Digital assets: 5 investor questions answered

- **What you need to know to get started in digital assets.**
- **The importance of safeguarding and adhering to regulatory compliance.**
- **How to integrate digital assets to diversify your portfolio.**

Our innovation team are fortunate to receive timely and insightful feedback about our clients' ambitions, challenges and opportunities in the rapidly evolving market of digital assets. These clients specialise in a diverse range of investment strategies and asset classes, making their insights and questions broadly relevant to all fund managers considering an investment in digital assets. Here, Simon Ware shares some of the common questions from investors interested in investing in digital assets – and answer them.

1. I'm expecting a distribution in digital assets – what should I do?

One of the best first steps you can take is to notify your fund administrator, who should have extensive experience supporting clients with a wide range of asset types and strategies, implementing robust control frameworks and reporting processes. Your fund administrator can also introduce you to potential solution providers, depending on your needs and objectives. An essential step when investing in digital assets is safeguarding against loss. Digital assets are stored in wallets, which require private keys to access. These keys should be entrusted to specialist and reputable custodians with high standards of security, governance, regulation and insurance, as well as a proven track record and industry recognition. Depending on the size of your fund, this may not be optional, and you may also need a depositary capable of monitoring your digital asset investments.

2. Aren't digital assets highly volatile?

They can be, or not. Just like traditionally represented assets, 'digital assets' encompasses a wide-ranging pool of assets, inevitably ranging from more to less volatile. This includes *some* popular crypto currencies, through to tokenised (digitally represented) private equity, real estate and gold. The profile of each asset is to be assessed on its merits for suitability with the fund strategy. You can read more here about the different types of digital assets.

3. I'm not investing now, but I want to keep my options open and future-proof my next fund, can you help?

As the investable universe evolves and grows, your partners should be eager to support your ambitions and have the tools and expertise to do so. While digital assets may not constitute the majority of your fund in the short term, it is essential to be able to fully integrate or 'normalise' such assets alongside the rest of your portfolio. This will enable you to leverage the benefits of diversification, innovation and efficiency that digital assets can offer. A partner with expertise in managing digital assets can help future-proof your fund and operations to cover your needs, starting with ensuring access to data for fund accounting and reporting, and working closely with your custodian. The goal is to make your digital asset journey as seamless and secure as possible, so you can focus on your core business and growth objectives. Read more here about how fund managers can leverage digital assets' benefits and efficiencies.

4. How does the KYC and AML process apply to digital assets? Are they anonymous?

Somewhat surprisingly, cash is still considered king for money launderers over crypto currencies and associated digital assets. Where traditional placement and layering methods may quickly hide the source of cash, blockchain's immutable and public transaction ledger provides specialist AML analytics platforms such as Elliptic and Chainalysis with a wealth of data to link to illicit activity. Were holders of illicitly obtained assets to try and exchange such assets, regulated exchanges will apply the same AML screening prior to permitting such a transaction. For funds, your AIFM and custodian will screen digital assets for AML risks in a typically automated process, quickly identifying risk factors and keeping you safe. Bear in mind that digitalising the delivery method of regulated assets does not circumvent any regulatory requirements, if anything it only serves to enforce such requirements even more effectively, including AML. You can read more here about regulations and safety features of digital assets.

5. Does a fund need to design a revised investment due diligence process to accommodate digital assets?

As an additional step in your investment due diligence, it is advisable to request or undertake technical due diligence to ensure that what you are buying represents and behaves as what it purports to, this is known as a smart contract audit. Smart contracts are the self-executing agreements containing the governing rules of a digital asset transaction. While they ensure the security, transparency, and efficiency of digital asset transactions, they also carry potential risks. For example, smart contracts may have bugs or vulnerabilities, however, an audit from a reputable provider will give you the best assurance and protection for your digital asset investments. These are the five questions asked most frequently by our clients – you might have others. Please send them in and we can come back to you. Aztec's Innovation team are eagerly working to support digital asset investment and administration in 2024. If you'd like to discuss practical steps towards investment in digital assets and if you have other questions we haven't answered, please contact Simon.