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DECRYPTING CRYPTO-FUNDS: THE KEY QUESTIONS

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DECRYPTING CRYPTO-FUNDS: THE KEY QUESTIONS

Many of the world's largest asset management firms are exploring the potential of crypto-funds but what are they, what are the risks, how are they regulated, how do you set one up, and who has custody of the assets? These were some of the questions discussed at the Clifford Chance Global Investment Management Group conference recently. Here are some of the highlights.

Crypto-funds: The Key Questions

- What are crypto-funds?
- What are digital assets?
- What are the risks and vulnerabilities?
- What are the fund structuring considerations?

What are crypto-funds?

A fundamental question is what is meant by 'crypto-funds'? There is no single answer to this but Hong Kong partner, Rocky Mui, explained: "Generally speaking, in Asia, crypto-funds can be divided into two: funds, with a typical fund structure, which invest in cryptocurrencies or other digital assets; and tokenised funds, where investors receive digital tokens rather than shares or partnership interests in a traditional fund vehicle."

David Adams, a senior associate in the Clifford Chance Washington, DC office elaborated: "In the US, a crypto-fund could include one with a normal structure that invests in digital assets such as Bitcoin or Ethereum, or a fund that issues digital ERC-20 or other tokens to investors in lieu of traditional shares. We are also seeing funds formed in the US to invest both in digital assets, such as Bitcoin, and in technology companies helping to develop digital assets and/or products related to digital assets."

Gregor Evenkamp, a partner in Clifford Chance Frankfurt agreed, noting that, in Germany, crypto-funds are mostly understood as traditional funds investing into cryptocurrencies. "In Europe, we now see several examples of regulated and unregulated crypto-funds. If you look closely at those funds, most of them invest either into cryptocurrencies or, in some cases, other digital assets offering direct economic benefits or value, with little interest to date in utility tokens."

Overall, the discussion concluded that, although there is no single definition of a crypto-fund, two principal models are emerging:

- funds which invest in digital assets
- funds which issue tokenised fund units

There are nuances, of course, so a fund could combine both of these models.

What are digital assets?

Another fundamental question is what are digital assets? Broadly, digital assets are thought of as falling into three categories: cryptocurrencies, security/asset tokens and utility tokens. The true picture is not so homogenous, but our "taxonomy" (above) is useful. So, what investments are crypto-funds actually making? Marian Scheele, Senior Counsel from Amsterdam observed: "At present, we are seeing funds with different types of investment strategy. For instance, some funds manage portfolios containing cryptocurrencies like Bitcoin, often combined with other cryptocurrencies or tokens, and some, although less common, have added digital assets to a mix of other more traditional asset types. Also, we are seeing funds that combine investing in crypto with high frequency trading activities."

Peter Chapman, a partner in the Financial Services Regulatory practice in London, queried whether the diversity of investment portfolios differed by region. In Europe, often Bitcoin and Ethereum represent the biggest stake, but what was the digital asset class of choice in the US?

"In the US financial services space, digital assets seem to break down roughly into cryptocurrencies, securities tokens and utility tokens. However, one of the issues is that a significant amount of uncertainty remains about how any given digital asset will be classified, and the SEC has taken a particularly expansive view of its jurisdiction meaning that many digital assets will be treated as securities tokens (and therefore regulated products)," said David Adams.

To date, the only more or less universally accepted non-security digital asset is Bitcoin, which is considered a cryptocurrency. Ethereum/Ether seems to be a non-security as well in its current iteration based on recent statements by SEC staff, but it is not 100% clear and its classification could change in the future. Members of the SEC staff have acknowledged that a "utility token" could hypothetically exist (e.g. a token issued that provides access to features on fully functional decentralised rails where no informational asymmetry exists). However, the consequences of making the wrong call about a digital asset can be severe, and can lead to SEC enforcement action. This raises the next question: are digital assets regulated elsewhere across the globe?

Peter Chapman explained that different jurisdictions have taken different regulatory approaches. "In Asia, for example, we see a broad spectrum, with China banning ICOs/cryptocurrencies, while Hong Kong and Singapore are taking a more "tech neutral" stance and looking to regulate using existing regulatory regimes. European regulators have taken an "engaged, monitoring approach", although many EU financial services regulators have published warnings to the public about investment risks inherent in crypto assets."

Risks and vulnerabilities

With such a complex picture, fund managers need to undertake appropriate due diligence to understand the risks and vulnerabilities before investing in digital assets and will need to consider factors beyond those typically considered for more traditional assets. Some such risks relate to the blockchain, such as bugs or hardware defects, which may result in your digital asset disappearing. One scenario is the "50% hack" where someone or something, is able to control more than 50% of the network and based on this control, would be able to change the rules, manipulate the system, transfer or even make the assets effectively disappear.

The market is also extremely volatile, as Gregor Evenkamp pointed out, with scams, market manipulation and fraud commonplace. Media reports suggest that 80% of Initial Coin Offerings (ICOs – a method of crowdfunding using blockchain and cryptocurrency technologies) are fraudulent. This explains why regulators have been paying close attention, given the investor protection issues that this raises, particularly in the absence of a central bank back-stop. The German regulator BaFin, for example, has recently consulted on new guidance, focusing on imposing increased diligence requirements on banks and financial service providers when dealing with virtual currencies.

David Adams reiterated that questions of regulatory status loom large in the US and can impact the value of digital assets, as an SEC enforcement action can pose an existential threat to digital asset companies due to potential investor rescission rights – particularly given the plunge in digital asset values at the beginning of this year.

Anti-money laundering (AML) is also deterring some traditional financial institutions from entering into the cryptocurrency market. "I think they are trying to get into a place where they feel comfortable, whether from a control or operational perspective. We are seeing certain markets trying to address this by developing non-deliverable derivatives over crypto, so they are only getting economic exposure and not actually touching the physical crypto, so trying to manage AML in that sense," explained Rocky Mui.

Another important issue is that cryptocurrencies can have an environmental cost as they may require significant computing power. "It is said that the Bitcoin network consumes as much energy as the whole of Hungary, which might spook environmental, social and governance (ESG) compliant investors," said Gregor Evenkamp.

This is not to say that traditional considerations are not important. These need to be examined as well, including the strength of developers and their entrepreneurial experience.

Setting up a crypto-fund

Although there are no specific rules for establishing a crypto fund, there are several important points to consider and these may be different compared to structuring a fund investing in more traditional assets, explained Marian Scheele. The first is regulation – determining whether the fund is regulated or not. In Europe, an assessment needs to be made as to whether the fund falls under the Alternative Investment Fund Managers Directive (AIFMD). This will usually be the case unless it is a small, sub-threshold fund. If the fund is in scope, all AIFMD rules apply.

The next important consideration are the characteristics of the investment – for instance, is there liquidity in the market for the relevant cryptocurrencies and therefore should the fund be open or closed-ended? Or should the fund manager work with gates (redemption possibilities that are maximised per period) and have the power to postpone redemption depending on specific market conditions? Close attention must also be paid to other details of the fund, Marian Scheele added, such as liability and indemnities, for instance, as well as the specific considerations around investment strategy, valuation (what will be the valuation principles and who will do the valuation?) and disclosures.

One of the most important questions in practical terms is how are the digital assets held and how do you verify ownership of the fund holding, for example, Bitcoin. Gregor Evenkamp said: "They are treated as financial instruments, but what does that mean? From a civil law perspective, they could be legal tender, or they could be e-money, they could be a claim, they could be an IP right, they could simply be an asset. This leads to the next question – how does this "thing" then transfer? Is it via a purchase agreement, or is it an exchange where you simply exchange the US dollar against Bitcoin?"

Different jurisdictions also take different approaches to custody of digital assets. From a German perspective, said Gregor Evenkamp, the fund owns the assets. But he added that when helping a client establish the first regulated crypto-fund, the identification of a custodian was the most critical step in the project. "We had to identify a licensed credit institution willing and

[1] (SEC Rule 206(4)-2)

able, in terms of IT resources, to deal with the [digital] assets, but it was an enormous learning curve for everyone involved."

He added, "Some smaller players, in close cooperation with regulators have now moved into this new crypto-custodian business. In the near future, I think we will see bigger players moving into that space. The Swiss Stock Exchange, for example, has just publicly announced that it will offer cryptocurrency custodian services for clients."

In the US, David Adams noted that difficult regulatory issues arise in respect of custody for SEC-registered advisers. For example, the SEC's "Custody Rule"[1] generally requires use of a "qualified custodian" to hold the funds and securities owned by a fund. Query if Bitcoin or digital assets are even "funds" or "securities" for purposes of the Custody Rule, and if any custodian is truly "qualified" in the context of this new asset class. Putting that aside, some reputable custody solutions are coming online in the US, including those offered by major US financial institutions like Fidelity.

With respect to self-custody, the Custody Rule creates an open question about an adviser's ability to self-custody. Most PE advisers will not meet the rule's definition of a "qualified custodian". There is an exemption from the "qualified custodian" requirement for uncertificated securities that permits self-custody under certain circumstances, but some of the exemption's requirements do not square with the nature of digital assets. For example, the uncertificated security exemption requires that ownership be recorded "only on the books of the issuer or its transfer agent in the name of the client", but Bitcoin ownership is also recorded on the Bitcoin blockchain. Thus, it is unclear whether this exemption applies in the context of Bitcoin and similar assets like Ethereum and ERC-20 tokens.

In Hong Kong, the SFC also allows self-custody of digital assets by licensed asset managers but subject to higher internal control standards. As Rocky Mui observed, the SFC recognises that there is no perfect solution. "It allows managers to self-custody digital assets but you have to have robust segregation between front office and the custody framework, and managers would be required to take out insurance over the assets under custody," he said.

The current and future regulatory framework

Experience to date shows the importance of striking the balance between regulation, investor protection and industry needs to create a level regulatory playing field internationally. Currently, there is a regulatory "gap", as digital assets do not fit squarely into existing regimes. In Hong Kong, for example, a digital asset needs to fall within the definition of a particular type of regulated instrument for it to fall within the jurisdiction of a regulator, and firms managing a portfolio which invests solely in non-security/futures digital assets are not required to be licensed as an asset manager. The SFC has tried to address this by imposing licensing conditions on existing licensed asset managers that may seek to manage non-security/futures digital asset portfolios.

In the US there is added complexity due to the number of regulators with responsibility in some way for crypto assets. Cryptocurrencies (e.g. Bitcoin) for example, are currently subject to a patchwork of regulations across 50+ states and US territories, which is

> **There clearly is a range of assets. Some are regulated, some are not, and different regulators take differing approaches which all makes for a complex picture.**
>
> —**PETER CHAPMAN**

> As a general rule, no specific rules apply for structuring a crypto-fund
>
> —**MARIAN SCHEELE**

complex and difficult to navigate. At the federal level, FinCEN has imposed federal AML obligations on cryptocurrency exchanges, issuers, and other gatekeepers. The SEC has asserted authority over securities tokens but provided no clear regulatory guidance on distinguishing securities tokens from cryptocurrencies and/or utility tokens. The SEC staff did issue a "Framework for 'Investment Contract' Analysis of Digital Assets" earlier this year, but many believe that it and some related guidance create more questions than answers. The CFTC also has an interest in this space with respect to, for example, cryptocurrency derivative products like Bitcoin futures. Despite the lack of clarity, many US federal and state regulators are aggressively pursuing enforcement actions against industry participants.

Overall, there is a real divergence in approaches across the spectrum and the regulators are not all pulling in the same direction (even those within the same country sometimes). Evidently, clear direction at an international level would be beneficial for all market participants.

Our Predictions

- The US digital asset market will continue to develop despite the recent chill of crypto winter and lingering regulatory uncertainty. Custodial providers like Fidelity and others make it more likely that funds and other institutional investors will enter the space, and several securities token exchanges are coming online that should help promote liquidity in the market.
- A harmonised view on the regulation of digital assets would be very helpful and steps should be taken to develop this, but global harmonisation remains unlikely. We are optimistic this will develop (unless an unexpected/damaging digital assets 'event' catalyses rapid regulatory action).
- Cryptocurrencies will continue to emerge as a recognised asset class, stablecoins will become more mainstream, and interest in crypto-funds will remain.
- Digital assets will become an established and recognised asset class, with regulated crypto-funds offering diversified exposure to investors.
- Expect to see more licensed asset managers managing these private crypto-funds.
- Retail crypto-funds are still some way off (although permitted in certain countries such as the Netherlands).

[i] The panel discussion on "Decrypting Crypto-funds" was part of the Global Investment Management Group Workshop that took place in March 2019 in Rome. Rocky Mui, Gregor Evenkamp, Marian Scheele and David Adams were on the panel, which was moderated by Peter Chapman.

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