies to elevate these issues to the court and push for more standard regulation, as has been done in other emerging industries throughout history.

The D.C. Circuit Court of Appeals heard oral arguments for the case, *Grayscale Investments, LLC v. SEC*, on March 7, 2023, and the Court's opinion is expected later this year.

*We use the generic term "ETF" to refer to exchange-traded investment vehicles, including those that are required to register under the Investment Company Act of 1940, as amended (the "'40 Act"), as well as other exchange-traded products which are not subject to the registration requirements of the '40 Act.