Turning information into cash: practical issues when setting up a crypto-fund

By Ben Watford & James Burnie

Setting up a crypto-fund is not straightforward. Participants can be unclear as to the nature of this nascent asset class, whether it is an asset class, and just generally what it all means and whether it is worth anything.

This article seeks to help demystify what is going on, and to guide managers seeking to enter the crypto ecosystem.

What are we talking about?

"Blockchain", simply put, is a technology which allows for a single piece of data (called a "token") to be viewed by multiple persons simultaneously, at any time of the day, in a way which is more secure than previous systems.

From an investment perspective, the key attribute is that, whereas before if a person liked someone else's data they could copy it and no-one would be able to split the original from the copy (think sharing MP3 music files), using blockchain the copy would be rejected by the original blockchain system. This means that, if a participant wanted to own a token held by another, the participant would have to buy that token and cannot just copy it.

The token, therefore becomes unique and the value of that token is determined by the value attributed to it by the participants. So, in the case of bitcoin, a bitcoin is worth whatever another participant is prepared to pay for it. If, however, the participants determine that the holder of a token is the owner of another asset, for example the owner of the token own a car, then the value of the token is driven by the value of the car (as the token is merely proof of ownership of the car). For a fund manager, tokens therefore fall into two types: those whose value is driven by supply and demand, e.g. bitcoin, and those whose value is driven by outside assets (it is easiest to see these as acting like vouchers for the relevant asset).

Tokens: the risk profile

The Financial Conduct Authority ("FCA") has also expanded, in its guidance, on the different types of tokens, splitting them into three core:

- *Security tokens:* this refers to those tokens that provide rights and obligations akin to specified investments, such as shares, bonds, fund units.
- *E-money tokens:* this category refers to any token that reaches the definition of e-money, which in broad terms means that it is a token which is linked 1:1 with traditional money.
- *Unregulated tokens:* this category refers to any token that does not meet the definition of e-money, or provide the same rights as other specified investments under the RAO. This includes tokens referred to as utility tokens, and exchange tokens.

The importance of this, for a fund manager, is as regards the level of protection when buying different types of token.

The risk profile of acquiring of security tokens / e-money tokens is a combination of (i) the risk profile of the asset (ignoring the blockchain element – i.e. the risk profile of a share / bond / other security etc. in the ordinary course); and (ii) the risk that the blockchain demonstrating title fails. As such, fund managers should be focussed, in addition to their usual due diligence for the asset class, on, for example, what back-up and business continuity procedures are in place should the blockchain break down.

Unregulated tokens have a different risk profile. Here, depending on the tokens, there is a need to carefully consider the underlying asset – for example, if the token gives rights to gold, is that gold carefully secured? Another issue is that has been a historic perception, wrongly, that somehow this law "does not apply" to these tokens. This is incorrect, as, for example, the common law against fraud and misrepresentation does still apply. Nevertheless, it is important when dealing in these tokens to have proper due diligence in place.

Roadblocks to creating an institutional quality crypto-fund

One key factor to ensuring a crypto-fund is launched successfully is ensuring the fund and its service providers are of sufficiently high quality that investors are happy to invest into it.

Key to this is getting on-board with quality service providers who are willing, able and capable of assisting. This includes: obtaining a bank account, ensuring that all the correct regulatory authorisations have been obtained, setting up with a custodian, setting up with an administrator, obtaining your own FCA authorisations or utilising an FCA umbrella hosting solution, finding suitable brokers, on-boarding credible directors and finding lawyers who can provide quality documentation which can be provided to investors.

To this end, it is worth noting that the crypto-community is still, relatively small, and as such it is important to make a good first impression. For example by using your lawyers to develop a detailed terms sheet and business plan, alongside a credible team, which clearly shows your vision.

Having a clear vision: profit vs risk appetite

When dealing with service providers is it important to have a clear vision for the fund, and, in relation to crypto funds strategies, this involves being able to answer questions such as:

What are you investing into?

There are three basic options. Option 1 is to invest into well-known tokens, such as Bitcoin and Ethereum. The advantage of this is that these tokens are relatively well known, however the disadvantage is that investors might questions why they would not simply buy / sell these tokens themselves, particularly if a passive investment strategy is used.

Option 2 is to invest into more exoteric tokens, e.g. through "token generation events" or "initial coin offerings". The advantage of these is that there can be greater potential volatility in terms of gain, however this is because these tokens are very high risk, and there is a very high chance of them becoming worthless. Also, many service providers will only support certain types of token – for example, it is common for service providers to only support bitcoin and tokens are "ERC-20" compatible (this is the platform behind, for example, Ether).

Option 3 is to invest into companies which are involved with crypto assets, e.g. through buying shares. The advantage of this is that there is a specific company you can, for example, secure your investment against, however it is questionable how this approach is different from other funds which are equity funds investing into FinTech.

What are the nature of your trades?

Different investment strategies might be used, e.g. passive, active or high frequency trading. If a high frequency trading strategy is used, it is important to make sure that your custodian and broker can support the speed of trading required.

What is your set up?

It is important also to consider the nature of the jurisdiction in which you wish to set-up. Some countries have specific regimes for crypto assets, however it is questionable the extent to which these are really helpful. It is also important to note that, if you are performing regulated activities in the UK, you will need permission from the FCA for these, and to this end it is worth considering, for example, whether a hosting solution, in which a regulated entity takes responsibility for you activities, can be used to avoid the cost of obtaining direct authorisation. ■

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