INSIGHTS

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STRONG FOUNDATIONS

INSTITUTIONALISING CRYPTO, FROM CUSTODY TO COMPLIANCE

EXECUTIVE SUMMARY

"Institutionalisation" has been a key aim for the digital assets sector since bitcoin and other cryptocurrencies started to make an impact on Wall Street a decade ago. In this Hedgeweek report we examine a series of key operational topics at the heart of crypto's quest to become part of the financial mainstream.

The report zeroes in on two central issues. Section one focuses on issues of custody, while section two provides an update on the regulatory situation, all underpinned by data-driven findings based on a survey of the Hedgeweek audience and exclusive insights from leading managers in the sector.

What are the buyside's key priorities when it comes to crypto custody? What about prime services? Is the regulatory outlook becoming more positive? All of these questions and more will be explored in this report, sponsored by BitGo, designed to provide industry practitioners with informed insights and useful context to help navigate the next phase of growth. We hope you find the findings in this report valuable.

WILL WAINEWRIGHT
HEAD OF HEDGE FUND RESEARCH

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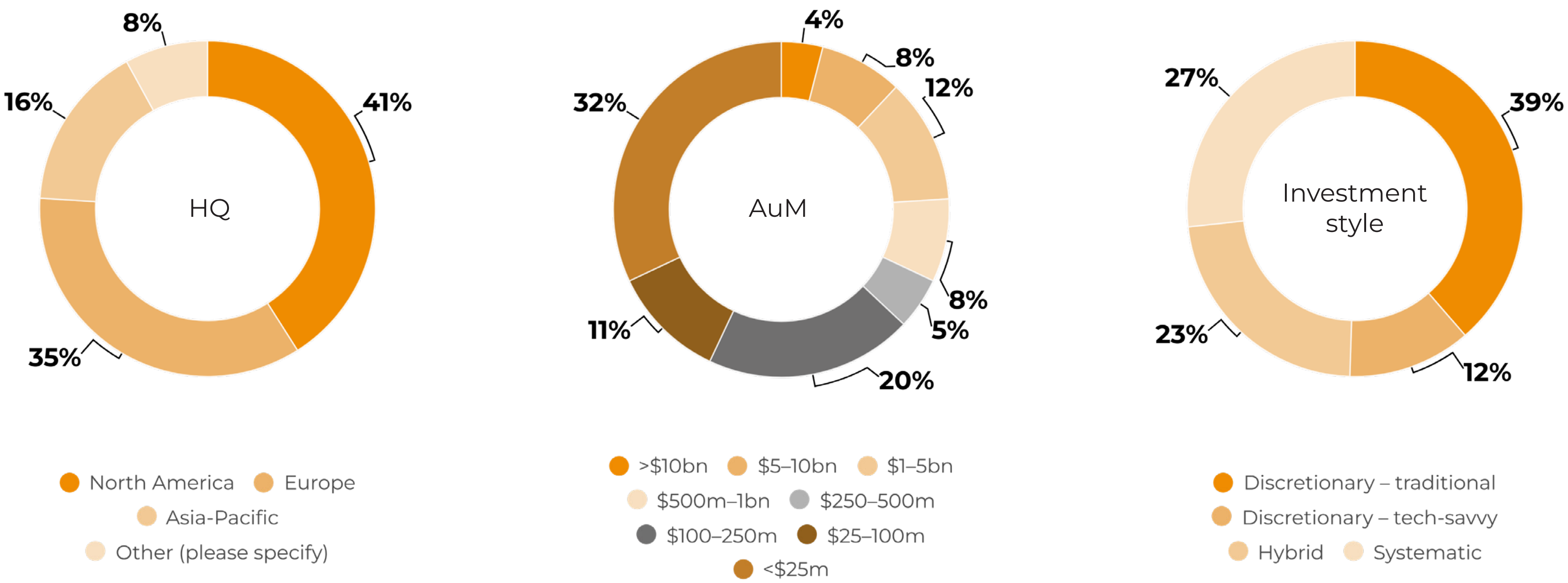


METHODOLOGY

A key source of data in this report is the results of Hedgeweek's hedge fund manager survey conducted in Q3 2024. Further insights in this report were gathered during interviews in April and May 2024 with named and unnamed industry sources, and additional third-party research and intel.

KEY FINDINGS

1

Regulated custody is seen as pivotal

Having a regulated custodian was seen as the biggest priority for firms considering the question of crypto custody, followed by security and the ability to trade from cold custody. Having a regulated custodian was seen as the "baseline" by one American crypto hedge fund manager. Another said it was necessary but not sufficient, with a whole series of further checks required before selecting a custodian.

2

Managers review custody choice annually

More than half of Hedgeweek's survey respondents said they reviewed the pick of custodian annually. One manager said this was the industry "gold standard" practice. Sources said using multiple custodians was now common in the industry to meet different technological demands and also for reasons of counterparty risk.

3

Crypto sector awaits institutional rush

Managers see inflows into the crypto space continuing, though the major institutional rush is yet to come. One saw bitcoin's recent price high a bullish signal. A second, Peter Habermacher of Aaro Capital, told Hedgeweek: "It takes time for institutional investors to approve new products. Over the next two years, we would expect significant inflows through Morgan Stanley and other intermediaries."

4

US plays regulatory catch-up

Regulatory news, particularly in the US, is regarded as more positive than it has been for years after this year's SEC approvals, the passage of a bipartisan bill establishing a new crypto framework and the prospect of a new president replacing Joe Biden. "Regulatory uncertainty" was seen as the biggest operational risk to continued growth in the space – narrowly ahead of fraud risk – making progress imperative.

GETTING IT RIGHT

Custody is a critical issue in the digital assets sector as it continues its quest towards institutionalisation. This section brings together buyside perspectives on the current state of play.

Charles Adams, who works in investor relations at London firm Nickel Digital Asset Management, has witnessed a sea change in custodian approaches since he entered the industry more than a decade ago.

"When I got into the space in 2013 there were no regulated custodians, now we have a huge choice," he tells Hedgeweek. That choice ranges from crypto-native organisations to traditional financial institutions increasing their offering in digital assets.

"The custodian space has seen a lot of change in the post-FTX world; the innovation and the competition have been fierce. There is not a day that goes by that we are not thinking about custody and what's the next step? How can we improve our solution?"

That sentiment is not unique in the space, with custodians – which safeguard crypto assets on behalf of managers – occupying a critical role in a sector which has faced issues over trust and transparency.

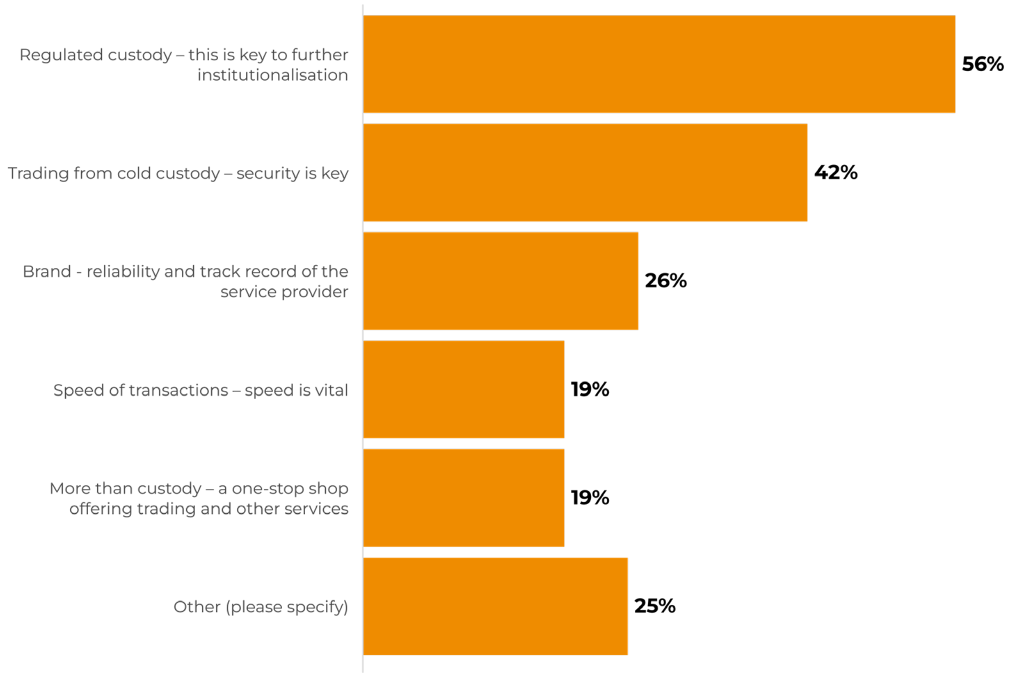
It is therefore unsurprising that for more than half of the industry (56%), working with a regulated custodian is a key priority (see Fig. 1.1).

"If custodians are not qualified or regulated, we will not use them — that's our baseline," says Adam Guren, founder and CIO of Hunting Hill Global Capital in New York.

"When it comes to security, there are distinct issues to consider. First, there's the risk of an affiliated entity; if the custodian entity is not bankruptcy remote, it won't work for us, and we would categorise that under the security risk of the asset. Separately, we examine the technology involved in security."

Security is seen as the second-highest priority in crypto custody, picked by 42% (up to three selections were permitted).

Fig. 1.1 How do you perceive crypto custody - what are the top priorities (select up to three)?



Source: Hedgeweek Hedge Fund Manager Survey Q3 2024

"Regulated custody is a necessity, but not sufficient," adds Peter Habermacher, CEO at Aaro Capital. "It gives managers and their investors, particularly institutional investors, comfort that providers are following rules and meeting a minimum set of required standards.

"But it's still very important for us and other institutionally minded firms to really understand the custody process from start to end – examining potential weaknesses and the technological and legal chinks in the armour that could cause a problem. If there's one little bug undermining the system, a custodian can be regulated as much as they want but it is not going to help much if someone exploits that."

Brand and track record of the service provider (26%) and speed of transactions (19%) were also key priorities. But speed "shouldn't come at the expense of checks needed to ensure that transactions have been properly authorized," says Habermacher. "If it isn't properly authorized, it's much harder to undo the transaction on a blockchain."

In crypto, if the recipient who you've incorrectly transferred to does not want to send it back, it's much harder to reverse the transaction – there's not a bank that can act on a sender's behalf to do this, even with a court order. "If you're a high frequency trader, then trading from custody is usually the best option. But for security reasons, having fast assets does present more risks for fraud."

Most of the industry (57%) evaluates their custody option once a year. Many of the bigger

Everybody prefers to have a regulated custodian. It’s about knowing not only that your assets are secure, whether it’s through cold storage or not, but that you’re regulated and audited.

Brett Reeves
Director, Head of Europe Sales, BitGo

digital asset managers use multiple providers for different purposes, and also to reduce the counterparty risk (akin to the rise of the multi-prime model in the hedge fund industry after the 2008 financial crisis).

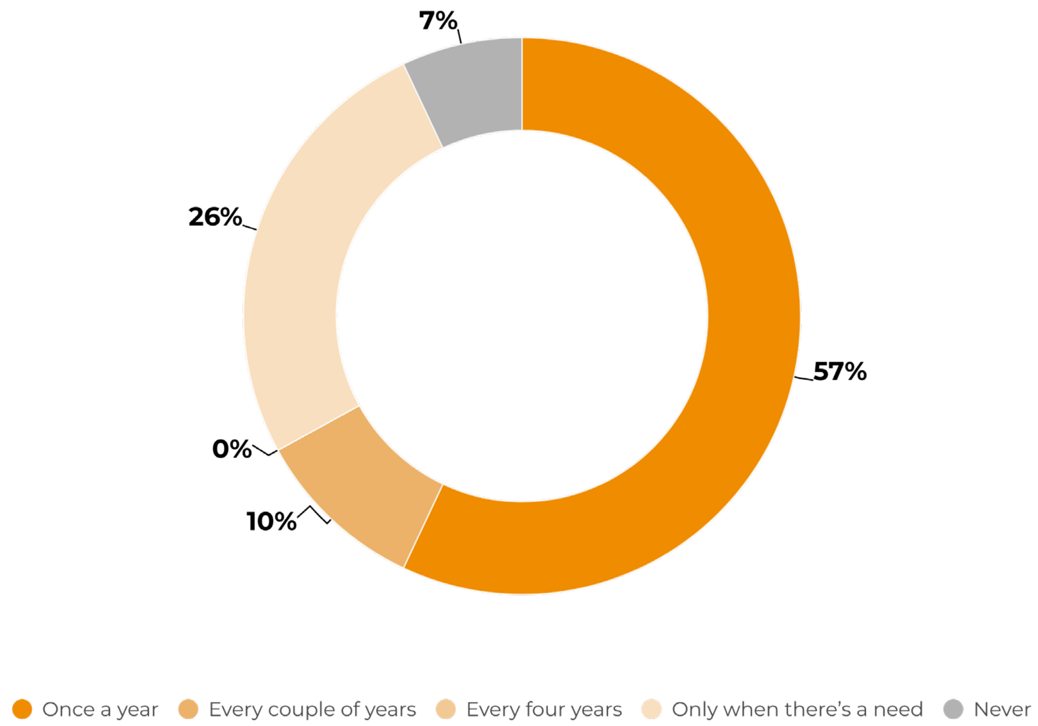
Peter Habermacher describes an annual review as the "gold standard" industry practice. "When assessing a custodian, it is important to understand the process from a technological perspective and the verifications involved," he says.

"Are there ways in which it can be exploited by a rogue agent or someone just trying to get access to the funds? If things go wrong, the decision-maker is going to be asked more questions if it is a small start-up compared to an established brand name, which is another reason why firms plump for the bigger names.

For Adam Guren, custody review is continuous and based on usage (in contrast to the service provider checks on functions like cybersecurity and audit which happen annually). "We tend to be a "sticky" client when it comes to custody because the friction involved in onboarding and off-boarding is significant," he says.

"Our evaluation questions are things like: What does the cold storage setup look like? How are transfers handled securely? Another, albeit lower priority, is auditing the financials of the firm and understanding how cybersecurity is embedded in their processes and controls. This is something we evaluate for all our service providers, not just custodians."

Fig. 1.2 How frequently do you evaluate your custody solution?



Source: Hedgeweek Hedge Fund Manager Survey Q3 2024

KEY FINDING

Regulated custody is key issue for all sizes of firm – but other priorities differ

Top three crypto custody priorities, for $500m-plus firms:

1ST
Regulated custody – this is key to further institutionalisation

2ND
More than custody – a one-stop shop offering trading and other services

3RD
Trading from cold custody – security is key

Top three crypto custody priorities, for sub-$500m firms:

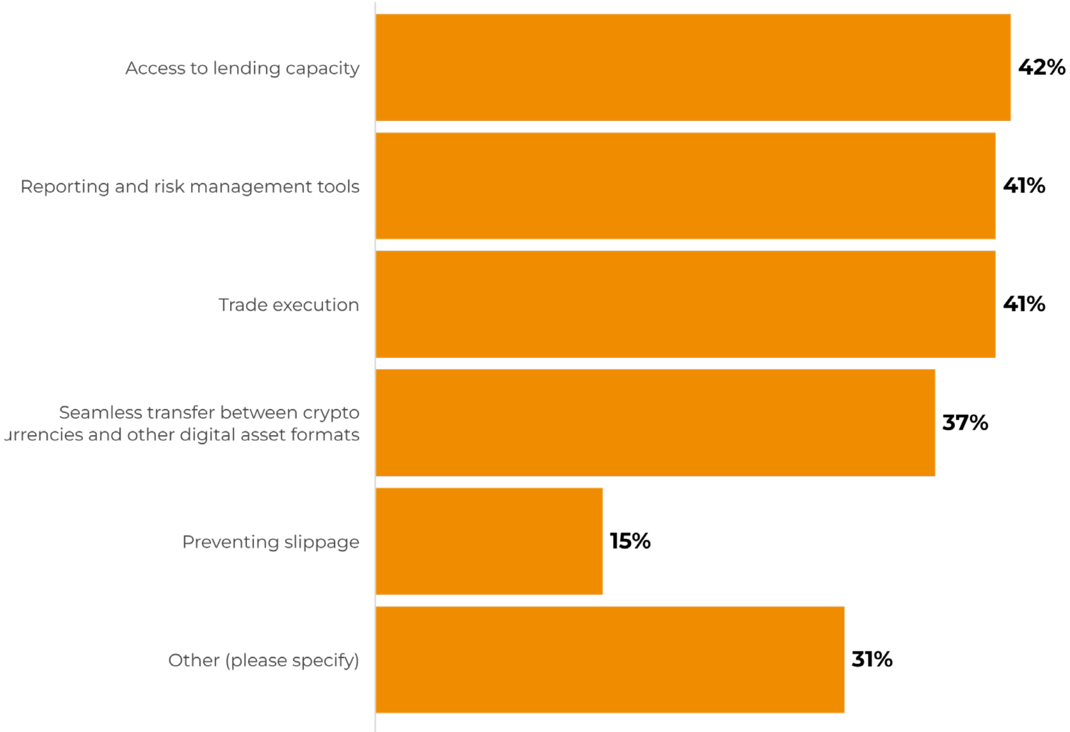
1ST
Regulated custody – this is key to further institutionalisation

2ND
Trading from cold custody – security is key

3RD
Brand - reliability and track record of the service provider

Source: Hedgeweek Manager Survey Q3 2024. Respondents could pick up to three options.

Fig. 1.3 Prime services in the digital assets space – what are the top priorities (select up to three)?



Source: Hedgeweek Manager Survey Q3 2024

The Hedgeweek audience was also asked for their views on prime services in digital assets, another quickly developing area (see Fig. 1.3). Access to lending capacity was a priority for 42%, the most popular answer, closely followed by reporting and risk management tools; and trade execution (both 41%) and seamless transfer between cryptocurrencies and other digital asset formats (37%).

Responses selecting "other" highlighted low fees, cap intro liquidity and trade optimisation.

Providers in the crypto space typically providing a Direct Market Access solution with some limited financing capabilities, explains Brett Reeves, Director, Head of Europe Sales, at BitGo.

"We predominantly focus on secure trading access, liquidity provision and then borrowing and lending. It perhaps looks more like a securities financing business in the traditional markets.

"Risk management is so important because if we're lending out our assets, we need to make sure that they are secure. The lack of risk management has been very harmful in the digital asset industry in the last two years."

> When assessing a custodian, it is important to understand the process from a technological perspective and the verifications involved.

Flows update

The acid test of "institutionalisation" will be the extent to which large institutions start backing the sector with material inflows.

Peter Habermacher, Aaro Capital CEO, says July was particularly strong in terms of crypto ETF flows and on stablecoin flows as well. "The long-term holders of bitcoin have swung heavily towards accumulation again, which is positive," he says.

"So there's money flowing back into crypto. But it takes time for institutional investors to approve new products. Over the next two years, we would expect significant inflows through Morgan Stanley and other intermediaries."

Adam Guren, founder and CIO of Hunting Hill Global Capital, concurs. "Bitcoin recently reached its all-time high, which is a strong bullish signal. If more institutions enter the market now, there's considerable potential for further growth and positive price action."

FINDING A FRAMEWORK

Regulatory uncertainty is seen as the biggest risk to continued expansion in the digital asset fund sector, but there is increased hope the US is improving its approach.

The SEC's approval of spot bitcoin ETF trading at the start of this year was widely seen as reluctant acceptance, given the regulator's approach to crypto in recent years. But it was followed by an ethereum equivalent over the summer, and there is hope surrounding various regulatory and legislative developments which could herald an improvement in America's attitude to digital assets.

That would be very welcome, given the sector's view that regulatory uncertainty is the operational factor posing the biggest risk to continued expansion in the digital asset fund sector (picked by 32%, see Fig. 2.1). Given the sector's negative incidents and issues with bad actors, the fact it was narrowly ahead of fraud risk (picked by 31%), is significant.

Regulatory uncertainty has been most focused in the US, which has been regarded as taking a more critical and less amenable approach than many key jurisdictions elsewhere in the world. "The SEC has tried to regulate using existing powers, a very different approach to pretty much every other country that has brought in crypto-specific regulations," explains Peter Habermacher, Aaro Capital CEO.

"But now there is a bill moving through Congress with bipartisan support which will provide a decided piece of regulation and more certainty."

That bill – the Financial Innovation and Technology for the 21st Century Act – is moving forward against the backdrop of a presidential race between Donald Trump, who has spoken positively towards the industry, and Kamala Harris, who is expected to take a less critical perspective than Democrat incumbent President Biden.

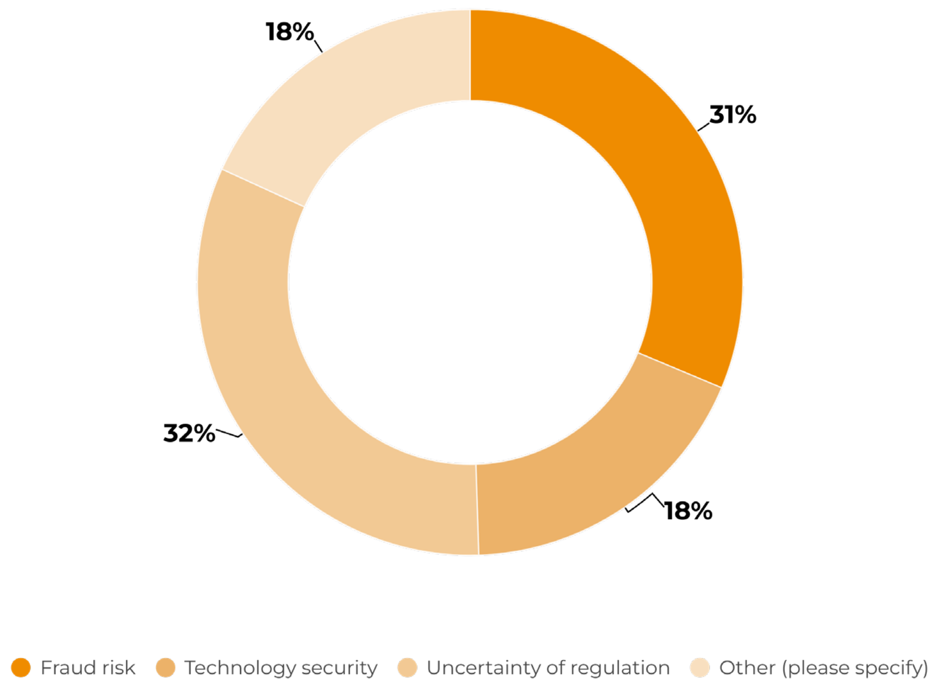
"I believe the Biden administration has taken a very anti-crypto stance, and it seems much of the industry has placed its hopes on Trump. However, what we really need is a bipartisan regulatory framework that supports the industry or at least provides the clarity that is currently lacking," says Charles Adams of Nickel Digital Asset Management.

"Whatever the outcome, it seems likely to be an improvement over the past four years. One of the first calls made by Vice-President Harris's campaign officials was to Mark Cuban with questions about crypto policy, this is a good sign."

"There's certainly a more optimistic regulatory outlook in the United States than we've seen in years, if ever," adds Adam Guren, CIO of Hunting Hill Global Capital.

"The bill currently moving through Congress is positive, as is the fact that we'll have a new president soon, regardless of party, and potentially a change in leadership at the SEC. These developments should bring more regulatory clarity over the next 6 to 12 months. The US outlook has been improving throughout the year, particularly since the introduction of the Bitcoin ETF."

Fig. 2.1 Which operational factor poses the biggest risk to continued expansion in the digital asset fund sector?



Source: Hedgeweek Manager Survey Q3 2024.

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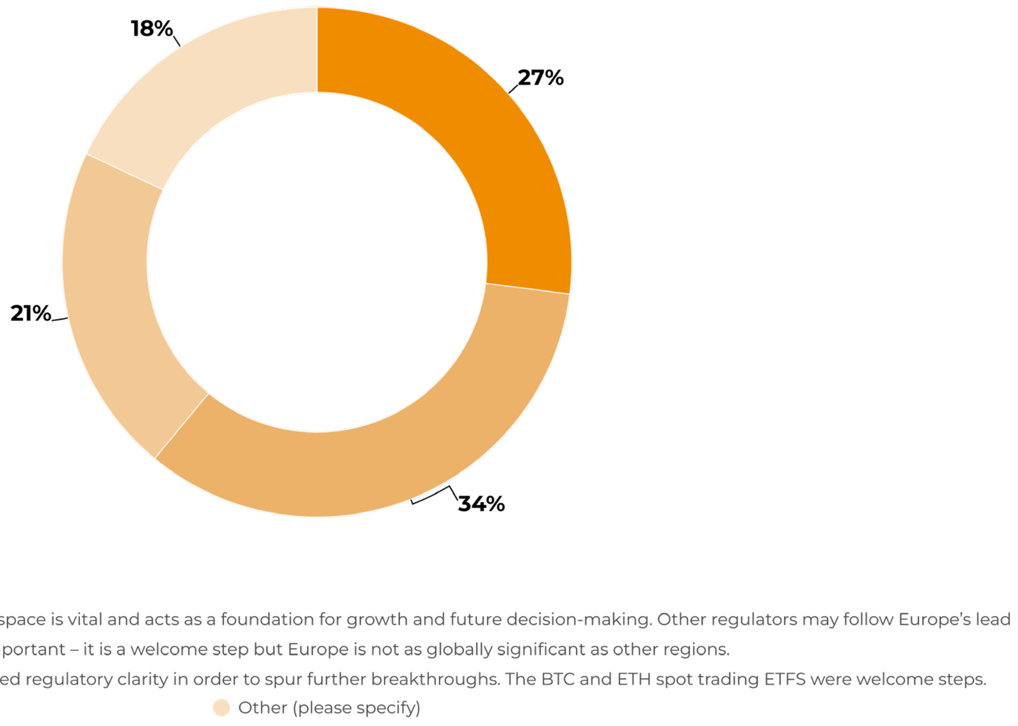
What we really need is a US bipartisan regulatory framework that supports the industry or at least provides the clarity that is currently lacking.

Charles Adams
Investor Relations, Nickel Digital Asset Management

Fig. 2.2 How significant is the Markets in Crypto Assets Regulation (MiCA) introduced by the European regulator?



Source: Hedgeweek Manager Survey Q3 2024

Charles Adams of Nickel believes it is only a matter of time before the US catches up with the rest of the world. "As the largest capital centre in this industry, the US has a last-mover advantage, allowing it to observe which regulations have been effective and which have not," he says, noting that the sector now has some influential supporters drawn from the more traditional side of Wall Street.

"I used to call Michael Saylor bitcoin's chief salesman, it seems to have moved to Larry Fink. If I was going to have one person out there beating the crypto drum, it would be him given the scale of the institution he runs and his links on Wall Street."

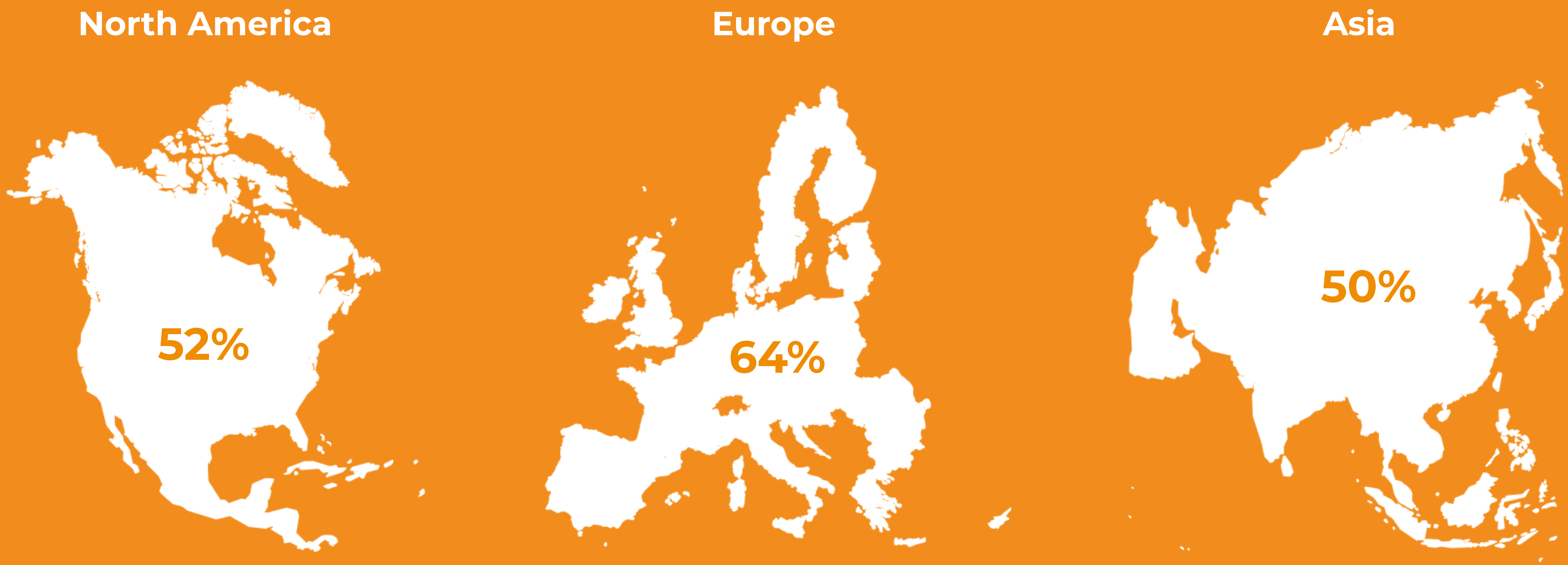
Though European jurisdictions have already proved more open to the sector, progress continues, with the Markets in Crypto Assets Regulation (MiCA) being introduced by the EU. More than three-fifths of respondents (61%) termed this either a very or fairly important step (see Fig. 2.2). For 27%, it was very important since "regulatory clarity in this space is vital and acts as a foundation for growth and future decision-making – other regulators may important Europe's lead."

For 34% it was fairly important, due to the EU's limited influence compared to the US, but only 21% judged it not important. One respondent judged it important but commented that its efficacy will come down to whether future changes are made so regulations remain appropriate over time, and whether other countries adopt similar or the same measures.

KEY FINDING

European crypto managers more likely to review their custodian annually

Percentage of respondents saying they evaluate your custody solution on an annual basis:



Source: Hedgeweek Manager Survey Q3 2024

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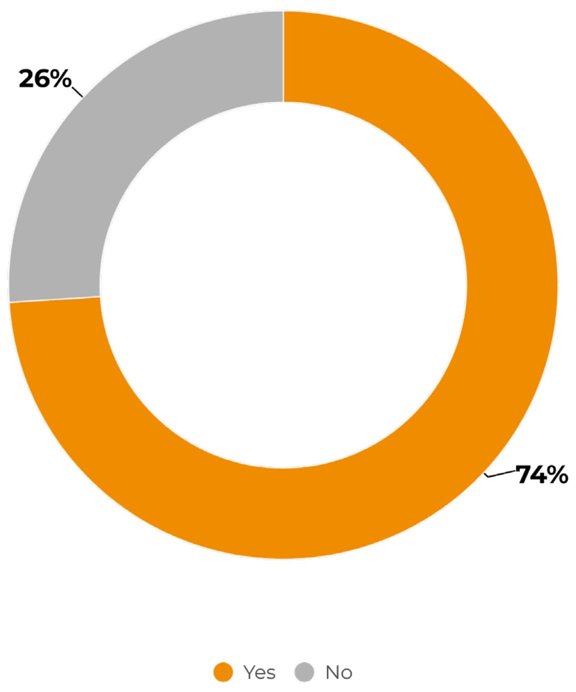
"The truly optimistic scenario would be an international race to the top in terms of crypto regulatory frameworks, where the industry in each country is encouraged with incentives rather than penalties," says Adam Guren of Hunting Hill Global Capital. "The US has some catching up to do in this area compared to other jurisdictions around the world."

Other issues in the space remain live talking points. The Hedgeweek audience was asked if there was an issue being an exchange and custodian simultaneously, with 74% in agreement. Conflicts of interest risk was seen as high. "They can have the same parent, but the underlying legal entities (and assets) need to be segregated," pointed out one respondent.

Fig. 2.3 Is there an issue being an exchange and custodian simultaneously?



Source: Hedgeweek Manager Survey Q3 2024

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Director, Head of Europe Sales, BitGo

How do buyers assess priorities when selecting a custodian?

Different segments of buyers have different priorities when it comes to custody. A miner, not actively trading all the time, will want to make sure their assets are completely secure. If you're looking at a trading entity, security is also incredibly important, but so is speed of access to the market. They might need slightly different solutions. Ultimately, though, everybody prefers to have a regulated custodian. It's about knowing not only that your assets are secure, whether it's through cold storage or not, but that you're regulated and audited.

What roles are exchanges playing?

The way crypto is set up currently, a lot of people have their assets on exchange for ease of use. It is a single point of failure risk to keep your assets on exchanges — especially where that exchange is also a custodian. That's why we set up the Go Network. Go Network introduces a variety of solutions to enable trading with asset security: one is our off-exchange settlement product where assets can be held away from the exchange but still access individual exchange liquidity. Another is through BitGo's own aggregated liquidity pools which facilitate OTC trading via the world's leading market makers with instant settlement. Go Network has Bitstamp, INX and other leading exchanges integrated, and we are in the process of onboarding new partners most used by our clients.

What changes can we expect on the regulatory front?

Regulatory clarity is coming, specifically in Europe with MiCA. Stablecoins are already being regulated in Europe, and the rest of the asset class will be regulated from January 2025. So I think the regulatory risk is dissipating, but I don't want to say disappearing as the US is still the elephant in the room. The election result will play a big role in that. It has been great to see progress in the US with the BTC and ETH ETFs but it is lagging behind the rest of the world.

Let's be clear though, what happened with FTX wasn't just a crypto problem, it was fraud and fraud is a risk in whichever industry you work in. It's bad actors, plain and simple. If there is greater regulatory clarity, there are more audits and external reviews into businesses which will help prevent bad actors from hiding their crimes and hurting the industry.

CONCLUSION

The digital asset sector's journey towards institutionalisation has a way to run – and few would say it has been entirely smooth so far. But most would agree that momentum is building in several key areas which, together, are pushing crypto in the right direction.

This report has majored on two key themes at the heart of trust and transparency issues, starting with the custodian relationship. Nothing could be more important than the way in which assets are safeguarded, particularly in the crypto world. The survey revealed the level of importance which industry members put on having a regulated custodian, but also their wider views. As one industry expert highlighted, regulated custodians didn't exist a decade ago. Where could the industry end up a decade, or even half a decade, from now?

Regulatory progress, most notably in the US, is showing signs of positive movement which could bring years of uncertainty to an end. Providing a stable and amenable regulatory environment would deliver welcome clarity, not just in the world's largest financial centre but around the world.

All of these trends are supportive of the sector's quest towards institutionalisation. Achieving that goal will be key to bringing more allocators on board and meeting the asset class's long-term goal to become part of the financial mainstream.

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