

MEMO# 35429

September 11, 2023

Court Rules Against SEC for Denying Application to List Spot Bitcoin Fund

[35429]

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TO: ICI Members SUBJECTS: Alternative Investments
Fintech and Digital Assets
Litigation & Enforcement
Trading and Markets RE: Court Rules Against SEC for Denying Application to List Spot Bitcoin Fund

Last week, the U.S. Court of Appeals for the D.C. Circuit vacated a Securities and Exchange Commission order denying Grayscale Investments, LLC, from listing and trading a spot bitcoin fund on a national securities exchange.[\[1\]](#) In its opinion, the court held that the SEC failed to treat like cases alike and that its order was arbitrary and capricious because the SEC did not adequately distinguish the Grayscale spot bitcoin fund from similar bitcoin futures funds that were approved for listing and trading.

This memo provides background on the application and the court's standard of review, then summarizes the court's decision.

Background

A national securities exchange generally must seek approval for a rule change before listing a new type of product for trading. Under the Securities Exchange Act of 1934, any exchange rule must be "designed to prevent fraudulent and manipulative acts" and may not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers . . ."[\[2\]](#)

In the spring of 2022, the Commission approved rule changes to list the Teucrium Bitcoin Futures Fund and the Valkyrie XBTO Bitcoin Futures Fund—both bitcoin futures funds.[\[3\]](#) In June 2022, however, the Commission denied Grayscale's proposal to list its spot bitcoin fund.[\[4\]](#) In its order, the Commission found that the Grayscale proposal was not designed to prevent fraudulent and manipulative practices, even though the fund had an identical surveillance sharing agreement as the bitcoin futures funds with a bitcoin futures market—the Chicago Mercantile Exchange (CME).

Under its own standards, the Commission requires bitcoin-based exchange-traded products (ETPs) to have their listing exchanges enter into surveillance sharing agreements with

markets that are: (1) related to the listing exchange; (2) regulated; and (3) of a significant size.^[5] The Commission believes that surveillance sharing agreements deter fraud because they facilitate the availability of information needed to fully investigate a manipulation if it were to occur.^[6] Because the CME futures market is related to Grayscale's spot bitcoin fund and is regulated, the only issue was whether the CME was of a "significant size" for Grayscale's application. When evaluating this "significant size" test, the SEC looks at two factors: (1) whether there is a "reasonable likelihood that a person attempting to manipulate an ETP would . . . have to trade on [the related] market to successfully manipulate the ETP;" and (2) that it is "unlikely that the trading in the ETP would be the predominant influence on prices in the [surveilled] market."^[7] The Commission concluded that Grayscale failed on both.

Grayscale appealed the SEC's order to the Court of Appeals contending that the Commission acted arbitrarily and capriciously by denying the listing of Grayscale's proposed bitcoin fund but approving the listing of the two materially similar bitcoin futures funds.

Under the Administrative Procedure Act, a reviewing court must "hold unlawful and set aside agency action" that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."^[8] In determining whether something is arbitrary and capricious, the court looks at whether the agency's decision was "reasonable and reasonably explained."^[9]

Decision

The court compared the Commission's approach to funds holding bitcoins directly and those holding bitcoin futures to evaluate Grayscale's argument that the Commission acted arbitrarily and capriciously. In its decision, the court first evaluated whether Grayscale's spot bitcoin fund is similar and should have received the same treatment as the bitcoin futures funds. It then reviewed the SEC's analysis of the two factors of the "significant size" test.

Whether the spot bitcoin fund is similar and should have received the same treatment as the bitcoin futures funds.

The court found that Grayscale presented substantial evidence that the spot bitcoin fund was similar to the bitcoin futures funds and should have received the same treatment. The funds all track the bitcoin market price. In addition, while Grayscale bitcoin fund invests directly in bitcoin and the bitcoin futures funds invest in futures based on bitcoin, Grayscale presented uncontested evidence that there is 99.9 percent correlation between the bitcoin price and the CME bitcoin futures prices. Moreover, the court determined that each fund's surveillance sharing agreement with the CME is identical and should have the same likelihood of detecting fraudulent or manipulative conduct in the market for bitcoin and bitcoin futures.

Prong 1 of the "Significant Size" Test: Whether there is a reasonable likelihood that a person attempting to manipulate the spot bitcoin fund would have to trade in the CME market.

The court also found that, when denying Grayscale under the first prong of the significant size test, the Commission failed to provide the necessary "reasonable and coherent explanation" for its inconsistent treatment of similar products.

First, the court noted that the SEC's determination that there was not a reasonable

likelihood that a person attempting to manipulate the Grayscale bitcoin fund would have to trade on the CME was inconsistent with its approach to the bitcoin futures funds. For the bitcoin futures funds, the SEC found it unnecessary to make such a finding.[\[10\]](#) The court also found that the Commission did not back its assertion that owning bitcoin that are not traded on the surveilled future exchange was a significant difference among the funds and its questioning of whether a surveillance-sharing agreement with the CME would detect and deter fraud affecting the price of Grayscale's spot bitcoin. It concluded that the SEC's unexplained discounting of the "obvious" correlation between the spot and futures markets fell short of the required standard for its determination.

In addition, the court found fault with the Commission's position that Grayscale would not pass the first prong because it did not provide causal evidence that fraud or manipulation impacting spot bitcoin would similarly impact CME bitcoin futures contracts. On this point, the court pointed to the 99.9 percent correlation and explained that, though correlation does not equal causation, the almost perfect correlation was at least strong evidence of causation. It added that the Commission failed to explain why a surveillance sharing agreement with the CME was sufficient to protect bitcoin futures ETPs from potential fraud, but not Grayscale's proposed ETP.[\[11\]](#)

Thus, the court concluded that the SEC did not adequately explain its inconsistent treatment of similar products under prong 1 of the significant size test, which it concluded was arbitrary and capricious.

Prong 2 of the "Significant Size" Test: Whether trading in the spot bitcoin fund would be the predominant influence on prices in the CME bitcoin futures market.

The court found the Commission failed to explain its determination that the proposed Grayscale bitcoin ETP could be the predominant influence on price of the bitcoin futures traded on the CME. It noted that, while the size of Grayscale's fund dwarfs the futures market, the Commission did not adequately connect the value of Grayscale's assets to the conclusion that those assets would influence prices on the CME futures market. The court noted that, because Grayscale owns no futures, it only would be able to impact the CME bitcoin futures market through the spot market but that the Grayscale fund only owns 3.4 percent of that spot market.[\[12\]](#)

Finally, the court concluded that the SEC did not treat like cases alike under this prong. It highlighted the Commission's determinations that the second prong was satisfied for the bitcoin futures ETPs because the CME bitcoin futures market had progressed and matured significantly, so trading on a single ETP was unlikely to be the predominant influence on the CME. The Commission, however, failed to explain why that reasoning does not similarly apply to the Grayscale fund, as the Commission previously has noted that the spot market is deeper and more liquid than the futures market, so any manipulation should be more difficult, not less.

Kenneth Fang
Associate General Counsel

Julia O'Toole
Legal Intern

Notes

[1] See *Grayscale Investments, LLC v. Securities and Exchange Commission*, No. 22-1142 (DC Cir. 2023), available at [https://www.cadc.uscourts.gov/internet/opinions.nsf/32C91E3A96E9442285258A1A004FD576/\\$file/22-1142-2014527.pdf](https://www.cadc.uscourts.gov/internet/opinions.nsf/32C91E3A96E9442285258A1A004FD576/$file/22-1142-2014527.pdf). A spot bitcoin fund is a fund that invests directly in bitcoin, as opposed to a bitcoin futures fund, which invests in bitcoin futures.

[2] See Section 6(b)(5) of the Securities Exchange Act.

[3] See Self-Regulatory Organizations; NYSE Arca, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 2, To List and Trade Shares of the Teucrium Bitcoin Futures Fund Under NYSE Arca Rule 8.200-E, Commentary .02 (Trust Issued Receipts) (Apr. 12, 2022), 87 Fed. Reg. 21,676, available at <https://www.govinfo.gov/content/pkg/FR-2022-04-12/pdf/2022-07748.pdf>; Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, To List and Trade Shares of the Valkyrie XBTO Bitcoin Futures Fund Under Nasdaq Rule 5711(g) (May 5, 2022), 87 Fed. Reg. 28,848, available at <https://www.govinfo.gov/content/pkg/FR-2022-05-11/pdf/2022-10065.pdf>.

[4] See Self-Regulatory Organizations; NYSE Arca, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, to List and Trade Shares of Grayscale Bitcoin Trust Under NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) (July 6, 2022), 87 Fed. Reg. 40,299, available at <https://www.govinfo.gov/content/pkg/FR-2022-07-06/pdf/2022-14310.pdf>.

[5] See *id.* at 40,300.

[6] *Id.*

[7] *Id.*

[8] See 5 U.S.C. § 706(2).

[9] See *FCC v. Prometheus Radio Project*, 141 S. Ct. 1140, 1158 (2021).

[10] On this note, the Commission argued that it did not need to make the finding because the bitcoin futures funds only invested in bitcoin futures.

[11] The court also criticized the SEC for faulting the applicant for not showing that the bitcoin futures market leads the spot market, as the Commission offered no compelling reason why the lead/lag relationship between spot and futures bitcoin markets was central for assessing the potential for fraud and manipulation for bitcoin ETPs but not for bitcoin futures ETPs.

[12] The Commission asserted that Grayscale underestimated how it could grow if approved as an ETP, but the court found that the Commission did not explain why underestimating these assets posed a threat to the CME bitcoin futures market—the market under surveillance. Further, it added that the Commission failed to note Grayscale's evidence that the bitcoin market's simultaneous growth in market capitalization would cause Grayscale's ETP to have minimal impact on the bitcoin spot price and, accordingly, on bitcoin futures.

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