The Library of COINgress: Charting a New Course for Diligence

What are the driving questions as we enter the next chapter of digital assets?

Cryptocurrency user adoption has skyrocketed over the past 18 months, in some ways outpacing the internet boom from the late '90s. But as a nascent industry, it's experiencing some growing pains. Digital assets infrastructure is at a critical point - enduring stress tests and rebuilds to maintain and potentially scale this growth over time. Amid the latest 'crypto winter', investors are focused on how to diligence investments and operations and wondering what lies ahead.

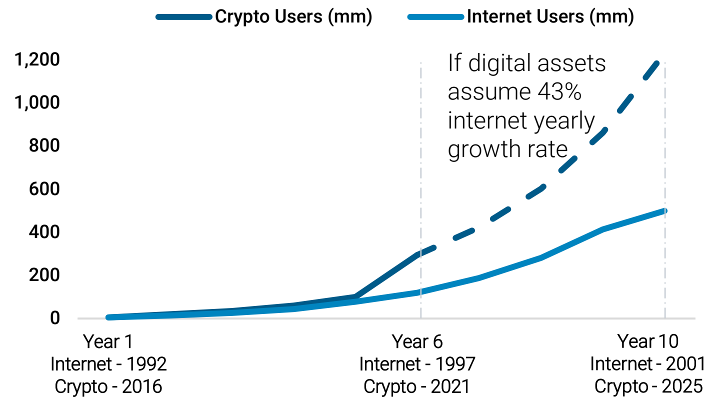
Sustainable Growth Expectations

Institutional allocators seek **sustainable investment partnerships over the long term**, and booming, high growth industries and returns tend to accompany risky, **potential busts on the other side…**

While crypto investments have had periods of great performance, **institutions aim to actively manage volatility and protect on the downside.** New fund launches are looking to match this **risk/reward matrix.**

Institutional digital asset managers are evaluating liquid and illiquid opportunities, determining the available options for **risk-adjusted returns** for investors over both **shorter and longer time horizons.**

User adoption and growth
Early internet vs. digital assets



Sources: World Bank, Crypto.com, Statista, Global Macro Investor

What Gives Investors Pause?

Many financial analysts with years of experience in traditional markets are just getting up to speed on digital assets, and as Finance 101 will tell you, **don't invest in what you don't understand.** Teams are dedicating resources to refresh their investment due diligence (IDD) processes for cryptocurrencies and blockchain investments. Common questions touch on topics such as:

TECHNICAL EXPERTISE	Deep knowledge on this space is table stakes, but increasingly important as more projects begin to fail. From protocols to 'tokenomics' to blockchain tech – managers should understand both the technical fundamentals and financial macro implications on their crypto investments. Many GP's are producing content and hosting/participating in events which highlight their knowledge.
CRYPTO-NATIVE PEDIGREE	For some, less importance is placed on traditional Wall St. pedigree for managers in this space. Some investors would rather see backgrounds from crypto-native firms – groups born from this industry. Rising interest in launches of teams with 'DeFi' backgrounds and 'TradFi' risk management experience.
TRACK RECORDS	LP's are rethinking return targets and noting style drift from current strategy and prior track records.
SPEED TO MARKET	This is a 24/7 market, with unique real-time datasets and resources (i.e. Nansen, Discord, Dune, Github). Managers need to keep up with the pace of new information, while still acting strategically.
SIZING	Being overweight or underweight in speculative and volatile investments such as digital assets is tough to define. Investors have been challenged to determine the appropriate allocation ranges.

Spotlight on Speculative Capital

The decision to invest in any risk-on asset, such as equities, real estate, high yield-bonds, or crypto, is subject to **speculative risk.** No one has a crystal ball and must accept the possibility that any of these **investments could result in gains or losses.**

Investors are noting digital assets investment as speculative capital – **managing risk through sizing, diversification, and hedges**.

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Diligence Turns Interest to Allocations

Investors are adjusting underwriting processes for the digital assets space

Once investors get comfortable with a manager from an investment perspective, the next challenge to get allocations over the line revolves around the Operational Due Diligence (ODD) process. Internal boards and committees need to sign off on certain operational aspects, but the framework of these processes typically have more traditional assets in mind….

Notable differences between **'TradFi – Traditional Finance'** and **'DeFi – Decentralized Finance'** Operational Due Diligence:

CUSTODY RISK	Central to digital assets is their public and private keys, which confer control and ownership of these assets in various wallets. Custody of digital assets revolves around key management and is distinctly different from traditional asset custody. There are 3 main custody options, all with a unique set of risks: 1. Self-custody 2. Exchange-hosted wallets 3. Third-party custody via qualified custodian or IT solution
PEOPLE RISK & TURNOVER	A space with wide swings of wealth accumulation and destruction results in constant talent mobility, and even *anonymity in some cases*. Investors highlight the importance in degrees of certainty that founders & managers are well-incentivized and committed to their funds and projects for the long term.
TAX CONSIDERATIONS	General tax principles are applied to digital assets, which these laws were not initially intended for. This results in a host of confusing use cases – i.e. cryptocurrencies are treated as property is some cases and are subject to taxable events that traditional currencies and commodities wouldn't be.
AML/KYC CRYPTO COMPLIANCE	Digital assets have been associated with nefarious activity, yet many, *including the FBI*, argue that the blockchain, as an immutable record, makes it easier to track and uncover illicit actions. Traditional asset protection is diligenced proactively with AML/KYC processes, but digital assets are being handled on a more retroactive basis. There are steps taken to mitigate risk, but the focus on a transaction, not a person, shifts crypto compliance procedures to 'KYT' – *Know-Your-Transaction.*
EMERGING SERVICE PROVIDERS	Many third-parties, offering collateral services, credit, and counterparty execution for cryptocurrencies are still considered start-ups. These groups have encountered hacks and fraud, and as with any underdeveloped industry, are working through kinks and bugs in their infrastructure.

Mapping out Third-Party Support and Regulation

A new menu of service providers with familiar regulators

Many third-party crypto firms position themselves as 'one-stop-shops', with services ranging from custody to execution. Some traditional finance terms used to describe these services tend to stray from their direct meaning. i.e. Crypto prime brokers aren't necessarily offering financing, and crypto clearing houses are more so facilitating settlements than clearing.

Jefferies Capital Intelligence has been **tracking emerging and leading counterparties** for each of the below functions:

Qualified Custodians

Some firms are custody-only, while others offer a suite of products. Note the differences between hardware security module (HSM) and multi-party computation (MPC).

Legal Counsel

Institutions invested or planning to invest in digital assets are relying on the regulatory guidance and general counsel from firms building out blockchain legal teams.

Cryptocurrency and Token Exchanges

Centralized or decentralized counterparties to buy and sell digital assets. Note that money transmitter licenses required for these firms to trade vary globally and by state.

Outsourced Digital Assets Due Diligence

Emerging groups are offering dedicated risk reviews and best practice resources to help diligence companies, counterparties, and fund managers.

All Eyes on Washington

The **regulatory environment** continues to evolve, but now has added urgency in the wake of crushing recent industry headlines. The SEC doubled its new Crypto Assets and Cyber Unit, while the recently proposed bill by Sen. Gillibrand (D-NY) and Lummis (R-WY) gives more authority to the CFTC. Long-term believers think **regulation and clarity is essential for further institutionalization** but will likely result in short-term pain for many investors, funds, and service providers in this industry.

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SOURCES

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