

# Dissent of Commissioner Hester M. Peirce to Release No. 34-83723; File No. SR- BatsBZX-2016-30



**Commissioner Hester M. Peirce**

I respectfully dissent from the Commission’s order disapproving a proposed rule change, as amended, to list and trade shares of the Winklevoss Bitcoin Trust on Bats BZX Exchange, Inc. (“BZX”).<sup>[1]</sup> As the order notes, in reviewing such a proposed rule change, the Commission considers whether the proposed change is consistent with the Securities Exchange Act of 1934 (“Exchange Act”) and the rules and regulations thereunder.<sup>[2]</sup> Contrary to the Commission’s determination, I believe that the proposed rule change satisfies the statutory standard and that we should permit BZX to list and trade this bitcoin-based exchange-traded product (“ETP”). Accordingly, I would set aside the action the staff took by delegated authority in this matter and approve the proposed rule change.

In addition, I am concerned that the Commission’s approach undermines investor protection by precluding greater institutionalization of the bitcoin market. More institutional participation would ameliorate many of the Commission’s concerns with the bitcoin market that underlie its disapproval order. More generally, the Commission’s interpretation and application of the statutory standard sends a strong signal that innovation is unwelcome in our markets, a signal that may have effects far beyond the fate of bitcoin ETPs. I will discuss each of these issues in turn.

## **I. The Proposed Rule Change Satisfies the Requirements of Exchange Act Section 6(b)**

The Commission is disapproving BZX’s proposed rule change because it finds the proposed rule inconsistent with Section 6(b)(5) of the Act, which requires, in part, that the rules of a national securities exchange be “designed to prevent fraudulent and manipulative acts and practices [and]

to protect investors and the public interest.” The Commission focuses its decision not on the ETP shares to be listed on the exchange but on the underlying bitcoin spot market. It rejects BZX’s argument that the underlying bitcoin market is resistant to manipulation and, contending that BZX does not have surveillance-sharing agreements with one or more regulated markets of significant size in the bitcoin spot market, finds that the proposed rule does not comply with Section 6(b)(5).

The Commission erroneously reads the requirements of Section 6(b)(5). The disapproval order focuses on the characteristics of the spot market for bitcoin, rather than on the ability of BZX—pursuant to its own rules—to surveil trading of and to deter manipulation in the ETP shares listed and traded on BZX. Section 6(b)(5), however, instructs the Commission to determine whether “[t]he rules of the exchange” are, among other things, “designed to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade,” and “are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.”<sup>[3]</sup> It says nothing about looking at underlying markets, as the Commission often has done in its orders.

I am persuaded that the rules of the exchange satisfy the Section 6(b)(5) standard. As detailed in the exchange’s proposed rule filing, the shares of the Winklevoss Bitcoin Trust (“Trust”) would trade under BZX Rule 14.11(e)(4), which governs the listing and trading of Commodity-Based Trust Shares.<sup>[4]</sup> This rule would require the ETP shares to meet initial and continued listing standards.<sup>[5]</sup> It also would impose obligations on registered market makers in the shares intended to deter market manipulation and other misconduct, including limitations on certain trading activities and a requirement to make available to BZX certain records of transactions by such market makers.<sup>[6]</sup> BZX would have the ability to halt trading in the ETP shares, including in response to market conditions that are inconsistent with the maintenance of a fair and orderly market.<sup>[7]</sup> These requirements together convince me that BZX’s proposal to list the ETP shares under its rules is consistent with Section 6(b)(5).

Because the disapproval order focuses on the bitcoin spot market, it does not give adequate weight to the important function that exchanges, as self-regulatory organizations (“SROs”), perform under our regulatory framework. BZX should, and would, play a central role in monitoring trading in shares of the Trust. In performing that function, BZX would exercise the responsibilities entrusted to it as an SRO and would be subject to Commission oversight. In exercising these responsibilities, BZX would have powerful regulatory and business incentives to ensure the integrity of the products that it lists for trading. Nothing in the record suggests that BZX is unwilling or unable to fulfill its responsibilities under the Exchange Act.

Approval of this order would demonstrate our commitment to acting within the scope of our limited role in regulating the securities markets. The Commission’s mission historically has been, and should continue to

be, to ensure that investors have the information they need to make intelligent investment decisions and that the rules of the exchange are designed to provide transparency and prevent manipulation as market participants interact with each other.

The Commission steps beyond this limited role when it focuses instead on the quality and characteristics of the markets underlying a product that an exchange seeks to list. As today's disapproval order states, many previous orders approving other ETPs have noted the existence of surveillance-sharing agreements between the ETP-listing exchange and regulated exchanges that trade in the underlying product. It is not clear that these agreements were essential to the Commission's prior decisions to approve other ETPs. Even if they were determinative in prior decisions, I do not believe that an analysis of such agreements or of the nature of the underlying market was ever appropriate under Section 6(b)(5).<sup>[8]</sup>

The concerns underlying the disapproval order go to the merits of bitcoin—and thus the bitcoin-based ETP at issue here—as an investment. The order raises concerns about potential future actions of potential large holders of bitcoin,<sup>[9]</sup> academic speculation about past manipulation in the market,<sup>[10]</sup> and the lack of regulation of the spot market.<sup>[11]</sup> Indeed, if the disapproval order's rigorous standard were applied consistently, many commodity-based ETPs would be in peril, as rumors of manipulation plague many commodity markets,<sup>[12]</sup> and surveillance-sharing agreements with regulated markets cannot eliminate the sometimes messy nature of the commodities markets. Moreover, because it opines at length about the quality of the bitcoin spot market, the disapproval order suggests that, when we do finally approve an ETP on bitcoin (or any other product traded in a non-traditional market), investors may reasonably—but incorrectly—conclude that the investment carries with it the SEC's imprimatur because the Commission has performed due diligence on the underlying market and, through its approval, is certifying the quality of that market.

For all of these reasons, I would limit review of BZX's rule filing to a consideration of whether the exchange's rules governing the trading of the ETP shares are consistent with Exchange Act Section 6(b)(5). Based on the record before the Commission, I find that they are consistent and would approve the rule filing.

Even if I accepted the majority's approach and focused on the underlying bitcoin markets, I would reach the same conclusion. As an initial matter, I am not convinced that the Commission's emphasis in recent orders on whether there is a "regulated market of significant size" for the underlier, as that phrase is interpreted by the Commission in the disapproval order, is the appropriate test under our prior approval orders.<sup>[13]</sup> It is well established that privately generated regulation can be effective at achieving well-functioning markets even absent government regulation.<sup>[14]</sup> In any case, the relevant market for purposes of this proposed listing,

the Gemini Exchange, is in fact regulated by the New York State Department of Financial Services.<sup>[15]</sup> Moreover, BZX has entered into a surveillance-sharing agreement with the Gemini Exchange, the closing auction price of which would be used to calculate the net asset value of the ETP.<sup>[16]</sup>

## II. The Disapproval Order Inhibits Institutionalization

In disapproving the proposed listing, the Commission points to problems in the bitcoin market that I believe would be mitigated by institutionalizing the market—a phenomenon that bitcoin ETPs would foster. For example, the order points to the price disparities across bitcoin markets.<sup>[17]</sup> While I contend that the markets are already better connected by active arbitrageurs than the Commission's order suggests, the establishment of an ETP would invite more price arbitrage and thus better connections among markets. Because authorized participants could compose their baskets with bitcoin obtained from any source, the availability of the ETP would bring prices at different exchanges closer together. Greater participation by institutional investors in the bitcoin market would help to pressure exchanges to bolster their defenses against theft, encourage greater investment in custody solutions in the bitcoin space, and make it more difficult for market manipulators to escape the notice of their fellow market participants.

The disapproval order discourages new institutional participants from entering this market. Worse, it suggests that approval for bitcoin ETPs will come only when bitcoin spot and derivatives markets have matured substantially,<sup>[18]</sup> yet, at the same time, contributes to further delay in their maturation, as potential institutional investors may reasonably conclude that the Commission will continue to repress market forces for the foreseeable future. As long as these investors decline to enter the bitcoin market because there is no efficient vehicle that would reduce the costs of entry, the features of the bitcoin market that cause the Commission concern are likely to persist.

The disapproval order therefore unintentionally undermines investor protection. It precludes investors from accessing bitcoin through an exchange-listed avenue that offers predictability, transparency, and ease of entry and exit. Investors who want to diversify their portfolios by adding a bitcoin component will be relegated to the spot market, which will not benefit from the increased institutional discipline that approval of this product would bring.<sup>[19]</sup> These investors also will not have access to the types of disclosures that a listed ETP would provide (and that our regulations are intended to promote).

To maximize investor choice, foster competition, and avoid unnecessarily depriving investors of protections available under the Exchange Act and BZX's rules, I would approve this order and welcome the Commission's

consideration of other bitcoin-based ETPs that offer different pricing mechanisms, are pegged to bitcoin futures markets, seek to be registered under the Investment Company Act of 1940, or otherwise differ from the ETP at issue here. Investors would benefit from having multiple, competing options for gaining exposure to bitcoin. It is also important that we not give one sponsor a monopoly in providing bitcoin ETPs.

Investors, of course, might conclude, based on the disclosures required in connection with listing the ETP shares, that neither direct nor indirect exposure to bitcoin is appropriate for them. Investors who determine that bitcoin is an appropriate investment may determine that one or more of these ETPs are inconsistent with their needs or are poorly designed to accommodate the unique characteristics of bitcoin. Even if all the ETPs we approve fail to generate investor interest, approval of such products would further the Exchange Act objective of “remov[ing] impediments to . . . a free and open market”<sup>[20]</sup> and empower them to make their own decisions about the merits of these products. The majority’s disapproval erects impediments and disempowers investors.

### III. The Disapproval Order Dampens Innovation

More generally, the disapproval order demonstrates a skeptical view of innovation, which may have an adverse effect on investor protection, efficiency, competition, and capital formation well beyond this particular product. The disapproval order’s broad interpretation of the Commission’s statutory mandate signals that the Commission reserves for itself the authority to judge when an innovation is ripe enough, respectable enough, or regulated enough to be worthy of the securities markets. By suggesting that bitcoin, as a novel financial product based on a novel technology that is traded on a non-traditional market,<sup>[21]</sup> cannot be the basis of an ETP, the Commission signals an aversion to innovation that may convince entrepreneurs that they should take their ingenuity to other sectors of our economy, or to foreign markets, where their talents will be welcomed with more enthusiasm.

By withholding approval of a bitcoin-based ETP because the underlying market insufficiently resembles the markets for other commodities, we set ourselves up as the gatekeepers of innovation. Securities regulators are ill-equipped to fill this particular role.<sup>[22]</sup> It is telling that the disapproval order’s analysis shows little consideration of the relatively advanced features of this still nascent market. For example, trading in bitcoin is electronic, which facilitates competition and price transparency.<sup>[23]</sup> Bitcoin are interchangeable, so that a purchaser is sure to get exactly the same thing no matter where she purchases it.<sup>[24]</sup> In addition, bitcoin mining is not geographically limited (except to the extent it migrates to places with cheap electricity), so it is not subject to geopolitical threats that plague other commodity markets.<sup>[25]</sup> Rather than considering the unique opportunity that these innovative characteristics of the bitcoin

market present to investors, the order analyzes the ETPs through a legal and regulatory framework derived from prior approval orders for commodities with very different characteristics.

In sum, I would rather we err on the side of approving products so that investors, who are generally better judges about these things than we are, can form their own views about a particular innovation and act on those views in the market.<sup>[26]</sup>

## IV. Conclusion

By precluding approval of cryptocurrency-based ETPs for the foreseeable future, the Commission is engaging in merit regulation. Bitcoin is a new phenomenon, and its long-term viability is uncertain. It may succeed; it may fail. The Commission, however, is not well positioned to assess the likelihood of either outcome, for bitcoin or any other asset. Many investors have expressed an interest in gaining exposure to bitcoin, and a subset of these investors would prefer to gain exposure without owning bitcoin directly. An ETP based on bitcoin would offer investors indirect exposure to bitcoin through a product that trades on a regulated securities market and in a manner that eliminates some of the frictions and worries of buying and holding bitcoin directly. If we were to approve the ETP at issue here, investors could choose whether to buy it or avoid it. The Commission's action today deprives investors of this choice. I reject the role of gatekeeper of innovation—a role very different from (and, indeed, inconsistent with) our mission of protecting investors, fostering capital formation, and facilitating fair, orderly, and efficient markets. Accordingly, I dissent.

Hester M. Peirce, Commissioner

---

[1] See Exchange Act Release No. 79183 (Oct. 28, 2016), 81 FR 76650 (Nov.3, 2016) (amending, and replacing, original rule filing in its entirety).

[2] See Exchange Act Release No. 34-83723 at Section I.

[3] 15 U.S.C. 78f(b)(5) (emphasis added). This interpretation comports with the Commission's view, articulated in a disapproval order issued shortly after the statute's enactment, that the legislative history of Section 6(b)(5) indicates that this provision was intended to limit the authority of exchanges to impose rules on their members. See In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 12737, 1976 SEC LEXIS 984, 37-39 (Aug. 25, 1976) (SR-NYSE-76-7; SR-NYSE-76-8) ("In the Matter of New York Stock Exchange"). In that order, which disapproved certain proposed rule changes by the New York Stock Exchange, the Commission further noted that "Section 6(b)(5) underlines that the purpose of the Act in providing for self-regulatory organizations has always been to minimize regulation of the securities markets by providing an opportunity for the industry to regulate itself and, in turn, to

promote the efficient functioning of the securities markets by providing the maximum opportunity for private initiatives and innovative experimentation.” Id. at 38-39 (emphasis added).

[4] See supra note 1, at 76651.

[5] See id. at 76667.

[6] See id. at 76666-67.

[7] See id. at 76667-68. BZX also proposes to provide relevant information about the ETP to its members via an Information Circular, including suitability requirements for members recommending the ETP shares to customers, the risks of trading the ETP shares, the methods by which pricing information will be disseminated, and prospectus delivery requirements. See id. at 76668.

[8] One comment letter on another proposed rule change suggests considering what a parallel inquiry by the Commission for equity securities might look like. See Letter from Joseph A. Hall, Partner, Davis Polk & Wardwell LLP, to Brent J. Fields, Secretary, Securities and Exchange Commission, at 2-3 (Sep. 12, 2017) (on file at <https://www.sec.gov/comments/sr-nysearca-2017-06/nysearca201706-2436861-161053.pdf>). The commenter suggests that the rationale of the initial disapproval order in this matter and another bitcoin-related product also might lead the Commission to assess risks common in an issuer’s industry prior to permitting an equity security to be listed, in addition to requiring listed companies to provide disclosures to investors purchasing their shares on an exchange. See id. at 3. If the Commission determined that a particular industry was susceptible to certain types of misconduct, the rationale set forth in the disapproval order could justify requiring, for example, information-sharing agreements with regulators or other authorities responsible for policing such risks or enforcing relevant legal requirements. See id. The merit-based nature of such an approach would be immediately apparent.

[9] See supra note 2, at Section III.B.1.(b)(i) (stating that “a market participant with a dominant ownership position would not find it prohibitively expensive to overcome the liquidity supplied by arbitrageurs and could use a dominant market share to engage in manipulation”).

[10] See id. (stating that “recent academic papers suggest that the price of bitcoin can be, and has been, manipulated through activity on bitcoin trading venues”).

[11] See id. at Section III.C.2 (stating that “a substantial majority of bitcoin trading occurs outside the United States, and even within the United States, there is no comprehensive federal oversight of bitcoin spot markets”).

[12] See, e.g., Craig Pirrong, *The Economics of Commodity Market Manipulation: A Survey* (2017) (explaining that “[t]he subject of market

manipulation has bedeviled commodity markets since the dawn of futures trading”). Even apart from manipulation, commodity prices are subject to influences well beyond the ability of any exchange selling a commodity-based ETP to control. See, e.g., Joe Weisenthal and Tracy Alloway, This is how the chocolate market actually works (June 4, 2018), <https://www.bloomberg.com/news/articles/2018-06-04/this-is-how-the-chocolate-market-actually-works> (explaining that the price of cocoa responds to factors such as weather, politics, people, and regulation).

[13] Reliance on the presence of significant, regulated markets has been more prominent in the Commission’s approval orders for commodity-based ETPs since 2017. See Exchange Act Release No. 82593 (Jan. 26, 2018), 83 FR 4718, 4719 (Feb. 1, 2018) (SR-NYSEArca-2017-140) (discussing surveillance arrangements for listing of gold-based ETP); Exchange Act Release No. 82448 (Jan. 5, 2018), 83 FR 1428, 1436 (Jan. 11, 2018) (SR-NYSEArca-2017-131) (same for gold- and silver-based ETP); Exchange Act Release No. 81918 (Oct. 23, 2017), 82 FR 49884, 49885 (Oct. 27, 2017) (SR-NYSEArca-2017-98) (same for gold-based ETP); Exchange Act Release No. 81077 (July 5, 2017), 82 FR 32024, 32025 (July 11, 2017) (SR-NYSEArca-2017-55) (same for gold-based ETP); Exchange Act Release No. 80319 (Mar. 28, 2017), 82 FR 16247, 16254 (Apr.3, 2017) (SR-NYSEArca-2016-101) (same for bitcoin-based ETP). On the other hand, approval orders for ETPs prior to 2017 seem to place less explicit emphasis on the presence of an agreement with a “significant, regulated market.” See, e.g., Exchange Act Release No. 68973 (Feb. 22, 2013), 78 FR 13726, 13739-40 (Feb. 28, 2013) (discussing surveillance arrangements in connection with listing of copper-based ETP); Exchange Act Release No. 59895 (May 8, 2009), 74 FR 22993 (May 15, 2009) (SR-NYSEArca-2009-40) (approval order for listing of gold-based ETP); Exchange Act Release No. 50603 (Oct. 28, 2004), 69 FR 64614, 64618) (Nov. 5, 2004) (discussing surveillance arrangements for listing of gold-based ETP); Exchange Act Release No. 35518 (Mar. 21, 1995), 60 FR 15804 (Mar. 27, 1995) (SR-Amex-94-30) (approval order for commodity-linked notes, noting that listing exchange had “entered into certain surveillance sharing agreements with each of the futures exchanges upon which the underlying designated futures contracts trade”).

[14] See, e.g., Edward Peter Stringham, *Private Governance: Creating Order in Economic and Social Life* chs. 4-6 (2015) (describing the private regulation of early stock markets).

[15] See supra note 1, at 76651-52 (stating that “Gemini Trust Company, LLC will be the custodian of the Trust (the ‘Custodian’)” and that “[t]he Custodian is a New York State-chartered limited liability trust company that operates under the direct supervision and regulatory authority of the NYDFS”). See also Press Release, New York State Department of Financial Services, NYDFS Grants Charter to “Gemini” Bitcoin Exchange Founded by Cameron and Tyler Winklevoss (Oct.5, 2015) (available at

<https://www.dfs.ny.gov/about/press/pr1510051.htm>) (noting that “Gemini applied to NYDFS for a charter to operate as a trust under that process for virtual currency exchanges in July 2015”; that “NYDFS conducted a rigorous review of that application, including but not limited to the company’s anti-money laundering, capitalization, consumer protection, and cyber security standards”; and that “[a]s a chartered limited purpose trust company with fiduciary powers under the Banking Law, Gemini can begin operating immediately and is subject to ongoing supervision by the NYDFS”).

[16] See supra note 1, at 76668 (noting that BZX “has entered into a comprehensive surveillance sharing agreement with Gemini Exchange”). Cf. supra note 2 at Section III.D.2.(a) (noting prior approval order where “the listing exchange had entered into surveillance-sharing agreements with each of the futures markets on which pricing of the [product] would be based”).

[17] See supra note 2, at Section III.B.1.(b)(i) (expressing skepticism regarding “the actual effectiveness of arbitrage in the bitcoin spot market, either in terms of how closely prices are aligned across different bitcoin trading venues or how quickly price disparities are arbitrated away”).

[18] See, e.g., id. at Section III.D.2.(b) (noting that “[f]oreign currency derivatives traded on national securities exchanges for decades before the Commission approved currency-trust ETPs”) (emphasis added); id. at Section III.G (explaining that “the market for bitcoin-based derivatives is not yet well developed” in contrast to the platinum and palladium markets, “where futures products on those metals had been trading for several decades before commodity-trust ETPs were launched”) (emphasis added); id. at Section III.E.3.(a) (noting that bitcoin futures started trading only in late 2017 and that the Commission lacks information about how these markets may develop).

[19] See Letter from Craig M. Lewis, Professor of Finance, Vanderbilt University, “SolidX Bitcoin Trust: A Bitcoin Exchange Traded Product” (Feb. 13, 2017) (on file at <https://www.sec.gov/comments/sr-nysearca-2016-101/nysearca2016101-1579480-131874.pdf>) (describing potential benefits that a bitcoin-based ETP could bring to the market and the opportunity such a product would provide investors to diversify their investment portfolios). Admittedly, the recently established bitcoin futures markets may help foster institutional participation in the market for bitcoin.

[20] 15 U.S.C. 78k-1(b)(1).

[21] See supra note 18.

[22] See Shira Ovide and James Oberman, Flashback to Apple’s 1980 IPO, Wall St. J. (Oct. 6, 2011) (<https://blogs.wsj.com/deals/2011/10/06/flashback-to-apples-1980-ipo/>) (discussing how Massachusetts regulators decided that Apple’s IPO was

too risky for the state's residents). See also In the Matter of New York Stock Exchange, supra note 3, at 38-39 (noting the purpose of providing for SROs in our regulatory framework as “always having been to minimize regulation of the securities markets...and, in turn, to promote the efficient functioning of the securities markets by providing the maximum opportunity for private initiatives and innovative experimentation”).

[23] Bitcoin by definition does not involve physical delivery; by contrast, ETPs referencing physical commodities traded in spot markets may still involve authorized participants in taking delivery of the commodity, which may be a time-consuming, labor-intensive process. See Exchange Act Release No. 68440 (Dec. 14, 2012), 77 FR 75468, 75474 n.83 (Dec. 20, 2012) (SR-NYSEArca-2012-28) (approving ETP based on physical copper, which would involve “an authorized participant taking delivery of copper from an LME warehouse,” requiring the authorized participant “to wait in the queues described by [a commenter], just like other owners withdrawing metal from that warehouse”).

[24] Cf. Exchange Act Release No. 59895 (May 8, 2009), 74 FR 22993, 22994 (May 15, 2009) (SR-NYSEArca-2009-40) (noting market standards to help ensure generally uniform standards of purity and other characteristics of gold bars used in trading in the spot markets).

[25] Cf. Exchange Act Release No. 60971 (Nov. 9, 2009), 74 FR 59283, 59284 (Nov. 17, 2009) (noting that South Africa and Russia together “accounted for 78% of total platinum group metals supply in 2008”).

[26] I acknowledge the concerns about potential retail investor harm arising from easier access to bitcoin. However, any increased risk must be weighed against the increased protections described in Part II above and the liberty interest that investors have in making their own choices, regardless of whether a regulator would make those same choices.