



TRANSACTIONS – ADVICE – LITIGATION

## **MANAGERS OF CRYPTO FUNDS – BE PREPARED!**

### *The five most difficult license requirements for managers of crypto funds under the AIFMD*

The financial sector is changing rapidly. A new FinTech development is an everyday occurrence nowadays. Crypto currencies and tokens, as well as their initial offering (ICOs), are causing the regulators headaches. Depending on the exact terms of the crypto, the structuring of fund flows and the use of proceeds of an ICO, crypto assets can fall outside the scope of the current regulatory framework. In such cases, the regulators cannot do much more than warning the market and the relevant stakeholders of the risks involved. Please see our prior [blog](#) in which recent warning publications are listed.

Crypto funds are one of those new FinTech developments. Crypto funds are investment institutions that invest their funding (i.e. the proceeds of the investments by participants in exchange for units/participation rights in the investment institutions) in crypto assets. These crypto assets could be well known bitcoins, Ether and Litecoins but also numerous type of (other) altcoins. The [SEC](#) recently confirmed that bitcoin and Ether are not securities. However, it also mentioned that generally other altcoins are considered securities. From a Dutch law perspective, this is not necessarily the case. Each crypto asset needs to be assessed on its terms to determine whether or not it qualifies as a security or another financial instrument.

Recently, the Netherlands Authority for the Financial Markets (the AFM) published an [awareness letter](#) (in Dutch) addressed to new market entrants who wish to apply for or should apply for a license as manager of a crypto fund.

The letter is also relevant to existing and new market parties that are currently active in crypto assets as exempted managers of crypto funds under the *de minimis* / light framework. If the total assets under management by such a light manager exceeds the applicable threshold, the exemption no longer applies and such manager needs to apply for a license within 30 days in order to proceed its activities during the license application procedure. In order to be able to apply for a license within 30 days, such a light manager needs to proactively prepare for the license application (in particular its administrative organisation and internal control procedures and the cooperation with a depositary within the meaning of the AIFMD) well in advance if it expects to exceed the applicable threshold.

The AFM creates awareness with the letter by sharing its concerns in respect of managing crypto funds. The AFM reiterates that there are substantial risks involved with the investment in and management of crypto funds. Moreover, the AFM emphasizes that it has serious doubts whether managers of crypto funds can meet the heavy requirements for an AIFM license if or once they need one.

The AFM foresees issues for a manager of a crypto fund in respect of complying with a number of license requirements. To assist such a manager in preparing for a license application, the AFM has prepared some questions that the manager must be able to answer satisfactorily before applying for a license. These questions also show which five license requirements the AFM considers the most difficult for managers of crypto funds to comply with.

**So, crypto fund managers, take advantage and prepare yourselves!**



## **LIQUIDITY MANAGEMENT**

Under the AIFMD, the liquidity management systems and procedures that managers employ should be aligned with a consistent investment strategy, liquidity profile and redemption policy. Managers of open-ended crypto funds need to be prepared to fund the exercise of a unitholder's redemption right. The AFM expects a manager of a crypto fund to be able to answer the following questions:

1. How can it be assured in a liquidity policy of a crypto fund that it holds sufficient liquid assets to be able to comply with (compulsory) redemption rights and/or re-purchase rights of its investors?
2. How does a manager of a crypto fund estimate the liquidity of investments in crypto assets, taking into account volatility and trading volume, fragmentation of the crypto markets and the influence of a big order on the pricing of a crypto asset because of such fragmentation?
3. How can be dealt with volatility of crypto assets between the moment of receipt of the redemption request and the actual redemption?
4. How does a manager execute stress tests under normal liquidity conditions as well as under exceptional liquidity conditions that enable it to assess the liquidity risk of the crypto fund?

## **VALUATION**

The net asset value per unit in a crypto fund is difficult to determine due to the volatility of the crypto assets. However, a proper and independent valuation of the assets of the crypto fund is an important indicator of the performance of the fund and its manager. The AFM expects a manager of a crypto fund to be able to answer the following questions:

5. How does a manager formulate the valuation procedures in respect of a crypto fund, taking into account that managers need to ensure appropriate, consistent and independent valuation procedures and an impartial valuation with all due skill, care and diligence?
6. How does a manager implement valuation procedures in an appropriate, consistent and independent manner in order for the crypto assets to be valued accurately and at fair value, taking into account the volatility of crypto assets, the fragmentation of the crypto markets, the potential lack of independent data and transactions, the unregulated status of the crypto markets and the risk of manipulation of the crypto markets?

## **DEPOSITARY**

The independent depositary - that needs to be appointed upon a manager becoming subjected to the license obligation under the AIFMD - has a difficult position in respect of crypto funds. The depositary is responsible for the proper monitoring of cash flows of the crypto fund and to overlook the account administration, custody and safe-keeping of cash and financial instruments. The depositary is also responsible for the verification of ownership of the assets of the crypto fund. The AFM expects a manager of a crypto fund to be able to answer the following questions in respect of the performance of the tasks by the depositary:

7. Can crypto assets that qualify as financial instruments be held in custody and be registered in a financial instruments account opened in the depositary's books within the meaning of the AIFMD? If so, how does a depositary delegate its safe-

- keeping functions to third parties and how are periodic reconciliations performed by the depositary and the delegate third party?
8. How does the depositary verify the legal ownership of the crypto funds of its crypto assets?
  9. Does a depositary have special rights to safeguard that crypto assets can not be transferred, traded or delivered without the depositary being informed thereof?
  10. Does a depositary have direct access to documents that substantiate each position and transaction of the crypto fund in crypto assets when the crypto assets are registered in accounts (wallets) provided by third parties (wallet providers)?
  11. The depositary has an important role in the valuation process of the NAV of the units in the crypto fund. Also in light of the questions raised above, how does a depositary take care of its obligations regarding such valuation?

### **PRODUCT APPROVAL AND REVIEW PROCESS (PARP)**

If the units in a crypto fund are offered to retail investors the manager needs to have a product approval and review process in place. This is to ensure that a balanced weighing of interests is taken into account during the development, the approval and the review of the units in the crypto fund that are offered to those investors. On the basis of the PARP, it should be clear which type of investors are targeted by the fund as well as for which type of investor investing in the crypto fund is not suitable. The requirements applicable to the PARP depend on the complexity and impact of the financial product involved. Given the complexity of (indirectly) investing in crypto assets, the AFM expects a manager of a crypto fund to be able to answer the following questions in detail during the product development process:

12. What is the target group and what is the intended objective?
13. For which group of clients is investing in the crypto fund not suitable?
14. Which scenarios have been analysed and how can it be warranted that investing in the crypto fund meets the intended objective in the various scenarios without affecting the interests of the client?
15. In which way are the provision of information and the distribution tailored to the target group?

### **ANTI-MONEY LAUNDERING AND ANTI-TERRORIST FINANCING ACT**

Managers of investment institutions, such as crypto funds, must meet the requirements of the Anti-Money Laundering and Anti-Terrorist Financing Act. These requirements apply to both licensed AIFMs as well as managers that are exempted of the license requirement and operate under the light regime.

For more information: please contact:



T +31(0)20 760 31 36  
M +31(0) 6 1522 18 92

[machiels@fglawyersamsterdam.com](mailto:machiels@fglawyersamsterdam.com)



T +31(0)20 760 31 37  
M +31(0) 6 2706 32 02

[hakvoort@fglawyersamsterdam.com](mailto:hakvoort@fglawyersamsterdam.com)