Grayscale wins the Securities and Exchange Commission ("SEC") case – a spot bitcoin ETF just got a bit closer

Published 11 September 2023

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The SEC's denial ruled "arbitrary and capricious"
On August 29th, 2023, a US federal Court of Appeals ruled that the Securities and Exchange Commission ("SEC")'s denial of Grayscale's Bitcoin Trust (GBTC) to a spot bitcoin ETF was "arbitrary and capricious". The SEC has argued that the bitcoin spot market is vulnerable to price manipulation and hence it has not approved any spot bitcoin ETFs in the US yet. In our view, this is a bit peculiar as the SEC has approved bitcoin futures and leveraged bitcoin futures products, both of which are based on the spot price. The appeals court also agreed with Grayscale's arguments that the spot and futures products are closely correlated and that both use a similar CME1 surveillance sharing agreement capable of detecting fraud and price manipulation. The SEC was ordered to review the application once more.

Approval getting closer but timing remains uncertain
After Grayscale's win, the spot bitcoin ETF applications of several other companies2 were delayed, yet again. The new deadline for the SEC is in mid-October 2023. While it is possible that the SEC could find another problematic area with all the applications, an issue that it has not raised before in the past ten years since the first spot bitcoin ETF application was filed, we think it is becoming more difficult for the SEC to to so and delay the launch of a spot bitcoin ETF. Europe already offers several physically-backed and institutional-grade spot bitcoin exchange-traded products (ETPs).

Most other product options in the market are less efficient in giving exposure to the underlying bitcoin price. It is noteworthy to mention that the decision made by the federal appeals court was bi-partisan. In our view, it would be most fair to create a level playing field for all applicants and approve all applications at the same time. It typically matters a lot who gets approved first. The first bitcoin futures ETF, the ProShares Bitcoin Strategy ETF (Ticker BITO), still has over 97% market share.

Changing competitive landscape
Digital Currency Group's (DCG) **closed-end GBTC** trust has been available for accredited investors as a private placement with a minimum investment of $50,000. This fund has been charging investors an annual 2% fee, which with the current $16 billion AUM comes up to $320 million annually. As soon as there is a spot bitcoin ETF in the market, this product becomes instantly uncompetitive and needs to be reconstructed. But, for the time being, it acts as a nice cash cow for DCG, which has been struggling with its Genesis subsidiary. In addition to being expensive, GBTC's price does not track the price of bitcoin very

well and, currently, GBTC's discount to net asset value (NAV) is still -19% although the gap has narrowed from its widest discount of -49% in December 2022.

Bitcoin futures provide an inefficient exposure to bitcoin as investors suffer from rolling costs of futures3 and return slippage. Although rolling costs of bitcoin futures are just an estimated 4-7%4, they still make the products less efficient and more cumbersome than a familiar ETF wrapper. We expect the role of bitcoin futures to decline once a spot bitcoin ETF becomes available.

Another way investors have sought exposure to bitcoin has been a bitcoin proxy Microstrategy (MSTR), a business intelligence software company with a large treasury of bitcoin. The company controls 153,800 bitcoins or almost $4 billion worth of bitcoin. The price of MSTR and bitcoin are closely correlated. MSTR also gives a less than ideal exposure to bitcoin as it is exposed to risks related to the company's business model, management decisions and execution ability. We therefore think it will become much less attractive for investors as a bitcoin proxy once a spot product is available.

We also believe that a bitcoin spot ETF product could take business away from centralized exchanges, such as Coinbase and Kraken, because their trading fees can be quite high6, particularly with smaller trading amounts. We believe this could be one of the reasons why Coinbase has been diversifying its business model to stablecoins7 and layer 2 solutions.

Most inflows expected to come from advisory and institutional market
We think a spot bitcoin ETF wrapper will be immediately attractive to those seeking an exposure to the price of bitcoin. Institutional investors and advisors are familiar with the ETF structure because it trades like a stock. It also tends to have tax benefits in retirement accounts in the US and it offers an easy way to trade crypto eliminating the need to custody crypto assets. An ETF wrapper also offers an easy way to integrate bitcoin exposure to portfolio management, trading, reporting and risk management systems.

Spot bitcoin ETF price war likely
Our expectation is that the expense ratio of a spot bitcoin ETF could be in the range of 35-100bp, although some larger issuers could go even lower. The SPDR Gold Trust (GLD) charges 40bp while the largest bitcoin futures product BITO has a 95bp annual MER . Several issuers have applied for ethereum futures products in October and one applicant, Roundhill, has disclosed a 19bp management fee for its ethereum futures fund. The price war for a spot bitcoin ETF could prove to be intense.

What will be key for institutional investors is the liquidity of the product. The bid-ask spread is likely to be very tight for the most liquid products and these funds are most likely to have the greatest appeal for institutional investors.

Market expected to grow bigger over time
Over the long term, the spot bitcoin ETF is likely to widen the customer base interested in crypto. The US advisory market is $30 trillion in size and the institutional market (pension funds, endowments, insurance companies) is approximately $70 trillion in size. If just 0.5% of the Advisory market were to be allocated to bitcoin, this would translate to $150 billion in investment flows over time. We believe it is possible that $20-$30 billion could flow to spot bitcoin ETF products over the shorter-term as the current GBTC, bitcoin

futures, MSTR and some exchange investors move to this more cost efficient and easier to trade bitcoin product.

In the short term, there are uncertainties, though. GBTC was created in 2013 and some investors could take profits in the potential conversion process. GBTC is large, $16 billion in size, and even a small part of this in the market could have a meaningful impact on the price.

To put his in context, this year has seen very low liquidity and volume in bitcoin supply. It is estimated that it has taken approximately $20-50 million so far this year to take the bitcoin price down by 1% . When the price is dropping, even less is needed to have the same impact on the price.

1 Source Chicago Merchantile Exchange

2 Source WisdomTree, BlackRock, Wise Origin (Fidelity), Invesco Galaxy, VanEck, Bitwise, Valkyrie Digital Assets, ARK21 Shares

3 Source Longer-dated futures contracts trade at a premium to those closer to expiry, also called contango; when the price of bitcoin is going up, it is more expensive to buy the next month’s futures contract resulting in futures rolling cost.

4 Source Bloomberg

5 Source Microstrategy, Q2 2023 Financials

6 Source Coinbase, exchange fees

7 Source Coinbase took a minority stake in Circle Internet Financial, the issuer of USDC stablecoin, in August 2023

8 Source MER=management expense ratio

Important Risks Related to this Article

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