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Seizing early opportunities: A strategic guide for setting up an EU crypto fund

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With Bitcoin reaching new all-time highs and positive market sentiment over the last several months, digital assets continue to draw significant interest from traditional investors. This can be credited to several demand drivers: (1) US Bitcoin spot ETFs proving to be the most successful ETF launch in history; (2) a growing number of financial institutions incorporating digital assets into their diversification strategies; (3) Bitcoin's store-of-value reputation; and (4) the rise of other digital assets now recognised as blue-chip investments, among others.

Still, entry into the digital asset market remains a challenge for many traditional investors despite its existence for over a decade. At the same time, traditional products like funds remain relatively scarce in the digital asset space and are, for the most part, restricted to private placements with low liquidity and limited investor numbers.

However, the impressive performance of digital assets has led many asset managers to rethink their strategies, with plans to upgrade their fund structures to include digital assets and capitalise on benefits such as broader distribution, and bypass AuM caps. Given the regulatory challenges in the US, European and Asian fund promoters are now uniquely positioned to capitalise on this opportunity and take the lead in digital asset products.

But this is easier said than done. Setting up a crypto fund can be complex, and it is a transition that comes with a number of critical questions: Which jurisdictions are ideal for launching these products? Which vehicle suits targeted investors best? And, finally, which counterparties guarantee high-grade security and long-term success?

Step 1: Choosing the right jurisdiction

The most crucial step in setting up a crypto fund is choosing the right jurisdiction. Despite the introduction of the Markets in Crypto-assets (MiCA) Regulation, the regulatory landscape in Europe is far from harmonised. Although MiCAR aims to harmonise the market of crypto-asset providers, it does not regulate how and on what conditions EU investment funds may actually invest in digital assets.

This matter is governed by UCITS and AIFM Directives and as these acts do not explicitly regulate investments in digital assets, it is mostly up to the local authorities and regulators to decide – and their approaches vary greatly. Some countries (e.g. Poland) actively discourage local players from setting up in their home states, thus in this article we focus on jurisdictions keen to serve as hubs for fund managers in the digital assets' space.

Luxembourg, Europe's primary fund jurisdiction, was and is of greatest interest to digital asset fund promoters. Yet until recently the CSSF's guidance of November 2021 clarifying that alternative funds can invest in digital assets under the condition that their managers obtain a special license from the Luxembourg regulator had little practical meaning, as there were no fund managers licensed to do so. This has changed with the authorisation of 6Monks[1] as the first Luxembourg AIFM licensed to create and manage funds investing in digital assets. It goes without saying that for Luxembourg to flourish as the go-to jurisdiction for digital asset funds, development of the service provider ecosystem is required. At the same time, given its significant role in the EU's fund industry, Luxembourg's position will remain crucial for adopting digital asset funds.

Ireland, the closest contender for Luxembourg's #1 fund hub spot, is known for its robust fund industry and strong ties to overseas markets, but as in the case of the Grand Duchy, the development of the crypto fund market has been rather slow – the Central Bank of Ireland guidelines do not allow direct exposure of funds to digital assets until the regulator is satisfied with the depositary safe-keeping arrangements, which might make setting up crypto funds in Ireland cumbersome.

With the two largest fund jurisdictions slow to develop their own offering for digital asset funds, there's room for other member states to play a more significant role.

Despite Malta's 'blockchain island' initiative not being quite the success it was hoped for, there are many reasons to consider Malta as the domicile for a digital asset fund. The regulatory framework is already largely aligned with MiCA requirements, which may reduce the impact of the regulation becoming applicable later this year. Most importantly, Malta has many service providers ready and willing to collaborate with crypto fund promoters, and unlike Luxembourg, there is a significant number of management companies, administrators and depositaries authorised to perform their role in the digital asset fund ecosystem.

As for other contenders, Switzerland, although not an EU member, is at the forefront of digital assets adoption, however, its position outside the EU can be limiting, particularly in terms of access to the single market and the harmonisation of regulations.

The same goes for Gibraltar, which has made efforts to position itself as a digital assets hub, attracting numerous blockchain and virtual assets businesses. However, the limited prominence of its fund industry may affect its ability to fully leverage the potential of crypto funds.

While the ultimate choice of jurisdiction for an EU digital assets fund will be subject to a multitude of factors, what is important is that fund promoters operating in that space have options to choose from and can decide which domicile best suits their needs – and most importantly, the needs of their investors.

[1] https://delano.lu/article/6-monks-secures-authorised-aif

Step 2: Identifying investors

We categorise potential investors into two broad groups: "inactive" and interested in digital assets, and already "active" but who want to diversify further.

- The inactive group spans high net-worth individuals (HNWI), family offices, or institutional clients like insurance companies, corporate treasuries, or sovereign wealth funds who prefer regulated structures and conventional financial products tied to digital assets.
- The active group likely includes early adopters looking for new diversification opportunities, investment strategies and other digital assets, or perhaps reducing operational and counterparty risks with other products.

Asset managers should base their choice of jurisdiction and fund structure on the very needs and requirements of their investors, but factors like distribution channels and regulatory restrictions for each product need to be considered carefully. For instance, in terms of qualification and distribution for a broader target audience, considerations like public placements and passporting rights for cross-broader distribution become top priorities.

That being said, finding a suitable structure for setting up a crypto fund that avoids the limitations of either unregulated or highly regulated investment fund structures is also something to bear in mind. Depending on these structures, this may hinder fundraising capabilities and distribution rights or impose restrictions on the available strategies and available counterparties. Still even after choosing a jurisdiction, determining which option is best can be complex.

Step 3: Fund structuring

European jurisdictions offer a variety of fund structures, ranging from unregulated, semi-regulated to fully regulated – and each option has its pros and cons.

<u>Unregulated structures</u> allow for the most flexibility and least regulatory burden, as most legal requirements will not apply – this is the case for example for Luxembourg AIFs managed by registered rather than authorised AIFMs. However, an unregulated set-up usually means less security for investors, as there is no depositary required to safekeep the assets and exercise oversight over the fund's operations and in some cases even the auditor is optional. Furthermore, using an unregulated structure means the EU passport and the related possibility of distributing the funds to the European audience is off-limits, and fund promoters have to rely on national private placement regimes, which have their limitations and risks and may restrict fundraising capabilities.

A <u>semi-regulated fund</u>, be it a Luxembourg RAIF, Maltese NAIF or Irish QIAIF, may be the most optimal structure allowing a proper balance between regulatory requirements and flexibility necessary to set up a digital asset fund. These structures allow for a quick setup and are eligible for an EU distribution passport while ensuring the security of investors by requiring the fund to appoint professional service providers who work together to maximise the effectiveness of running the fund.

Step 4: Selecting service providers

Regardless of the jurisdiction and structure chosen for the digital assets fund, its success will rely on the choice of service providers.

All semi-regulated structures discussed above require the fund to appoint an authorised AIFM, who is responsible for portfolio and risk management of the fund, an administrator whose role is primarily to cover fund accounting and transfer agency (although it's worth noting that in some cases the AIFM takes on that role as well) and a depositary, responsible for safekeeping of the fund's assets, monitoring of cash flows and oversight of the fund's operations.

The choice of the AIFM will largely depend on the jurisdiction – in Luxembourg where currently only one AIFM is authorised to manage digital asset funds the selection is rather limited, whereas Malta has a significant number of fund managers with licenses and experience in the digital assets space. For administrators, the key aspect to consider is the technology and infrastructure used in the performance of this function taking into account that in most cases, an administrator serves as the primary point of contact for the fund's investors.

We firmly believe that the depositary function is crucial in the set-up of a digital asset fund. In particular, arrangements concerning custody of the fund's digital assets are of utmost importance. Some service providers provide an all-in service, encompassing the traditional depositary role and crypto custody, however, our view is that the collaboration of specialised entities to work in tandem as the depositary and custodian of digital assets provides the highest level of security, adding another pair of eyes to keep the investments of the fund safe and risk minimised.

This is because crypto custody, or digital asset custody, is a highly specialised and dynamic field, so it is important to collaborate with a custodian who is up to speed with the industry's rapid developments. For instance, a solid understanding of crypto custody procedures and emerging trends will allow funds to quickly adopt new assets and investment strategies, which can help them maintain a competitive edge. Furthermore, establishing an extensive security framework and governance structure not only attracts investors but also secures the long-term viability of the fund.

Choosing to establish the fund under a regulatory framework that is both supportive of and stringent towards digital assets can widen the pool of reputable banks willing to act as service providers or distribution partners. The benefit of solid governance that adheres to strict security and anti-money laundering guidelines is a strategic advantage for funds aiming to gain a foothold in the product shelves of top European banks – and this in turn, will improve the credibility, attracting further funding from investors and institutions.

Putting all the puzzle pieces together

Looking at the current demand drivers behind digital assets and blockchain technology, it is clear that the market is maturing. Institutional investors are increasingly recognising the potential of digital assets, whether through spot ETF products, Bitcoin's store of value appeal, the increasing interest in adding digital assets in conservative portfolios, or the backing from major financial institutions leveraging digital assets and blockchain technology for their own financial agendas.

As traditional finance (TradFi) becomes more familiar with the digital asset market, the demand for other competing digital assets and protocols also opens up more diversification strategies and investment opportunities, while the growing trend of tokenisation is also fast becoming a significant catalyst towards bridging TradFi with the regulated crypto market, and this can be seen with the increasing involvement from regulators and market leaders like BlackRock. There are many drivers that could bring additional meaningful demand to the market, of course, but perhaps as crypto funds establish stronger roots over time, they could provide a necessary gateway to match this demand, injecting a new wave of fresh capital into the digital asset market.

Looking to the future with regulations in mind, it may seem that there are no significant developments to look forward to – after all, with Directive 2024/927 amending both AIFMD and UCITS already published, it seems unlikely that the EU will further harmonise activities of funds investing in the digital assets anytime soon. However, with the MiCAR coming fully into force, the overall digital assets environment may become more common and we expect local regulators to help develop their national ecosystems to realise the potential of collective investment in digital assets.

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