Digital Assets: Regulation across jurisdictions and future considerations

---

1. New regulation for digital assets is coming into force from June

2. Crypto-asset regulation differs per jurisdiction

3. To invest in digital assets, managers need to consider knowledge gap and verification tools

---

Investment managers want to realise the potential of digital assets within their portfolios. But first, managers need to understand the regulatory landscape surrounding digital assets, and funds' eligibility to invest in them. ***Angel Ramon Martinez Bastida*** *and* ***Simon Ware*** *map out how digital assets are regulated across jurisdictions as the digital asset landscape matures*

The steep growth of interest in digital assets, or crypto-assets, as a means of opening up private markets to more investors and creating new opportunities, also raises challenges around AML, regulation and safeguarding to create certainty for investors.

The surest way to allay investor fears and give crypto-markets the opportunity to reach their potential is through robust regulation. For investment managers too, understanding whether their funds are eligible to invest in digital assets and, if so, where and which ones, is a vital step into the investment future.

Before exploring how different jurisdictions are implementing and harmonising regulation around digital assets, here's a definition of key types of digital assets, and coverage under existing regulation. European Markets in Crypto-Assets (MiCA) regulation that takes effect in June and December this year refers to digital assets not currently covered by existing regulation such as cryptocurrencies. The intent being that already regulated asset classes will continue under the same regulation, whether in digital or traditional form.

Categories of digital assets

The term Digital assets broadly refers to all assets in which a cryptographic token is used to represent value. However, there are important subsets within this main category:

Digital Currencies: Delivered in multiple forms, such currencies may be backed by real central bank issued currency (think 'e-Euro'), or unbacked but pegged to a single or collection of currencies or following a complex algorithm to help manage volatility. Such currencies are broadly considered 'stablecoins', this is in contrast to the world-famous and fully decentralised Bitcoin, being unbacked, unpegged and demonstrating higher volatility. Different approaches will depend on the application, with greater transactional speed, transparency and interconnectivity being key.

Security Tokens: Typically, these are digital representations of either tangible (Real-world-assets or RWAs) or intangible assets, designed to ease distribution with transactional efficiencies, fractionalisation and potential liquidity. Given the pre-existing recognition of many of these asset types (securities etc.), these continue to be covered under existing regulation rather than being impacted by MiCA (more to follow). An increasing range of such tokens are now reaching the market, including gold, diamonds, real estate and equity, with the holder entitled to the associated gains of the underlying tokenised assets.

Utility Tokens: These tokens provide future access rights that can be redeemed against a service or product, rather than ownership, and are typically not considered speculative assets to the same extent as other digital assets. Such tokens typically have a more limited range of uses, their success being tied to the utility of (and inherent value of) the creators' application. An example of utility tokens includes governance, being assigned to communities as a manner to exercise voting rights.

In practice, clearly categorising the wide range of digital assets between these and different regulatory classifications is not always immediately clear – digital currencies may track mainstream assets with or without being backed by reserves, others may be backed by a range of non-FIAT currency assets or proprietary algorithms, and may or may not be issued by a central authority.

All these factors and more will influence which category the asset falls into. Detailed classification information from the Blockchain Council can be found here

Regulatory approaches to digital asset funds

The legislation that most shapes investment managers' digital assets strategy in Europe is MiCA, which came into force in June 2023, with the application of the framework coming into effect this year. MiCA, adopted by the EU, harmonises how the digital asset market will be regulated and applies to both traditional institutions in the financial sector and new players emerging in the crypto ecosystem, regulating digital assets issuance and service provision. To benefit from a regulated status at European level, these entities must meet a set of specific requirements.

MiCA will apply in two main phases: first the rules applicable to the two types of stablecoins (asset-referenced and e-money tokens) will apply from 30 June 2024, while harmonised rules applicable to crypto-asset service providers will apply from 30 December 2024. MiCA is part of the Digital Finance Package published in 2020 together with other regulatory initiatives such the Digital Operational Resilience Act (DORA).

Several approaches have been taken across jurisdictions as to whether an alternative investment fund may invest directly in digital assets, and to what extent. Set out below are the guidelines for the jurisdictions where Aztec operates.

1. Luxembourg

The Commission de Surveillance du Secteur Financier (CSSF) has proactively addressed this subject and has published several rounds of FAQs on the matter. Currently, AIFs may invest in digital assets under the condition that their units are marketed only to well-informed investors and exposures can be direct or indirect (i.e., investments in financial instruments with digital assets). If their AIFMs are authorised in Luxembourg, these funds will need an extension of their license for investment in digital assets. Their depositaries also need to notify the

CSSF and have an appropriate operating model that integrates the specific risks related to the safekeeping of these assets

2. UK

The Financial Conduct Authority (FCA) makes it clear that while the technology remains ahead of the regulation, it's a 'buyers beware' approach. However, in the UK it is possible to be indirectly exposed to investment in digital assets for Non-UCITS Retail Schemes (NURS), Qualified Investor Schemes (QIS) and Funds of Alternative Investment Funds (FAIFs). Funds investing in digital assets can only be marketed to professional investors and exposures can be up to 100%. Their management company must be registered and subject to money laundering regulations.

3. United States

Eligible vehicles for digital fund assets in the U.S. include trusts, mutual funds and ETFs (exchange traded funds). Exposure allowances are tailored depending on the vehicle and can be up to 100%. For trusts, only accredited investors are able to invest, while for mutual funds and ETFs individual investors are included. The Securities and Exchange Commission (SEC) urges investors considering a fund with exposure to digital assets to carefully weigh up the potential risks and benefits of the investment, and requests funds to provide important investor protections regarding valuation and custody of fund assets or liquidity requirements (for mutual funds and ETFs).

4. Ireland

The Central Bank of Ireland (CBI) only allows indirect exposures to digital assets. A Qualifying Investor Alternative Investment Fund (QIAIF) may invest up to half of its net asset value in digital assets, being subject to different structure and liquidity requirements depending on the extent of the proposed digital assets investment. AIFMs managing these funds must have appropriate risk management processes and procedures in place to manage specific risks related to these assets and that the funds disclose such risks clearly in their offering documents. Direct investment in digital assets is not permitted until such time as it is demonstrated to the CBI that a depositary can meet its obligations under AIFMD to provide custody or safe-keeping services to digital assets

5. Jersey

The Jersey Financial Services Commission (JFSC) has shown a proactive approach to digital assets funds and approved the world's first regulated cryptocurrency investment fund in 2014. Since then, several digital asset funds have been successfully set up in Jersey. Jersey Private Funds (JPFs) are suitable vehicles for digital asset funds marketed to professional or eligible investors. Jersey Expert Funds (JEFs) are an alternative when a wider investor population is targeted, as these can be marketed to an unlimited number of expert investors. The regulatory efforts by the JFSC have been centred around the JPFs and JEFs' service providers, and not the funds themselves, for which an elevated level of flexibility is allowed.

6. Guernsey

The Guernsey Financial Services Commission (GFSC) has issued a statement noting that it encourages innovation and will help those working within the digital asset sector to better understand the regulatory framework. The GFSC treats digital asset investments with the same thresholds and rigour as it does all investments. It notes though that it will require additional proof that the professional investors are making an informed decision given the volatile and speculative nature of these transactions.

Future considerations:

The rise of digital assets have led to a number of additional factors which private fund managers and investors alike should consider, as we've detailed below:

1. AML and transactional transparency

Digital assets make it possible to trace every transaction an asset has ever been part of, which raises risk and compliance questions. If someone gives you a $100 bill, you have no feasible way of knowing if that person got that money from an ethical source. With digital assets, every transaction leaves a trail so the question becomes about percentage or value of exposure.

So, for example, if that $100 is part of an investment of $10, 000, it is but 1% of the whole that is tainted, is that risk acceptable? Again, this becomes a risk policy issue for the investment manager. If investors are able to access this level of insight, does it follow they will adjust their expectations in line with it? For an investment manager too, with considerations such as sanctioned persons or countries, this could be a concern. Regulators too must decide on what due diligence is necessary as a minimum.

2. Mandatory reporting

Effective from 1 January 2026, DAC 8, an EU Directive on administrative cooperation in taxation, requires information exchange and mandatory reporting for CASPs (crypto-asset service providers) and digital assets operators. A CASP is defined as a ‘legal person or other undertaking whose occupation or business is the provision of one or more crypto-asset services to clients on a professional basis and that is allowed to provide crypto-asset services’. The objective is to increase tax transparency and safeguard investors across the EU. Before it takes effect, the industry needs to assess how this new directive will impact their operations.

3. Knowledge gap

For managers and investors there is the opportunity to learn more about how to evaluate, safeguard, and verify digital assets. Existing approaches need modernising and updating to cater for this emerging asset class.

4. Enhanced Due diligence

The other important issue is the verification of a digital asset. This means being sure that once you have it there is no loophole or code that removes it from you, for example. Also, it is essential to ensure that the token being purchased does in fact represent the intended asset. Fortunately, market-ready specialist auditors do exist to verify digital assets, but this represents an additional requirement for investment managers and investors to evaluate the investment as they would any other.

5. The tipping point

One thing is for sure, digital assets and the continued digitisation of the financial sector will continue apace. Already, first credit cards and now phone payments have disrupted the physical cash market and as comprehension and take up continue around digital assets, banks will respond by developing their own, more stable, versions and these central bank digital currencies (CBDCs) coming to market is when digital assets will be considered mainstream.

Digital assets are a new and evolving asset class that offer both opportunities and challenges for investors and regulators. The regulatory landscape for digital asset funds will continue to change and develop, as different jurisdictions balance innovation and regulation, and manage cross-border transactions. Investors and fund managers who are interested in digital assets should be aware of the legal and tax implications of their activities, and stay updated on the latest developments and trends in this dynamic and exciting field.

Aztec’s Innovation team are eagerly working to support digital asset investment and administration in 2024. If you would like to discuss practical steps towards investment in digital assets or gain more insights on the approach followed by the different financial regulators, please contact Angel Ramon Martinez Bastida or Simon Ware.