

Crypto-asset investment structures: A primer

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The world of crypto-assets has evolved rapidly, offering innovative investment opportunities as an alternative to traditional financial markets. For investors seeking potentially high returns, diversification, or exposure to the decentralised economy, crypto-assets represent a new frontier. However, the complexities of this market - coupled with its relatively young and rapidly changing nature - require careful consideration when it comes to structuring investment vehicles.

This article covers the key elements of a crypto-asset investment structure, from asset selection to risk management and compliance.

Types of crypto-assets

Before diving into investment structures, it's important to understand the different types of crypto-assets available.

Crypto-assets can be broadly categorised into several types, each offering distinct opportunities and risks:

Cryptocurrencies/"coins"

These are digital currencies that use cryptography for security and operate on decentralised networks, the most well-known being bitcoin (BTC) and ether (ETH).

What makes a currency or coin different from a token is that the fees of the network are paid in the currency of said network. If you move bitcoin on Bitcoin, you pay a fee in bitcoin. If you move USDC tokens on Ethereum, you pay your fee in ether, not USDC tokens.

Cryptocurrencies are often used as stores of value, means of exchange, or a method to transfer value across borders as well as being used for network fees. This means that they are both a usable digital commodity and a means of exchange at the same time, which is one of the reasons why most regulators around the world have difficulty in deciding how they should be treated.

Tokens

These are digital assets built on top of a blockchain (most commonly on Ethereum's blockchain). Tokens can be categorised into utility tokens, security tokens, and governance tokens.

- **Utility tokens** give holders access to a specific service. They might, for example, be payment vouchers for real world purchases.
- **Security tokens** represent ownership of an underlying asset or share in a venture. These are tokens that are also traditional securities in some way, or tied to them.

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- **Governance tokens** relate to voting rights. There are all sorts of protocols, Decentralised Autonomous Organisations and real-world associations that use governance tokens to undertake poll votes online. Usually, each whole token represents a vote in a poll. There is no industry standard as to the voting rights granted, but generally all governance tokens have equal weight whenever they are able to be validly used.

Tokens can be a bit of a minefield for the uninitiated, as there can be a lot of crossover, with a single token being capable of having a blend of elements of each token type.

Stablecoins

Stablecoins are pegged to the price of an underlying asset (like the US dollar) to maintain stability in their value. Common examples include Tether (USDT) and USD Coin (USDC). They offer a way to reduce volatility and provide a more stable store of value in the crypto world.

Stablecoins are typically either backed by assets to the value of the pegged asset (such as US treasuries and cash deposits), or can be supported by loaned crypto-assets locked in a smart contract, such that an algorithm balances the market price of the locked crypto-asset to hold the peg.

Non-fungible tokens (NFTs)

NFTs represent unique digital assets, whereby the token itself is unique and generally points towards a web link that contains digital content. Typically, this web link points to data stored on the Interplanetary File System, which is a digital peer-to-peer file sharing system that is not stored on any one server.

Often associated with collectibles, art, or other forms of ownership, there is no reason that an NFT cannot represent anything, and the filed item could be a contract or bill of ownership for a real world asset.

While NFTs are still a nascent market, they have created significant investment opportunities in digital art and collectibles.

It can be tricky to confirm the specific nature of an NFT from a marketplace listing. There are ways to encode things like third party payments into NFTs that buyers need to be aware of. This feature was designed to automate royalty payments back to the original creators, but like all good intentions this is very much exploitable by nefarious actors and buyers should inspect the coding of NFTs that they wish to buy. Some NFTs can be clawed back and others can be destroyed ("burned") after a number of transfers or after a trigger event, like a key date being reached.

Fortunately, NFTs can be inspected on most networks before they are bought.

The selection of specific crypto-assets for an investment structure will depend on the investor's risk tolerance, market strategy, and objectives. Understanding the differences between these asset classes is critical to building an effective investment structure.

Investment structure types

Crypto-asset investments can take various forms, depending on the investment goals and the nature of the assets being held. Some of the key structures include:

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Direct purchase of crypto-assets

The most straightforward method of investing in crypto-assets is to purchase cryptocurrencies, tokens, or other assets and hold them directly on a wallet, whether this is a hardware wallet or a software wallet, that you control absolutely and are solely responsible for. This approach allows investors to have direct ownership of the crypto-assets, either through centralised exchanges (e.g. Binance, Coinbase) or decentralized exchanges (e.g., Uniswap, Sushiswap).

- **Pros:** Direct ownership allows for full control over assets, allows for a high level of digital security at a modest cost that is affordable for smaller investments, and potential returns can be high.
- **Cons:** Price volatility risk is also high, due to crypto market dynamics and pricing mechanisms. Additionally, managing private keys, security, and custody of assets can be complex, and investors bear the full risk of loss in case of market downturns or technical failures. There is no-one to blame if you were to, say, [lose your private keys in a waste disposal facility](#).

Crypto-asset funds

For those who prefer indirect exposure, crypto-asset funds offer a more professional approach to crypto investing.

These funds pool capital from multiple investors and are managed by professional fund managers. The fund might focus on a specific type of crypto-asset (e.g. Bitcoin-focused funds) or offer diversified exposure to various crypto-assets.

Private equity and venture capital funds may invest in blockchain startups, tokenized assets, or projects that aim to revolutionise various sectors (finance, healthcare, real estate). Investors gain exposure to the growth potential of blockchain technology and new projects.

Hedge funds typically use sophisticated strategies to manage risks and generate returns. These funds can engage in long and short positions, arbitrage opportunities, and sometimes engage with decentralised finance (DeFi).

Crypto exchange-traded funds or exchange-traded products allow investors to gain exposure to crypto-assets without directly owning them. These products track the performance of specific crypto-assets, providing a diversified way to invest within a conventional portfolio.

- **Pros:** Professional management and the ability to diversify across multiple crypto-assets. They are a “low-tech” investment option for those not well-versed in managing crypto directly. The investor does not generally take responsibility for the custody risk.
- **Cons:** Management fees can eat into returns, and the performance depends on the expertise of the fund manager. Some fund names can be misleading, and a fund that claims to be exposed to Bitcoin could (for example) have a percentage of its assets invested into Bitcoin mining companies, payment service providers and crypto-asset exchanges, which would only be apparent from reading the key investor information document or key information document (as applicable).

Decentralised finance (DeFi) protocols

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DeFi protocols represent a new wave of decentralised financial services that operate without intermediaries like banks. These protocols allow users to earn interest, lend, borrow, or exchange crypto-assets in a decentralised manner. By using smart contracts, DeFi platforms can automate processes and ensure transparency and efficiency in financial transactions.

Investors can earn yield through lending their assets to others or by providing liquidity to decentralised exchanges.

There is a process called "yield farming" that is typically used by project teams who issue crypto-assets to distribute their own tokens. Investors who are providing liquidity to (usually decentralised) exchanges receive a "liquidity pool token" which is used to reverse their deposit into the exchange. However, some projects open a smart contract where the investor can lock up that token itself and in exchange make itself eligible to claim an amount of the new tokens distributed by the project team.

The project team benefits from yield farming because the investors are incentivised to supply liquidity of the new token to exchanges, promoting circulation and preventing a "bank run" scenario. The investor stands to benefit because they are receiving a share of newly-minted tokens early on before market forces have led to price discovery.

- **Pros:** The potential for high returns, transparency, and security (via smart contracts). Investors can also access services not available in traditional finance, like decentralized lending and borrowing.
- **Cons:** DeFi protocols come with significant risks, including smart contract vulnerabilities, liquidity risks, and regulatory uncertainty. Some DeFi protocols require a time commitment that can cause investors to miss prime opportunities to crystallise their gains.

Risk management strategies

Given the inherent volatility and risks in the crypto-asset market, risk management is a critical component of any crypto-investment structure. Investors should consider a few key strategies:

Diversification

Diversification is essential to mitigating risk in the crypto-asset market. Instead of putting all funds into a single crypto-asset, investors can spread their exposure across multiple assets or investment products. For example, a portfolio might include Bitcoin, Ethereum, and stablecoins, along with a selection of other tokens.

It is now possible to buy into pre-packaged diversified crypto-investment products in the form of tokens, fund units or derivatives. However, investors would be wise to note that the price of Bitcoin still influences the prices of most crypto-assets. The market price performance of Bitcoin represents a systemic price volatility risk to the whole market.

Hedging

Hedging involves taking positions that offset potential losses in other parts of the portfolio. In crypto, this might include using options, futures, or other derivatives to mitigate downside risk. Investors may also consider holding stablecoins during periods of high volatility, reducing exposure to price fluctuations.

Security procedures

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Security is a top concern in crypto investments, especially for direct ownership. To manage this, investors must implement strong security protocols, such as using hardware wallets, multi-signature wallets, and ensuring proper custody for any private keys.

Regulatory compliance

The crypto market is still evolving, and regulations around crypto-assets are constantly changing. Ensuring compliance with local and international laws, such as the Financial Action Task Force guidelines and Anti-Money Laundering regulations, is essential for investors. Regulatory compliance is also vital for DeFi projects or crypto funds that want to operate globally without facing legal repercussions.

Custody solutions

Crypto-asset custody refers to the secure storage and management of digital assets. As crypto-assets are generally held in digital wallets, it is essential for investors to utilise secure storage solutions. This can include:

- **Self-custody:** Where investors manage their assets using private keys stored offline (cold storage).
- **Third party custodians:** Professional custodians offer insured, regulated, and institutional-grade storage solutions for large-scale investors.

Tax considerations

Crypto-assets are subject to varying tax regulations depending on the jurisdiction.

Investment structures must account for capital gains tax, income tax, or even wealth tax. Investors must understand the tax implications of their crypto holdings and consider strategies such as tax-loss harvesting or engaging with tax professionals who specialise in crypto-taxation.

Conclusion

Creating a robust crypto-asset investment structure requires careful consideration of the various elements, including the types of assets, investment vehicles, risk management strategies, and the security procedures that the investors are willing to adopt.

By understanding the main investment models - ranging from direct purchases to more sophisticated fund structures and DeFi strategies - investors can navigate the complexities of the crypto market while optimising for potential returns.

Due to the highly volatile and speculative nature of the crypto market, careful planning and professional advice are crucial in ensuring that crypto investments align with an investor's risk tolerance and long-term financial goals.

More information

Our crypto and digital asset team has extensive experience of working with cutting-edge technology businesses in this burgeoning sector which increasingly crosses into the capital markets space.

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We have the corporate and regulatory expertise to ensure our clients are well supported with the launch of their cryptocurrency businesses, or to raise funds through the issue of virtual tokens. We have advised on the launch of a number of virtual currency exchangers, crypto investment fund managers and funds, and international groups and clients on fundraisings, including raising funds through virtual token offerings.

If you are interested in setting up a crypto-asset investment structure, please do reach out to a member of the team highlighted on the right hand side of the screen.

For more information please contact:



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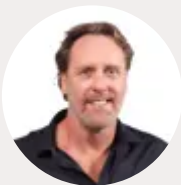
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