ETFs, Alternatives and Cryptocurrencies

Nascent developments – but no cigar yet

HAMLIN LOVELL talks to JOHN J MAHON, PARTNER, SCHULTE ROTH & ZABEL

A range of liquid alternative strategies have been packaged into '40 Act funds – with daily dealing – and UCITS funds, which often also have daily dealing and must offer at least twice-monthly dealing. But so far ETFs, offering intra-day dealing, have not become a widely used vehicle for alternatives. Over 1,000 alternative UCITS exist, but we are only aware of a smaller number of alternative ETFs, in areas such as trend-following, managed futures, commodities, merger arbitrage, long/short equity, quantitative equity and senior secured loans. Few of them have raised substantial assets, and some of them are running less than $10 million. Yet overall ETF industry assets at above $3.3 trillion have now overtaken hedge fund industry assets, estimated at $3 trillion. There is speculation that some of the largest quantitative managers could soon launch active alternative ETFs, but this has not happened yet.

The SEC is proposing to reform and modernise ETFs in various ways, which could include relieving them of the need to go through the cumbersome process of seeking "exemptive relief" from some '40 Act provisions before launching. "It has historically been much easier to act as a sub-adviser for a mutual fund, than to attempt to launch a new ETF structure," says Schulte Roth & Zabel investment management partner John J Mahon. Mahon is based in the firm's Washington DC office and regularly assists clients in connection with the establishment and operation of ETFs, mutual funds, BDCs and both open-ended and closed-ended registered funds.

The SEC Chairman, Jay Clayton, has said publicly that he wants to "embrace innovation" in ETFs. But it is not yet clear whether they will become an attractive vehicle for alternatives that can compete with '40 Act mutual funds, or exchange listed closed end funds (CEFs).

Clearly, many alternative strategies are not liquid enough for a '40 Act or a UCITS and would certainly not be liquid enough for an ETF either. Many private credit assets cannot be valued daily, let alone intraday. "If it won't work in a mutual fund it won't work in an ETF either," says Mahon.

Commercially, ETFs do not appear to be as appealing for hedge fund managers. "Base management fees are lower than on many other investment vehicles, and managers have to forgo any incentive fees. By way of comparison, in the private credit space, fee structures on business development companies, or BDCs, can often be higher than similarly-managed private credit funds," he continues.

Commodity ETFs and ETPs do exist, and Mahon argues that it can often be easier to set up commodity products that fall outside the scope of the '40 Act as public vehicles.

ETFs are very popular because they offer investors intraday liquidity. "The key difference between ETFs and CEFs is that whereas CEFs need not offer investors redemption rights, ETFs in the US are considered to be open-ended '40 Act funds, offering redeemable securities," says Mahon. As a result, authorised purchasers of ETFs, which act as market-makers, have an incentive to keep the market price close to the net asset value, through buying or redeeming ETF shares in exchange for baskets of securities that mirror the ETF holdings. If the price is above NAV, the authorised purchasers have an incentive to buy the basket and deposit it with the ETF. If the market price is below NAV, the authorised purchases have an incentive to redeem shares in the ETF in exchange for the underlying basket of securities.

But this liquidity can come with costs as well as benefits, because the process requires daily portfolio transparency. This is entirely natural for passive, index-based strategies where the index composition is already public knowledge, but many hedge fund managers would not be keen to reveal all of their holdings in near real time. "The concern with complex, proprietary, quantitative, data-driven trading models, is that if managers disclose portfolio holdings too often, others could potentially reverse engineer the trading model and strategy," says Mahon. "And if anything, the SEC's proposed reforms may increase the level and frequency of portfolio disclosure," he adds.

Cryptocurrency ETFs

In November 2018, Switzerland's Six Exchange approved the first cryptocurrency ETP, the Amun Crypto ETP, which contains five cryptocurrencies: 50% Bitcoin and 25% XRP, with the rest in Ethereum, Bitcoin Cash, and Litecoin. The exchange also plans to list derivative products for Bitcoin, Bitcoin Cash (BCH), XRP, Litecoin (LTC) and Ethereum (ETH), individually; though this is not so remarkable, since CME Group and CBOE already launched bitcoin futures in December 2017.

For at least three years, there have been high hopes that the SEC may approve a US-listed cryptocurrency ETF. The SEC has thus far rejected at least nine cryptocurrency ETF applications, including those based on synthetic and physical models, but the regulator has not foreclosed the possibility. The SEC has postponed decisions and reverted with further comments and questions in what could be interpreted as an iterative and investigative process of researching this new market phenomenon.

Though there has been speculation that specific rule changes, including those around self-regulated exchanges, could lead to approval for a US-listed cryptocurrency ETC, the SEC has actually flagged up a large number of issues on which it needs to get comfort.

Price discovery is one of them. "Opaqueness around how prices are determined is one

concern where the SEC would likely want to see more visibility," says Mahon. Concerns have been raised that some venues used for trading cryptocurrencies could be vulnerable to price manipulation, fraudulent trades, and may not provide accurate data on volumes traded. Using other trading venues, exchange monitoring and surveillance technology, and deriving prices from index providers could be seen as steps towards offering some transparency in this area.

Notwithstanding a clutch of recently rolled out custody offerings (for example from Fidelity, Nomura, and Bakkt), Mahon argues that, "custody is a tricky issue with no readily apparent solution yet that would clearly satisfy the '40 Act and Investment Adviser's Act provisions on custody. It is a bit of a square peg in a round hole from a regulatory perspective given how cryptocurrencies are held from a technological perspective. There is a lot of pressure to come up with something workable, but the question is what features will be required to satisfy the SEC's concerns". It is not yet clear whether including insurance – a feature of at least one proposed ETF – might adequately address the concerns here.

But he argues, "even if exchange, transparency, and custody solutions can be found, the bigger issue is whether regulators like the SEC can get comfortable with letting retail investors invest in cryptocurrency ETFs. Retail investors can already buy bitcoin directly, subject to minimums, but an ETF would let far more investors do so without any minimum investment size." Ultimately the SEC always has to keep one eye on its investor protection mandate.

In summary, he predicts,"the SEC has set out a roadmap stating that if concerns can be resolved, there is a possibility of a cryptocurrency ETF. The door is not closed. We imagine that some version of a cryptocurrency ETF will eventually meet the SEC's criteria, with likely a long line of managers seeking to copy it". **THFJ**

Schulte Roth&Zabel
New York | Washington DC | London | www.srz.com