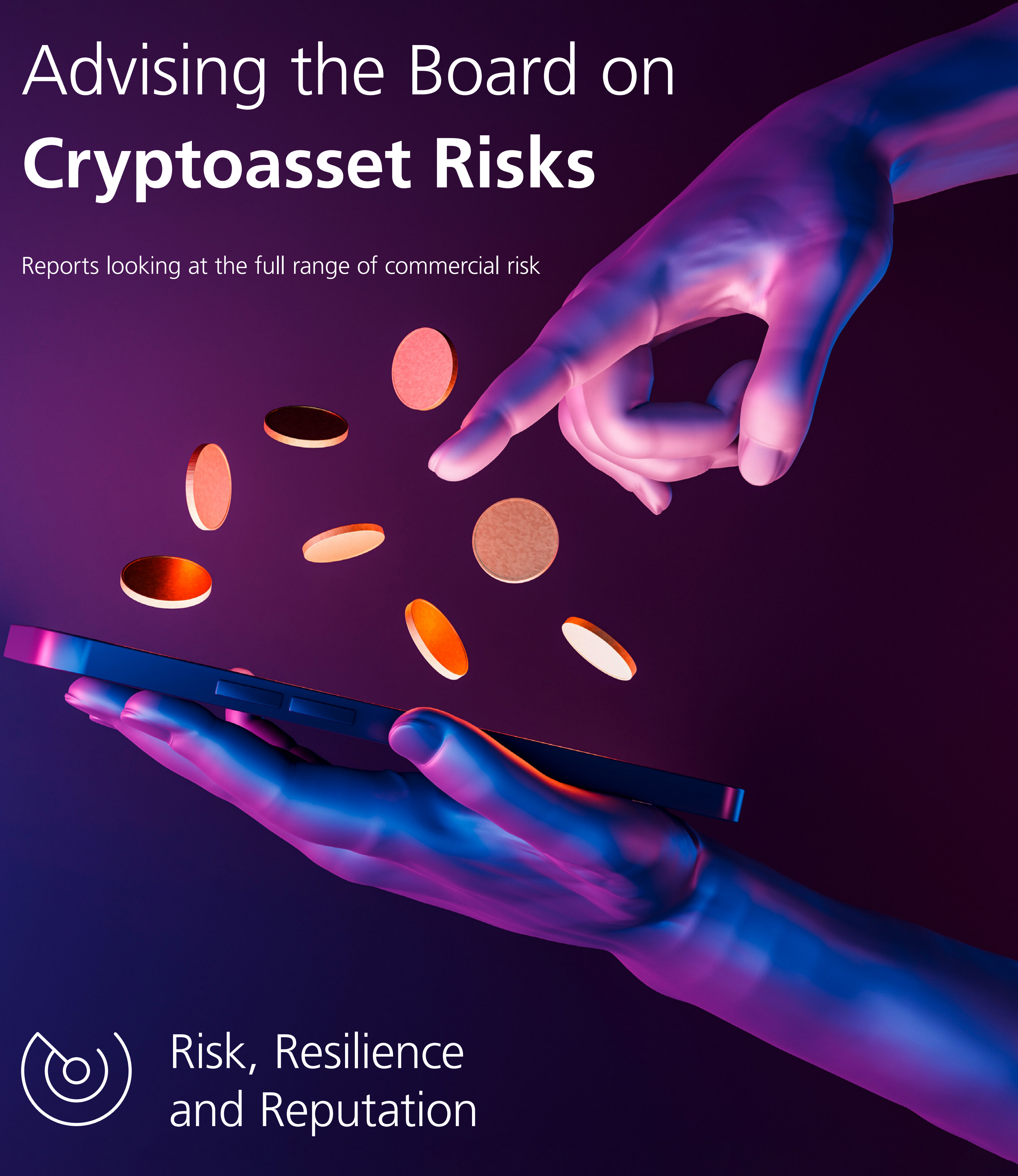
CMS
law·tax·future

Advising the Board on **Cryptoasset Risks**

Reports looking at the full range of commercial risk



Risk, Resilience and Reputation

Directors’ risk report

The cryptoasset market has grown significantly in recent years and is now a buoyant financial market, with the global market currently valued at over $1 trillion, according to CoinMarketCap. The market has seen both retail and institutional activity and now many companies are considering the application of cryptoassets to their businesses whether as payment methods, bridges between traditional finance and alternative finance, market infrastructure or investment in itself. Whilst this presents various opportunities, it may also present challenges for boards in respect of navigating the market and the risks involved.

What is crypto?

There is no universal definition of “cryptoasset” with commercial and legal definitions varying from jurisdiction to jurisdiction. In the UK, cryptoassets are generally seen as a digital representation of value or rights that is secured by encryption and typically use some type of distributed ledger technology (“**DLT**”). Cryptoassets can take many forms, including what are commonly referred to as “security tokens”, “e-money tokens” and “unregulated tokens” in the UK. Some firms will already have experience or expertise with cryptoassets, such as financial services and technology firms. The below discussion is a high-level overview of the possible risks that boards should be alive to when considering investing in or using cryptoassets in their businesses.

What are the key opportunities for companies considering cryptoassets?

1. **Investing in cryptoassets –** cryptoassets have a possibility for very high returns, which is a clear opportunity for companies looking to diversify their proprietary investments and invest in alternative assets to help make their balance sheets more profitable (although please see point 4 below about potential losses).
2. **Use as a payment method –** cryptoasset use for payments may be cheaper and faster than traditional payment methods, particularly for cross-border payments, where settlement times can be lengthy and/or complex. Adopting cryptoassets as a form of payment may attract a wider market of clients and make a business proposition more attractive.

What are the key risks for companies investing in cryptoassets?

As with any investment, investing in cryptoassets has risk. These risks can be summarised as follows:

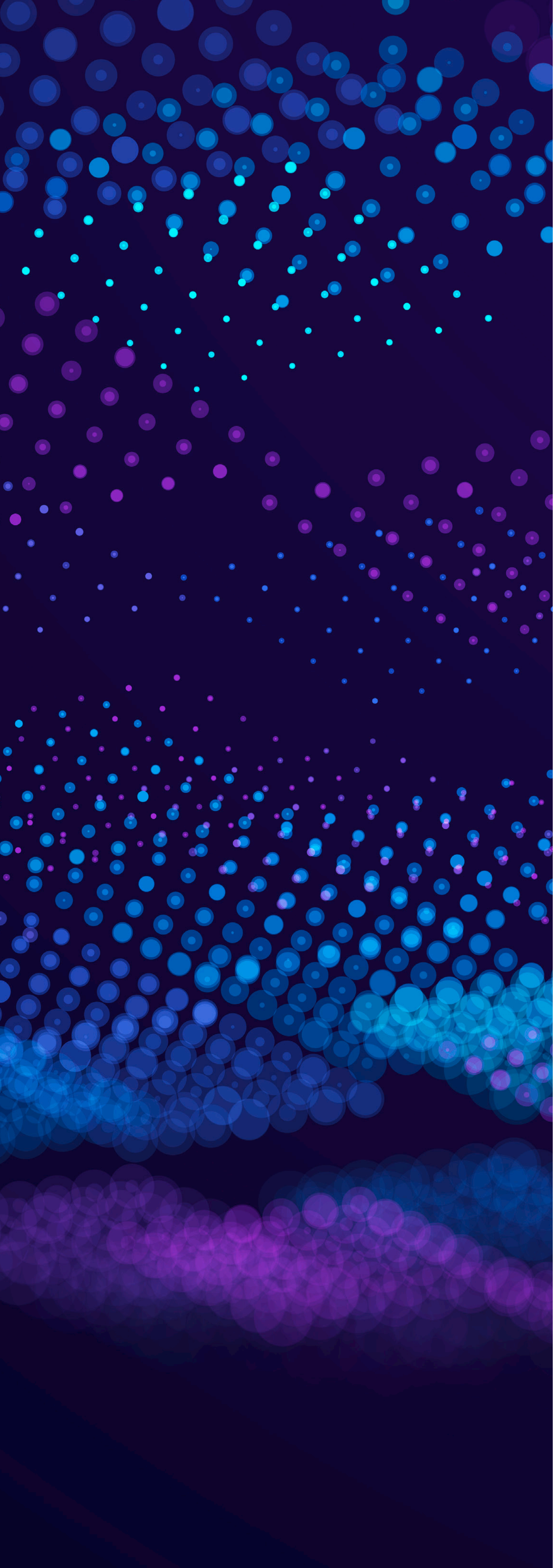
1. **Liquidity -** some cryptoassets may be highly illiquid, meaning that they are infrequently traded, and may therefore be more difficult or impossible to sell within a reasonable timeframe or at a price which reflects "fair" value. Liquidity also varies between exchanges, with some exchanges having a more liquid trading market than others. The holding of cryptoassets can often be highly concentrated which impacts prices and liquidity further. Further, some jurisdictions may place restrictions or even bans (such as in China) on the trading of cryptoassets, restricting or preventing the withdrawal of capital. Therefore, it is important for boards to carefully consider the current and potentially future regulatory position of cryptoassets in each jurisdiction in which they propose to invest or trade. Boards should also carefully consider the types of cryptoassets that they invest in, for example, "meme coins" may not be as liquid as more main stream coins such as BTC and ETH.

2. **Reputational risk -** investments in cryptoassets may be high profile and, consequently, so too are any significant losses from cryptoasset investments. Various companies have had losses in the millions and billions reported in the media, which has led to share prices falling and significant concerns from shareholders and any counterparties. Boards should carefully consider whether there are any reputational risks relating to investments and the views of shareholders, if necessary.

3. **Lack of transparency in the market -** there is a perceived lack of transparency in the cryptoasset market (discussed below) which will impact a board's decision-making abilities regarding possible cryptoasset investments, as well as any communications with shareholders and reporting requirements.

4. **Potential for losses -** as with many investments, there is a risk that all of the capital invested may be lost. In this respect, directors should consider the volume with which they are able to invest and how cryptoassets fit with the company's risk profile and wider investment strategy. Similar to other investment strategies, investing smaller amounts or employing diversification strategies will help boards to mitigate risk. It should also be noted that cryptoassets are not regulated in the same way as more conventional assets and this could increase the risk of losses. For example, unlike deposits, cryptoassets do not benefit from the Financial Services Compensation Scheme in the UK so losses will be borne by investors. Further, profits made from investments in cryptoassets may be subject to Capital Gains Tax in the UK which will impact profits on cryptoasset investments.

5. **Regulatory environment –** the constant changing regulatory environment, means that it is difficult to know whether a firm with whom a company transacts with has the appropriate licensing and authorisations to carry on their activity. The regulatory landscape is changing and boards should keep abreast of developments. In particular, a board must carry out appropriate due diligence on its counterparties and/or service providers to make sure they are comfortable that the company is appropriately licensed.



What are the key risks for companies accepting cryptoassets as a payment method?

1. **Price volatility -** cryptoassets are considered very high risk, speculative investments, and the value of cryptoassets can be extremely volatile. Cryptoassets are vulnerable to sharp changes in price due to unexpected events or changes in market sentiment. Other factors that may affect the price of cryptoassets include changes in the total number of cryptoassets in existence, the monetary policies of governments, the fiat withdrawal and deposit policies of exchanges, the fees associated with processing transactions, trade restrictions and regulatory measures. A sophisticated, technical understanding may be needed to fully understand the characteristics of, and the risks associated with, particular cryptoassets. Cryptoassets which are ‘unbacked’, meaning that they are not linked to an underlying asset or tangible value, are particularly volatile given that they are valued based on demand alone. Therefore, even where there may be value in long-term investment in cryptoassets, use as a payment method can be difficult as price and value is unpredictable. How cryptoassets prices are determined and the execution of transactions at exchanges is often not transparent. Boards should ensure that any cryptoassets that are used as payment methods have a track record of stability (where possible) or use is combined with fiat currency to mitigate value risk.

2. **Limited use to date -** the uptake of cryptoassets as a payment method has been limited to date. Notable examples of companies who have used cryptoasset payments include IT and travel companies, and some have explored use of cryptoasset as a means of paying employee salaries. Indications are that use of cryptoassets for cross-border payments are slightly higher, with surveys suggesting that 37% of businesses are engaging in this activity (PYMNTS Blockchain Payments Tracker). In general, however, the use of cryptoassets for payments is not widespread. The primary reason for this is likely the concerns over price volatility of cryptoassets making it difficult to determine precise value at the time payment. It is also important to note that transfers of small amounts of money through cryptoassets may not benefit from lower fees or enhanced speed compared to conventional methods. To mitigate the risks of using cryptoasset payments, directors could consider limiting: the types of cryptoassets accepted to those considered to be more stable, the value accepted, and the jurisdictions in which payments may originate or be accepted.

3. **Perceived risks related to AML and KYC compliance risk –** cryptoassets are often linked to a high risk of fraud and fraudulent transactions, limited traceability of transactions, and inconsistency of AML and KYC procedures. However, there are tokens that are created with AML and KYC baked into them and the regulatory requirements in various jurisdictions now impose AML/KYC requirements on cryptoasset exchange and other intermediaries. There are also specialised compliance solutions which can be used for these purposes and directors should ensure they understand the nuances of each cryptoasset that is accepted as a use of payment.

4. **Criminal activities:** fraud and cyber-attacks - cryptoasset exchanges (where cryptoassets are bought and sold) are targets of fraud, scams and cyber-attacks. This leads to risks of theft and of operational problems which could delay or halt payments. Whilst this is not a risk distinct to cryptoassets, exchanges have fast become a popular target for hackers so this risk should be particularly noteworthy when conducting board discussions. Similarly, there are risks with digital wallets, where cryptoassets are stored once purchased. Electronic wallets have what is referred to as a "public key" and a "private key" which is similar to a password that allows access to cryptoassets in the walllet. However, electronic wallets are not impervious to hackers and cryptoassets may be stolen from an electronic wallet with little prospect of having them returned. The loss of a private key required to access an electronic wallet may be irreversible and it may result in the loss of the cryptoassets stored in the electronic wallet. This then might result in lost value for a company if the cryptoasset has not been converted to fiat currency.

5. **Blockchain settlement -** the transfer of fiat and cryptoassets will involve third parties and/or blockchain networks. It is generally impossible to cancel, reverse or modify a transaction that has been submitted to any blockchain network supporting a cryptoasset. Where settlement is delayed, it is likely that the value of the relevant cryptoasset or fiat currency (whether measured in the value of any other fiat currency or cryptoasset, as applicable) will change between the time of the relevant order or payment and the time of delivery. This risk is conventionally referred to as currency risk or foreign exchange risk, with regard to fiat, and as market risk, with regard to cryptoassets traded on markets. There are also some instances where blockchain transactions may be unconfirmed for a duration of time and, in some circumstances, may not be confirmed at all. There is therefore a risk that where such instances occur, transactions may never complete and cryptoassets may remain in a state where they cannot be transferred to another electronic wallet. There is therefore a risk that you may be unable to recover cryptoassets if they are sent using an unsupported network.

What are the **key risks** for companies tracking the market?

There are often difficulties tracking the cryptoasset market and this is a concern for companies who invest in cryptoassets or use it as a payment method.

1. **Price volatility -** as discussed above, cryptoassets can be extremely volatile and prices may not be transparent. For companies, this presents challenges in terms of assessing their valuation as either an investment or on the transfer of cryptoassets as a means of payment. To mitigate against this risk, boards may consider deploying technology solutions or additional personnel to monitor the market and any price fluctuations. This is particularly important where using cryptoassets as a payment method, given the difficulties determining value. Boards should also carefully consider how they report price and value of cryptoassets, noting the volatility.

2. **Lack of transparency within the market -** information about cryptoasset products is often misleading, incomplete or inaccurate. Due to the way that cryptoasset investment products are marketed, often aggressively and on social media, information is often short and focused on potential gains and not risk of losses. Boards should be alive to this issue and apply usual investment strategy approaches to decisions relating to cryptoassets where possible.

3. **Product complexity -** the cryptoasset market can be very complex, given the range of products available. As of early 2023, there were over 20,000 different types of cryptoassets (although many of these are no longer traded). The products themselves are also often very complex. Having sufficient understanding to discuss and fully evaluate these products at board level will likely be challenging for some companies without pre-existing expertise in this market. Boards should understand the nature and complexities of specific products before trading or allowing them as payment methods and/or permitting investment.

Risk thermometer

Choice of asset
Have you considered liquidity, stability and PR risks associated with the crypto asset of your choice?

Law
Have you taken advice on regulatory position of crypto assets in each jurisdiction of relevance?

Impact on balance sheet
Have you factored in price volatility including cause by delays by third parties and/or blockchain networks and any potential impact on profits and reporting?

Summary

Practical risk management for directors

Ensure that the company can afford to lose all capital invested in cryptoassets.

Diversify cryptoassets where possible.

Consider limiting cryptoasset payments by value, type, or jurisdiction.

Ensure understanding of cryptoassets in the company and at board level.

Ensure the company has sufficient personnel, including legal, compliance, reporting and monitoring staff that understand the nuances of the cryptoasset market.

Review the company's technical capabilities and ability to deploy effective mitigation solutions.

Research different jurisdictions approached to cryptoassets, including their regulatory position and sentiment moving forwards. Do not assume that all jurisdictions treat cryptoassets in a similar way.

Contacts

Kushal Gandhi
Partner
T +44 20 7367 2664
E kushal.gandhi@cms-cmno.com

Mike Ringer
Partner
T +44 20 7524 6080
E Mike.Ringer@cms-cmno.com

Sam Robinson
Partner
T +44 20 7524 6836
E Sam.Robinson@cms-cmno.com

Yasmin Johal
Associate
T +971 52 501 7582
E Yasmin.Johal@cms-cmno.com

CMS Law-Now™

Your free online legal information service.

A subscription service for legal articles
on a variety of topics delivered by email.
cms-lawnow.com

CMS Cameron McKenna Nabarro Olswang LLP
Cannon Place
78 Cannon Street
London EC4N 6AF

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000

2310-0179635-4