The key differences between European bitcoin ETPs and US bitcoin ETFs

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January 2024 will go down in history for cryptocurrency investors and the asset management industry. After 10 years of spot bitcoin exchange-traded fund (ETF) filings, the SEC took the unprecedented step of approving 11 filings on the same day. The euphoria of these launches spread far beyond the US, with many European investors seeking to understand when European spot bitcoin ETFs would be launched.

European investors have been able to invest in physically backed Bitcoin exchange-traded products (ETPs) since 2019. The clamouring for an ETF version is grounded in an expectation that ETFs are superior to ETPs, and therefore that many US spot bitcoin ETFs are superior to European physical bitcoin ETPs. But is that really the case? The answer isn't as straightforward as many would expect, or like.

For most investors, the distinction between US ETFs and European ETPs lies mainly in the different legal and regulatory framework they must adhere to. But regardless of their setup, they both provide a flexible and liquid wrapper representing transparent exposure to an underlying asset. With that said, while US ETFs can provide exposure to single commodities such as physical gold and be referred to as a fund, in Europe this term is reserved for a diversified basket of securities. In Europe, single commodity exposures aren't possible under the UCITS framework due to diversification requirements, amongst others.

This is why, typically, the structure used to give access to physical spot exposure to a single commodity or cryptocurrency is via an ETP (a perpetual debt note backed by the underlying asset). This structure isn't referred to as a fund, although it provides a similar investment experience. It functions like a fund, has strong investor protections, maintains full transparency of assets and appoints an independent trustee who holds the legal right to those assets and represents investor interests.

If we are seeking to understand the differences between US bitcoin ETFs and European bitcoin ETPs we need to look beyond the naming conventions, legal structures, and regulations they must adhere to. We must also acknowledge that a European-listed ETP, such as WisdomTree Physical Bitcoin (BTCW), offers investors a convenient, secure and liquid wrapper that represents direct and transparent exposure to the underlying asset, just as a US spot bitcoin ETF does. So, what are the tangible differences between US bitcoin ETFs and European bitcoin ETPs?

Cash vs in-kind creation and redemptions

In the US, the SEC has mandated that bitcoin ETFs creations and redemptions must be processed only by delivering cash in exchange for shares, whereas European ETPs are able to exchange bitcoin themselves for shares in what's known as an 'in-kind' transaction. In-kind transactions can be significantly more efficient than cash – particularly when dealing with digital assets such as bitcoin. This can have long-term implications on the performance, trading spreads and security of the product that can have a sizeable effect on overall investor costs and returns over time.

While the primary market creation/redemption process isn't something that clients deal with directly, it plays an important role in product performance and structure. The ability to create and redeem in-kind, and the implications of being restricted to cash orders is something that investors should be aware of when choosing an appropriate ETP – particularly with digital asset ETPs.

To represent some of these implications, we have used WisdomTree Physical Bitcoin ETP as an example of the European ETP structure versus the US ETF structure:

1.Slippage risk

When US ETF issuers accept cash orders, they must process them at the end-of-day net asset value (NAV) of the ETF. It is however impossible for issuers to always trade at the actual NAV of the fund, and any differences between the NAV of the ETP's underlying assets and the prices achieved by the issuer when executing, otherwise known as slippage, are borne by the authorised participants (APs) along with trading commissions.

These costs get passed back to the investor and result in uncertainty in execution costs for APs, typically leading to higher spreads. If these costs aren't passed back, they will impact the NAV which may in turn impact investment performance for shareholders. With in-kind redemptions APs source the bitcoin themselves. This means APs can more efficiently use any existing bitcoin in inventory, likely translating into lower spreads for investors.

2.Prolonged settlement of creations

Because US spot bitcoin ETFs need to process cash orders and then execute them by trading bitcoin, they can't settle primary market orders on a T+0 basis. T+0 settlement for primary market orders can mean lower financing costs for market makers and APs, and less settlement risk, typically translating into lower spreads for investors.

By adopting an in-kind creation process, an AP can settle T+0 as shares can be issued once bitcoin is delivered, which is effectively instantaneous. This speedy settlement is currently only possible for creations because the issuer needs to receive shares from a redemption order in advance of releasing the corresponding bitcoin.

3.Hot wallet trading

As US spot bitcoin ETFs are unable to accept bitcoin in-kind, they need to purchase or sell bitcoin to process a creation or redemption order, usually on a cryptocurrency exchange. This requires a hot wallet in order to trade the bitcoin, which represents a potential security risk as hot wallets are internet-enabled and more susceptible to hacking or theft.

Conclusion

Seeking access to the spot price of bitcoin via an ETF, in other words a structure that enjoys all the UCITS benefits, is not possible in Europe. The idea that an ETF is always better than an ETP comes with numerous caveats and may be a distracting narrative that prevents investors from allocating to an asset class that could potentially improve the risk adjusted return of a portfolio. European investors should be looking at existing European bitcoin ETPs, understanding the unique risks presented with some products (like crypto lending and liquidity risk), the issuer expertise and transparency, and how to evaluate the real performance of a crypto ETP. Digging beneath the surface can be a worthwhile exercise, after all, appearances can be deceptive.

More detailed information on the key differences between European bitcoin ETPs and US bitcoin ETFs is available here.

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