

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 notes (ETNs) are UCITS-eligible investments. However, we have applied the framework for UCITS eligibility to crypto ETNs, which we believe is a helpful way to assess eligibility. As crypto assets/crypto ETNs become more mainstream, this analysis will evolve. Key points emerging from the analysis are:

- i. On 2 March 2020, the Federal Financial Supervisory Authority of Germany, BaFin, defined crypto assets (such as Bitcoin and Ether), as financial instruments, on the basis that they are a digital representation of value (inter alia). Based on BaFin's definition of crypto assets, these are viewed as cryptocurrencies.
- ii. Crypto ETNs would meet the definition "transferable securities that do not embed a derivative" of the Eligible Assets Directive.
- iii. Article 50 of the Eligible Assets Directive ("EAD"), which specifies eligible investments, does not appear to preclude investments in crypto ETNs. 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 ETNs that are listed on the SIX in Switzerland and on other regulated exchanges across Europe.
- iv. The ESMA Opinion on Article 50(2)(a) of the EAD excludes collective investment schemes as eligible investments for the "trash bucket" of UCITS, but not crypto assets or crypto ETNs; therefore, crypto ETNs may be purchased in the trash ratio.
- v. The European Commission and European regulators view crypto assets as a potential financial instrument which is expected to grow in use by the investor base, in the medium to long term.

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 notes (ETNs) based on crypto assets ("crypto ETNs"), such as Bitcoin and Ethereum.

UCITS eligibility

It is generally accepted that UCITS can invest in ETNs to the extent that such an investment complies with the rules set forth in the Eligible Assets Directive¹ (“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 ETN must therefore: (i) **not** embed a derivative which references an ineligible asset, and (ii) be a transferable security

(i) Embedding a derivative

The IAS Accounting Standards define a derivative as an instrument that contains a component which fulfils the following criteria: by virtue of that component some or all of the cash flows that otherwise would be required by the transferable security which functions as host contract 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 ETNs do not fall under the above definition by virtue of their structure which **does not** involve embedding a derivative instrument.

Under the legal structure, ETNs are debt obligations of the issuer and, similar to a physical gold ETN, investors in the crypto ETN have an entitlement to an amount of cryptocurrency. As is the case with debt securities, crypto ETNs 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.

¹Eligible Assets Directive 2007/16/EC <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32007L0016&from=EN>

(ii) Transferable security

	EAD definition of transferable security	Crypto ETN 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 ETNs would meet this criterion
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 ETNs listed on the SIX Swiss stock exchange and more recently on German, Dutch and French regulated venues would meet liquidity criteria, particularly where liquidity is facilitated by market makers
C	Reliable valuation is available for them	As above, ETNs listed on regulated exchanges would likely meet this criterion, by virtue of making available reliable and regular market prices for the ETNs
D	Appropriate information is available for them	As above, ETNs listed on regulated exchanges would likely meet this criterion, by virtue of making available reliable, regular and comprehensive information to the market on the ETNs
E	They are negotiable	As above, crypto ETNs would be listed on regulated exchanges
E	Their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS, pursuant to the UCITS Directive	A crypto ETN may fit into a UCITS investment policy and/or objective
G	Their risks are adequately captured by the risk management process of the UCITS	A crypto ETN has characteristics (as stated above) which could be captured within a risk management policy

In conclusion,

- + The ETN itself would likely meet EAD's definition of transferable security
- + By applying the above definition, physically-backed crypto ETNs would not be deemed to "embed a derivative"

Access via regulated markets

Article 1 of the UCITS Directive² 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 ETNs, 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 ETNs which can be accessed via regulated stock exchanges such as the regulated markets of the Frankfurt Stock Exchange, Euronext Amsterdam, Euronext Paris and the SIX.

Classification of crypto as "financial instruments"³

On 2 March 2020, the Federal Financial Supervisory Authority of Germany, BaFin, issued [guidance](#) to clarify the status of crypto assets. The German Banking Act (KWG) defines crypto assets as financial instruments on the basis that they are digital representation of a value that has not been issued or guaranteed by any central bank or public body and is not necessarily linked to a currency specified by law and that does not have the legal status of a currency or money, but is accepted as a medium of exchange by natural or legal persons and can be transmitted, stored and traded electronically. Our interpretation is that ETNs that use cryptocurrencies as underlying assets would be eligible for UCITS investments.

²Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 (<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A02009L0065-20140917>)

³Guidance notice – guidelines concerning the statutory definition of crypto custody business (section 1 (1a) sentence 2 no. 6 of the German Banking Act Kreditwesengesetz – KWG) (March 2020) [.TXT/?uri=celex%3A02009L0065-20140917](https://www.bafin.de/SharedDocs/Pressemitteilungen/DE/2020/03/kwg-richtlinien-zur-statistischen-angabe-von-crypto-wertpapieren-als-sonstige-fremdverbriefte-wertpapiere.html?__blob=publicationFile)

Potential classification of crypto as “currencies”

ETNs that use cryptocurrencies as underlying assets would be eligible for UCITS investments, where regulators would clarify that such underlying assets could be seen as “currencies”. According to EY’s “IFRS Accounting for Crypto Assets” analysis⁴, such a conceptualisation is conceivable, on the basis that cryptocurrencies constitute limited and general-purpose media of exchange.

The use of such underlying assets would still be subject to sufficient liquidity constraints, which would likely limit the range of underlying assets to a small number of established cryptocurrencies with large market capitalisations, such as Bitcoin or Ether.

The 10% trash component of the portfolio

While the ESMA Opinion on its Interpretation of Article 50(2)(a) of the UCITS Directive introduced limitations to the scope of the “trash bucket”, it is generally accepted that those restrictions pertain to holding units or shares in collective investment undertakings which do not meet the eligibility criteria (Art 50(1)). However, crypto assets or ETNs with crypto as underlying assets, are not cited in those limitations.

European regulators’ approach to crypto assets

- + In its [Opinion](#) on “virtual currencies”, the **European Banking Authority** (EBA) defines virtual currencies as a digital representation of value.
- + The majority of European regulators believe that security/investment tokens generally qualify as financial instruments⁵.
- + The **ESMA⁶ and EBA⁷ reports** were published in early 2019 and highlight the risks and benefits (provided relevant safeguards are in place) associated with crypto assets. Both ESMA and the EBA call for an EU-level legal definition of crypto assets, and to test whether crypto assets would qualify as financial instruments, thereby bringing them into regulated scope and ultimately making them eligible instruments for investing by mainstream authorised collective investment schemes.

⁴Ernst & Young “IFRS Accounting for Crypto Assets” <https://eyfinancialservicesthoughtgallery.ie/wp-content/uploads/2018/03/EY-IFRS-Accounting-for-crypto-assets.pdf>

⁵ ESMA “Advice: Initial Coin Offerings and Crypto Assets” and “Annex 1: Legal qualification of crypto assets - survey to NCAs”. (January 2019)

⁶ESMA “Advice: Initial Coin Offerings and Crypto Assets” (the “Report”) and “Annex 1: Legal qualification of crypto assets - survey to NCAs”. (January 2019)

⁷EBA “Report with advice for the European Commission on crypto assets (January 2019)

- + **All European National Competent Authorities** (“NCAs”) agreed that pure “utility tokens” do not qualify as financial instruments and are therefore not regulated⁸.
- + **The European Commission** has proposed new legislation Regulation on Markets in Crypto-assets (Mica), and Transfer of Funds Regulation (ToFR) to regulate crypto assets⁹.
- + The EU Commission also launched a “Fintech Action Plan: For a More Competitive and Innovative EU Financial Sector” (2018). The EU FinTech Lab aims to raise the level of regulatory supervisory capacity and knowledge about new technologies (including crypto).
- + **The Fifth Money Laundering Directive** (MLD5) extends certain requirements, such as know-your-customer checks to cryptocurrency exchanges and custodian wallet providers, thereby bringing a certain level of legitimacy to the token/crypto assets economy.
- + **AMF**, the French Financial Markets Authority, adopted a legal framework to oversee initial coin offerings and digital asset service providers in France. The PACTE Bill was adopted on 11 April 2019¹⁰, and allows (inter alia) insurance providers to offer products based on crypto assets in a regulated environment: “This was not the primary objective of the Pact, but insurers will be able to offer products based on crypto assets.” (Joel Giraud, deputy and budget manager La République En Marche).
- + **BaFin** considers payment tokens to be “units of account” and therefore “financial instruments”. This is in contrast with ESMA’s view and the majority of other national competent authorities. As above, this classification means that service providers involved in initial coin offerings, crypto assets marketing, processing or operation of secondary market trading facilities, may be required to obtain a licence under the German Banking Act.
- + The **UK Jurisdiction Taskforce of the LawTechUK Delivery Panel** (a government-supported industry body), has backed the use of digital assets such as Bitcoin and Ethereum by financial market participants. According to the task force, (a) crypto assets are legally equivalent to property and (b) smart contracts are capable of satisfying the requirements of contracts in English law and are thus enforceable by the courts. Statutory requirements for a signature can be met by techniques such as private key encryption¹¹.

⁸ESMA “Advice: Initial Coin Offerings and Crypto Assets” (the “Report”) and “Annex 1: Legal qualification of crypto assets - survey to NCAs”. (January 2019)

⁹<https://www.cliffordchance.com/insights/resources/blogs/talking-tech/en/articles/2022/07/MiCA-EU-reaches-agreement-on-the-crypto-assets-regulation.html>

¹⁰<https://www.economie.gouv.fr/plan-entreprises-pacte#>

¹¹ESMA “Advice: Initial Coin Offerings and Crypto Assets” and “Annex 1: Legal qualification of crypto assets - survey to NCAs”. (January 2019).

- + The **FCA** plans to extend the UK regulatory perimeter to cover utility and exchange tokens¹². On 6 October 2020, the FCA published a policy statement prohibiting the marketing, distribution and sale of derivatives and ETNs that reference certain types of crypto assets to retail investors.
- + The **UK and Luxembourg**¹³ NCAs instituted regulatory sandboxes where innovations can be tested in an environment that disapplies regulation to an extent, in order for both firms and regulators to learn about the needs of governance. These arenas are likely to influence or interact with UK and EU policy making.
- + **The CSSF** (Commission de Surveillance du Secteur Financier), the Luxembourg financial services regulator has issued a warning regarding virtual currencies which states that “entities under the prudential supervision of the CSSF must take into account that investing in virtual currencies is not suitable for all kinds of investors and investment objectives. UCITS, UCIs addressing non-professional customers and pension funds are thus not allowed to invest directly or indirectly in virtual currencies.”¹⁴
- + **CNMV** (Comisión Nacional del Mercado de Valores) the Spanish financial services regulator, had published an FAQ stating that “If the CIS are UCITS or harmonised, they can have exposure to cryptocurrencies through financial instruments whose performance is linked to such currencies, which do not include an embedded derivative (ETC, ETN and any so-called “delta one” instrument).”¹⁵
- + The **CBI** (Central Bank of Ireland) has released a Q&A indicating that the CBI has not seen information which would satisfy it that crypto assets are capable of meeting the eligible asset criteria for UCITS or that indirect exposure to crypto assets is capable of being appropriately risk managed.¹⁶

¹² The UK’s regulatory sandbox regime is discussed in IH-Y Chiu, “A Rational Regulatory Strategy for Governing Financial Innovation” (2017)

¹³ DA Zetzsche et al, “Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation” (2017)

¹⁴ CSS publication (Warning regarding virtual currencies) (Online available at <https://www.cssf.lu/en/2018/03/warning-regarding-virtual-currencies/> [accessed on 2 December 2021]

¹⁵ CNMA 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])

¹⁶ CBI publication (UCITS Q&A ID 1100 - <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/ucits/guidance/ucits-q-a-33rd-edition.pdf?sfvrsn=2>)

CONCLUSION

- + There is substantial EU-level discussion in relation to the crypto economy and the technology that powers the distributed ledger technology economy. With its definition of crypto assets as financial instruments, BaFin has paved the way towards definitive regulatory policies in Europe and we expect other countries in the EU to follow suit. So far, over 40 banks in Germany have filed for the crypto-custodial license, including Börse Stuttgart, the second largest stock exchange in Germany and ninth largest in Europe.
- + There is evidence that the European Commission and European countries are changing their stance to cryptocurrencies: they view it as a potential financial instrument which is expected to grow in use by the investor base in the medium to long term.
- + The European Commission will introduce a legal framework for crypto assets. It is only a matter of how soon.
- + Besides BaFin, other European NCAs (France, Luxembourg) are looking to develop and adopt crypto asset regulation, with a view to proposing themselves as leaders in digital technology and fintech locations.
- + Before EU-wide harmonisation is achieved, there is a risk that cryptocurrency-related regulation is not consistent across the EU.
- + There is a risk of gold-plating, given Germany's stance on developing a regulatory framework for crypto assets before the EU Commission does.

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