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Channels for Exposure to Bitcoin Revisited

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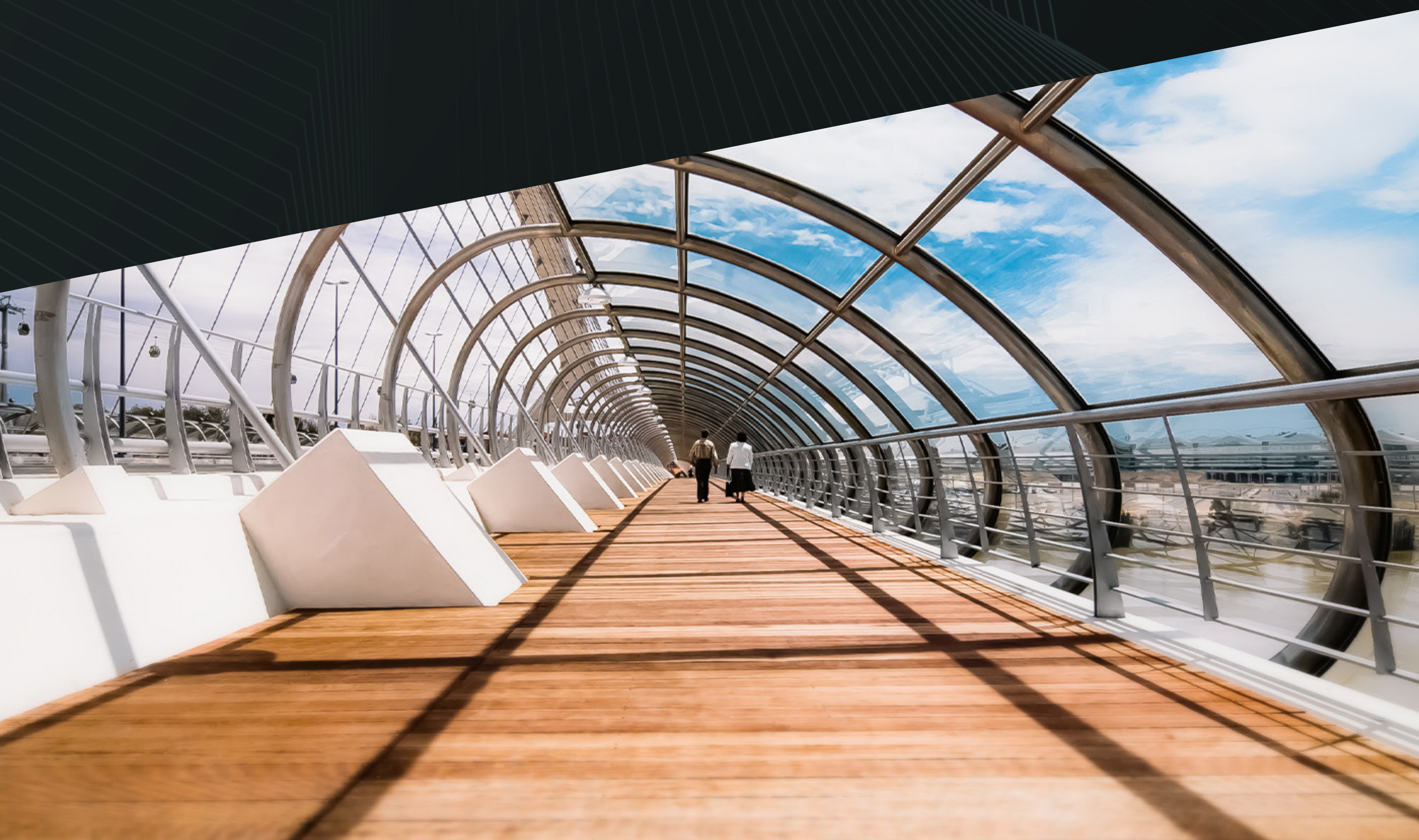

Introduction

If an investor determines that bitcoin is appropriate for their portfolio, often the next logical question concerns how to gain exposure. Unlike traditional asset classes, a core feature of bitcoin (and digital assets broadly) is the ability for holders to self-custody the assets and establish true ownership, removing the need to trust intermediaries to control the assets. However, many institutions with fiduciary obligations face regulatory and operational limitations that prevent them from taking direct custody of assets. Additionally, self-custody requires robust security and risk management processes that some institutions may not feel comfortable taking on or may not have the time, resources, or technical expertise to build.

To accommodate for this reality, investor options for exposure to bitcoin have expanded significantly as institutional interest has grown. In this piece, we focus on the benefits and challenges of the multiple channels institutional investors may consider after deciding to make an allocation to the asset class. Below is a table summarizing differences between these channels, followed by a more in-depth discussion of the varying benefits, considerations, and costs of each channel institutional investors may contemplate when looking to make an allocation to bitcoin in their portfolios.

Channel for Exposure	Benefits	Considerations	Cost
Spot Trading and Custody	• Freedom for investors to custody assets where they see fit • Capital efficiency (ability to pledge as collateral to access liquidity) • 24/7 trading capabilities • Exposure to assets aligned with original philosophy of the asset class • Reusability/utility of assets—ability to transfer, lend, borrow against	• Fragmented liquidity (difficult to guarantee best execution prices) • Isolation from traditional assets, resulting in tax and reporting inefficiencies • Variable trade execution costs • Technical Due Diligence • Decision to self-custody	• Variable expense but typically lower than other channels
Bitcoin Futures/ Futures-Based Exchange Traded Funds	**BITCOIN FUTURES** • Trade on the same platform as futures contracts of other assets • Regulated by same agency (CFTC) that oversees contracts for traditional commodities • Physical-settled futures deliver bitcoin to contract buyers upon expiration • No need for stakeholders of physical-settled futures to worry about potential manipulation on underlying spot exchanges at time of settlement, as they might for cash-settled futures **FUTURES-BASED EXCHANGE TRADED FUNDS** • Convenient because fund managers handle the purchasing of contracts and bundle them into shares	**BITCOIN FUTURES** • The settlement price of cash futures relies on a spot price index • Possible expense of long exposure to bitcoin via futures • Bitcoin futures may trade at a premium to account for the cost of custody • Primarily cash-settled instruments **FUTURES-BASED EXCHANGE TRADED FUNDS** • Futures contracts do not track spot prices exactly • Investors subject to losses through contract rolling premiums • Possible expense of long exposure to bitcoin via futures	• Variable
Actively Traded Funds	• Potential to outperform bitcoin	• Longer lock-up periods (1–3 years) with quarterly redemptions	• 1–2% with 10–20% carried interest
Spot Exchange Traded Product	• Institutional-grade bitcoin custody • Near real-time creation/ redemption mechanism that allows shares to trade close to NAV • Tax and reporting efficiencies • Streamlined accessibility • Liquidity	• Third-party risk • May have higher fees than those associated with buying bitcoin directly • Like other wrapped product channels, only available for trading during stock market hours	• Variable, depending on the issuer

Background

In July 2021, Fidelity Digital Assets℠ worked with Yassine Elmandjra of Ark Invest to highlight some of the most common investment vehicles for bitcoin exposure. Since then, investor interest in bitcoin has continued to grow, but many institutional investors have been limited to derivative markets. After years of effort, investors can now get exposure to bitcoin via a spot bitcoin exchange-traded product (ETP) added directly to their traditional investment accounts. In this updated piece, we discuss the benefits and considerations of different channels for exposure, including third-party custody, futures contracts and futures-based exchange traded funds, actively managed funds, and, most recently, spot ETPs.

Spot Trading and Custody

Much of Bitcoin's early infrastructure was primarily built for individual users and investors, with fewer options for robust, secure, institutional custody solutions. Historically, the lack of enterprise-grade solutions has been an obstacle for institutional investors seeking to gain exposure to bitcoin. In recent years, many digital asset native and incumbent service providers have launched institution-focused custody services to protect client assets and help them to meet their regulatory and fiduciary obligations.

Today, the benefits of gaining exposure to bitcoin by working with a third-party custodian include the maturation of custody solutions, the relatively lower cost of maintaining spot exposure via custodians, and the potential capital efficiency benefits of holding the underlying bitcoin. As a result, spot trading and custody offer a popular avenue for exposure. Below, we outline benefits and considerations for investors to be aware of as they consider gaining spot bitcoin exposure.

Potential Benefits

Freedom For Investors to Store Their Assets Where They See Fit

One potential benefit for investors gaining exposure to bitcoin through the spot market is the autonomy they have in custodying their assets based on their individual needs and preferences, including the ability to self-custody and control their own private keys. Additionally, investors may choose to store their assets with several mature, third-party custodians, with important factors to consider, which we outline in the paragraphs below. In recent years, the digital asset landscape has rapidly matured with the launch of integrated trade execution and custody solutions built specifically for institutional clientele to facilitate the acquisition, long-term storage, and protection of bitcoin by large, regulated investors. Ultimately, spot exposure grants investors more flexibility in making custody decisions that are best suited to their own unique preferences and desires.

Custodians may regularly undergo operational and security (e.g., SOC) audits, adhering to the standards of any traditional service provider. They may also hold state trust licenses or national banking charters. The satisfaction of these criteria, along with other requirements discussed in the Investment Advisers Act of 1940, has led some regulated entities to interpret that certain bitcoin custodians are qualified custodians.[1] This is important for investors like registered funds, who must hold investment securities with firms that are classified as qualified custodians.[2] Note that the Securities and Exchange Commission (SEC) has reiterated that bitcoin is not classified as a security[3] but has proposed enhanced measures for its custody rule by requiring that investment advisors safeguard all client assets, including digital assets, with a qualified custodian.[4] While the SEC has provided generalized guidelines on custody best practices, it is important for investors to diligently understand and review the merits of each custodian before making a decision to entrust the storage and safety of their assets with the custodian of their choosing.

Low Cost

Another advantage of spot bitcoin exposure is that it is one of the more cost-efficient ways to access the asset because of relatively low aggregate fees (trade execution and custody costs), compared with most other access points. Annual custody fees and fee schedules differ based on providers, but most providers charge 50bps or less of total assets under custody. Depending on the provider, the custody fee rate may also scale as total assets on a platform increase. Trade execution costs include trading fees and slippage that investors may experience, especially when establishing large positions.

Opportunities for Capital Efficiency

Apart from self-custody, storing physical bitcoin at a custodian is the most direct way to establish exposure to the largest digital asset by market cap. One key advantage of exposure to physical bitcoin is capital efficiency. If bitcoin continues to become more widely accepted as an investable asset, borrowers may increasingly leverage the asset as collateral to access liquidity while maintaining their position. Lenders may see value in bitcoin's use as collateral because it offers certain appealing characteristics, such as being liquid, borderless, and the ability to facilitate fast and final settlement and real-time price discovery. As markets mature, the added value of utility and reusability of these assets in other ways, such as transferring, lending, and borrowing, may grow alongside potential price appreciation.

24/7 Trading

Perhaps the greatest benefit of a borderless, decentralized digital asset is its global market. While exchanges and other service providers offering spot bitcoin are often fragmented and based on local jurisdictions, many operate 24/7 and are not subject to limited market hours, weekends, holidays, and, thus, trapped liquidity. This offers investors and asset managers more flexibility in actively managing their bitcoin.

Considerations

Technical Due Diligence

Given the relatively more technical nature of digital asset custody, some investors may feel ill-equipped to appropriately perform due diligence on service providers. For example, they may struggle to understand the differences between the hardware security module (HSM) and multi-party computation (MPC) models for securing assets or the pros and cons of omnibus versus segregated custody, among other considerations. Thus, certain institutions may prefer investment vehicles that allow them to outsource evaluation of service providers due to internal gaps in technical expertise and experience.

Fragmented Liquidity

Liquidity in digital asset markets is often fragmented. Digital assets, such as bitcoin, trade globally on multiple exchanges of varying volume, transparency, security, and regulatory status. This presents a significant contrast with traditional capital markets, where trading occurs on single exchanges that are required by law to guarantee clients National Best Bid and Offer (NBBO), or the best available purchase (lowest) and sale (highest) prices. Bitcoin exchanges are not subject to such requirements and therefore are unlikely to be able to guarantee "best execution" across all platforms in all jurisdictions.

However, a growing number of institutional service providers are rolling out integrated execution services and smart-order routing solutions that will allow clients to fund a single account and get access to multiple liquidity providers to attempt better price execution and improve capital efficiency.

Lack of Integration with Traditional Assets

Until recently, institutional investors could not access bitcoin through the same accounts or platforms they might use to access traditional assets classes, creating a fragmented experience in managing exposure across asset classes and presenting operational challenges (e.g., taxes and reporting). The ability to integrate bitcoin holdings into traditional portfolios and view the assets together in a single interface is a significant user experience improvement for investors. This has been further enhanced as some traditional banks and custodians have begun to offer digital assets alongside traditional assets by building, buying, or working with subcustodians. Tailwinds supporting this trend include interest from institutional clients and prospects; regulatory support from key agencies, such as the Office of the Comptroller of the Currency (OCC); and competitive pressure, all while maintaining the possibility of self-custody for investors.

Bitcoin Futures

Investors may also use bitcoin futures to build long exposure, hedge spot exposure, or establish risk-neutral exposure to bitcoin. There are a variety of Bitcoin futures options, ranging from highly regulated products offered on familiar platforms to more lightly regulated products offered on offshore platforms that carry significant leverage.

Regulated, Cash-Settled Futures

Potential Benefits

Cash-settled bitcoin futures offered by Commodity Futures Trading Commission (CFTC) regulated platforms, such as CME, have become among the dominant products satisfying institutional interest. Institutions are attracted to CME's cash-settled futures because they trade on the same platform as futures contracts of other assets. They are regulated by the same agency (the CFTC) that oversees contracts on traditional commodities, creating a familiar playing field.

Another advantage of trading on CME is that the exchange already has connections to futures commission merchants (FCMs) that institutions use to access and clear other futures contracts. There are more than two dozen FCMs who support the clearing of bitcoin futures, including E*Trade, Macquarie, TD Ameritrade, and Wedbush, among others. Because FCMs are already integrated, it is easy for them to trade new cash-settled products offered on the platform. The fact that the futures are cash-settled adds another element of convenience because the exchange, the FCMs, and the clients do not need to worry about custody upon physical delivery.

Considerations

The settlement price of cash futures relies on a spot price index. Platforms offering cash-settled futures must reference a combination of robust and regulated exchanges of sizes that are not susceptible to price manipulation.

Additionally, cash-settled bitcoin futures are generally in contango versus spot, meaning futures trade at a premium to spot and longer-dated futures trade at a higher premium than shorter-dated futures. As a result, long exposure to bitcoin through futures may be a relatively expensive option, depending on the level of contango. Maintaining long exposure to bitcoin via cash-settled futures also requires rolling the contract before expiration, adding incremental trading costs above the premium.

Generally, futures contracts trade at a premium to account for storage costs associated with holding underlying assets (e.g., physical commodities like gold or oil). Therefore, bitcoin futures might trade at a premium to account for the cost of custody. A more likely explanation could be that institutions that face regulatory or operational limitations in acquiring spot bitcoin may be willing to pay a premium to access bitcoin futures.

While the premium may be a headwind for participants establishing a long position, it may also be a feature for traders looking to lock in a risk-neutral roll yield by going long spot bitcoin (or shorter-dated futures) and shorting longer-dated futures.

Regulated Physical-Settled Futures

Potential Benefits

Physical-settled futures deliver bitcoin to contract buyers upon expiration (if contracts are not rolled), which may be appealing to institutions that want exposure to the underlying asset, especially if the contracts are offered by regulated institutions. Additionally, stakeholders do not have to worry about potential manipulation on underlying spot exchanges at the time of settlement in the same way they might for cash-settled futures.

Considerations

Regulated physical-settled futures have not seen the same adoption (volume and open interest) as regulated cash-settled futures. This could be because FCMs may be unwilling to support these contracts, to avoid clearing and settling physical bitcoin transactions. This presents a barrier to adoption by institutions whose counterparties may not support the contracts.

Actively Traded Funds

Investors may also find value in gaining exposure to bitcoin through an actively managed investment product. As a transparent, liquid, and volatile asset that trades 24/7, bitcoin offers a compelling opportunity for active managers to generate alpha on top of regular price action. While bitcoin's inability to fit neatly within the traditional active management framework thus far has dissuaded many institutional investors from adopting an actively managed strategy, bitcoin offers a unique set of tools that investors can leverage to assess its fundamentals. Specifically, market participants can source data to analyze bitcoin in more depth than is possible with any other traditional asset. In the same way that a government statistical agency publishes data about a country's population and economy or a public company publishes quarterly financial statements disclosing growth rates and earnings, Bitcoin provides a real-time global ledger that publishes data about the network's activity and inner economics.

The structure of actively managed bitcoin vehicles commonly takes the form of a hedge fund. Costs typically include a management fee (1–2%) and carried interest (10–20%). Lock-up periods are longer than those of alternative vehicles of exposure, typically ranging between one and three years with quarterly redemptions. The strategies vary widely and include neutral/hedged and arbitrage strategies. For more aggressive investors seeking to outperform bitcoin, an actively managed strategy may be the optimal path.

Spot ETPs

To date, multiple spot bitcoin ETP applications have been approved both domestically and internationally, including in the U.S., the E.U., Australia, Germany, Canada, and Brazil. Most recently, and perhaps most notably, the SEC in the U.S. has approved multiple spot bitcoin ETP applications. While the SEC had previously raised several issues in its denial of applications, the U.S. Court of Appeals for the District of Columbia held that the SEC failed to adequately explain its reasoning in disapproving the listing of Grayscale's bitcoin ETP, resulting in the SEC changing its stance and approving a wave of spot bitcoin ETPs in the U.S.[5]

Potential Benefits

Redemption Mechanism

Publicly traded trusts are securities that typically trade at premiums or discounts because there is a six- to twelve-month seasoning period during which shares in private placements must be locked up, creating a disconnect between the time supply hits secondary markets and the demand. A bitcoin ETP, on the other hand, allows near–real-time redemption and creation through authorized participants whose role is to arbitrage ETP shares when the value of the shares in the secondary market deviates from the net asset value (NAV) of the fund holdings in real time.

Approved Product

Certain fiduciaries, such as registered investment advisers (RIAs), want access to familiar products that address operational limitations they may face (e.g., products that simplify reporting and trading on behalf of clients). Until the approval of a spot ETP, among the best options were publicly traded trusts trading over the counter that generally deviate from NAV. However, certain firms may only be authorized to or simply prefer to trade securities offered on national exchanges with strict reporting requirements, offering more visibility and transparency. A bitcoin ETP approved by the SEC that trades on a national exchange offers such a product, which provides protections and disclosures unavailable with other vehicles currently available in the U.S.

Accessibility

Additionally, a bitcoin ETP allows retail and institutional investors to access bitcoin through a low-cost security wrapper that is (1) likely to trade close to NAV for the reasons outlined above and (2) widely available through many popular traditional brokerage platforms and financial institutions without the hassle of dealing with separate digital asset exchanges and wallets. The regulatory transparency and ease of use may usher in capital allocations from a greater number of individual and institutional investors. An ETP provides a vehicle for more conservative or less experienced individual investors who may be uncomfortable with or concerned about appropriately vetting newer digital asset service providers as well as institutional investors who may have similar concerns or be limited in accessing bitcoin through other options currently available.

Bitcoin Custody

Secure custody and trading of bitcoin has historically been a key concern for regulators. In recent years, the development of sound and secure digital asset custody has been built with a quality that satisfies institutional standards. Institutions now have a variety of reputable digital asset custodians to choose from, which continue to display, iterate, and improve their security and robustness.

Considerations

The SEC has previously raised multiple issues with bitcoin ETP applications, including concerns about bitcoin custody, manipulation in and surveillance of bitcoin markets, and whether there is a U.S. regulated bitcoin market of significant size. One notable consideration of a spot bitcoin ETP is, like that of other wrapped product channels, that it is only available for trading during stock market trading hours.

Manipulation, Surveillance, and Size of Bitcoin Markets

Bitcoin trades across extremely fragmented markets as exchanges trade 24/7/365 across the globe but lacks the interconnectivity offered in traditional markets. The development of mature trading venues across spot and derivatives markets has helped to create a reliable and regulated market of significant size. As the space has continued to grow, pricing efficiency has increased as large traditional market makers have begun to consider the space worthy of their involvement.

Potential Future Exposures

The Franklin Templeton–backed Receipts Depository Corporation has made plans to issue bitcoin-based depository receipts (DRs), exempt from SEC registration for qualified institutional buyers (QIBs) in the U.S. These bitcoin depository receipts are designed similarly to American Depository Receipts (ADRs), allowing for direct ownership of the underlying bitcoin asset without the complexities of holding the asset itself.

These would allow QIBs to convert their existing bitcoin holdings into DRs and vice versa, while allowing these investors to use the same technology, workflows, and counterparty relationships they leverage for traditional equities. Broadridge Corporate Issuer Solutions will act as transfer agent and Anchorage Digital will provide custody in a bankruptcy remote structure, adhering to U.S. regulatory standards and ensuring the bitcoin held in custody cannot be lent, rehypothecated, or pledged.

The addressable market for this product, compared with a spot ETP or other investment product, is completely different; an ETP is available to a larger universe of investors than the limited pool of qualified institutional buyers who can buy nonregistered depository receipts. A differentiator between the Receipts Depository Corporation product and the spot ETPs is the ability to turn existing bitcoin units into depository receipts.

With newfound spot ETP approval, it would not be unreasonable to expect those who are not qualified to buy DRs and institutions that do not currently hold bitcoin to favor an ETP product, while those QIBs who do currently hold bitcoin to favor the deposit receipt–based product. Regardless, this development offers additional optionality for institutions interested in investing in bitcoin.

Conclusion

Bitcoin's custody structure as a true bearer asset creates unique challenges for asset managers. This has led to a variety of investment vehicles for allocators to consider using to gain exposure to bitcoin. Each option has its own unique trade-offs regarding custody, cost, and operational burden, among other considerations. Over time, these products have become cheaper, easier to use, and increasingly more efficient.

It is important to note that despite the fact that these different channels offer their own proposed efficiencies and improvements in accessing bitcoin as an investable asset, bitcoin and digital assets, broadly speaking, come with their own risks and trade-offs. Without clear legislation and regulatory frameworks surrounding these assets, along with the volatile nature of their market value, there will remain risks associated with losing the value of the investments, which are not subject to the same protections as other traditional currencies or investments.

Security risks inherent to bitcoin and digital assets subject owners of the private keys to safeguarding the movement and protection of the assets, and if these keys are compromised, lost, or stolen, investors may lose the total value of their investment. Digital asset transactions cannot be undone or reversed once ownership is transferred, further emphasizing the need for strict security and operational controls in protecting private keys.

While market infrastructure and maturation has improved over time, including the approval and trading of spot bitcoin ETPs, liquidity risks remain. A highly concentrated allocation to a single digital asset with low trading volume can pose challenges to investors looking to execute trades at their desired price levels.

Regulatory approval of a more traditional investment product, such as a spot ETP, could provide an even more competitive landscape that may benefit investors. For those able to analyze the various trade-offs associated with the available channels for exposure and potentially make an allocation, the current situation enables an opportunity for these investors to be one step ahead of their peers.

This is an updated report and the original version was written by and in partnership with Yassine Elmandjra of ARK Invest. The original report can be found here.

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