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Cryptocurrency & blockchain 2018

Carbon offset specialist utilises token & blockchain

World's first digital cryptocurrency index and ETF

Policing the Wild West



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Cryptocurrencies and blockchain move centre stage

By Beverly Chandler

It's a true sign of the times. The two top performing hedge funds of 2018, according to data providers Preqin, are both focused on cryptocurrencies and blockchain.

Silver 8 Capital - read about them further on in this report - managed the highest returning hedge fund last year focusing on financial technology, with a particular focus on blockchain and the crypto world, returning 770.74 per cent, while Global Advisors' Bitcoin Investment Fund came in second with returns of 330.08, according to Preqin.

Further evidence comes from HFR, whose Cryptocurrency Index was up 155.70 per cent for the last 12 months to end June, while its Blockchain Index was up 142.07 per cent for the same period.

Traditional fund managers may hate the sector but investors love it. Warren Buffett has been steadfastly 'bashing bitcoin' for a number of years. During his recent Berkshire Hathaway annual shareholder meeting, Buffett referred to bitcoin as 'rat poison squared'.

The crypto industry has responded with typical vigour with a billboard response from Genesis Mining and a huge bet from an Aussie crypto expert that bitcoin's price will beat the Berkshire Hathaway share price by 2023. But all of this is just the theatricals and pantomime that surrounds an extraordinary new investment phenomenon that can no longer be easily dismissed.

A quick summary of the cryptocurrency industry, for those who have not yet been exposed, reveals that bitcoin is the best



known and biggest of the digital – or crypto – currencies, first named in a paper in 2008 and launched in 2009 by a mysterious and anonymous figure who goes under the name of Satoshi Nakamoto.

At the time of writing bitcoin now has a market cap of around USD131 billion and a value of around USD7,660 per coin. The power behind bitcoin lies in its ledger, the register of bitcoins recorded in a distributed database. This ledger is based on blockchain and even for those for whom digital currencies are a step too far, blockchain's inherent strengths offer a compelling development. To achieve independent verification of the chain of ownership of every bitcoin, each network node stores its own copy of the blockchain which gives consensus to all who use it and in theory defends it from potential hackers.

One of the key strengths of cryptocurrencies, or other systems based on blockchain, is that it has no one central governing body which controls it and everyone who is involved in it has some degree of control over it.

The technology used through crypto coins or tokens creates an investment democracy that allows customers and suppliers to connect directly, without the need for a central entity like a bank or a financial institution to make a transaction, which means that assets can be shifted safely, swiftly and cheaply.

Interviewed in GFM's AlphaQ on the launch of his blockchain and tokenised investment grade diamond investment, Abacus Capital's Hogi Hyun explains: "You can trade bitcoin 24/7 on any one of 200 exchanges and you are not stuck with the usual fund administrator route for subscriptions or redemptions. If you cash in a PE or hedge fund, you are probably looking at 30 to 40 days from redemption to get your money, but settlement is 10 minutes on a crypto exchange."

The strength of the blockchain has led to the launch of a huge number of cryptocurrencies. The top three in terms of being closest in form to an actual currency (bitcoin has its own cash machines, for instance) are bitcoin, ethereum

and ripple but just the process of stepping away from a fiat currency – one that is backed by a government – has enabled investment creators who are on a mission to create a currency that supports their goals.

Within this report, we interview Veridium which has developed a token and used blockchain to develop its carbon neutralisation programmes for corporates and in the past GFM's AlphaQ title has followed the fortunes of Swarm. This is a firm that uses blockchain to democratise traditionally institutional investments such as private equity, giving the retail investor of all sizes access to institutional investment funds.

Swarm CEO Philipp Pieper says: "We are building a regulatory compliant exchange for asset-backed tokens designed around true cooperative ownership. So, in the end, when someone buys security tokens of one of the assets on the platform, there is a real ownership of that entity."

If there is a new financial industry, there must be a new index and where there is an index, there must be an index fund or an ETF. The battle to get a bitcoin ETF launched has been fought long and hard. Global Advisors, mentioned above, now CoinShares Group, and its subsidiary Swedish firm XBT Provider AB, have been offering ETPs on cryptocurrencies for some time.

In 2015 XBT Provider started by launching Bitcoin Tracker One and Bitcoin Tracker Euro on Nasdaq in Stockholm, which, it says, became the world's first bitcoin tracking ETPs to be offered on a regulated exchange. 2017 saw XBT join CoinShares and launch Ether Tracker One and Ether Tracker Euro. XBT saw asset growth for their products grow by a factor of 36 in 2017, finishing the year with assets under management of USD1.06 billion, having peaked mid-December at USD1.53 billion.

Figures for April 2017 – March 2018 from NASDAQ Stockholm reveal XBT Provider ranks as the second largest issuer by exchange traded volume (USD6.5 billion, 37.9 per cent), with its four crypto tracking ETPs ranking in four of the top five spots for total volume traded on exchange in the same period, out of 1600+ ETPs.

So, the demand is there, even if the products are not coming out of a major financial centre, such as New York. And it is in the US that we have seen the bloodiest of battles in the attempt to create a crypto ETF, with the SEC firmly fending off all efforts from the great and the good, saying, most recently, as it knocked back the Winklevoss twins for the second time: "The arguments submitted in support of this claim are incomplete and inconsistent, and are unsupported or contradicted by data."

However, maybe the first digital crypto index and ETF from Kryptoin ETF Systems, interviewed in this report, will be the one to crack it. Donnie Kim, Kryptoin CEO explains how his patent pending invention sidesteps equity exchanges to create a digital ETF. ■

Investing in transformative technology

By Manuel Anguita

How did Silver 8 come to invest in crypto assets in 2015?

Much of the credit must go to my business partner and Silver 8's other co-founder, Jose Suarez, who is responsible for the vision. Jose has been a serial entrepreneur and tech investor for the best part of 25 years, experiencing first-hand the development of the internet. I have a very different background as I'm a financial markets professional, mainly in the hedge fund arena. We met 20 years ago when I was starting my career with Goldman Sachs in New York and Jose was heading Walker Digital, Jay Walker's (founder of priceline.com) innovation lab. I moved back to Europe, but we remained friends since.

Back in 2014, Jose asked me to take a serious look at bitcoin and the technology behind it. I was initially very sceptical as I really did not understand what the purpose of this new technology was, but Jose was persistent and encouraged me to read the materials he sent across. I followed his advice and soon became hooked in an intellectual capacity. I left everything I was doing and challenged myself to really understand how an open blockchain could function as an alternative source of trust to the traditional financial system. It took us almost a year to develop a conviction, but we finally invested the first dollar of our own capital in the summer of 2015.

What is your investment approach?

Although we initially focused on blockchain technology, the overall investment aim of Silver 8 is to achieve outsized returns by providing exposure to different technologies



Manuel Anguita, Co-Founder of Silver 8

that, in our opinion, will be transformational for trade, finance and commerce. With this thesis in mind, we designed a flexible investment strategy that enables us to express our views via three different asset classes: digital assets (aka cryptocurrencies), venture capital, and financial technology related equities, all under the same investment vehicle. These three asset classes allow us to get exposure to early, growth and more mature stages of the technology development cycle.

In terms of the risk profile, we started the fund with a very high conviction that blockchain-based digital assets were going to develop rapidly. Therefore, our fund had a bias towards early stage technology exposure, on the higher end of the risk spectrum. Although we remain primarily invested in blockchain related assets, we now also have exposure to other fintech areas.

We are primarily a research-oriented firm; we spend time understanding technologies and companies that can have a material impact that we can monetise for our investors. Having said that, in most of our positions we have an investment horizon of one to three years; we are not extremely long term oriented. In addition, a smaller portion of the book is dedicated to short term trading, given that digital assets markets are still imperfect and offer beautiful trading opportunities. We also have some venture capital positions that will likely take several years to realise. Therefore, our investment strategy is a base layer of fundamental convictions on top of which we keep degrees of freedom to be nimble when necessary.

What are your thoughts on 2018's retracement and the current status of the blockchain space? What are the main potential triggers that could turn the market?

Digital assets experienced a phenomenal rally that started in 2016 and accelerated in 2017 to a level that, quite honestly, nobody expected. In fact, according to industry publications, Silver 8 was the top performing technology hedge fund in both years, and the overall top performing hedge fund across all strategies in 2017.

Behind this prolonged and outstanding rally there were a number of reasons, some of them firmly based on strong fundamentals and others that were derived from excessive speculation. In 2018, the market has corrected considerably from the previous indiscriminate excess. At the time of writing, the overall digital asset market has a total capitalisation of around USD300 billion, down from the USD800 billion peak reached in early January.

In our view, blockchain technology remains in the realms of early stage development, so we believe many of the consumer-oriented projects being launched are just a few years too early. We remain convinced that this technology is going to provide an alternative financial architecture, primarily for developing regions of the world, but it is still going to take several years until we see a consumer facing working deployment. We are still in the phase of developing a blockchain protocol standard, for which a number of projects are competing. As a consequence, we are quite selective on the exposures we take.

When dealing with assets with 100 per cent realised volatility, making short term predictions is a fool's game, at least from our perspective. We would rather focus on technological developments, adoption metrics and market technicals (not so much technical analysis, but more understanding overall money flows). On the technology side, we are seeing promising projects and a very healthy growing number of start-ups and young engineers building up the necessary expertise. From an adoption perspective, the space is experiencing hype and doom cycles that reach higher bottoms after corrections (measured in terms of overall awareness of the technology). However, the technology is still lagging behind in terms of actual users, due to high barriers to adoption, primarily in terms of usability, security and regulatory clarity.

In terms of market flows, digital assets remain mainly a retail phenomenon, larger outside US and Europe. Nevertheless, the market structure is rapidly evolving, and we believe it is a question of time before institutional-grade products are developed. There are already several contracts for bitcoin futures listed in

the US and a number of ETF and other products are awaiting regulatory approval.

Setting aside the noise and volatility, we strongly believe this is a market that is here to stay. Purely from a portfolio management perspective, digital assets offer a unique combination of liquidity and exposure to the asymmetrical pattern of returns of early stage technology. In our opinion, no other asset class offers this profile. Certainly, early stage technology is very risky in absolute terms, but it is also driven by return factors unrelated to the economic cycle; therefore, digital assets and traditional assets returns remain uncorrelated.

Does Silver 8 have any institutional investors? Who is the largest investor?

We have a number of institutional investors that include insurance companies, funds of funds, investment advisors and foundations. These currently make up about 40 per cent of the fund. The principals remain the largest investors with more than 25 per cent of the fund, and the balance comprises Family Offices and HWNIs. The majority of our investors are US-based, followed by South-East Asia and Europe.

What sets Silver 8 apart from other funds in the crypto realm?

When we started investing in crypto back in 2015, there were only a handful of funds with exposure to the space. Now, there are more than 300, the majority having been established from mid-2017 onwards. Being early participants has allowed us to develop deep expertise, especially in the operational complexities of this new asset class. With one of the longest track records in the industry, we've directly experienced its tremendous development, and we've had to adapt our procedures to all of its operational and technical idiosyncrasies.

Secondly, we've made every effort in assembling a product that is as institutionally inviting and friendly as is currently possible. From our documentation, to service providers, to legal & compliance, etc, everything has been prepared with this objective in mind. We want to offer a sensible approach to exposure within blockchain and wider financial technologies that is of institutional ilk.

Finally, Silver 8 relies on the combination of 50+ years of professional investing experience of our principals and the rest of the team. The length of tenure, combined with the mix of backgrounds, has allowed us to apply the standards of a professional hedge fund management approach to a new asset class with a strong technology component. We leave you with a thought that many funds have either a technology savvy leadership team or one that has financial markets experience; Silver 8 is one of the lucky few to have both sides of the coin. ■

Carbon Liability
Accounting & Risk
Management
Tool for Portfolio
Managers

THE LONG ROAD TO SUSTAINABILITY JUST GOT A LOT SHORTER

Automated Carbon Accounting Tool
Unique Carbon Hedge Vehicle
Tokenized Carbon Assets for
Liquidity & Fungibility

VERIDIUM, a collaborative initiative by IBM, Stellar & EcoSmart-Labs, is creating tokenized trading markets for carbon credits and other natural capital assets.



VERIDIUM
ECOSMART-PROTOCOL™

www.veridium.io | info@veridium.io

The EcoSmart-Protocol™ is a technology standard for the automated accounting of carbon liabilities and the use of tokenized carbon offsets as a long-term hedge.

Veridium offers carbon offsets

Interview with Todd Lemons

A brand-new social impact offset token has come out of a 25-year history of creating sustainable solutions for corporations, explains Todd Lemons, chairman of the Veridium Foundation.

Veridium is a collaborative initiative between a coalition of industry leaders including IBM, Stellar, Brian Kelly Capital Management, EnVision Corporation, and IDEACarbon (a division of IDEAGlobal),

Some 10 years ago, InfiniteEARTH (also part of the EnVision group of companies), authored the first forest carbon accounting methodology, now known as REDD+ (reducing emissions from avoided deforestation and degradation), which is now embodied in the Paris agreement.

The company developed the first internationally recognised REDD+ project known as Rimba Raya, which consists of 65,000 hectares of tropical forest on the island of Borneo in Indonesia. Rimba Raya was the first REDD+ project to be validated under the VCS standard and the first to receive a Triple Gold rating under the CCBA standard. Today, InfiniteEARTH's Rimba Raya project is still one of the largest carbon credit suppliers, as well as the largest privately funded orangutan reserve in the world.

The firm sells those carbon credits to a dozen Fortune 500 companies. These companies face huge challenges in accurately and efficiently accounting for their carbon footprint. No two manufacturing processes are alike, and measuring the carbon emissions liabilities on hundreds of inputs in the complex global supply chain for a single product, is a resource intensive process.

"To compound the problem, that level of granularity doesn't necessarily lead to accuracy," Lemons says.

Pressure is coming from governments and NGOs, but is primarily being driven



Todd Lemons, chairman of the Veridium Foundation

by institutional investors who want to understand their exposure to the emissions liabilities of their portfolio companies.

Consequently, risk managers at institutional funds are pressuring firms to measure and mitigate (offset) their carbon footprints. The motivations are not just altruistic, but also because the market has become aware that failing to recognise these liabilities will increasingly have a financial impact on the bottom line. There is mounting evidence that there is a strong correlation between high ESG (Environmental & Social Governance) ratings and financial performance.

Challenging as it may be, companies are attempting to map their carbon footprint throughout the entire supply chain and then understand the arcane word of carbon markets. Company CFOs must then buy carbon offset credits at the corporate level in order to offset their carbon liabilities, but then turn around and allocate those expenses back up stream to specific operational units.

The stakes are higher and the problem is even more complex when trying to hedge against future carbon liabilities, Lemons explains. "Companies lack the necessary tools to mitigate future carbon liabilities risks".

There are two classes of carbon credits: one that trades on the European Carbon Exchanges, which are liquid and can be held as assets, but typically expire within one or two years so don't offer a long-term hedge solution. The second type, such as those offered by REDD+, have long expiration dates and have even broader environmental offset capacity, including biodiversity and water conservation and positive social impact value. But, these credits are traded OTC, so cannot be listed as assets since they have no public price indicator.

"We have struggled with our clients to help find solutions to simplify and automate the whole process," Lemons says. "As blockchain emerged as a viable technology and companies began to explore using it for supply chain management platforms, such as IBM's Hyperledger Fabric, we found that the technology could facilitate solutions to these carbon accounting and offsetting challenges.

"First, we can tokenise the higher quality environmental assets such as REDD+ credits, making them liquid, making them liquid and therefore able to be classified on the balance sheet as an asset. This makes them the ideal long-term hedge vehicle for mitigating future carbon liabilities.

"Secondly, we have developed a completely unique accounting approach that looks at the problem differently through the creation of a library of carbon density per dollar coefficients based on a fixed set of industry sectors. By assigning a carbon footprint per dollar of transaction value in a given industry sector, we are able to provide an accounting tool that is more efficient, by several orders of magnitude, than the current process.

"We know from credible sources that certain sectors are responsible for X per cent of total global emissions and we know what the total revenues for those sectors are. This unique tool, known as the EcoSmart-Protocol, allows us, with a fairly high degree of certainty, to calculate the carbon liabilities for each dollar of transaction value at very precise points along the value chain."

Increasingly companies are using blockchain for supply chain management, which provides a platform to execute these calculations in an open and immutable accounting ledger, which then simplifies auditing.

"In the old world, databases didn't speak to each other very well, even in same organisations or among trading partners. Although we live in a global connected world, there is still a tremendous amount of manual reconciliation."

Blockchain links everything together and, as the chain builds, it preserves that history in an immutable, open record.

The 'consensus' model of blockchain technology also reduces disputes. In the past, when the records of the same transaction on two different databases disagreed, it required



manual arbitration and reconciliation. With blockchain, the record is preserved in an open and immutable ledger on a thousand different servers or nodes. This means that conflicting data on one is treated as an anomaly and disregarded because there is 'consensus' among the other 999.

"This consensus model is also what makes blockchain so secure," Lemons says. "A hacker accomplishes nothing by hacking and modifying the record on a single server or node. They would have to hack all of them, which is virtually impossible".

To deliver its solution to market, Veridium has tokenised the underlying carbon credits as the CARBON token and tokenised the utility token as VERDE. The VERDE token grants access to the EcoSmart-Protocol, the accounting software that calculates carbon liability, and then automatically instructs the purchase of CARBON tokens. The tokens are then 'burned' (taken out of circulation) and the underlying carbon credits are 'retired' (also removed from circulation).

"With regard to offsetting, the distinction most people don't understand is that you are not just letting polluters pollute," Lemons says. Carbon taxes and 'allowances' issued by governments are 'permissions to pollute', with little assurance that the revenues are ever contributed to actual emissions reductions.

"Offsets, on the other hand, pay for direct emissions reduction in arrears. It takes a carbon offset project like Rimba Raya a year to complete its annual audit. So, we are currently selling 2016 carbon credits, which are independently verified emissions reductions that occurred in 2016. So, emissions reduction is guaranteed since it already occurred, versus a promise to produce an unquantified emissions reduction in the future.

"We have prevented 130 million tonnes of emissions from ever happening by preventing the conversion of the Rimba Raya forest to palm oil. That's the equivalent of removing four million cars from the roads every year for 30 years", Lemons says.

"In the case of Rimba Raya, carbon credits are a crucial funding mechanism for forest conservation. Veridium and blockchain technology make that product more digestible for corporate users, which means we can now effect real environmental change at scale". ■



KRYPTON BLOCKCHAIN 10 ETF

KRYP

Why invest in this fund:

- Track the capitalization of the crypto market
- Direct exposure to cryptocurrencies
- Asset backed by cryptocurrencies
- Alternative to equities
- Aggressive growth

ETF facts:

Asset Class: Cryptocurrency

Inception Date: Nov 11, 2017

Exchanges Listed: TBD

NAV Exchange: Bittrex

Rebalance Frequency: Semi Annually

Top 10 holdings:

1. Bitcoin
2. Bitcoin Cash
3. Dash
4. Ethereum
5. Ethereum Classic
6. Litecoin
7. NEO
8. OMG
9. Monero
10. Ripple

Pre ICO

September 1, 2018

Dutch auction sale

100,000 tokens

Seed round

UP TO 40% OFF NAV

This is not an offer for Security Tokens

Kryptoin launches first crypto ETF

Interview with Donnie Kim

The first crypto blockchain ETF to be listed on digital exchanges by Kryptoin ETF Systems, is on its way, having launched its Blockchain 10 Index in November of last year. Kryptoin CEO Donnie Kim explains that the Kryptoin Cryptocurrency Blockchain ETF systems is a patent pending platform upon which ETF tokens can be created to track and encapsulate indices formulated to represent the evolving digital currency markets.

“We started off by identifying two big megatrends,” Kim explains. “We had been developing fintech applications for four years and saw a huge trend in the usage of ETFs. The assets that were going into them had been increasing for 18 years straight and then we saw another megatrend, with the increase in market capitalisation of bitcoin. When we started we didn’t know it would take off to this extent but we realised that people would need access to the crypto market in the form of ETFs.”

Existing, and, so far, unsuccessful attempts to create bitcoin ETFs are dismissed by Kim because they are attempting buy the value of bitcoin through equity exchanges.

“Our ETF is totally different,” he says. “We are creating units and indexes from cryptocurrencies and offering access to those ETFs on digital exchanges.”

Amongst the team of eight at Kryptoin is a specialist ETF adviser, Jason Toussaint, former CEO of SPDR GLD ETF, the largest Gold ETF in the industry. November 2017 saw the firm’s first crypto Blockchain 10 index composed of the top 10 coins by market capitalisation and, since then, the firm has observed that the potential ETF closely mimics the cryptocurrency market capitalisation.

“We have an app that enables the exchange trading creation and redemption of the underlying,” Kim says. Currently bitcoin, ethereum, ripple and bitcoin cash dominate



Donnie Kim, CEO of Kryptoin

the index. The path to launching the ETF lies through the ICO of the KRP token, a process that Kim is confident will be completed in a few months. Kryptoin is seeking USD50 million, mostly to purchase underlying assets (95 per cent) while the balance will go to marketing & operations and development & system upgrades.

“Once the ICO is completed, it will be launched on the major digital exchanges just like a regular ETF does on an equity exchange,” Kim says. “There has to be a mechanism to direct exchange trade digital currencies so there may be a way to integrate fiat currencies in the future.”

“We have lots of interest from people who think that this is the future and see a lot of money waiting to invest in an index of the cryptocurrency market through a single coin.”

The Kryptoin platform is able to calculate the NAV of the token and that NAV is the value of the underlying.

“When we started, the NAV was USD20 and when bitcoin hit 19,000 it went to USD150 and now it’s down to USD51. It’s less volatile than buying individual coins. When the cryptocurrency market is really roaring it can get volatile but it is a basket so less volatile than any single one coin.

“The market cap of the crypto market at the moment is about USD400 billion and that is projected to increase to USD10 trillion in the next three years, so we project that the NAV will go to USD2,200.”

Kim reports that his firm is getting a lot of interest from people in the ETF industry. “There is a natural interest to see the progression of what is going on in the market and we are early and the first firm to have created something like this.”

Only 100,000 tokens will be sold in the Pre-ICO in a Dutch Auction Format on September 1, 2018. ■



JP Integra is the leading Cayman specialist in trust, private equity, and fund solutions for international, private and sovereign clients

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The rise of crypto and token business

Interview with Dominic Lawton-Smith

Dominic Lawton-Smith is head of Private Client & Private Equity at Cayman-based boutique fund administrator, trustee and corporate services firm JP Integra Group. The company is 11 years old, has Cayman trust, fund administration and corporate services licences, enabling it to work with private, institutional and sovereign clients and has over USD6 billion under administration. It specialises in the provision of administrative and fiduciary services to clients with international investment, offering and estate planning projects in the long or short term. JP Integra leverages its offering and its legal and accounting skills with Cayman's position as a key global crossing place for trade.

"When establishing funds and organising ICOs and token offerings it pays to have a professional team in a fiscally neutral, high quality jurisdiction involved," Dominic says. "We provide full services in compliance with the highest international standards of AML/CFT and CRS/FATCA reporting without adding an extra layer of entity tax which would reduce the returns for investors and originators in their home jurisdictions."

Cayman is proving a very popular jurisdiction for ICO, token and cryptocurrency vehicles; in fact, what is believed to be the largest ICO to date was hosted on Cayman – the EOSIO blockchain platform raised USD4 billion over the six months ending in June this year.

Lawton-Smith reports that JP Integra has considered a high number of related approaches during the last two years but only took their first step into the business at the end of 2017 after watching the sector begin to mature, so that the proportion of well-considered and advised projects became dominant; at the same time, more complimentary service offerings were developed so that it became more practical to deliver compliant solutions.



Dominic Lawton-Smith, Head of Private Client & Private Equity at JP Integra

"As a fund administrator and trustee, we are used to doing the full sweep of anti-money laundering (AML) checks as well as know your client (KYC) and other due diligence type work; for us, a crypto asset has a lot in common with some of the more exotic derivatives or options".

Token or coin offerings can be likened to private equity style investments, Lawton-Smith says. "These are very exciting new structures for raising money to fund exciting new ideas, often characterised as an alternative to an Initial Public Offering. The impact of token offerings internationally is expected to be huge, they will provide the capital enabling many of the next generation of medium to large business ideas to become reality. However, while the potential for great new business ideas to be funded is very exciting, it is important to remember that a token can convey any collection of rights or privileges determined by the issuer which often do not include an equity interest in the business. For the investor to do well, the token sale has to be successful, the management team have to be successful and the benefits of the token have to be sufficient to warrant the risk of investment – if any of these components are missing the investor/purchaser might be facing a complete loss."

"The most in-demand services in the sector from us are either full service fund administration for funds investing in crypto assets or 'AML/KYC only' compliance services for token offerings. The latter is often a requirement of the bank offering a custody solution. It is very important not to underestimate the risk of a project being used to launder money, it could threaten the project and help unpleasant people achieve unacceptable goals. By providing an institutional quality service level we are

protecting the purchasers /investors as well as the client company and its directors.”

Cayman is not a retail fund environment and Lawton-Smith says that his priorities when looking at token offerings or other cryptocurrency schemes include ensuring that the scheme is only open to qualified investors who have the means and experience to make their own investigations as well there being a solid law firm and clear disclosures about the offering or investment.

Lawton-Smith observes that a lot of token schemes originate from a team in the US (often with Silicon Valley connections) who seeks to raise money internationally. Apart from Cayman’s reputation for funds and the high quality and number of its resident professionals, the trusted court system attracts businesses to Cayman where there are concerns about patent trolls and other frivolous litigation risks.

“Patent trolls send out volumes of baseless lawsuits which an innocent client has to either settle (if cheaper) or engage a law firm to deal with. It would be very difficult for patent trolls to make these attempts economic where the legal situs for the claim is a Cayman court.”

A second strength of Cayman for the token offering and cryptocurrency industry, Lawton-Smith says, is that it is the default investment jurisdiction for businesses from the US generally, being in the same or adjacent time zone as well as being compliant with US and international standards of financial regulation and reporting.

“If a capital raise is taking place outside the US on behalf of entrepreneurs based in the United States, the requirements are different to a domestic, US capital raise and so the default is to come to Cayman. Apart from US anti-money laundering laws, US lawyers in related sectors increasingly highlight the potential for US federal wire fraud charges if enough care is not taken – making sure the right checks are done is essential”

Lawton-Smith observes that token issuances are a fast and relatively informal way to raise money: “You might be funding a business that is yet to be built, subject to the nature of the tokens you have purchased; should the company be successfully launched, participation may allow you to buy services for delivery in the future at an

enormous discount. Tokens are a crucially important way to raise money and I can only imagine that the use of them as a way to raise capital will continue to grow.”

“In an age where it’s difficult to borrow money from banks, ICOs and token offerings are an important financing option for business; it’s very important that they are allowed to take place although we all need there to be safeguards.”

One of Lawton-Smith’s concerns is that anonymity lies at the heart of the cryptocurrency and blockchain world and that this does not fit well with the need for any participant in the institutional finance industry (internationally) to know who they’re dealing with and be satisfied that currency (fiat or crypto) is from an acceptable source.

“Anonymity is attractive from a ‘privacy for honest people’ perspective but it’s no use to us in a regulated services environment. Blockchain, the distributed ledger, is revolutionary but it doesn’t include counterparty identification so there is no reference as to who is the buyer and who is the seller.”

“If we are going to make full use of the enormous potential of blockchain/distributed ledger technology, it must be fit for purpose in a compliant setting – how else do we know we’re keeping the bad guys out of the system and make the smart contract revolution possible?”

Lawton-Smith and others in the sector are aware of initiatives (including some based in Cayman) that will enable private data, fit for KYC / AML purposes to be secured on the blockchain or other distributed ledger system so that the person who is the subject of the data will be able to choose to release it to defined counterparties for defined periods of time and that this will be a much more efficient way to exchange the required information.

“Some liken the meeting of the crypto & token concepts with the international financial services sector to dragging the Wild West into the regulated world – or at least the elements of it that are needed to do business. There’s still some way to go before we have a really efficient and compliant investment process but it is important that we get there and that good quality ICOs / token offerings are able to flourish efficiently.” ■



PROTOS

ASSET MANAGEMENT

Protos is an asset management firm based in Switzerland
focused on factor investing in crypto-assets



The emerging world of cryptocurrency asset management

Interview with Matthew Shaw & Philipp Kallerhoff

Drawing on decades of experience, Matthew Shaw and Philipp Kallerhoff are founders of Protos Asset Management, a Swiss based cryptocurrency asset manager that brings the investing concepts of value, momentum and volatility to the crypto world in the form of a fully traditionally regulated Cayman Island based fund. Protos was set up in 2017 as the pair came out of a crypto investment business in Canada.

“Protos is an asset manager specialising in cryptocurrencies, using some of the traditional tools of hedge funds to manage risk using classic premia strategies,” says Shaw.

The first closed-end fund was launched in mid-December 2017 and is dedicated two thirds to liquid quantitative strategies and one third to investments in bespoke blockchain assets. On the liquid side, the fund applies proprietary strategies across more than 50 cryptocurrencies, with a minimum of USD100 million in market capitalisation, and uses long and short techniques to trade traditional factors such as value, momentum, size and volatility.

To aid research, Protos has created and launched prototerminal.com, a publicly available database of the top 100 cryptocurrencies. The firm has collected a large amount of historic data including prices, trading volume on exchanges, transaction volume on blockchains, news, active addresses, hashrates, token supply, github commits and others. The data is used to create benchmark indices to make sense of the performance of this new asset class. The benchmark indices – value, trend, low volatility and small cap, are derived from the risk premia topic in traditional finance.



Matthew Shaw, co-founder of Protos Asset Management



Philipp Kallerhoff, co-founder of Protos Asset Management

Kallerhoff says: “With equities you have a balance sheet, analysts crunching numbers and applying ratios. With cryptocurrencies you have similar numbers, however one big advantage is that all the fundamentals are publicly available in blockchain. Every transaction is public.”

The fund trades through brokers that execute trades across digital exchanges that deliver best prices and OTC trading desks are used to fulfil larger orders.

“Liquidity in cryptocurrencies is about USD10 billion a day in 1600 cryptocurrencies and about USD1 billion is going in and out of fiat currencies.”

Shaw explains that Protos is focused on building a scalable, industry standard investment product for investors.

“We have gone for independent auditors, good fund administrators, independent directors, and have separated front and back office functions. We also use third-party bank custodians. It’s a slightly counter intuitive approach, one not adopted by every crypto fund, as part of the point is to be at a place where you don’t need a third party to be involved, but in order to attract traditional money you have to have good governance.”

Protos has a wide range of investors including individual accredited investors, some institutions, some family offices and professionals involved in venture capital who have invested personally.

The team is based in Switzerland. Shaw says: “It’s a very crypto friendly country which early on clarified the regulatory infrastructure for crypto and has a good crypto eco-system. It’s a good jurisdiction from which to run a fund – we are a regulated Swiss asset manager.” ■

Governing the digital asset revolution

By John D'Agostino & Paras Malde

Crypto 101

Distributed ledger (DL) technology is the foundation on which crypto-currencies (or crypto-assets, depending on where one falls in the debate) lie. Bitcoin, the most well-known use case for DL, is an attempt to solve the problem of storing and transferring value in a digital, decentralised system. Bitcoin is a means to compensate people/servers for the effort required to “mine” (confirm) blocks of transactions and add them to the global ledger/chain (block+chain). Bitcoins are gifted to these miners upon completion of their efforts (without which the system couldn't function) The increasing secondary value of Bitcoin can then be considered as increasing the confidence in the long-term viability of distributed ledger technology as well as the desire for a store of value that is (a) modern, (b) easily stored/transferable, (c) secure and (d) somewhat anonymous.

Put simply, if Sam wants to transfer two bitcoin to Jennifer, he sends a transaction request to the bitcoin blockchain – software running on thousands of computers worldwide. Miners check to make sure Sam has the bitcoin, and race against each other to solve a complex and energy intensive mathematical formula so they can be the ones to officially place the transaction in a block of other transactions. Once a majority of miners agree a block is verified, the miner who did the work gets paid in Bitcoin for their effort. At that point the blockchain has been irreversibly amended, and Jennifer now owns those Bitcoin.

The modern-day gold rush

There are over 1700 crypto currencies in the market today with a total market capitalisation of USD300 billion+ according to CoinMarketCap. With more popping up



John D'Agostino, Global Leader, Investor Engagement at DMS Governance



Paras Malde, Director at DMS Governance

each day, crypto-currencies are the modern-day gold rush. The amount of attention that crypto currencies are generating on a daily basis has created a “fear of missing out” amongst investors and consumers alike. With this level of growth, crypto currencies have found a place as an asset class in investment portfolios (mostly retail more than institutional at this stage) as an alternative to the traditional alternative assets such as real estate and commodities.

This has further sparked the rise of crypto currency hedge funds. Autonomous NEXT, a FinTech analytics firm, has counted 75 crypto hedge funds that have raised about USD800 million to date and who aim to raise USD1.2 billion more in the near future. The crypto funds strategies range from investing in initial coin offerings, widely known as ‘ICOs’, which raise money by selling investors digital tokens in exchange for crypto currencies, to buying and holding traditional crypto currencies such as Bitcoin, Ethereum and Litecoin.

Volatility

Much has been made of Bitcoin's volatility. Certainly, compared to more established asset classes like equity long short, the daily price moves can seem volatile. The relative lack of breadth and depth in the Bitcoin market, regulatory uncertainty and the presence of significant players with the ability to shift market sentiment no doubt contribute to this sense of risk.

However, observing the daily historical volatility of Bitcoin shows that, in general, it's daily vol ranges between 4 and 7 – not particularly shocking when compared to many options markets. It is the vol of vol that is striking – with sudden gap ups to 10, 20 or 40 that quickly recede. Until recently, most of these shocks have been to the upside, and as actual or short positions



have been impossible until recently, have not hurt anyone aside from a regretful seller. As margin and shorting comes into play, this vol of vol will have greater potential impact, but should, if the market develops gradually, recede in magnitude and frequency.

Regulations

Many countries like Bangladesh, Bolivia, Thailand, and Vietnam (among many others) have tried to ban crypto currencies like Bitcoin. Other countries like China and South Korea have entirely banned ICOs. But there are some countries like Australia, Russia, Japan, and Venezuela which have made Bitcoin an official legal tender and are regulating it.

The surge in crypto currencies has led to an abundance of scams, prompting global regulators to warn investors of fraudsters. The US SEC, UK FCA, Singapore MAS have all released statements warning investors of inherent risks involved with crypto currencies. As part of its effort to fight cybercrime and protect retail investors from cyber threats, the US SEC announced the creation of a new cyber task force. Among other things, the unit will target ICOs and other violations involving distributed ledger technology that run afoul of SEC regulations.

Cryptocurrencies seems to straddle the boundaries between commodity, security and currency. Earlier this year the US CFTC approved the first Bitcoin options exchange. Subsequent to this announcement, the SEC issued an investigative report which concluded that tokens offered and sold by a "virtual" organisation known as "The DAO" were securities and therefore subject to the federal securities laws.

Given the trading and clearing mechanism, there is also a notion in the regulatory industry that a crypto currency system may be deemed

as an Automatic Clearing House ("ACH") and hence ACH rules would be applicable.

Regulators globally have been working on determining appropriate crypto currency regulations for several years however it has only been until recent surge in crypto currencies that they have dedicated large amount of resources to find appropriate resolutions.

Service providers & challenges

One thing that the digital asset markets currently lacks is a vibrant community of service providers willing to engage with it. While a few have taken on this business many are adopting a wait and see approach. DMS has begun a Digital Asset Working Group to attempt to formulate industry best practices around DL strategies, including crypto. The group includes representation from all parts of the ecosystem including:

Banking – the transition from fiat currencies to crypto currencies sounds exciting to many enthusiasts and hedge funds (somewhat alike) however the full transition and wide acceptability of crypto currencies will take time and will require an entirely new banking infrastructure. It is imperative that a banking partner is identified that fully understands banking rules and regulations and is committed to ensuring compliance with this fast-evolving asset class. Fortunately, the advances in FinTech industry have resulted in several banking projects that look to provide crypto currency friendly services. It has, however, yet to be determined if they will be widely accepted by global regulators.

Auditor – each of the key areas of audit focus as with a traditional alternative fund such as transaction testing, valuation, custody and existence of assets will have unique challenges for funds investing in cryptocurrencies. Funds that will trade in multiple crypto currencies on multiples exchanges will have to establish a strong valuation policy that will support the volatility, liquidity, treatment of forks and pricing of each currency. Tools such as Block Explorers may assist auditors to perform transaction testing however it may prove to be a cumbersome process. Funds that will not use a custodian for crypto assets will need to ensure the

auditors get fully comfortable with the self-custody mechanisms and controls. The funds will rely heavily on the administrator during audit so it will be essential that the auditor and administrator have a good existing relationship or prove that they will be able to work together seamlessly.

Administrator – administrators will be doing some of the heavy lifting of ensuring investor and accounting records are accurately tracked. When selecting an administrator, crypto funds should ensure that the technology and blockchain/crypto experience of the administrator matches the structure and investment strategy of the fund. Also, ensuring that the administrator has a comprehensive AML/KYC programme that satisfies regulatory requirements in applicable jurisdictions will be highly essential. Funds should strongly consider avoiding in-kind subscriptions/redemption (opting for fiat in/fiat out instead) to avoid complex AML issues at least in the current early days of the industry.

Legal counsel – Law firms have embraced the crypto trend and are rapidly getting up to speed. It is imperative that a fund select domestic and offshore legal counsels that are at the forefront of cryptocurrency regulatory developments, market trends, and technology developments. Ensuring sufficient investment and risk disclosures in a fund's foundational and offering documents are going to be a crucial safeguard against any future action against a fund. One should be cautious, however, as legal support in establishing a crypto is not an implicit endorsement that the strategy or that the structure will withstand future regulatory scrutiny. Everyone here, including lawyers, are in speculative mode at this point.

Tax advisor – identifying and engaging a knowledgeable tax advisor will be important to assist a fund in navigating the cryptocurrency space full of legal uncertainties. A fund should amongst other matters adopt a well-advised policy on calculation of capital gains, in-kind transactions and related party transactions. Funds that have an open and transparent approach towards tax will be less likely to draw in regulatory scrutiny.

Compliance – investment manager CCOs will have their hands full thinking through the myriad new compliance issues and regulatory requirements that will arise over the next 12-18 months. Investment managers should ensure that they engage appropriate compliance experience to avoid a serious regulatory nightmare. To keep an open dialogue for good actors, DMS is in active conversations with Cayman, US and EU regulators either directly or through representation on industry working groups

Governance – while there are many governance similarities between a traditional alternative asset fund and crypto fund, engaging independent directors with the knowledge of crypto assets are essential for crypto funds given the highly specialised nature of this investment strategy. DMS has been in the business of governance for over 17 years and can provide a comprehensive governance solution with the appropriate knowledge of the crypto industry and breadth of relevant crypto industry contacts.

Summary – thoughts on the way forward

With all the unknowns, one has two options: 1) wait for regulatory clarity OR: 2) make a good faith effort. We have outlined some options that address option two:

- Selection of the most suitable jurisdiction to incorporate.
- Carrying out in depth due diligence on the trading exchanges is pivotal as is ensuring all necessary documents are in place.
- Start with a simple approach of first ensuring acceptance of fiat currency for subscriptions and redemptions.
- Avoid crypto in-kind capital transactions.
- Clearly document all research and trading processes.
- Identify the most suitable key service providers.
- Clearly understand taxation responsibilities and ensure correct documentation of them. Provide sufficient oversight and governance.

We hope this information to be useful as you navigate through this uncharted industry. If you would like to discuss any of the topics in more detail, please feel free to please contact us. ■