<u>Response to SEC Questions Regarding Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Winklevoss Bitcoin Shares Issued by the Winklevoss Bitcoin Trust, File Number SR-BatsBZX-2016-30</u>

We agree with some of the commenters' uncertainties regarding the proposed Winklevoss Bitcoin Trust ETF and the risks, resiliency, quality and reliability of Bitcoins/cryptocurrencies as an underlying asset for an ETF. We are, along with others, also concerned about the long-term viability of Bitcoins/cryptocurrencies.

Unlike other ETF underlying assets, there are no real assurances Bitcoins will exist in the future or whether they had any actual value when created (in fact, there was a lengthy debate as to whom created the theory to begin the mining of Bitcoins in the first place[1]). This cryptocurrency is 'mined' by computer programmers and has no backing from any authoritative financial source or government. It seems rather unusual that Bitcoin was used for transactions for years without knowledge of the creator and the miners of the crypto-technology.

The cryptocurrency has experienced extraordinary volatility and substantial risk from computer-generated hacking. If there is an ETF based on Bitcoin and there is a major security incident, it will disrupt investors in Bitcoin and have an immediate impact in the world of cryptocurrency ETFs, disrupting those investors as well.

Cryptocurrency is relatively new and no one appears to be a true expert in the field. The mere concept that Bitcoins are somehow 'mined' from a computer program and the risks/problems that have already been exposed create several important issues that have not been fully analyzed and are not clearly understood.

A Cryptocurrency ETF

The mechanics of current U.S. exchange traded products bring serious additional questions to the table as to how this ETF and other potential exchange traded products based on cryptocurrencies would operate.[2] Hopefully these questions can be easily answered by those intimately involved with Bitcoins.

ETF share creation/redemption through purchases and sales of assets underlying ETFs are the sole responsibility of Authorized Participants. Generally, as in this proposal, there is a creation/redemption unit level of 50 thousand shares that Authorized Participants must use in

[1] Washington Post article, *12 questions about Bitcoin you were too embarrassed to ask*, Timothy B. Lee, November 19, 2013 https://www.washingtonpost.com/news/the-switch/wp/2013/11/19/12-questions-you-were-too-embarrassed-to-ask-about-bitcoin/
Time article, *The One Big Reason Why It Matters Who Invented Bitcoin*, Alex Fitzpatrick, December 9, 2015 Updated May 2, 2016, http://time.com/4142523/bitcoin-inventor-satoshi-nakamoto-craig-wright/

[2] See our previous comments to the SEC, including: *Response to SEC Questions Regarding Exchange Traded Products, File Number S7-11-15*, August 14, 2015 http://www.sec.gov/comments/s7-11-15/s71115-19.pdf , *Response to SEC Questions Regarding 'Open-End Fund Liquidity Risk Management Programs' File Number S7-16-15*, January 13, 2016 https://www.sec.gov/comments/s7-16-15/s71615-60.pdf, and *Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies File Number S7-24-15*, March 28, 2016 https://www.sec.gov/comments/s7-24-15/s72415-111.pdf

order to create or redeem shares of an ETF. The creation/redemption baskets for the Winklevoss Bitcoin Trust have recently been requested to be reduced to 10 thousand shares.[3]

Authorized Participants are not required to create or redeem shares of an ETF. Neither the Authorized Participants nor the ETF operators have a regulatory mandate to ensure that underlying assets are created and redeemed in response to the trading in the marketplace.[4] This is a fatal flaw in ETFs, i.e. none of the firms involved with ETFs have any obligation to create shares of an ETF which results in the purchase of underlying assets.[5]

Because of this design flaw, the ETF trading in the marketplace can be disconnected from the creation/redemption process. The Authorized Participants can create a shadow portfolio for the ETF, interjecting themselves as the central counterparty between purchasers and sellers of the ETF shares and internalize synthetic positions that are a derivative of the ETF (in essence, acting as if they were the issuer). This can be accomplished primarily through short sales, but also through other means that result in the Authorized Participants' clearing firm amassing highly leveraged positions that are undisclosed to regulators and other market participants.[6]

The proposed Bitcoin-based ETF contains the same fatal flaw that is found in the makeup of ETFs, i.e. ***no one is actually required*** to create/redeem underlying assets. We consider this flaw very relevant in the Bitcoin marketplace, because Bitcoins can become, in essence, monopoly money (an underlying ETF asset that is not backed by legitimate currency, stocks, bonds, commodities or even supported by swap agreements guaranteed by international banks). When an ETF has not purchased underlying assets in accordance with marketplace activity, under stressed market conditions and heavy redemption requests (i.e. a run on the bank that could be fueled by synthetic positions), its' assets may be quickly depleted and it would not be able to fulfill its' redemption obligations.

Due to the anonymity and lack of regulation, Bitcoin has been heavily used for illegal activity.[7] If something illegal occurs within the ETF and there is a public regulatory action against it or its' operators, could this adversely affect the underlying cryptocurrency? We question what will happen to a Bitcoin-based ETF and its' investors if financial participants lose trust in Bitcoin or other cryptocurrency operations and refuse to redeem/exchange them for

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[3] The Winklevoss Bitcoin Trust's S-1/A filed October 18, 2016 and Bats BZX Exchange, Inc. Amendment to the proposal dated October 28, 2016 states the creation/redemption baskets will consist of 10,000 shares.

[4] BlackRock, the largest global ETF operator by assets under management, explained the contractual requirements/obligations of Authorized Participants to the ETF: "Authorized Participants are not agents of the ETF – they are ***not required to create or redeem ETF shares under any circumstances***, and **only do so when it is in *their interest***." BlackRock Letter to the SEC Re: Exchange-Traded Products, Release No. 34-75165; File No. S7-11-15, Page 3, August 11, 2015 http://www.sec.gov/comments/s7-11-15/s71115-10.pdf

[5] These relationships are structured through the agreements between the ETF and the Authorized Participants. However, the agreements do not supercede federal securities laws, rules and regulations nor industry rules and standards of practice. In other words, if the ETF operators', their agents' and/or Authorized Participants' activity results in misrepresentation or fraud in the market, they are still liable for their behavior.

[6] *Follow-Up Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies, File Number S7-24-15*, April 11, 2016 https://www.sec.gov/comments/s7-24-15/s72415-192.pdf

[7] MIT Technology Review, *Bitcoin's Dark Side Could Get Darker,* Tom Simonite, August 13, 2015 https://www.technologyreview.com/s/540151/bitcoins-dark-side-could-get-darker/
Bloomberg article, *Are Bitcoins the Criminal's Best Friend?*, Stephen Mihm, November 18, 2013 https://www.bloomberg.com/view/articles/2013-11-18/are-bitcoins-the-criminal-s-best-friend-

genuine currency? Given that the proposed ETF may add the appearance of legitimacy to Bitcoin, will this cause other cryptocurrencies/ETFs based on them to enter the marketplace? Would an ETF environment provide legitimacy to a cryptocurrency that can be used extensively for criminal operations?

Blockchain Accounting for Bitcoins/Cryptocurrencies

The purpose of Blockchain is to maintain transparency for each and every transaction (i.e. a continuous type of audit trail though the counterparties remain anonymous). While the Blockchain accounting for typical owners of Bitcoin is fairly straightforward, an ETF would become an owner of the cryptocurrency (a Blockchain customer), but with the addition of secondary market trading activity. The underlying assets of cryptocurrency ETFs may potentially be significantly impacted by ETF purchases and sales. Should the Blockchain audit trail account for short sales, securities lending and other transactions of the ETF?

Below are a few questions regarding a Bitcoin ETF and its' relationship to Blockchain[8] accounting:

- What is the mechanism to inform the Blockchain accounting system of synthetic Bitcoin positions that are created by Authorized Participants in a secondary market (internalized to the clearing firm) outside of the ETF's portfolio of Bitcoins and not yet resulting in purchases or sales?
- How are short sales resulting in synthetic shares of the ETF that investors trade, which are supposed to generate a purchase of Bitcoins by the ETF (a virtual 'IOU' from a clearing firm to the investor), accounted for within the Blockchain audit system?
- If a cryptocurrency ETF is illiquid and there is not enough trading to effectively create baskets large enough to cause a creation/redemption, there is a natural lag time between the secondary market trading and the creation/redemption process. How is this lag to be accounted for in the Blockchain, which appears to be intended to provide instant accounting transparency?
- Like other ETFs, will this Bitcoin-based ETF be traded in the options and futures markets that can further create additional synthetic positions? If so, how are these to be accounted for within the Blockchain environment? How will the accounting system be notified of these transactions?
- If large synthetic positions are created from the ETF, could these positions be a risk that jeopardizes the cryptocurrency itself?
- Will there be a structure for securities lending in the secondary ETF market, which may/will create collateral and liability risks? How will these transactions be accounted for in the Blockchain? What will be the mechanics of notifications of securities lending activities from the clearing firms to the Blockchain accounting ledgers? If these transactions are not accounted for, does securities lending cause the Blockchain ledger to be inaccurate and therefore defeat its' purpose of instantaneous execution and settlement of transactions?

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[8] Blockchain has been described by IBM http://www.ibm.com/blockchain/what_is_blockchain.html and the Wall Street Journal *CIO Explainer: What Is Blockchain?*, Steven Norton, February 2, 2016 http://blogs.wsj.com/cio/2016/02/02/cio-explainer-what-is-blockchain/

- How will Blockchain account for secondary market activity which is based on share entitlements, versus contractual settlement which is the theoretical goal of Blockchain accounting? In the Blockchain system, will there be disclosure of contractual settlement of the securities, transparency of securities lending, a commitment for future delivery and ultimately a notification of actual delivery of the security? In other words, how will the chain of ownership be recorded and disclosed?
- How will the gatekeepers of the ETF (the auditors and management) monitor all the various aspects in the trading of the ETF and the activity of the underlying to make sure they are all being accounted for correctly within the Blockchain environment?

Conclusion

The SEC has been wise in its' very careful consideration of sanctioning an ETF based on a cryptocurrency.

We believe the above concerns and others raised by a number of commenters shows there are substantially more questions to be answered before one publicly traded investment vehicle is created (with potential for many derivative products in the future) based on what may be considered essentially 'monopoly money'.