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Grayscale Court Victory Feels Right and Just

by Professor Marc Powers

It has bewildered and disappointed me for some time that the administrative agency where I began my legal career, the United States Securities and Exchange Commission, has been so antagonistic towards the development and adoption of Blockchain. The advantages this technology has to offer for both the advancement and efficiency of our financial system, to say nothing of the societal good it can provide to the billions of citizens worldwide unbanked or repressed economically and politically, is beyond dispute. So, the Commission's ongoing efforts under the leadership of Chairman Gary Gensler to thwart its advancement, given his prior academic studies of Blockchain at MIT, can only be attributable to his ambitious larger agenda to expand the SEC's authority. Thankfully for the nascent industry seeking to develop despite this overreach, the judicial branch is willing to judge and evaluate the efforts of "The Administrative State" and where necessary, reign it in. This is precisely what has occurred in the D.C. Circuit decision issued August 29, 2023, *Grayscale Investments, LLC v. SEC*.

Prior to the *Grayscale* decision, the investment trust that holds spot Bitcoin ("BTC") sought SEC approval to convert to an exchange traded fund or product ("ETF"). Among other things, this would allow the investment product to trade on the NYSE, rather than on the OTC, and allow for daily redemptions. Almost one million investors reportedly own shares of GBTC, including me.

The SEC had denied 15 applications by Grayscale and other proposed sponsors based on explanations that the spot Bitcoin market was too unreliable "to prevent fraudulent and manipulative acts and practices…"—the legislative and agency standard for approval of listed exchange rule changes pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 19b-4 promulgated thereunder and Section 6(b)(5) of the Exchange Act. The SEC has also cited an ineffective surveillance-sharing agreement with a government regulated market. The Commission issued repeated denials even though it approved two futures-based bitcoin ETFs beginning in April 2022, where there is a surveillance-sharing agreement with the Chicago Mercantile Exchange.

To be sure, those digital assets offered to and traded with the investing public that clearly fall within the definition of "security" under Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Exchange Act should be subject to our government's regulation under the federal securities laws. These laws protect investors and cultivate the raising of capital through a fair and efficient securities markets by requiring certain levels of disclosure about the securities and their issuers. However, through numerous enforcement proceedings involving digital assets, cryptocurrency exchanges, and blockchain protocols, the SEC has engaged in what can fairly be called a jurisdictional "land grab", seeking broad control over most of the digital assets landscape.

Professor Marc Powers is currently an adjunct professor at Florida International University College of Law, where he is teaching "Blockchain Regulation" and "FinTech Law." He retired from practicing at an Am Law 50 law firm at the end of 2020. While there, Professor Powers built and led the firm's national securities litigation, SEC defense, and hedge fund industry practices. He began his legal career at the SEC working in the Enforcement Division.

Chairman Gensler stated at a Practicing Law Institute event in September 2022 that "most" cryptocurrencies are "securities" over which the SEC has jurisdiction. He has also made clear his intentions for blockchain-use cases and cryptocurrencies: U.S. government control and preservation of our legacy financial system and financial institutions. In other words, the antithesis of the ethos of the Bitcoin Blockchain. On June 6, 2023, in an interview on CNBC, when asked about the recently filed SEC lawsuit against Coinbase, Chairman Gensler said, "We don't need more digital currency, we already have digital currency, it's called the U.S. Dollar." Such a statement by the head of an administrative agency Congress created to oversee disclosure laws, not merit-based laws, lays bare that the SEC's recent enforcement and jaw-boning actions seek more than just securities-law compliance. Rather, they are intended to kill the unregulated use cases that Blockchain technology allow.

Against this backdrop, a unanimous panel of the D.C. Court Circuit found that the SEC's latest denial of Grayscale's application violated the Administrative Procedure Act. Writing for the court, Judge Neomi Rao found the denial to be "arbitrary and capricious": "The denial of Grayscale's proposal was arbitrary and capricious because the Commission failed to explain its different treatment of similar products. We therefore grant Grayscale's petition and vacate the order."

Plainly, the court found each of the SEC's explanations for denial of a spot ETF as lacking in reasonableness and merit. The court stated:

> "The Commission never explained why Grayscale owning bitcoins rather than bitcoin futures affects the CME's ability to detect fraud. While the Commission asserted that owning assets not traded on the surveilled exchange was a 'significant difference' and proclaimed that there was 'reason to question whether a surveillance-sharing agreement with the CME would, in fact, assist in detecting and deterring fraudulent and manipulative misconduct affecting the price of the spot bitcoin held by that ETP,' it provided no support for these claims. Grayscale Order, 87 Fed. Reg. at 40,317. Grayscale, however, provided evidence that CME bitcoin futures prices are 99.9 percent correlated with spot market prices. Based on that data, fraud in the spot market would present identical problems for a Bitcoin ETP and bitcoin futures ETP. Bitcoin futures are derivatives of bitcoin and, if the market is efficient, arbitrage will drive the prices together. The Commission's unexplained discounting of the obvious financial and mathematical relationship between the spot and futures markets falls short of the standard for reasoned decision making."

Now that the appeals court has vacated SEC's denial of Grayscale's petition, it will be interesting to see how the SEC responds. Will it realize that its efforts to thwart blockchain advancement is inappropriate and approve this year Grayscale's petition? I believe so, just like I correctly predicted that Grayscale's petition to the D.C. Court would be successful. Will the Chairman finally give serious attention to the thoughtful digital asset proposals for reasoned regulation advanced by SEC Commissioner Hester Peirce in her two "safe harbor" speeches in February 2020 and April 2021? Who knows?

But I do know that unless and until the SEC acts more reasonably in Blockchain-use cases, the courts and Congress will continue to hand the Commission defeats in the form of favoring the CFTC as the preferred regulator over the space as in the recently reintroduced *Lummis-Gillibrand Responsible Financial Innovation Act*. I also believe the next major SEC court defeat, after its losses in the *SEC v. Ripple* and Grayscale cases these past two months, will be in Coinbase's mandamus action against the SEC in the Third Circuit. Let's hope the SEC Chair listens to what the courts and Congress, and his fellow commissioners, are saying to him.

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