Digital assets, an emerging asset class for alternative investment managers

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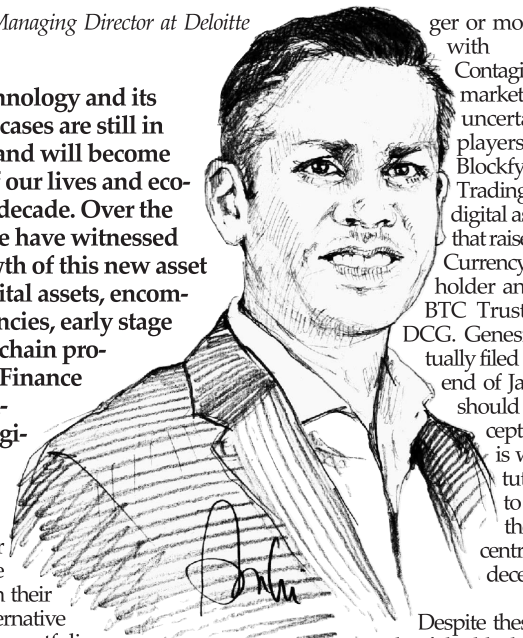

Blockchain technology and its countless use cases are still in their infancy and will become an important part of our lives and economy over the next decade. Over the last 10 to 13 years, we have witnessed an exponential growth of this new asset class, defined as digital assets, encompassing cryptocurrencies, early stage investment in blockchain projects, Decentralized Finance (DeFi), mining infrastructures, Non-Fungible Tokens (NFT), and the Metaverse.

Crypto-assets and other digital assets have become an asset class in their own right and a real alternative for diversifying one's portfolio. Because this market is still in its early stages, investors should consider entering this sector, as soon as possible to maximize the potential brought by digital assets and their use cases.

We have seen a growing interest from institutional investors in this new asset class:
- More and more listed companies (e.g., Micro Strategy[1], and Tesla[2]), and unlisted companies are accumulating digital assets on their balance sheets.
- Major alternative asset managers (e.g., Fidelity) have invested significantly into the industry.
- Many Exchange Traded Funds (ETFs) have been approved by the SEC and other regulatory bodies around the world (like Canada and Singapore).
- Private banks are now offering their clients access to digital assets.
- Some banks are even exploring the world of digital assets even further by creating their own wallet and metaverse.
- Access to these assets is becoming easier for retail investors, and large companies, such as PayPal[3], Visa[4], WhatsApp[5], Facebook[6] (rebranded as Meta), Tesla[7], which among others, are opening the door of our lives to digital assets.
- The total capitalization of crypto assets reached a record high in November 2021.

Following the last bull market in 2021 that led Bitcoin and many other crypto asset to reach new all-time highs in terms of valuation, 2022 has been a very difficult year for digital assets, in general. We have seen countless black swan events, like the bankruptcy of major players, such as Terra Luna, 3AC, Celsius, voyager or more recently FTX together with Alameda Research[8]. Contagion started to spread on the market creating massive fear and uncertainty around other big players, such as Crypto.com, Blockfy or even Genesis Global Trading, the leading institutional digital asset financial services firm that raises concerns around Digital Currency Group (DCG), its shareholder and Greyscale, through its BTC Trust, another subsidiary of DCG. Genesis Global Trading eventually filed for bankruptcy protection end of January 2033[9]. But all this should not affect investors' perception on digital assets. This is why, major financial institution, in a communication to its investors, stressed that the FTX collapse is one of a centralized actor and not of the decentralized protocols[10].

Despite these events, the fundamentals of the blockchain are still strong, and so is the investors' appetite for gaining exposure to digital assets. For instance, Man Group recently announced the launch of a new crypto hedge fund with approximately USD 140 billion commitment[11]. Another example is the fact that 91% of institutional investors are willing to invest in tokenized products and want exposure to crypto[12].

An interesting element from this survey is the fact that 72% of institutional Investors who participated in the survey declare being comfortable with traditional custodians and need integrated providers who can accommodate hybrid portfolios. In other words, there is a tremendous opportunity for traditional actors to offer their clients access to this new asset class.

In Luxembourg, the CSSF has already taken steps to allow the alternative investment funds industry to adapt to the new era. In particular, the CSSF released an FAQ[13] concerning undertakings for collective investments to give asset managers who want to set up an alternative investment fund dedicated to digital assets useful guidelines. The main takeaways are the following:
- UCITS or UCIs addressing non-professional customers and pension funds are not allowed to invest directly or indirectly in virtual assets. They can, however potentially invest in any assets that qualify as financial instruments, such as shares of companies active in the virtual asset ecosystem.
- AIFs are authorized to invest in virtual assets as long as their units are distributed to professional investors only. In case the AIF is managed by a Luxembourg base AIFM, the latter should ask for an extension of its authorization from the CSSF for this new investment strategy. The AIFM should have appropriate internal functions to apprehend all the risks related to digital assets, notably the volatility, the liquidity and the technological risks
- Initiator of AIF intending to invest in virtual assets are expected to present their projects beforehand to the CSSF.
- AIFMs should apply for a virtual asset service provider license with the CSSF[14] if they perform the following services:
a) the exchange between virtual assets and fiat currencies, including the service of exchange between virtual currencies and fiat currencies;
b) the exchange between one or more forms of virtual assets;
c) the transfer of virtual assets;
d) the safekeeping or administration of virtual assets or instruments enabling control over virtual assets, including the custodian wallet service;
e) the participation in and provision of financial services related to an issuer's offer or sale of a virtual asset.

In addition, asset managers should address all CSSF recommendation points and consider the increased risk profile relating to anti-money laundering and terrorist financing that investing in virtual asset can imply.

Luxembourg has a unique opportunity to embrace decentralization and the "Internet of Value" to create a business friendly ecosystem for digital assets and maintain its leadership in the alternative investment fund industry. A certain level of openness and flexibility will be required to consider the benefit of blockchain technology and its infinite application from the government and the regulator, rather than mainly focusing on the usual pitfalls surrounding digital assets.

Digital assets are a growing topic of interest for Luxembourg's service providers as well. They are looking at the best way to serve their clients with this new asset class especially for regulated structures. This requires a strong understanding of the technologies and ecosystem around the digital assets, and of the regulatory framework applicable to such alternative investments funds and digital assets (potentially using a skilled and experienced advisor to make the bridge between the innovation and tech team and the regulatory team). A lot of existing services, such as custodian services, fund administration services or transfer agents should evolve and revolutionize themselves. They can count on the support of the existing Luxembourg blockchain community for that.

Despite the quite recent emergence of digital assets in the alternative investment world, Luxembourg already established a useful framework that should be enhanced once the Market in Crypto-Assets (MiCA) regulation[15] becomes applicable. This, combined with Luxembourg's existing toolbox for alternative investment vehicles, makes Luxembourg the obvious jurisdiction to set up a digital assets fund. Indeed, Luxembourg has been the leading jurisdiction for the alternative investment fund industry for many years. This is not only due to the presence of fully trained and experienced workforce in Luxembourg, but also due to various available vehicles, such as Part II funds, Specialized Investment Funds (SIF), Investment Companies In Risk Capital (SICAR), Reserved Alternative Investment Funds (RAIF) or securitization vehicles (SV). Each of those vehicle targets specific type of investors, from retail investors to professional ones, and have different level of regulation (highly regulated for Part II funds to indirectly regulated for the RAIF). It is also possible to select another path depending on the business/regulatory needs and opt for a non-regulated structure. This is a great opportunity, notably for non-EU based asset managers (like the US), to extend their investor base and market their product to EU investors.

Given the variety of investment strategies that can be used and combined with digital assets, legal and tax aspects should be carefully considered and linked to the vehicle type and its underlying structures, to provide investors greater protection, security as well as transparency.

1) https://www.coindesk.com/business/2022/12/28/michael-saylors-microstrategy-buys-another-2395-bitcoin-for-428m/
2) https://www.bbc.com/news/technology-64428257
3) https://www.paypal.com/lu/webapps/mpp/crypto
4) https://www.visa.com.bz/solutions/crypto.html
5) https://www.reuters.com/markets/currencies/metas-whatsapp-will-allow-crypto-payments-through-novi-wallet-us-2021-12-09/
6) https://about.fb.com/news/2021/10/facebook-company-is-now-meta/
7) https://www.tesla.com/support/dogecoin#:~:text=What%20cryptocurrency%20does%20Tesla%20accept,making%20your%20purchase%20with%20Dogecoin.
8) https://www.reuters.com/technology/crypto-companies-crash-into-bankruptcy-2022-1201/#:~:text=The%20crypto%20hedge%20fund%20Three,Luna%20and%20TerraUSD%20in%20May.
9) https://www.coindesk.com/business/2023/01/20/genesis-global-files-for-bankruptcy-protection/
10) https://watcher.guru/news/jpmorgan-identifies-centralized-players-as-root-cause-of-recent-crypto-collapses
11) https://www.bloomberg.com/news/articles/2022-11-18/man-group-readies-crypto-hedge-fund-despite-ftx-chaos
12) BNY Mellon, Migration to digital assets 2022 Survey of Global Institutional Clients
13) FAQ Virtual assets – Undertakings for collective investment, CSSF v3, March 2022
14) Law of 12 November 2004 on the fight against money laundering and terrorist financing transposing Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering
15) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593

69 financial services actors sign up to the Luxembourg Women in Finance Charter

On International Women's Day, the Luxembourg Women in Finance Charter was launched with 69 signatories, which include the country's leading financial services firms, to improve gender diversity in the Luxembourg financial centre.

At a Ring the Bell to mark International Women's Day at the Luxembourg Stock Exchange (LuxSE), the Luxembourg Women in Finance Charter was launched by its founding partners ABBL, ALFI, ACA, LuxCMA, LuxFLAG, under the patronage of the Ministry of Finance, and in the presence of the first signatories, which include the European Investment Bank and the European Investment Fund.

By signing the Charter, financial sector companies underline their ambition to make the financial centre more inclusive and encourage the representation of women at all levels. This also plays a key role in addressing the growing need for talent that the sector faces. Under the Charter, financial institutions commit to designating an executive within their firm that will be responsible and accountable for gender diversity and inclusion, and commit to setting voluntary targets to achieve greater gender balance within their firm, notably at executive and senior management level, and to publicly report on progress towards the targets.

(from left to right) Catherine BOURIN, ABBL ; Isabelle DELAS, LuxFLAG ; Julie BECKER, LuxCMA ; Yuriko BACKES, Minister of Finance ; Corinne LAMESCH, ALFI ; Octavie Dexant, ACA © LuxSE

Signatories to the Luxembourg Women in Finance Charter span across the breadth of the financial sector and include leading banks, asset managers and insurance firms in Luxembourg as well as the Luxembourg Stock Exchange. Given the size and international role of the financial centre, Luxembourg and its financial services industry is fully aware of their responsibility in promoting gender diversity. With more than 60'000 women and men employed in the financial sector and related services, the financial industry is also one of the largest employers in the country and can therefore play an important leadership role by setting the right examples. While Luxembourg has the lowest gender pay gap in the EU, it is still a long way to go in order to increase the share of women in middle management and senior leadership positions.

Minister Yuriko Backes said: "Gender equality is not just a social issue. Diversity and gender equality are macro-critical and make economic sense: more diversity leads to better decision-making and better economic outcomes for companies and for society. This is why, as Minister of Finance, I have decided to champion the creation of a national Women in Finance Charter, and act as its patron, with the aim to achieve greater gender balance in the financial sector. I congratulate the founding partners on this lighthouse initiative and I invite financial sector companies in Luxembourg to join the 69 signatories that have signed up today on this important journey."

An important part of this journey to increase gender balance in senior management will be the monitoring of progress. The annual reporting that is foreseen will strengthen each signatory organization's sense of commitment and allow us to collectively take stock to see if the financial centre's ambitions are on target. The Ministry of Finance, working with the financial sector associations, will support the publication of a yearly progress report based on the individual target setting.

The Ministry of Finance supports the Charter as part of its overall strategy to promote greater gender diversity in the financial sector and gender finance more broadly. The launch of the Charter also coincided with the listing on the LuxSE of the first Sub-Saharan gender bond ever issued.

List complet of signatories:
https://gouvernement.lu/en/actualites/toutes_actualites/communiques/2023/03-mars/08-backes-women-finance-charter.html

Source : Ministry of Finance