# Subscriptions in digital assets: what are the risks?

*Daniella Skotnicki, of Harneys, examines the inherent risks and challenges on subscriptions in digital assets*

Digital assets have grown exponentially in value over the past few years. The current market cap of all cryptocurrencies is estimated at $287bn by industry website CoinMarket Cap, with large numbers of investors holding substantial amounts of digital assets, often with only limited diversification in a few major cryptocurrencies.

Although, in the United States at least, there may be limited tax advantages in using digital assets to subscribe for interests in investment funds, it can be difficult from a practical perspective to convert large amounts of digital asset holdings to fiat currency. Investment funds offering investors the option to make their investments in digital assets have access to a broad pool of capital from an investor base which is familiar with the asset class.

The challenge for investment funds accepting subscriptions in digital assets is ensuring that the anti-money laundering and counter-terrorist financing obligations (AML/CFT) of the entity have been complied with, that the digital assets are appropriately valued and locating service providers who are willing to assist with this process and provide services to the fund. As a result of these challenges, many investment funds have decided not to accept subscriptions in digital assets; however, this prevents them from accessing a large pool of available capital.

This article generally considers subscriptions in digital assets to investment funds, however the same issues arise in respect of payments for tokens received in digital assets by an initial coin offering (ICO).

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## Compliance and digital assets

Cayman investment funds are subject to Cayman AML/CFT obligations. In order to comply with these obligations, funds must establish procedures to identify the subscriber, verify the source of funds received from investors and that funds are actually received from the subscriber's wallet.

The challenge with digital assets subscriptions is that, unlike a fiat transfer from a bank account, there is no name associated with the wallet from which the transfer can be made which can be easily verified by the receiving party and the transfer is not being made from a regulated financial institution.

Further, regulators worldwide are particularly mindful of AML/CFT when it comes to cryptocurrencies because of a widespread perception that the pseudonymous nature of cryptocurrencies allows criminals and terrorists to transfer and launder their assets.

If a subscription is received in fiat currency, the fund will generally receive a wire transfer from the subscriber's bank account. If the transfer originates from a regulated bank which is subject to anti-money laundering obligations, the fund can take some comfort that Know Your Client (KYC) checks on the subscriber have been performed and will confirm in the relevant wire details that subscription monies are from an account in the name of the subscriber. While the fund may still need to conduct their own KYC checks, the entity can take some comfort in respect of the source of the funds.

With digital assets subscriptions the verification of source of funds and matching them to the subscriber is currently much more complicated. The concern with cryptocurrencies is that, while the subscriber may fill out subscription documents and provide the fund with detailed KYC documentation, it is difficult to verify that the digital assets transferred to the fund are in the control of the subscriber.

The entity accepting the subscriptions, or a service provider appointed by the entity, will need to establish policies and procedures to verify the source of the digital assets to match to a subscriber in addition to conducting KYC checks on the subscriber.

The procedures employed will depend on the sophistication of the service providers' systems and may include: using software to trace the history of transactions on the blockchain to the initial bank transfer from fiat or the point at which the coin was mined (i.e. for BTC) and using that to imply a risk rating to the digital assets; ensuring ownership and


control of the wallet by requiring a live video link transfer from the subscriber's wallet; gaining read-only access to wallets and/or matching the details associated with the wallet to the KYC provided by the subscriber. The fund may also limit subscriptions to those from exchange provided wallets which are regulated and which have implemented AML procedures.

As the procedure available for each digital asset will vary, entities may limit subscriptions only to certain major digital assets such as ethereum and bitcoin while avoiding those digital assets providing secrecy such as monero or zash.

The challenge for entities is that few fund administrators have implemented these procedures and if they have, the fees associated with accepting subscriptions in digital assets are generally much higher than in respect of those in fiat. This is likely to change in the future as more software solutions are developed, become more widely available and less costly. Regulators and service providers will need to be comfortable that the solutions offered are as reliable at verifying the source of funds as a transfer from a regulated bank.

***As more solutions to the AML and valuation issues arise and service providers including banks and administrators become more comfortable with the solutions available, subscriptions in digital assets may well become more widely accepted***

## The difficulty in valuing digital asset subscriptions

Typically, the interests in an investment fund are priced in fiat currency, and the challenge is therefore in ensuring that the value assigned to subscriptions in kind is accurate and does not disadvantage the subscriber or other investors by over or under valuing the subscriptions. It is difficult to value cryptocurrencies because even if they are listed on exchanges, the value of the digital assets may vary across exchanges and there are hundreds of exchanges. The other issue is volatility and the value may vary significantly between the date of receipt and the effective subscription date.

The fund should ensure that they have clear policies for valuing the in-kind subscriptions outlined in the offering documents. These will very often be the same valuation policies applied to the fund generally.

## Is it worth accepting subscription in digital assets?

Despite challenges with accepting subscription in digital assets, implementing appropriate policies and procedures provides access to a much larger pool of capital which is currently underutilised. As more solutions to the AML and valuation issues arise and service providers including banks and administrators become more comfortable with the solutions available, subscriptions in digital assets may well become more widely accepted. HFM