How the Professionals Gain Cryptocurrency Exposure

A comparison between trusts, futures and exchange traded products

Written by ETC Group

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Introduction

As the price of bitcoin breaches $60,000\(^1\) giving cryptocurrency’s pivotal asset a $1 trillion market cap, early questions of ‘if’ and ‘why’ to buy bitcoin as part of standard portfolio asset allocation have quickly morphed into ‘how’ and ‘when’. It is no longer an option to simply ignore the cryptocurrency as it becomes more tightly embedded in the financial architecture of world banking systems. But even the most ardent bitcoin advocate would agree that the level of complexity around choosing the right digital asset investment product remains an unnecessary headache.

The ‘how’ question brings with it some difficult choices. Buying and holding the cryptocurrency outright, perhaps using cryptoexchanges, and leaving crypto in that exchange’s wallet, is not an option for most risk-averse investors. Cryptoexchanges remain largely unregulated and opaque venues for trading bitcoin and other cryptoassets and as such are not ideal for most investors seeking safe exposure. Not all are insured against losses. Cryptocurrency exchanges in the main do not qualify for deposit insurance programs like the FDIC in the US or the FSCS in the UK because of their grey-area regulatory status.

For most, this method involves unacceptably high levels of risk, not least because of the frequency of high-profile cybersecurity hacks over the last decade. Even Binance, the world’s largest cryptoexchange by volume, was hacked to the tune of 7,000BTC in 2019. Cryptoexchanges appear and collapse with alarming regularity, which makes for compliance issues. Their lightly regulated nature also leaves the door open to all sorts of sharp practices: as would-be bitcoin ETF provider Bitwise reported to the SEC in 2019, 95% of trading volume across the market could be faked by wash-trading. That’s without even considering the difficulties of crypto-to-fiat withdrawals which vary wildly from exchange-to-exchange and bank-to-bank.

At the same time, as Raoul Pal of Real Vision notes, bitcoin remains an “unprecedented call option on the future”, offering a built-in scarcity diametrically opposed to unfettered central bank money printing. Certainly it makes for an interesting statistic to note that 75% of all US dollars in existence were created after the invention of bitcoin. And so the answer to the question of when to buy bitcoin appears to be “now, and quickly”.

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\(^1\) As at 13.03.21
Both the flood of institutional investors into the asset class and the wider macroeconomic picture have strengthened the momentum behind bitcoin’s recent bull run. Interest rates globally will likely remain at historic lows for several years.

For example, in December 2020 the Bank of England’s Monetary Policy Committee held British interest rates at 0.1% and noted it could bring forth negative interest rates in 2021 in line with the European Central Bank and the Bank of Japan. The Bank, too, has indicated that it will continue its record-busting £895bn quantitative easing (QE) plan to buy up UK gilts and corporate debt. We live in an age of infinite QE, heralded by open-ended buying of US Treasuries and mortgage-backed securities by the US Federal Reserve, which has resolved to continue its mass balance sheet expansion “in the amount needed”.

In fact, the Fed’s balance sheet could soon reach $10 trillion, more than double the peak it hit in the wake of the Great Financial Crisis. We need little reminding that this is the very same crisis that heralded the invention of cryptocurrency in the first place. Today’s lack of return on cash continues to push more money into stock markets — and indeed any highly liquid asset class that promises a return of more than 0.1%. Signs that inflation is on the comeback are also making investors rather nervous, with forecasts rising in tandem with blowout government spending and liquidity dumps in the wake of the coronavirus pandemic.

Asset managers are facing increasingly tough questions from their clients about how they can protect portfolios in the face of such concerns. The question then becomes: what is the simplest, cheapest, most secure and most investor-friendly way to gain exposure to the cryptocurrency industry’s flagship asset?

This report will consider and compare three main options:

- **ETC Group’s physically backed bitcoin ETP**, currently being the most liquid cryptocurrency exchange traded product on Germany’s XETRA trading venue, the largest ETF exchange in Europe, and
- **Grayscale Bitcoin Trust (GBTC)**, the largest bitcoin investment product, traded on OTC Markets,
- **CME Group’s Bitcoin futures contracts**, trading on the largest crypto futures exchange.

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2 [https://www.boerse-frankfurt.de/etfs](https://www.boerse-frankfurt.de/etfs) - see “ETNs”
Security and Accuracy

Since the early 1990s investors have been getting passive access to single asset, whole-market and sector trackers through exchange traded funds, products and commodities — ETFs, ETPs and ETCs. The promise of these financial instruments and the reason they have all but taken over the market is because they offer to your average investor a much-simplified point-and-click investment strategy.

Exchange-traded products (ETPs) in Europe are divided into the following three categories: ETFs (Exchange Traded Funds), ETCs (Exchange Traded Commodities), and ETNs (Exchange Traded Notes).

For illustrative purposes only
Source: Bloomberg. Data as of 25.02.21

To that end, ETC Group’s Bitcoin ETP or also referred to as Physical Bitcoin ETC (BTCE) (ISIN:DE000A273Z04) gives mainstream investors the opportunity to acquire exposure to Bitcoin in a seamless, convenient way that exactly matches their experience of buying equities or any other asset class. The product is structured in a similar way like ETCs on physical Gold, hence featuring a physical delivery mechanism for the underlying asset.

This cryptocurrency ETP debuted on XETRA on 8 June 2020 and has since built a reputation for being an accurate, transparent representation of the bitcoin price.

It is marketed and distributed by HANetf, registered with the post-trade settlement provider Clearstream Banking AG (owned by the Deutsche Börse) and is 100% physically-backed by bitcoin. The ETP currently holds 18,343.137BTC, with the value of its holdings recently surpassing $1 billion. It remains one of the safest and most liquid ways to gain exposure to bitcoin. At a unit price around $55 at time of writing, BTCE remains relatively accessible.

Crucially each unit of BTCE gives the holder a claim on a predefined amount of bitcoin. It is eligible to buy in tax-advantaged accounts like ISAs and SIPPs.

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5 (in the UK) a self-invested personal pension, a pension plan that enables the holder to choose and manage the investments made. Tax laws may change, and you should always seek independent advice.
BTCE offers investors several key security upgrades over buying and holding cryptocurrency directly or holding those coins or tokens on cryptocurrency exchanges. First of all, it eliminates the need for individuals to deal with cryptographic keys. Second, it means there is no need to buy and hold bitcoin directly on unregulated exchanges, nor deal with hardware wallets.

The revolutionary aspect of bitcoin as money, that it is secured with public-private key cryptography, is also one of its key practicality failures. Nowhere is this more clearly obvious than in the gargantuan losses suffered by early investors who forgot their passwords or account key-phrases.

Programmer Stefan Thomas argued to the New York Times in January 2021: “This whole idea of being your own bank — let me put it this way: Do you make your own shoes?” At the time of the interview Mr Thomas’ irretrievable bitcoin funds, locked in an encrypted wallet to which he had long-since forgotten the password, were valued at $220m, and at more recent prices closer to $354m.

“As Bitcoin’s value has soared and fallen and he could not get his hands on the money, Mr Thomas has soured on the idea,” the New York Times reported, with the programmer adding: “The reason we have banks is that we don’t want to deal with all those things that banks do.” Where there are large amounts of money involved, nobody wants processes to be messy and uncertain.

Investors may also find it difficult to trust consumer hardware wallets: the two main providers being Ledger and Trezor.

The security division of San Francisco cryptoexchange Kraken alleged in January 2021 that Trezor wallets and their derivatives were vulnerable to brute force hacks that can reveal users’ private keys. Ledger customers have seen their private contact details dumped on hacking forums and while no keys were exposed, security remains a concern.

BTCE by contrast, comes with all the standard protections that investors expect from a professionally-registered and distributed investment product. BTCE holds bitcoin secured in qualified, regulated cold (offline) storage with BitGo, the institutional custody provider that uses industry-leading multi-signature contract security. The failure of cryptoexchanges to correctly secure their customers’ cryptocurrency is well documented. For example, it was revealed in 2018 after the hack on Japan’s largest exchange at the time, Coincheck, that the exchange co-mingled all its customer funds in a single internet-connected wallet. If I am a pension fund buying bitcoin I don’t want to have to explain to my clients that I lost their capital on what I thought was a secure exchange, only to see headlines that their funds were held in a single hot wallet that did not even require multi-signature access.

All of this said, because of the regulatory limitations placed on asset managers and fund managers, institutional investors often do not have permission to hold physical bitcoins anyway.

Of course, as with any financial instrument, your capital is at risk. Bitcoin is a highly volatile instrument and past performance is no guarantee of future performance.
Trading at a Premium

As the oldest bitcoin investment vehicle of its kind, Grayscale Bitcoin Trust (OTCMKTS: GBTC) remains arguably the first port of call for institutional investors seeking exposure to bitcoin. And yet it comes with some major inefficiencies and some rather unpalatable trade-offs, which we will investigate here.

GBTC debuted as a private placement to accredited investors on September 25, 2013. At this point in time, bitcoin remained largely a fringe asset touted by cryptography enthusiasts on internet bulletin boards. BTC/USD was undergoing its first major bull market, trading in a range between $53 and $1,242, having reached parity with the US dollar two years earlier.

Sadly, bitcoin’s graduation into the mainstream has not, to date, brought with it a host of simple, transparent investment options. And one of the more interesting aspects of GBTC is that it consistently trades at a significant premium to NAV.

Over the last 12 months, GBTC has traded at an average 17.63% premium to NAV in the secondary market\(^6\). At times of particularly extended volatility over that period, the premium has topped 40%\(^7\). This is not a particularly investor-friendly situation.

\[ \text{Source: YCharts.com} \]

Past performance is no guarantee of future performance.

In fact, in the last five years of GBTC, there has been only a single day when GBTC has traded at a discount to NAV, and then only at 0.34%. The maximum value over this time was during the retail buying frenzy in the midst of the 2017 bitcoin bull market, when the GBTC premium skyrocketed to 132.4%. Over the last 5 years, the average premium paid above the bitcoin price was 38.08%\(^8\).

Ryan Alfred of crypto analytics firm Digital Asset Data (latterly acquired by NYDIG) noted last year: “The premium is the amount you’re willing to pay to not custody your own private key, and still get exposure to the underlying asset.” While there are investors who are willing to accept this significant compromise, Alfred was right when he added that: “No institution would pay this for any other asset class.”

\(^6\) https://ycharts.com/companies/GBTC/discount_or_premium_to_nav as of 05.03.21
\(^7\) Ibid
\(^8\) Ibid
If Grayscale’s premium was more widely publicised it is likely that retail investors would balk at the knowledge they must pay on average 20% more than an asset is worth on the open market, and during times of historic volatility as much as double its value.

It may be useful here to understand the mechanism of why the GBTC premium to NAV exists.

Every ETP has a net asset value (NAV), which the market considers the fair value of each share, based on the ETP’s underlying holdings. Because shares of an ETP trade on an exchange these market values can fluctuate to prices above (a premium) or below (a discount) to the NAV value.

Any divergence away from the NAV is arbitraged away by market makers, and so (according to Bloomberg data), BTCE very accurately tracks the price of bitcoin and its premium is miniscule compared to GBTC: an average of 0.63% over the last 12 months. Clearly there is more value for money in investors in products that are able to tightly track the bitcoin price. Below is a chart of the BTCE price vs XBT-EUR.

Past performance is no guarantee of future performance
Source: Bloomberg. Data as of 23.02.21

Exchange-traded products like BTCE were designed to avoid excessive premiums through their redemption mechanism: as noted above, this is the ability for any investor to redeem their shares for physical bitcoins. By contrast, accredited investors can take part in daily private placements for GBTC, subscribing for shares at par value of the NAV. After a six-month lockup period, these institutional investors can sell their shares in the secondary OTC markets, and there is no redemption mechanism.

Accredited investors and market makers being unable to redeem shares for underlying assets, in this case bitcoin, has led to a permanent disconnect between GBTC market prices and its NAV.

Grayscale periodically closes off its trusts to new investors, the most recent time being 21 December 2020. Not only does this raise accessibility questions, it is also during these times that the premium to NAV spikes, as investor demand exceeds supply. On the date mentioned, the GBTC premium to NAV reached a 10-month high of 40.18%.

“The fact that cryptocurrency is still a fringe asset to most investors, with few alternatives, allows premiums to reach such high levels,” Ryan Alfred noted at the time. While the GBTC premium may have been a representation of the amount institutions were willing to pay to avoid hassle, now that safe, liquid alternatives like BTCE exist, Alfred’s assertion is no longer strictly true. Investors do not have to be forced into a corner, paying vast premiums over and above the spot price of bitcoin, simply to get easy-access exposure without technical headaches or custody issues.
CME Futures

Another bitcoin exposure option that does not require custody is CME’s bitcoin futures contract. In December 2017 just as the last bitcoin bull market was peaking, CME (the Chicago Mercantile Exchange) and CBoe (Chicago Board Options exchange) both launched bitcoin futures. The introduction of these decades-old, recognised trading venues was considered a significant step at the time.

While the market size has grown steadily, accessibility remains relatively convoluted compared to easy-access ETPs. And CME is not even the world’s biggest venue for bitcoin futures. As shown in the chart below, it has been largely eclipsed by Binance in both open interest and daily trading volume.

For illustrative purposes only
CME does benefit by being a long-registered reputable and regulated trading venue — which Binance is not. And the counterparty risks of trading futures on any of the other exchanges listed above are likely too extreme to bear. Again, nobody wants processes to be messy and uncertain where large amounts of money are involved. Certainly I don’t want the possibility that my profits could disappear in a puff of smoke if my counterparty fails to perform.

But as Izabella Kaminsky writes for the Financial Times: “The launch of CME Bitcoin futures heralded in a new risk-controlled crypto era. Not only did CME futures make it possible to short Bitcoin without having to worry about counterparty risk, enabling better price discovery in general, they also facilitated the introduction of contango trades. This was especially the case for regulated and creditworthy institutions who had the capacity to both fund the margin capital needed to operate at the CME and met the exchange’s minimum credit standards.”

Contango is a concept well-known in commodities trading, where an institutional investor buys a physical commodity or asset like bitcoin at market value, but sells a future at a premium to that price, hedging their exposure (and lowering risk), and collecting a riskless yield if they can hang onto it until the settlement date.

That’s not to say CME Bitcoin futures are risk-free, by any measure, Kaminsky notes. “If institutional managers did decide to invest most heavily in bitcoin futures, the risk remains they would end up taking the other side of hedge fund or broker/dealer contango trades. This would risk institutions replicating [a] negative yield exposure.”

While CME announced that over the course of 2020 it added 3,050 new trading accounts, an increase of 84% over 2019, these numbers are hardly earth-shattering, and for all the publicity and hype there exists far more investor interest in standard regulatory products like ETPs and ETFs than in buying futures contracts. Cash-settled futures remain a rather arcane way for your average investor to get exposure to the bitcoin price and remain mostly the preserve of hedge funds or very sophisticated traders. Additionally, futures accounts with CME require a separate account: whereas BTCE can be easily bought through most bank or brokerage share-trading accounts. And at 5BTC (~$275,682), the price per contract is well out of the reach of most retail investors.

The real issue with using CME futures for a long position in bitcoin is one of operational difficulty and cost. Rolling contracts forward using calendar spreads is an option, but that does mean trading out of one contract and into a deferred contract.

The pricing of CME contracts are based on the Bitcoin Reference Rate index, which aggregates trading activity across four cryptoexchanges: itBit, Kraken, BitStamp, and GDAX, between 3pm and 4pm GMT daily. And yet CME Bitcoin futures trade at a significant premium to spot prices — according to data by Skew Analytics, the numbers are significant. The premium extends on average 10% higher than the spot price, annualised over the last three months for three-month rolling futures.

So bitcoin futures too, are more expensive than the actual bitcoin price, leaving retail investors overpaying again. BTCE’s average 12-month premium of just 0.63%, compared to a 10% CME premium or a Grayscale 17.63% premium again looks rather handy.

Above and beyond the issues with access and premium prices, there is also the question of margin requirements. CME began trading in 2017 with a margin requirement of 47%.

At times of high volatility, for example during the last bitcoin bull run, brokers like Goldman Sachs have demanded that clients put up 100% margin — effectively asking that clients set aside funds equal to the full cost of any bitcoin futures trade — as a condition for clearing the transaction. While we haven’t seen sky-high margin requirements like these in recent years. CME reportedly still requires 35% margin for its bitcoin futures product.

Taken together these issues make costs prohibitively high, leaving long-term holders liable to avoid CME Bitcoin futures altogether.
Risks of Investing in ETCs:

- Bitcoin ETC’s are a highly volatile digital asset and performance is unpredictable.
- Like equities, an investor’s capital is fully at risk and you may not get back the amount originally invested.
- Exchange rate fluctuations can also have both a positive and negative effect on returns.
- Past performance of A Bitcoin ETC is no guarantee of future performance.
- The product may not be a suitable investment for all investors and each investor should determine the suitability of its investment in light of their own circumstances.
- For a full, list of risks associated with the ETHE product, please consult the prospectus.

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Conclusion

The investment landscape for bitcoin has altered rapidly even in the past 12 months. Blackrock has “started to dabble” in bitcoin, it told CNBC. Large numbers of US investors now have indirect exposure to cryptocurrency whether they like it or not. The number of multinationals expanding their treasury holdings of bitcoin is increasing daily, with a $1.5bn bitcoin shopping spree by Tesla (NASDAQ:TSLA) only the most recent. Tesla joining the S&P 500 in December 2020 also means that millions more investors also have exposure to bitcoin through tracker funds and index funds. And among the billionaire hedge fund managers who have defected from cryptocurrency skeptic to advocate over the past few years are Stanley Druckenmiller, Paul Tudor Jones of Tudor Opportunities, Ray Dalio of Bridgewater Associates, Scott Minerd of Guggenheim Partners, and Bill Miller, to name but a few.

Minerd, for his part, filed with the SEC in November 2020 to reserve the right to put up to 10% of his $5.3bn Macro Opportunities Fund into GBTC. One wonders whether, given the better value ETP opportunities now available, Minerd’s fund would consider the Grayscale premium to be a deal-breaker.

Certainly the two products appear to have relatively equal liquidity. According to Skew Analytics, GBTC trades on average $145m a day, while BTCE recently passed $100m in daily trades and has grown materially larger since November 2020.

And Grayscale’s ultimate ambition for GBTC is a recognition of the success of the bitcoin exchange traded product structure. Its CEO Michael Sonnenshien noted in a February 2021 interview with TheBlockCrypto’s Frank Chapparo that their hope is to move GBTC onto a registered national bourse, as BTCE already has. “We spent the better part of 2017 in contact with the SEC, we ultimately realised that the regulatory environment wasn’t ready for a Bitcoin ETF [but] we hope in the future, like we were planning to in 2017, to register and uplist GBTC onto a national securities exchange as a bona-fide ETF,” he said.

SEC Commissioner Hester Peirce added recently that a bitcoin exchange-traded product is the “natural” way for investors to seek exposure to bitcoin, despite the lack of such an investment vehicle in the US.

So with CME bitcoin futures unlikely to capture the attention of most retail investors, and the issues of Grayscale’s premium to NAV overwhelming its positive attributes, it may appear that BTCE makes the most logical investment choice for investors to gain exposure to bitcoin.
About BTCE

BTCetc – ETC Group Physical Bitcoin (Ticker: BTCE) is an exchange traded cryptocurrency that tracks the price of bitcoin. BTCE is 100% physically backed by bitcoin and trades on Deutsche Börse’s XETRA. It was the world’s first centrally cleared Bitcoin ETC, providing investors with a safe, transparent and liquid way to gain exposure to bitcoin. Each unit of BTCE gives the holder a claim on a predefined amount of bitcoin. BTCE is issued by ETC Group and marketed and distributed by HANetf.

The value of your investment may go down as well as up and past performance is no indication of future performance. Your capital is at risk.

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Contact Us

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About HANetf

ETC Group has partnered with HANetf to market and distribute BTCE in Europe.

HANetf is an independent ETF specialist working with third-party asset managers to bring differentiated, modern and innovative ETF exposures to European investors.

Founded by two of Europe’s leading ETF entrepreneurs, Hector McNeil and Nik Bienkowski, HANetf provides a complete operational, regulatory, distribution and marketing solution for asset managers who want to successfully launch and manage UCITS ETFs.
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