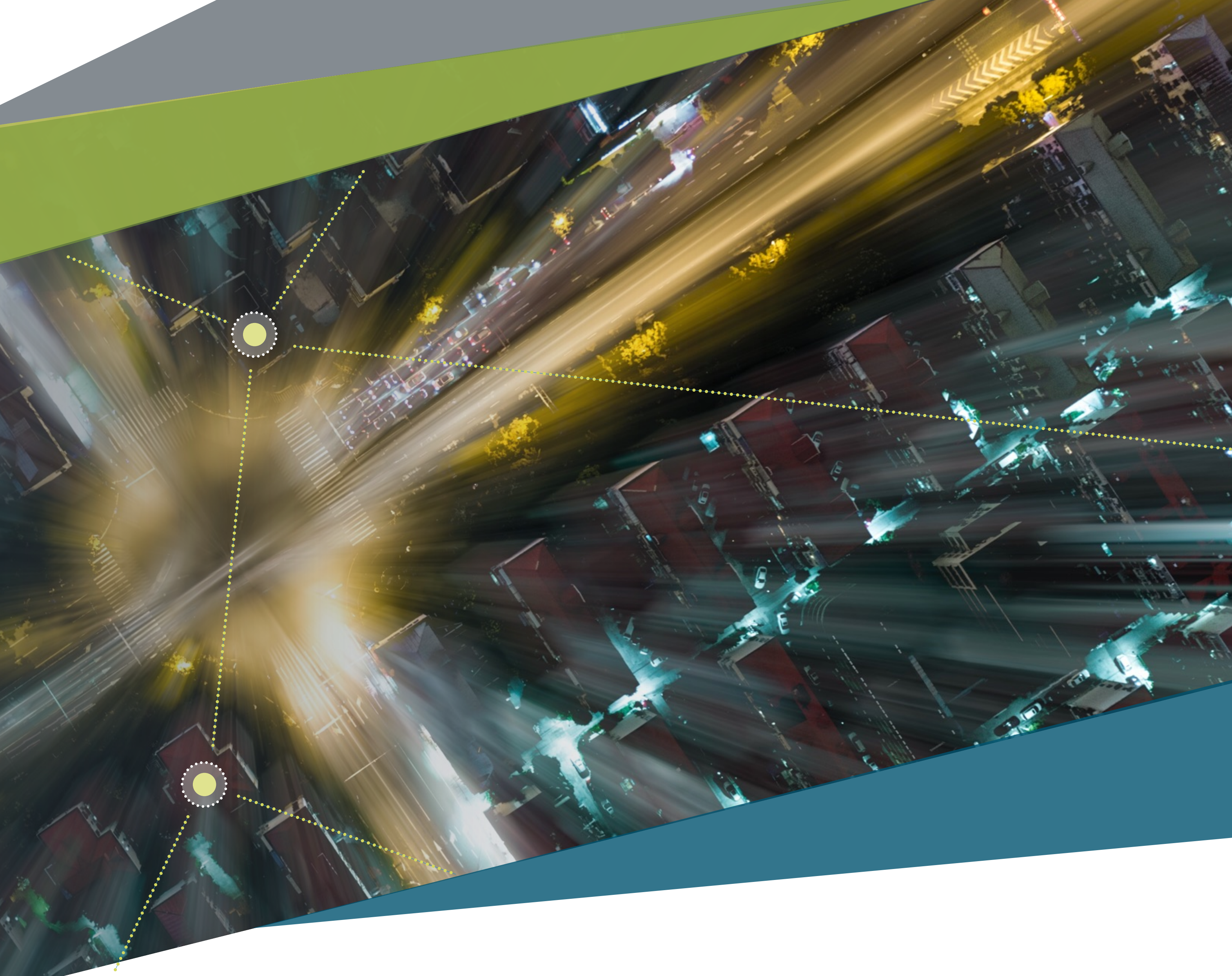

FIDELITY INSTITUTIONAL INSIGHTS

The Intersection of Cryptocurrency and Wealth Management

What Advisors Need to Know Now

Introduction

Bitcoin, cryptocurrency (crypto), and digital assets are suddenly topics of everyday conversation. While pockets of interested parties have been watching this story and industry develop, it now appears poised for mainstream acceptance.

The explosion of interest in crypto has been fueled in no small part by the dramatic growth of this market. At the beginning of 2017, the capitalization of the total crypto market was less than $18B, according to CoinMarketCap. A little more than five years later, in late 2021, the crypto market hit a high of nearly $3T, before settling back down around $2T.[1]

With only 16% of Americans reporting that they've yet invested in cryptocurrency,[2] it seems that the elevated volatility and risk in this market may be tempering trust and investment.

However, interest remains strong as investors actively explore this market and look to advisors for help. In a 2021 survey, nearly half of all advisors reported that their clients are asking about crypto, versus just 17% the prior year.[3]

Sophisticated investors in the United States and beyond also appear to be jumping in. In a survey of institutional investors, high-net-worth investors, and financial advisors, more than half reported that they've already invested in digital assets, and 7 in 10 reported that they plan to do so.

In this same survey, nearly 8 in 10 respondents indicated that digital assets have a place in a portfolio.[4] That's a remarkable indication of growing acceptance, but it also begs the question:

What is its place? How does it perform, and fit, within an investment portfolio?

While regulators and financial service providers are making progress in developing answers to this question, it remains open. In this dynamic environment, few are ready to publish a comparative evaluation of risk and returns across the different options for exposure—or even a point of view on if or how much to invest in crypto at all.

Introduction

Yet many investors are undeterred by the unresolved questions, and they're looking to advisors for help understanding and stepping into this market. They don't need all the answers; they see value in crypto—as a potential inflation hedge, as an historically uncorrelated asset, or as a speculative investment—and they want help thinking through how best to get in. Investors don't want to wait; so, advisors can't afford to wait either.

The purpose of this publication is to help advisors to establish a foundational understanding of the different ways that investors commonly gain exposure to digital assets, along with some important factors to consider in evaluating and selecting from those options.

This document doesn't include everything advisors need to know; it's a starting point and a guide to furthering their working knowledge of this market.

We'll explore some of the most popular options for direct and indirect exposure to crypto, and we'll focus our discussion of potential benefits and drawbacks across these options on four factors that are central to an advisor's ability to navigate crypto with their clients:

1. Expenses
2. Tax Treatment
3. Protections
4. Estate Planning

Fidelity has been involved with crypto and digital assets for the last seven years, and we continue to expand our own capabilities and knowledge here. We're applying the experience, rigor, and innovative approach that we're known for to this new market, and we're committed to bringing insights like this to our clients.

Now's the time for advisors to dig into crypto. Investor interest in this market presents an invaluable opportunity for advisors to build trust with their clients by helping them to navigate a new and exciting opportunity with high potential risk and reward. Advisors that embrace this opportunity may well attract new clients from advisors who don't.

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Common Options for Exposure to Crypto

The options we'll address are some of the more common paths that investors are exploring to get exposure to crypto. We recognize that there are other options in market, with different attributes across our considerations, that may appeal to some investors. Further, as this market grows and evolves alongside the overall blockchain and Decentralized Finance (DeFi) ecosystem, new approaches may alter this landscape.

Direct Exposure

Direct exposure refers to direct investment in crypto, held within a crypto account or wallet. Retail and institutional offerings add intermediary layers between investors and their assets, offering convenience and support—and in some cases, security—in exchange for reduced control. Direct ownership of native tokens also presents options for non-investment uses of crypto within the broader DeFi ecosystem.

Self-Custody

With self-custody, investors may purchase cryptocurrency on an exchange and/or receive it in transfers or payments. Investors store that crypto in a hot or cold wallet and retain the “keys” to access it. While retail and institutional custody may offer specific non-investment uses for crypto, only self-custody offers full, direct access to the broader DeFi ecosystem.

Retail Custody

Retail custody is similar to self-custody in that investors purchase crypto directly on an exchange and/or receive it in a transfer or payment. Those assets are held by a custodian (sometimes the same entity as the exchange) who retains the “keys” to access those assets on behalf of the investor. Retail may provide some access to DeFi.

Institutional Custody

Institutional custody also offers direct ownership of crypto, held by a custodian who retains the “keys.” The difference here is that this account is offered through an advisor and may provide better integration with wealth management. However, within the broad category of retail, some offerings may more closely resemble institutional. Curated access to DeFi may be available.

Indirect Exposure

Indirect exposure refers to investment in a security or product that has an underlying investment in cryptocurrency or related companies. Some investors may prefer these options for their familiar structures and well-regulated markets. While some account types with impactful features may be eligible to hold these products, we’re generally considering them as held within a brokerage account.

Futures Contracts

Futures contracts are derivative securities that allow owners to secure prices for future purchases of assets or the equivalent cash value. They initially focused on commodities, but they now cover a range of assets, including crypto. While futures were among the first options for indirect exposure, the cost to roll monthly contracts may limit their appeal.

Public Funds

A variety of products are offered to the public as crypto funds, ranging from mutual funds/ETFs with exposure to crypto futures and/or equities of related companies, to trusts initially offered through private placements and subsequently traded on public exchanges. This variability makes it critical to understand each option, individually.

Private Funds

With few exceptions, funds with direct exposure to crypto are currently only available through private placement. While that puts this approach out of reach for many investors, those with access to private markets may value this option. As this market evolves and matures, strategies originated for private markets may migrate into public ones.

Expenses

With the tremendous growth in this market, we've seen a growing diversity of offerings, even within each category. This inherent variability makes a meaningful, generalized comparison of total expense across the common options for exposure very challenging. In lieu of that approach, we suggest that advisors and investors consider the expenses of each specific offering individually and independently. To help advisors and investors determine where to look as they work to aggregate fees for each specific product in consideration, we've inventoried below the different types of potential fees that we've seen associated with each option. This table may not be exhaustive of the many offerings in market.

TYPES OF FEES INVESTORS MAY INCUR WHEN INVESTING IN EACH OPTION FOR EXPOSURE		Self-Custody	Retail Custody	Institutional Custody	Future Contracts	Public Funds	Private Funds
Transaction	Fees that may be charged by brokers or other providers to buy, sell, transfer, or convert assets.	✓	✓	✓	✓	✗	✗
Management	Fees charged by fund investment managers and/or general partners.	✗	✗	✗	✗	✓	✓
Custody	Fees assessed to custody digital assets for funds or other institutional investors.	✗	✗	✓	✗	✗	✗
Performance	Additional fees that may be charged by actively managed private funds.	✗	✗	✗	✗	✗	✓ ✗

In addition to these fees, investors may incur additional expenses or inefficiencies with some of these products. This includes potential premiums or discounts for exchange-traded products, as we've seen with some public funds. In addition, investors in futures contracts and futures-based ETFs may see significant costs associated with rolling expiring contracts, especially when high expectations around the future price of crypto drives these markets into contango.

Tax Treatment

It is critical that advisors understand the tax treatments common to each option for exposure, as well as those specific to individual products in consideration. The IRS designation of crypto as property has easy-to-understand but impactful implications for investors with direct exposure. Conversely, growth and innovation among products with indirect exposure has led to the use of a variety of tax structures, even among products marketed within the same categories (such as "funds" or "trusts"). This variability means that seemingly similar products may be taxed differently, as it is the tax structure of these products—rather than how they're categorized in market—that determines their tax treatment. For this reason, it is critical that advisors and investors read the offering documents for each option in consideration to understand how it is structured and taxed.

Direct Exposure

- IRS notice 2014-21 specified that "virtual currency" such as Bitcoin is treated as property for tax purposes.
- This designation means that owners of these assets generally recognize gains/losses when the asset is sold or otherwise disposed. This includes conversions to fiat currency, exchanges into other digital assets, and purchases of goods or services.
- Generally, tax principles of property transactions apply, including treatment of gains/losses for assets held for more than a year as long-term capital gains.
- For assets held for a year or less, and in certain other circumstances, gains may also be taxed as ordinary income.

Indirect Exposure

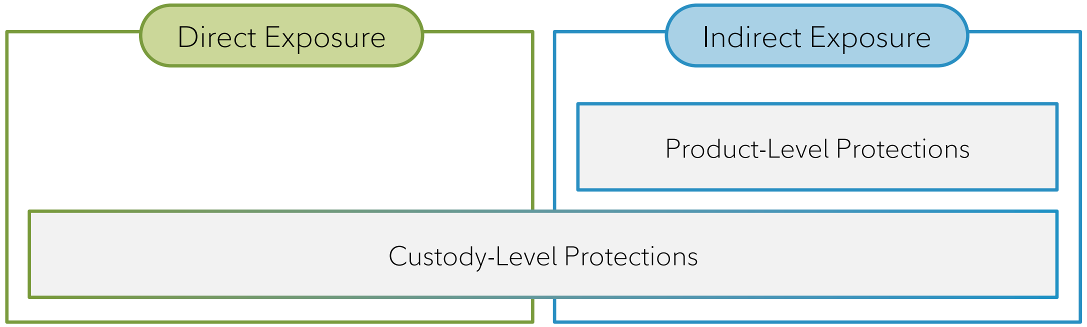
- Investors should review relevant offering documents to determine the anticipated tax treatment of any crypto products before investing.
- Existing futures contracts are taxed as 1256 contracts—this is not dependent on underlying assets. Similarly, many of the common fund structures are taxed much like traditional equity and/or fixed income mutual funds, depending on their holdings.
- Other digital asset "funds" use the grantor trust or partnership structure to allow pass-through tax treatment. Investors in those products should anticipate allocation of income and gains as if they were direct investors in the underlying assets.

The goal of this page is to help advisors understand the tax treatments specific to each option, but this doesn't mean that broader tax strategies such as holding assets within certain kinds of trusts or tax-advantaged accounts don't apply. In some cases, these strategies may be available for crypto investments and could have a significant impact on investors' tax situations. Investors should always consult a tax advisor familiar with their situation to fully understand those impacts, as well as their overall tax liability.

Protections

The bearable and digitally native nature of crypto, along with the recent explosion of interest in it, make crypto investors targets for cybercriminals. Additionally, the nascence of this market, along with the evolving regulatory regime around the assets and their custody, raises potential concerns around investor safety. This begs the question: What protections do the different options for exposure offer? While custodians of direct exposure products generally take some steps to safeguard client assets and may retain relevant insurance policies, it is critical to read the fine print for each offering to assess the veracity of these protections. Custody-level protections may also carry over to indirect exposure products, where they're layered with protections specific to those types of products. Investors should consider these risks, along with the trust they have in potential providers to safeguard their assets. For self-custody, investors must assess the relative vulnerability of exchanges and hot or cold wallets on their own: this would be a difficult and daunting task for almost anyone.

PROTECTIONS MAY BE SPECIFIC TO CUSTODY OR PRODUCT TYPE



IN LIEU OF REGULATORY REQUIREMENTS, PROTECTIONS MAY VARY BY PROVIDER

While regulators provide the oversight, systemic risk management, and various protections that investors are accustomed to for indirect exposure, regulation around direct exposure is still evolving and does not generally offer the same assurance. Instead, most of the protections in market are offered by the providers. Some providers retain insurance policies against potential losses, and investors are protected by providers' operational controls and overall cybersecurity and risk management programs. These protections may vary considerably from one product and provider to another, and investors should consider these differences before they place their trust—and assets—with a provider.

Estate Planning

Estate planning can be a complex process, and crypto adds another layer of complexity. While investors in indirect exposure investments can leverage established practices in estate planning to designate beneficiaries and provide those beneficiaries with access to the assets, these same mechanisms aren't generally available for direct exposure options. For self-custody in particular, if beneficiaries don't receive sufficient information and access to claim an inheritance, those assets are lost beyond recovery. These types of estate planning concerns are a big reason why some investors prefer indirect exposure investments.

CRYPTO INVESTORS MUST CONSIDER WHO WILL RECEIVE THESE ASSETS IN THE EVENT OF THEIR DEATH, AS WELL AS HOW THEY WILL ACCESS THEM

WHO

By Contract

Commonly available in accounts that allow indirect exposure options, Transfer on Death instruction and account beneficiary designation allow owners to specify beneficiaries. This option is generally not available for direct exposure options, though some institutional and retail providers may soon offer it.

By Law

Accounts titled jointly, with rights of survivorship or by the entirety, are owned equally by both tenants. If one dies, the survivor becomes the sole owner of the account. Joint titling is typically only available for indirect exposure options that can be held in a brokerage account.

By Trust

Some investors prefer to use trusts to govern who receives which assets upon their death. However, crypto presents novel issues for estate and trust attorneys, including whether a trustee can hold crypto and comply with its fiduciary obligations, including the prudent investor rule.

By Probate

Assets not covered by titling, trusts, or beneficiary designation pass according to the owner's will, through the probate process. In lieu of a will, state laws direct the distribution of assets. The potential publicity, delays, and expenses make probate the option of last resort.

HOW

Account titles and designations include mechanisms that provide the named party with full access to the assets at or before death. So, for indirect exposure options using these methods, ensuring the safe transfer of assets isn't an issue. However, owners of direct exposure options that don't allow these methods are challenged by the sensitivity of the "key" and access information. Crypto is a bearable asset, and the private "key" is all anyone needs to access it. Investors may need to work with their attorney to securely transfer this information to their fiduciary or beneficiaries outside of the estate plan. Investors relying on the probate process need to make arrangements on their own to transfer this information outside of probate, where the proceedings and contents of the will become a matter of public record. Some may choose to share their "key" with a loved one—or divide it among several. Others may engage a trusted third party to facilitate the transfer. Others still may consider using a safe deposit box or digital vault.

The same access issues that beneficiaries may encounter in the event of death could hinder access for power of attorney holders and health care proxies in the event of incapacity.

Summary of Considerations

Much of the energy and attention surrounding crypto has been focused on direct exposure. As these options mature and regulation solidifies, they may become common components of personal finance. While some investors value the autonomy of self-custody, the additional support, convenience, and security of institutional custody—or even some retail custody providers—may be more appealing to the masses. Unsurprisingly, options to invest in crypto through familiar and well-regulated investment vehicles have quickly gained traction among investors. Limits of this interest may be tied to the relatively small number of options currently available to the public.

	Direct Exposure			Indirect Exposure		
	Self-Custody	**Retail Custody**	**Institutional Custody**	**Futures Contracts**	**Public Funds**	**Private Funds**
Expenses	Transaction fees		Transaction, custody fees	Transaction fees	Management fees	Management, sometimes performance fees
Tax treatment	Taxed as property with gains and losses recognized at sale or disposition; may also produce ordinary income, depending on the asset			Existing futures contracts are taxed as 1256 contracts	Tax treatment depends on tax structure/varies by product; review offering documents before investing	
Protections	Wallets may provide some protections	Custodians may provide some protections	Custodians and advisors may provide some protections	Well-regulated investment products; custodians and investment managers may provide additional protections		
Estate planning	Established estate planning, account titling, and beneficiary designation practices may not be available to direct exposure investors			Established estate planning, account titling, and beneficiary designation practices are generally available to investors		

Key Takeaways

For many, crypto has quickly become an area of interest and an opportunity to explore. The growth and energy around this market is reason to wonder whether continued proliferation and broad acceptance are around the corner.

Investors are turning to trusted advisors for help, and advisors need to be ready to have those conversations. This moment offers an opportunity for advisors to build their brands and strengthen relationships with clients, but it also presents a risk that advisors may fall behind the evolving investment landscape.

Now is the time for advisors to invest in their competencies around crypto. This document offers a foundation and framework for advisors to start thinking about crypto and how they may be able to incorporate it into their practices, but this is just the beginning. Advisors need to be ready, with the knowledge and capabilities that more and more investors are seeking, when this double-edged opportunity knocks.

Here are some ideas for advisors to get started:

1. Prioritize your foundational education around blockchain, cryptocurrency, and the rapidly evolving digital asset ecosystem.
2. Research specific options to invest in crypto and consider which may be a fit for different clients. This document can point you in the right directions, but you must read the fine print of each offering to fully understand how it functions.
3. Engage your partners! The emergence of crypto is disrupting much of the financial services industry, and we're all working to understand and adapt to its impact. Why not work together?
4. Determine how best to implement digital asset capabilities within your practice and within any guardrails established by your firm.
5. Refine your points of view around digital assets. Draft talking points and develop a strong working knowledge of them to aid client conversations.

To learn more about how Fidelity can help you explore the possibilities of digital assets, contact your Fidelity representative.

Endnotes

[1] https://coinmarketcap.com/charts/.

[2] Pew Research Center, 2021.

[3] Financial Planning Association, Trends in Investing Survey, 2021.

[4] Fidelity Digital Assets℠, Institutional Investor Digital Assets Study, 2021.

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Digital assets are speculative and highly volatile, can become illiquid at any time, and are for investors with a high risk tolerance. Investors in digital assets could lose the entire value of their investment. Supply and demand changes rapidly and is affected by a variety of factors, including regulation and general economic trends. Digital Asset exchanges may suffer from operational issues, such as delayed execution. Digital asset exchanges have been closed due to fraud, failure, or security breaches. Assets that reside on an exchange that shuts down or suffers a breach may be lost. Cryptocurrencies are created, issued, transmitted, and stored according to protocols run by computers in the network. It is possible Digital Asset protocols have undiscovered flaws, which could result in the loss of some or all assets. Advancements in quantum computing could break cryptocurrency cryptographic rules. There may also be network-scale attacks against cryptocurrency protocols, which result in the loss of some or all of assets.

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