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UCITS Eligible assets and cryptocurrency investments



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Executive summary

Currently there are no definitive regulatory policies available on whether crypto exchange-traded products (ETPs) are UCITS-eligible investments. In fact, certain European regulators accept crypto exchange-traded products as eligible assets while others seem to take a more restrictive view. We have applied the framework for UCITS eligibility to crypto ETPs, which we believe is a helpful way to assess eligibility. As crypto assets/crypto ETPs become more mainstream, this analysis will evolve. Key points emerging from the analysis are:

- i. Crypto ETPs meet the definition of “transferable securities that do not embed a derivative” of the Eligible Assets Directive.
- ii. Article 50 of the UCITS Directive¹, which specifies eligible investments, does not appear to preclude investments in crypto ETPs. It is important to note that the trading venues, through which the fund were to invest, would need to be regulated markets. This requirement is met by certain crypto ETPs that are listed on the SIX in Switzerland, regulated markets of the Frankfurt Stock Exchange, Euronext Amsterdam and Euronext Paris, and more recently on the London Stock Exchange. This view is supported by BaFin’s (the Federal Financial Supervisory Authority of Germany) position which allows German UCITS to participate in the price performance of crypto assets indirectly via the investment in so called 'delta one certificates,' that is, through unleveraged crypto ETPs². It is also supported by CNMV’s (Comisión Nacional del Mercado de Valores) position, the Spanish financial services regulator, which published an FAQ stating that “If the CIS are UCITS or harmonized, they can have exposure to cryptocurrencies through financial instruments whose performance is linked to such currencies, which do not include an embedded derivative (ETC, ETP and any so-called 'delta one' instrument)”³.

1 (Directive 2009/65/EC).

2 https://www.bafin.de/DE/Aufsicht/FinTech/Geschaeftsmodelle/DLT_Blockchain_Krypto/Kryptotoken/Kryptotoken_node.html

3 CNMV publication 'Preguntas y respuestas sobre la normativa de IIC, ECR y otros vehículos de inversión colectiva cerrados' [Questions and answers about the regulations of IIC, ECR and other closed collective investment vehicles] (online available at <https://www.cnmv.es/docportal/Legislacion/FAQ/QAsIIC.pdf> [accessed on 2 Decemeber 2021]).

Introduction

The purpose of this note is to set out and explain the current legal and regulatory environment affecting the ability of UCITS to purchase unleveraged exchange-traded products (ETPs) based on crypto assets ('crypto ETPs'), such as bitcoin and ether.

UCITS eligibility

It is generally accepted that UCITS can invest in ETPs to the extent that such an investment complies with the rules set forth in the Eligible Assets Directive⁴ (EAD). The EAD is generally interpreted to mean that permitted investments are transferable securities that do not embed a derivative (Art 2(2)(c) of EAD). European law generally requires a “look-through approach” where the transferable security embeds a derivative. As a result, any transferable security that embeds a derivative, must reference an eligible asset, as defined by the EAD.

In order to comply with the EAD, the crypto ETP must therefore: (i) not embed a derivative which references an ineligible asset, and (ii) be a transferable security.

(i) Embedding a derivative:

The International Accounting Standards (IAS) define a derivative as an instrument that contains a component that, by virtue of that component, some or all of the cash flows that otherwise would be required by the transferable security which functions as a host contract, and can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative.

Physically backed crypto ETPs do not fall under the above definition by virtue of their structure, which does not involve embedding a derivative instrument.

Under the legal structure, ETPs are debt obligations of the issuer and, similar to a physical gold ETP, investors in the crypto ETP have an entitlement to an amount of cryptocurrency. As is the case with debt securities, crypto ETPs involve a one-off purchase payment to the issuer and a final repayment to the holder at maturity. There are no margin payments between the issuer and the holder, which are generally associated with derivative arrangements.

(ii) Transferable security

| | (ii) EAD definition of transferable security | Crypto ETP characteristics |
|---|---|---|
| A | The potential loss which the UCITS may incur with respect to holding these instruments is limited to the amount paid for them | Unleveraged crypto ETPs would meet this criterion |

⁴ Eligible Assets Directive 2007/16/EC <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32007L0016&from=EN>.

| | (ii) EAD definition of transferable security | Crypto ETP characteristics |
|---|---|--|
| B | Their liquidity does not compromise the ability of the UCITS to comply with Article 37 of the UCITS Directive, relating to its redemption responsibilities towards unit-holders | Crypto ETPs listed on the SIX Swiss stock exchange and the regulated markets of the London Stock Exchange, Frankfurt Stock Exchange, Euronext, Amsterdam and Euronext Paris meet the relevant liquidity criteria, particularly where liquidity is facilitated by market makers |
| C | Reliable valuation is available for them | As above, ETPs listed on regulated exchanges meet this criteria, by virtue of making available reliable and regular market prices for the ETPs |
| D | Appropriate information is available for them | As above, ETPs listed on regulated exchanges meet this criteria, by virtue of making available reliable, regular and comprehensive information to the market on the ETPs, including a prospectus which is approved by the Swedish regulator under the European prospectus regulation |
| E | They are negotiable | As above, crypto ETPs are listed on regulated exchanges and hence freely negotiable in line with the relevant exchange rules |
| F | Their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS, pursuant to the UCITS Directive | A crypto ETP may fit into within a UCITS investment policy and/or objective, depending on the investment policy of the relevant UCITS |
| G | Their risks are adequately captured by the risk management process of the UCITS | A crypto ETP has characteristics (as stated above) which can be captured within a risk management policy |

In conclusion,

- + The ETP itself meets the EAD’s definition of “transferable security”.
- + By applying the above definition, physically backed crypto ETPs are not deemed to “embed a derivative”.

Access via regulated markets

Article 1 of the UCITS Directive explicitly defines UCITS in relation to investments in transferable securities as defined by MiFID, or other liquid financial assets. Article 50 further specifies the types of holdings permissible within UCITS. To the extent that a fund was to invest in crypto ETPs, that definition would not, in itself, appear to preclude its compliance with the UCITS Directive. However, the trading venues through which the fund were to invest, would need

to be authorised and regulated markets or Multilateral Trading Facilities (MTF), as defined by MiFID. Currently, this requirement is met by a number of crypto ETPs which can be accessed via regulated stock exchanges such as the regulated markets of the London Stock Exchange, Frankfurt Stock Exchange, Euronext, Amsterdam and Euronext, Paris and the SIX.

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