January 12, 2024

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Ark 21Shares Ethereum ETF, File No. SR-CboeBZX-2023-070
VanEck Ethereum ETF, File No. SR-CboeBZX-2023-069
Hashdex Nasdaq Ethereum ETF, File No. SR-NASDAQ-2023-035

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on several proposed rule changes filed by the Cboe BZX Exchange, Inc., and The NASDAQ Stock Market, LLC (collectively referred to as the "Exchanges") with the Securities and Exchange Commission ("SEC" or "Commission"), seeking to list and trade shares of spot ether exchange-traded products ("ETPs").[2]

Two days ago, on January 10, 2024, the Commission approved the first spot bitcoin ETPs. That action was not supported by the law or facts and was a grievous, historic mistake that will result in untold investor harm. In truth, ***it is little more than an ETP for Ponzi schemes*** that is already being widely if not fraudulently misdescribed and mis-sold as an ETF. The SEC's approval of a spot bitcoin ETP is the height of irresponsibility, no better than a police commissioner who, knowing there's a very high crime area with no cops on the beat and no lights, nonetheless authorizes companies to send busloads of unsuspecting travelers into those neighborhoods in the middle of the night, even though they have exposed wallets filled with cash and lots of expensive jewelry hanging around their necks. We all know how that's going to turn out. The SEC must not make the same mistake again.

As you know, the SEC's approval of a spot bitcoin ETP does not change the fundamental facts about that worthless product: bitcoin still has no legitimate use after 15 years; it will remain the preferred financial product of speculators, gamblers, predators, and criminals worldwide; and it will continue to be a cesspool of fraud, manipulation, and criminality. Nevertheless, ***the SEC's approval will provide America's investors with at least four levels of false comfort***:

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Ark 21Shares Ethereum ETF, File No. SR-CboeBZX-2023-070; VanEck Ethereum ETF, File No. SR-CboeBZX-2023-069; Hashdex Nasdaq Ethereum ETF, File No. SR-NASDAQ-2023-035.

1. it will be and has already been seen as an approval if not an endorsement of bitcoin and crypto more generally;
2. it will be and already has been misreported and misdescribed as an approval of the much more well-known and trusted ETF investment vehicle which has materially more investor protections;
3. it will allow the involvement of traditional and trusted financial firms like Blackrock and Fidelity to suggest an unmerited level of legitimacy; and
4. it will inevitably lead investors to assume that these ETPs will be subject to meaningful regulation and investor protections, because they'll believe that otherwise the SEC wouldn't have approved them, even though that won't be the case.

This is all false comfort that is going to result in millions of American investors, including many just trying to save for a decent retirement, risking their hard-earned money in a worthless, speculative, and highly volatile financial product. There is no—and will be no—effective cop on the bitcoin beat. The same is true for ether and the Ethereum ecosystem. The Commission must not compound the spot bitcoin ETP mistake by now approving spot ether ETPs.

The Statutory Standard Cannot Be Met.

The rules of an exchange must be designed to "prevent fraudulent and manipulative acts and practices" and "protect investors and the public interest."[3] The potential for fraud in the spot ether market is so great that the rules of an exchange cannot permit the listing and trading of a spot ether ETP and still be consistent with the requirement that the exchange's rules be designed to prevent fraud and manipulation and protect investors and the public interest.

Numerous studies have "concluded that most of the reported trading volume of Bitcoin and Ether is attributable to wash trading."[4] For example, one study that focused on the most widely recognized and heavily traded cryptocurrencies, including ether, found that "the volume of wash trading is, on average, as high as 77.5% of the total trading volume on unregulated exchanges."[5] This is because "cryptocurrencies are particularly susceptible to wash trading under limited regulatory oversight," which makes wash trading an "industry-wide phenomenon."[6]

Wash trading is also prevalent in the Ethereum ecosystem generally. A recent study found that "price manipulation is ***rampant*** on Ethereum-based decentralized exchanges."[7] According to

[3] 15 U.S.C. § 78f(b)(5).

[4] Guenole Le Pennec, Ingo Fiedler, and Lennart Ante, *Wash Trading at Cryptocurrency Exchanges*, ScienceDirect (Nov. 2021), https://www.sciencedirect.com/science/article/abs/pii/S1544612321000635.

[5] Lin William Cong, Xi Li, Ke Tang, and Yang Yang, *Crypto Wash Trading*, at 5, 7 (Aug. 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220. The study did not find evidence of wash trading on regulated exchanges, but it noted that, as of mid-2022, regulated exchanges covered less than 3% of spot market transactions. *Id.* at 2.

[6] *Id.* at 3.

[7] Olga Kharif, *Wash Trading is Rampant on Decentralized Crypto Exchanges*, Bloomberg (Sept. 12, 2023) (emphasis added), https://www.bloomberg.com/news/articles/2023-09-12/wash-trading-is-rampant-on-decentralized-crypto-exchanges?sref=mQvUqJZj.

the study, wash trading "amounted to at least $2 billion worth of cryptocurrencies since September 2020."[8] The deployer of one token made approximately $2 million in profits in two hours in May 2021.[9] Other analyses have reached similar conclusions regarding the Ethereum marketplace.[10]

The Ethereum network also has features that make it vulnerable to fraud and manipulation more broadly. Relays are responsible for adding blocks of transactions to the Ethereum blockchain. Recently, one infrastructure provider exited the network, which left "only four other major relay players to handle most Ethereum blocks and raises concern of potential problems, ranging from censorship of transactions to stealing of other key operators' profits."[11]

In addition to relays, the network is run by "parties called builders, which compile most transactions into blocks, and validators, which order blocks into a blockchain."[12] But both "builder and validator functions are dominated by a handful of participants."[13] Four builders account for the majority of blocks built.[14] And one validator currently controls 32.3% of validator power.[15] "A validator controlling 34% could potentially falsify transactions."[16]

In light of these factors, it is not surprising that ether has "had some significant crashes, sometimes in astonishingly short amounts of time."[17] "Notably, it went from a high of almost £3,000 per coin in May 2021 to less than £1,300 a month later, a drop of more than 50%."[18] This "extreme volatility," combined with the inherent risks of trading in ether, is why buying ether "is a gamble."[19] The Commission cannot find that the proposed rule changes are designed to prevent fraud and manipulation and protect investors and the public interest. Approval would therefore conflict with the standards set forth in Section 6(b)(5) of the Exchange Act.

<u>The Exchanges' Arguments Based on Comparative Risks Are Irrelevant and Unpersuasive.</u>

The Exchanges acknowledge that the statutory standard requires that an exchange's rules be designed to prevent fraud and manipulation and protect investors and the public interest. Cboe argues that the "manipulation concerns previously articulated by the Commission are sufficiently

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8 *Id.*

9 *Id.*

10 Andrew Hayward, *Hot Ethereum NFT Platform LooksRare is Rife with Wash Trading—And Ok With It*, Decrypt (Jan. 12, 2022), https://decrypt.co/90317/ethereum-nft-market-looksrare-wash-trading.

11 Olga Kharif, *Ethereum is Becoming More Concentrated After a Key Infrastructure Provider Dropped Out*, Bloomberg (Sept. 30, 2023), https://www.bloomberg.com/news/articles/2023-09-30/ethereum-eth-concentration-grows-after-key-relay-provider-drops-out?sref=mQvUqJZj.

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.*

17 Kat Tretina and Mark Hooson, *How to Buy Ethereum (ETH)*, Forbes Advisor (Jan. 10, 2024), https://www.forbes.com/uk/advisor/investing/cryptocurrency/how-to-buy-ethereum/.

18 *Id.*

19 *Id.*

mitigated to the point that they are outweighed by quantifiable investor protection issues that would be resolved by approving" the proposed rule changes.[20] Those investor protection issues, according to Cboe, are that "investors that would otherwise seek cryptoasset exposure through a Spot Ether ETP are forced to find alternative exposure through fewer and more risky means."[21] Cboe cites OTC Ether Funds as an example of a riskier way of investing in ether.[22]

This argument is irrelevant and unpersuasive. The statutory standard is not whether the rules of an exchange would be better than the even-worse over-the-counter market. The statutory standard is whether the rules of an exchange are designed to prevent fraud and manipulation and protect investors and the public interest. The concerns about fraud and manipulation in the spot ether market are in no way neutralized by any risks to investor protection in the OTC market. Rather, the concerns about fraud and manipulation in the spot ether market are the risks to investor protection that the Commission must guard against. Thus, the Exchanges have not sufficiently allayed those concerns.

The fact that investors in spot ether ETPs would be "afforded the benefits and protections" of exchange-traded products also misses the point.[23] The nature of the investment vehicle as an ETP will not protect investors. First and foremost, the value of their investment will be subject to the same risks of fraud and manipulation in the spot ether market as investors who hold ether directly. The SEC should not subject investors to these risks and should instead find that the proposed rule changes are not designed to prevent fraud and manipulation and protect investors and the public interest. Second, notwithstanding the massive confusion about ETPs and widespread if not uniform misreporting about them, ETPs provide investors with very few protections. For example, among other things, the SEC does not have exam authority, custody requirements, or conflicts of interest rules for ETPs.[24] ETPs are ***not*** ETFs even though virtually all the media outlets have conflated the two products and misreported the approval of a bitcoin ETP as the SEC's approval of a bitcoin ETF.

<u>The Proposed Surveillance-Sharing Agreements Do Not Provide an Alternative Means of Satisfying the Statutory Standard.</u>

Cboe argues that the Commission "has historically approved or disapproved exchange filings to list and trade . . . spot-based Commodity-Based Trust Shares" on the "basis of whether the listing exchange has in place a comprehensive surveillance-sharing agreement with a regulated

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20 *Notice of Filing of Proposed Rule Change to List and Trade Shares of the ARK 21Shares Ethereum ETF Under BZX Rule 14.11(e)(4), Commodity-Based Trust Shares*, Exchange Act Release No. 98467, 88 Fed. Reg. 66,515, 66,521 (Sept. 27, 2023).

21 *Id.* at 66,517.

22 *Id.*

23 *Id.*

24 *See* Commissioner Caroline A. Crenshaw, *Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), https://www.sec.gov/news/statement/crenshaw-statement-spot-bitcoin-011023.

market of significant size related to the underlying commodity to be held."[25] It is true that the Commission has stated that concerns about fraud and manipulation may be allayed through a comprehensive surveillance-sharing agreement with a regulated market of significant size. But ***that is not the statutory standard***. The statutory standard is the prevention of fraud and manipulation and the protection of investors and the public interest. The concerns about fraud and manipulation in ether trading and the vulnerabilities in the Ethereum ecosystem demonstrate that spot ether trading is so susceptible to fraud and manipulation that there is no surveillance-sharing agreement with a regulated market of significant size that could sufficiently protect the public to justify approving the rule changes. The rule changes should be denied on that basis alone.

In any event, the Exchanges do not establish that a regulated market of significant size exists. The two-part test for "significant size" requires a showing that: 1) a would-be manipulator in the spot product would *have* to trade in the surveilled market, and 2) the market for the spot-based product would be unlikely to overwhelm the surveilled market. As to the first element, the exchanges point to the CME Ether Futures market. According to Cboe, "the CME Ether Futures market, which launched in February 2021, is the proper market to consider in determining whether there is a related regulated market of significant size."[26] But Nasdaq acknowledges that "there is still a lack of consensus on whether the CME ether futures market is of 'significant size' in relation to the spot Bitcoin or Ether market based on the test historically applied by the Commission."[27] And in the spot bitcoin ETP approval order, the Commission found that the CME market was "not of 'significant size' related to spot bitcoin."[28] There is no reason for the Commission to reach a different result with respect to the relationship between the CME Ether Futures market and spot ether.

Nor could the Exchanges satisfy the second element of the "significant size test." The spot market is likely to grow quickly and substantially as a result of the approval of the spot bitcoin ETPs, and if this growth causes the spot market to eventually eclipse the futures market—if it does not already—surveilling the futures market to identify misconduct in the spot market will become meaningless.[29]

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[25] 88 Fed. Reg. at 66,517.

[26] *Id.*

[27] *Notice of Filing of a Proposed Rule Change to List and Trade Shares of the Hashdex Nasdaq Ethereum ETF under Nasdaq Rule 5711(i)*, Exchange Act Release No. 98563, 2023 WL 6307192, at *9 (Sept. 27, 2023).

[28] *Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units*, Exchange Act Release No. 99306 (Jan. 10, 2024), https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf, at 10.

[29] *See* Crenshaw, *Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products*.

<u>The Price Correlation Analysis Applied by the Commission in the Bitcoin Context Was Fatally Flawed and Is Equally Unavailing Here.</u>

To approve the spot bitcoin ETPs, the Commission abandoned its traditional two-part test for determining whether proponents of a new listing can point to a surveillance-sharing agreement with a market of "significant size." [30] It turned instead to what it called a price correlation analysis. But that analysis was fatally flawed in a number of respects. Moreover, even a reliable finding of price correlation would fail to address the threat of fraud and manipulation in the ether market.

Based on a correlation analysis that the Commission conducted examining the relationship between prices in the CME bitcoin futures market and the spot bitcoin market, the Commission concluded "that fraud or manipulation that impacts prices in spot bitcoin markets would likely similarly impact CME bitcoin futures prices."[31] The Commission's correlation analysis found that the CME bitcoin futures market was consistently highly correlated with the spot bitcoin market for the past 2.5 years.[32] The Commission also concluded that prices generally moved in close alignment between the spot bitcoin market and the CME futures bitcoin market.[33] As a result, because the CME's surveillance could, in the Commission's view, assist in detecting the impact of fraud and manipulation on CME bitcoin futures prices, the Exchanges' so-called comprehensive surveillance-sharing agreement with the CME could "be reasonably expected to assist in surveilling for fraudulent and manipulative acts and practices in the specific context of the Proposals."[34] On this basis, the Commission approved the spot bitcoin ETPs.

This basis for approval was problematic in a number of critical respects, and the analysis should not be employed in the context of the proposed rule changes here. The analysis was flawed, and even assuming that the Commission's price correlation findings applied to the ether futures and spot markets, they do not establish that the market for ether futures contracts would reliably detect manipulation in the spot ether market.

First, the Commission's correlation analysis was incomplete. It relied on a "subset" of selected spot bitcoin markets to examine the relationship between prices in the CME bitcoin futures market and the spot bitcoin market. The Commission did not explain—and we submit cannot explain or justify—why a subset was representative of the entirety of the spot markets worldwide. Even a perfect correlation with incomplete data cannot be deemed sufficient.[35] Reliance on a similarly incomplete analysis in the ether context would yield similarly unreliable results.

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30 *Id.*
31 https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf, at 10.
32 *Id.* at 9.
33 *Id.*
34 *Id.* at 10.
35 Crenshaw, *Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products.*

Second, the fact that prices between the spot bitcoin market and CME bitcoin futures market generally move in close alignment does not account for the times when the prices are not aligned.[36] In other words, it is not clear why the prices generally moving in alignment means that fraud that impacts prices in the spot bitcoin market would similarly impact prices in the CME bitcoin futures market. Thus, the entire premise that price correlation leads to reliable detection of manipulation is fatally flawed.

Finally, the fact that two variables are correlated in the past does not mean they will continue to be correlated in the future. As noted above, if the ether spot market does not already overwhelm the ether futures market, it soon will if the Proposals are approved. In short, surveilling the futures market to identify misconduct in the spot market is almost certainly impossible now and will soon be decidedly impossible if trading in the spot ether ETPs is approved.[37]

In any event, even accepting the analysis that the Commission used to approve the spot bitcoin ETPs, the Exchanges have not submitted an analysis sufficiently similar to the correlation analysis that the Commission used to support the approval of the spot bitcoin ETPs to justify approving the proposed rule changes regarding spot ether ETPs on the same basis. Although Cboe asserts that its "research indicates that daily correlation between the Spot ETH and CME ETH Futures . . . was over 99.88%,"[38] the Commission stated in the spot bitcoin ETP approval order that "calculating correlation using only *daily* price observations provides no information on how prices in the two markets are associated—if at all—*throughout* the trading day."[39] As a result, there is no surveillance-sharing agreement that could reasonably be expected to assist in surveilling for fraudulent and manipulative acts and practices in the spot ether market. The Commission must find that the proposed rule changes do not satisfy the statutory standard and deny them.

Approval Would Also Violate the Statutory Public Interest Standard.

Exchange Act Section 6(b)(5) plainly provides that the rules of an exchange must be designed not only to "prevent fraudulent and manipulative acts and practices" but also to "protect investors and the public interest." As with the spot bitcoin ETPs, the spot ether ETPs utterly fail this test.

Approving the proposed rule changes would subject investors to the very risk of harm that the SEC exists to prevent. It would further expose investors to an industry rife with fraud and manipulation. Yet the crypto industry would be able to claim that the SEC has endorsed its products, a pattern we are already seeing regarding the SEC's improvident approval of a spot bitcoin ETP. The industry would also be able to hide behind the veneer of a well-known, trusted vehicle due to the claims and reporting that the SEC approved an ETF rather than an ETP. The involvement and legitimacy of traditional financial firms would only exacerbate the situation. At

36 *Id.*
37 *Id.*
38 88 Fed. Reg. at 66,521.
39 https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf, at 7 n.30 (emphasis in original).

best, investors will be lulled into a false and misleading sense of comfort and, at worst, intentionally misled. Yet the value of their investment will be subject to the same risks of fraud and manipulation in the ether market as investors who hold ether directly. A wave of investor harm is sure to follow.

Conclusion

We hope these comments are helpful as the Commission considers these matters.

Sincerely,

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