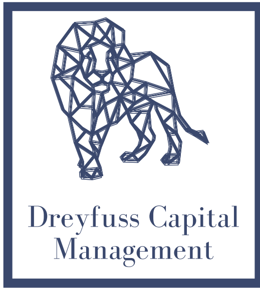


Converting Grayscale Bitcoin Trust into spot Bitcoin ETF

From: Dreyfuss Capital Management
To: Securities Exchange Commission

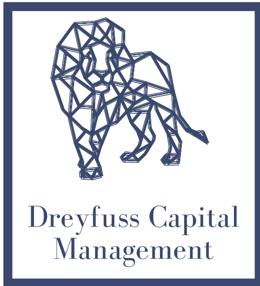
Thank you for taking the time to review my comments. First, I'd like to say that as an investment advisor, I am proud that the SEC and government regulatory authorities are careful and diligent in performing their work and safeguarding investor assets. Recently, an application was filed by the Grayscale Bitcoin Trust to convert to a spot Bitcoin ETF. I would like to offer my thoughts as to why approval is prudent and in the best interest of investors.

If I understand correctly, the SEC is concerned over volatility and manipulation in the spot Bitcoin market and how this affects investors ability to safely participate. Manipulation schemes such as spoofing and frontrunning can hurt the average investor and put their assets and financial futures at risk. Frankly, one would find great difficulty in claiming that the spot Bitcoin market is free of manipulation. There are great exchanges that don't allow margin and shorting which can reduce this issue, but there are many crypto exchanges that do offer these options and this can lead to speculative froth and outright manipulation. If a spot Bitcoin ETF were approved, that would allow institutional traders a more robust liquid market and more tools to manipulate the spot market. Another argument proposed is that Bitcoin is more a commodity than it is a security, and the SEC should only have purview over ETFs that hold securities, such as futures where the SEC has regulatory authority over the underlying asset's market.

The argument to allow a spot Bitcoin ETF acknowledges the fact that the Bitcoin markets are oft manipulated. At the same time, there are few investment markets that don't suffer from some sort of manipulation. In Section 703 of the Sarbanes-Oxley Act from 2002 it was found that between 1998-2001. 1,596 securities professionals were found to have aided and abetted violations of and/or violated the Federal securities laws in actions brought by the SEC. During the Great Recession, the Investment Company Act of 1940 did not prevent nor prosecute many large financial institutions from bundling sub-prime loans with investment grade loans and reselling them in packages under fraudulent pretenses. J.P. Morgan Chase has been fined billions of dollars in three separate cases of market manipulations involving Libor and the precious metals markets using the same tactics used in the spot Bitcoin market.

Even though all this is true, it doesn't necessarily mean that the SEC should approve and open a new market for manipulation. One could easily argue that given all the current manipulation in markets that the SEC can and should prevent the opening of new markets to these nefarious actors. While this argument is certainly not considering free market theory and may be compelling in a news soundbite, it lacks coherence on several levels in proper context.

First, as we mentioned before, J.P. Morgan was fined almost one billion dollars in 2020 for manipulating the futures markets by spoofing orders for precious metals. Yet, the SEC approved applications to establish futures based Bitcoin ETFs. If manipulation was of concern, and the argument of the SEC was to not expand new markets to predatory practices, then surely a futures based ETF would not be approved as futures markets are rife with manipulation. If the argument to not approve is due to the SEC not having the regulatory authority over the Bitcoin spot market, as this authority falls to the CFTC, then it is quite hard to understand how spot commodities based ETFs like GLD and SLV are approved. If the SEC doesn't have regulatory authority over commodity spot markets, how are these ETFs approved?



Converting GBTC into a spot Bitcoin ETF

It would seem that the SEC argument must be two-fold. Commodity spot markets are already manipulated, and since the Bitcoin spot market has no deliverable underlying asset like GLD and other commodity ETFs, the SEC needs to be more diligent than with other commodities. This argument is based on the assumption that regular commodity based ETFs have deliverable underlying assets. However, this argument falls flat as well. Looking into the prospectus of gold and silver based ETFs like GLD and SLV, it clearly states they are not required to hold physical gold and silver as underlying assets. Rather, they hold a fractional share of these physical assets, and the remainder of shareholder value is held in derivatives contracts. Therefore, theoretically it is possible that two investors could come to redeem the same share of actual bullion if there were to be a "run on the fund." In this case, an investor would be better protected by mandating that the fund hold the underlying asset as opposed to a derivative. Paradoxically, having futures based commodity ETFs actually makes derivatives markets more liquid and easy to manipulate than spot markets. If a institution wanted to corner the market in a commodity, they would have to source that commodity from many different vendors. Using a liquid derivatives/futures market, they are able to freely speculate in and manipulate a centralized marketplace that is primarily used by traders, and doesn't require the infrastructure to receive or deliver any actual assets. Roughly 60% of spot Bitcoins are held by long term investors, not traders gaming the market.

In summary, we have established the following:

- Derivatives markets suffer from the same type of manipulation as spot markets.
- Commodity ETFs that hold the underlying commodity as their NAV are already approved.
- Commodity ETFs would better protect investors from manipulation if they require that the totality (or close to it) of NAV be held in the underlying commodity as is generally found with equity based ETFs.
- Creating liquidity in derivatives markets while restricting liquidity in spot markets can encourage manipulation by giving liquidity to a market dominated by traders, rather than prevent manipulation.

In conclusion, the SEC can and should protect investors from predatory market participants. While the spot Bitcoin markets do suffer from manipulation, increasing the liquidity of such markets would actually reduce the influence of predatory forces by encouraging long term ownership across a broader spectrum of investors. Corporations seeking to diversify their balance sheets are likely to be long term buy and hold investors. This will reduce the power of "Bitcoin whales" to sway markets. It will also drive liquidity away from derivatives markets, which are primarily used by professional traders as opposed to investors seeking long term exposure. Mandating that spot Bitcoin ETFs only work with exchanges that and are US based and restrict shorting and leverage could encourage better governance in the spot market and protect investors. The SEC should work together with other regulatory bodies, like with other commodity ETFs, to ensure that investors are protected and ETFs that claim to hold an underlying commodity, whether Bitcoin, gold et cetera., are supervised and regulated. This will only help investors who are likely to grow their alternative assets holdings and would like a government body to protect them while doing so.

Thank you for your time,
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