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Employee Benefit Plan Review

Structuring Crypto Exchange-Traded Funds

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Q New cryptocurrency exchange-traded funds (ETFs) have recently entered the market. What Employee Retirement Income Security Act (ERISA)[1] considerations are there when structuring crypto ETFs?

A As cryptocurrencies have become more ubiquitous, investment providers have sought ways to offer investors exposure to the crypto markets. Several cryptocurrency ETFs have launched recently. The structure of these crypto ETFs – a grantor trust – is different from the structure of most other ETFs – which are commonly registered under the Investment Company Act of 1940 (40 Act).[2] As such, there are different ERISA considerations in connection with a grantor trust crypto ETF than there are with a fund registered under the 40 Act.

The internal operations of registered funds are exempt from ERISA. This is because ERISA Section 401(b)(1) provides that in the case of a plan that invests in any security issued by an investment company registered under the 40 Act, the assets of the plan will be deemed to include such security, but will not, solely by reason of a plan's acquisition of the security, be deemed to include any assets of the investment company.

Additionally, ERISA Section 3(21)(B) provides that a plan's investment in a "registered investment company" does not necessarily result in either the company or its investment adviser "to be deemed to be a fiduciary." Consequently, the internal operation of ETFs registered under the 40 Act are not subject to ERISA, though the sale of such ETFs to benefit plans would be subject to ERISA.

"Plan Assets"

If the assets of a grantor trust crypto ETF were deemed to be "plan assets," this could result in, among other things, the application of the prudence and other fiduciary standards of ERISA to investments made by the fund and the possibility that certain transactions in which the ETF might otherwise seek to engage in the ordinary course of its business and operation could constitute non-exempt "prohibited transactions" under Section 406 of ERISA and/or Section 4975 of the Code, which could restrict the ETF from entering into an otherwise desirable investment or from entering into an otherwise favorable transaction.

In addition, fiduciaries who decide to invest in the ETF could, under certain circumstances, be liable for "prohibited transactions" or other violations as a result of their investment in the ETF or as co-fiduciaries for actions taken by or on behalf of the ETF or the ETF sponsor.

On the other hand, U.S. Department of Labor (DOL) regulations provide a definition of "plan assets," which would make such assets subject to ERISA. This definition provides that certain entities are always deemed to hold plan assets if any plan has an interest in such entity. These include group trusts, collective or common trust funds of banks, insurance company separate accounts (unless maintained solely in connection with fixed obligations of the insurance company, which remain unaffected by investment performance) and investments in entities that provide plan benefits.

Additionally, the assets of any entity in which a plan has an "equity interest" except:

(1) An issuer of "publicly offered" securities;
(2) An operating company, real estate operating company or venture capital operating company;
(3) An entity in which the participation of benefit plan investors is not significant; or
(4) The mortgage underlying a guaranteed government mortgage pool certificate.

"Publicly Offered"

Currently, the regulations provide that a "publicly offered" security is a security that is freely transferable, part of a class of securities that is "widely held," and is either part of a class of securities registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934 or sold to the plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act of 1933 and the class of securities of which such security is a part is registered under the Securities Exchange Act of 1934 within 120 days after the end of the fiscal year of the issuer during which the offering of securities to the public occurred. A security is "widely held" only if it is held by 100 or more investors independent of the issuer and one another. A class of securities will continue to satisfy the 100 independent advisor condition even if it is subsequently held by fewer than 100 independent investors, so long as the reduction in independent holders is a result of events beyond the control of the issuer.

Currently, the regulations provide that investments by benefit plan investors will be deemed "not significant" if benefit plan investors own, in the aggregate, less than 25% of the total value of each class of equity interests of the entity (determined by not including the investments of persons with discretionary authority or control over the assets of such entity, of any person who provides investment advice for a fee (direct or indirect) with respect to such assets, and "affiliates" (as defined in the regulations issued under ERISA) of such persons; provided, however, that under no circumstances are investments by benefit plan investors excluded from such calculation). The term "benefit plan investors" includes all "employee benefit plans" as defined in and subject to the fiduciary responsibility provisions of ERISA, all "plans" as defined in and subject to IRC Section 4975, and all entities that hold "plan assets" due to investments made in such entities by such benefit plan investors.

Grantor trust ETFs do not fall into the categories of entities that are always deemed to hold plan assets. However, it is possible for a grantor trust crypto ETF to be subject to ERISA if an ERISA plan (or IRA) owns an "equity interest" and none of the exceptions apply. The exceptions to plan asset status for operating companies and guaranteed government mortgage pool certificates do not apply to crypto ETFs. Therefore, the operations of a grantor trust crypto ETF can be subject to ERISA unless (1) its class of equity interests is "publicly offered" (i.e., there are 100 or more independent investors), or (2) participation of benefit plan investors is "not significant" (i.e., less than 25% of investors in any class of equity interests is comprised of benefit plan investors).

Conclusion

Given the nature of how securities listed on an exchange are bought and sold and how ownership is held, it is nearly impossible for a fund to know the identities of all its investors. For example, most securities these days are held in street name by other financial institutions, even though the end owner may be a retail or institutional account.

Therefore, it is possible for a grantor trust crypto ETF to have less than 100 independent investors or 25% or more of its equity interests owned by benefit plan investors, thereby making the ETF subject to ERISA and the IRC. Thus, sponsors of grantor trust crypto ETFs should take care to ensure that the fund's disclosures, trading and vendor agreements and other fund documents appropriately address and disclose the ERISA risks associated with the fund.

Notes

1. References to ERISA also include references to parallel provisions of Section 4975 of the Internal Revenue Code (IRC).
2. Commodity and currency ETFs are also commonly structured as grantor trusts.

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