MASON HAYES & CURRAN

The Evolution of Digital Asset Exposure in Irish Investment Funds

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Crypto assets in a high-interest-rate world

Many market commentators had viewed crypto assets including crypto currencies as a traditionally speculative asset class which would only survive in a ‘risk-on’ environment. However, analysts have noted the resilience of established digital coins. Bitcoin in particular has continued to perform steadily despite repeated increases in interest rate levels since March 2022.

In the US, the options for investors seeking to obtain exposure to Bitcoin and Ethereum, the two largest crypto currencies by market capitalisation, have gradually grown. Initially, many investors purchased crypto currencies directly from exchanges. Subsequently, the SEC approved ETFs investing in Bitcoin and Ethereum futures. At the beginning of 2024, the SEC approved the first batch of ETFs directly investing in Bitcoin. More recently, spot Ethereum ETFs began trading in the US in July of this year. In the case of spot Ethereum ETFs, these products are not permitted by the SEC to engage in any ‘staking’ which would involve generating a yield by locking up underlying Ether holdings for a specified period of time.

The current state of play in the Irish market

When considering exposure to digital assets, the Central Bank of Ireland distinguishes between:

1. Tokenised traditional assets where the value is linked to an underlying traditional asset or a pool of traditional assets, such as financial instruments or commodities, and
2. Other digital assets that are based on an intangible or non-traditional underlying

The Central Bank has issued guidance for those digital assets which are based on intangible and non-traditional underlying assets, which includes crypto currencies.

Qualifying investor alternative investment funds

Qualifying investor alternative investment funds, or QIAIFs, can usually avail of a fast-track one-day regulatory approval process in Ireland. Pre-approval submissions are required by the Central Bank only for a limited cohort of QIAIFs with specific exposures. Subject to certain additional requirements which are primarily placed on the relevant alternative investment fund manager, closed-ended/limited liquidity

QIAIFs and open-ended QIAIFs can obtain indirect exposure to crypto assets of up to 50% and 20% of net assets respectively without having to go through any additional Central Bank pre-approval process. QIAIFs which intend to take indirect exposures above these thresholds need to make a pre-approval submission to the Central Bank.

A proposal to hold crypto assets directly would require a pre-approval submission to the Central Bank. The Central Bank has stated that it will not permit direct exposure to digital assets until such time as it is demonstrated to the Central Bank that a depositary can meet its obligations under AIFMD to provide custody or safe-keeping services for these assets. In addition to the Central Bank's focus on depositaries' safekeeping obligations for directly held crypto assets, depositaries can similarly have concerns from a safekeeping perspective depending on the operation of the digital 'wallet' which would store the crypto assets. Digital wallets which are held offline, often referred to as 'cold' wallets, may prove safer but operationally a fund holding crypto assets directly may have to connect a wallet to the internet from time to time in order to fund redemptions.

UCITS / Retail Investor Alternative Investment Funds (RIAIFs)

The Central Bank does not currently permit direct or indirect exposure to crypto assets in UCITS or RIAIFs.

While direct and indirect exposure to crypto assets in Ireland is not permitted through either UCITS or RIAIFs, these funds can still gain exposure to companies involved in the broader crypto asset ecosystem. For example, subject to the standard eligibility requirements, UCITS and RIAIFs can purchase traditional shares or fixed income instruments which issue from crypto miners, exchanges or other similar entities to provide a level of indirect exposure. This is similar to the approach taken for other asset classes including private equity where UCITS or RIAIFs can purchase shares in listed private equity managers to provide a level of exposure to the private equity market.

More recently, the European Securities and Markets Authority (ESMA) has issued a Call for Evidence as part of its review of the Eligible Assets Directive[1] (EAD). The EAD provides a framework for determining the eligibility of assets for UCITS products. There has been significant innovation and development in financial products and securities since the inception of the EAD in 2007, particularly in the digital asset space. ESMA's focus in reviewing the EAD is to push for a consistent approach across the EU where differing interpretations between national regulators has led to some fragmentation and inconsistent approaches in determining the eligibility of certain asset classes for UCITS. Interestingly, part of the Call for Evidence focuses specifically on direct and indirect exposures to crypto assets. However, it remains to be seen how ESMA will respond to feedback from industry on crypto asset exposure in UCITS products noting the focus of the UCITS regime as a retail framework.

Comment

While QIAIFs in Ireland can already access indirect exposure to crypto assets within certain thresholds without delaying the fast-track approval process, the regulatory landscape remains complex and evolving. Given the strong international brand name of the UCITS product, it will be interesting to see the output from ESMA following the completion of the Call for Evidence on the EAD. For asset managers and investors, staying informed of these regulatory shifts is crucial for navigating opportunities in the digital asset space. As the market continues to mature, strategic decisions made today could shape your competitive edge in this rapidly changing environment.

For more information and expert advice, contact a member of our Investment Funds team.

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[1] Commission Directive 2007/16/EC on UCITS eligible assets.