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## Management of crypto investment funds

This communication focuses in particular on new parties entering the market who wish to apply for a licence as manager of an alternative investment fund in cryptos. In addition, the AFM would like to inform existing market parties who are currently active as exempt manager of an investment fund in cryptos or that intend to manage an investment fund in cryptos. Such because investment in cryptos and the management thereof involve considerable risks and any desired expansion of the existing product range with cryptos entails considerable additional management risks.

The AFM therefore wishes to be informed of this desired expansion at an early stage. An exempt manager is obliged to apply for a licence if the relevant threshold value of the assets under management is exceeded. The threshold value that applies to managers of open-ended investment funds is €100 million. In addition, a licence must be applied for if one of the other [conditions for exemption](#) is exceeded. A manager of an investment fund is required to comply with several important [requirements](#) (based on European regulations) in order to obtain a licence. These requirements are intended to protect, among other things, the interests of retail investors and to guarantee the proper operation of the market. No distinction is made in this connection between the various forms of investment.

### High threshold

The AFM considers it necessary to provide information because there are strong concerns as to whether managers of investment funds are able to comply with all of the licence requirements. These concerns are based on several factors, namely: the considerable growth in the interest among new market parties in performing these services combined with often limited knowledge about the applicable legislation. The consequence is ignorance about how supervision standards can be met in practice. The matters set out above, combined with the inherent characteristics of the current cryptos and crypto markets, mean that the AFM also has serious doubts whether the managers of investment funds that invest in cryptos are able to comply with the strict licence requirements.

### International context

The AFM issued warnings about [cryptos](#) and [ICO's](#) on previous occasions. The AFM does not stand alone in this. Supervisory authorities all over the world (such as the [SEC in the United States](#), the MAS in Singapore, and the FCA in the United Kingdom) also see risks. Main concerns are: a lack of transparency, manipulation, defective valuation, fraud and the use for other forms of criminal activity.

In view of the highly global nature of these developments the AFM advocates international coordination in both a European and international connection. This coordination concerns the

qualification of cryptos and ICO's, the risks, the applicable statutory regimes and any new regulations to be developed.

## Management of investment funds in cryptos investment fund

The AFM has formulated several questions concerning the main subjects. The manager must be able to answer these questions satisfactorily before a manager of an investment fund that invests in cryptos submits a licence application or is able to obtain a licence. Naturally, all other [licence requirements \(in Dutch\)](#) must be satisfied as well.

### Liquidity management

The [AIFMD](#) lays down rules in order to ensure that investors in investment funds are actually able to subscribe and redeem if these investment funds provide for this option. A manager is required among other things to align its liquidity management with the investment strategy, the liquidity profile and the redemption policy. The manager is required to satisfy additional requirements if a investment fund has a redemption obligation (an open-ended investment fund). Pursuant to the AIFMD, a manager has to maintain sufficient liquidity in order to be able to comply with its redemption obligation among other things. The AFM has the following questions in this connection:

- How does a manager ensure that its policy provides that the investment fund maintains sufficient liquid assets in order to comply with (mandatory) requests to redeem?
- How does a manager of an investment fund assess the liquidity of investments in cryptos?
  - How are the volatility and trade volume of cryptos weighed in this assessment?
  - How is the volatility of cryptos handled between the moment an investor requests to redeem and the moment of actual redemption?
  - How is the price impact of a large order as a result of the fragmentation in the crypto markets taken into account in this assessment?
- How does a manager conduct stress tests in both normal and extraordinary liquidity circumstances that enable it to assess the liquidity risk of the investment fund?

### Valuation

An accurate valuation of the intrinsic value of units or shares in an investment fund and the assets of an investment fund are important to be able properly to assess the performance of an investment fund. For investment funds subject to a redemption obligation, a sound valuation forms the basis for the price at which investors can subscribe and redeem. In addition, a sound valuation means that the performance of an investment fund becomes measurable. That is why the AIFMD devotes a great deal of attention to valuation. The AFM has the following questions and concerns about the establishment of an adequate valuation policy by the manager of an investment fund in cryptos:

- How and what valuation policy is established by a manager? A valuation policy must be appropriate, transparent and consistent. It is based on independent sources of price-determination and market data.
- How does a manager implement its valuation policy with appropriate, transparent and consistent procedures so that the assets are valued accurately and at fair value?
  - How is the (considerable) volatility of cryptos accounted for in this connection?
  - How is the fragmentation of the crypto markets accounted for in this connection?

- How are cryptos valued in the absence of independent data and/or transactions or, in other words, how does a manager ensure that the assets in the form of cryptos are valued fairly and accurately?
- How is a fair valuation ensured in view of the unregulated status of the crypto markets?
- How is the risk of manipulation within the crypto markets accounted for in the valuation of the assets?

## Depository

The AIFMD provides for the appointment of an independent depository who supervises several aspects of the management of an investment fund. Before it can be determined what tasks and responsibilities depositaries have with respect to (participants in) investment funds in cryptos, it must first be determined how these cryptos should be classified. This will have to be determined for each individual crypto, because depending on its characteristics it concerns a financial instrument or other assets as referred to in Article 21 (8) AIFMD. This qualification is decisive for the question of which rules apply to the depository when performing its tasks.

Several questions and/or concerns on the part of the AFM concerning the depository's performance of its tasks are:

- Is it possible to hold cryptos that qualify as financial instruments in a financial instruments account as referred to in Article 21 (8)(a) AIFMD?
  - If so, how is the delegation of depository tasks to third parties handled?
  - How can reconciliations be performed on a regular basis by the depository/delegate?
- How is verified that the investment fund or the legal owner pursuant to Section 4:37j Wft is the (exclusive) owner of the cryptos?
- How can a depository ensure that there are procedures that guarantee that the cryptos cannot be assigned, traded or transferred without the depository having been informed of this?
- Does a depository have direct access to documents that substantiate every position and transaction of an investment fund concerning cryptos if these are held with third parties (wallet providers)?
- How does the depository comply with its valuation obligations, also in view of the questions raised above, arising from Article 19 AIFMD and Article 94 [AIFM Regulation](#)?

## Product approval and review process

If a manager of an investment fund offers units or shares in an AIF to non-professional investors, such a manager is required to have a [product approval and review process](#) in place. This means that it applies adequate procedures and measures that guarantee that the interests of customers are taken into account in a balanced manner during the development of the financial product.

The procedures and measures should ensure among other things that the target group of the product is defined. The intended aim of the target group is analysed and described in this connection. It is also described for which group the product is not suitable.

In addition, analyses must be performed in which the operation of the product in various scenarios is determined and from which it is evident that the product does not harm the customer's interest. Product information and distribution must also be aligned with the target group. Requirements concerning the product development process depend on the complexity and impact of the financial

product. In view of the complexity of investment in cryptos, we expect that the following questions are answered in detail during the product development process:

- What is the target group and what is the intended objective?
- For which group of customers is the product not suitable?
- What scenarios were analysed and how is it ensured that the product complies with the intended objective in the various scenarios and does not harm the interests of the customer?
- How are the information and distribution aligned with the target group?

## **AML**

The manager of investment funds must also comply with the requirements of the Money Laundering and Terrorist Financing (Prevention) Act (Wwft). These requirements apply irrespective of whether the manager is active under the licence regime (Section 2:65 Wft) or under the regime that applies to exempt managers (Section 2:66a Wft). This means that a manager who is exempt from the obligation to hold a licence must also comply with the Wwft.