

What Do the SEC's Recent Bitcoin Disapproval Orders Really Mean for Investors?

Regulators responded to a narrow question about trading bitcoin-based securities, with orders that should not limit innovation in bitcoin technologies.

On March 10, 2017, the US Securities and Exchange Commission (SEC) issued an order (the BZX Order) disapproving a rule change that Bats BZX Exchange (BZX) had proposed to list and trade shares issued by the Winklevoss Bitcoin Trust.¹ On March 28, 2017, the SEC issued another order (the NYSE Arca Order, together with the BZX Order, the Orders) disapproving a rule change that NYSE Arca had proposed to list and trade shares of the SolidX Bitcoin Trust.² The Orders do not allow securities with bitcoin as the underlying asset to be traded on a national securities exchange because of the SEC's concern that bitcoin markets are unregulated and susceptible to manipulation. Importantly, the Orders do not impact trading in bitcoin, but only the proposed trading in instruments that would be securities on national securities exchanges with underlying assets in bitcoin. The Orders do not break the SEC's silence to date on its specific views of bitcoin and other cryptocurrencies as securities, and the Orders do not otherwise affect cryptocurrencies, blockchain and distributed ledger technology, or any of their respective applications.

Background

The facts underlying the proposed rule changes which BZX and NYSE Arca filed are substantially similar. BZX and NYSE Arca each filed a proposal to change its rulebook in 2016 to permit the listing and trading of a bitcoin trust.³ Each trust planned to hold bitcoins as its only or primary underlying asset. The trusts planned to issue and redeem the shares to authorized participants.⁴ The investment objective of the trusts would be for the shares to track the price of bitcoins traded on a separate bitcoin exchange (in the case of BZX's proposal) or the price of bitcoins as measured by TradeBlock XB index (in the case of NYSE Arca's proposal), which represents the value of one bitcoin in US dollars drawing on bitcoin trading data from constituent bitcoin exchanges.⁵ In connection with its proposal, BZX entered into a surveillance-sharing agreement with the separate bitcoin exchange.⁶

The SEC disapproved both proposed rule changes because regulators did not find the proposals to be consistent with Section 6(b)(5) of the Securities Exchange Act of 1934 (the Exchange Act), which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest.⁷ The SEC's disapproval analysis focused principally on potential fraudulent and manipulative acts and practices relating to bitcoin trading, either in the spot market or in the bitcoin derivatives market, and whether BZX or NYSE Arca would be able to surveil and detect such fraudulent and manipulative

practices that could affect the value of the trust shares to be traded if BZX or NYSE Arca were approved to list such shares.

Recognizing that the proposals were similar to many past proposed rule changes to list and trade shares of exchange-traded products (ETPs) holding commodities, such as precious metals, the SEC examined the proposals under the standards it has applied to previous commodity-trust ETPs.⁸ A key consideration in determining whether to approve or disapprove a commodity-trust ETP in prior filings was the susceptibility of the shares or the underlying asset to manipulation. In that regard, the SEC considered (i) whether comprehensive surveillance-sharing agreements are in place with significant markets for the underlying asset or derivatives on the underlying asset, and (ii) whether these significant markets are regulated.⁹

The SEC found that BZX did not have comprehensive surveillance-sharing agreements with significant, regulated markets for trading the underlying commodity, *i.e.*, bitcoin, or derivatives on bitcoin. First, the SEC found that BZX did not demonstrate that the separate bitcoin exchange with which it had a surveillance arrangement was a significant market for bitcoin; rather, commenters indicated that significant markets for bitcoin reside outside of the US, such as in China. Second, the SEC noted that the significant markets for bitcoin are currently unregulated.¹⁰ Similarly, the SEC found that NYSE Arca had not entered into a surveillance-sharing agreement with a significant, regulated, bitcoin-related market and that the significant markets for bitcoin or derivatives on bitcoin are not regulated markets with which NYSE Arca can enter into a surveillance-sharing agreement.¹¹

In both Orders, the SEC rejected the argument that the underlying market for bitcoin is not susceptible to manipulation. Nor was the SEC persuaded that the unique properties of bitcoin and the bitcoin market are so different from the properties of other commodities and commodity futures markets as to justify a significant departure from the precedents of other commodity trust ETPs.¹² In addition, the SEC disagreed that regulation of trading in the bitcoin trust shares would be a sufficient and acceptable substitute for regulation of the underlying spot or derivatives markets related to bitcoin. The SEC viewed the surveillance procedures proposed by both BZX and NYSE Arca as insufficient because no surveillance-sharing agreements exist with significant, regulated markets for trading bitcoin or derivatives on bitcoin.¹³

Based on the foregoing factors, the SEC found that the proposed rule changes were inconsistent with the requirements of Section 6(b)(5) of the Exchange Act.

BZX's Subsequent Petition for Review

Pursuant to the SEC's Rules of Practice, BZX and NYSE Arca can seek Commission review of the Orders by filing a written notice of intention to petition for review within a specified period. On March 17, 2017, BZX submitted a written notice of its intent to petition for review of the BZX Order.¹⁴ On March 24, 2017, BZX submitted its petition for review.¹⁵ This effectively stays the BZX Order until the Commission orders otherwise.¹⁶ In conducting its review, the SEC has the authority to affirm, reverse, modify, set aside, or remand the initial BZX Order, which was made by the SEC's Division of Trading and Markets pursuant to delegated authority.¹⁷

What Do the Disapproval Orders Mean for Cryptocurrencies and Blockchain Technology?

- The scope of the Orders is limited to the ability of BZX and NYSE Arca to list the proposed bitcoin trust shares for trading. Although the Orders discuss bitcoin, and to some degree the unique properties of bitcoin and the underlying bitcoin market, the disapprovals of listing and trading bitcoin trust shares do not implicate the use of blockchain, the technology underlying bitcoin, in bitcoin or

other circumstances. To date, the SEC has not expressed any specific view or issued guidance on its regulation of bitcoin and other cryptocurrencies as securities, or on blockchain or distributed ledger technology, or on their use cases in the financial services industry and markets.

- Similarly, although the Orders discuss bitcoin as a “digital asset” or “commodity,” the Orders do not address the question of whether bitcoin is a “security.” Because the issue considered in the Orders concerns whether the listing exchange, *i.e.*, BZX or NYSE Arca, has the ability to detect fraud and manipulation in trading bitcoin trust shares through establishing comprehensive surveillance-sharing agreements with significant, regulated markets, the Orders did not need to decide whether bitcoin is a security. In fact, the government’s view of cryptocurrencies continues to evolve. In recent enforcement actions, the US Commodity Futures Trading Commission (CFTC) has adopted the view that bitcoin and other cryptocurrencies are commodities,¹⁸ while the Internal Revenue Service has declared that bitcoin and other cryptocurrencies should be taxed like property.
- The Orders disallow bitcoin trust shares from being listed for trading on a national securities exchange until significant bitcoin markets or derivatives markets on bitcoin are subject to regulation consistent with those regulatory principles applicable to national securities exchanges or derivatives markets for detecting and deterring manipulation. Whether the SEC will issue an order consistent with the original BZX Order issued by its Division of Trading and Markets remains to be seen.
- Although the Orders stymied the listing of two specific bitcoin-related securities products for trading on national securities exchanges, the Orders should not impede innovation in cryptocurrencies given their limited scope. How cryptocurrencies and related instruments will continue to evolve to become widely-traded investment products, and how regulated derivatives markets on cryptocurrencies may develop, remains to be seen.

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Endnotes

- ¹ See Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust (March 10, 2017), *available at*: <https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf>.
- ² See Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1, Relating to the Listing and Trading of Shares of the SolidX Bitcoin Trust under NYSE Arca Equities Rule 8.201 (March 28, 2017), *available at*: <https://www.sec.gov/rules/sro/nysearca/2017/34-80319.pdf>.
- ³ See BZX Order, *supra* note 1, at p. 2 and NYSE Arca Order, *id.*, at p. 2.
- ⁴ See BZX Order, *id.* at p. 3 and NYSE Arca Order, *id.* at p. 4.
- ⁵ See BZX Order, *id.* at p. 4 and NYSE Arca Order, *id.* at pp. 3-4.
- ⁶ See BZX Order, *id.* at p. 4.
- ⁷ See BZX Order, *id.* at pp. 19-20 and NYSE Arca Order, *supra* note 2, at pp. 23-24.
- ⁸ See BZX Order, *id.* at p. 20 and NYSE Arca Order, *id.* at 24.
- ⁹ See BZX Order, *id.* at pp. 20-36 and NYSE Arca Order, *id.* at pp. 24-43.
- ¹⁰ See BZX Order, *id.* at p. 37.
- ¹¹ See NYSE Arca Order, *supra* note 2, at p. 44.
- ¹² See BZX Order, *supra* note 1, at pp. 29-30 and NYSE Arca Order, *id.* at 34-37.
- ¹³ See BZX Order, *id.* at pp. 26-27 and NYSE Arca Order, *id.* at pp. 41-42.
- ¹⁴ See Notice of Intention to Petition for Review of Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust; Exchange Act Release No. 80206, File No. SR-BatsBZX-2016-30 (March 20, 2017), *available at* <https://www.sec.gov/rules/sro/batsbzx/2017/batsbzx-petitionforreview.pdf>.
- ¹⁵ See In the Matter of the Petition of Bats BZX Exchange, Inc., File No. SR-BatsBZX-2016-30, Petition for Review (March 24, 2017), *available at* <https://www.sec.gov/rules/sro/batsbzx/2017/petition-for-review-sr-batsbzx-2016-30.pdf>.
- ¹⁶ See Rule 431(e) of SEC's Rules of Practice, 17 CFR 201.431(e).
- ¹⁷ See Rule 431(a) of the SEC's Rules of Practice, 17 CFR 201.431(a).
- ¹⁸ *In re Coinflip, Inc., d/b/a/ Derivabit, et al.*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 15-29 (Sept. 17, 2015), *available at* <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf> (Derivabit Order). For further discussion, please refer to our *Client Alert* regarding the Derivabit Order: Cryptocurrencies Are Commodities: CFTC's First Bitcoin Enforcement Action, *Client Alert* No. 1874 (Sept. 21, 2015), *available at* <https://www.lw.com/thoughtLeadership/LW-CFTC-first-bitcoin-enforcement-action>.