



January 2024

The key differences between European bitcoin ETPs and US bitcoin ETFs

WisdomTree Market Insights



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Introduction

The recent Security and Exchange Commission (SEC) approvals of spot bitcoin exchange-traded funds (ETFs) in the United States have dominated headlines. These listings undoubtedly represent significant progress towards mainstream adoption of digital assets and the early statistics around their launch are impressive. In the short time since listing, these ETFs have already traded a stunning \$21.7bn on US exchanges, seen total net inflows of \$837mn into bitcoin exposure, and represent over \$25bn of investor assets¹.

The reason these ETFs have been so impactful is because it can be difficult to make direct investments in digital assets². At best, investors need to manage wallet security, trading fees and navigate multiple exchanges with differing reputations. That's where physically backed bitcoin exchange-traded products (ETPs) come in. The ETP wrapper offers a flexible, transparent, and liquid way for investors to access cryptocurrency, with none of the complication and risk associated with self-custody of crypto assets. Buying a crypto ETP can be as easy for investors as buying any listed equity or fund and doesn't involve further admin; this is all handled by the issuer, with costs incorporated within transparent management fees and trading spreads.

What some non-US investors may not realise is that physically backed crypto ETPs offering spot exposure, such as [WisdomTree Physical Bitcoin \(BTCW\)](#), have been available to buy in Europe since 2019. While both the US and European equivalents were launched to provide a transparent and liquid way to access bitcoin without the need to manage storage, there are some important differences between the two.

Firstly, in terms of their legal structure and name itself (ETF vs ETP), but more importantly, the way in which they function behind the scenes in what's known as the 'primary market' where financial entities known as Authorised Participants (APs) are able to create or redeem shares directly with the issuer.

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 - and 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.

1 Source: Bloomberg, data as 24 January 2024.

2 In this paper we will focus specifically on bitcoin.

Structure

Most US ETFs will be set up as a type of trust under the framework of a legal act called The Securities Act of 1933. This act provides significant protection for US investors who want to access single commodities such as physical spot products which don't meet the diversification or regular distribution sharing requirements of the better-known Investment Company Act of 1940 structure. Although US ETFs can provide exposure to single commodities, they can still be referred to as a fund, even though in Europe this term is reserved for a diversified basket of securities.

Conversely in Europe, single commodity exposures aren't possible under the UCITS³ framework due to diversification requirements, amongst others. The typical structure therefore used to access physical spot exposure to a single commodity has typically been via a perpetual debt structure. 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 (in the case of WisdomTree Physical Bitcoin), and appoints an independent trustee who holds the legal right to those assets and represents investor interests.

For most investors, the difference between an ETF and ETP represents small differences in legal structure and regulatory rules between products intended for US and non-US investors. Just like an ETF, an ETP such as WisdomTree Physical Bitcoin offers investors a flexible and liquid wrapper that represents direct and transparent exposure to the underlying asset.

Cash vs in-kind creation and redemptions

All investors in ETPs transact in the secondary market, better known as stock exchanges, either directly as a professional investor or via their broker. An often-overlooked aspect of ETPs is their function in the primary market. In the primary market, shares are created and redeemed to order as needed on a daily basis⁴ without any explicit limit and at their fair value by entities known as APs. Authorised Participants are large, generally prominent financial entities that provide liquidity and serve as a conduit between investors and the issuer. The creation/redemption mechanism is extremely important to ETPs and ensures that they closely track the value of their underlying assets throughout the trading day.

When create or redeem orders are placed, there must be a proportional increase or decrease of underlying assets which the ETP represents exposure to. This part of the creation/redemption process is incredibly important.

3 Undertakings for the Collective Investment in Transferable Securities.

4 APs place trades for ETP shares without any explicit limit and at their fair value.

In general, there are two ways to accomplish this:



Cash – where APs or the issuer exchange cash for ETP shares in the event of a creation or redemption.



In-kind – where APs or the issuer exchange the underlying assets themselves for ETP shares in the event of a creation or redemption.

While the overarching mechanism is the same as seen in the figures below, processing creations in cash requires an extra step in the create/redeem flow.

Figure 1: Cash (US bitcoin ETFs)

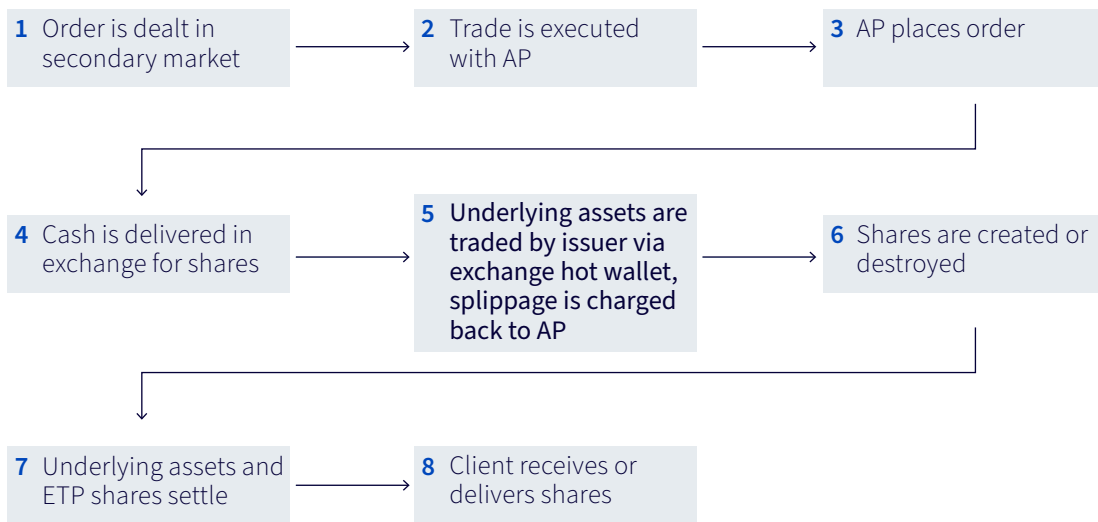
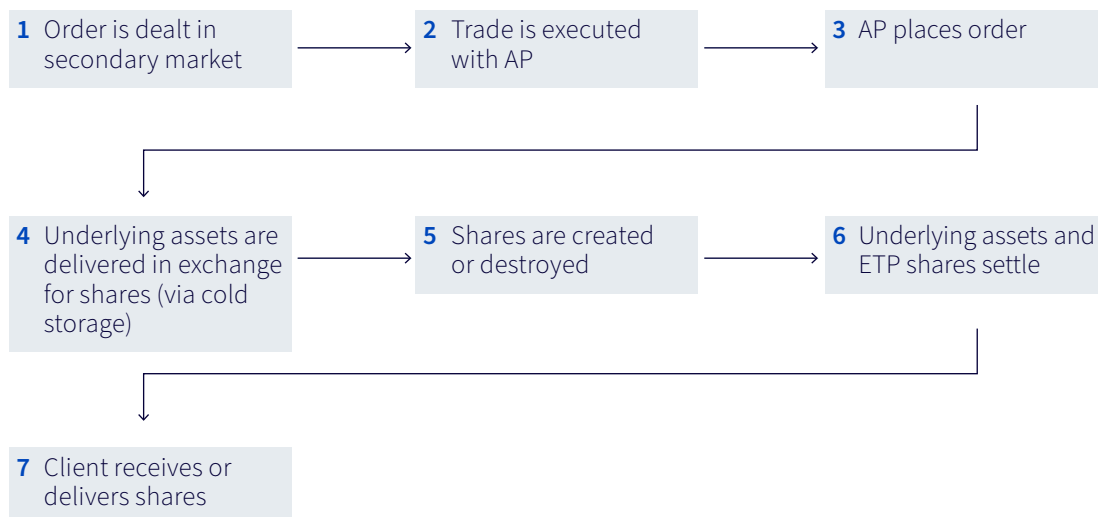


Figure 2: In-kind (WisdomTree Physical Bitcoin - BTCW)



While processing creation/redemption orders with cash only adds one step to the primary market process, it has some important drawbacks for investors, particularly on ETPs providing exposure to digital assets.

In the comparison below we have used WisdomTree Physical Bitcoin as an example of the European ETP structure versus the US ETF structure.

Trading risks in the primary market

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.

- + As it's impossible for the issuer to always trade at the actual NAV value, they must pass slippage costs to APs. Slippage refers to the difference between the NAV of the ETP's underlying assets and the prices achieved when the issuer bought or sold them. In addition to slippage, the issuer also needs to pay trading commissions.
- + These costs get passed back to the investor and result in uncertainty in execution costs for APs, typically leading to higher spreads for investors. If these costs aren't passed back, they will impact the NAV which may in turn impact investment performance for shareholders.

By contrast, WisdomTree Physical Bitcoin never charges any slippage or trading costs given trades aren't settled in cash.

- + Rather than the issuer taking cash and buying or selling bitcoin on behalf of the ETP, APs source the bitcoin themselves.
- + This means that APs can more efficiently use any existing bitcoin in inventory, and the trading is done by the best firms in the world, likely translating into lower spreads for investors.

2. Prolonged settlement of creations

Because US 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.

- + WisdomTree Physical Bitcoin can settle T+0 as shares can be issued once bitcoin is delivered, which is effectively instantaneous. (T+0 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).
- + 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.

3. Hot wallet trading

US ETFs can't accept bitcoin in-kind, so 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.

By comparison, WisdomTree Physical Bitcoin doesn't use an intermediary hot wallet and only accepts orders via cold storage transfer. Cold storage refers to a secure digital wallet that isn't internet-enabled, significantly reducing the risk of hacking or theft. Private keys are held offline and there are geographic, environmental, human and device redundancies in place.

Conclusion

In summary, 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.

Figure 3: Structural comparison of European ETPs and US ETFs

Primary Market	US Bitcoin ETFs	WisdomTree Physical Bitcoin ETP
Creation/Redemption mechanism	Cash only	In-kind only
Hot wallet transfer	Yes	No
Slippage on orders	Yes	No
Cold storage transfer	No	Yes
Always 100% physical bitcoin	No	Yes
T+0 settlement possible	No	Yes (creations only)

Glossary

Secondary market: Stock exchanges where end investors access (buy and sell) shares of ETPs either directly or via a broker.

Primary market: The environment where APs create or redeem shares of an ETP directly with the issuer. The primary market is restricted to APs and can't be accessed by other entities.

Authorised participants: Large, generally prominent financial entities who have signed legal agreements with the issuer and meet specific requirements in order to create or redeem shares of the ETP directly with the ETP issuer.

Hot wallet: An internet-enabled and online digital wallet.

Cold wallet: A digital wallet that isn't internet-enabled and is stored in a secure way.

Cash: A method of transfer within the primary market where APs or the issuer exchange cash for ETP shares in the event of a creation or redemption.

In-kind: A method of transfer within the primary market where APs or the issuer exchange the underlying assets themselves for ETP shares in the event of a creation or redemption.

Slippage: The difference between the NAV of the ETP's underlying assets and the prices achieved when the issuer bought or sold them.

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