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The ETP breakthrough

Crypto's regulatory milestone

Introduction

On January 10, 2024, the US Securities and Exchange Commission (SEC) approved the listing and trading of a number of exchange-traded products (ETPs) with a direct (spot) interest in bitcoin (BTC), a leading digital asset.[1] Until this approval, and on the heels of a 2018 decision,[2] all applications for a spot bitcoin ETP had failed due to concerns about investor protection, the potential for price manipulation, and for lack of surveillance-sharing agreements with a regulated bitcoin market of significant size. In October 2021, the SEC approved the first exchange-traded fund (ETF) with exposure to bitcoin through exchange-traded futures contracts traded on the Chicago Mercantile Exchange.[3] In the wake of the approval of this futures ETF, there was a court challenge against the SEC. It dealt with an earlier denied application for a conversion of an over-the-counter (OTC) bitcoin spot product into an ETP. On August 29, 2023,[4] the US Court of Appeals for the District of Columbia Circuit granted the applicant's petition for review and vacated the SEC's prior denial. That decision helped pave the way for the ultimate approval of spot bitcoin ETPs in January 2024. Soon thereafter, while not without twists and sudden timing that likely surprised even the applicants, the SEC also green-lighted the listing of spot ether ETPs.[5]

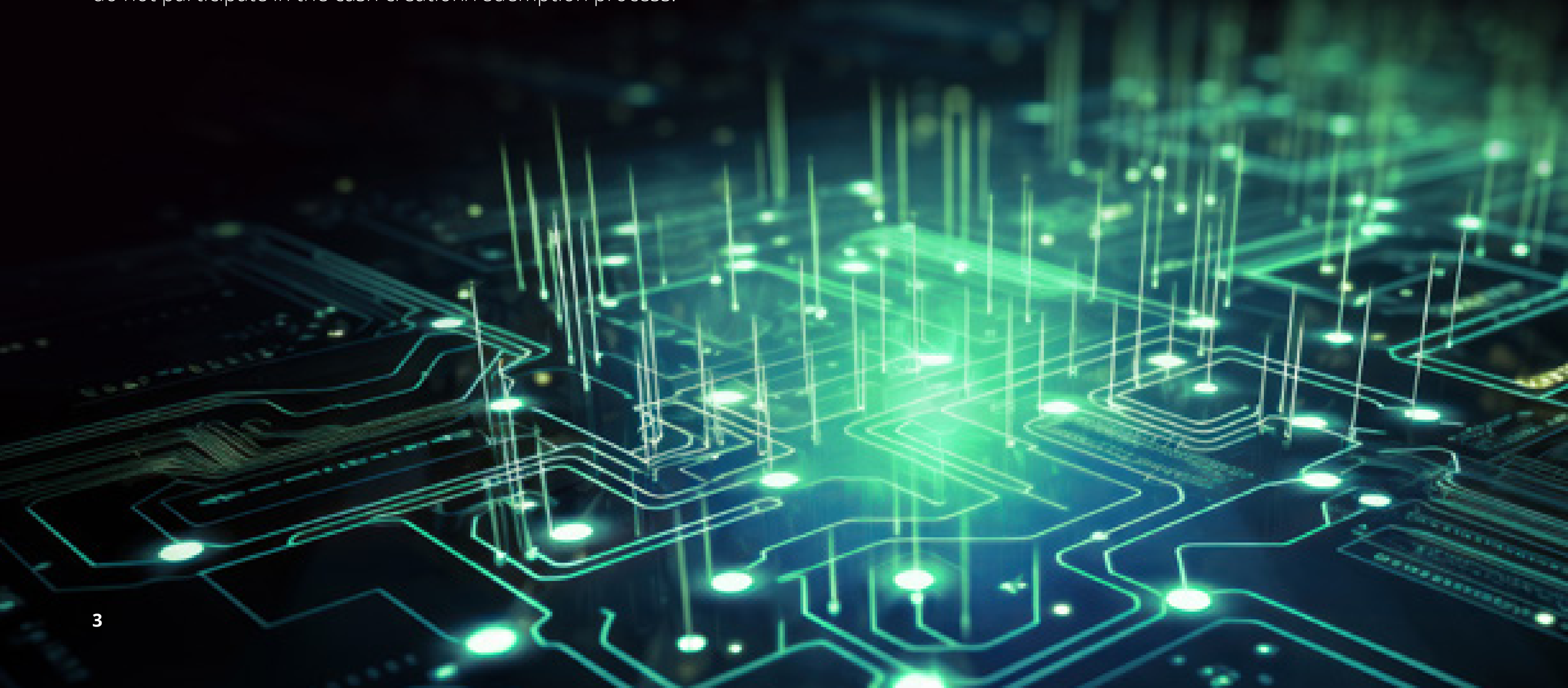
An ETF and an ETP—they are not the same

Let's begin with a few definitions and some context regarding ETFs. An ETF is an investment vehicle registered under the Investment Company Act of 1940 (also known as the 40 Act), similar to a traditional mutual fund. However, there is a key difference. Instead of investors subscribing to and redeeming directly from the fund, as with an open-end mutual fund, the shares of an ETF are listed on an exchange for investors to buy and sell on the secondary market. The sponsor of an ETF relies on authorized participants (APs), FINRA registered broker-dealers, to create and redeem shares of the ETF in exchange for securities or for a basket of securities tracked by the ETF. The APs, in turn, deal in the ETF shares on an exchange (i.e., the secondary market). During the life of an ETF, depending on the market conditions, the APs facilitate the creation of additional shares (creation units) or the redemption of shares (redemption units). APs typically turn to creation units when demand exceeds supply, and the ETF is trading at a premium to its net asset value (NAV). On the other hand, they rely on redemption units when supply exceeds demand, and the ETF is trading at a discount. The create and redeem process is effective in reducing the discount/premium to NAV at which the shares of an ETF are trading.

For a typical ETF, the create and redeem process usually takes place in-kind (i.e., ETF shares are exchanged for securities and vice versa). Most of the initial spot bitcoin ETP applications indicated they would use in-kind creations and redemptions. Yet, in the course of the SEC comment period, all applications underwent revision to provide for only a cash creation and redemption process. This also carried over for the spot Ethereum ETP. As a result, instead of the APs engaging in the purchase or sale of bitcoin or ether in exchange for the shares of the ETP, it is the ETP itself that engages in the purchase or sale of bitcoin or ether to fulfill the creation and redemption in cash. Bear in mind that, since shareholders of the spot ETPs buy and sell the shares on the secondary market, they do not participate in the cash creation/redemption process.

The approved spot bitcoin and ether products are not ETFs. ETFs, a subset of ETPs, are registered as investment companies under the 40 Act. Given the rather clear SEC pronouncements that bitcoin is not a security, a spot bitcoin product did not have to register as an investment company under the 40 Act (It would, were bitcoin deemed a security). Instead, it was registered under the Securities Act of 1933 (33 Act) as an ETP. This determination was not as clearcut for ether and, in fact, may have contributed to an important missing feature of the spot ether ETPs—staking. It was included as a feature of the ETPs in the initial applications submitted to the SEC but was removed by all applicants only days before the SEC approved listing on May 23, 2024. As ETPs, these spot products have a sponsor that is not registered with the SEC as an investment adviser pursuant to the Investment Advisers Act of 1940 (it would be for an ETF). Consequently, it is not subject to regulation by the SEC, notably under rule 206(4)-2, the "custody rule" that is part of the Investment Advisers Act of 1940.

In addition, given their status as registrants under the 33 Act rather than the 40 Act, ETPs have different SEC reporting requirements compared to ETFs. Specifically, the ETPs file annual audited financial statements on Form 10-K and quarterly financial statements on Form 10-Q. This is the same as for a traditional public company for which the shares are traded on a US stock exchange. By contrast, while ETFs do file annual audited financial statements on Form N-CSR, they additionally file only semi-annual financial statements.



Spot ETPs: An Overview

Both the bitcoin and ether spot ETPs have made clear that, for US federal income tax purposes, they intend to be treated as grantor trusts. To be deemed a grantor trust (as opposed to a corporation or partnership) the trusts have a single class of ownership interest. That class represents an undivided beneficial interest in the trust assets, and the trustees have no power under the trust agreement to vary the trust's investments. As grantor trusts, the ETPs are not subject to entity-level tax. Many sponsors thus far have obtained "should" legal opinions asserting grantor trust status. They typically do disclose, however, that this opinion is not binding for the IRS, and the IRS could determine that the spot ETP is a publicly traded partnership subject to a corporate-level entity tax.

The first iteration of the ether ETPs are not permitted to stake their underlying ETH to receive additional ETH staking rewards. If and when the SEC does permit staking, this will likely engender additional complexities that ETP issuers will need to consider. Of particular importance would be the question of whether the ability to generate staking rewards would constitute a power to vary the investment of trust certificate holders and thereby violate the requirements for the ETP to be treated as a grantor trust. Secondarily, there would be the issue of the character and sourcing of the staking rewards. While the IRS issued Revenue Ruling 2023-14 to address the timing of income recognition (included in gross income when taxpayer has "dominion and control" over the rewards), it was silent on character and the source of the income. So, uncertainty remains regarding the rate at which the income is taxed and possible incurrence of withholding taxes. Furthermore, there is uncertainty whether staking constitutes an active trade or business. That determination may also have an impact on the ability of the ETP to qualify as a grantor trust rather than as a business entity for tax purposes and on whether the staking income is considered effectively connected income ("ECI") that would make it subject to US taxation for foreign investors.

Entity reporting

For US federal income tax purposes, an ETP deemed a grantor trust is not regarded as a business entity. Shareholders are treated as direct owners of a pro rata share of the underlying asset. Any income and expenses generated by the trust are not reported at the entity level. Instead, they are passed through to the shareholders. When the ETP sells trust assets to pay its expenses, the proceeds are allocated to the shareholders. They then calculate their gain or loss based on their tax basis in the coin that was sold. There is no entity level tax reporting or filing for federal income tax purposes.

Shareholder reporting

For tax purposes, the spot ETP will likely qualify for simplified tax reporting under Treas. Reg. 1.671-5 (Widely Held Fixed Investment Trusts). The trust agreement will typically limit the ETP to only holding the underlying coin and will permit sales only to cover entity level expenses. As a result, the ETP will likely meet the de minimis exception that allows the ETF to provide a shareholder letter in lieu of 1099-B reporting.

In the shareholder letter, the trustee (sponsor) will provide shareholders with sufficient information to determine the following: the amount of underlying assets that they initially purchased; their share of income and expenses; and the amount and date of any asset sales and corresponding proceeds from those sales. The shareholders should have sufficient information to determine their initial and adjusted basis in the underlying assets, their allocable income and expenses, and any gain or loss they will recognize on each disposition that the ETP has made. The administrative expenses will be considered miscellaneous itemized deductions to the extent they were not incurred while carrying on a trade or business. Were that the case, those expenses are non-deductible for individual shareholders through at least 2025. Shareholders will need to do a gain or loss calculation for each separate purchase of the ETP shares (tax lots). For a typical OTC traded product that may have limitations on when and how often investors can acquire the product, there tends to be minimal amounts of tax lots per investor. With an ETP, however, the result could be that shareholders have a substantial amount of tax lots. This could lead to a burdensome calculation for shareholders.

Treasury and the IRS addressed shareholder reporting of ETPs in the final digital asset broker reporting regulations issued on July 28, 2024. The regulations confirm that the ETPs are not within the scope of 1099-DA reporting, but instead remain subject to the reporting requirements under Treas. Reg. 1.671-5 described above.

For the ether ETPs, shareholder reporting could be complicated by the presence of staking rewards (if they become enabled).

Futures ETFs

An ETF that is holding futures contracts with collateral requirements and differing expiration dates cannot be classified as a grantor trust for federal income tax purposes. That is because it violates the grantor trust rules regarding varying the trust assets.[6] As such, most BTC & ETH futures ETFs have registered with the SEC under the 40 Act and have elected to be taxed as a regulated investment company (RIC). RICs are corporations that are not typically subject to entity level tax. Instead, they pass the taxable income to the RIC shareholders in the form of a dividend (reported on Form 1099-DIV).[7] There are, however, various limitations and requirements to be taxed as a RIC for tax purposes—and they can pose significant challenges for ETFs that invest primarily in BTC & ETH futures.

RICs are required to generate at least 90% of their gross income from passive "securities" investments, such as dividends, interest, gains from the sale of securities, and other income from investments in securities. While there are many definitions of what constitutes a security for US tax purposes, digital currency does not appear to fit the definition specific to RICs.[8] As a result, the income generated from BTC & ETH futures is likely not deemed passive income from securities investments. To be deemed passive income would require the RIC to hold the futures contracts in a non-RIC corporate subsidiary. Typically, this will be done in a wholly owned corporation domiciled in a tax haven (such as the Cayman Islands), an entity that would then be considered a controlled foreign corporation (CFC). The CFC rules generally require that the RIC recognize any net positive earnings and profits (E&P) at the CFC level during a given year as a deemed dividend paid to the RIC.[9] That E&P/deemed dividend is then added to any other net income earned by the RIC and is paid out to the ETF shareholders as a dividend taxed at ordinary rates. Furthermore, any net losses generated in a particular year may not be carried forward to offset future earnings.[10] These rules can result in investors receiving substantial taxable dividends even in a scenario where their overall investment is down. For example, a fund that experiences significant losses in a taxable year and generates modest gains in a subsequent year may need to distribute those gains to investors as those previously generated losses will not be available to offset those subsequent gains. This whipsaw can be detrimental to investors gaining exposure to the fund in a taxable account.

In addition to the income requirement, RICs are also subject to various investment limitations. One such limitation is that a RIC cannot invest more than 25% of its assets in any one security (including a wholly owned subsidiary), as measured on the last day of each quarter.[11] Managing this limitation can be burdensome. That is particularly true given the volatility of the asset class and the inflows and outflows that occur with a listed ETF. The ETF may need to exit positions earlier than anticipated as a measurement day approaches, which could result in additional drag on the returns to the shareholders. While this requirement aims to protect shareholders from the inherent risk of an overly concentrated portfolio, many shareholders investing in this product are not looking for "diversification".

Potential Benefits of ETPs?

A potential benefit of investing in an exchange-traded product, including an exchange-traded fund, should be clear: access to investment strategies that may otherwise be hard to execute, particularly for a retail investor. Traditionally, ETFs are diversified investment vehicles that invest no more than 25% of their assets in a single issuer and that have the stated investment strategy of tracking an index or delivering on another targeted strategy. A spot ETP invests only in that digital asset. So, the question is: Why would someone consider investing in a spot ETP that charges a fee rather than just purchasing digital currency directly? This kind of ETP may not be right for everyone. But there are several potential reasons why an investor may want to consider purchasing a spot ETP. First, access to an ETP can help enable retirement vehicles, such as 401(k)s and IRAs, to help gain an exposure that may otherwise not be possible. Second, unlike an ETP, investing directly in bitcoin or ether may require an investor to either open an account with a digital asset exchange or use a personal finance platform that provides access to digital asset trading. In addition, they should either arrange a third-party crypto custodian or self-custody—both of which may also involve a direct or indirect fee. Depending on the individual (or an institution), some may be more comfortable with, the dynamics of the underlying blockchain technology as they transact and store digital assets, such as bitcoin or ether. Others, however, may feel a certain level of discomfort with an actual or perceived risk associated with securing private key material. Instead, they may appreciate the ease and reassurance of accessing exposure through traditional channels that rely on already-established brokerage accounts. That way they can delegate the safe-guarding of private keys and other aspects of management to qualified third-party institutions. A spot ETP may not be for everyone, but it can open the market to many who may not have been able or willing to enter the market in the past.

What might the future hold?

Starting with the approval of the futures-based ETFs in 2021 and continuing with the spot ETPs in 2024, exchange traded crypto products have become more popular with investors and embraced by some of the largest investment managers in the world. This combination of established investment managers, traditional distribution channels, and a developing asset class has helped crypto products become more successful.

There are areas for concern, however. The ether ETP launch in July resulted in net outflows compared to the predecessor OTC products in the weeks preceding the launch.[12] This is likely the result of the ETP currently not offering staking. If staking continues to be elusive for ETPs, it could challenge the viability of the product in the future.

There may also be some concern in the industry regarding the cash requirement for the create/redeem process. While similar single commodity trusts with more traditional underlying assets (gold, silver) are able to facilitate subscriptions and redemptions in-kind, their digital asset counterparts are forced to use cash. This results in wider spreads between the NAV and the price of the ETP, due to the increase in time it will take to facilitate the transaction. The APs may be disincentivized to participate given the increased risk they are taking on, as well as prospective shareholders potentially opting for a direct holding in the coin instead of through an ETP. Increased price volatility and transaction costs could also be a result of the cash requirement.

Conclusion

The SEC's approval of spot bitcoin and ether ETPs is an exciting development for investors who may seek exposure to these assets via an exchange-traded vehicle. While the futures-based products helped accomplish this in some measure as well, issues related to tax efficiency and tracking errors inherent in futures contracts can make them far from perfect. The spot product may, however, help alleviate these challenges.

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Endnotes

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