



The Crypto Conundrum

Why Won't the SEC
Approve a Bitcoin ETF?

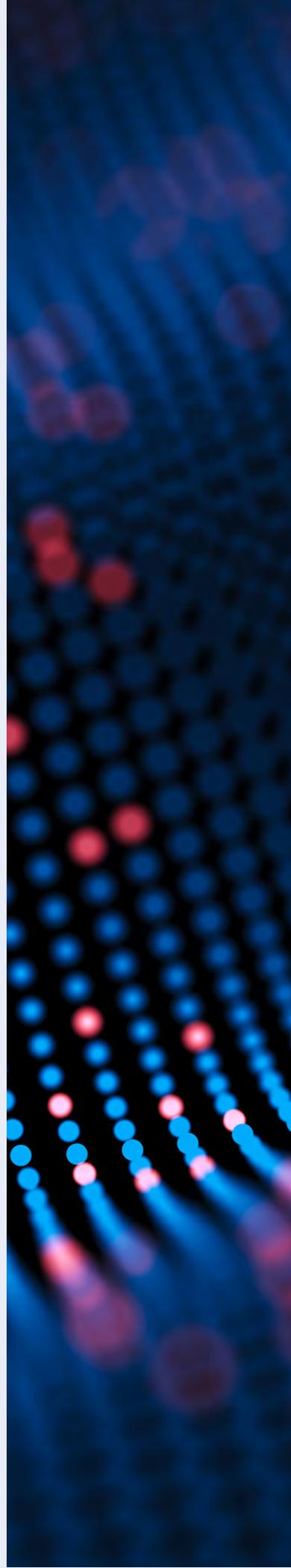
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Chamber of Digital Commerce

The Chamber of Digital Commerce is the world's largest trade association representing the blockchain technology ecosystem. Our mission is to promote the acceptance and use of digital assets and blockchain technologies. We are supported by a diverse membership that represents the industry globally, including innovators, operators, and investors. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop an environment that fosters innovation, job creation, and investment.



Acknowledgements

The Spot Bitcoin ETF Initiative (the “Report”) is a Chamber of Digital Commerce-led initiative created to be a key resource for legislators, regulators and market participants seeking to understand the history of the U.S. Securities and Exchange Commission’s denial of an increasing number of spot bitcoin ETF applications and supporting a path forward to approval.

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The Chamber of Digital Commerce would like to thank the approximately 30 industry experts representing a range of organizations, including ETF issuers, legal experts, custodians, and capital markets professionals, who assisted in the development of this Report for their valuable contributions. Our expert participants included the following:

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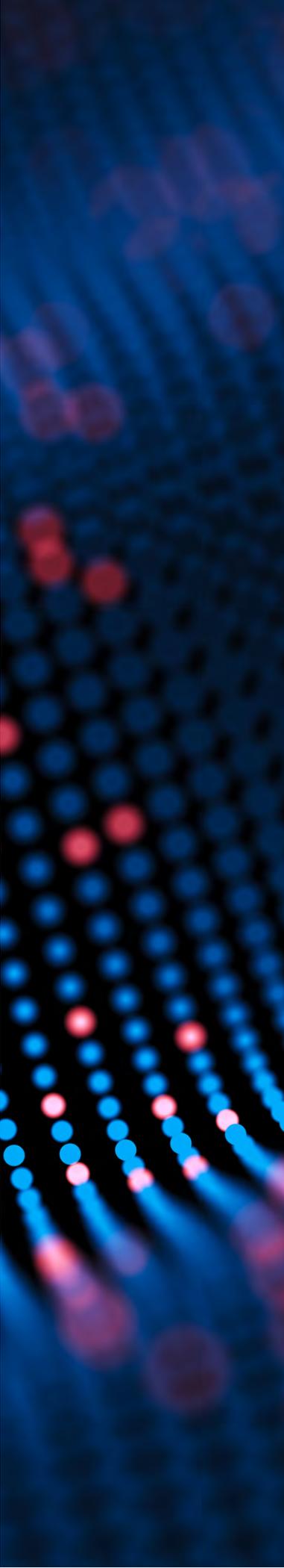
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I. Executive Summary

In 2013, the Securities and Exchange Commission (the “SEC”) received its first filing seeking to register shares of an exchange-traded fund (“ETF”) that would hold the cryptocurrency bitcoin (throughout this Report, ETFs that directly hold bitcoin will be called “Bitcoin ETFs”). Since that time, the SEC has rejected each and every application seeking to list a Bitcoin ETF on a national securities exchange, citing a range of concerns that this Report will demonstrate have been fully addressed by asset managers seeking to offer responsible, transparent and regulated bitcoin exposure to retail and institutional investors.

The Chamber of Digital Commerce (the “Chamber”) believes that the time has come for U.S. investors to have access to a Bitcoin ETF. Specifically, the Chamber maintains that:

- The ETF structure provides investors with transparent, liquid and cost-effective exposure to bitcoin.
- The SEC’s concerns about investor protection are misguided and counterproductive, as the failure to approve a Bitcoin ETF merely forces investors to seek bitcoin exposure through unfamiliar means of direct access or other riskier and often more expensive product structures. As a result, investors are currently forced to access bitcoin outside of any existing financial advisory relationships.
- The bitcoin market has been greatly institutionalized in recent years and rigorous research has now been conducted that shows the SEC’s fears about market manipulation are largely unfounded.
- Many of the large U.S. cryptocurrency exchanges now have in place extremely sophisticated trade surveillance tools that allow for mitigation against market manipulation, systems that are very similar to those utilized by traditional securities exchanges.
- Rather than playing a leading role in responsible adoption of new technologies and products, the United States is falling behind the rest of the world, as more countries approve such products. The United States is increasingly seen as being an undesirable place for innovators in the digital asset space to conduct operations due to the current regulatory environment. Similarly, U.S.-based asset managers, unable to offer these innovative products in the domestic market, are instead being encouraged to launch these products in foreign markets, giving non-U.S. investors access to regulated and transparent exposure and greater protections than their U.S. counterparts. To date there have been no reported instances of hacking or theft and no indications of market manipulation relating to these internationally listed Bitcoin ETFs.

The push to get the SEC to approve the listing and trading of a Bitcoin ETF in the United States continues to show frustratingly little progress despite the tireless efforts of the asset management industry and the desire of the investing public to access bitcoin through the familiar and time-tested ETF structure regulated by the SEC. As the SEC continues to stonewall, the United States continues to fall further behind other countries as capital that would have been invested in the United States, which would be managed by U.S. firms employing U.S. persons, is instead deployed in other, more innovation-friendly countries. Securities regulators in other heavily regulated, sophisticated financial markets throughout the world, including those in Canada, Germany, Sweden, Switzerland, and most recently, Australia, have prudently assessed the current state of the bitcoin market and the potential benefit to their countries’ investors, and allowed

issuers in those countries to bring Bitcoin ETFs and other cryptocurrency exchange-traded products to market. Bitcoin ETFs now trade on some of the largest non-U.S. securities exchanges in the world, including in Canada, which has positioned itself as the world leader in regulated crypto investing, a role traditionally played by the United States in nearly every other asset class. To date, there have been no reported instances of hacking or theft and no indications of market manipulation relating to these internationally-listed Bitcoin ETFs.

The demand both at home and abroad for a Bitcoin ETF stems from the benefits provided by the ETF as an investment vehicle. It is often said that ETFs have “democratized” investing by allowing retail investors to gain cost-effective exposure, not only to traditional asset classes like equities and bonds, but also to assets such as gold, silver, and platinum, which were once too expensive and impractical to own. The transparency inherent in the ETF structure allows investors not only to know precisely what an ETF holds, but also to gain insight into the true costs of their investment. This transparency in fees has led to fee compression across the investing industry, and retail investors are now paying approximately half as much in fees as they were paying in 1996. Furthermore, an ETF allows an investor to quickly get into or out of an investment at any time during the trading day across an exchange, which serves to guarantee that an investor knows that the price they are paying or receiving for their investment is a fair reflection of the market. As is true of nearly every other asset class, investors in bitcoin will immediately benefit from the access, transparency and liquidity derived from obtaining their exposure through the ETF structure.

The SEC cannot deny the significant market demand for bitcoin (including, and notably, at the institutional level), yet an investor seeking to invest directly in bitcoin (absent a Bitcoin ETF) must do so without the umbrella of federal securities regulatory protection that has developed over the past 80 years. The financial adviser or broker-dealer with whom a retail investor interacts for their traditional investments largely does not provide cryptocurrency-related services, and thus investors must parse through an ever-expanding roster of entities seeking to provide these services, including away from their existing financial adviser and without the benefit of holistic financial advice. In addition, bitcoin’s idiosyncratic features, especially relating to its custody, subject bitcoin investors to the risk that they will simply lose access to their investment should they lose the private key required to transact in their bitcoin. Allowing U.S. investors to get exposure through the purchase of a professionally managed Bitcoin ETF significantly mitigates these concerns.

Yet, little, if any, progress has been made towards convincing the SEC to approve such a product.

This is despite the fact that the SEC has now also allowed trading for several ETFs that hold Chicago Mercantile Exchange (“CME”)-traded bitcoin futures, which rely on the same pricing data as spot bitcoin. The SEC’s official justifications for denying the applications remain the same as those offered in its first denials, despite a significant maturation and institutionalization of the market, proofs of concept offered by similar products operating abroad, and robust and rigorous research undertaken by market participants showing the SEC’s stated concerns to be unfounded. The SEC has imposed on the industry an extraordinary requirement, the so-called “Winklevoss Standard,” which requires proof that bitcoin price discovery occurs on the CME, where bitcoin futures contracts trade, as opposed to on the major cryptocurrency trading venues such as Coinbase or Gemini. The imposition of this requirement has no precedent. Two of the most sophisticated industry participants, Bitwise Asset Management and Fidelity Investments, at their own time and expense, nonetheless set out to design and implement research programs that provided the empirical

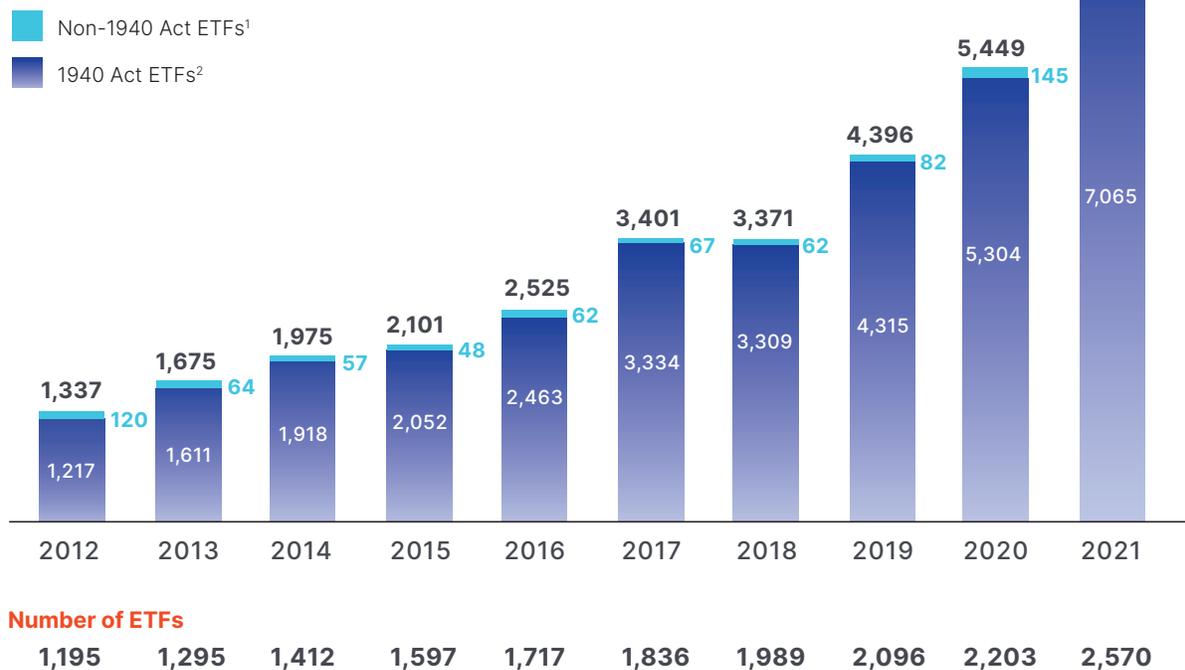
evidence to make this required finding. Their reports showed that price discovery on bitcoin does in fact occur on the CME on a statistically significant basis. The SEC’s standard has been met – and yet, the SEC has continued to issue denials.

II. State of Play

On July 1, 2013, the Securities and Exchange Commission (the “SEC”) received its first filing seeking to register shares of an exchange-traded fund (“ETF”) that would hold the cryptocurrency bitcoin (throughout this Report, ETFs that directly hold bitcoin will be called “Bitcoin ETFs”). The proposed fund would allow U.S. investors the ability to invest in bitcoin using the now ubiquitous ETF structure, perhaps the most impactful investing innovation of the past 30 years. The ETF’s unique structure introduced significantly enhanced accessibility, transparency and liquidity in an investment product that ushered in a revolution in the way that Main Street and Wall Street investors alike invest. As of December 31, 2021, the U.S. ETF market had grown to nearly \$7.2 trillion in assets under management.

Total Net Assets and Number of ETFs

Billions of dollars, year-end



¹ The funds in this category are not registered under the Investment Company Act of 1940 and invest primarily in commodities, currencies, and futures.

² The funds in this category are registered under the Investment Company Act of 1940.

It is often said that ETFs have “democratized” investing by allowing retail investors to gain cost-effective exposure, not only to traditional asset classes like common stocks and bonds, but also to assets such as gold, silver, and platinum, which were once more difficult to own. The transparency inherent in the ETF structure allows investors to know precisely what a fund holds and also provides them insight into the true costs of their investment. This transparency in fees has led to fee compression across the investing industry, and retail investors now pay approximately half the amount of fees than was the case in 1996.¹ Furthermore, an ETF allows an investor to quickly get into or out of an investment at any time during the trading day across an exchange, which serves to guarantee to investors that the price they are paying or receiving for their investment is a fair reflection of the market. As is true of nearly every other asset class, investors in bitcoin will immediately benefit from the access, transparency and liquidity derived from obtaining their exposure through the ETF structure.

Bitcoin’s regulatory status and certain unique structural features mean that investors will especially benefit from gaining access to bitcoin through a regulated Bitcoin ETF. Because bitcoin is not a “security,”² an investor seeking to invest directly in bitcoin does so without the umbrella of federal regulatory protection that has developed over the past 80 years. Firms that provide advice regarding the purchase or sale of non-securities such as bitcoin are not required to register with the SEC or state securities regulators or comply with the requirements of the Investment Advisers Act of 1940 (the “Advisers Act”) and its accompanying rules, as is the case for individuals and firms providing investment advice relating to securities. The Advisers Act contains many provisions designed to protect investors and ensure that their advisers are acting in their best interest. Individuals and firms providing investment advice on bitcoin are not subject to these requirements. Moreover, the platforms and exchanges that facilitate the sale and custody of bitcoin are not subject to the requirements of the Securities Investor Protection Act of 1970 (“SIPA”) and the Securities Exchange Act of 1934 (the “1934 Act”) that are imposed upon broker-dealers of traditional securities.

Ultimately, this means that the financial adviser, broker-dealer or exchange with whom a retail investor interacts for their traditional investments largely does not provide cryptocurrency-related services, and thus investors must parse through an ever-expanding roster of entities seeking to provide these advisory, brokerage, trading and custodial services. It can be very difficult for the average investor to conduct the level of due diligence necessary to understand different types of bitcoin services, how the bitcoin is held (e.g., in an omnibus wallet) and related safeguards. In fact, it is likely the average investor may conduct little or no diligence. Moreover, without SIPA and other protections, investors may be unable to adequately understand the level of risk to which they are exposed by transacting through these unregulated entities. Beyond the risk an investor runs of falling victim to an unscrupulous bitcoin adviser, broker or exchange, bitcoin’s idiosyncratic features, especially relating to its custody, subject a bitcoin investor to the risk that they will simply lose access to their investment should they lose access to the private key required to transact in their bitcoin. Stories in the media of investors permanently losing access to their investments are widespread and a leading crypto-analytics firm has estimated that nearly 23% of all bitcoin in circulation may be lost forever due to loss of private keys.³

1 Inv. Co. Inst., *ICI Research Perspective: Trends in the Expenses and Fees of Funds, 2020*, (Mar. 2021 Vol. 27, No. 3), <https://www.ici.org/system/files/attachments/pdf/per27-03.pdf>.

2 William Hinman, Director, Div. of Corp. Fin., Remarks at the Yahoo Finance All Markets Summit: Crypto, Digital Asset Transactions: When Howey Met Gary (Plastic), (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.

3 Rick Delafont, *Chainalysis: Up to 3.79 Million Bitcoins May Be Lost Forever*, NEWSBTC, <https://www.newsbtc.com/news/bitcoin/chainalysis-up-to/> (last visited Jun. 9, 2022).

Allowing U.S. investors to get exposure to bitcoin through the purchase of a Bitcoin ETF significantly mitigates nearly all of these risks. It would allow investors, to a large degree, to outsource the role of due diligence of service providers to the issuer of the Bitcoin ETF itself. While any industry will have bad actors – and the bitcoin industry is not immune – in recent years there has been a large-scale institutionalization of the industry and there are many institutions with safeguards in place that mirror those of regulated entities providing equivalent services in the world of traditional finance.

There are now many cryptocurrency exchanges that have applied for and received the BitLicense that is issued by the New York Department of Financial Services. This regulation imposes on licensees' minimum capital requirements, anti-money laundering and know-your-customer requirements as well as requirements relating to how client assets must be custodied, among many other provisions. Furthermore, the Chamber has learned through its research for this Report that many of these large cryptocurrency exchanges now have in place extremely sophisticated data surveillance tools that allow for mitigation against potential market manipulation. In many cases this mitigation is more robust than is the case with other asset classes, owing to the unique richness and transparency of blockchain-based data. The Chamber has learned that these systems are, in any event, very similar to those utilized by traditional securities exchanges.

With regard to custody of bitcoin, there is now a cryptocurrency custodian, Anchorage Digital Bank, N.A. ("Anchorage"), that has secured conditional approval for a national charter from the U.S. Office of the Comptroller of the Currency ("OCC").⁴ Additionally, some of the largest and most reputable traditional bank custodians for ETFs in the United States have either become, or noted an intent to become, custodians for bitcoin, including Fidelity Digital Assets, U.S. Bank, The Bank of New York Mellon Corporation and State Street Bank and Trust Company.

Many highly-regulated entities operate in the bitcoin ecosystem with systems in place to protect client assets and avoid the type of fraud and vulnerability that plagued the bitcoin market in its infancy. By allowing investors to gain exposure to bitcoin through the purchase of a Bitcoin ETF, investors can outsource these due diligence requirements to the issuer of the Bitcoin ETF itself, experts in the space, who are able to ensure that the Bitcoin ETF's service providers are only those entities subject to the highest standards, with core service provider agreements available to the public as exhibits to the Bitcoin ETF's registration statement. In addition, because shares of a Bitcoin ETF would themselves be a security, an investor's existing registered investment adviser would be able to provide investment advice regarding the purchase and sale of such shares and the investor would be able to hold such shares in their traditional brokerage account. Gone would be the days when such an investor would lose access to their bitcoin investment simply because they forgot the private key.

⁴ News Release 2021-6, Office of the Comptroller of the Currency, OCC Conditionally Approves Conversion of Anchorage Digital Bank (Jan. 13, 2021), <https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-6.html>.

Falling Behind

Unsurprisingly, there has been an overwhelming effort from the asset management industry, with broad support from the investing public, in seeking to obtain SEC approval of a Bitcoin ETF. The SEC received over 11,400 letters in support of Grayscale Investments, LLC's ("Grayscale") application to convert Grayscale Bitcoin Trust ("GBTC")⁵ into a Bitcoin ETF, with over 99% of the letters received by the SEC advocating for the application's approval. This application was nonetheless denied by the SEC on June 29, 2022.

But it is not just U.S. investors that want these products; U.S. asset managers want to provide them. At least 16 distinct companies, including some of the largest and most respected names in the asset management industry, have applied to the SEC for the right to offer a Bitcoin ETF to investors. All such requests have been denied – some multiple times.

As the SEC continues to stonewall, the United States continues to fall further behind other countries as capital that would have been invested in the United States is instead deployed in other, more innovation-friendly countries. Securities regulators in other heavily regulated, sophisticated financial markets throughout the world, including those in Canada, Germany, Sweden, Switzerland and Australia, have judged the current state of the bitcoin market and the potential benefit to their country's investors, and allowed issuers in those countries to bring Bitcoin ETFs and other cryptocurrency exchange traded products to market. Bitcoin ETFs now trade on some of the largest non-U.S. securities exchanges in the world, including in Canada, which has positioned itself as the world leader in regulated crypto investing, a role traditionally played by the United States in nearly every other asset class. There are now over 70 exchange-traded products holding bitcoin and other cryptocurrencies that trade in Europe, with an estimated total of \$7 billion in assets.⁶

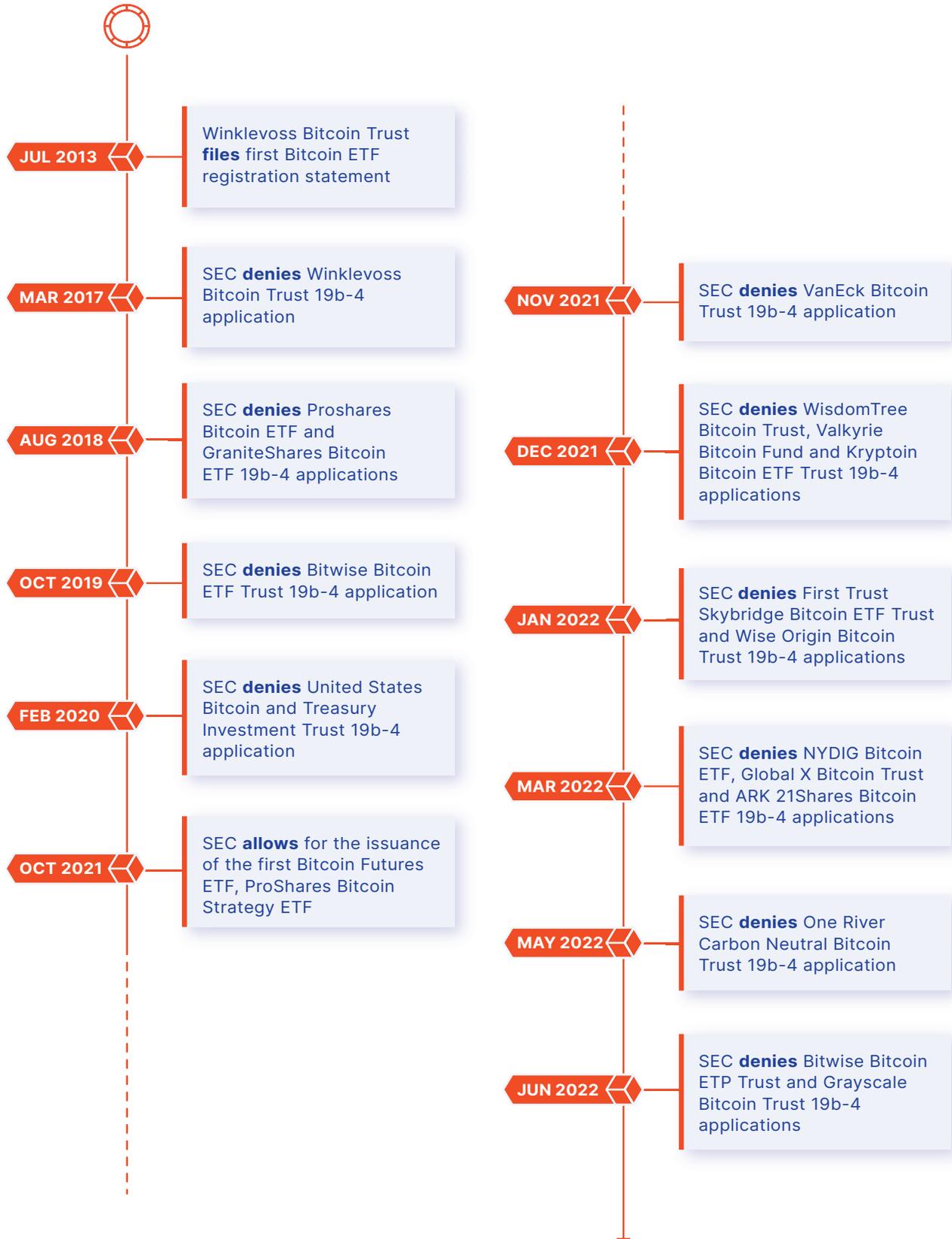
There is also widespread global recognition that digital assets and the blockchain technology underpinning them represent the next great evolution in financial innovation, and countries around the world are seeking to position themselves as the global hubs for this emerging industry.

But the United States is no closer to having a Bitcoin ETF than when Cameron and Tyler Winklevoss filed the first registration statement for a Bitcoin ETF in 2013. Despite having a head start on this process, the U.S. capital markets and their participants now find themselves in an unfamiliar and unenviable position, languishing behind the rest of the world as it relates to this revolutionary technology.

5 GBTC is the largest bitcoin investment fund in the world. It holds about 3.4% of all outstanding bitcoin, with approximately \$15 billion in assets under management, tens to hundreds of millions of dollars in daily trading volume, and more than 850,000 investor accounts in the United States. Although publicly traded, today GBTC is not a Bitcoin ETF because it has not been granted approval by the SEC pursuant to Section 19(b) and Rule 19b-4 to list on a national securities exchange. For this and related reasons, GBTC is ineligible to offer continuous share redemptions and creations, which in turn results in its shares trading at discounts below or premiums above the net asset value of its bitcoin. GBTC is currently trading at an approximately 30% discount to the value of its bitcoin assets under management. Because GBTC has approximately \$15 billion in assets under management, that results in roughly \$4.5 billion of value being kept from existing U.S. investors. One benefit of converting GBTC to a Bitcoin ETF would be to allow for shares to be arbitrated through simultaneous creations and redemptions. That would cause shares trading at a discount to better reflect the net asset value of its bitcoin, and thus would protect the more than 850,000 investors currently invested GBTC.

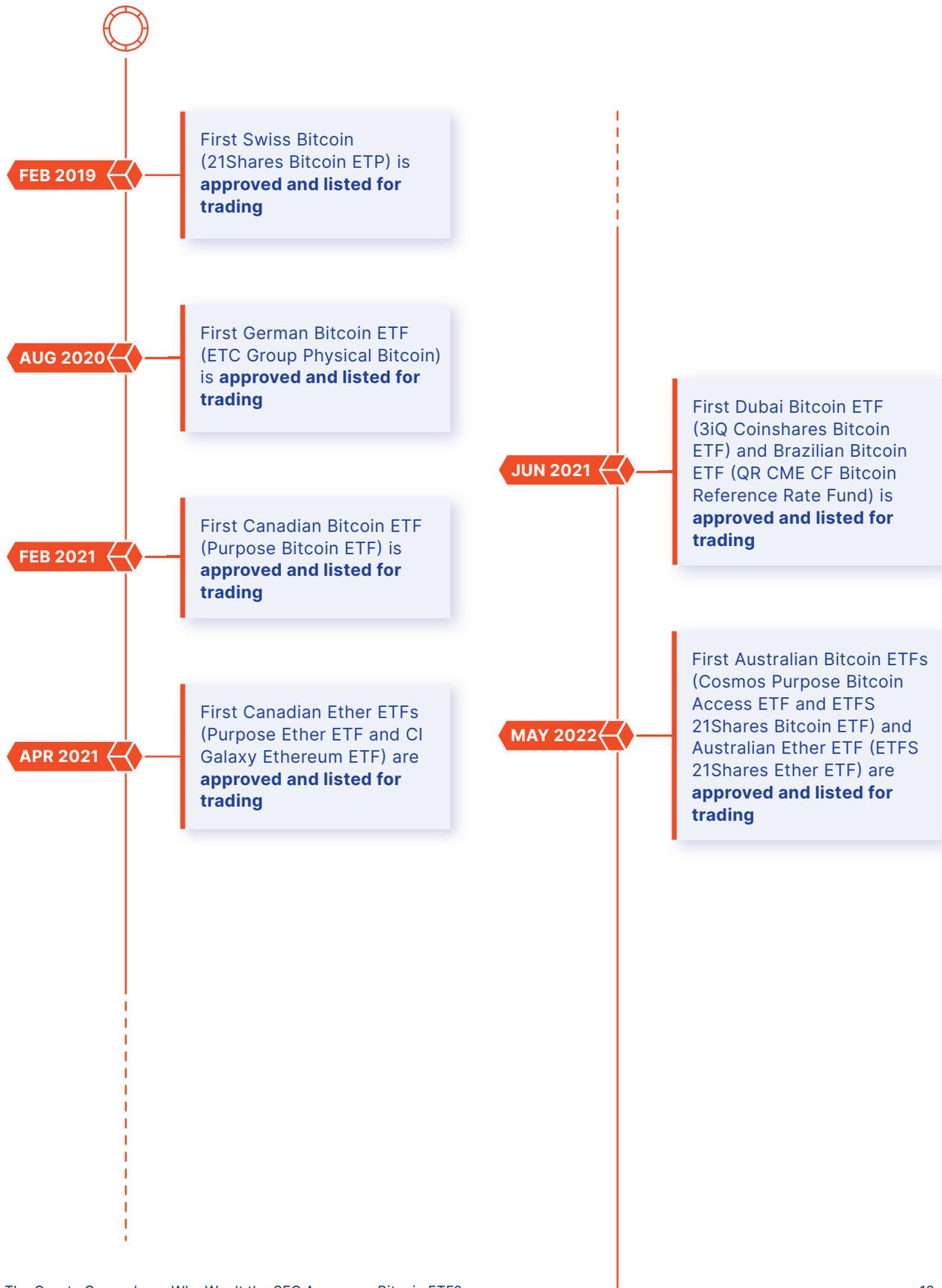
6 Tanzeel Akhtar, *Crypto Exchange-Traded Products Are Blossoming in Europe*, COINDESK (Mar. 1, 2022, 2:57 PM), <https://www.coindesk.com/markets/2022/03/01/crypto-exchange-traded-products-are-blossoming-in-europe/>; *Submission by the Sponsor to the Commission in connection with a meeting between representatives of the Sponsor, BZX, and Commission staff on September 8, 2021*, <https://www.sec.gov/comments/sr-cboebzx-2021-039/sr-cboebzx2021039-250110.pdf> [hereinafter Sponsor Submission] (comparing numbers with the with btc-focused analysis from the SEC).

U.S. Timeline



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International Timeline



As noted above, the country leading the way in this regard is Canada. The Ontario Securities Counsel (“OSC”) approved Canada’s first Bitcoin ETF in early 2021. However, the OSC initially shared the SEC’s skepticism towards bitcoin exchange traded products. The Director of OSC’s Investment Funds & Structured Products (“Director of IFSP”) branch initially blocked the public offering of a closed-end investment trust that held bitcoin acquired on cryptocurrency trading platforms regulated under the BitLicense issued by the New York Department of Financial Services.

In justifying its denial, the Director of IFSP explicitly pointed to the SEC’s (then recent) denial of Bitwise Asset Management’s (“Bitwise”) application to list a Bitcoin ETF in October 2019. The issuer of the proposed product, 3iQ Corp. successfully appealed the decision, with OSC Commissioner Lawrence Haber issuing a number of stinging rebukes to the Director of IFSP in his opinion regarding the proper role of securities regulators: “It is not the role of securities regulators to approve or disapprove of the merits of securities being offered to the public . . . It is also outside the scope of the authority of securities regulators to immunize investors against risk or against loss. And, it is not the job of securities regulators to ban speculation or risk taking.”⁷

In his opinion (see Appendix A), Commissioner Haber also made a number of consequential other findings regarding bitcoin. He expressly rejected the Director of IFSP’s argument that bitcoin was an illiquid asset, noting that trading volumes for bitcoin exceed trading volumes for other Canadian equities and funds that are considered liquid.⁸ Even with 3iQ Corp. conceding the existence of some wash trading and fake volume, Commissioner Haber also squarely addressed IFSP’s concern about the existence and potential impact of market manipulation and rejecting outright the argument that market manipulation techniques, such as wash trading and fake volume, prevented price discovery in the bitcoin markets.

Staff did not demonstrate that the purpose of [fake volume and wash trading] was to manipulate the price of bitcoin or that wash trading or fake volume has had a significant effect on bitcoin prices. On the evidence before me, the purpose of wash trading and fake volume is to attract crypto-asset traders and issuers of new crypto-assets by creating the illusion that a platform has liquidity. The evidence of other types of market manipulation identified by Staff also did not establish systemic and sustained manipulation of the price of bitcoin.⁹

⁷ 3iQ Corp. (Re), 2019 ONSEC 37 para. 3-4 (CanLII).

⁸ *Id.* at para. 53.

⁹ *Id.* at para. 72.

Staff has not proven that true price discovery in the bitcoin market is prevented by insufficient ‘true trading’ or price manipulation, at least on the [New York Department of Financial Services] regulated exchanges.¹⁰

Following their successful appeal, 3iQ Corp. launched The Bitcoin Fund in April 2020. Less than one year later OSC approved the launch of the first Bitcoin ETF in Canada. The shares of the Purpose Bitcoin ETF began trading on the Toronto Stock Exchange, one of the largest stock exchanges in the world, on February 18, 2021. The reception was immediate. Within one month, \$1 billion had flowed into the ETF. Now, there are at least five such ETFs, cumulatively with billions of dollars in assets under management. One of the newest bitcoin funds to launch in Canada was sponsored by Fidelity Investments, one of the largest asset managers in the world, and a U.S. company that has sought – and been denied – approval from the SEC to launch a similar product in the United States.

These Bitcoin ETFs have operated properly in Canada without issue. During the production of this Report, the Chamber conducted interviews with one of these Canadian issuers, 3iQ Corp., to discuss their experience in managing such products thus far. When asked if 3iQ had experienced any operational issues in the management of their Bitcoin ETFs, 3iQ Chairman and CEO Fred Pye’s response was unambiguous: “Absolutely none. Not one hiccup since the day it was launched.” To date there have been no instances of hacking or theft and no indications of market manipulation relating to these Canadian Bitcoin ETFs. Following this success, OSC has approved the launch of Ether ETFs in Canada as well, putting the United States even further behind its northern neighbor.

But Canada is far from the only analogous market in the world that has benefitted from the launch of Bitcoin ETFs in their jurisdiction. The German securities regulator, the German Federal Financial Supervisory Authority (“BaFin”), also approved a bitcoin ETP in 2020, the ETC Group Physical Bitcoin. This product, as well as others provided by ETF issuers such as WisdomTree and Fidelity Investments, are listed and traded on some of Europe’s largest regulated securities exchanges, including Deutsche Borse’s XETRA, SIX Swiss Exchange and Euronext Paris, the largest stock exchanges in Germany, Switzerland and France, respectively. These products have also been managed without reported operational issues of any kind. Recently, in May 2022, Australian securities regulators approved the listing of a Bitcoin ETF on Australian securities exchanges. Similar products also trade on Nasdaq Nordics, Nasdaq Dubai and Sao Paulo’s B3 stock exchange.

Despite the apparently successful approaches taken by many other global regulators, little, if any, progress has been made towards convincing the SEC to approve such a product. The SEC’s official justifications for continuing to deny these applications remain the same as those offered in its first denials, despite the significant maturation and institutionalization of the market, proofs of concept offered by similar products operating abroad, and robust and rigorous research undertaken by market participants showing the SEC’s stated concerns to be overstated and, in many cases, unfounded. The SEC has imposed on the industry an unprecedented requirement, the so-called “Winklevoss Standard,” which requires asset managers

¹⁰ *Id.* at para. 70.

to prove that price discovery on bitcoin occurs on the CME, based on futures contracts referencing bitcoin, as opposed to on the major cryptocurrency trading venues such as Coinbase or Gemini. As noted above, the imposition of this requirement has no precedent. Nonetheless, two of the most sophisticated industry participants, Bitwise Asset Management (“Bitwise”) and Fidelity Investments, at their own time and expense, set out to design and implement research programs that provided the empirical evidence to demonstrate this showing. Their reports (see Appendices B and C) showed that price discovery on bitcoin does in fact occur on the CME on a statistically significant basis. Accordingly, the SEC’s standard has been met – and yet the SEC has continued to issue denials, including denying Bitwise’s most recent application on June 29, 2022.

The regulatory regime pursuant to which the SEC considers (and thus far has denied) applications to list Bitcoin ETFs, and other similar novel products, is complex and byzantine. The second half of this Report is an overview of that regime and provides context and basis for the SEC’s repeated denials. It also illustrates the glaring inconsistencies of the SEC’s approach – inconsistencies that, in the mind of Davis Polk & Wardell LLP (“Davis Polk”), one of the country’s pre-eminent law firms, and Munger, Tolles & Olson, led by former U.S. Solicitor General, Donald B. Verrilli, Jr., rise to the level of a violation of the Administrative Procedures Act (the “APA”) as an arbitrary and capricious exercise of the SEC’s rulemaking authority, and a violation of the Exchange as unfair discrimination between issuers. As discussed in more detail below, Davis Polk has written two publicly-available memoranda on behalf of Grayscale and GBTC to the SEC persuasively articulating this position. At the SEC, however, these arguments have fallen on deaf ears, as evidenced by the denial of the Grayscale 19b-4 application on June 29, 2022. Grayscale immediately appealed the decision on the basis of the arguments set forth in the memoranda (see Appendix D). The case now heads to the United States Court of Appeals for the District of Columbia Circuit.

After nearly ten years of working with the SEC on the pursuit of a Bitcoin ETF, few market participants believe the true reason the SEC continues to issue denials on Bitcoin ETF applications has much connection to the legal standards the SEC cites in its denials. When asked what further data might be provided to the SEC to show that the standard had been met, one high-ranking executive at an issuer who has engaged extensively with the SEC on these issues summed up the feelings of many: “The deep analytical research has been done and supports the conclusion that [the Winklevoss Standard] has been met,” they said. “If what they’ve been given doesn’t satisfy them, nothing will.” An executive at another issuer expressed a similar feeling: “It stopped being a legal problem once Chairman [Gary] Gensler took over the SEC. Now it’s a political problem.”

A Political Problem

This brings us to the heart of the matter. The SEC, as a regulator of securities, wants its remit expanded to cover the bitcoin markets, especially the exchanges on which bitcoin trades, even though Chairman Gensler recently re-affirmed as recently as late June 2022 his belief that bitcoin was a commodity, and not a security.¹¹ The justification for the denials offered by the SEC, which will be covered in more detail in the second part of this report, are based on the notion that there are inadequate systems currently in place for

¹¹ Maria Gracia Santillana Linares, *SEC Chairman Gary Gensler Implies That Ether Is a Security and Falls Under His Jurisdiction*, FORBES (June 27, 2022, 6:02 PM), <https://www.forbes.com/sites/mariagraciasantillanalinares/2022/06/27/sec-chairman-gary-gensler-implies-that-ether-is-a-security-and-falls-under-his-jurisdiction/?sh=1414b5f17775>.

identifying manipulation in the underlying bitcoin market. When that standard was first articulated in 2017 under the SEC's prior chairman, Jay Clayton, there was good reason to believe that an SEC approval of a Bitcoin ETF would soon follow as a matter of course once these systems were implemented. The SEC began working extensively with issuers and eagerly reviewed the data with which it was provided. The Chamber learned, through its extensive discussions with issuers in connection with this Report, that toward the end of Chairman Clayton's term, multiple issuers received signaling from the SEC's staff that an approval of a Bitcoin ETF could be issued in the near term. This changed with the appointment of Chairman Gary Gensler in April 2021. The long-running engagement between the SEC staff and issuers was abruptly cut off.

Approximately around this time, Chairman Gensler began citing the need for the SEC to oversee the bitcoin exchanges before a Bitcoin ETF should be approved. Chairman Gensler said as much in September 2021 when pressed by Senator Pat Toomey, the top Republican on the Senate Banking Committee, about the SEC's progress in approving a Bitcoin ETF: "This lack of regulatory oversight and surveillance [over the bitcoin exchanges] leads to concerns about the potential for fraud and manipulation," the Chairman stated. "Congress could bring the bitcoin markets under the U.S. regulatory umbrella, which could be helpful in our consideration of bitcoin exchange-traded products."¹²

The possibility that the true pretext for the application denials was not based on any unmet legal standard but rather as a means of effectuating a jurisdictional land grab was highlighted by SEC Commissioner Hester Peirce in a scathing rebuke of the SEC and her fellow Commissioners at the Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem in June 2022. "The Commission's willingness to be persuaded, though, turns on whether the Commission's primary concern is legal and logical coherence with our [prior] approvals ... and not, say, using the prospect of a [Bitcoin ETF] approval as an inducement to get exchanges to come in and register."¹³ This sentiment was echoed by the Editorial Board of the Wall Street Journal in the first sentences of a July 6, 2022 article entitled "Gary Gensler's Bitcoin Land Grab":

Securities and Exchange Commission Chairman Gary Gensler has his regulatory eye on cryptocurrency markets, and he's taking investors hostage in the process. That's the best way to explain the agency's blockade of [Bitcoin ETFs].

In recent months, legislation has been introduced in the Senate that would bring cryptocurrency exchanges within the federal regulatory ringfence. In June 2022, Senators Cynthia Lummis and Kirsten Gillebrand introduced the Responsible Financial Innovation Act (the "RFI Act")¹⁴ which would create a complete regulatory framework for digital assets and resolve much of the legal ambiguity surrounding the asset class. Notably, the RFI Act grants the Commodity Futures Trading Commission ("CFTC"), and not the SEC,

¹² *Oversight of the U.S. Securities and Exchange Commission: Hearing before the Comm. on Banking, Hous., & Urban Affairs*, 117th Cong. 10 (2021) (statement of Gary Gensler, Chairman, SEC), https://www.banking.senate.gov/imo/media/doc/gensler_responses_to_toomey_qfrs_on_crypto.pdf.

¹³ Speech, Hester M. Peirce, Comm'r, SEC, Remarks at the Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem: Necessary Regulation or Crippling Future Innovation? (June 14, 2022) <https://www.sec.gov/news/speech/peirce-remarks-regulatory-transparency-project-conference>.

¹⁴ S. 4356 – 117th Congress (2021-2022): Responsible Financial Innovation Act. (2022, July 7). <https://www.congress.gov/bill/117th-congress/senate-bill/4356>

exclusive jurisdiction over the exchanges upon which digital assets trade. Chairman Gensler has expressed skepticism towards the RFI Act but Rostin Behnam, Chairman of the CFTC, has reacted favorably to it, commenting that it “does a very good job.”¹⁵ Nonetheless, passage of the bill appears to be a long way off as it must still go through multiple Senate committee mark-ups before a full vote.

In addition, in August 2022, Senators Stabenow and Boozman introduced the Digital Commodities Consumer Protection Act (the “DCCP Act”)¹⁶ that specifically designates bitcoin and ethereum as digital commodities and defines ‘digital commodity’ as “a fungible digital form of personal property that can be possessed and transferred person-to-person without necessary reliance on an intermediary.” Digital commodities would not include securities or fiat-backed digital currencies. The legislation would also provide the CFTC with authority over the spot market for assets deemed to be digital commodities and create a registration regime for those assets.

Given that Congressional approval of the RFI Act, the DCCP Act, and similar legislation doesn’t appear imminent, there is broad consensus that Chairman Gensler is now seeking oversight of the cryptocurrency exchanges through the SEC’s own rulemaking mechanism. In a February 2022 interview, SEC Commissioner Peirce echoed the widespread belief about Chairman Gensler’s intentions: “I think [Chairman Gensler] is trying to pull those crypto platforms into our orbit,” she said.¹⁷ She then went on to acknowledge that one of the biggest issues with this objective is that such rulemaking doesn’t appear to be imminent, appearing nowhere on the Chairman’s already ambitious agenda: “If you look at the agenda that Chair Gensler has put out, I don’t see anywhere on that agenda, a rule directed toward crypto exchanges.” It now appears to many that under Chairman Gensler the SEC does not intend to approve a Bitcoin ETF until the SEC’s authority to regulate is expanded to cover the cryptocurrency exchanges, whether that be through legislation, unilateral SEC rulemaking or, most dubiously, through SEC enforcement actions. Unfortunately for U.S. investors, entrepreneurs and asset managers alike, such an extension of authority does not appear forthcoming in the near term.

A Question of Investor Protection

The mission of the SEC is threefold: (i) investor protection; (ii) facilitation of capital formation; and (iii) maintenance of fair, orderly and efficient markets. The SEC has thus far prevented a Bitcoin ETF from coming to market on the basis of that first prong, investor protection. Bitcoin is a novel asset. Its proponents reasonably draw comparisons to other asset classes, but its underlying blockchain technology, decentralized and largely anonymous structure, 24-hour trading day and proof-of-work verification technique are unusual, and it is understandable why the SEC would initially move cautiously. Bitcoin’s initial association with nefarious activities on the “dark web” and the multitude of headlines of hacks and scams in its early days also did not help.

¹⁵ Allyson Versprille, *CFTC Chairman Signals Support for Lummis-Gillibrand Crypto Plan*, BLOOMBERG LAW (June 8, 2022, 9:59 AM), <https://news.bloomberglaw.com/banking-law/cftc-chairman-signals-support-for-lummis-gillibrand-crypto-plan>.

¹⁶ S. 4760 – 117th Congress (2021-2022): Digital Commodities Consumer Protection Act of 2022. (2022, August 3). <https://www.congress.gov/bill/117th-congress/senate-bill/4760>

¹⁷ Jennifer Schonberger, *Crypto Regulation Is Coming, Just Not This Year: SEC’s Pierce*, YAHOO!NEWS (Feb. 3, 2022), <https://news.yahoo.com/crypto-regulation-coming-just-not-this-year-se-pierce-172824069.html>.

But just as it is fair to extend some empathy to the SEC regarding its initial skittishness, it is also fair to ask what protection the SEC is actually offering today by preventing a Bitcoin ETF from coming to market. After all, it is not as if, by preventing the issuance of a Bitcoin ETF, the SEC is preventing U.S. investors (and retail investors in particular) from accessing the cryptocurrency markets – far from it. A poll conducted by the Pew Research Center in 2021 found that 16% of Americans (41.5 million) have already invested in cryptocurrencies, including 31% of Americans between the ages of 18 to 29.¹⁸ That is a number that is only rising as time goes on. It is believed that 55% of investors who currently own bitcoin began investing over the past 12 months.¹⁹ In an ironic twist, by preventing the offering of a Bitcoin ETF, which may ultimately be the avenue of exposure for many, if not most, retail bitcoin investors, the SEC hasn't protected them from the asset class; it has merely forced them to acquire their exposure in a less regulated and/or foreign environment where they are much more susceptible to unscrupulous actors and the risks of self-custody. Conversely, rather than advancing the SEC's mission as stated above, the SEC's Bitcoin ETF denials are arguably undermining that mission. This point was expressly made by OSC Chairman Lawrence Haber in overturning the Staff of the OSC's initial denial of 3iQ Corp.'s application to offer a closed-end fund that held bitcoin:

Denying investors the opportunity to invest in bitcoin through a public fund would not promote fair and efficient capital markets and confidence in capital markets. Instead, it would suggest that investors should acquire bitcoin through unregulated vehicles, and capital market participants should be encouraged to create those vehicles.²⁰

As securities regulators around the world also get comfortable that Bitcoin ETFs are appropriate and beneficial for their country's citizens, the SEC's belief that such avenues of exposure are still inappropriate for American investors appears increasingly devoid of logic and squarely at odds with any notion of investor protection. It is also in direct contrast to the entire ethos of the U.S. federal securities regime enacted by Congress in the wake of the Great Depression. One of the foundational pieces of federal securities legislation is the Securities Act of 1933 (the "1933 Act"). The 1933 Act is often referred to as the "truth in securities" law, as it created the basis of U.S. federal securities regulation as a "disclosure-based" regime and the SEC as a disclosure-based rather than a "merits-based" regulator. The underlying premise is that if U.S. investors have the appropriate information, they can make rational and informed investment decisions. This is intentionally in contrast to a "merit-based" regime, whereby a regulator takes on the role of determining whether a particular investment is suitable or appropriate for investors.

18 Andrew Perrin, *16% of Americans Say They Have Ever Invested In, Traded or Used Cryptocurrency*, PEW RES. CTR. (Nov. 11, 2021), <https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/>.

19 *Grayscale Investments Study Reveals More than a Quarter of U.S. Investors Currently Own Bitcoin*, GLOBENEWSWIRE (Dec. 6, 2021, 8:00 AM), <https://www.globenewswire.com/news-release/2021/12/06/2346525/0/en/Grayscale-Investments-Study-Reveals-More-than-a-Quarter-of-U-S-Investors-Currently-Own-Bitcoin.html>.

20 3iQ Corp. (Re), 2019 ONSEC 37 para. 111 (CanLII).

In stark contrast to this long-established ethos, the SEC has now positioned itself as a merit regulator on this matter. It has determined that the American public cannot yet handle the responsibility of familiar, cost-effective, liquid, transparent and regulated access to the bitcoin markets. Unfortunately, the cost of this position has fallen, and will continue to fall, on U.S. investors and the U.S. capital markets. The SEC continues to force U.S. investors who wish to invest in this transformative asset class into unregulated or foreign alternatives. At the same time, investment and innovation continues to occur elsewhere, in jurisdictions that promote a more welcoming environment for asset managers, investors, innovators and entrepreneurs.

Meanwhile, what had been privately alleged – that the SEC’s behavior in how it considered and ultimately denied the Bitcoin ETF applications had been a violation of the APA and Exchange Act – was finally made public in November 2021 in a publicly-filed memorandum to the SEC on behalf of Grayscale (the “First Davis Polk Letter”). In April 2022, after additional inconsistent SEC decision-making, Davis Polk filed a second memorandum with the SEC on behalf of Grayscale (the “Second Davis Polk Letter” and with the First Davis Polk Letter, the “Davis Polk Letters”) doubling down on the claims of its first letter, asserting that the SEC’s decision-making with regard to its consideration and disapproval of Bitcoin ETF applications to this point has constituted arbitrary and capricious behavior under the APA, unfair discrimination between issuers under the Exchange Act and a violation of the law. Evidently not persuaded, the SEC issued a denial of the Grayscale application on June 29, 2022.

III. Context of Denials

A brief review of the regulatory landscape in which ETFs and the national securities exchanges on which their securities list and trade is necessary to understand the context in which issuers have been applying – and the SEC has been denying – applications to launch a Bitcoin ETF. In general, issuers that have sought to bring a Bitcoin ETF to market have first filed a registration statement seeking to register the shares of the entity, usually a trust, that will hold the bitcoin delivered to it pursuant to the unique mechanism by which ETFs acquire and dispose of assets. Once registered, that entity would sell its shares to investors that will provide them with a pro rata interest in the assets of the entity, which in this case is bitcoin.

These shares are registered pursuant to the requirements of the 1933 Act, one of the foundational pieces of U.S. federal securities legislation that was borne out of the misdeeds that led to the stock market crash of 1929 and the subsequent Great Depression. As previously discussed in greater detail herein, the 1933 Act created a disclosure-based regime. Accordingly, when the SEC reviews a registration statement filed by an issuer, its concern is making sure the registration statement contains all the material information an investor needs to evaluate an investment on its merits and make an informed investment decision. By design, the 1933 Act does not give the SEC the affirmative ability to approve or disapprove the issuance of a security, provided that the disclosure contained in the registration statement is accurate and complete. Thus, when it is said that the SEC has denied an issuer the right to issue a Bitcoin ETF, it is not a rejection of the registration statement.

The grounds for rejection, rather, come from the second foundational piece of U.S. federal regulation – the Securities Exchange Act of 1934 (the “1934 Act”). The 1934 Act set forth the requirements for the

registration and regulation of national securities exchanges. However, self-regulation by the national securities exchanges is a basic premise of the 1934 Act. Congress recognized the regulatory role of national securities exchanges in Section 6 of the 1934 Act, requiring all existing securities exchanges to register with the SEC and to function as self-regulatory organizations (“SROs”). SROs are subject to various requirements under the 1934 Act, including the requirement in Section 19(b) and Rule 19b-4 thereunder to file any proposed rule changes with the SEC. The SEC reviews these proposed rule changes and ultimately has authority to determine whether they may be implemented under the guise of ensuring that securities exchanges continue to operate in alignment with the purposes of the 1934 Act.

Due to the characteristics of the proposed Bitcoin ETFs and existing SRO rules, a national securities exchange wishing to list the shares of a Bitcoin ETF must file with the SEC’s Division of Trading and Markets a proposed rule change pursuant to what is known as a Rule 19b-4 application. This application process, and the necessity that the SEC affirmatively approve such applications, ultimately gives the SEC the authority to allow – or disallow – the listing and trading of new and novel products such as Bitcoin ETFs. The 19b-4 application process is not unique to Bitcoin ETFs and has been used in relation to the successful listing of hundreds of ETFs in a variety of asset classes over the last 20 years, including for a variety of commodity products further discussed below. However, it is through this application process that the SEC has thus far prevented Bitcoin ETFs from being offered in the United States, as the SEC has denied all applications that would allow the shares of such products to trade on U.S. securities exchanges.

The “Winklevoss Standard”

In early 2017, the SEC issued its first denial of a 19b-4 application by an issuer, the Winklevoss Bitcoin Trust, that sought to list and trade shares of an ETF that provided exposure to the price of bitcoin. Since then, the SEC issued numerous additional denials.

In each of these denials, the SEC determined that the application failed to demonstrate that the proposal was consistent with the requirements of Section 6(b)(5) of the 1934 Act and, in particular, the requirement that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices. The SEC’s first critical finding in its review of these applications was that the applicants had not established that bitcoin markets were uniquely resistant to fraud or manipulation.²¹

That being the case, the SEC determined that the principal means by which a national securities exchange may satisfy the requirements of Section 6(b)(5) of the 1934 Act is through entry into comprehensive surveillance-sharing agreements that “help to ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making [the ETF] less readily susceptible to manipulation.”²²

21 Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to List and Trade Shares of the Winklevoss Bitcoin Trust (“Second Winklevoss Order”), Release No. 34-83723 (July 26, 2018), 83 Fed. Reg. 37579 (Aug. 1, 2018) (quote at Fed. Reg. 37591); Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Listing and Trading of Shares of the Bitwise Bitcoin ETF Trust Under NYSE Arca Rule 8.201-E (“Bitwise Order”), Release No. 34-87267 (Oct. 9, 2019), 84 Fed. Reg. 55382 (Oct. 16, 2019) (quote at Fed. Reg. 55386); Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, to Amend NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) and to List and Trade Shares of the United States Bitcoin and Treasury Investment Trust Under NYSE Arca Rule 8.201-E, Release No. 34-88284 (Feb. 26, 2020), 85 Fed. Reg. 12595 (Mar. 3, 2020) (“USBT Order”) (quote at 12597).

22 Exchange Act Release No. 35518 (Mar. 21, 1995), 60 Fed. Reg. 15804 (Mar. 27, 1995).

These comprehensive surveillance-sharing agreements theoretically enable a listing exchange to obtain information necessary to detect and deter market manipulation and other trading abuses upon request of information from one party to the other. The SEC has described a comprehensive surveillance sharing agreement as including an agreement under which a self-regulatory organization may expressly obtain information on (i) market trading activity, (ii) clearing activity and (iii) customer identity, and where existing rules, laws or practices would not impede access to such information.²³

In its denial of the application filed by Bats BZX Exchange on behalf of the Winklevoss Bitcoin Trust, the SEC set forth the importance and definition of a surveilled, regulated market of significant size. Specifically, the SEC stated that “[for all] commodity-trust [exchange-traded products or “ETPs”] approved to date for listing and trading, there has been in every case at least one significant, regulated market for trading futures on the underlying commodity—whether gold, silver, platinum, palladium, or copper— and the ETP listing exchange has entered into surveillance-sharing agreements with, or held Intermarket Surveillance Group (“ISG”) membership in common with, that market.”²⁴

The SEC then set forth its interpretation of what constituted a “regulated market of significant size.” This two-prong definition of the term “significant market” came to be known as the “Winklevoss Standard”:

[The SEC interprets] the terms ‘significant market’ and ‘market of significant size’ to include a market (or group of markets) as to which (a) there is a reasonable likelihood that a person attempting to manipulate the ETP would also have to trade on that market to successfully manipulate the ETP, so that a surveillance-sharing agreement would assist the ETP listing market in detecting and deterring misconduct, and (b) it is unlikely that trading in the ETP would be the predominant influence on prices in that market.²⁵

The industry was disappointed with these initial denials but did not despair. Futures contracts that used bitcoin as the reference asset (“Bitcoin Futures”) had recently begun trading on the CME in December 2017. The market for those contracts was growing steadily and given that the CME was regulated by the Commodity Futures Trading Commission (“CFTC”), the CME would constitute a regulated market in the eyes of the SEC. Equally encouraging, the CME and the securities exchanges on which shares of a Bitcoin ETF would trade were members of the ISG, meaning that the surveillance agreements required by the SEC under the Winklevoss Standard were already in place. All that needed to be done was to show that the CME met the SEC’s standard of a “market of significant size.”

²³ See Letter from Brandon Becker, Dir., Div. of Mkt. Regulation, Comm’n, to Gerard D. O’Connell, Chairman, Intermarket Surveillance Group (June 3, 1994), <https://www.sec.gov/divisions/marketreg/mr-noaction/isg060394.htm> (“ISG Letter”).

²⁴ Second Winklevoss Order, 83 Fed. Reg. 37594.

²⁵ *Id.*

In one of its disapproval orders, the SEC laid out how data relating to the trading of Bitcoin Futures on the CME would satisfy the Winklevoss Standard:

... a lead-lag relationship between the bitcoin futures market and the spot market ... is central to understanding whether it is reasonably likely that a would-be manipulator of the ETP would need to trade on the bitcoin futures market to successfully manipulate prices on those spot platforms that feed into the proposed ETP's pricing mechanism. In particular, if the spot market leads the futures market, this would indicate that it would not be necessary to trade on the futures market to manipulate the proposed ETP, even if arbitrage worked efficiently, because the futures price would move to meet the spot price.²⁶

Thus, the SEC had placed the emphasis on the question of price discovery. Price discovery refers to a market's contribution toward determining a common price for an asset. The price of bitcoin would be reflected in both the value of the Bitcoin Futures on the CME and in the spot bitcoin markets as well. Both of those markets would incorporate new information about the value of bitcoin at different speeds. Greater contribution from a particular market is considered to reflect the degree to which that market "leads" in demonstrating new information about the asset. The SEC had put the onus on the industry to determine whether the price of bitcoin reflected in the value of Bitcoin Futures on the CME "led" the price of bitcoin in the spot markets. The primary means of demonstrating whether one market leads another in price discovery is through what is known as a "lead-lag" analysis.

Industry participants dutifully set out to do the research and provide the lead-lag analysis that the SEC seemed to require. At least two market participants, Bitwise and Fidelity Investments, independently undertook rigorous and unprecedented research programs to provide this lead-lag analysis. In June 2021, Bitwise released the results of its research program in a white paper entitled "Price Discovery In the Modern Bitcoin Market: Examining Lead-Lag Relationships Between The Bitcoin Spot and Bitcoin Futures Market" (the "Bitwise Lead-Lag Report") (see Appendix B).

The Bitwise Lead-Lag Report sought to build upon a growing level of research to determine whether price discovery in the bitcoin market primarily takes place on spot cryptocurrency exchanges or on the CME on which Bitcoin Futures trade. Using a diversity of statistical approaches, the paper found that the

²⁶ Bitwise Order, 84 Fed. Reg. at 55,411. See also USBT Order 85 Fed. Reg. at 12,612.

Bitcoin Futures market leads the bitcoin spot market in a consistent and statistically significant manner. It also included a broad literature survey and identified ten academic and practitioner studies seeking to determine whether price discovery in the bitcoin market occurred in the spot market or on the CME where Bitcoin Futures trade. Of those ten papers, seven found that price discovery in bitcoin was occurring on the CME and one found that the evidence was mixed with regard to whether price discovery occurred on the CME or in the spot markets.²⁷ Of the two studies that found price discovery occurred on the spot market, one contained a critical methodological flaw — the authors conducted their price discovery analysis on a per-lifetime-of-each-contract basis, rather than a standard rolling-contract basis. The other study that found that price discovery occurred on the spot market was subsequently contradicted by one of its own co-authors in a more recent study, which observed bitcoin price discovery over a longer time period, before ultimately finding that price discovery occurred on the CME.²⁸

Fidelity Investments commissioned a similar research study and published its findings in January 2022 in a white paper entitled “Suitable Price Discovery Measurement of Bitcoin Spot and Futures Markets” (the “Fidelity Lead-Lag Report”) (see Appendix C). The Fidelity Lead-Lag Report focused primarily on more recent trading activity, looking at tick level trade data for the bitcoin spot market and the Bitcoin Futures market from January 1, 2019 through March 31, 2021. It examined the speed of price discovery across 20 distinct bitcoin spot markets and 26 different markets upon which Bitcoin Futures trade. Its conclusions echoed the finding of the Bitwise Lead-Lag Report, that the price of bitcoin on the CME led all other spot and Bitcoin Futures exchanges.²⁹

This was the exact analysis the SEC required in order to make a finding that its standard had been met. Between the Bitwise Lead-Lag Report and the Fidelity Lead-Lag Report, and the seven other studies referenced in the Bitwise Lead-Lag Report, there had now been nine distinct research reports showing that the CME Exchange led the bitcoin spot exchanges. It appeared that the first prong of the Winklevoss Standard had been met.

However, that was not the end of the analysis. Now that it had been shown that the CME “led” in terms of price discovery, the SEC had also required it be shown that the market on the CME was sufficiently deep such that a Bitcoin ETF, if approved, would not become the dominant influence on prices in that market, causing an artificial distortion in price discovery. Bitwise also conducted research on this topic and produced a second white paper entitled “Is It Likely That A U.S. Bitcoin ETP, If Approved, Will Become The Predominant Influence on Prices In the CME Bitcoin Futures Market?” (the “Bitwise Report on Predominant Influence”) (see Appendix D).

Using a replicable, data-driven approach that relied on extensive historical data on U.S. ETPs, the Bitwise Report on Predominant Influence demonstrated that even using the most aggressive assumptions regarding the size of a Bitcoin ETF launch, it was unlikely that a Bitcoin ETF would become the predominant influence on prices in the CME.³⁰

²⁷ Matthew Hougan, Hong Kim & Satyajeet Pal, Bitwise Asset Mgmt., Price Discovery In the Modern Bitcoin Market: Examining Lead-Lag Relationships Between The Bitcoin Spot and Bitcoin Futures Market 14 (2021).

²⁸ *Id.*

²⁹ Kevin Robertson & Jiani Zhang, Dep’t of Quantitative Research & Inv.: Fidelity Inv. Inc., Suitable Price Discovery Measurement of Bitcoin Spot and Futures Markets 18–19 (2021).

³⁰ Matthew Hougan, Hong Kim & Satyajeet Pal, Bitwise Asset Mgmt., Is It Likely That A U.S. Bitcoin ETP, If Approved, Will Become The Predominant Influence on Prices In the CME Bitcoin Futures Market? 15 (2021).

The SEC remains unmoved, claiming that the Winklevoss Standard still has not been met, regardless of the information with which it has now been presented. In the Chamber's extensive interviews with market participants, it was the SEC's denials in the face of this robust research that caused many to believe there was no data that could be provided to the SEC to convince it to approve a Bitcoin ETF.

This belief is shared by one of the SEC's own commissioners, Hester Peirce, who in a 2020 dissent to one of the SEC's bitcoin denials provided the following blunt assessment of the SEC's approach to such products:

This [denial] order is the latest in a long string of disapproval orders that the [SEC] has issued regarding bitcoin-related products. This line of disapprovals leads me to conclude that the [SEC] is unwilling to approve the listing of any product that would provide access to the market for bitcoin and that no filing will meet the ever-shifting standards that the [SEC] insists on applying to bitcoin-related products—and only to bitcoin-related products.³¹

Persistent Inconsistencies

Another source of frustration among industry participants is the degree to which the SEC has treated bitcoin differently from all other analogous commodities and the ETPs that hold them. This was pointed out by SEC Commissioner Pierce in her remarks in June 2022 at the Regulatory Transparency Project Conference:

The reasons for [the SEC's] resistance to a [Bitcoin ETF] are difficult to understand apart from a recognition that the Commission has determined to subject anything related to bitcoin—and presumably other digital assets—to a more exacting standard than it applies to other products.³²

Comparing the standard utilized by the SEC when considering a Bitcoin ETF versus the standard it applied when considering a Platinum ETF (the "Platinum Order")³³ or a Palladium ETF (the "Palladium Order")³⁴ most clearly illustrates these discrepancies.

31 Statement, Hester M. Peirce, Comm'r, SEC, Dissenting Statement of Hester M. Peirce in Response to Release No. 34-88284; File No. SR-NYSEArca-2019-39 (Feb. 26, 2020), <https://www.sec.gov/news/public-statement/peirce-dissenting-statement-34-88284>.

32 Speech, Hester M. Peirce, *supra* note 11.

33 Order Granting Approval of Proposed Rule Change Relating to Listing and Trading Shares of the ETFS Platinum Trust ("Platinum Trust Order"), Release No. 34-61219 (Dec. 22, 2009).

34 *Id.*

When considering Bitcoin ETFs, the SEC imposed the Winklevoss Standard, requiring a showing that the Bitcoin ETF's listing exchange have surveillance agreements in place with a "regulated market of significant size." Even further, the SEC required that Bitcoin ETF applicants themselves prove that this regulated market led the underlying spot market in terms of price discovery.

In the approvals issued by the SEC in the Platinum Order and the Palladium Order, the SEC was satisfied that the listing exchange "may obtain information" from other exchanges through surveillance sharing. However, the SEC stopped well short of requiring surveillance sharing like it did with Bitcoin ETFs. The theoretical existence of such agreements was sufficient.

The actual utility of these information sharing arrangements is even in doubt, as Cliff Cone, partner at Clifford Chance U.S. LLP and co-head of its U.S. asset management practice pointed out:

The SEC has been placing all of this weight on these information sharing arrangements, and yet, in the other contexts when they are in place, as far as we can tell, the SEC has never once unearthed anything. So the speculation is that the use of these information sharing agreements isn't the issue, it's simply that they must exist to satisfy some theoretical notion of prevention of market manipulation.

He also noted that the presence of these arrangements did not detect the systematic price fixing of the London Bullion Market Association Gold Price (the "LBMA Gold Price") from 2004 to 2013. The LBMA Gold Price is the calculation used by most Gold ETFs to value their holdings.

Additionally, there was never any requirement that the applicants for the Platinum ETF and Palladium ETF make any showing whatsoever regarding the relationship between the spot market for palladium or platinum and the futures contracts that reference those metals. Conclusory statements about the existence of platinum or palladium futures was enough for the SEC in those instances (as it was for Gold ETFs and Silver ETFs as well). This is in direct contrast to the SEC's treatment of Bitcoin ETF applicants, who were told that sophisticated lead-lag analyses needed to be provided to show that price discovery occurred in the futures market. Even when presented with multiple rigorous academic studies demonstrating that its unusual and highly-elevated standard had been met, the SEC still issued denials based on methodology critiques.

Bitcoin Futures ETFs – An Inconsistency Too Far

Another significant inconsistency relates to the SEC's approval of ETFs that directly hold Bitcoin Futures ("Bitcoin Futures ETFs"), as opposed to spot bitcoin itself. In August 2021, in a speech before the Aspen Security Forum, Chairman Gensler caught the entire industry by surprise by signaling the SEC's newfound

willingness to consider the approval of Bitcoin Futures ETFs.³⁵ Prior to the Chairman’s speech, the SEC was not willing to consider Bitcoin Futures ETFs. Several issuers had sought to bring such products to market in late 2017 after Bitcoin Futures began trading on the CME for the first time. The SEC individually reached out to such issuers and instructed them to discontinue that pursuit as the SEC did not believe such products were appropriate at the time.³⁶

After the Chairman’s speech the SEC quickly acquiesced to the listing and trading of Bitcoin Futures ETFs, apparently deriving much comfort from the fact that Bitcoin Futures were a regulated product that traded on a regulated exchange and would be held in a fund registered pursuant to the Investment Company Act of 1940. Chairman Gensler served as the Commissioner of the CFTC, the regulator of the CME and Bitcoin Futures, from 2009 to 2014, likely giving him a unique sense of familiarity with futures contracts and the exchanges on which they trade. The first of these Bitcoin Futures ETFs, the ProShares Bitcoin Strategy ETF, began trading in October 2021. Since then, other such products have been brought to market as well.

Bitcoin Futures ETFs are arguably a step in the right direction. They allow investors some ability to gain exposure to bitcoin through an ETF, since they derive their exposure to bitcoin through a portfolio of futures contracts. However, because these funds hold Bitcoin Futures as opposed to bitcoin itself, they have structural characteristics that make them inferior to a Bitcoin ETF. A futures contract is a legal agreement to buy or sell a particular asset at a predetermined price at a specified time in the future. To obtain bitcoin exposure, Bitcoin Futures ETFs enter into long positions in the near term (generally one month) in Bitcoin Futures that trade on the CME. As those contracts near expiration, a Bitcoin Futures ETF sells them and replaces them with longer-dated contracts – a strategy called “rolling.” The problem is that, in general, the price of shorter-term futures contracts is lower than that of longer-term contracts. Therefore, every time a Bitcoin Futures ETF rolls its position, this discrepancy between the price of the cheaper contracts the fund is selling and the more expensive contracts the fund is buying erodes the fund’s performance. This problem is also exacerbated by the fact that the market knows these funds will roll their positions as the contracts approach their expiration. This allows market participants to “front-run” these funds and drive the roll costs up even further. The chief investment officer of Bitwise has conservatively estimated that these roll costs will erode performance by 5-10% per year.³⁷ Others have projected that this erosion could approach nearly 30% on an annual basis.³⁸ A Bitcoin ETF, which derives its exposure through holding bitcoin directly instead of through Bitcoin Futures, would not be subject to this erosion, which has proven to be the case with the many Bitcoin ETFs currently trading internationally. As a result of this erosion, U.S. investors stand to lose hundreds of millions of dollars from holding Bitcoin Futures ETFs, losses which could be prevented by SEC approval of Bitcoin ETFs.³⁹

35 Statement, Gary Gensler, Chairman, SEC, Remarks before the Aspen Security Forum, (Aug. 3, 2021), <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

36 See Nikhilesh De, *Bitcoin ETF Proposals Withdrawn After SEC Pushback*, COINDESK (Jan. 9, 2018), <https://www.coindesk.com/more-bitcoin-futures-etf-proposals-withdrawn-after-sec-pushback/> (Noting the withdrawals of all three ETF applications that the SEC gave public notice of, along with two others that had been submitted by Direxion Shares ETF Trust and VanEck Vectors ETF Trust).

37 Michael Wursthorn, *Another Bitcoin Futures ETF Bites the Dust*, WALL ST. J. (Nov. 11, 2021 3:48 PM), <https://www.wsj.com/articles/another-bitcoin-futures-etf-bites-the-dust-11636663692>.

38 Michael J. Casey, *Opinion: Why a Bitcoin Futures ETF Is Bad for Investors*, COINDESK, <https://www.coindesk.com/policy/2021/10/22/why-a-bitcoin-futures-etf-is-bad-for-investors/> (last updated October 22, 2021 3:29 PM).

39 See, e.g., Notice of Filing of a Proposed Rule Change to List and Trade Shares of the WisdomTree Bitcoin Trust under BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, Release No. 34-94184 (Feb. 8, 2022), 87 Fed. Reg. 8318 (Feb. 14, 2022) at 8324–25.

However, beyond the approval of a product that is structurally inferior, the approval of Bitcoin Futures ETFs represents another inconsistency in SEC decision-making. Each of the Bitcoin Futures ETFs invests in Bitcoin Futures that are priced according to the CME CF Bitcoin Reference Rate. The CME CF Bitcoin Reference Rate is determined according to pricing data collected from certain cryptocurrency trading venues, including Bitstamp, Coinbase, Gemini, itBit and Kraken.⁴⁰

And yet, in November 2021, one month after the SEC approved the listing and trading of a Bitcoin Futures ETF that priced its Bitcoin Futures off the CME CF Bitcoin Reference Rate, the SEC denied the 19b-4 application for VanEck Bitcoin Trust, a proposed Bitcoin ETF, even though that ETF would price its shares using the exact same exchange constituents. This was explicitly noted in a footnote to the SEC's denial: "[T]he Benchmark constituents are the same platforms as the CME CF Reference Rate..."⁴¹

Thus, the SEC had no concerns regarding the integrity of the CME CF Reference Rate when considering Bitcoin Futures ETFs, but one month later it arrived at the conclusion that the CME CF Reference Rate was not reliable in the context of a Bitcoin ETF application. The SEC had permitted investors to gain indirect exposure to bitcoin, through a derivatives instrument that is poorly understood by the average investor, despite the derivatives market being exposed to the identical risks of pricing manipulation that were the stated basis of the SEC's repeated denials of Bitcoin ETF applications.

Industry participants and their legal advisers had privately muttered for years that the SEC's inconsistent approach to its consideration of Bitcoin ETFs has constituted a violation of the APA. However, the SEC's approval of a Bitcoin Futures ETF was viewed by many to be an inconsistency too far. It was this inconsistency that served as the basis of Davis Polk's claim in the Davis Polk Letters that the SEC's continued denials of Bitcoin ETF applications, while approving Bitcoin Futures ETFs, constituted a violation of the APA by being an arbitrary and capricious exercise of the SEC's authority and a violation of the Exchange Act as being unfair discrimination between issuers.

The Davis Polk Letters explained that the SEC must treat similarly situated products similarly unless it has a reasonable basis for disparate treatment⁴² and emphasized that a federal agency "can be said to be at its most arbitrary" when it "treats similar situations differently."⁴³ The Davis Polk Letters also asserted that the risks of fraud and manipulation in the bitcoin market impacting a Bitcoin ETF are indistinguishable from those same risks impacting the Bitcoin Futures ETFs. It is presumed that the arguments outlined in the Davis Polk Letters will serve as the basis for Grayscale's appeal of the denial of its application to the D.C. Circuit Court of Appeals, which is being led by Grayscale's Senior Legal Strategist, former U.S. Solicitor General, and partner at Munger, Tolles & Olson, Donald B. Verrilli, Jr. (see Appendix E).

Litigating against the SEC, once considered an unthinkable approach, is now one of the most viable options for eventually getting a Bitcoin ETF to market. However, litigation is inherently uncertain and litigating against the government is notoriously time consuming and expensive. It is also generally considered to be ill-advised to litigate against your regulator. While a litigation-driven approach is on the table, it remains

40 CF Benchmarks, CME CF Cryptocurrency Pricing Products: Constituents Exchanges List 4, (2020), <https://docs-cfbenchmarks.s3.amazonaws.com/CME+CF+Constituent+Exchanges.pdf>.

41 Order Disapproving a Proposed Rule Change to List and Trade Shares of the VanEck Bitcoin Trust under BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, Release No. 34-93559 (Nov. 12, 2021), 86 Fed. Reg. 91326 (Mar. 15, 2021) ("VanEck Denial") (quote at note 32).

42 Letter from Davis Polk & Wardwell LLP, to Vanessa Countryman, Sec'y, SEC (Nov. 29, 2021) (citing *Kirk v. Comm'r SSA*, 987 F.3d 314, 321).

43 *Id.* (quoting *Kirk*, 987 F.3d, at 321).

an avenue of last resort for many issuers, and it remains to be seen whether other issuers will follow Grayscale's lead in appealing their application denials.

Looking Ahead

The SEC's denial of both the Bitwise and Grayscale 19b-4 applications on June 29, 2022 represent a blow to the prospects of the SEC approving a Bitcoin ETF in the near term, absent a writ of mandamus from the D.C. Circuit Court of Appeals ordering the SEC to do so. In connection with its application, Bitwise conducted a research program that ultimately yielded 140 pages of results that were filed with the SEC in connection with its 19b-4 application that showed that the Winklevoss Standard had been met. The breadth, thoroughness and robustness of the analysis provided in support of a 19b-4 application had no parallel. Yet, the SEC ultimately found ways to accept almost none of the conclusions that research produced on the basis of obscure methodology critiques. As cynicism grows around the real justifications for the SEC's continued denials of Bitcoin ETF applications, it remains an open question as to whether issuers will continue to expend their resources conducting research that may ultimately have little bearing on whether the SEC approves their application.

Meanwhile, the SEC will now begin defending its denial of the Grayscale application in the courts. For months leading up to the SEC's decision on the Grayscale application, Grayscale publicly argued that it believed a denial of its application would constitute a violation of the APA and Exchange Act and postured that it would be willing to litigate if such a denial was issued. Its law firm, Davis Polk, publicly filed the two letters detailed above laying out the basis for the claim that a denial of the Grayscale application would be an APA violation. Grayscale also conducted in-person meetings with Commissioners and members of the Staff to present these points. Evidently not persuaded, the SEC issued a denial of the Grayscale application on June 29, 2022. Grayscale filed their appeal of the denial within one hour of it being issued.

Due to a procedural nuance of the denial – it being issued by the SEC's full Commission (the Commissioners and the Chair) – Grayscale was able to immediately pursue its litigation with the courts. The case will be decided upon by the United States Court of Appeals for the District of Columbia Circuit. The judges for the case will be three randomly-selected judges from the D.C. Circuit Court of Appeals. According to some estimates, a final decision may not be expected until July 2023 at the earliest, and may not come until 2024.

Upon the issuance of the decision, either Grayscale or the SEC could appeal. Under certain rare circumstances, the losing party could seek an "en banc" hearing whereby the appeal would be heard and decided upon by the entire body of D.C. Circuit Court judges. In the alternative, the losing party could appeal to the Supreme Court, which would need to grant certiorari in order to hear the case. Grayscale has intimated that in the event it loses in the D.C. Circuit Courts it will appeal to the Supreme Court.⁴⁴

⁴⁴ Brian Ponte, *Grayscale Prepared to Take Bitcoin Trust to Supreme Court*, IGNITES (July 8, 2022), https://www.ignites.com/c/3668764/472064?referrer_module=searchSubFromIG&highlight=Grayscale%20Prepared%20to%20Take%20Bitcoin%20Trust%20to%20Supreme%20Court.

IV. Conclusion

The Chamber believes that the time has come for U.S. investors to have access to a Bitcoin ETF that directly holds bitcoin. The purpose of this Report is to provide a cohesive and detailed analysis of the key actions that have taken place since the first Bitcoin ETF application was filed in support of that belief.

To that end, we feel that it is critically important for U.S. legislators, regulators and investors to understand and acknowledge the following critical points:

- To date, at least 16 different companies have applied to the SEC for the right to offer a Bitcoin ETF to U.S. investors. All such requests have been denied – some multiple times.
- The SEC’s official justifications for denying the applications remain the same as those offered in its first denials, despite a significant maturation and institutionalization of the market, proofs of concept offered by similar products operating abroad, and robust and rigorous research undertaken by market participants showing the SEC’s stated concerns to be unfounded.
- The SEC has imposed on the industry an unprecedented requirement unique only to bitcoin, which requires that an applicant prove that price discovery on bitcoin occurs on the CME, where futures contracts referencing bitcoin trade, as opposed to on the major cryptocurrency trading venues such as Coinbase or Gemini. The imposition of this requirement has no precedent, including with respect to other commodity-based ETFs approved by the SEC.
- Many of the large U.S. cryptocurrency exchanges now have in place extremely sophisticated trade surveillance tools that allow for mitigation against market manipulation, systems that are very similar to those utilized by traditional securities exchanges.
- Two of the most sophisticated industry participants designed and implemented research programs that showed that price discovery on bitcoin does in fact occur on the CME on a statistically significant basis. The SEC’s standard has been met – and yet, the SEC has continued to issue denials.
- As cynicism grows around the real justifications for the SEC’s continued denials of Bitcoin ETF applications, it becomes less likely that issuers will expend additional resources conducting additional research that may ultimately have little bearing on whether the SEC approves their application.
- The SEC has shown significant inconsistency in its analysis of whether or not bitcoin price discovery on the CME is statistically significant inasmuch as the SEC approved the listing and trading of several Bitcoin Futures ETFs in October 2021. Each of these Bitcoin Futures ETFs invests in Bitcoin Futures that are priced according to the CME CF Bitcoin Reference Rate. The CME CF Bitcoin Reference Rate is determined according to pricing data collected from certain cryptocurrency trading venues, including Bitstamp, Coinbase, Gemini, itBit and Kraken. However, just one month after it approved the first Bitcoin Futures ETF, it found that the CME CF Reference Rate was not reliable in the context of a Bitcoin ETF application.

- The United States is falling behind. Regulators in Canada, Germany, Sweden, Switzerland, and Australia have allowed issuers in those countries to bring Bitcoin ETFs and other cryptocurrency exchange traded products to market. To date there have been no reported instances of hacking or theft and no indications of market manipulation relating to these international Bitcoin ETFs.
- It is becoming clear that Chairman Gensler does not intend to approve a Bitcoin ETF until the SEC's authority to regulate is expanded to cover the cryptocurrency exchanges, whether that be through legislation, unilateral SEC rulemaking or SEC enforcement actions, creating a belief among market participants that the true pretext for the application denials is not based on any unmet legal standard but rather as a means of effectuating a jurisdictional land grab.
- In the meantime, U.S. retail investors are being denied access to a well-understood and cost-efficient investment product, as well as the protections offered around SEC-registered products by financial advisers, broker-dealers and stock exchanges with whom retail investors interact for their traditional investments.

Also as noted in the Report, the SEC's continued refusal to approve a Bitcoin ETF has now led to litigation. In its appeal of the June 2022 rejection of its application, Grayscale has asserted that the SEC's decision-making with regard to its consideration and disapproval of Bitcoin ETF applications constitutes arbitrary and capricious behavior under the APA, unfair discrimination between issuers under the Exchange Act and a violation of the law. The case will be decided upon by the United States Court of Appeals for the District of Columbia Circuit with a final decision not expected until July 2023 at the earliest.

Unfortunately, it is becoming increasingly probable that it will take litigation or focused efforts by Congress to break through the SEC's increasingly arbitrary and unwarranted treatment of this important investment product. Moreover, if the SEC's ability to transform itself into a merit-based regulator goes unchecked, the future of innovation and capital raising in the United States will be dark indeed.

V. Appendixes

Appendix A - *In the Matter of 3iQ Corp. and the Bitcoin Fund Reasons and Decisions*, Ontario Securities Commission, (Dec. 10, 2019, File No. 2019-7), https://www.osc.ca/sites/default/files/pdfs/proceedings/rad_20191029_3iq-2.pdf.

Appendix B - Bitwise Asset Management, *Price Discovery In the Modern Bitcoin Market: Examining Lead-Lag Relationships Between The Bitcoin Spot and Bitcoin Futures Market*, (June 21, 2022), <https://static.bitwiseinvestments.com/Bitwise-Bitcoin-ETP-White-Paper-1.pdf>.

Appendix C - Fidelity Investments, Inc., *Suitable Price Discovery Measurement of Bitcoin Spot and Futures Markets*, (Jan 20, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4012165.

Appendix D - Bitwise Asset Management, *Is It Likely That A US Bitcoin ETP, If Approved, Will Become The Predominant Influence on Prices In the CME Bitcoin Futures Market?*, (Feb. 25, 2022), <https://www.sec.gov/comments/sr-nysearca-2021-89/srnysearca202189-20117902-270822.pdf>.

Appendix E - *Grayscale Investments, LLC. V. Securities and Exchange Commission*, Petition for Review, U.S. Court of Appeals for the District of Columbia Circuit, (June 29, 2022), <https://grayscale.com/wp-content/uploads/2022/06/DC-Circuit-Petition-for-Review-as-filed.pdf>.