

3-1-2019

Regulation over Refusal: How Bitcoin Backed ETFs Can Usher the SEC into the Modern Era

Shaun T. Weber

Maurice A. Deane School of Law at Hofstra University

Follow this and additional works at: <https://scholarlycommons.law.hofstra.edu/jibl>



Part of the [Law Commons](#)

Recommended Citation

Weber, Shaun T. (2019) "Regulation over Refusal: How Bitcoin Backed ETFs Can Usher the SEC into the Modern Era," *Journal of International Business and Law*. Vol. 18: Iss. 2, Article 10.

Available at: <https://scholarlycommons.law.hofstra.edu/jibl/vol18/iss2/10>

This Notes & Student Works is brought to you for free and open access by Scholarship @ Hofstra Law. It has been accepted for inclusion in Journal of International Business and Law by an authorized editor of Scholarship @ Hofstra Law. For more information, please contact lawscholarlycommons@hofstra.edu.

NOTE

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN
USHER THE SEC INTO THE MODERN ERA

*Shaun T. Weber**

I. INTRODUCTION

The United States Securities and Exchange Commission (“SEC”) formed in the years following the Great Depression for the purpose of protecting investors, maintaining efficient, fair and orderly markets, and facilitating capital formation.¹ In addition to ensuring each one of these three goals is achieved, since the inception of the SEC,² the commission continuously attempts to increase capital formation.³ However, the SEC’s recent denials of applications for Exchange-Traded-Funds (“ETF”), such as Bats BZX Exchange, Inc.’s⁴ application, appear to contradict the SEC’s repeated public announcements to focus efforts on increasing capital formation.⁵

On July 26, 2018, the SEC rejected Bats BZX Exchange, Inc.’s application for a physically backed ETF that utilized bitcoin as the underlying asset.⁶ This was the second attempt made by the Winklevoss twins⁷ to create the first ever ETF using bitcoin as the underlying asset, which in turn, if successful, would provide an alternative method for investors to purchase an ownership interest in shares of bitcoin.⁸ This alternative method would be subject to regulations governed by the SEC. The SEC rejection of the Winklevoss’

* J.D. Candidate, Maurice A. Deane School of Law at Hofstra University, 2020. I would like to extend gratitude to my Notes & Comments Editor, Jaclyn Kaplan, and my Faculty Advisor, Professor J. Scott Colesanti, L.L.M., for their invaluable guidance throughout this process. In addition I would like to thank my family, particularly my father, Thomas Weber, for inspiring me to attend law school and ultimately leading me to discover my true passion.

¹ See *What We Do*, U.S. SECURITIES AND EXCHANGE COMMISSION (Jun. 10, 2013), <https://www.sec.gov/Article/whatwedo.html>.

² *Id.*

³ Chris Rohde, *SEC Shifts Focus to Capital Formation*, WEALTHFORGE (Mar. 8, 2018), <https://www.wealthforge.com/insights/could-accredited-investor-rules-be-eliminated-sec-commissioner-weighs-in>.

⁴ The Bats BZX Exchange is one of the four U.S. equities exchanges operated by Cboe.

⁵ See generally Leslie Silverman, Nicolas Grabar & Andrea Bashman, *SEC Continues Efforts To Facilitate Capital Formation*, LAW360 (Sept. 6, 2017), <https://www.law360.com/articles/960863/sec-continues-efforts-to-facilitate-capital-formation>.

⁶ Brent J. Fields, *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* (Jul. 26, 2018), <https://www.govinfo.gov/content/pkg/FR-2018-08-01/pdf/2018-16427.pdf>.

⁷ See *CONNECTU, LLC v. Zuckerberg*, 482 F. Supp.2d 3 (D. Mass. 2007), Cameron and Tyler Winklevoss are twins who are most notable for suing Mark Zuckerberg, the founder and CEO of Facebook, claiming he stole their idea. The lawsuit eventually went in favor of Facebook. Since then, the Winklevoss twins have made a name for themselves in the financial industry with their innovative approach to bitcoin and cryptocurrencies.

⁸ See *Exchange-Traded Funds (ETFs)*, U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 6, 2017), <https://www.sec.gov/fast-answers/answersetfhtm.html>.

proposal by citing to risks of market manipulation⁹ and various forms of fraud associated with a bitcoin backed ETF.¹⁰

More specifically, the SEC relied on a three-part conjunctive test to determine whether to deny or approve the proposal.¹¹ However, before the SEC utilizes the three-part test, they must first determine whether the market the proposal is intended for is a market that is inherently resistant to market fraud and market manipulation.¹² The SEC stated a bitcoin ETF would only be approved if (1) it entered into a comprehensive *surveillance-sharing and monitoring system*¹³ with a (2) *significant* and (3) regulated market *with a significant and regulated bitcoin market*.¹⁴ However, despite the Winklevoss' twins' efforts to comply with these guidelines,¹⁵ the SEC determined the proposed market was neither significant, nor regulated to the extent necessary to satisfy the high burden of the three-part test.¹⁶

The SEC should be encouraging investors to submit proposals for approval. By failing to approve the Winklevoss' proposal for a bitcoin backed ETF, the SEC has increased the risk of losing profits to foreign investors.¹⁷ The incredible growth rate of bitcoin over the past eight years illustrates that virtual currencies will be a part of our future.¹⁸ The technology behind bitcoin known as "blockchain" is so technologically advanced that the possible applications and potential future uses of blockchain are virtually limitless.¹⁹ Therefore, the SEC must find a way to work with bitcoin in order to start preparing to create regulations for virtual currencies.²⁰ A possible first step in finding a solution to the regulatory problems associated with bitcoin and virtual currencies would be to follow the lead of other foreign countries and begin to enforce existing regulations, where applicable, on bitcoin and the various functions associated with the use of bitcoin.²¹

⁹ *Manipulation*, INVESTOPEDIA, <https://www.investopedia.com/terms/m/manipulation.asp> (last visited Sept. 4, 2018) (defining market manipulation as the act of artificially inflating or deflating the price of a security or otherwise influencing the behavior of the market for personal gain).

¹⁰ Joseph Young, *Why Did the SEC Reject All Derivative-Backed Bitcoin ETFs*, CCN (Aug. 23, 2018), <https://www.ccn.com/why-did-the-sec-reject-all-derivative-backed-bitcoin-etfs/>.

¹¹ SEC Order, *supra* note 6 Part I.

¹² *Id.* Part III(B).

¹³ See generally Bradley Berman, Lloyd S. Harnetz, & Anna T. Pinedo, *Comprehensive Surveillance Sharing Agreements*, LEXOLOGY (Apr. 9, 2014), <https://www.lexology.com/library/detail.aspx?g=17857b81-d22d-4d6d-a02a-fdc2aa23421a> (defining what comprehensive surveillance sharing agreements are)(emphasis added).

¹⁴ SEC Order, *supra* note 6 Part III(B)(1)(b)(i).

¹⁵ See discussion *infra* Section IV(A).

¹⁶ SEC Order, *supra* note 6 Part V.

¹⁷ *SEC chief warns investors about bitcoin losses overseas*, SMARTBRIEF (Feb. 2, 2018), <https://www.smartbrief.com/branded/635D2192-7CCE-4A2F-B6DB-0EC8232131AD/C813AA08-29F5-4230-909D-4D7B28110E92>.

¹⁸ Andrew Tar, *Digital Currencies vs. Cryptocurrencies, Explained*, COINTELEGRAPH: THE FUTURE OF MONEY (Dec. 13, 2017), <https://cointelegraph.com/explained/digital-currencies-vs-cryptocurrencies-explained>.

¹⁹ Gareth W. Peters & Efstathios Panayi, *Understanding Modern Banking Ledgers Through Blockchain Technologies: Future of Transaction Processing and Smart Contracts on the Internet of Money*, SPRINGER INTERNATIONAL PUBLISHING SWITZERLAND (Sept. 1, 2016), https://link.springer.com/chapter/10.1007/978-3-319-42448-4_13.

²⁰ SMARTBRIEF, *supra* note 17.

²¹ See Gregory V. Ficcaglia, *Heads or Tails: How Europe Will Become the Global Hub for Bitcoin Business if the United States Does not Reexamine Its Current Regulation of Virtual Currency*, 40 SUFFOLK TRANSN'L L. REV. 103 (2017).

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

If the SEC continues to maintain its current stance²² towards bitcoin and other virtual currencies by repeatedly denying proposals for bitcoin backed ETFs, proposals which were made in good faith effort to comply with the SEC prescribed guidelines,²³ investors will begin to seek approval from foreign, more modern, markets for approval of their proposals.²⁴ The European Union (“EU”) announced their plan to create legislation which would regulate all cryptocurrencies.²⁵ This announcement came recently after a period in which the EU experienced a greater demand for ETFs than ever before.²⁶ The EU is not alone on the forefront for finding ways to comply with regulating bitcoin and other virtual currencies; Japan began to make preparations.²⁷ Japan has recently undertaken a project aimed to build-up Hong Kong as an epicenter for capital formation facilitated through ETFs.²⁸

The purpose of this note is to analyze the SEC’s approval process regarding the Winklevoss’ bitcoin backed ETF. Part II will provide the required in-depth analysis of what bitcoin actually is, as well as how an ETF functions in order to under what the Winklevoss Twins proposed and the potential benefits associated with a bitcoin backed ETF. Part III focuses on countries other than the United States. Specifically, what foreign countries have done in terms of creating regulations for virtual currencies. Part IV analyzes each element of the three-part conjunctive test that the SEC utilizes to determine whether a proposal will be approved or denied, and ultimately, provides the SEC’s reasoning in support of its denial. Finally, this note proposes a change to the SEC’s current approval process, a change in which the SEC would determine approval of a proposal by balancing each element of the test to determine whether the proposal is sufficient to satisfy the elements based upon the totality of the circumstances rather than force every proposal to adhere to the strictest standards of each element.

²² See Asjlyln Loder & Paul Vigna, *SEC Rejects Nine Proposed Bitcoin Exchange-Traded Funds*, WALL ST. J. (Aug. 22, 2018), <https://www.wsj.com/articles/sec-rejects-nine-proposed-bitcoin-exchange-traded-funds-15349>.

²³ Notice of Filing of Proposed Rule Change to List and Trade Shares of SolidX Bitcoin Shares Issued by the VanEck SolidX Bitcoin Trust. (Release No. 34-83520; File No. SR-CboeBZX-2018-040) (Jun. 26, 2018), <https://www.federalregister.gov/documents/2018/07/02/2018-14114/self-regulatory-organizations-cboe-bzx-exchange-inc-notice-of-filing-of-proposed-rule-change-to-list>.

²⁴ See *Market Entry Strategies*, TRADE START.CA, www.tradestart.ca/market-entry-strategies (last visited Nov. 15, 2018).

²⁵ *Cryptocurrency Regulations in the EU*, COMPLY ADVANTAGE, <https://complyadvantage.com/knowledgebase/crypto-regulations/cryptocurrency-regulations-eu-european-union/> (last visited Nov. 15, 2018).

²⁶ Philip Stafford, *The differences between US and European ETF markets*, FIN. TIMES (Dec. 7, 2016), <https://www.ft.com/content/aa4e3be2-baff-11e6-8b45-b8>.

²⁷ Nathan J. Hochman, *Policing the Wild West of Cryptocurrency*, LOS ANGELES LAWYER (Nov. 2018), <https://www.lacba.org/docs/default-source/lal-back-issues/2018-issues/november-2018.pdf>.

²⁸ *Strengthening Hong Kong as a Capital Formation Centre for Exchange Traded Funds*, FINANCIAL SERVICES DEVELOPMENT COUNCIL, FSDC Paper No. 16 (retrieved Dec. 22, 2018) http://www.fsd.org.hk/sites/default/files/ETF%20Paper%20-%20English%28final%29_2.pdf.

II. THE RISE OF TECHNOLOGY IN THE FINANCIAL MARKETS

In January of 2009, the first ever bitcoin was created when “Genesis Block” was mined.²⁹ Nobody truly knows who created bitcoin, in fact, nobody knows how many people were involved in the creation of bitcoin.³⁰ However, “Satoshi Nakamoto” is the pseudonym for the person or group of people who are credited with creating bitcoin.³¹ Bitcoin was the first ever virtual currency, colloquially referred to as cryptocurrencies, created.³² Cryptocurrencies are an entirely new form of asset intended to be used as a means of exchanging.³³ To verify transactions between bitcoin users, “Distributed Ledger Technology” (also known as “blockchain”) is used to record and verify transactions made using the currency.³⁴ This technology relies on a peer-to-peer operating system.³⁵ When a bitcoin user transfers any amount of bitcoin to another user, the transaction is recorded on a ledger available to every participant in the market.³⁶ As each transaction is recorded in the ledger, the transactions are compiled into blocks.³⁷ Next, an engineer must create an algorithmic computer code that is capable of mathematically solving the equations in the block: the first engineer to solve the equation is rewarded by the ability to place their solved block on top of the previously solved block, extending the chain, as well as an additional amount of bitcoin.³⁸ This new form of technology is a faster system of verification than any other regulated financial transaction verification system in existence.³⁹

A. The Future of Global Transactions

²⁹ Steve Fiorillo, *Bitcoin History: Timeline, Origins and Founder*, THESTREET (Aug. 17, 2018, 1:27 PM), <https://www.thestreet.com/investing/bitcoin/bitcoin-history-14686578>.

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ See Tar, *supra* note 18.

³⁴ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG (Nov. 21, 2013), <https://bitcoin.org/bitcoin.pdf>.

³⁵ *Id.*

³⁶ Tawnya Plumb, *Blockchain: What's In It For Lawyers?*, GEORGE W. HOPPER LAW LIBRARY, 41WYLLAW 50 (Feb. 2018).

³⁷ *Id.*

³⁸ See Nakamoto, *supra* note 34.

³⁹ *Digital Currencies*, BANK OF ENGLAND (Aug. 22, 2018), <https://www.bankofengland.co.uk/research/digital-currencies>.

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

As stated above, bitcoin is the original cryptocurrency.⁴⁰ If an investor chooses to purchase bitcoin, he or she may choose from three categories of bitcoin issuers. A potential investor may purchase bitcoin from: (1) miners; (2) secondary markets; or (3) bitcoin exchanges.⁴¹ The first category is “Miners” -, this category is responsible for creating every bitcoin in circulation.⁴² Bitcoin mining is the process of generating the computer code in order to solve the mathematical equations of each block, then after solving the equations, placing the block next in line on the blockchain.⁴³ Any person can mine bitcoin, they just need access to the internet and suitable hardware.⁴⁴ A bitcoin miner compiles a number of recent transactions into blocks and then uses a computer code to solve mathematical equations for the transactions.⁴⁵ The miner that solves the equation first will retain the right to place the next block in the blockchain and claim the rewards.⁴⁶ The rewards include the transaction fees associated with the transactions the miner compiled, in addition to new bitcoin that is released.⁴⁷ While bitcoin mining may sound like a simple process, the process is extremely complex, challenging and tedious.⁴⁸ In addition to being extremely challenging, Bitcoin mining also requires a tremendous amount of electrical energy, in fact, the amount of energy consumed to power bitcoin mining is larger than the amount of energy consumed by entire countries.⁴⁹

However, there is a finite number of bitcoins to be mined.⁵⁰ Once 21 million bitcoins have been mined, every possible bitcoin will be in circulation.⁵¹ As of January 2018, 16.8 million bitcoins have been mined and are currently in circulation.⁵² When the supply of bitcoin in circulation reaches the maximum 21 million, the number of miners will decrease.⁵³ Many analysts speculate that the limited supply of bitcoin will cause the price of bitcoin to continually increase.⁵⁴

Investors may also choose to purchase bitcoins through a secondary market.⁵⁵ The secondary market is composed of merchants and miners re-selling bitcoins to third parties.⁵⁶

⁴⁰ Fiorillo, *supra* note 29.

⁴¹ J. Scott Colesanti, *Trotting Out the White Horse: How the S.E.C. Can Handle Bitcoin's Threat to American Investors*, 65 Syracuse L. Rev. (2015).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Bitcoin Energy Consumption Index*, DIGICONOMIST, <https://digiconomist.net/bitcoin-energy-consumption> (last updated Jan. 2019).

⁵⁰ See Molly Jane Zuckerman, *80% of all Bitcoins Already Mined, Only 4.2 Million Coins Left Until Supply Cap*, COINTELEGRAPH: THE FUTURE OF MONEY (Jan. 15, 2018), <https://cointelegraph.com/news/80-of-all-bitcoins-already-mined-only-42-million-coins-left-until-supply-cap>.

⁵¹ *Id.*

⁵² *Id.*

⁵³ Nathan Reiff, *What Happens to Bitcoin After All 21 Million are Mined?*, INVESTOPEDIA (Aug. 4, 2018), <https://www.investopedia.com/news/what-happens-bitcoin-only-42-million-coins-left-until-supply-cap>.

⁵⁴ *Id.*

⁵⁵ See Colesanti, *supra* note 41.

This market is extremely hard to identify, but the actions of the secondary market are more in line with bitcoin's original purpose, using bitcoin as a currency instead of a speculative investment.⁵⁷

Finally, self-proclaimed "exchanges" also have the ability to issue bitcoin to investors.⁵⁸ This category poses the largest threat to the United States investing public.⁵⁹ Many of these exchanges provide false information regarding exchange status or vanish without a concrete explanation.⁶⁰

There are numerous attractive advantages bitcoin offers to consumers that traditional financial institutions are unable to provide.⁶¹ Bitcoin has the potential to provide users better security, lower transaction fees, and access to everybody in the market, allowing for universal recognition amongst users across the globe, while users retain complete control of all of their assets.⁶²

Bitcoin differs from traditional payment systems, such as cash or credit cards, because cryptocurrencies are held by digital means and are encrypted;⁶³ the process is completed through distributed ledger technology.⁶⁴ Encrypting bitcoin and storing it in a digital wallet prevents bitcoin users from having their assets stolen, while on the other hand, traditional payment systems cannot provide this same form of protection.⁶⁵ There is no transaction mechanism in existence that is more efficient or secure than the distributed ledger technology through which bitcoin operates.⁶⁶

Using bitcoin for financial transactions lowers transaction fees by eliminating the need for an expensive "middleman."⁶⁷ Bitcoin allows a user to transact with another party directly, meaning, the user does not need to go through a broker, lawyer, or other financial institutions in order to complete a transaction.⁶⁸

As technology continues to advance, globalization is increasing and, major corporations conduct business with multiple companies located across the world in foreign countries every day.⁶⁹ Bitcoin eliminates all currency-exchange fees.⁷⁰ This decreases the

⁵⁶ *Id.*

⁵⁷ SEC v. Shavers, No. 4:13cv00416, 2013 WL 3810441 (E.D. Tex. July 23, 2013) (alleging only that Bitcoin satisfies the prerequisite of "money" in determining the presence of an investment).

⁵⁸ Colesanti, *supra* note 41.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Brad Stephenson, *The Pros and Cons of Cryptocurrency Decentralized Exchanges*, LIFE WIRE (June 19, 2018), <https://www.lifewire.com/cryptocurrency-centralized-exchanges-pros-cons-4158225>.

⁶² See *Benefits of Using Cryptocurrency*, NASDAQ (Feb. 27, 2017), <https://www.nasdaq.com/article/the-benefits-of-using-cryptocurrency-cm753571>.

⁶³ *Id.*

⁶⁴ See *Digital Currencies*, *supra* note 39.

⁶⁵ See NASDAQ, *supra* note 62.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ See Raj Aggarwal, *Technology and Globalization as Mutual Reinforcers in Business: Reorienting Strategic Thinking for the New Millennium*, MGMT. INT'L REV., 39.2, 83 83-104 (1999).

⁷⁰ See *Could Bitcoin Become a New Global Currency?*, N. J. INST. OF TECH. (2019), <https://graduatedegrees.online.njit.edu/resources/mba/mba-infographics/could-bitcoin-become-a-new-global-currency/>.

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

cost of conducting transactions with foreign countries as well as promotes uniformity in the global market.⁷¹ If the cost of transacting is stated in terms of the value of bitcoin, the cost will remain the same regardless of the countries' national currency, which decreases the amount of time spent on each transaction and eliminates confusion.⁷² Currently, billions of people in the developing world are increasingly using mobile devices to conduct financial transactions.⁷³ Bitcoin is designed for low-cost, no-fee transactions, thus it follows that as more people gain access to mobile devices connected to the internet, bitcoin will grow in popularity.⁷⁴ It is expected that bitcoin and cryptocurrencies in general will experience the same growth mobile phone technology experienced in the 1990s and early 2000s.⁷⁵

The United States experienced problems creating regulations for bitcoin largely due to the fact that regulatory agencies are experiencing great difficulty defining what bitcoin should be considered.⁷⁶ The Internal Revenue System ("IRS") has defined bitcoin as property, therefore, subjecting investors' profits from bitcoin to the IRS' tax provisions as if they were gross income.⁷⁷ The Commodity Futures Trading Commission ("CFTC") announced in 2015 that virtual currencies fit within the definition of a "commodity".⁷⁸ Furthermore, several states have attempted to use the state's money transmitter statutes to apply to the uses of bitcoin.⁷⁹

In *SEC v. Shavers*, the SEC set the precedent that selling bitcoin to a "group of local people" constituted the sale of securities.⁸⁰ Therefore, any person involved in fraud or misrepresentation associated with the sale of bitcoin would be subject to sanctions imposed by the SEC.⁸¹ The SEC supported its decision to deny the Winklevoss' proposal by citing to instances when fraud, theft and market manipulation took place in the bitcoin market.⁸²

⁷¹ *Id.*

⁷² *Id.*

⁷³ See NASDAQ, *supra* note 62.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ See Evan S. Strassberg, Brad R. Jacobsen, Michael Best, & Friedrich, *Regulation of the unregulated: How Bitcoin and Cryptocurrencies Show That the Government Can Regulate Anything*, 34 Westlaw J. Corporate Officers and Directors Liability 1, 2 (Jul. 9, 2018), <https://1.next.westlaw.com/Document/I906757537ade11e8a5b3e3d9e23d7429/View/FullText.html?navigationPath=Search%2Fv1%2Fresults%2Fnavigation%2Fi0ad62aef0000168af572af375b3d0d8%3FNav%3DANALYTICAL%26fragmentIdentifier%3DI906757537ade11e8a5b3e3d9e23d7429%26startIndex%3D1%26contextData%3D%2528sc.Search%2529%26transitionType%3DSearchItem&listSource=Search&listPageSource=47212355512f68cc39739982f643b640&list=ANALYTICAL&rank=3&sessionScopeId=f1ea9622f10c1e94cc591937585679868c47f05d0960318a7b73859ed6b347ed&originationContext=Search%20Result&transitionType=SearchItem&contextData=%28sc.Search%29>.

⁷⁷ *Id.*

⁷⁸ In the Matter of Coinflip, Inc., Derivabit and Rancisco Riordan, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of The Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Doc. No. 15-29 (2015).

⁷⁹ Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing a Framework For Regulating Cryptocurrency Payments Intermediaries*, 32 Yale J. on Reg. 495 (2015).

⁸⁰ See *Shavers*, *supra* note 57.

⁸¹ 15 U.S.C. § 22.

⁸² See SEC Order, *supra* note 6 Part III(B)(2)

However, the debate regarding what bitcoin constitutes continues. The SEC should have approved the Winklevoss' proposal in order to create another avenue to regulate bitcoin.

B. An Innovated Improvement on Mutual Funds

An ETF is a relatively new form of a marketable security that tracks an index, a commodity, bonds, or a basket of assets similar to an index fund.⁸³ ETFs are registered with the SEC as investment companies.⁸⁴ Investors are drawn to investing in ETFs because they provide an opportunity to combine one's investment with other investor's investments into a fund which invests in stocks, bonds, or other assets.⁸⁵ A marketable security is an extremely liquid financial instrument changed into cash efficiently for a low cost.⁸⁶ An ETF "is a pooled investment vehicle with shares that trade intraday on stock exchanges at a market determined price"⁸⁷, unlike mutual funds which are bought and sold at a single price.⁸⁸ ETF's are funds that own the underlying asset of the fund then divides the ownership into shares.⁸⁹ The underlying asset may be a wide variety of things, such as: shares of stock, bonds, oil futures, gold bars, foreign currency, etc.,⁹⁰ or in the Winklevoss's situation, bitcoin⁹¹. Every shareholder of an ETF is entitled to a share of the profits.⁹²

ETFs have been called a "genuine financial innovation" largely due to an ETF's ability to combine features that typically pertain to open-end mutual funds with features that were previously reserved for solely close-end funds.⁹³ An ETF provides the investor an opportunity to buy or sell shares on an exchange intraday⁹⁴, similar to a closed-end fund, as well as the ability to create or redeem the ETF's shares at the end of the day, just as an open-end fund.⁹⁵ Combining features from both a traditional open-end mutual fund with features

⁸³ James Chen, *Exchange-Traded Fund – ETF*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/etf.asp> (last vis.).

⁸⁴ See Kenneth Fang & Jane Heinrichs, *Understanding the Regulation of Exchange-Traded Funds Under the Securities Exchange Act of 1934*, INVESTMENT COMPANY INSTITUTE (Aug. 2017).

⁸⁵ *Id.*

⁸⁶ Will Kenton, *Marketable Securities*, INVESTOPEDIA, <https://www.investopedia.com/terms/m/marketablesecurities.asp> (last visited Apr. 18, 2019).

⁸⁷ *Frequently Asked Questions About ETF Basics and Structures*, INVESTMENT COMPANY INSTITUTE, https://www.ici.org/pubs/faqs/faqs_etfs (last visited Jan., 2018).

⁸⁸ See Fang, *supra* note 84.

⁸⁹ See (ETF) INVESTOPEDIA, *supra* note 83.

⁹⁰ *Id.*

⁹¹ Jonathan Berr, *Winklevoss twins become first "bitcoin billionaires,"* MONEYWATCH (Dec. 19, 2017) <https://cbsnews.com/news/winklevoss-twins-bitcoin-billionaires-investment-price-surges/>.

⁹² See (ETF) INVESTOPEDIA, *supra* note 83.

⁹³ Apostolos Thomadakis, *The European ETF Market: What can be done better?*, CEPS (Apr. 24, 2018), <https://www.ceps.eu/publications/european-etf-market-what-can-be-done-better>.

⁹⁴ Ian Harvey, *Intra-day Traders*, INVESTOPEDIA, <https://www.investopedia.com/university/introduction-stock-trader-types/intraday-traders.asp> (last visited Apr. 19, 2019) (describing intraday as a trading style in which the trader opens and closes a new position in a stock in the same trading day).

⁹⁵ See Thomadakis, *supra* note 93.

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE SEC INTO THE MODERN ERA

of a close-end fund, creates the ability for the ETF to combine primary dealing⁹⁶ with secondary trading⁹⁷.

While ETFs and mutual funds share a few similar qualities, they are not completely synonymous.⁹⁸ Although an ETF is constructed and regulated similarly to a mutual fund⁹⁹, an ETF affords investors the ability to trade at any point in the day on a national securities exchange market at current market prices,¹⁰⁰ whereas mutual funds may only be bought or redeemed at the close of each trading day.¹⁰¹ This allows an investor to enter or pull out of a position at any time he or she chooses.¹⁰²

The ETF formation process begins when a sponsor determines the investment objective of the proposed ETF.¹⁰³ The sponsor also chooses both an index¹⁰⁴ and a method of tracking it.¹⁰⁵ The next stage of the process involves the sponsor developing tactical investment strategies to employ, when necessary, to reach the investment objective.¹⁰⁶

In order for an ETF to issue shares to investors it first needs an authorized participant.¹⁰⁷ An authorized participant is somebody who has the duty of purchasing the underlying asset the ETF holds.¹⁰⁸ If an authorized participant decides to purchase an additional amount of the underlying asset, they can then use the increase in value of the ETF to issue additional shares to new or current investors.¹⁰⁹

⁹⁶ A “primary dealer” is a pre-approved bank, broker-dealer, or other financial institution that is able to make business deals with the U.S. Federal Reserve, such as underwriting new government debt. These dealers must meet certain liquidity and quality requirements as well as provide a valuable flow of information to the Fed about the state of the worldwide markets. *Primary Dealer*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/primarydealer.asp> (last visited Nov. 15, 2018).

⁹⁷ Will Kenton, *Secondary Markets*, INVESTOPEDIA, <https://www.investopedia.com/terms/s/secondarymarket.asp> (last visited Nov. 15, 2018).

⁹⁸ (ETFs), *supra* note 8.

⁹⁹ *Understanding ETFs*, iSHARES BY BLACKROCK, <https://www.blackrock.com/ca/individual/en/literature/brochure/understanding-etfs-en-ca.pdf?nc=true&siteEntryPassthrough=true> (last visited Oct. 15, 2018).

¹⁰⁰ (ETFs), *supra* note 8.

¹⁰¹ *Id.*

¹⁰² *Active vs. Passive ETF Investing*, INVESTOPEDIA, <https://www.investopedia.com/articles/mutualfund/05/activepassive.asp>. (last visited Oct. 28, 2018).

¹⁰³ See Fang, *supra* note 84.

¹⁰⁴ See *Index ETF*, INVESTOPEDIA, <https://www.investopedia.com/terms/i/index-etf.asp>. (last visited Oct. 23, 2018) “Index” Index ETFs are exchange-traded funds that seek to track a benchmark index like the S&P 500 as closely as possible. They are like index mutual funds, but where mutual fund shares can be redeemed at one price each day, the closing net asset value (NAV), index ETFs can be bought and sold throughout the day on a major exchange. With an index ETF, investors gain exposure to numerous securities in a single transaction. Index ETFs can cover U.S. and foreign markets, specific sectors or different asset classes (i.e. small-caps, ADRs, etc.). Each asset incorporates a passive investment strategy, meaning the provider only changes the asset allocation when changes occur in the underlying index. See *Id.*

¹⁰⁵ See Fang, *supra* note 84

¹⁰⁶ *Id.*

¹⁰⁷ See FAQ, *supra* note 87.

¹⁰⁸ *Authorized Participant*, INVESTOPEDIA, <https://www.investopedia.com/terms/a/authorizedparticipant.asp> (last visited Oct. 20, 2019).

¹⁰⁹ *Id.*

A sponsor of an ETF may choose to manage the fund in one of three styles: (1) professionally managed by a SEC-registered investment advisor; (2) passively managed, or (3) actively managed.¹¹⁰ The main difference between management style hinges on the use of the ETF's intraday trading functions.¹¹¹ The passively managed ETFs track a particular market index attempting to achieve the same return as the index, these ETFs are often referred to as index funds.¹¹² In order to achieve the same return as the index, a passively managed ETF utilizes a "buy and hold" approach when it comes to trading.¹¹³ The buy and hold strategy consists of purchasing a stock and holding it for an extended period of time, a passive manager is not concerned with minor price fluctuations in the short-term.¹¹⁴ For a passive manager, the ETF's flexibility in offering intraday trading is merely an extra convenience, not something that is needed to ensure the success of the ETF.¹¹⁵ The majority of passively managed ETFs outperform their actively managed counter-parts.¹¹⁶

An actively managed ETF relies heavily on the ability to conduct intraday trading, or trading at any point throughout the day.¹¹⁷ Actively managed ETF purchase or sell investments in order to remain consistent with the fund's investment objective.¹¹⁸ Unlike a passively managed ETF, which tracks an index, an actively managed ETF may track a particular investment manager's¹¹⁹ top picks, mirror an already created mutual fund, or decide to reach a certain investment objective.¹²⁰ Traders for an actively managed ETF monitor the direction of the market and trade appropriately.¹²¹ The main goal for these traders is to find profitable opportunities by taking advantage of the market's short-term movements.¹²² Actively managed ETFs create the opportunity for both mutual fund investors and fund managers to benefit.¹²³ When an ETF is designed to mirror a mutual fund, the intraday trading capabilities of an ETF will entice investors to invest in the ETF rather than the mutual fund.¹²⁴ By investing in the ETF rather than the mutual fund, the cash flow in and out of the mutual fund will decrease, which will make the fund more manageable and cost effective, thus increasing the value of the mutual fund for the investors.¹²⁵

C. A Win for Everybody

¹¹⁰ See (ETFs), *supra* note 8.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ James Chen & Brian Beers, *Buy and Hold*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/buyandhold.asp> (last visited Feb. 17, 2019).

¹¹⁵ See *Active vs. Passive*, *supra* note 102.

¹¹⁶ See (ETFs), *supra* note 8.

¹¹⁷ See Chen & Beers, *supra* note 114.

¹¹⁸ *Id.*

¹¹⁹ James Chen, *Investment Manager*, INVESTOPEDIA, <https://www.investopedia.com/terms/i/investment-manager.asp> (last visited Apr. 1, 2019).

¹²⁰ Chen & Beers, *supra* note 114.

¹²¹ *Id.*

¹²² *Id.*

¹²³ Chen & Beers, *supra* note 114.

¹²⁴ *Id.*

¹²⁵ *Id.*

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

The SEC has repeatedly announced new efforts to focus on capital formation,¹²⁶ one of its three goals in the mission statement.¹²⁷ It has been speculated that the approval of a bitcoin ETF could create an influx of six or seven billion dollars in new capital formation.¹²⁸

A six or seven-billion-dollar influx would represent 5.6% of bitcoin's current market cap of \$120 billion.¹²⁹ This estimation is based upon the effect of gold ETF on the price of gold.¹³⁰ Overall analysts are expecting a 76% increase in the price of bitcoin,¹³¹ which could cause the price of a single bitcoin to reach \$35,000.00.¹³²

A bitcoin backed ETF would not only create an influx in capital formation, it would also increase investor protection. When an investor purchases shares in the Winklevoss twins' ETF, they are not only purchasing an ownership interest in the profits derived from bitcoin fluctuation, but they are also purchasing an insurance policy. If a shareholder of the Winklevoss twins' ETF experiences a loss due to fraud, they may be able to sue the ETF in order to recover damages. If an investor purchases bitcoin on their own and then experiences losses, there is no system for retribution currently in place.

III. BITCOIN ON A GLOBAL SCALE

The economic principles behind controlling a new market tend to favor those who enter in the early stages rather than those arrive late.¹³³ Since bitcoin's inception in 2009, countries across the globe have begun making preparations to regulate bitcoin.

¹²⁶ See Rohde, *supra* note 3.

¹²⁷ See *What We Do*, *supra* note 1.

¹²⁸ Willy Woo, *Charts: How an ETF Approval Could Impact Bitcoin's Price*, COINDESK (Feb. 10, 2017), <https://www.coindesk.com/charts-etf-approval-impact-bitcoins-price/>.

¹²⁹ Alex Kruger, *The Bitcoin ETF: breaking down the CBOE ETF proposal*, HACKERNOON (Aug. 7, 2018), <https://hackernoon.com/cboe-bitcoin-etf-53992ec38a70>.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *What Is Bitcoin ETF? How Will It Impact The Bitcoin Price?*, COINSWITCH, (Jul., 24, 2018). <https://coinswitch.co/news/bitcoin-etf-approval-what-is-bitcoin-etf>.

¹³³ See Matthew Burgess, *It May Be Too Late to Get Into This Leading Equity Market*, BLOOMBERG (May 31, 2018), <https://www.bloomberg.com/news/articles/2018-05-31/it-may-be-too-late-to-get-into-this-top-performing-stock-market>.

A. The United Kingdom

The United Kingdom has long been established as one of the leading countries on the forefront of Fintech¹³⁴ innovation.¹³⁵ However, that is not the case when it comes to bitcoin and cryptocurrency, as the United Kingdom has many shortcomings when it comes to regulating this new form of asset.¹³⁶ Any conduct associated with the issuance of equity and debt is regulated by the Financial Conduct Authority (“FCA”), the FCA is the United Kingdom’s equivalent of the United States’ SEC.¹³⁷ The FCA’s main goal is to ensure financial markets operate efficiently.¹³⁸ This goal is achieved in three ways: first, by providing consumers and investors with protection; second, by stimulating fair and efficient market competition, and finally by enhancing market integrity.¹³⁹

The FCA elected to maintain its position that crypto-assets designed for the main purpose of payment or a means of exchange does not sit within the scope of FCA’s authority.¹⁴⁰ Under the Markets in Financial Instruments Directive II (“MiFID II”), the FCA does not consider virtual currencies to be currencies or commodities, therefore, virtual currencies evade the jurisdiction of the FCA.¹⁴¹ The FCA still retains authority to regulate activities related to bitcoin derivatives such as futures, options, and even a bitcoin backed ETF, if approved.¹⁴²

The MiFID II was announced on January 3, 2018, as a complete overhaul of the EU’s previous regulation that was in place for financial markets.¹⁴³ So far, the MiFID II was enacted for the purpose of creating greater transparency in the European market and to increase safety and efficiency in the European Exchange-traded products (“ETPs”) market, typically associated with fragmented liquidity and off-exchange trades, by increasing the reporting requirements for all trades.¹⁴⁴

In March of 2018, the Bank of England warned the public of a bitcoin regulatory suppression.¹⁴⁵ The Bank of England stated this new call for action is warranted as cryptocurrencies are “inherently risky” and have failed to fulfill the most basic functions as money.¹⁴⁶

¹³⁴ Julia Kagan, *Fintech*, INVESTOPEDIA, <https://www.investopedia.com/terms/f/fintech.asp> (last visited Apr. 5, 2019).

¹³⁵ Stefan Stankovic, *Cryptocurrency Regulation In The UK*, CRYPTOBRIEFING (Aug. 22, 2018), <https://cryptobriefing.com/cryptocurrency-regulation-uk/>.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *About Us*, FIN. CONDUCT AUTH., <https://www.fca.org.uk/> (last visited Oct. 8, 2018).

¹⁴⁰ See Stankovic, *supra* note 135.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ Lara Crigger, *New Light Shines On Europe ETF Trading*, ETF.COM (Apr. 18, 2018), <https://www.etf.com/sections/features-and-news/new-light-shines-europe-etf-trading>.

¹⁴⁴ *Id.*

¹⁴⁵ Partington, R.J. *Bitcoin faces regulatory crackdown, Bank of England warns*, THE GUARDIAN (Mar. 2, 2018), <https://www.theguardian.com/business/2018/mar/02/bitcoin-faces-regulatory-crackdown-bank-of-england-warns>.

¹⁴⁶ *Id.*

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

While the United Kingdom has fallen behind in cryptocurrency regulation, the European Union has secured legislative support for ventures involving cryptocurrencies.¹⁴⁷ The European Union warned it will use this legislative support to regulate cryptocurrencies if the risks continue to increase.¹⁴⁸

ETF growth in Europe is currently exceeding ETF growth in the United States.¹⁴⁹ Bringing an ETF to market in Europe is a vastly different process in Europe than it is in the U.S.¹⁵⁰ Unlike the U.S., where all trades, regardless of the exchange, must be settled through a single securities depository, Europe is a culmination of regional markets and each market has its own exchanges as well as its own settlement facilities.¹⁵¹ In order to list an ETF in Europe, the ETF must be registered in every jurisdiction of sale, as well as the preferred local listing in each market.¹⁵² Currently there are 6,607 ETFs admitted for listing across 23 exchanges.¹⁵³ This means a European ETF must consider the requirements needed across multiple national exchanges, the local regulations of each jurisdiction and the appointment of local agents.¹⁵⁴ All these ETFs led to a € 721 billion turnover¹⁵⁵ in Europe in December of 2017.¹⁵⁶

In order to begin selling ETF shares in Europe, the ETF must be registered under the Undertakings for Collective Investment in Transferable Securities III (“UCITS III”) brand for sale in every single jurisdiction the shares will be listed or sold.¹⁵⁷ Once an ETF is registered for sale, most often the ETF is listed in each jurisdiction¹⁵⁸ on a domestic exchange.¹⁵⁹ Although the listing process varies significantly in each jurisdiction, the process typically involves the three following steps: (1) appointment of local service providers (as appropriate)

¹⁴⁷ See Stankovic, *supra* note 135.

¹⁴⁸ See Partington, *supra* note 145.

¹⁴⁹ *Bringing ETFs to Market Listing in Europe*, DILLON O EUSTACE, <https://www.dilloneustace.com/download/1/Publications/Listings/Bringing%20ETFs%20to%20Market%20-%20Listing%20in%20Europe.PDF> (last visited Nov. 15, 2018).

¹⁵⁰ *Id.*

¹⁵¹ See Crigger, *supra* note 143.

¹⁵² See Eustace, *supra* note 149.

¹⁵³ See Thomadakis, *supra* note 93.

¹⁵⁴ *Id.*

¹⁵⁵ See *Turnover*, INVESTOPEDIA, <https://www.invetopedia.com/terms/t/turnover.asp> (last visited Nov. 15, 2018). “Turnover” is an accounting term that calculates how quickly a business collects cash from accounts receivable or how fast the company sells its inventory. In the investment industry, turnover is defined as the percentage of a portfolio that is sold in a particular month or year. A quick turnover rate generates more commissions for trades placed by a broker. See *Id.*

¹⁵⁶ See Thomadakis, *supra* note 94.

¹⁵⁷ See Eustace, *supra* note 149.

¹⁵⁸ *Id.*

¹⁵⁹ See Mark McCracken, *explain Domestic exchange*, TEACHMEFINANCE.COM, www.teachmefinance.com/Financial_Terms/Domestic-exchange.html (last visited Nov. 14, 2018). “Domestic Exchange” Also called inland exchange; exchange between two places in the same country; in other words, drafts or orders for money drawn at one place and payable at another place in the same country. Drafts constitute the commonest form of domestic exchange and are purchased for use as such by both banks and individuals. When drawn against persons to whom merchandise has been sold they are known as commercial bills. Domestic exchange is calculated in only on kind of money, whereas foreign exchange is calculated in two kinds. See *id.*

– Paying Agent, Registration Agent, Legal Adviser, Listing Sponsor, Market Makers, Distributors; (2) Application to Listing Authority for listing approval (in the UK only through UKLA¹⁶⁰); and, (3) Application to Exchange for listing & trading.¹⁶¹

The first step entails ensuring officers are placed into appropriate roles. A paying is one who accepts payments on a security from the issuer and then redistributes the payments to individual shareholders of the security.¹⁶² The FCA regulates which companies are listed for trading on UK Stock Exchanges under the United Kingdom Listing Authority (“UKLA”).¹⁶³

In terms of regulation, the EU views ETFs as being traded on the main market, thus they are subject to regulations under the Markets in Financial Instruments Directive II (MiFID II).¹⁶⁴ Under MiFID II, a new transparency and reporting regime was implemented for the purpose of extending to all trading venues for shares or particular equity-like instruments, such as ETFs.¹⁶⁵ Despite bitcoin evading regulation under the MiFID II directly,¹⁶⁶ the EU would still be able to utilize the MiFID II to regulate bitcoin as an underlying asset of the ETF.¹⁶⁷

B. Germany

Germany was truly one of the first countries to be on the forefront of finding solutions to the problems virtual currencies pose as they were the first country to issue regulations, in which it appears bitcoin would be regulated similar to a currency.¹⁶⁸ Bitcoin is defined as an “economic asset,” therefore, much like the United States, the Germany Tax regime defines bitcoin income as gross income.¹⁶⁹ This enables Germany to tax transactions between non-commercial users under the gross income rules.¹⁷⁰ However, the Germany Federal Financial Supervisory Authority classifies bitcoin as a “unit of account,” therefore, entities that offer bitcoin exchange for financial services in Germany are subject to regulation under the German Banking Act.¹⁷¹

¹⁶⁰ United Kingdom Listing Authority (“UKLA”).

¹⁶¹ See Eustace, *supra* note 149.

¹⁶² Julia Kagan, *Paying Agent*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/payingagent.asp> (last visited Jan. 16, 2018).

¹⁶³ United Kingdom Listing Authority (UKLA).

¹⁶⁴ See Thomadakis, *supra* note 93.

¹⁶⁵ *MiFID II / MiFIR series*, NORTON ROSE FULBRIGHT (Apr. 2014), www.nortonrosefulbright.com/knowledge/publications/115289/mifid-ii-mifir-series.

¹⁶⁶ See Stankovic, *supra* at 135.

¹⁶⁷ See Eustace, *supra* note 149.

¹⁶⁸ See Ficcaglia, *supra* note 21.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

C. Japan

Since April of 2017, all cryptocurrency exchange businesses located in Japan are subject to regulation through the Payment Services Act.¹⁷²

Recently, Japan experienced a rapid expansion in the ETF industry.¹⁷³ After becoming worth \$1 billion within about a month since inception, the JPMorgan BetaBuilders Japan ETF (“BBJP”) became the second fastest ETF to be worth \$1 billion in assets.¹⁷⁴ The Bank of Japan (“BoJ”) is currently buying large portions of ETFs across the globe; however, the BoJ does not use these shares to vote on corporate decisions, nor does it tell the ETF fund managers to vote on their behalf.¹⁷⁵ This led many analysts to speculate on whether the BoJ would continue its current trend or whether they were preparing for a larger move in the financial markets.¹⁷⁶

IV. THE MEASURE OF INTELLIGENCE IS THE ABILITY TO ADAPT
TO CHANGING CIRCUMSTANCES

The SEC invokes a two-step process when considering whether to approve or deny a proposal.¹⁷⁷ First, the SEC determines whether the market the proposal is intended for is a market that is inherently resistant to market fraud and market manipulation.¹⁷⁸ As bitcoin operates on a decentralized market with no central regulating authority the SEC unequivocally determined the bitcoin market was not resistant to neither market manipulation nor market fraud.¹⁷⁹ If the intended market is not inherently resistant to manipulation or fraud, the SEC then determines whether the proposal is listed on an exchange that is: (1) partnered with a comprehensive monitoring system, (2) significant; and, (3) regulated market.¹⁸⁰ Despite the Winklevoss’ tremendous efforts to comply with the guidelines created by the SEC, the SEC nonetheless denied their proposal for a bitcoin backed ETF.¹⁸¹

¹⁷² *Regulation of Cryptocurrency: Japan*, LIBRARY OF CONGRESS
<https://www.loc.gov/law/help/cryptocurrency/japan.php> (last visited Oct. 30, 1990).

¹⁷³ Cinthia Murphy, *Japan ETF Shines, Bitcoin ETF Plans Dull*, NASDAQ (Jul. 30, 2018), <https://www.nasdaq.com/article/japan-etf-shines-bitcoin-etf-plans-dull-cm999061>.

¹⁷⁴ *Id.*

¹⁷⁵ Leo Lewis, *What is behind the Bank of Japan’s ETF buying surprise?* FIN. TIMES (Aug. 24, 2018), <https://www.ft.com/content/8f472648-a783-11e8-8ecf-a7aef1beff35b>.

¹⁷⁶ *Id.*

¹⁷⁷ See SEC Order, *supra* note 6.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ See Proposed Rule Change, *supra* note 23.

A. Zuckerberg to the SEC: These Guys' Cannot Catch a Break

The Winklevoss twins first gained notoriety when the blockbuster motion picture *The Social Network* was released. In the movie, the twins are most known for alleging Mark Zuckerberg stole the billion-dollar platform for Facebook from them, and in the end, the Winklevoss twins lost the lawsuit against Zuckerberg.¹⁸² In the years following the failed lawsuit, the Winklevoss twins became key players in the bitcoin industry, proposing a bitcoin backed ETF as their latest venture.

In 2013, the Winklevoss' made an \$11 million-dollar investment in bitcoin,¹⁸³ the Winklevoss twins are now billionaires due to this investment.¹⁸⁴ The Winklevoss twins had the foresight to see the tremendous potential bitcoin and cryptocurrencies posed to investors, and took advantage of this opportunity by founding the Gemini Trust Company, also commonly referred to as "Gemini Exchange," in 2014.¹⁸⁵ The Gemini Exchange allows users to buy and sell a wide range of digital currencies¹⁸⁶ and fiat currencies¹⁸⁷ on an open market.¹⁸⁸ Transfers of U.S. dollars can also be facilitated through the Gemini Exchange.¹⁸⁹ Since Gemini's inception in 2014, the company expanded rapidly and currently operates in the United States, United Kingdom, Canada, Singapore, South Korea and Hong Kong.¹⁹⁰

In May of 2016, the Gemini Exchange began to take-off once it became the first licensed ethereum¹⁹¹ exchange in the United States.¹⁹² Then, two years later in April of 2018, Gemini started offering block trading, which gave users the opportunity to buy and sell large orders of digital currencies that are not on Gemini's order books.¹⁹³ An order book is an electronic list of all buy and sell orders for a certain security or financial instrument, the list is

¹⁸² See Zuckerberg, *supra* note 7.

¹⁸³ See Berr, *supra* note 91.

¹⁸⁴ Sean Ross, *5 of the World's Top Bitcoin Millionaires*, INVESTOPEDIA (Oct. 2, 2018), <https://www.investopedia.com/articles/people/083016/who-are-top-5-bitcoin-millionaires.asp>.

¹⁸⁵ Jacob Pramuk, *Bitcoin exchange Gemini safe and legal: Founder*, CNBC (Oct. 8, 2015), <https://www.cnbc.com/2015/10/08/bitcoin-exchange-gemini-safe-and-legal-founders.html>.

¹⁸⁶ A digital currency is an asset that only exists electronically. Digital currencies such as Bitcoin were designed to be used to make payments, but today many digital currencies are held as speculative assets by investors who hope their value will rise. See Digital Currencies, *supra* note 39.

¹⁸⁷ James Chen, *Fiat Money*, INVESTOPEDIA, <https://www.investopedia.com/terms/f/fiatmoney.asp> (last visited Apr. 2019).

¹⁸⁸ Jake Frankenfield, *Gemini Exchange*, INVESTOPEDIA, <https://www.investopedia.com/terms/g/gemini-exchange.asp> (last visited Jun. 8, 2018).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ See Jake Frankenfield, *Ethereum*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/ethereum.asp> (last visited Dec 11, 2018). Ethereum is a decentralized software platform that enables SmartContracts and Distributed Applications (DApps) to be built and run without any downtime, fraud, control or interference from a third party. Ethereum is not just a platform but also a programming language (Turing complete) running on a blockchain, helping developers to build and publish distributed applications. See *Id.*

¹⁹² See Gemini Exchange, *supra* note 187.

¹⁹³ *Id.*

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

organized by price level.¹⁹⁴ By offering block trading, Gemini created more liquidity opportunities.¹⁹⁵

Although Gemini experienced tremendous expansion between 2016 and 2018, the most important partnership Gemini formed was with Nasdaq in April 2018.¹⁹⁶ By partnering with Nasdaq, Gemini gained emittance to use Nasdaq's SMARTS technology, this technology lowers the amount of fraudulent activity and manipulation of digital currency prices.¹⁹⁷ Nasdaq's SMARTS technology reduces surveillance challenges by: (1) transplanting regulatory guidelines and rules governing trading contact into trading alerts to minimize potential violations in trading; (2) efficiently analyzing and managing alerts; and, (3) sourcing, capturing and maintaining data elements required to conduct a complete review of all trading activity.¹⁹⁸

One of the crucial elements of the SEC's three-part approval process is that the ETF needs to be listed on an exchange partnered with surveillance-monitoring technology¹⁹⁹ provided for rejecting proposals for bitcoin backed ETFs.²⁰⁰ Utilizing SMARTS technology Gemini can monitor trading activity, specifically searching for irregular trading behavior.²⁰¹ Once the technology spots any irregular trading behavior, Gemini gains the ability to eliminate the behavior and, in turn, reduces the risk of market manipulation.²⁰²

The Winklevoss twins own 1% of all bitcoins currently in circulation.²⁰³ Bitcoin shares a few similarities with gold: there are a finite number of bitcoins that can be created just as there is a finite amount of gold in existence and just like gold is mined, bitcoin also must be mined in order to be created.²⁰⁴

The Winklevoss', acting on the behalf of Bats BZX Exchange, Inc. ("BZX"), filed a proposed rule change, pursuant to Section 19(b)(1)²⁰⁵ of the 1934 Act and Rule 19b-4 thereunder,²⁰⁶ seeking to list and trade shares of the Winklevoss Bitcoin Trust, on June 30, 2016.²⁰⁷ On March 10, 2017, the SEC disapproved the proposed rule change²⁰⁸, acting under authority provided to the Division of Trading and Markets.²⁰⁹ In response, BZX submitted a

¹⁹⁴ Will Kenton, *Order Book*, INVESTOPEDIA, <https://www.investopedia.com/terms/o/order-book.asp> (last visited Apr. 20, 2018).

¹⁹⁵ See Gemini Exchange, *supra* note 187.

¹⁹⁶ *Id.*

¹⁹⁷ Nathan Reiff, *Crypto: What Are Nasdaq, Winklevoss Twins Up To?*, INVESTOPEDIA (Apr. 30, 2018), <https://www.investopedia.com/tech/crypto-what-are-nasdaq-winklevoss-twins/>.

¹⁹⁸ *Id.*

¹⁹⁹ See SEC Order, *supra* note 6.

²⁰⁰ Joseph Young, *Why Did the SEC Reject All Derivative-Backed Bitcoin ETFs?*, CCN (Aug. 23, 2018), <https://www.ccn.com/why-did-the-sec-reject-all-derivative-backed-bitcoin-etfs/>.

²⁰¹ See *Crypto: What Are Nasdaq, Winklevoss Twins Up To?*, *supra* note 196.

²⁰² *Id.*

²⁰³ See Ross, *supra* note 184.

²⁰⁴ Nathan Reiff, *What Happens to Bitcoin After All 21 Million are Mined?*, INVESTOPEDIA (Aug. 4, 2018), <https://www.investopedia.com/news/what-happens-bitcoin-after-all-21-million-are-mined/>.

²⁰⁵ 15 U.S.C. § 78s(b)(1).

²⁰⁶ 17 CFR 240.19b-4.

²⁰⁷ See Proposed Rule Change, *supra* note 23.

²⁰⁸ See SEC Order, *supra* note 6.

²⁰⁹ See 17 CFR 200.30-3(a)(12).

Petition for Review on March 24, 2017.²¹⁰ On April 24, 2017 the SEC granted BZK's Petition for Review.²¹¹ The SEC set May 15, 2017 as the deadline for any person, whether a party to the action or not, could file a written statement either in support of or in opposition to the March Disapproval Order.²¹² On July 26, 2018 the SEC set aside the March Disapproval Order and disapproved BZK's proposed rule change.²¹³

The proposal attempts to create an ETF that would list and trade shares of SolidX Bitcoin Shares issued by the VanEck SolidX Bitcoin Trust ("Trust"), pursuant to BZX Rule 14.11(e)(4),²¹⁴ on the Gemini Exchange.²¹⁵ The Trust is responsible for controlling the bitcoin owned by the Trust.²¹⁶ SolidX Management LLC, a wholly-owned subsidiary of SolidX Partners Inc., is the Trust's sponsor.²¹⁷ Delaware Trust Company is listed as the trustee.²¹⁸ The Bank of New York Mellon is the Administrator, Transfer Agent and the custodian, with matters pertaining to cash, of the Trust.²¹⁹ For the creation and redemption of Baskets²²⁰ of Shares Foreside Fund Services, LLC, will act as the marketing agent.²²¹ The Trust will not be actively managed,²²² at no point will the Trust be involved in any activities designed for the purpose of obtaining profit from, or to ameliorate losses caused by, the fluctuations in the price of bitcoin.²²³

Bitcoin is the sole asset the Trust will purchase.²²⁴ The Trust will only hold a limited amount of cash in order to facilitate the creation and redemption of Baskets as well as to pay the Trust's expense.²²⁵

The functions of the Trust are limited to the following circumstances: (1) issuing Baskets in exchange for the cash and/or bitcoin deposited with the Bank of New York Mellon or the Trust, as consideration; (2) purchasing bitcoin from various exchanges and in OTC transactions; (3) selling bitcoin (or transferring bitcoin, at the Sponsor's discretion, to pay the Management Fee) as necessary to cover the Sponsor's Management Fee, bitcoin Insurance Fee, Trust principals' and employees' salaries, expenses associated with securing the Trust's bitcoin and Trust expenses not assumed by the Sponsor and other liabilities; (4) selling bitcoin as necessary in connection with redemptions; (5) delivering cash and/or bitcoin in

²¹⁰ See SEC Order, *supra* note 6.

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ The Commission approved BZX Rule 14.11 (e)(4) in Securities Exchange Act Release No. 65225 (Aug. 30, 2011); 76 FR 55148 (Sept. 6, 2011) (SR-BATS-2011-018).

²¹⁵ See Proposed Rule Change, *supra* at note 23.

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ The Trust will issue and redeem "Baskets", each equal to a block of 5 Shares, only to "Authorized Participants." See Proposed Rule Change, *supra* note 23.

²²¹ *Id.*

²²² See discussion, *supra* Section II(B).

²²³ See Proposed Rule Change, *supra* note 23.

²²⁴ Form S-1 Registration Statement Under the Securities Act of 1933, United States Securities and Exchange Commission, Washington, D.C. 20549, Jul. 1, 2013

²²⁵ See Proposed Rule Change, *supra* note 23.

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

exchange for Baskets surrendered for redemption; (6) maintaining insurance coverage for the bitcoin held by the Trust; and, (7) securing the bitcoin held by the Trust.²²⁶

The Trust's investment objective is for the Shares to reflect the performance of the price of bitcoin, minus the Trust's operations expenses.²²⁷ To attain this investment objective, the Trust will invest the majority of its assets in bitcoin traded mainly in the over-the-counter markets, without being leveraged or exceeding pertinent position limits.²²⁸

According to the Trust's Registration Statement,²²⁹ the Trust is not registered under the Investment Company Act of 1940, as amended,²³⁰ as an investment company, nor is it a commodity pool as defined in the Commodity Exchange Act.²³¹ Therefore, neither the Trust, nor its Sponsor, would be subjected to regulation as a commodity pool operator or a commodity trading advisor in relation to the BZX Shares.²³²

The proposed Trust has the option to allow the Sponsor to receive bitcoin in the amount needed to pay the Management Fee, or sell bitcoin in the amount required to allow payment in cash of the Management Fee and other Trust expenses or liabilities, not assumed by the Sponsor.²³³ This will cause the amount of bitcoin sold to fluctuate based upon the Trust's level of expenses as well as the market price of bitcoin.²³⁴

B. Darwinism

The common saying "survival of the fittest" refers to Charles Darwin's theory that those species who adapt and change in accordance with their surroundings are the species that continue to survive.²³⁵ Although, Darwin based his theory specifically on the habits of animal species,²³⁶ this same concept can be applied to a wide variety of circumstances. The idea that those who are willing to change their habitual behavior in order to continuing thriving in their preferred environment will outlive their counterparts who refuse to adapt readily applies participants in the global economy. It is easy to see on a micro-level that businesses who continue to improve their products and services in order to comply with an ever-changing marketplace last longer and are more successful than those who are stubborn and refuse to depart from the traditional norms.²³⁷ The same concept of adapting to a changing marketplace can be applied on a macro level to the SEC and the U.S. as a participant in the global economy.

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ See Form S-1, *supra* note 223.

²³⁰ 15 U.S.C. 80a-1.

²³¹ See Proposed Rule Change, *supra* note 23.

²³² *Id.*

²³³ See Proposed Rule Change, *supra* note 23.

²³⁴ *Id.*

²³⁵ Robert J. Richards, "The Meaning of Evolution", UNIV. OF CHI. PRESS (Feb. 2, 2009), available at https://books.google.com/books?id=z-72dKSiciEC&dq=darwin%27s+theory&lr=&source=gbp_navlinks_s.

²³⁶ *Id.*

²³⁷ See Martin Reeves & Mike Deimler, *Adaptability. The New Competitive Advantage*, HARV. BUS. REV. (Aug. 2011), <https://hbr.org/2011/07/adaptability-the-new-competitive-advantage>.

When technology drives innovation to the point where an entirely new, more efficient method for achieving a desired outcome, society does not simply ignore it because it poses risks.²³⁸ In fact, quite the opposite occurs: a demand for more innovation is created.²³⁹ When a new market is created, comprised of one market participant, offering a product, it poses potential risks for participants to enter the market with newer products aimed to eliminate those risks is created.²⁴⁰

C. The Process

The SEC denied the Winklevosses' proposal because it did not consider the Cboe BZX Exchange to be either a significant enough market or a regulated market.²⁴¹ Cboe is the second-largest U.S. equities market operator, only behind NASDAQ, and operates four U.S. equities exchanges: (1) BZX Exchange; (2) BYX Exchange; (3) EDGA Exchange; and, (4) EDGX Exchange.²⁴² The Cboe BZX Exchange is subjected to the supervision of the New York State Department of Financial Services.²⁴³ Furthermore, BZX entered into a comprehensive surveillance-sharing agreement with the Gemini Exchange.²⁴⁴

The SEC must be aggressive in order for the United States to maintain its grip on the global economy.²⁴⁵ If there is no significant, regulated bitcoin market the SEC should be eager to approve the BZX Exchange's proposal in order to work with the Winklevoss twins, whom have made countless efforts to comply with the strict guidelines²⁴⁶, to create a significant, regulated bitcoin market with comprehensive monitoring technology.

The Winklevosses' ETF would list shares of the Winklevoss Bitcoin Trust on the Cboe BZX Exchange.²⁴⁷ The BZX Exchange is tied to the Gemini Exchange.²⁴⁸ Since the Gemini Exchange is subject to NYSDFS regulation the BZX Exchange is therefore subject to the same regulation.²⁴⁹ The Gemini Exchange also utilizes SMARTS technology to monitor market activity, SMARTS technology is the most comprehensive surveillance-monitoring technology in existence.²⁵⁰ In addition to Gemini's comprehensive surveillance-monitoring technology the approval of the Winklevosses' proposed ETF would have increased BXZ

²³⁸ See *Introduction to Risk management in the Public Procurement of Innovation*, PROCUREMENT OF INNOVATION PLATFORM, <https://procurement-forum.eu/resource/download/456/Paper17-4.pdf> (last visited Sept. 16, 2019).

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ See SEC Order, *supra* note 6.

²⁴² *Cboe U.S. Equities*, CBOE <https://markets.cboe.com/us/equities/overview/> (last visited Dec. 22, 2019).

²⁴³ See Proposed Rule Change, *supra* note 23.

²⁴⁴ *Id.*

²⁴⁵ See Dan Burrows, *Report: Who Really Controls Global Economy?*, CBS NEWS (Oct. 24, 2011), <https://www.cbsnews.com/news/report-who-really-controls-global-economy/>.

²⁴⁶ See Loder, *supra* note 22.

²⁴⁷ See Proposed Rule Change, *supra* note 23.

²⁴⁸ *Id.*

²⁴⁹ See Proposed Rule Change, *supra* note 23.

²⁵⁰ *Id.*

REGULATION OVER REFUSAL: HOW BITCOIN BACKED ETFs CAN USHER THE
SEC INTO THE MODERN ERA

exchange's market share to over 10% of the total possible volume of bitcoin (don not forget: only 80% of the total bitcoin volume is currently in circulation).²⁵¹

Despite NYSDFS regulation, SMARTS technology and a 10% market share of the total volume of bitcoin worldwide the SEC still chose to deny the proposal.²⁵² If the Winklevosses' proposal did not satisfy the SEC's "significant, regulated and partnered with a comprehensive surveillance monitoring system" then such an exchange does not exist for a bitcoin backed ETF. Now is the time for the SEC to become part of the solution, rather than continually thwarting those who make an honest good faith effort to comply with its strict standards.

The Gemini Exchange has grown at an exponential rate and shows no signs of stopping, from January 23, 2017 to May 10, 2017, the exchanges' market share increased from 0.33% to 7.14% of the total worldwide bitcoin volume.²⁵³ If the SEC were to approve the BZX proposal for a bitcoin backed ETF, the entire Winklevoss Bitcoin Trust would be listed under the Gemini Exchange increasing its market share by a full one percent.²⁵⁴ When a single shareholder owns over 10% of a corporation's total number of shares that particular shareholder is considered a dominant shareholder.²⁵⁵ The simplest way to understand the meaning of a dominant shareholder is to think of each share as representing a single vote for corporate decisions. Dominant shareholders are said to have a large enough portion of the corporation's total number of shares to have a significant impact on the outcome of corporate decisions decided by a shareholder vote.²⁵⁶ If a shareholder is considered dominant for owning 10% of a corporation's stock, then why does the same concept not apply in order to an exchange that lists approximately 10% of the total volume of an asset worldwide significant?

V. CONCLUSION

The SEC should modify the approval process to a process of balancing each factor rather than requiring each proposal to achieve each factor to the fullest extent. The price volatility associated with bitcoin caused the SEC to reach a determination denying the Winklevoss Twins' proposal too quickly. Adapt or die, it is no secret that in recent years technology has changed the way financial transactions are conducted and those who welcome the changes or discover alternatives methods to handle the change are the individuals who likely achieve success. As technology continues to advance, the world continues to shrink. Bitcoin offers the fastest method for securing financial transactions and these transactions occur between two parties regardless of each parties' geographical location.

²⁵¹ *Id.*

²⁵² See SEC Order, *supra* note 6.

²⁵³ Press Release, NYDFS Grants First Charter to a New York Virtual Currency Company, New York State Department of Financial Services (May 7, 2015), https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1505071.

²⁵⁴ See Proposed Rule Change, *supra* note 23.

²⁵⁵ Jay Dahya, Orlin Dimitrov, & John J. McConnell, *Dominant Shareholders, Corporate Boards and Corporate Value: A CrossCountry Analysis* Purdue CIBER Working Paper, Paper No. 41, <http://docs.lib.purdue.edu/ciberwp/41>.

²⁵⁶ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

Bitcoin and its ability to conduct the most efficient and secured transactions are an innovation that is here to stay. The SEC should reform its approval process in order to favor the pioneers of the digital currency age rather than continuing to deter their efforts. Each time the SEC denies a proposal for a bitcoin backed ETF, the risk of forcing investors to turn to foreign markets increases, which in turn increases the risk of the U.S. losing its grip on the global economy.