

Securities and Exchange Commission
100 F St. N.E.
Washington, DC 20549-1090

Re: Order Scheduling Filing of Statements on Review for an Order of Disapproval of Proposed Rule Change To List and Trade the Shares of Bitwise Bitcoin ETF Trust published

Commissioners,

In accordance with the notice [Order Scheduling Filing of Statements on Review for an Order of Disapproval of Proposed Rule Change To List and Trade the Shares of Bitwise Bitcoin ETF Trust](#) published on November 18, 2019, I would like to submit the following comments as it relates to [File No. SR-NYSEArca-2019-01 \(Proposal to List and Trade Shares of the Bitwise Bitcoin ETF Trust Under NYSE Arca Rule 8.201-E\)](#):

The first and foremost mandate of the Securities and Exchange Commission (SEC) is to protect retail investors. yet the reticence to approve a Bitcoin exchange-traded fund has unintentionally funneled individual investors into an inefficient alternative vehicle where value is being siphoned away by more sophisticated institutional investors.

Grayscale Investments, a subsidiary of the crypto-conglomerate Digital Currency Group (DCG), has methodically amassed AUM of ~\$2.6bn (as of 10/31/19) and claimed the title of world's largest cryptocurrency asset manager. While many factors have contributed to the firm's success, not the least of which is launching in 2013 before much of the world had even heard of Bitcoin, there is one factor that stands out: **arbitrage**. Grayscale's early lead amongst passive crypto asset managers is in large part due to:

- *Regulatory arbitrage*: choosing compliance with the lower standards of FINRA-regulated OTC markets rather than being captive to the SEC's indeterminable timeline for approval of crypto ETFs
- *Embracing institutional arbitrage flows*: trading activity in the Grayscale Bitcoin Trust (ticker: GBTC) indicates that a material amount of inflow is likely tied to institutions profiting from the market price premium to NAV in a hedged (risk-neutral) fashion, most often at the expense of retail investors

To its credit, GBTC was the first 'traditional' investment vehicle (loosely defined as brokerage account accessible) in the US providing average retail investors the opportunity to participate in the wealth creation event that is Bitcoin. But the cryptocurrency investment market has evolved: Bitcoin is ubiquitous, liquid derivatives markets exist, insured custody solutions are abundant, and exchanges are becoming regulated, all of which should open the door for a Bitcoin ETF. Retail investment dollars follow the path of least resistance which still leads to GBTC; the most

important reason a Bitcoin ETF needs to be approved is to protect retail investors from themselves.

OTC vs. ETF: Regulatory Arbitrage in Action

Presumably, the decision by Grayscale to structure their investment products *not* as exchange-traded funds (ETFs) but rather Trusts was strategic: ETFs require Securities and Exchange Commission (SEC) approval and registration, while Trusts are unregistered investment vehicles that can still be freely tradeable as over-the-counter (OTC) securities. Primary issuance at the net asset value (NAV) of Grayscale Trusts is only available to accredited investors and subject to a one-year holding period, however the publicly-quoted OTC shares of the Trusts are available to everyone at a market price. The requirements for OTC public-listing involve partnering with a market maker to file [Form 211](#) which needs to be approved by the Financial Industry Regulatory Authority (FINRA), but generally speaking the bar for becoming one of the 10,000+ OTC securities is rather low. And once listed on one of the [OTC Markets Group Inc.](#) venues (OTCQX, OTCQB and Pink markets) the Grayscale products can be bought and sold at all the most popular retail brokerages — the accredited investor qualifier is instantly lifted and they can even be held in tax-advantaged accounts such as IRAs and 401(k)s. In March 2015 Grayscale chose Merriman Capital, Inc. as the Designated Advisor for Disclosure for listing GBTC on the OTCQX marketplace. As an aside, it's worth noting that Merriman Capital was [expelled from the Securities Industry by FINRA](#) in January 2017, an action that would presumably cause concern for Grayscale in regards to the [“Bad Actor” Disqualification provision](#) associated with their reliance on Rule 506(c) of Regulation D.

Where you can find GBTC

Invest in GBTC today at any of the following brokerage firms:



Source: <https://dropgold.com/what-is-gbtc-and-how-do-i-invest-in-bitcoin/>

The strategy has paid off — currently there are no US-listed Bitcoin ETFs in existence and GBTC is a \$2.5bn product. In fact, the SEC has rejected (or requested a withdrawal of) over a dozen Bitcoin ETF applications while FINRA recently approved the listing of Grayscale's [fourth publicly-quoted investment product](#). The Bitcoin ETF applications varied in fund structure, running the gamut of physically-backed to futures-based and levered, and their sponsors included reputable, incumbent capital markets and asset management firms such as NYSE, CBOE, Bats, VanEck, and Invesco. The Winklevoss brothers had the esteemed pleasure of their BTC ETF proposal being denied by the SEC twice. And while prospective crypto ETF issuers have been battling unsuccessfully just to get off the ground, Grayscale is seeing record inflow...

Last month Grayscale released its [Q3 2019 report](#) highlighting record asset gathering. And during the short window from Oct. 8th — 22nd in which GBTC was open to the private placement of new shares it saw another ~\$200mm of inflow despite a broad market selloff during that time. The Q3 report notes that institutions, particularly hedge funds, continue to be the dominant driver of asset gathering and were responsible for 84% of the inflow last quarter. Naturally, news headlines tend to make the triumphant claim that institutional adoption of cryptocurrency has arrived.



CNBC

Crypto investment firm Grayscale rakes in \$330 million this year despite bitcoin bear market



Business Insider

Hedge funds pumped more than \$200 million into a family of crypto funds last quarter



Barron's

New Cryptocurrency Fund Finds a Side Door Into Your Brokerage Account



The Block

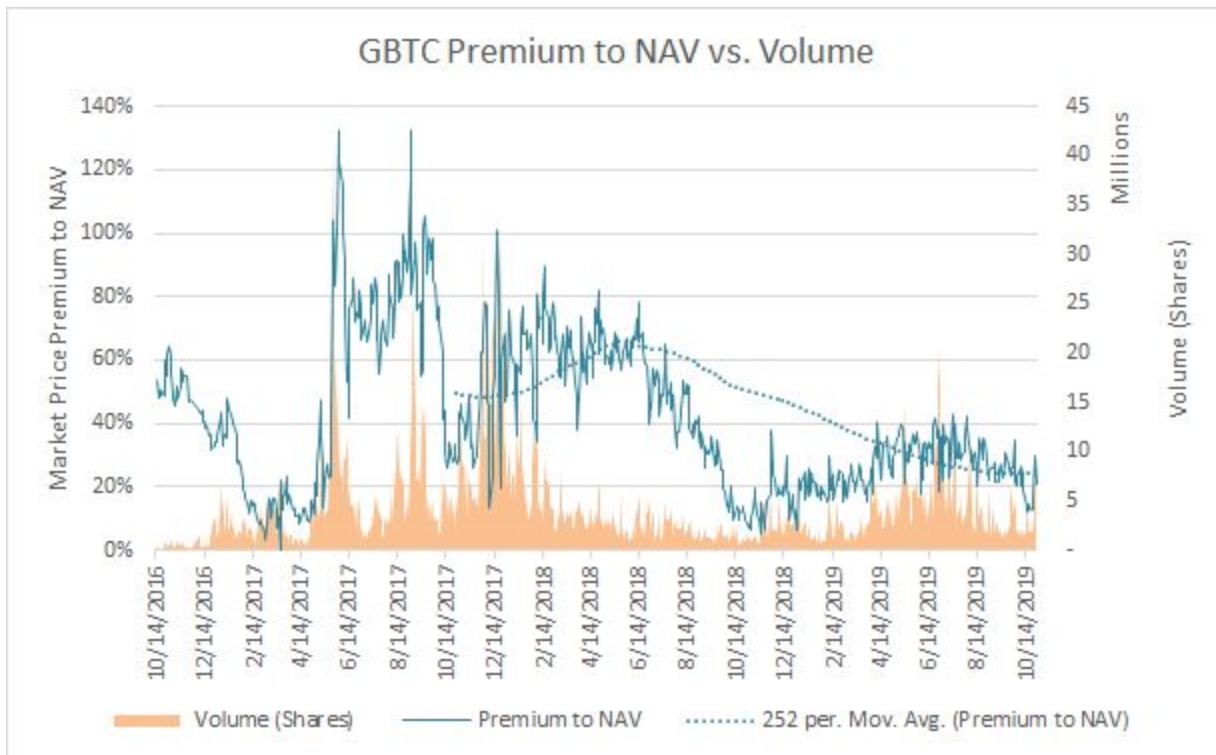
Grayscale Sees Record Q3, Hitting More Than \$400M in Inflows Over the Past Year

Source: <https://grayscale.co/>

However, one would be hard pressed to find an institution (especially a hedge fund) that uses high-fee products with extended lock-up periods that trade at wild deviations from their net asset values as a means of establishing a long position, especially when that exposure (in the case of Bitcoin) is readily available in liquid spot and regulated futures markets. Although, those conditions are exactly what hedge funds and market makers look for when implementing arbitrage strategies. Analyzing the trading activity in GBTC indicates that a material amount of inflow is likely tied to institutions profiting from the market price premium to NAV in a hedged (risk-neutral) fashion, most often at the expense of retail investors.

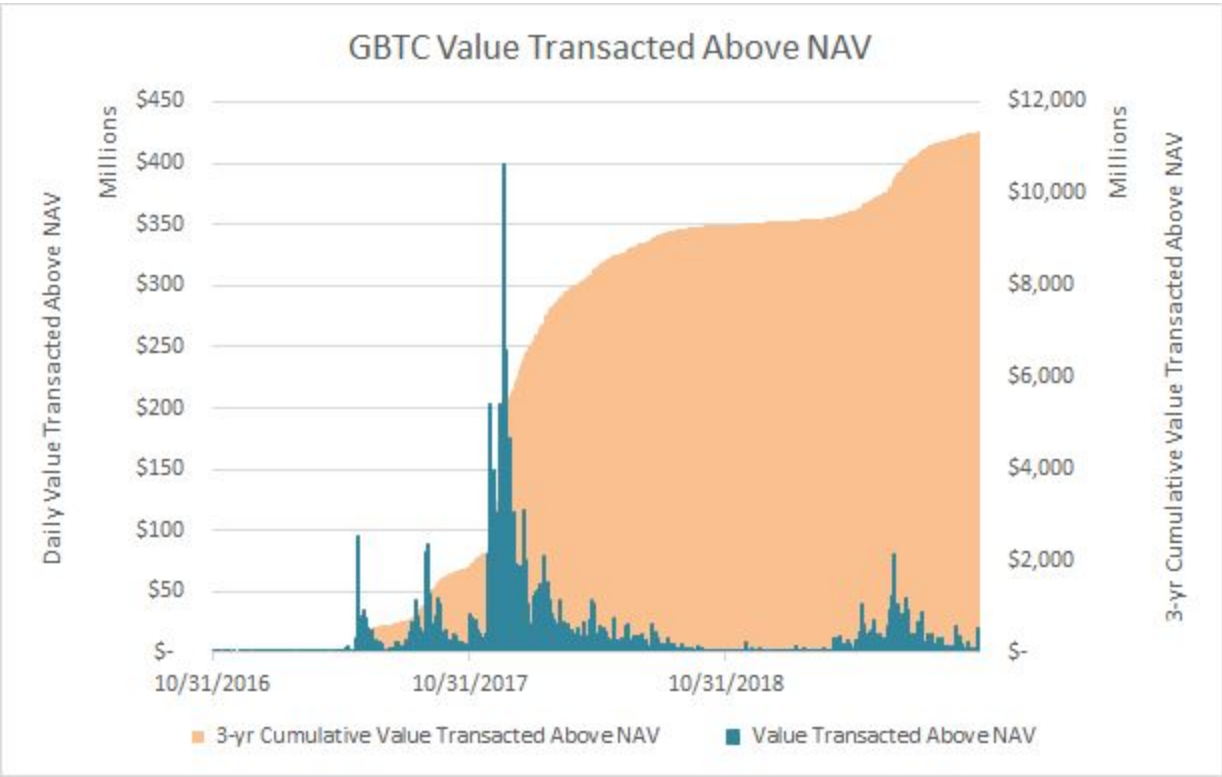
Two Sides to Every Trade

It's no secret that the market price for GBTC trades at a wild premium to its NAV. The trailing twelve month (TTM) average premium to NAV is 25%, which is a marked improvement from the 50% TTM average premium as of October 2018. What's less talked about is how GBTC has quietly become one of the most widely traded OTC securities in the US. According to data from OTC Link ATS (the leading OTC trading platform) GBTC is routinely near the top of the volume statistics in terms of total trades, and it claimed the title of [most active](#) OTC security in terms of notional volume for much of 2019 amidst this year's BTC rally. For context, the \$4 trillion US-listed ETF market consists of nearly 2,500 funds, and GBTC's \$2.5bn AUM (as of 10/31/19) and year-to-date average daily volume (ADV) of \$40mm+ would place it within the top 200 largest ETFs by both measures.



Source: Bloomberg data

Stated more acutely, this combination of steep market price premium and sizable volume has led to over \$11bn of cumulative GBTC value transacted **above** NAV over the past three years¹.



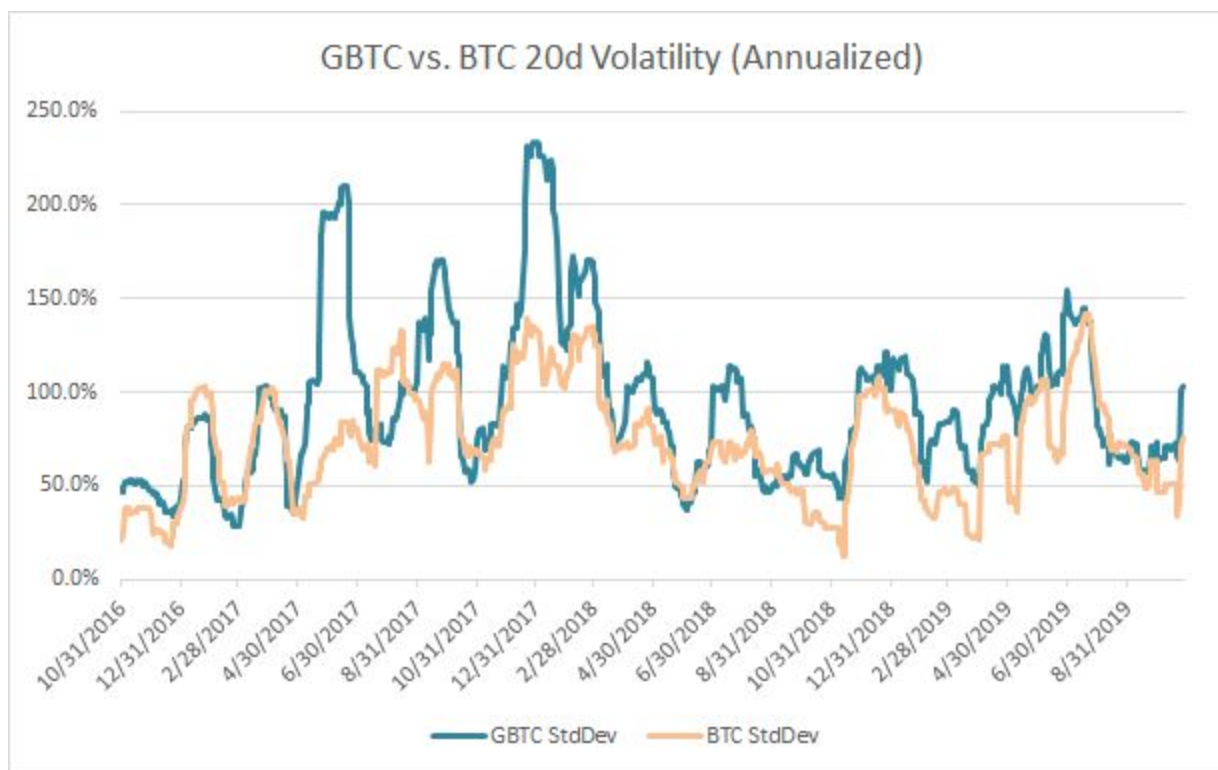
Source: Bloomberg data

¹ Assumes the following:

notional volume = closing market price * share volume

value transacted above NAV = share volume * (closing market price — NAV)

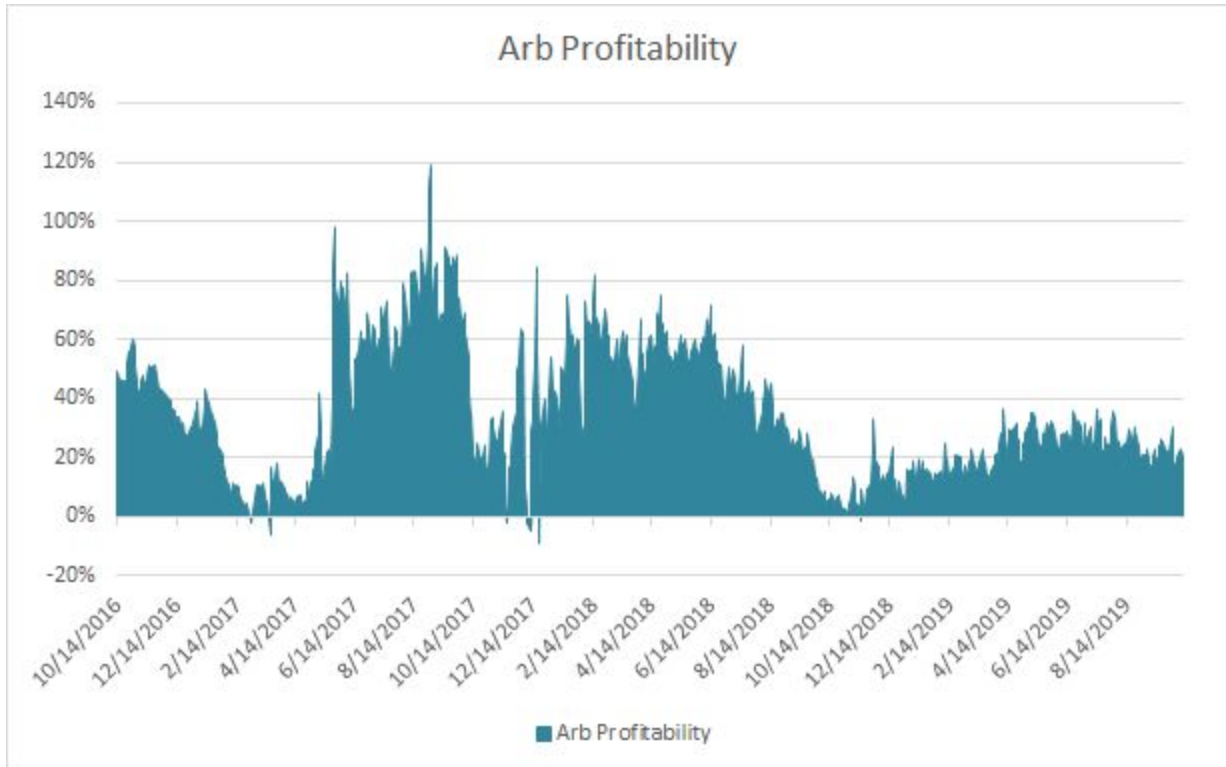
Another unfortunate byproduct is that fluctuations in GBTC's unusually large market price premium to NAV cause the volatility of GBTC to be consistently higher than Bitcoin itself.



Source: Bloomberg and Coinmetrics; annualized volatility calculated on a 252 trading day year for consistent comparison

The supposed original intent of listing GBTC for trading on OTC markets was to give accredited investors who participated in the private placement an opportunity to sell their shares since Grayscale does not offer a redemption facility. But according to the [GBTC 2Q19 Quarterly Report](#) there were only 89 'beneficial owners' and the public float (number of freely tradeable shares) of 189mm shares is just a fraction of the 775mm shares of total volume in the first three quarters of 2019. So, who is behind all this volume?

Grayscale reports their asset gathering is led by hedge funds yet their [#DropGold](#) marketing campaign and actions such as the 91-for-1 share split in January 2018 to significantly lower the share price of GBTC are clearly targeting retail investors. So why the disconnect? The most likely scenario is that hedge funds and market makers are creating new shares of the Grayscale Bitcoin Trust and simultaneously shorting GBTC on OTC markets at elevated market price premiums to NAV. This arbitrage trade allows for institutional investors to profit from the premium to NAV in a risk-neutral fashion.

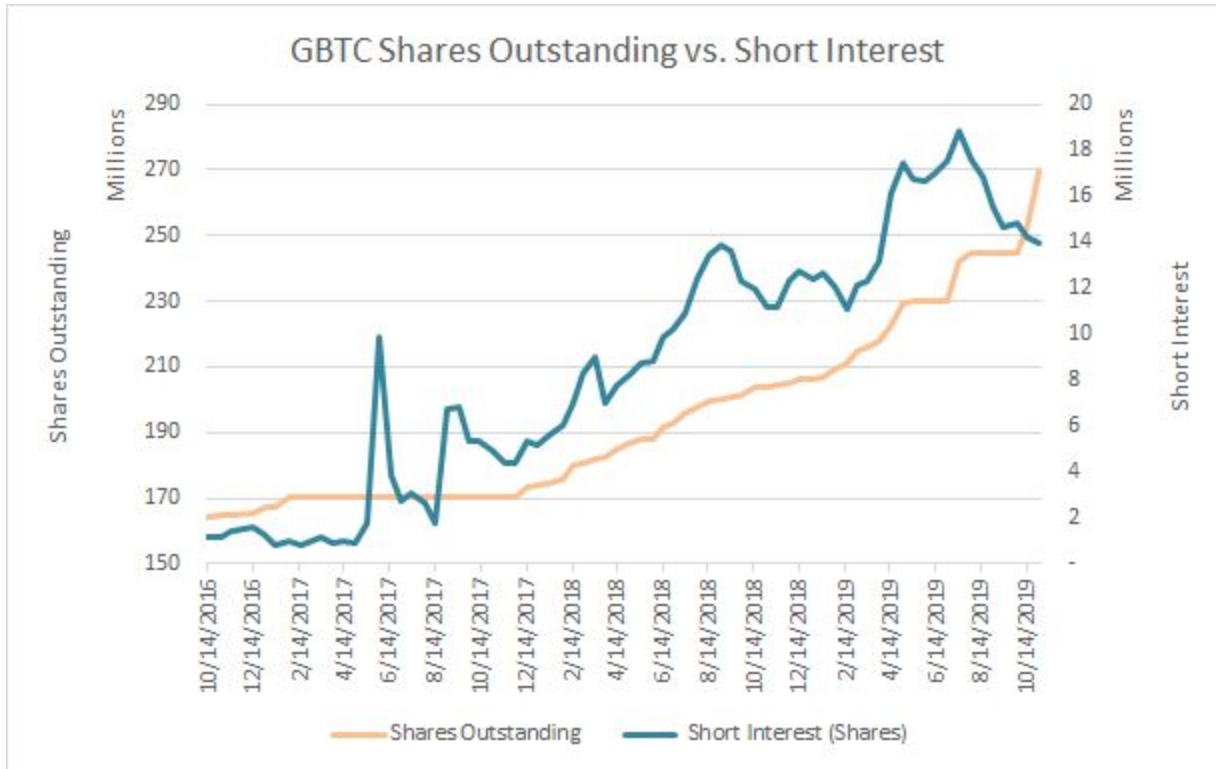


Source: Bloomberg and Markit Securities Finance data

The above chart shows the potential profitability of this trade (if initiated on that day), assuming GBTC is sold short at the market price and new shares are created at NAV via the private placement on the same day. By selling the market price and buying the NAV of the same asset the trader pockets the market price premium (minus the year-long carry costs) with taking on little to no market risk. The profitability calculation accounts for carry costs of 2% management fee on the long position and the borrow fees (assuming the value-weighted average fee of all open loans) on the short position.² The trade would need to be held for a year due to restrictions on the newly minted private placement shares, over which time the borrow costs on the GBTC short position could move against you. But in general, the annual carry costs are low and sticky as the GBTC borrow market has become quite liquid in-line with the growth of the fund. After the one-year holding period the [restrictive legend is removed](#) from the private placement shares and its merely an accounting exercise to close out the positions. The overall trade should be fairly capital efficient for hedge funds who receive advantageous margin requirements from their prime brokers. Hedged returns of more than 20% in a world with ~\$12 trillion of negative yielding debt is bound to catch the eye of every savvy institution around.

² Arbitrage profitability = market price premium to NAV — (annualized borrow fee + 2% management fee)

There may be additional investor specific costs such as market impact, illiquidity premiums, cost of capital and basis risk that reduce profitability.



Source: Bloomberg data

As the chart above shows, short interest has grown significantly over the past three years but tends to halt (or even decline) when share issuance is closed. Short interest peaked at 18.8mm shares in July of this year, representing nearly 8% of shares outstanding, just before the fund experienced a multi-month closure to the issuance of new shares. It's also worth noting the short interest data may be understated seeing as Grayscale reports that over half of their investor base is offshore and short interest reporting is only required of FINRA member firms (offshore brokers may not be FINRA members).

Replace Your Gold With GBTC

We get it. For the **average investor**, gaining exposure to digital currencies like bitcoin has been challenging. **Let us make it easier for you – enter GBTC.**

Grayscale Bitcoin Trust (GBTC) is an investment vehicle that enables investors to gain exposure to the price movement of bitcoin.

Investing in GBTC is as easy as owning shares in other financial products. We handle the heavy lifting - freeing you up from the hassle of comparing exchanges, setting up wallets, and converting fiat into bitcoin - while giving you the investment options you want. GBTC is publicly quoted on OTCQX® and can trade on most platforms.

Source: <https://dropgold.com/wp-content/uploads/2019/09/Meet-GBTC-Infographic.pdf>

Grayscale's marketing efforts are proving effective as elevated buying activity from retail customers is what makes this profitable arbitrage possible. An obvious but often

underappreciated fact of capital markets is that there are two sides to every trade. Unsuspecting and less-informed individual investors are the other side — the wrong side — of institutional arbitrage flows.

Conclusion

“The path of least resistance is what makes rivers run crooked.” — Elbert Hubbard

Grayscale’s business model has proved ingenious and has adhered to all regulatory requirements for the route chosen. Yet statements in fact sheets like “Modeled on popular commodity ETFs...” indicate their chosen route may be a bit crooked. SEC regulated ETFs — which GBTC is not — maintain the highest trading integrity with exchange-listed liquidity protections and mandated redemption facilities on a daily basis. These qualities would undoubtedly prevent physically-backed crypto ETFs from trading at such significant deviations from NAV as experienced by GBTC and other publicly-quoted Grayscale products. Let us not forget that [ETHE](#) traded at a [2,000% premium](#) just after listing. Concerns of ‘fraud and manipulative acts and practices’ in the Bitcoin spot market have been cited by the SEC as grounds for rejecting BTC ETF applications, yet the retail investors the agency vows to protect are still buying an unregulated³ BTC investment vehicle and are essentially paying hedge funds and market makers a 25%+ fee to do so. The SEC is understandably hesitant to give their stamp of approval on the high-risk crypto sector, but more harm than good may be done by waiting too long.

Respectfully submitted,



Keegan Toci, CFA

³ The [disclosures for GBTC](#) state: “The Products are NOT registered with the Securities and Exchange Commission (“SEC”) or any other regulatory agency in any jurisdiction, and are NOT subject to the same regulatory requirements as SEC-registered exchange traded funds or mutual funds, including any requirement to provide certain periodic and standardized pricing and valuation information to investors. Shares of the Products are not insured by the Federal Deposit Insurance Corporation or any other governmental agency. Investments in the Products are speculative investments that involve high degrees of risk.”