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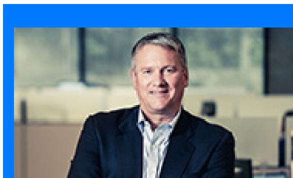
# NAVIGATING CRYPTO'S EVOLUTION: REFLECTIONS ON A TRANSFORMATIVE YEAR AND WHAT LIES AHEAD

CRYPTO HAS EXPERIENCED AN EVENTFUL 12 MONTHS OR SO, TO SAY THE LEAST. IN A YEAR THAT SAW THE DEMISE OF NUMEROUS CRYPTO CURRENCIES, FUNDS AND EXCHANGES, CULMINATING IN FTX'S COLLAPSE, MANY OBSERVERS HAVE QUESTIONED THE FUTURE OF THE INDUSTRY, PARTICULARLY WITH POTENTIAL REGULATORY ACTION ON THE HORIZON IN THE USA.

However, new digital asset managers are still coming to market, investments in blockchain technology continue to be made and the rapid rise of AI is posing some interesting questions about the intersection of AI and crypto, and what that might mean for the development and use of digital currencies in the future.

We asked four of our digital assets experts, Dan Smith, Karine Seguin, Aaron Sammut and David Mungall, to take stock of the market, and give their opinions on the impact of the events of the last year and what lies ahead for the digital asset industry.



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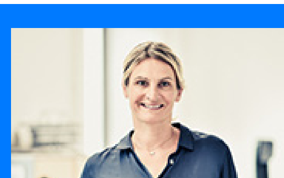

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## WHAT WERE THE MAJOR MILESTONES AND TRENDS OF THE LAST 12/18 MONTHS?

KARINE: The main milestone for me has been the institutionalisation of the asset managers entering the asset class. About 18 months ago, we started seeing alternative investment managers setting up digital asset sub-funds alongside their traditional HF or VC strategies. Following the market downturn and FTX, those managers have revised their growth plans.

Some have decided to close their funds, others have revised their strategies by increasing their VC activity or reducing the DeFi allocations for example. What the recent market turmoil has confirmed is that if you want to raise capital for a crypto strategy you will need to stack the odds in your favour and opt for a regulated investment manager, set up in a recognised jurisdiction, with established and reputable service providers. That said, it is interesting to note that this trend has not been matched by the same degree of institutionalisation of the investor base. While there are more truly institutional investors allocated to crypto, the majority are still mainly HNWIs and family offices.

DAN: We've talked for quite some time about crypto space dividing into two categories:

1. The institutional space, which is well-regulated, and which is where institutional investors are comfortable and increasingly active. As Karine recognises, the growth of this category has been accelerating.

2. The individual trader space that operates in a much less rigid framework, without institutional grade controls. This category is going backwards and will fall away, as it won't be able to attract investment because of regulatory and reputational concerns.

DAVID: Stripping away the highs-and-lows of the retail investment space, the meme stock excitement, the crypto winter, and the FTX collapse, I agree that we've seen the underlying institutional space continue along its long-term trajectory. Across the industry, technologies and service providers, there has been continued investment intellectually and financially which has brought further maturity and innovation. Regulation has remained a key focal point for the industry and whilst many jurisdictions made important steps forward in regulating the asset class (e.g., the EU and Cayman Islands), the United States remains a large gap.

This did see some shifts in business flows, with the UAE notably experiencing an influx of interest and activity. In the Cayman Islands, whilst new fund launches have slowed because of a cooling of capital raising, the timely introduction of the VASP (Virtual Asset Service Provider) guidance promoted the jurisdiction as a favourable option for digital asset focused companies and foundation companies, notably for decentralised autonomous organisations, by providing clarity and certainty. Coupled with the availability of a favourable investment zone, the Enterprise City, and institutional-grade crypto-native and crypto-friendly service providers with a long-service history of serving digital asset clients, there has been continuing growth of the digital asset industry in the Cayman Islands.

AARON: We did experience some moments important to ourselves, with the quality of our client service recognised through a number of award wins, but if I must mention one thing it's that none of our clients closed down directly because of what happened in the industry (such as FTX, Signature Bank). Their exposure was minimal, and these events did not impact their operations, which confirms the quality of the partners we work with and who choose to work with us.

## HOW HAVE OUR CLIENTS EVOLVED?

DAN: A client of ours that signed in 2021 and who I thought was never going to launch is just now launching. It's another data point to say that there continue to be managers and investors that believe in the space.

AARON: I think that over the last year, our clients have stabilised and consolidated their strategies, although a number did start looking at DeFi strategies. However, DeFi wasn't traded as much as expected (at least within our clients) and it was still treated with caution. One strategy which definitely hit the road was crypto VC. A number of funds have launched investing in VC tokens, seeding these tokens to "help" them going to market in the coming months. We expect this sector to continue growing in the coming months.

KARINE: Our EU-based clients have evolved from crypto-native crypto traders to fully fledged asset management firms, typically regulated by the UK FCA, the French AMF or the Swiss FINMA. This brought new requirements such as daily reconciliations, SOC certifications, depositary services or crypto-focused AML/KYC officers. Being an independent multi-asset fund administrator with over 40 years of experience has enabled us to meet those demands while still keeping a tailored approach.

DAVID: As our clients continue to seek alpha in the space, we have seen a broadening of strategies in recent years. Where TradFi has existed historically, the digital asset space has now evolved to provide an equivalent in almost all cases, enabling asset managers to find opportunities that make use of their expertise and which align with their risk appetite.

Innovation in the space continues at speed, with venture capital identifying companies and technologies that can disrupt across industries, including financial services. As our clients continue to explore new ideas and encounter new challenges, our model of providing knowledgeable client managers locally to our clients, has been recognised in being able to deliver timely information and solutions specific to their needs.

## IS TECHNOLOGY KEEPING UP WITH THE PACE OF THE SECTOR?

DAVID: Technology is at the core of the industry, with innovation creating new opportunities for asset managers and service providers. Tokenisation of real-world assets remains a hot topic at industry events, which is leading clients to seek out service providers familiar with the blockchain and handling of coins. This evolution extends into our industry with the tokenisation of funds themselves now becoming a reality.

Coupled with advancements in robotics and artificial intelligence, the service provider landscape is quickly becoming differentiated for those that can leverage these new technologies for the benefit of their clients. With regulators globally taking action (for example the U.S. OFAC sanctions and arrests in relation to the Tornado Cash mixer), for clients holding and transacting via wallets or looking to raise capital via in-specie coin subscriptions, the importance of having a service provider with deep experience in anti-money laundering processes (including utilisation of wallet screening technologies) has become a real focus.

DAN: Our existing clients, including the big ones, remain bullish. They project growth in the AUM of current funds and talk about launching their next. They very much believe Web 3 is a real thing and have investors that are willing to give them money to put into companies in the space, with an emphasis on VC strategies in particular.

AARON: We believe that there are a number of technology solutions out there which are becoming more specialised in their product line. We have seen demos of technologies, which specialise in DeFi, others on market data, others on automation. Technology providers are realising that they cannot service everything and are focusing on what they can do best. This might be of a great help to administrators, but the challenge is the fees charged by these systems.

## HOW IS THE SERVICE PROVIDER ECOSYSTEM CHANGING?

AARON: Indeed, the service providers in the ecosystem have evolved a lot compared to a couple of years ago and this was evidenced even more after FTX. Banks, brokers, exchanges, auditors have become more cautious in their approach to digital assets. Banks are now questioning each fiat currency transaction, and exchanges/brokers (at least the main ones) have an onboarding exercise which is close to those of the banks.

We can confirm this because they have been placing additional requirements on us as administrators, let alone the requirements on the fund manager. When it comes to audit, this has become a time-consuming exercise. The number of reports and granularity is challenging, and unfortunately not all technology solutions have what the auditors are after, meaning we have to resort to manual calculations to bridge the gap.

KARINE: While the offering for custodians, brokers, lawyers, auditors, directors or fund administrators has kept pace with the demand, the major impediment for crypto funds going forward remains the banks. With two of the main go-to-banking options now gone (Signature and Silvergate), the industry will need to figure out which alternatives to use. It is too early to say if traditional banks, Electronic Money Institutions or other jurisdictions will take the lead, but there is no doubt that the industry will look for ways to adapt.

DAVID: With a unique blend of continuous innovation and regulatory uncertainty in the asset class, the service providers that have thrived have been those with agility and openness to collaborate with clients and peers. We pro-actively engage with and support the crypto community in our jurisdictions and internationally, with participation in the Blockchain Association of the Cayman Islands and the Alternative Investment Manager Association Digital Asset Working Groups for example. We're proud to support our digital asset clients and other crypto-friendly service providers, to continue building the growth of the asset class.

## WHAT ARE THE PRACTICAL IMPLICATIONS OF THE COLLAPSE OF FTX, SIGNATURE AND SILVERGATE?

AARON: The FTX debacle has definitely impacted funds, some more than others. FTX was a trusted exchange with a lot of funds holding digital assets on it. Considering the impossibility (at least for now) to withdraw funds and to value those assets, fund managers had to either impair such holdings or create side pockets for any probable future liquidity of the said assets.

With Silvergate and Signature Bank going down, it has created a "vacuum" of banking solutions for crypto funds since these two banks were the most widely used across the industry. As a consequence, funds had to start looking for other options perhaps in other jurisdictions which before weren't thought about. A banking solution is very important for funds to raise capital through subscriptions in fiat currency. Unless they find a quick solution, they either have to stop attracting fiat subscriptions or else attract subscriptions in kind.

KARINE: FTX and the closure of the two main crypto banks mark the beginning of the "Regulatory Period" for crypto assets. It is interesting to note that the majority of our crypto clients have been in favour of more regulation, so in general they feel very positive about the future.

DAVID: These high-profile failures have provided a focus on governance and risk management, with investors seeking clarity and assurances on the protection of their investment. With failure in centralised counterparties and stable coins, interest naturally moves more towards decentralisation. There has also been a reflection point for the funds in relation to governance, with a continuing trend in adoption of independent directors with experience in the jurisdiction and asset class.

Regulation remains a key topic and will for several years to come, with notable attention on the availability of US banks to provide fiat on-ramps/ off-ramps to our clients. Whilst this remains uncertain, our clients are faced with a narrower list of smaller regional banks to consider, along with the corresponding counterparty risk. Looking at the Cayman Islands, with the jurisdiction being an institutional-focused investment market, with the highest standards of regulatory oversight and corporate governance, there has, however, been minimal impact on the administration activities for our clients.

## WHAT DO WE EXPECT GOING FORWARD?

AARON: These past few months have been quite turbulent and have put a lot of pressure across the industry, especially when it comes to the crypto “sceptics” trusting the sector. There were certainly fund managers who decided to delay launching their fund, but the digital assets market has shown its resilience in the past and we are sure it will show it again. As a matter of fact, in the wake of major failures in the non-crypto banking industry, Bitcoin’s price registered a sharp increase in response to this.

DAVID: With crypto and digital assets still being synonymous with Bitcoin in the mainstream, in the years ahead we should expect to see a broadening in investment strategies as the market matures. Regulation (notably in the US) will eventually appear, through necessity and reaction to events like FTX, but whether this will enable the banking gap to be closed is yet to be seen. The shift towards newer jurisdictions, will continue to draw the attention of global regulatory bodies, including the FATF, which will focus clients back to the well-established jurisdictions.

Tokenisation will continue to advance and put pressure on all market participants to ‘re-plumb’ their operations and technology, providing an opportunity for those who can innovate to remain agile to the change and build long-term constructive partnerships with their clients and providers. The Bitcoin halving in April 2024 may also bring some good news to the market (a crypto spring perhaps...), with this event historically always resulting in a bull run.