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NFTs and Virtual "Dust": The Unlikely Issue Perplexing US Bitcoin ETFs

Bitcoin ETFs in the US have amassed over 500,000 Bitcoins since the start of the year after the Securities and Exchange Commission officially approved the ETFs for retail investors. This has seen the likes of Blackrock become the fastest ETF to amass $10b of assets under management (AUM). However, the surge in direct Bitcoin investments has given rise to an unlikely phenomenon: ETFs are accumulating digital assets like non-fungible tokens (NFTs) which were inadvertently received from their Bitcoin purchases.

These digital assets and/or NFTs which are known colloquially as "dust" have come embedded from past cryptocurrency transactions that were sold by previous owners. In essence, it is akin to stapling a cheque to a $5 note when you purchase an item. The unexpected influx of these digital assets has seen them appear in digital wallets across different providers like Bitwise Asset Management, Blackrock, and Cathy Wood's Ark Investment Management. "Dust" from these cryptocurrency transactions, by design of the blockchain, cannot be unwound as these transactions were processed through it. This has seen the likes of cartoon images of rainbow vomiting frogs and even the "Bitcoin Puppet" surface in digital vaults of ETF providers, all made possible by creating a token that allows images and text to be embedded into Bitcoin, creating Bitcoin NFTs.

Although ETF providers have unexpectedly run into a small windfall (from receiving "dust" through their Bitcoin purchases, they cannot sell down these digital assets as it would require further regulatory approval from the SEC and could entail complicated tax implications for investors. ETFs would not risk running afoul of any tax regulations or the SEC as it would definitely affect its attractiveness to retail investors. SEC filings have shown that ETF providers are actively taking steps to keep "dust" at arm's length from the main asset manager which has seen a few ETFs implement house policies pertaining to "dust". Blackrock has a policy of forfeiting the "dust" by placing it in a separate digital wallet where the "dust" can be held in perpetuity or liquidated and donated to charity. Other ETF providers like Bitwise have all but revealed the blockchain addresses of their digital wallet aimed at providing transparency to investors while being able to track the market value of the "dust".

Regardless of the policies that ETF providers adopt in their treatment of "dust", this phenomenon has exposed the rigidity of legacy tax rules and SEC regulatory structures which could be a potential hindrance to the widespread adoption of and participation in cryptocurrency (especially for retail investors). Both ETF providers and the SEC will need to continue working together to regulate and provide accessible cryptocurrency denominated investment products for retail investors.

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