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The ETP breakthrough

Bitcoin'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 crypto 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 want of surveillance-sharing agreements with a regulated bitcoin market of significant size. Yet, in October 2021, the SEC approved the first exchange-traded fund (ETF) with exposure to bitcoin. It was grounded in exchange-traded futures contracts traded on the Chicago Mercantile Exchange. There was, however, a court challenge in the wake of the approval of this futures product. It dealt with an earlier denied application for a conversion of an over-the-counter (OTC) bitcoin product into an ETP. On August 29, 2023,[3] the US Court of Appeals for the District of Columbia Circuit granted the applicant's petition for review and vacated the SEC's denial. That decision ultimately paved the way for the approval of spot bitcoin ETPs in January 2024.



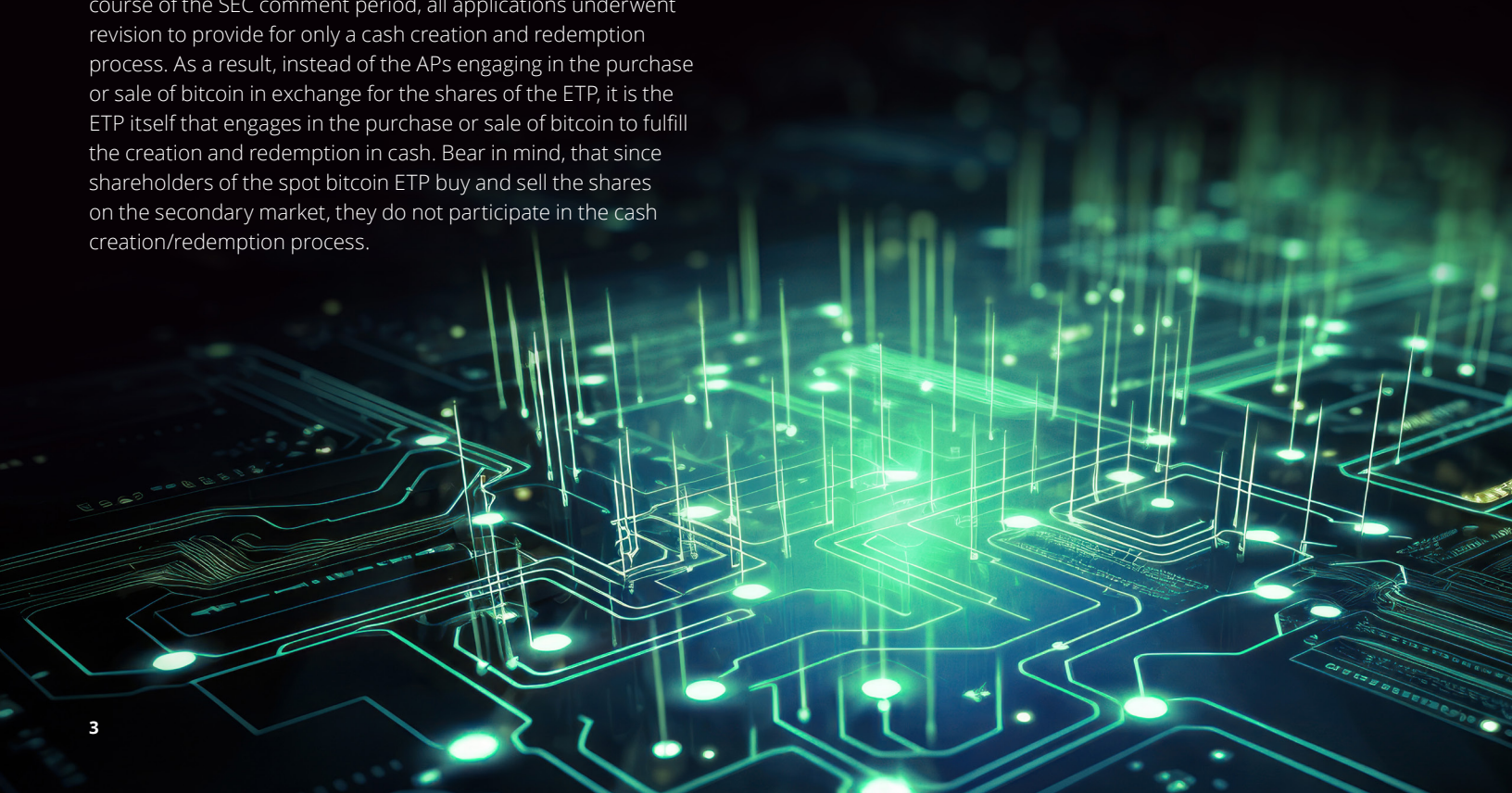
An ETF and an ETP—they are not the same

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 and redeeming directly to, or 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 example, in anticipation of the conversion of an OTC bitcoin trust product to an ETP, the discount to the NAV can narrow to near zero from levels that were originally as high as or above 40%.

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. As a result, instead of the APs engaging in the purchase or sale of bitcoin in exchange for the shares of the ETP, it is the ETP itself that engages in the purchase or sale of bitcoin to fulfill the creation and redemption in cash. Bear in mind, that since shareholders of the spot bitcoin ETP buy and sell the shares on the secondary market, they do not participate in the cash creation/redemption process.

The approved spot bitcoin 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 does not have to register as an investment company under the 40 Act. (It would were bitcoin deemed a security.) Instead, it is registered under the Securities Act of 1933 (33 Act). Therefore, they are deemed to be ETPs rather than ETFs. As an ETP, the spot bitcoin product has 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, they have different SEC reporting requirements compared to ETFs. Specifically, the ETPs file annual audited financial statements on Form 10-K and will also file 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 file only semi-annual financial statements rather than quarterly ones.



Spot bitcoin ETP: Overview

Recently launched spot bitcoin ETPs have made clear that, for US federal income tax purposes, they want 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 bitcoin ETP is a publicly traded partnership subject to a corporate-level entity tax.

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 bitcoin. 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 bitcoin that was sold. There is no entity level tax reporting or filing for federal income tax purposes.

Shareholder reporting

For tax purposes, the spot bitcoin 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 bitcoin and will permit sales of bitcoin 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 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.



Bitcoin futures ETF

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. As such, most bitcoin 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). 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 bitcoin 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, bitcoin does not appear to fit the definition specific to RICs. As a result, the income generated from bitcoin futures may not be 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. That E&P/deemed dividend is then added to any other net income earned by the RIC and is paid out to the bitcoin futures 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. 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 very 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. 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 a bitcoin futures ETF only want exposure to bitcoin.



Why would one consider a spot bitcoin ETP?

The potential benefit of investing in an exchange-traded product, including an exchange-traded fund, is 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 bitcoin ETP invests only in bitcoin. So, the question is: Why would someone consider investing in a spot bitcoin ETP that charges a fee rather than just purchasing bitcoin 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 bitcoin ETP. First, access to an ETP enables retirement vehicles, such as 401(k)s and IRAs, to gain an exposure to bitcoin that may otherwise not be possible. Second, unlike an ETP, investing directly in bitcoin may well require an investor to either open an account with a digital asset exchange or use a personal finance platform that provides access to bitcoin trading. In addition, they have to either arrange a third-party crypto asset custodian or self-custody—all of which may also involve a direct or indirect fee. Depending on the individual (or an institution), some may be comfortable with, and even enjoy, the dynamics of the underlying blockchain technology as they transact and store crypto assets, such as bitcoin. Others, however, may feel a certain level of discomfort with an actual or perceived risk associated with securing private key material. Instead, they would appreciate the ease and reassurance of accessing bitcoin 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 bitcoin management to qualified third-party institutions. A spot bitcoin ETP may not be for everyone, but it certainly opens the market to many who may not have been able or willing to enter the market in the past.

What might the future hold?

So, what about exchange-traded products for other types of crypto, such as ether (ETH)? One can ask, since the SEC has already approved futures-based ETH ETPs, wouldn't the same logic apply in the case of an ETH product? And consequently, wouldn't the attending approval be imminent? Let's not jump to conclusions. The SEC statement announcing the approval of the BTC ETP noted:

> "Importantly, today's Commission action is cabined to ETPs holding one non-security commodity, bitcoin. It should in no way signal the Commission's willingness to approve listing standards for crypto asset securities."

As mentioned earlier in this article, and further highlighted in the quotation above, the SEC views BTC as a commodity and not a security. There is no such clarity, however, regarding the SEC's view on ETH or other digital assets. That absence of clarity could prove to be a substantial barrier to the creation of more digital asset instruments.

That said, there are currently multiple applications pending for spot ETH ETPs, and they look similar (if not identical) in form to the BTC ETPs. Many of the applicants have already updated, or are in the process of updating their filings to change their nature from "in-kind" to "cash only" subscriptions and redemptions. That's in order to further align with the spot bitcoin ETP. One applicant has also introduced the notion of an ETP that participates in the staking of the ETP's digital assets so it can generate additional return for investors. As you will recall, the Ethereum network transitioned to a "proof-of-stake" network over a year ago. As a result, holders who stake, or "lock-up" their ETH for a period of time are ultimately given a reward in the form of additional ETH.

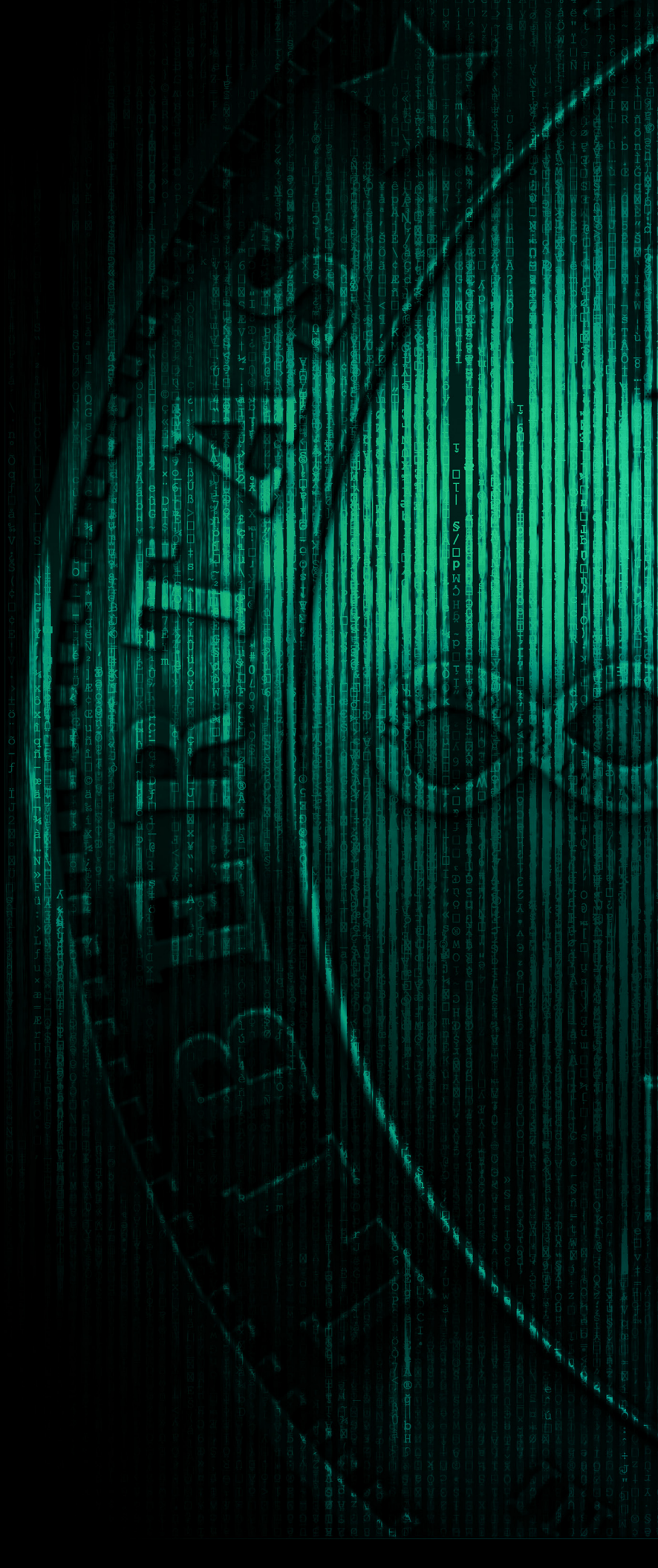
This is an exciting development. But it could also engender additional regulatory and legal complexities. The IRS has already issued Revenue Ruling 2023-14. It ruled that staking rewards are included in gross income for the year in which the taxpayer has "dominion and control" over the rewards and they are calculated at fair market value. This ruling did not address the character or source of the income, however. So, uncertainty remains regarding the rate at which the income is taxed and any possible incurrence of withholding taxes. Furthermore, there is uncertainty regarding whether staking constitutes an active trade or business. That determination may have an impact on the tax classification of the ETP and the deductibility of expenses. It may also affect foreign investors in that they may have income that is effectively connected to a US trade or business and hence subjecting them to US taxation. In addition to tax uncertainty, in their filing, the sponsor of the ETP disclosed some additional risks related to staking; namely, a risk that the fund might have to forfeit a portion of its staked coins (slashing) owing to "malicious activity," possible loss of value due to the creation and sale of new ETH, or possible liquidity issues resulting from the unstaking process.



Conclusion

The SEC's approval of a spot bitcoin ETP is an exciting development for investors who seek exposure to bitcoin via an exchange-traded vehicle. While futures-based bitcoin ETFs can accomplish this in some measure, issues related to tax efficiency and possible tracking errors inherent in futures contracts make ETFs far from perfect. The spot bitcoin product may, however, alleviate these issues.

A prospective shareholder should consider, however, the administrative burden that could result from investing in a bitcoin spot ETP. Note that prospective shareholders will not receive a Form 1099 for this product, requiring them to manually calculate their taxable income and adjust and track the tax basis for each individual lot purchased.



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Endnotes

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