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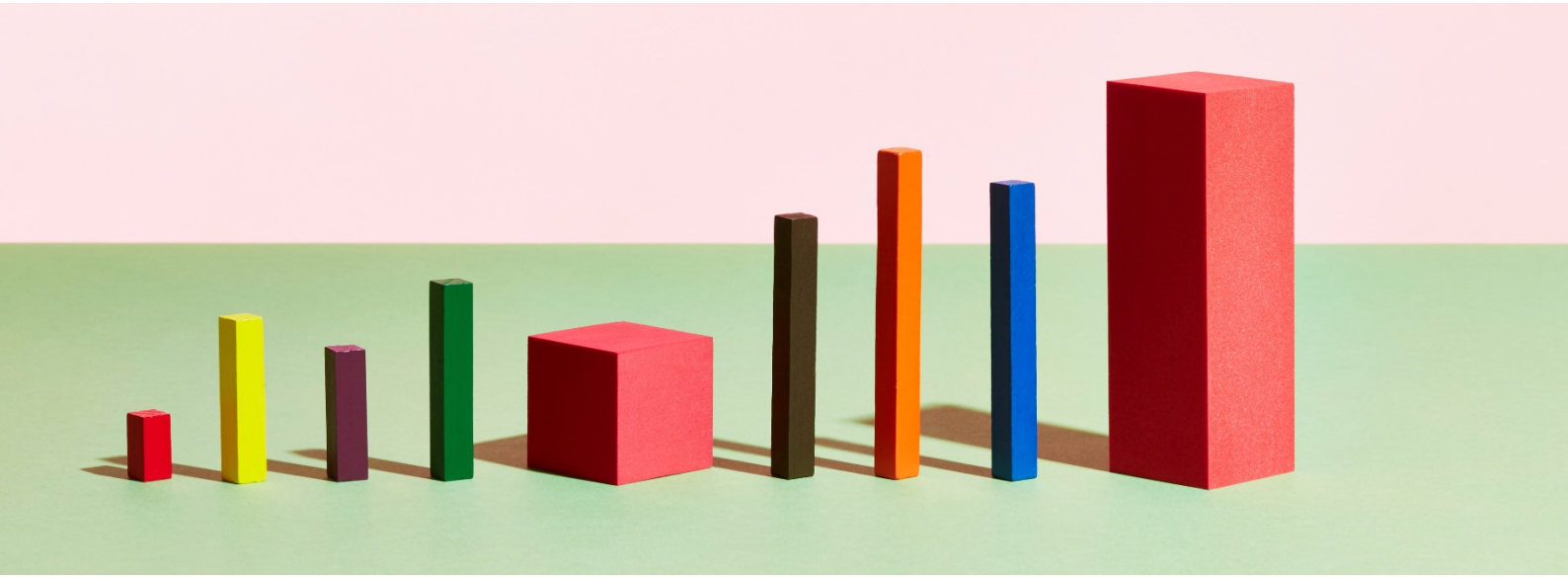

Crypto exchange traded notes: Key building blocks

December 2023

Crypto exchange traded notes have grown in popularity in recent years, with a steadily increasing range of features and underlying cryptoassets being brought to market.

While performance of most cryptoassets remains volatile, interest in crypto linked structures has renewed in recent months, in anticipation of the SEC's decision on whether to approve spot bitcoin and ether exchange traded funds in the US (and the more recent bounce in cryptocurrency prices).

In this briefing, we explain what crypto exchange traded notes are and examine some of the key structural and legal issues that may arise when establishing a programme to issue those notes.

What are crypto exchange traded notes?

Crypto exchange traded notes ("Crypto ETNs") are financial products linked to one or more specified cryptoassets. The linkage means that the value of Crypto ETNs will rise and fall in-line with the underlying cryptoassets, subject to the deduction of fees and expenses. This gives investors exposure to the changing value of the underlying cryptoassets but, crucially, without needing to hold the cryptoassets themselves – this may appeal to investors that do not wish to deal in cryptoassets directly, manage wallets and/or transact on unregulated crypto exchanges.

Key points:

- Crypto exchange traded notes are debt instruments that give investors exposure to one or more cryptocurrencies or indices
- Programmes for the issuance of crypto exchange traded notes are generally structured in the same way as programmes relating to traditional underlyings, but with a few key differences
- Crypto exchange traded notes give rise to unique custody, disruption, security and regulatory issues that warrant close consideration

Instead, investors hold a conventional instrument that can be easily bought and sold on a traditional exchange. Listing on an exchange has the same benefits as traditional ETNs, namely increased transparency and liquidity.

In this briefing we concentrate on Crypto ETNs issued as debt instruments, which are distinct from crypto exchange traded funds (which we do not consider).

Key features

The overall structure of a Crypto ETN is similar in many respects to ETNs backed by more traditional assets (e.g. commodities like gold or metal). As with those traditional structures, in a typical Crypto ETN:

- The issuer will be a special purpose vehicle incorporated for the sole purpose of issuing ETNs under a tailored issuance programme.
- One or more authorised participants will be appointed to manage the subscription and redemption of the ETNs (which is conducted on a continuous basis).
- The return on the ETNs is delivered to investors upon redemption, through the difference between the initial subscription amount and the final redemption amount[1]. This will generally reflect the change in the value of the underlying assets, subject to the deduction of fees and expenses. ETNs do not typically bear interest.

The key difference when compared to traditional ETNs, of course, is that the underlying assets will be a specified cryptoasset or basket of cryptoassets, or index that references cryptoassets. Most structures are physically backed, meaning the underlying cryptoassets are purchased by the issuer (or the authorised participant on its behalf) whenever new ETNs are issued, and secured in favour of the investors.

Structural and legal considerations when establishing a Crypto ETN programme

- Jurisdiction of incorporation

  When establishing a Crypto ETN, one of the main preliminary points to consider is where to incorporate the special purpose entity that will act as issuer. The chosen jurisdiction will have a variety of implications, including (if offering the ETNs to the public in the EU or listing on an EU regulated market) which regulator may be chosen to act as the "competent authority" responsible for reviewing and approving the programme base prospectus[2].

- Underlying assets

  Another key preliminary question in the structuring of a Crypto ETN programme is the universe of underlying cryptoassets that could be selected to back a particular Crypto ETN (either on a single asset basis or as part of a basket). Early Crypto ETNs focused exclusively on bitcoin and ether, as the most prevalent cryptoassets with the deepest liquidity. Over time, however, Crypto ETNs linked to a broader range of underlying assets have emerged. It is now commonplace to see prospectuses that list a wide range of possible underlying cryptoassets.

  A variant is Crypto ETNs linked to an index of cryptoassets. Programmes that seek to accommodate index-linked notes must consider several additional factors. This principally includes selecting which index (or indices) should be accommodated by the programme, the mechanism by which the index is periodically rebalanced, and adding appropriate risk factors and disclosure to the prospectus (describing the index administrator, as well as the index itself).

- Cash or physical redemption

  A related point concerns whether the programme will allow the underlying cryptoassets to be transferred to investors at redemption (physical

1. Noting that certain programmes may provide for physical redemption, in which case the value is returned via the delivery of the cryptoasset, as explained further below.
2. Regulation (EU) 2017/1129 (the "Prospectus Regulation") requires issuers to publish a prospectus before offering securities to the public in the EU and/or listing securities on an EU regulated market. Crypto ETNs will be securities for this purpose, meaning a prospectus (that must have been reviewed and approved by an EU 'competent authority') is often needed. In most cases issuers of Crypto ETNs are able to choose between the competent authority of the Member State in which it has its registered office, or the competent authority of a Member State in which it is making a public offer or listing on a regulated market. For programmes, a single 'base' prospectus is approved and then completed for a particular issuance by the transaction-level final terms.

delivery) or sold, with a corresponding redemption amount paid to investors in fiat cash (cash redemption).

Structures giving investors the option to receive physical delivery of the underlying cryptoassets will need to carefully consider the procedures for delivering cryptoassets to investors (which may be conducted via the programme's authorised participants) and any potential regulatory restrictions.

- Custody and security

The issuer of a physically-backed Crypto ETN will (when issuing notes) purchase the relevant cryptoassets and secure them in favour of the noteholders. The issuer's custody arrangements and the nature of the security interest being granted will thus need to be carefully considered, as will the process for buying and selling the cryptoassets themselves.

The custody arrangements for Crypto ETNs are often bespoke, involving detailed negotiation regarding which cryptoassets and services are supported by the custodian, as well as how those assets are held[3], protected and accessed.

If a custodian's standard form agreement is used, adaptations must be made to take account of the Crypto ETN structure (e.g. by including limited recourse wording).The key features of such arrangements must then be disclosed to investors via the prospectus. In some cases, a Crypto ETN programme may be designed so that one of several different custodians may act as a custodian in respect of a particular series of ETNs (as specified in the applicable final terms). If so, the prospectus must include disclosure in respect of each potential custodian.

The security being granted by the issuer should be considered in tandem with the custody arrangements. Issuers will typically grant security over its rights, title and interests in the underlying cryptoassets in addition to its rights under the transaction documents (including, in particular, its rights under the relevant custody agreement against the custodian). However, various security- and custody-related questions arise in relation to these sorts of arrangements, some of which remain untested in the courts.

- Disruption and adjustment events

The terms and conditions of debt securities invariably specify a range of events or circumstances which, if triggered, give rise to certain contractual consequences. A classic example is the occurrence of an event of default, which may allow investors to redeem the securities early. In relation to Crypto ETNs, it is imperative that the conditions additionally contemplate various crypto-specific risks that exist in relation to the Crypto ETNs and the underlying cryptoassets. Fork events[4] and airdrops[5] are good examples, each of which may necessitate the inclusion of bespoke definitions (to help determine whether a fork event or airdrop has occurred) and disruption/adjustment provisions that apply if they do.

The nature of those sorts of provisions currently vary programme-by-programme. For instance, upon a hard fork occurring some programmes provide that the issuer has broad discretion to determine which fork to pursue, whereas others engage provisions that splits the underlying assets such that the Crypto ETN tracks the value of the original pre-fork cryptoasset and its post-fork counterpart. Several other variations exist.

If the Crypto ETN is linked to an index, adjustment or disruption provisions should be included in relation to the cessation or modification of the index, too (as is the case with traditional index-

3. An important point concerns the basis on which the cryptoassets are being held by the custodian on behalf of the issuer, and the bankruptcy remoteness of the assets. For example, structures subject to English law may wish to ensure the custodian holds the cryptoassets on a trust basis, within an individually segregated wallet (to ensure separation from the cryptoassets held by the custodian on behalf of its other clients, in addition to the custodian's own assets). The nature of cryptoassets themselves also raises several novel issues – for example, the security measured deployed by the custodian in relation to the storage of the private key(s).

4. A fork may occur in relation to a cryptoasset if its system protocols are modified, leading (in some cases) to a split in the blockchain and the creation of two distinct cryptoassets. A distinction is often drawn between (i) a 'hard' fork, where the modified protocol is incompatible with the old protocol which may lead to two distinct blockchains and cryptoassets (unless all participants upgrade to the modified protocol, which may be the case for planned upgrades) and (ii) a 'soft' fork, where the modified protocol is compatible and interoperable with the old protocol, in which case any fork is temporary and often immaterial.

5. An airdrop occurs in relation to a cryptoasset when holders of that cryptoasset are given the right to claim another cryptoasset (often for free) to promote the other cryptoasset. Some airdrops may require the holder to take certain actions before claiming the other cryptoasset. Custodians holding cryptoassets for the issuer to a Crypto ETP may not support airdrops in all cases, or may require users to cover its costs.

linked-notes).

- Regulatory issues

  Crypto ETNs are highly regulated products for two reasons:

  - Firstly, because they may engage the customary range of rules and regulations that apply to manufacturers and distributors of debt securities (for example, the Prospectus Regulation, MiFID II, AIFMD and so on), as well as any relevant tax, anti-money laundering and consumer protection-related rules.
  - Secondly, because they may engage various additional crypto-specific rules due to the cryptoassets nexus, which are evolving rapidly. For example, the UK FCA's prohibition on the sale to retail clients of cryptoasset exchange traded notes[6] and the EU MiCAR[7].

  These sorts of issues should be considered when establishing a Crypto ETN programme, when deciding the jurisdictions in which the Crypto ETNs may be marketed, distributed and sold, and when selecting service providers.

- Fees and expenses

  Manufacturers will need to consider the precise mechanism for extracting fees and expenses in relation to Crypto ETNs issued under programme. One route to do this is by deducting a fixed management fee when calculating the redemption amount due to investors, but alternative formulations are possible.

Additional product features

As the Crypto ETN market evolves, we have seen programmes build-in a range of additional product features. For example:

- Staking: Certain distributed ledger systems (notably Ethereum) use proof-of-stake consensus mechanisms, which allow holders to 'stake' their cryptoassets and receive rewards for successfully validating on-chain transactions. Crypto ETNs may permit the underlying cryptoassets to be staked in order to generate additional revenue. However, this is only feasible if supported by the custodian that holds the cryptoassets on behalf of the issuer. It also gives rise to certain risks,

6. See COBS 22.6 (Prohibition on retail marketing, distribution and sale of cryptoasset derivatives and cryptoasset exchange traded notes).
7. Markets in crypto-assets regulation (Regulation (EU) 2023/1114).

including the prospect of losing a portion of the staked cryptoassets if the custodian fails to comply with the relevant system's staking protocols. The risks and consequences of staking should be plainly set out in the programme prospectus and accounted for in the conditions of the Crypto ETNs themselves.

- Leverage and short/long exposure: Some Crypto ETN programmes facilitate leverage, which multiplies the effect of any changes in the value of the underlying cryptoassets or index. Some also embed optionality for long or short exposure, designed so investors will generally realise gains if the underlying cryptoassets or index rises in value (if long) or, alternatively, if the underlying cryptoassets or index falls in value (if short). Both features have been used in traditional ETNs for many years.
- Securities lending: Crypto ETNs may allow the issuer to lend the underlying cryptoassets to a third party in return for a fee, as means to generate additional revenue. The counterparty may provide collateral in respect of the loan and may onward-lend the borrowed cryptoassets to another end user. Securities lending arrangements must be disclosed in the prospectus, due to the various additional risks it may create.

Our offering

Simmons & Simmons LLP have been a market leader in structured finance and derivatives for many years. We combine our in-depth knowledge of traditional structured products with our cutting-edge digital assets experience to deliver highly bespoke solutions for our clients.

If you would like to discuss any of the issues raised in this note, please contact one of the lawyers listed further below.

This note should not be construed as legal advice. Readers are advised to speak to their legal counsel before taking action in relation to any of the matters described above.

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