

Maltese crypto funds

Joseph Ghio and Josianne Brimmer, of Fenech & Fenech Advocates, discuss crypto funds and Malta

There is little doubt that the past two years have seen an ever-increasing interest in all aspects of the fintech and blockchain industries across the globe. While it remains difficult to discern banks' and institutional investors' outlook on investments in crypto assets amid often conflicting statements and gratuitous predictions and warnings, the fintech industry has experienced a sharp growth, with billion dollar M&A and VC deals being closed in the first half of 2018, and large players, particularly in the digital payment services and peer-to-peer payment fields, attracting hundreds of millions by way of investment.

Crypto assets however remain a controversial investment class at best. JP Morgan Chase's CEO Jamie Dimon's dooming declaration in 2017 that bitcoin "is a fraud" did not stop the biggest bank in the US from hiring a new head of crypto-assets strategy only a few months later despite clear evidence that the rally of the price of bitcoin and other virtual currencies may have been textbook bubble. Indeed, there has been no shortage of excitement in this sector.



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But make no mistake – institutional money is following the evolution of crypto assets very closely and has no qualm about the fact that blockchain technology is changing their world and making it imperative for them to adapt to survive. Until crypto assets, a notoriously moving target that is however here to stay, are adequately regulated, noticeable investments by institutions and banks are bound to be restricted to mere scouting, purely speculative forays. Large investors remain concerned that absent a clear regulatory framework, virtual currencies will remain too volatile for their risk appetites.

Regulation will take time to develop and will likely remain in a constant state of flux as legislators strive to catch up with developments in the blockchain space. The prime driver of this rulemaking process will not change, however, and remains the same focus that has shaped financial services regulation in its earliest forms. The protection of investors, big and small, is the principal, albeit not only, threshold to be crossed before virtual currencies and other crypto-assets stop being a niche asset class.

Malta has been proactive and innovative in this respect and has introduced, in October 2018, a new suite of laws to regulate the so-termed 'virtual financial assets', distinguishing them from traditional financial instruments but designing a regulatory framework that, to a large degree, clones that already in place throughout the European Union under Mifid II. Under the new regime, the Malta Financial Services Authority (MFSA) now regulates both initial coin offerings and providers of services relating to virtual financial assets, earning Malta the moniker of 'Blockchain Island'.

Protection, integrity, soundness

Investor protection, as well as market integrity and financial soundness, in the context of collective investment schemes investing in virtual currencies, also led the MFSA to introduce new rules in early 2018 imposing supplementary licence conditions on funds investing directly or indirectly in this emerging asset class. Institutional investors seeking exposure to virtual currencies can now do so through Professional Investor Funds (Pifs) that are subject to specific requirements and standards addressing matters such as the competence of the parties involved, quality assessment and valuation of investments and risk management.

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Pifs are collective investment schemes licensed by the MFSA which are allowed to accept investments only from qualifying professional investors, broadly categorised following the definition of professional clients under Mifid, with minimum investment threshold in the fund of €100,000, among others investment experience and eligibility requirements.

Under Maltese rules, Pifs investing in virtual currencies can be set up and licensed as open-ended investment companies with variable share capital or closed-ended investments companies with fixed share capital, in each case governed by a board of directors that must have the knowledge and experience in information technology, notably distributed ledger technology and its application in the field of virtual currencies. This competence test is also extended to the service providers of the fund including the manager, administrator, custodian, compliance officer, money laundering reporting officer and auditor. The manager,

or the scheme itself in the case of self-managed funds, is required, among others, to set-up a dedicated in-house investment committee composed of at least three members, one of whom must satisfy the MFSA's competence requirements relating to virtual currencies.

The manager is also responsible to conduct duly documented quality assessments through appropriate research into the underlying virtual currencies, before the fund or special purpose vehicles controlled by the fund can be allowed to have an exposure to virtual currencies. The applicable Investment Services Rules issued by the MFSA require such quality assessment to take into account, among others, the investors and the issuers as applicable, the protocols and underlying technology infrastructure, the availability and reliability of information and the providers thereof, the service providers involved and the exchanges on which the virtual currencies are traded.

Risk management is another focus area of the Maltese rules for crypto funds requiring the manager, or the scheme itself if self-managed, to implement an appropriate, documented and regularly updated quality assessment process according to the investment strategy, objective and risk profile of the fund. The manager must also ensure that the risks associated with each investment position and the overall effect on the fund's investment portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures.

The fund would also be subject to liquidity management requirements to enable liquidity risk to be monitored and to ensure that the liquidity profile of the investments in virtual currencies by the fund comply with its underlying obligations, including with respect to the fund's redemption policy. For this purpose the fund would impose on the manager the obligation to conduct regular stress tests, under normal and exceptional liquidity conditions, with the periodic intervals determined on the basis of the nature, scale and complexity of the

investments in virtual currencies undertaken by the fund.

Maltese Pifs investing in virtual currencies are also subject to additional verification and valuation obligations that can be performed either by the manager or by an independent external valuer. The rules provide that the person responsible for the verification and valuation function must have the business organisation, systems, experience and expertise necessary to conduct the required verifications and valuations.

The protection of investors is further augmented by imposing on the fund the requirement to include in its offering documentation-specific risk warnings in respect of the proposed direct or indirect investments in virtual currencies.

Approachable and pragmatic

Testament to the high value which the regulator places on market soundness and investor protection, is the imposition by the MFSA on promoters interested in setting up funds investing in virtual currencies of a mandatory preliminary meeting between the said promoters of the fund and the Authorisations Unit of the MFSA in advance of a formal licence application being submitted. This obligation echoes one of the hallmarks of the success of Malta as an international fund domicile – the approachable and pragmatic disposition of the MFSA that is ever willing to entertain discussions with promoters from the earliest stages of incubation of a new fund project, while at the same time remaining a steadfast champion of market integrity and investor protection.

As part of the public consultation process leading to the issue of the new licence conditions applicable to Pifs investing in virtual currencies, the MFSA had also announced that similar rules would be introduced to other fund typologies such as Alternative Investment Funds and notified Aifs.

Such a move would further consolidate Malta's position as the jurisdiction of choice for funds – assisting promoters to bridge the gap between traditional investment vehicles, and the innovations demanded by the digital age. HEM