THE DIGITAL CHAMBER

Beyond Merit

How the SEC's Division of Investment Management Blocked Permissible Investments in Digital Assets

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The Digital Chamber would like to extend a special thanks to the following contributors who interviewed numerous members of The Digital Chamber, compiled their experiences and prepared the Report on behalf of The Digital Chamber:

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“Our federal securities laws lay out a basic bargain in our markets. Investors like you get to decide which risks to take so long as those companies raising money from the public make what President Franklin Roosevelt called ‘complete and truthful disclosure.

Under the securities laws, the SEC is merit neutral. Investors get to decide what investments they make based upon those disclosures. The SEC focuses on the disclosures about, but not the merits of, investments.”[1]

GARY GENSLER

CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

MARCH 6, 2024

1] Gary Gensler, Chair, U.S. Sec. & Exch. Comm’n, Office Hours with Gary Gensler: Climate Risk Disclosure (Mar. 6, 2024).

Executive Summary

On January 18, 2018, Dalia Blass, then the Director of the Securities and Exchange Commission's ("SEC") Division of Investment Management, issued the open letter that to this day is still simply referred to throughout the investment management industry as The Dalia Blass Letter.[2]

In that letter, Director Blass highlighted the novelty and certain unique characteristics of digital assets before expressing concern regarding the "significant investor protection issues" surrounding a registered investment company's investment in such assets. To help the staff at the SEC (the "Staff") "resolve" these issues, the letter posed 30 highly detailed questions to which fund sponsors were instructed to respond, with the potential of more questions to follow. Until these questions were "addressed satisfactorily" in the eyes of the Staff, fund sponsors were warned not to even begin the process of registering a fund that would seek to hold digital assets.

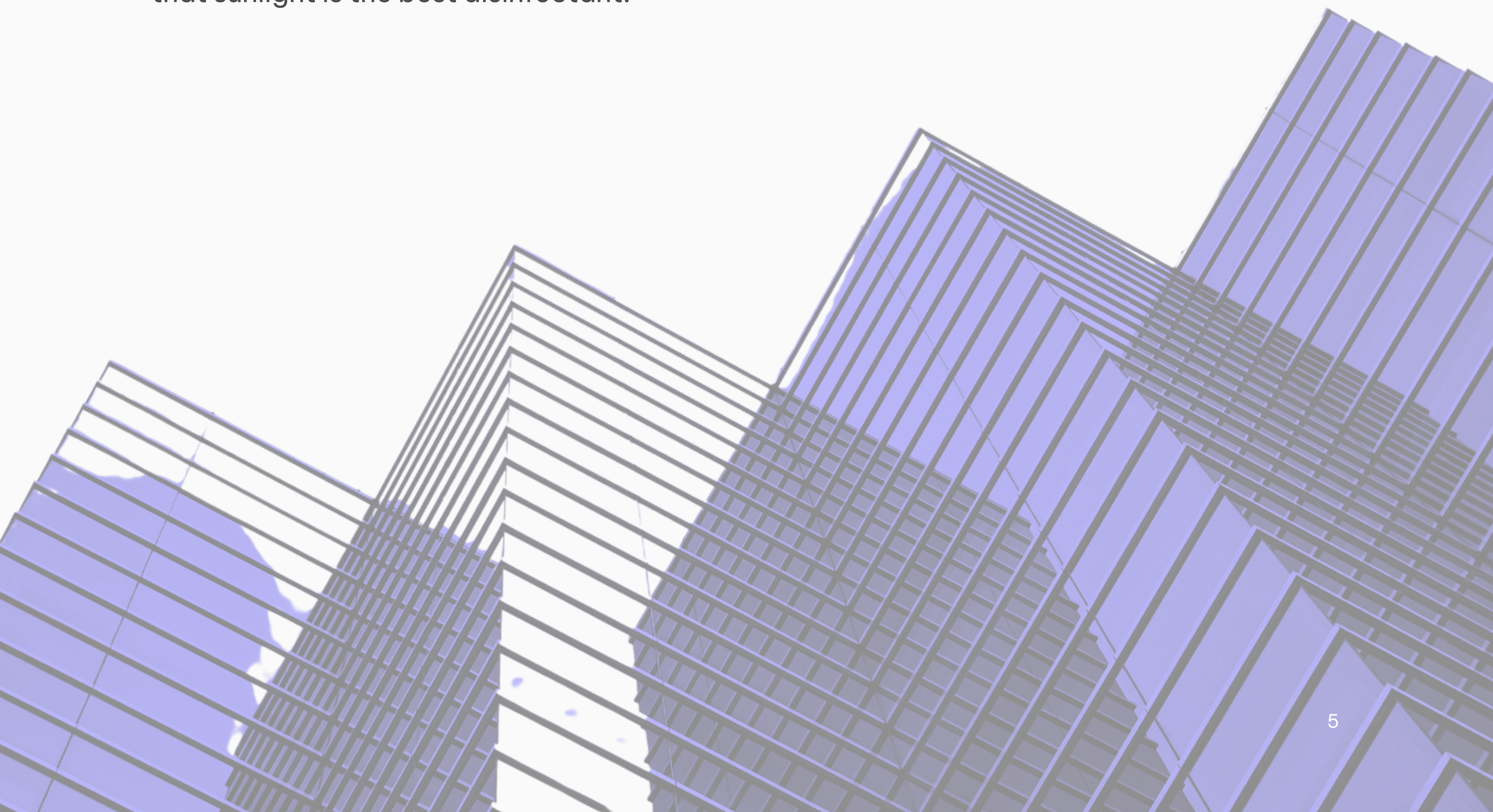
By empowering itself to determine when fund sponsors could properly offer to the investing public investment products holding digital assets, the SEC engaged in what is known as "merit regulation." A securities regulatory regime utilizing merit regulation is one where regulators are empowered to make subjective judgments about the merits of an investment, including its potential risks and benefits to investors. It assumes that investors need protection from themselves and that regulators are better equipped to judge what constitutes a good or bad investment. While it has long fallen out of favor among the Western-style democracies hosting the world's largest and most sophisticated securities markets, it remains the regulatory style of choice for autocratic regimes around the world.

2] U.S. Sec. & Exch. Comm'n, Division of Investment Management, Staff Letter: Engaging on Fund Innovation and Cryptocurrency-Related Holdings (Jan. 18, 2018), available at https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

Part II of this report seeks to make clear that the U.S. federal securities regulatory regime is not one based upon merit regulation. Instead, the United States (along with the United Kingdom, European Union, Japan, Hong Kong, Singapore, Canada, and Australia) utilizes what is known as a “disclosure-based” regime. A disclosure-based regime is a regulatory framework in which the primary method of protecting investors and ensuring market integrity is through the mandatory disclosure of relevant and material information by issuers of securities. The goal of a disclosure-based system is to empower investors to make informed decisions by ensuring they have access to accurate, comprehensive, and timely information.

In a disclosure-based regulatory regime, the role of the regulator (in the case of the United States, the SEC) is to ensure that the entities and products it regulates accurately provide the information required under the securities laws to allow investors to make informed investment decisions based upon their own beliefs, preferences, and circumstances. What the regulator is expressly not empowered to do is impose its own judgment upon the investing public regarding the soundness of an investment.

This role is not ambiguous or controversial, as evidenced by the quote from SEC Chairman Gary Gensler above. And yet, in recent years, accusations that the SEC has increasingly descended into merit regulation have grown increasingly loud. While the digital asset industry is certainly not alone in being targeted by the SEC’s merit-based excesses, it is perhaps the industry where the SEC has pushed the envelope the furthest. As a trade association representing the blockchain technology ecosystem, The Digital Chamber (“TDC”) has taken a role, on behalf of its membership, of shining a light on how such behavior affects companies operating within the digital asset industry under the belief that sunlight is the best disinfectant.



In 2022, TDC produced a report entitled "The Crypto Conundrum: Why Won't the SEC Approve a Bitcoin ETF?" That report, hereinafter referred to as "The Crypto Conundrum," chronicled how the SEC's Division of Trading and Markets had continually denied applications that had sought to allow the listing and trading of exchange-traded funds ("ETFs") that directly held bitcoin ("Bitcoin ETFs").

In seeking to justify its denials, the SEC had created a new standard by which to judge the applications (the so-called "Winklevoss Standard") that it had never before imposed when judging the merit of applications relating to other asset classes. "The Crypto Conundrum" argued that the imposition of this standard and the continual denials were based not on objective and dispassionate application of law and precedent, but rather on policy judgments made by the Staff regarding digital assets. Put more concisely, the report argued that the SEC had been acting as a merit regulator.

This position was resoundingly vindicated less than a year after the publication of "The Crypto Conundrum" when the D.C. Circuit Court of Appeals unanimously decided that the SEC's denial of a Bitcoin ETF application constituted "arbitrary and capricious" behavior and therefore a breach of the Administrative Procedures Act (the "APA"). The opinion paved the way for the approval of eleven Bitcoin ETFs in 2024 in what would turn out to be the most successful ETF launch in history.

While "The Crypto Conundrum" focused on the actions of the SEC's Division of Trading and Markets, this report focuses on the behavior of the Division of Investment Management, which is the division of the SEC responsible for the regulation of investment companies and advisors. Based on interviews with numerous issuers, this report details the lengths to which the Division of Investment Management had gone to prevent registered investment companies from providing meaningful exposure to bitcoin and other digital assets while the SEC imposed constantly changing standards that lacked basis in rule, statute, or law.

This report does not mean to suggest that the actions of the SEC were inspired by nefarious motives or grand conspiracies. It posits that the actions taken by the members of the Staff were consistent with the directions from their superiors and ultimately well intentioned. These individuals likely believed that investors were caught up in a mania of sorts, seeking to get rich quickly on an asset that lacked an investment thesis they personally found compelling. It appears that one of the goals of the Staff was to protect investors from themselves. Nevertheless, the road to hell, as they say, is paved with good intentions. The SEC's reputation as an impartial adjudicator of the law has suffered as a result of its treatment of these digital asset-related products.

Crucially, this report explicitly rejects any notion that the SEC's inappropriate treatment of digital assets can be laid at the feet of a particular political party, administration, or individual. The first anecdote recounted in this report occurred in 2015 when Barack Obama was President and Mary Jo White was the SEC Chair. The Dalia Blass Letter was issued during Jay Clayton's term as SEC Chair during Donald Trump's first administration, and it was the Gary Gensler-led SEC that unsuccessfully litigated seeking to prevent the issuance of Bitcoin ETFs. This is a story about how the Division of Investment Management as a whole has conducted itself over an almost ten-year period, as opposed to singling out the conduct of any particular individuals.

As we enter 2025, and with the SEC set to begin a new chapter in its history, this report seeks to play a very small part in encouraging the SEC to return to the authorized path on which it was initially set. There will always be a new asset or company that inspires wonder on the part of investors and skepticism on the part of the SEC. It is the hope that the SEC will learn from its experience with digital assets and in the future resist the siren song of merit regulation.

Part 1:

The Unbounded, Dangerous Territory Of Merit Regulation

> "The [SEC]'s approach to these bitcoin exchange-traded products is frustrating because it evinces a stubborn stodginess in the face of innovation.
>
> The irony is that, in taking this approach, the [SEC] wanders into the unbounded, dangerous territory of merit regulation for which the [SEC] is ill-equipped." [3]
>
> *HESTER M. PEIRCE*
> *SEC COMMISSIONER*
> *FEBRUARY 26, 2020*

3] Dissenting Statement of Hester M. Peirce in Response to Release No. 34-88284; File No. SR-NYSEArca-2019-39 (Feb. 26, 2020), https://www.sec.gov/newsroom/speeches-statements/peirce-dissenting-statement-34-88284.

When it comes to the federal regulation of U.S. securities markets, the United States utilizes a "disclosure-based" regime. A disclosure-based regime is a regulatory framework in which the primary method of protecting investors and ensuring market integrity is through the mandatory disclosure of relevant and material information by companies. This is in contrast to a "merit-based" regime, where the government makes value judgments about the quality of investments or the fairness of transactions. The goal of a disclosure-based system is to empower investors to make informed decisions by ensuring they have access to accurate, comprehensive, and timely information. This framework was established by the enactment of two foundational pieces of legislation, the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act").

The federal agency empowered to enforce these laws is the SEC, which itself was created by the Exchange Act. By design, the SEC's role is critical but limited. Its responsibility is to ensure that the companies and investment products it regulates accurately provide the information that is required of them under the securities laws to allow investors to make informed investment decisions based upon their own beliefs, preferences, and circumstances. What the SEC is expressly not empowered to do is impose its own judgments upon the investing public regarding the appropriateness or soundness of an investment.

Yet, in recent years, the SEC has increasingly faced accusations that it has been wandering into the "unbounded, dangerous territory of merit regulation," as SEC Chairman Hester Peirce artfully described in 2020. That the SEC has been acting as a merit regulator is one of the most common refrains heard by TDC from its members. Accordingly, TDC set out to chronicle and highlight such instances in this report with the hope that shining a light on such behavior might encourage the SEC to return to the authorized path on which it was initially set.

While these instances will not flatter the agency, it is of the utmost importance to emphasize that this report does not — in any way — seek to deny the absolutely vital role the SEC plays in the functioning of our capital markets and the credit it is due for policing them so effectively. It is because of, not in spite of, the SEC that the U.S. capital markets have become the overwhelmingly preferred destination of choice for companies seeking to raise capital and investors seeking to put their savings to work. While our disclosure-based system has facilitated the efficiency of U.S. markets and ease of capital formation, critical elements to the growth and success of U.S. markets, our commitment to fair and consistent regulatory oversight and the rule of law is just as, if not more, critical to that success. The SEC as a whole is composed of knowledgeable and well-intentioned individuals who deserve a tremendous amount of credit for the role they have played in the success of our markets.

However, there is something different about how the SEC acts when it is considering matters relating to digital assets. It has pursued a uniquely aggressive policy of regulation by enforcement with its numerous lawsuits against entities comprising the digital asset industry. This extends to its more tangential interactions with the industry, such as when retail asset managers are seeking to offer products that provide exposure to digital assets, and is something that came through in "The Crypto Conundrum," which chronicled the history of the SEC's curiously determined refusal, over nearly a decade, to approve the listing applications for the Bitcoin ETFs. "The Crypto Conundrum" highlighted the inconsistent treatment such products were receiving under the law and surmised that political considerations and ideological objections, rather than objections based on the application of law, were motivating the SEC's denial of these applications.

The conclusions drawn by "The Crypto Conundrum" were vindicated less than a year after its publication when, in June 2023, the U.S. Circuit for the D.C. Circuit (unanimously) overturned the SEC's denial of such a listing application by Grayscale Investments on the basis of a finding that the SEC had treated its consideration of the listing applications of a Bitcoin ETF differently than it had considered similar applications.[4] Such behavior from a government agency is a manifestation of "arbitrary and capricious behavior" forbidden by the APA. This decision ultimately forced the SEC to approve the listing of Bitcoin ETFs, which went on to have the most successful ETF debut in history.

4] Grayscale Invs., LLC v. SEC, No. 22-1142 (D.C. Cir. 2023).

"The Crypto Conundrum" included several quotes from Hester Peirce, an actively serving SEC Commissioner, regarding the disparate treatment received by products seeking to provide exposure to bitcoin and other digital assets.

> The reasons for [the SEC's] resistance to a [Bitcoin ETF] are difficult to understand apart from a recognition that the Commission has determined to subject anything related to bitcoin — and presumably other digital assets — to a more exacting standard than it applies to other products.[5]

This remark captures the essence of what was heard repeatedly when interviewing individuals in connection with this report: The SEC just treats this asset class differently. Until its thumb was forcibly removed from the scale by the D.C. Circuit Court of Appeals, the SEC refused to approve the listing of Bitcoin ETFs, not based upon its impartial application of law and precedent, but seemingly because it felt such ETFs were not appropriate for investors. This is the definition of merit regulation.

While the SEC's disparate treatment of digital assets has spanned three presidential administrations and SEC Chairs, former SEC Chairman Gary Gensler in particular became increasingly less coy about his unique disdain for the asset class as his term progressed. At an October 9, 2024, event at the NYU School of Law in Manhattan, he said of the digital asset industry: "With all respect, the leading lights of this field in [2024] are either in jail or awaiting extradition right now."[6] To characterize the small number of bad actors previously operating within the industry as its "leading lights" is an unnecessary smear that is axiomatic of the bias of which the SEC is accused.

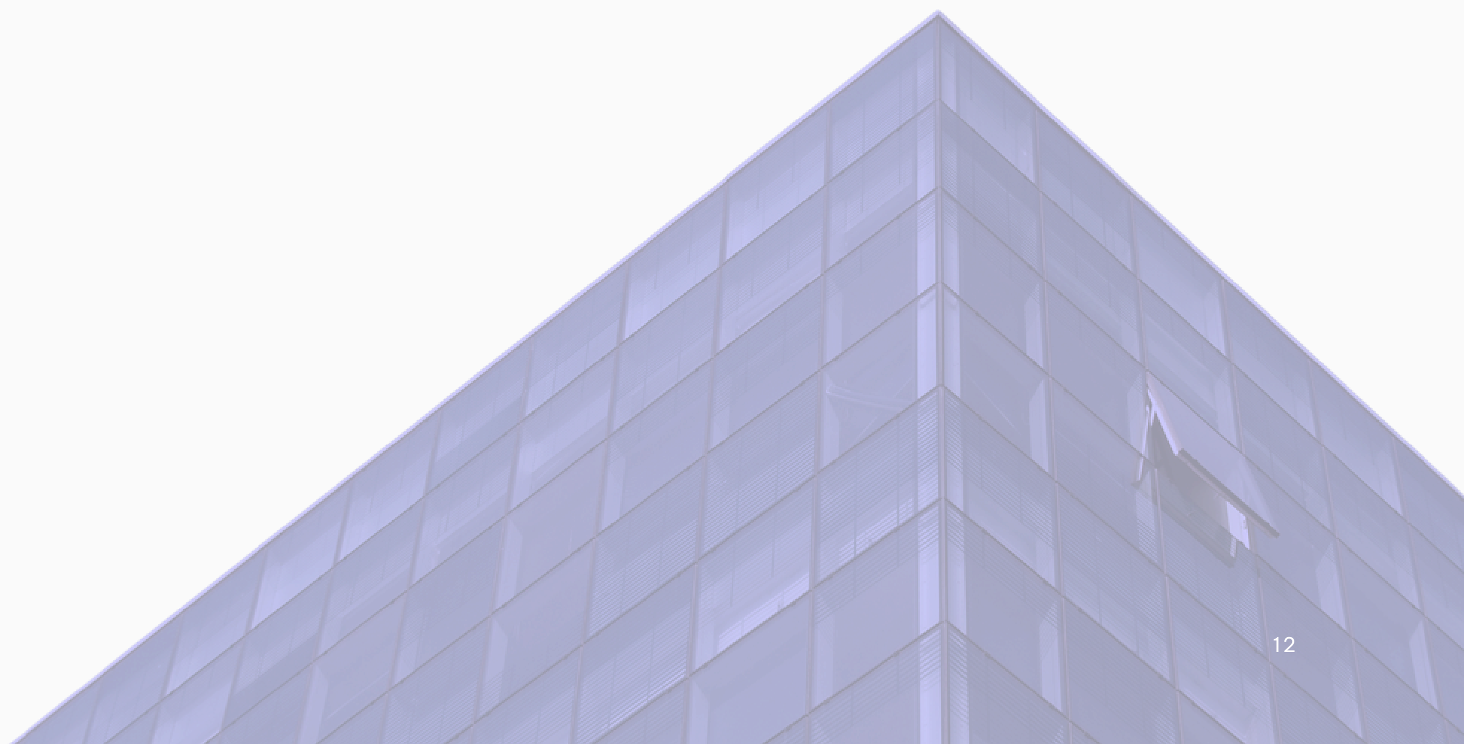
5] SEC Commissioner Hester M. Peirce, Remarks at the Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem: Necessary Regulation or Crippling Future Innovation? (June 14, 2022).

6] Cheyenne Ligon, "SEC Chair Gary Gensler on Crypto: 'It's Unlikely This Stuff Is Gonna Be a Currency,'" CoinDesk (Oct. 9, 2024).

While "The Crypto Conundrum" focused on the misadventures in merit regulation practiced by the SEC's Division of Trading and Markets, this report highlights the behavior of the SEC's Division of Investment Management and its oversight of investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act").

The Investment Company Act regulates the organization of investment companies, including ETFs and mutual funds, and has a structure similar to that of the Securities Act. Investment companies must register with the SEC and include in their registration statement detailed information about their investment objectives, principal risks, business operations, and structure. The Investment Company Act imposes limitations on certain practices, including limits on borrowing, leverage, and investment concentration. It also addresses conflicts of interests between fund managers and fund shareholders by prohibiting practices like self-dealing and by ensuring that fees charged to a fund are fair and reasonable.

The Division of Investment Management's role under the Investment Company Act is analogous, in part, to the SEC's Division of Corporation Finance's role under the Securities Act, which is described in detail in Part II of this report. It seeks to ensure that the disclosure provided by an investment company in its registration statement is accurate and that the relevant limitations and prohibitions are followed. If the provisions of the Investment Company Act are observed, meaning the disclosure is accurate and a fund does not exceed limitations or violate prohibitions, there is no ascribed role under the law for the SEC to say what a fund can and cannot hold, so long as such investments, and the risks accompanying such investments, are properly disclosed and within the limits imposed by the federal securities laws.



Most of the individuals spoken with during the preparation of this report agreed that, historically, the SEC has appropriately fulfilled its role. However, as bitcoin and ether rose to prominence throughout the 2010s, investment managers — driven by growing client interest — sought ways to provide exposure to this new, alternative asset class. It was at this juncture that many perceived the SEC to be overstepping its legislative boundaries to find ways to prevent such managers from doing so. Nevertheless, the federal securities laws were specifically designed to prevent the government from putting its thumb on the scale in such scenarios. Regardless of how well intentioned SEC staff may be, their role is not to impose subjective assessments of merit on the markets.

When presented with ways by which registered investment companies could provide exposure to bitcoin in compliance with all applicable statutes and regulations, the SEC should have expended every effort to make sure the registration statements and prospectuses of such funds fully described the risks of this new asset. The SEC could have reasonably required (and ultimately did require) funds to include prominent disclosures that such investments were uniquely volatile and could lose value. At that point, it is up to investors to assess whether the risk aligns with their individual financial circumstances and personal beliefs about the asset class's potential utility and future success. This is precisely how the system is designed to work.

But, as the following anecdotes will illustrate, that wasn't enough for the SEC. The Division of Investment Management did not want investors to be able to access this asset class through investments in a registered investment company regardless of what the law provided or how robust the disclosures were. Inconveniently for the Division of Investment Management, it had very few ways of enforcing this mandate. While its colleagues in the Division of Trading and Markets could hide behind the legal fig leaf of the so-called "Winklevoss Standard" during its ultimately ill-fated rejections of the Bitcoin ETF listing applications, the Division of Investment Management lacked even that pretext. Instead, it resorted to what seemed to be arbitrary denials and limitations that created uncertainty, benefitted some market participants versus others, stifled innovation, and limited choice and opportunities for the investing public.

The Siren Song of Merit Regulation

On September 15, 2015, in the twilight of Barack Obama's presidency and Mary Jo White's tenure as Chairman of the SEC, ARK Investment Management LLC ("ARK"), the investment adviser to Cathie Wood's suite of ETFs, put out a press release signaling that a new front had been opened in what at the time was still merely a border skirmish between registered fund sponsors and the SEC over the topic of bitcoin.

> **ARK INVEST BECOMES FIRST PUBLIC FUND MANAGER TO INVEST IN BITCOIN**
>
> ARK Investment Management LLC (ARK), an active manager of thematic exchange-traded funds (ETFs), is pleased to announce that the ARK Web x.0 ETF (NYSEARCA: ARKW) has become the first ETF to invest in bitcoin. ARK has made its investment for ARK Web x.0 ETF through the purchase of publicly traded shares of Grayscale's Bitcoin Investment Trust.[7]

7] ARK Invest Becomes First Public Fund Manager to Invest in Bitcoin, PR Newswire (Sept. 15, 2015), available at https://www.prnewswire.com/news-releases/ark-invest-becomes-first-public-fund-manager-to-invest-in-bitcoin-300143030.html.

At the time, the Grayscale Bitcoin Investment Trust (commonly known by its ticker, GBTC) represented one of the very few ways the public could get liquid investment exposure to bitcoin through an investment in a fund whose shares could be held in a traditional brokerage account. While shares of GBTC were available on the secondary market through OTC Markets' OTCQX platform, GBTC had a unique structure that differentiated it from traditional registered funds.[8]

Prior to the adoption of Rule 6c-11 of the Investment Company Act, the so-called "ETF Rule," ETFs operated pursuant to a patchwork collection of exemptive relief and listing rules imposed by the national listing exchanges. The overlay of these requirements imposed a requirement upon ETFs that their holdings of trusts like GBTC could not exceed 10% of the ETF's assets. Accordingly, ARK capped its exposure to GBTC at 10% in each of its ETFs that held GBTC.

8] GBTC began its life in 2013 as an unregistered private trust. It accumulated assets — assets that were subsequently invested in bitcoin — through sales of its shares to accredited investors in private placements. After a one-year lock-up period imposed by Rule 144 of the Securities Act of 1933, these shares were generally eligible to be resold by the original investors, including to the retail-investing public. By May 2015, a sufficiently critical mass of such shares had become freely tradable, allowing Grayscale Investments, LLC ("Grayscale"), the sponsor of GBTC, to have secondary shares of GBTC approved to be traded on OTC Markets' OTCQX platform. While OTCQX is technically an over-the-counter trading market, shares traded on the OTCQX platform can generally be bought and sold through most major brokerage accounts. Therefore, following the approval for secondary trading of its shares, GBTC became the first bitcoin fund that U.S. retail investors could purchase in the secondary market. By 2017, GBTC had become the largest bitcoin investment product in the world, a title it would hold for over seven years.

However, GBTC's structure had major drawbacks. The SEC adopted a maximalist view of the scope of Regulation M, a set of rules promulgated under the Securities Exchange Act of 1934, that prevented Grayscale from operating a redemption program for GBTC shares. This meant that GBTC was essentially operating as a closed-end fund and, as such, fell victim to the same problem plaguing many closed-end funds, that shares of such funds oftentimes trade in the secondary market at large premiums and discounts to their net asset value. At times, shares of GBTC traded at premiums of over 40% and discounts of nearly 50%.

This paradigm changed when Rule 6c-11 took effect in December 2019. Rule 6c-11 modernized the regulatory framework for ETFs by significantly streamlining the number of rules with which ETFs were required to comply. ETFs were no longer subject to their individual exemptive relief orders and, so long as they complied with Rule 6c-11, were deemed to satisfy the listing requirements of the national listing exchanges.

However, Rule 6c-11 did not include the requirement capping exposure to trusts like GBTC at 10%. Such instruments no longer received special attention under statute or regulation. To the extent that an ETF held such instruments, it was required to disclose that it intended to do so and the risks that accompanied such an investment, as was true of any other asset. Rule 22e-4 of the Investment Company Act also imposed the requirement that an open-end fund, such as an ETF, not invest more than 15% of its assets in "illiquid assets," which the rule defines as "any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment." [9]

Accordingly, if GBTC were deemed to be "illiquid," then an ETF's GBTC holdings would be capped at 15%. However, by 2019, GBTC's shares were trading on the OTCQX secondary market with an average daily trading volume of nearly $26 million. That number would rise to nearly $58 million in 2020 before exploding to over $293 million in 2021. These were not illiquid securities. In fact, by the classification system outlined by Rule 22e-4, GBTC's securities would have been properly classified as "highly liquid investments," the classification denoting the most liquid of securities.

As it related to its investments in GBTC, ARK believed — correctly — that its regulatory handcuffs had come off. It had been among bitcoin's earliest mainstream believers, having begun the due diligence process on GBTC shortly after its formation and long before it had become a household name. ARK had been repeatedly asked by investors why, if ARK's conviction on bitcoin was so strong, it was capping its exposure in its funds to 10%. Now that ARK could do so in complete compliance with the applicable statutes and regulations, it wished to increase its exposure to bitcoin in certain funds it managed beyond the 10% threshold that had been a relic of the prior regulatory regime.

9] See Rule 22e-4(a)(8) of the Investment Company Act.

Under the disclosure-based regime pursuant to which the SEC operates, the path the agency should have followed is unambiguous. The SEC should have enforced the disclosure obligations regarding investments that provide exposure to bitcoin. The SEC should have ensured that any investor in a fund with material exposure to GBTC understood that bitcoin was a novel and volatile asset class that could see its value drop precipitously. The SEC should have made sure prospective investors had enough information regarding the potential investment and then let such investors ultimately decide on the prudence of the investment for themselves.

However, that is not the path the SEC ultimately selected. Instead, the ill-fated decision was taken to actively try to prevent ETFs from increasing their exposure to bitcoin. But, by design, the means at the SEC's disposal to prevent this increased exposure were limited. There were no laws or regulations on the books that empowered the SEC to set caps on the levels of exposure an investment company could have to a particular asset class.

Lacking a legal or regulatory lever to pull, the SEC was left with a single option. It could only issue a verbal prohibition to issuers and then cross its fingers and hope such prohibition was obeyed. The prohibition was a bluff, after all. It had no force of law and no SEC rule or statutory basis for enforcement. It was not a reckless gamble, though. Regardless of whether the agency had any legal justification to issue such an order, every issuer has a strong disincentive to take action that could potentially anger its regulator. That this order would ultimately go unchallenged was a reasonable bet.

Once the SEC had taken its decision, one of the first calls went to ARK, who was told that even though the rules had changed, the SEC was acting under what the agency called "the status quo." The SEC informed ARK that its 10% limit on exposure to GBTC had been "grandfathered in," but that the SEC was forbidding such limit to be increased. When asked about the legal basis for the SEC's position, since the status quo had changed and there is no concept of "grandfathering in" investments under U.S. securities laws, the SEC gave no reply. It had no reply to give. When the SEC was asked what the consequences for noncompliance would be, it was again silent. ARK would be forced to use its imagination. That proved enough. ARK would not increase its GBTC holdings above the SEC's artificially created 10% threshold for years, costing investors in its funds the gains they would have reaped resulting from bitcoin's subsequent exponential increase in value.

Ironically, ARK was arguably treated better than other issuers, who were told that they were forbidden outright from investing in GBTC. When those issuers asked why ARK was able to hold GBTC and they were not, such issuers either were led to believe that ARK had been told to sell out of the position or were told that ARK's position had been "grandfathered in." Confronted with credible accusations that it was "picking winners and losers," the SEC relented and "permitted" issuers to invest up to 10% of their assets in GBTC. However, these other issuers were instructed that they were only "allowed" to derive their exposure to bitcoin through GBTC.

The industry enjoyed another breakthrough in 2021 when the Ontario Securities Exchange ("OSC") approved the listing of Bitcoin ETFs ("Canadian Bitcoin ETFs") on the Toronto Stock Exchange ("TSX"). While offerings of GBTC were not registered under the Securities Act of 1933 and the shares were not listed on a national exchange, these Canadian Bitcoin ETFs were regulated by the OSC and listed and traded on Canada's premier listing exchange. There was hope that this avenue of bitcoin exposure would be acceptable to the SEC.

But it was not to be. Multiple issuers reported essentially the same version of events. Each called the SEC and made its case for being allowed to invest in the Canadian Bitcoin ETFs. These Canadian Bitcoin ETFs had significantly cheaper fees than GBTC, they were priced at net asset value, they were listed on TSX, and they were regulated. It was felt that the SEC would surely agree that the Canadian Bitcoin ETFs were a suitable means by which to provide exposure to bitcoin.

The SEC felt differently. The agency initially told issuers they were prohibited from investing in Canadian Bitcoin ETFs in any amount. When asked for the legal basis for this position, again, none was provided. After some time had passed, the SEC decided that perhaps it had been too harsh. Instead of an outright prohibition, the SEC told issuers they could invest up to 1% of their assets in each of the various Canadian Bitcoin ETFs. Since there were only three such ETFs at the time, this meant that a fund could achieve up to a 3% exposure to bitcoin through investments in the Canadian Bitcoin ETFs. It was something, but still well below the 10% limit imposed on holdings of GBTC.

Several issuers reported that the SEC's treatment of Canadian Bitcoin ETF investments caused the notion to begin to crystallize within their organization that the SEC truly was making up rules as it went along. While issuers had never invested in entities employing the structure utilized by GBTC, these issuers had long managed funds that invested in Canadian entities that were listed on TSX. They knew that an outright bar on such investments didn't exist. When that outright bar was arbitrarily lifted in favor of another arbitrary limit, it was becoming increasingly difficult to avoid disillusionment.

The rules regarding the Canadian Bitcoin ETFs were especially galling to some issuers because they forced outcomes that the issuers believed were not in the best interest of investors. One issuer detailed its engagement with the Staff over its desire to exchange its 5% holding of GBTC for a 5% position in the Canadian Bitcoin ETFs. This issuer believed that getting exposure to bitcoin through the Canadian Bitcoin ETFs was preferable to exposure through GBTC. At the time, GBTC was trading at a premium of 30%, meaning that it took an investment of $13 to achieve $10 of exposure to bitcoin. Furthermore, GBTC was less regulated and more expensive compared to its Canadian Bitcoin ETF counterparts. The issuer felt it was in the best interest of its investors to provide exposure to bitcoin through an investment in the Canadian Bitcoin ETFs.

The SEC, presumably hamstrung by its own arbitrary rules, could not be reasoned with. It was going to continue to try to impose this arbitrary 1% limit. One issuer reported pleading with the Staff over the matter. This issuer reported telling the Staff that its due diligence process had determined that it was in the best interest of the fund it managed to derive exposure to bitcoin through investments in Canadian Bitcoin ETFs, as opposed to GBTC. The issuer specifically asked the Staff to confirm that the Staff was instructing it to invest in a product its internal processes had deemed to be inferior. The issuer was stunned when the Staff confirmed to it that was the Staff's guidance.

This is merit regulation. Both GBTC and the Canadian Bitcoin ETFs provided exposure to bitcoin. There is no legal basis for the SEC's position that investments in one product, but not the other, are permissible so long as the adequate disclosure regarding such investments is provided. There is certainly no justification for a 1% limit on the individual Canadian Bitcoin ETFs and a 10% limitation on GBTC.

The Chicago Mercantile Exchange ("CME") listed for trading a bitcoin futures contract regulated by the Commodity Futures Trading Commission ("CFTC") in December 2017.[10] From 2017 and into 2021, issuers had similar confounding experiences with the Staff when seeking to add CME listed bitcoin futures to mutual fund and ETF investment portfolios, notwithstanding that both mutual funds and ETFs held a variety of other futures contracts (from oil to cattle to cocoa to soybeans) in their portfolios. In the first half of 2021, the SEC incrementally allowed such exposure by mutual funds, although initially (and without reason) less than allowed under the Investment Company Act.

The SEC Staff then issued a statement in May 2021[11] regarding investing in bitcoin futures by registered investment companies, noting that ETFs were not allowed to invest any amount in bitcoin futures because ETFs "cannot prevent additional investor assets from coming into the ETF if the ETF becomes too large or dominant in the market, or if the liquidity in the market starts to wane." Yet, ETF investment managers had adeptly navigated those types of issues in a variety of other asset classes (including with respect to listed futures in other asset classes) while staying compliant with the Investment Company Act. ETF investment managers continued to be thwarted by the Staff - again, without legal justification - in their attempts to add CME listed bitcoin futures until October 2021.

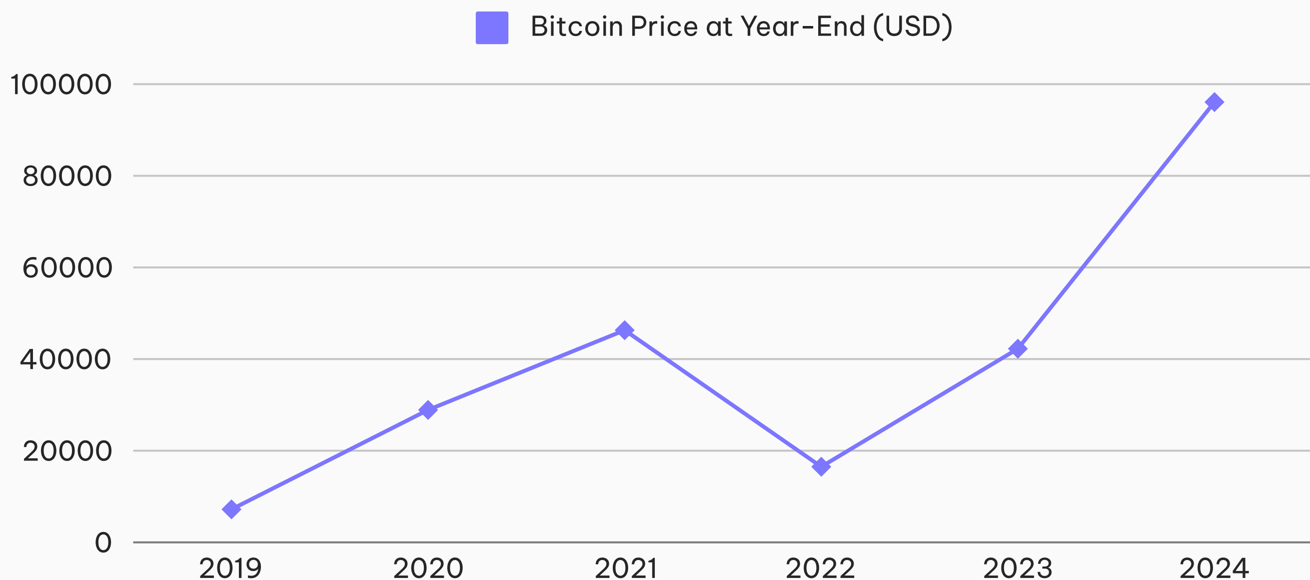
10] U.S. Commodity Futures Trading Comm'n, Who Trades Bitcoin Futures? (Nov. 2021), https://www.cftc.gov/sites/default/files/2021-11/WhoTradesBTC_V2_ada.pdf.

11] SEC Staff, Statement on Investing in the Bitcoin Futures Market, U.S. Sec. & Exch. Comm'n (June 10, 2021), https://www.sec.gov/newsroom/speeches-statements/staff-statement-investing-bitcoin-futures-market.

The investments suggested by these fund sponsors were unambiguously in compliance with the law. The fund sponsors knew it, their lawyers knew it, and the SEC knew it as well. And we know the SEC knew it because numerous issuers we spoke to during the production of this report said they challenged the SEC to name the law or regulation supporting its position and had their questions met with silence or evasion. This is not how the system has been designed to work. The reason the system has been designed to seek to curtail those impulses on the part of the SEC is because it is known that government agencies have no special insight into the soundness of an investment or the direction of markets. There is certainly no reason to believe government regulators are in a position superior to that of trained and experienced investment professionals regarding such questions.

When Rule 6c-11 took effect on December 23, 2019, bitcoin was worth $7,355. On December 31, 2024, bitcoin had reached a value of $96,090. That is a cumulative return of 1,206%.

On an annualized basis, the return is 66.82% a year over that time. By seeking to constrain investment exposure in regulated funds to 10% or 3% (pick your arbitrary limit), the SEC harmed investors by causing them to miss out on the investment gains they would have experienced. The SEC didn't prevent any harm by artificially capping investor exposure to bitcoin. Instead, it caused harm — harm that would have been avoided if the SEC had merely stuck to its mandate.



A Disclosure-Based System

While Part I of this report sought to detail specific recent instances of the SEC acting as a merit regulator, Part II seeks to make plain that such behavior directly conflicts with the intention of Congress when it enacted the foundational pieces of legislation that established the U.S. federal securities regime by providing a detailed account of the circumstances leading up to their enactment. The purpose of this history is to make it clear that the choice to adopt a disclosure-based system was the result of careful deliberation and intent on the part of President Franklin Delano Roosevelt and the Congress.

A.

The Initial Forays into Securities Regulation

“Everything but the blue sky” (1911–1933)

Prior to the enactment of the Securities Act in 1933, there was no federal oversight of the nation’s securities markets. Regulation had been on-going at the state level since 1911, when Kansas enacted the first law regulating the sale of securities.[11] Before the Kansas legislature took action, securities transactions were not subject to any specialized law or regulation. By the onset of the Great Depression, every other state had followed suit. Such[12] state securities laws were soon called “blue sky laws” because some lawmakers believed that “if securities legislation was not passed, financial pirates would sell citizens everything in [the] state but the blue sky.” [13]

Such blue sky laws were not uniform and varied from state to state but generally could be classified into two broad categories: antifraud laws and licensing laws.[14] Antifraud laws empowered state authorities to investigate suspected fraud and enjoin fraudulent activities. [15] Licensing laws gave state officials control over sales of securities within a state by prohibiting sales of securities therein until an application was filed and permission was granted by the state. [16] Officials of a state agency, most commonly a state securities commission, would review detailed information supplied by the issuer regarding the issuer’s financial history before passing judgment on the “soundness” of a securities offering.[17] Accordingly, this system gave state securities commissions the power to

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11] Ronald J. Colombo, “Merit Regulation via the Sustainability Rules,” 12 Journal of International Business and Law 1, art. 2 at 7 (2013).

12] Id.

13] Elisabeth Keller, Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934, at 331 (1988).

14] Comment, The New Federal Securities Act, 31 MICH. L. REV. 1118 (1933).

15] Keller, supra note 12, at 331.

16] Comment, supra note 13, at 1118.

17] Keller, supra note 12, at 332.

evaluate the merits of securities proposed to be offered.[18] It was the birth of so-called securities-based "merit regulation" in the United States.

Even as the Twenties roared and the stock market embarked on a seemingly never-ending ascent, there was a general belief among regulators that many underwriters and dealers of securities were not operating in a fair, honest, and prudent manner.[19] Investors were frequently enticed with promises of quick wealth, yet the typical offering circular used before the passage of the Securities Act provided little of the essential information required to assess the value of a security.[20] These circulars often lacked significant, if any, material details about an issuer's business or how the proceeds from the sale of the securities would be utilized.[21]

Given that the blue sky laws did little to prevent such questionable practices, demand did grow for federal regulation.[22] Several bills were introduced in Congress that contained disclosure requirements, antifraud measures, and federal aid for the enforcement of state blue sky laws.[23] However, for various reasons that differed from administration to administration, including President Coolidge's belief in the "benign tendency of things that are left alone," no laws were ultimately enacted at the federal level.[24]

18] Jonathan Katz, 1 Federal Securities Act of 1933, § 1.02.

19] H.R. REP. NO. 85, 73d Congr., 1st Sess. 2 (1933).

20] Keller, supra note 12, at 335.

21] Id. See also H.R. REP. NO. 85, supra note 20, at 2.

22] Federal Securities Act: Hearings before the House Interstate and Foreign Commerce Comm., 73d Congr., 1st Sess., on H.R. 4314, 101-103 (1933).

23] Keller, supra note 12, at 336.

24] Id.

B.

The Battle of the Philosophies

"Sunlight is the best of disinfectants; electric light the most efficient policeman" (1933)

Unfortunately for the country, the ills plaguing the securities market, duly left alone by President Coolidge, turned out to be anything but benign. The United States had endured stock market crashes in the past. The routs experienced in 1873, 1907, and 1921 were painful but nothing on the order of what the country would experience beginning in the fall of 1929.

On September 1, 1929, nearly two months before "Black Tuesday," the aggregate value of all stocks listed on the New York Stock Exchange was $89 billion.[25] By 1932, that number had dropped to $15 billion. From 1920 to 1933, $50 billion of securities were sold in the United States. By 1933, half of those securities were worthless.[26]

Congress had no choice but to enact legislation, though the shape that legislation would take remained uncertain. On one hand, the nation had decades of experience with blue sky laws based on merit regulation; on the other hand, those laws had largely proven ineffective. Despite this, when President Roosevelt tasked former Federal Trade Commission ("FTC") Chairman Huston Thompson with drafting a securities regulation bill, the resulting proposal was modeled after the most stringent blue sky laws and heavily influenced by merit-regulation principles.[27] It even included provisions allowing for the revocation of a security's registration if an administrative review found that the issuer's enterprise or security had not been founded on sound principles and that revocation served the public welfare.[28] Perhaps unsurprisingly, Thompson's bill also granted the FTC authority to act as the regulator for the securities industry.

25] Loss, Seligman, & Paredes, FUNDAMENTALS OF SECURITIES REGULATION, ch. 1, § C, at 9 (2023).

26] Id.

27] Keller, supra note 12, at 339.

28] S. 875 & H.R. 4314, 73d Cong., 1st Sess. § 6(c), (e), (f) (1933).

The draft bill encountered significant criticism during the hearings, with the strongest objections directed at the FTC's authority to revoke any security deemed not based on sound principles — a hallmark of merit regulation.[29] This approach conflicted sharply with President Roosevelt's vision for securities legislation. Like many of his contemporaries, Roosevelt was influenced by Supreme Court Justice Louis D. Brandeis, whose philosophy shaped the foundation of federal securities regulation in the United States.[30] Brandeis was a firm advocate of mandatory disclosure as the most effective way to reform the securities markets. In his influential work Other People's Money, he famously argued that "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman."[31] Brandeis contended that the law should not protect investors from making poor decisions, but rather ensure transparency in financial dealings.[32]

That is not to say Brandeis's philosophy of disclosure went unchallenged. William O. Douglas, who later succeeded Brandeis on the Supreme Court, was among those who questioned its effectiveness. Douglas argued that even if investors were provided with accurate information about the securities they were purchasing, it was doubtful that the average investor could understand or make use of that information. He noted, "[T]hose needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant."[33]

Douglas contended that the government had a responsibility to protect investors from their own misjudgments.

29] Keller, supra note 12, at 339.

30] Loss, supra note 24, at 10.

31] Id.

32] Id.

33] Id. at 12.

However, to the chagrin of Douglas, President Roosevelt rejected the notion that investors need to be protected from themselves. Instead, he embraced the philosophy of disclosure. The "battle of philosophies" was settled. Roosevelt entrusted his close friend and informal adviser, Felix Frankfurter, with the task of overseeing the redrafting of a new securities bill that would reflect their shared vision of the principles underlying the future securities regime.[34]

Frankfurter's team did not have to look far for inspiration. The British Companies Acts of 1908 and 1929 provided a useful model for a regulatory system akin to what Roosevelt envisioned. Unlike the merit-based licensing system used by individual American states, the British had adopted a disclosure-based regime.

The result of these efforts became the Securities Act. Under this act, issuers of securities are required to make specific public disclosures in a registration statement filed with the SEC before offering its securities for sale. This information is summarized in a prospectus, which is provided to potential investors before or at the time of purchase. Additionally, the Securities Act established stringent anti-fraud provisions, giving investors legal recourse against issuers who attempt to deceive them.

[34] Keller, supra note 12, at 339

The Securities and Exchange Commission Is Born

“Set a thief to catch a thief” (1934)

Congress’s work was far from finished upon the passage of the Securities Act, which primarily addressed the initial offering of securities but left the regulation of their subsequent trading largely untouched. The act did little to address the dubious practices that had plagued the stock exchanges leading up to the 1929 crash. Therefore, after completing the Securities Act, Congress turned its attention to crafting the Securities Exchange Act of 1934 (the “Exchange Act”), which President Roosevelt signed into law in June 1934.

The drafters of the Exchange Act sought to create a comprehensive framework for regulating the stock market. The new legislation required stock exchanges to establish rules for fair dealing, extended the Securities Act’s full disclosure requirements to all securities traded on national exchanges, and empowered the Federal Reserve to regulate the use of borrowed money in the stock market.[35]

The Exchange Act also addressed a key question: which government entity would oversee and enforce these new laws? While some drafters considered establishing a new independent agency, President Roosevelt initially favored leaving enforcement of both the Securities Act and the Exchange Act under the jurisdiction of the FTC. However, influential senators voiced concerns that the FTC lacked the specialized expertise in securities regulation required to effectively manage such a complex sector of the economy.[36] In the end, the drafters and the Senate prevailed, leading to the creation of the Securities and Exchange Commission.

35] Id. at 347.

36] Id. at 340.

SECURITIES AND EXCHANGE COMMISSION

SEC. 4. (a) There is hereby established a Securities and Exchange Commission (hereinafter referred to as the "Commission") to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate.[37]

While the first five commissioners appointed to the SEC were well known at the time, only one of them, the first chairman of the agency, remains a household name today: Joseph Kennedy, the *pater familias* of the Kennedy clan and father to future President John F. Kennedy.

The appointment of Joseph Kennedy was controversial even in its own time, as it was well known that he had amassed his fortune in the previous decade through market manipulation and insider trading.[38] Still, when Roosevelt was questioned about the wisdom of appointing someone with a history of stock manipulation and insider trading to head the agency responsible for enforcing the nation's new securities laws, he reportedly quipped: "Set a thief to catch a thief." [39]

37] 15 U.S.C. § 78a (1934).

38] Keller, supra note 12, at 348.

39] Peter J. Henning, "The Dual Duties of the Next S.E.C. Chief," New York Times (Jan. 24, 2013).

The Basic Bargain of Our Markets

“The SEC is merit neutral” (1934-2024)

SEC has played a pivotal, though narrow, role in the U.S. federal securities regime. Its primary responsibility has been to enforce the nation’s securities laws. While the statutes have undergone amendments over the years, and countless regulations have been implemented pursuant to their authority, all have been grounded in the same foundational philosophy established by the Securities Act and the Exchange Act.

The preceding historical overview was provided to underscore a key point: the decision to build a federal securities regime based on disclosure — rather than on a government agency’s assessment of merit — was neither accidental nor happenstance. It was a deliberate choice, one that defied the prevailing momentum and the country’s early, ill-fated experiments with merit regulation under the “blue sky laws.”

At the core of a merit-based system lies a form of paternalism: a belief that the government’s judgment about what is best for you is so superior to your own that it excludes you from the decision-making process. This notion is deeply contrary not only to the American ethos but also to basic intuition. There is no reason to assume that a lawyer at the SEC or a state securities commission possesses special insight into which securities an investor should or should not buy.

One of the most famous examples of this occurred when Massachusetts securities regulators initially barred state residents from purchasing shares in Apple’s initial public offering, deeming it “too risky.”[40] The annualized return on Apple stock from its IPO until January 2024 was approximately 19%, more than doubling the 9% annualized return of the S&P 500 Index over the same period.[41]

40] Richard Rustin and Mitchell Lynch, “Apple Computer Set to Go Public Today; Massachusetts Bars Sale of Stock as Risky,” The Wall Street Journal (Dec. 12, 1980).

41] Mark T. Uyeda, “Remarks at the 51st Annual Securities Regulation Institute,” U.S. Securities and Exchange Commission (Jan. 22, 2024).

Beyond the historical and cultural rationale, the results of this approach speak for themselves. The U.S. securities system, built on disclosure rather than merit regulation, has created the most efficient securities market in the world — one that fosters, rather than stifles, capital formation. By encouraging transparency rather than imposing arbitrary government approval processes, this system supports innovation and growth, allowing companies — especially startups and smaller businesses — greater access to public capital markets.

President Roosevelt's decision to adopt a disclosure-based regulatory regime was the catalyst that set the U.S. securities markets on a path to become the dominant force they are today. By the end of 2023, U.S. equity markets alone accounted for 42.6% of the $115 trillion in global equity market capitalization.[42]

Valued at $49 trillion, the U.S. equity market was 3.9 times larger than the next biggest market, the European Union.[43] A similar story can be told in the fixed income sector, where the U.S. markets comprised 39.3% of the $140.7 trillion in outstanding global fixed income securities.[44] At $55.3 trillion, the U.S. fixed income market was 2.1 times larger than that of the European Union, its closest competitor.[45]

It's no coincidence that most of the world's well-established and mature capital markets, such as those in the European Union, Japan, Hong Kong, Singapore, Canada, and Australia, have followed the United States' and United Kingdom's lead in adopting disclosure-based regimes. In contrast, countries that continue to operate under merit-based systems are often those with authoritarian or interventionist governments, such as mainland China and Saudi Arabia. At least partly as a result, China's equity markets account for just 9.5% of global equity market capitalization, and its fixed income markets represent only 16.3% of the global total.[46]

42] SIFMA, 2024 Capital Markets Factbook 6 (2024).

43] Id.

44] Id.

45] Id.

46] Id.

Conclusion

> “Our federal securities laws lay out a basic bargain in our markets. Investors like you get to decide which risks to take so long as those companies raising money from the public make what President Franklin Roosevelt called ‘complete and truthful disclosure.”

This report concludes with the same quote from Chairman Gensler with which it began, as it encapsulates the essence of the U.S. federal securities regulatory regime. This system is fundamentally designed to empower investors to make informed decisions about the risks they choose to take. The laws and regulations, and the agency that enforces them, exist to serve this principle, ensuring that investors have access to the best information possible when making these determinations. It is the “basic bargain” of our markets.
The SEC plays a critical role within that system, and the agency has done an admirable job in that role over the past 90 years. It is because of, not in spite of, the SEC that the U.S. capital markets have become the overwhelmingly preferred destination of choice for companies seeking to raise capital and investors seeking to put their savings to work. Nevertheless, by design, the role of the SEC is a limited one. Its task is focused on the disclosure accompanying a potential investment, not on whether such an investment would be prudent.

This report contends that, as it relates to a registered investment company’s exposure to digital assets, the agency overstepped its mandate. The SEC had never encountered an asset quite like bitcoin before — one that is purely digital in nature — and perhaps feared that the average investor was swept up in a speculative fever over an asset class lacking a cogent investment thesis. As the agency sought to indulge its impulse to save investors from themselves, it found very few tools at its disposal to effectuate its aims. This was by design, as seeking to save investors from themselves is explicitly not what Congress intended for the SEC when it created the agency. Congress had considered and actively pivoted away from merit-based regulation.

In its efforts to limit exposure to bitcoin and digital assets, the SEC adopted positions lacking adequate legal justification, leading to widespread disillusionment and charges of unfair treatment. Yet, in the end, bitcoin's adoption and value only increased. In seeking to protect investors, the SEC caused them to miss out on the large gains such investors would have otherwise experienced.

These missteps cannot be laid at the feet of a particular political party, presidential administration or SEC Chair. The incidents detailed within this report occurred during the presential administrations of Barack Obama, Donald Trump, and Joe Biden and during the SEC chairmanships of Mary Jo White, Jay Clayton, and Gary Gensler.

As we enter 2025 and with the SEC set to enter a new chapter in its history, this report seeks to play a very small part in encouraging the SEC to return to the authorized path on which it was initially set. There will always be a new asset or company that inspires wonder on the part of investors and skepticism on the part of the SEC. It is the hope that the SEC will learn from its experience with digital assets and in the future resist the siren song of merit regulation.