THE IMPORTANCE OF TRANSPARENCY IN DIGITAL ASSET PRODUCTS

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The following is an edited transcript of an episode of WisdomTree's Crypto Clarified podcast, focused on the topic of transparency in institutional grade digital asset products. The discussion is between Benjamin Dean, Director of Digital Assets, and Jason Guthrie, Head of Digital Assets (Europe).

Transparency in the digital asset and crypto space keeps coming up, what is meant by the term 'transparency'?

Transparency in markets, in products, is about proactively providing all the relevant information so that people can properly understand what they're engaging in and understand the risks associated with this activity. It is much more than disclosures. It is about proactively making information available and educating those that might use the product to ensure that there is a robust understanding of structure and risks.

How do institutional investors gain access to the digital asset space and how does this relate back to transparency, or the set of risks that can emerge in the absence of transparency?

One option is to use a service provider for access, which could be a custodial arrangement where another party manages those private keys.

Another is a brokerage-style arrangement where you have an account with the service provider; they do something in the back end to have reserves of that currency and whatever other activities they might be doing, but you rely on that service provider.

The third one is through financial products like mutual funds. Closed-ended products are very big in the US. Exchange-traded products are the major way in Europe.

It sounds like all three options create a whole set of new consequences and risks. What are some of the questions that an investor would want to ask when engaging in a custodial arrangement?

This really comes back to understanding the risks involved in the nature of the arrangement that you've got. If you are using a service provider, ask whether the digital assets are held directly for the benefit of you as the consumer. There are plenty of examples out there where you have exposure to that organisation, not the direct underlying. We've seen this in the context of brokerage firms - Voyager was a really good example of a more brokerage-style relationship than a custodial one.

In a proper custodial relationship, the digital assets are held, segregated, bankruptcy remote from the service provider being used. They're held solely for your benefit as the custodial client. People sometimes refer to this as 'physical holdings', which is a funny nomenclature for something that's purely digital. But the salient point is that the assets are held for the benefit of the investor. They're not going to be commingled with any of the funds of the service provider. And those digital assets aren't used for any other type of activity; for example, they're not lent out (unless that's something the investor explicitly wants to occur).

So there is a difference between physical exposure and synthetic exposure. When the product is physically backed, what is the service provider doing with the assets?

It's really important to understand the nature of the holdings, what the service provider may or may not be doing with them, and the risk that puts back on you as a client of that service provider.

To some extent, this comes down to the nature of the organisation being dealt with. The best way to think about it is a bank and their lending activity. You've put money in there, you can see your account, it says you've got X number of dollars or pounds but, on the back end of that, they are probably running a loan book lending that money out. And that's part of the business activity. Now, in banking, this is a well-established practice, it's very regulated. There are government guarantees over deposits, but that kind of arrangement does not really exist in the crypto service provider space.

Crypto lending has become a high-profile issue over the last few months. Three Arrows Capital's bankruptcy caused a cascade of onward bankruptcies. That was because they were a lending counterparty, and I don't think everybody understood that risk and who the counterparties were. There are well-established best practices for how to handle these sorts of things and the digital asset space desperately needs to look to the traditional finance world to start adopting those best practices. Transparency is at the heart of that, but it definitely isn't as prevalent as it should be.

To summarise on the topic of transparency, I suppose investors could consider the below as a rough checklist of questions they should be asking:

- Is the product physically backed or synthetic?
- Are there any provisions for lending occurring on the back end?
- Is any lending collateralised or not?

Turning to another big topic in the crypto space, Ethereum has recently changed its consensus mechanism to Proof-of-Stake. When considering 'staking' institutional investors often use the analogy of securities lending. Whilst conceptually similar, what are the main differences?

In a traditional securities lending arrangement, part of the risk comes from the credit worthiness of whoever borrowed the assets. You are exposed to the solvency of that business, how good their cash flows will be and how good their management is.

With staking, you are participating in the protocol and your chance of loss comes from an event called slashing. Part of the risk actually comes from the technology – if the technology doesn't do its job properly (in terms of contributing to the consensus) then the stake gets slashed. This ends up being more of an operational risk, in my view, than a counterparty risk. Of course, if you're using a service provider they need to do their job properly but, again, it's operational failing versus the credit worthiness.

So, with regards to staking, what questions should investors be asking?

Investors should think about it as a set of cybersecurity risks. I'd ask:

- Who is the validator node?
- What's their track record?
- How efficient are they?
- Where are they keys stored?

And so on and so forth. It's essentially operational risk, which contrasts with lending where the risks revolve mainly around counterparties, solvency and collateralisation.

To close, what implications might investors face if they don't pay attention to transparency-related issues?

Investors could suffer potential unexpected losses. The worst loss that anybody ever takes in financial markets is one that wasn't expected, that is, from a risk that the investor didn't know they had exposure to. If you invest in the S&P 500 and the S&P 500 goes down in value, you knew you had market risk when you went into that. But if your counterparty just suddenly disappears and you lose 100% of your money because they've gone insolvent and you weren't really accounting for that (or you weren't diversifying service providers to account for that risk), that is much more difficult to bear.

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