ASIC CP 343 Submission From Zerocap Pty Ltd

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www.zerocap.com

Zerocap Pty Ltd ABN: 99 164 874 597

Zerocap Pty Ltd is registered with AUSTRAC as a DCE service provider (DCE100635539-001)

Zerocap Pty Ltd is a Corporate Authorised Representative (Representative Number 001289130) of Gannet Capital Pty Ltd (ACN 139 264 690; AFSL 340799)

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1. Intro

Zerocap is a Melbourne based crypto assets firm focused on execution, custody and trading. We are backed by one of Australia's most respected Family Offices, and sit as a Corporate Authorised Representative under an AFSL for our regulated products. Our vision has always been to bridge the gap between the emerging crypto asset space and traditional finance. We are excited to work more closely with regulators as this space grows.

Pricing & Liquidity

Pricing has clearly been a challenge for the SEC to approve a bitcoin ETF in the USA. In 2017 the ProShares ETF was rejected because the futures market (proposed pricing mechanism) was not deep and liquid enough to prevent manipulation. Between 2013 and 2017 the Winklevoss ETF had multiple submissions to the SEC, all receiving similar concerns around pricing mechanisms - particularly around pricing data being tied largely to unregulated exchanges.

We are in a very different position now, with large institutional backing, and deep, varied liquidity that is significantly more efficient and less prone to manipulation. Notably, Bitcoin became a trillion asset class, which in itself, provides the depth that is seen in the world's largest cap stocks. Furthermore, the derivatives market has significantly increased volumes and the diversification of traders, further reducing risk of pricing manipulation. Spot markets now have regulated over-the-counter streaming liquidity that provide institutional access points for hedging. Some of the world's largest electronic trading firms and market makers have entered the space, bringing records of success in pricing various alternative asset classes.

Institutional Protections

Technology, insurance and certifications; over the past 18-months, the protections available to investors have progressed to a level which ETP products can clearly rely on. Custody technology is now able to split private keys across multiple hardware devices, create biometric signing procedures for governance, and open APIs for auditing functions. Zerocap has secured bespoke insurance on customer assets that is underwritten by Lloyd's of London - a clear sign that even the world's largest insurers are becoming comfortable with new generation custodial technology.

Certifications and licensing are presumably the next step for regulators. Zerocap are currently working towards SOC 2 Type II, and are hoping to operate our custody business under our current CAR status, but unfortunately do not have clear guidelines on whether we can operate a licensed custodian service for crypto-assets. This presents a risk for ETP products, as they will inevitably be forced to choose offshore custodians that don't offer the same legal protections as locally licensed custodians would.

Zerocap holds the view that efficient pricing, robust and secure regulated custody, and requisite protections are available to investors for bitcoin or other crypto-asset ETPs. The key barrier to entry for service providers is ambiguity in custodial regulations for those who aim to provide services to funds, ETPs and other regulated vehicles. We would like to work with ASIC on providing clarity, benchmarks and best practices for custodial providers in Australia.

2. B Meeting INFO 230 Expectations

B1Q1 Do you consider that crypto-asset ETPs should be available to retail investors through licensed Australian markets? Please provide details, including data on investor demand where available.

Yes - provided the requisite licensing requirements are clearly defined for custodians. At this current juncture, we have not come across any licensed custodians in Australia. We feel that providing custodial services to ETPs should require a wholesale AFSL, engage in regular audits, and hold themselves to the highest account.

The demand locally and globally is clearly there for ETFs, and they tend to have global distribution given their scarcity. The Canadian BTC ETF for example has had uptake from many Australians. Notably, this ETF had CAD$500M of inflows within two-days of launch. Through the Australian lens, an ETP product would provide the requisite protections for retail investors by virtue of the licensing and regulatory frameworks. This benefit alone has demand from many investors still sitting on the sidelines concerned about counterparty risk.

B1Q2 Do you consider that crypto-asset ETPs should be cleared and settled through licensed Australian clearing and settlement facilities? Please provide details.

We absolutely do. This not only provides local checks and balances, but also provides legal protections for businesses in the value chain.

The technological infrastructure is already in place for some providers, including Zerocap. Next steps could be the greenlighting licensing for a crypto asset custodian, and promoting operating under this model.

B1Q3 If you are a clearing participant, would you be willing to clear crypto-asset ETPs? Please provide your reasons.

We are not a traditional clearing participant as per the ASX definition, however we do clear crypto assets at scale for large investors and businesses. We are willing to clear for ETPs - operationally we would need to ensure that our current clearing model meets the requirements as per ASX and ASIC guidelines.

A native crypto custodian and clearing partner brings the added benefits of familiarity in the space, tried and tested risk protocols, and in our case - Lloyd's of London insurance on asset holdings.

B1Q4 If you are a trading participant, would you be willing to trade crypto-asset ETPs? Please provide your reasons.

Definitely - part of the yield opportunities in the crypto space are derived from the futures basis curve. We would engage in selling forward futures curves, and buying underlying spot - in this case, the ETP given its (presumably) low fees, liquidity and protections.

B1Q5 Do you agree with our approach to determining whether certain crypto-assets are appropriate underlying assets for ETPs on Australian markets? If not, why not?

You've generally identified the key concerns and areas that we would like to see.

1. We disagree with the need for a regulated futures market to hold the underlying spot asset in an ETP. Whilst it aids price discovery and hedging facilities, it inherently limits progress based on what the CME decides it will launch. There are very large spot markets, with multiple pricing channels across market makers, price feeds and exchanges that can provide robust pricing.
2. Liquidity depth is important, which is a subset of a "mature spot market".
3. The availability of local service providers is important - local regulated custodians and market makers in this jurisdiction.

B1Q6 Do you have any suggestions for additions or modifications to the factors in proposal B1? Please provide details.

1. Remove the need for a regulated futures market as outlined above.
2. Add requisite liquidity depth to "mature spot market", given the supply challenges when any underlying asset is placed into an ETP. Requisite depth could be defined by average daily trading volume vs market cap vs expected total AUM of ETP in year 1.
3. Add key local service provider requirements - regulated custodians and market makers in this jurisdiction.

B1Q7 Do you have any suggestions for alternative mechanisms or principles that could achieve a similar outcome to the approach set out in proposal B1? Please provide details.

No.

3. C Responsible Entity Obligations

Custody

C1Q1 Do you agree with our proposed good practices in relation to the custody of crypto-assets? If not, why not? Please provide any suggestions for good practice in the custody of crypto-assets.

On the whole this is an excellent set of good practices, all of which are already followed by Zerocap, or in the case of SOC 2 Type II certification, in-progress.

C1Q2 Are there any practical problems associated with this approach? If so, please provide details.

C1(b): Generally speaking, segregating crypto-assets is the proper approach. This can be a problem however where a product (ETPs, LITs and unlisted registered managed investment schemes) utilises a strategy that is not pure spot exposure.

For example, a fund may generate some portion of its returns via collateralised institutional lending, in which case the crypto-assets are not directly held by the custodian (although the collateral can be) and segregation is not possible. A strategy that utilises futures is another example where crypto-assets are not held directly by the custodian.

C1Q3 Do you consider there should be any modifications to the set of good practices? Please provide details.

Other than the consideration above, no.

C1Q4 Do you consider that crypto-assets can be held in custody, safely and securely? Please provide your reasons.

Absolutely. Blockchain presents an unprecedented opportunity for both transparency and security.

- Crypto-assets can be viewed on the blockchain, therefore enabling the investor, RE, custodian, administrators, regulators and other relevant parties proof that the assets exist and are where they should be
- Technology already enables removing any single point of failure, as noted in C1(d)
- Being digital enables encryption and redundancy not possible with other asset classes
- Whilst insurance is currently very difficult to access (Zerocap has secured unique insurance in the Australian market), capacity is growing

- There is rapid innovation and substantial investment in this space attracting the brightest minds; security and user experience are continuously improving

C1Q5 Do you have any suggestions for alternative mechanisms or principles that could replace some or all of the good practices set out in proposal C1? Please provide details.

C1(b) implies that unique public and private key(s) are required in order to maintain segregated assets. Whilst this is technically true (certainly for the public key), we feel it is important that ASIC understand evolving crypto-asset custody technology that creates abstractions from this concept in order to improve security and usability, in particular how a private key is handled with MPC. An excellent primer for this can be found at https://www.fireblocks.com/what-is-mpc/.

We would advise to be mindful about wording which may prohibit these types of solutions that still achieve desired outcome (segregated crypto-assets on the blockchain).

C1Q6 Should similar requirements to proposal C1 also be imposed through a market operator's regulatory framework for ETPs? If so, please provide reasons and how it could work in practice.

We do not have a view on whether this is necessary or beneficial.

Risk Management

C2Q1 Do you agree with our proposed good practices in relation to risk management systems for REs that hold crypto assets? If not, why not?

Mostly, however there may be situations where an RE would want to access liquidity provided via a decentralised exchange, for example DeFi crypto-assets. In the context of an ETP, the RE may typically source liquidity via an OTC desk, which would have the baseline level of regulation proposed. However, strictly enforcing this may have adverse consequences if the OTC desk is unavailable, providing inferior pricing or does not have sufficient liquidity itself.

Even though decentralised exchanges do not have a KYC and AML/CTF program, we are still able to enforce this via the use of blockchain analysis tools such as Chainalysis (used by Zerocap). We suggest allowing the use of decentralised exchanges where it makes sense.

C2Q2 Are there any other regulations (other than KYC and AML/CTF) that should form part of an appropriate baseline level of regulation for crypto-asset trading platforms used by REs and connected service providers? Please provide details.

No.

C2Q3 Are there any practical problems associated with this approach? If so, please provide details.

As stated in our response to C2Q1.

C2Q4 Are there any other matters related to holding crypto-assets that ought to be recognised in the risk management systems of REs and highlighted through ASIC good practice information? Please provide details and any specific proposals.

No.

C2Q5 Should similar requirements to proposal C2 also be imposed through a market operator's regulatory framework for ETPs? If so, please provide reasons and outline how it could work in practice.

We do not have a view on whether this is necessary or beneficial.

Disclosure

C3Q1 Do you agree with our proposed expectations regarding disclosure obligations for registered managed investment schemes that hold crypto-assets? If not, please explain why not.

Agree, indeed Zerocap have already met these disclosure obligations (and more as noted below) in the Information Memorandum distributed for the Zerocap Bitcoin Trust (an unlisted wholesale unit trust). A core tenet of blockchain and cryptocurrency is transparency -- this should be maintained in a regulated environment.

C3Q2 Are there any practical problems associated with this approach? If so, please provide details.

No.

C3Q3 Are there any additional categories of risks that ought to be specified by ASIC as good practice for disclosure in relation to registered managed investment schemes that hold crypto-assets?

The following are copied verbatim from the Information Memorandum for the Zerocap Bitcoin Trust (an unlisted wholesale unit trust) and are therefore in the context of a fund, however still apply to an ETP.

Counterparty risk:

- The risk of loss caused by another party defaulting on its financial obligations either because they become insolvent or cannot otherwise meet their obligations to the Fund which could have a detrimental impact on the Funds' performance and result in substantial losses.

- This includes (but is not limited to) execution venues, intermediaries and custodial services.

Insurance risk:

- Insurance premiums may be impacted by numerous factors, and the insurance policy does not cover all possible risks to the assets of the Fund.
- It is possible that the insurance policy may change, be cancelled or that coverage may cease during the life of the Fund.

Tax changes:

- Changes to legislation may impair the tax status of the Fund, the net proceeds of sale of cryptocurrency or any tax concessions that are currently available to investors as a result of an investment in the Fund.

Liquidity:

- Under certain conditions liquidity of a particular market or security may be restricted, thus affecting the performance of the Fund, valuation of the Fund's assets or ability to meet redemptions.

The following are Bitcoin-specific risks however also apply to many other crypto-assets.

51% Attack:

- A group of miners controlling more than 50% of the hash rate could prevent new transactions from gaining confirmations, allowing them to halt payments between some or all users. They would also be able to reverse transactions that were completed while they were in control of the network, meaning they could doublespend coins.

Adoption:

- Lack of developer, miner and user adoption of bitcoin may affect the network's performance and impact the investment.

Competition:

- Other cryptocurrencies may threaten bitcoin's dominance, eat into its market share, attract miners and investors away from bitcoin, which may adversely affect the price of bitcoin.

Development:

- Bitcoin is free software and any developer can contribute to the project. Developers may propose or make amendments to the code or network which adversely affects performance of the asset.

Fees:

- An increase in transaction fees could disincentivise the use of bitcoin, which in turn affects demand, which may have an adverse effect on price. This may also cause miners to sell at higher rates than usual, creating downward pressure on price.

Lack of Incentives:

- If the reward for solving blocks becomes insufficient to incentivise miners to validate the blockchain, the hash power may drop causing confirmations of transactions to slow or cease. This may also make a 51% Attack more likely.

Design and Distribution Obligations

C4Q1 Are there any aspects of the DDO regime that need to be clarified for investment products that invest in, or provide exposure to, crypto-assets?

No.

4. D Listed Investment Entities

Settings for Investment Entities

D1Q1 Do you agree that crypto-assets are capable of being appropriate assets for listed investment entities on Australian markets? If not, why not?

Yes. The diversification benefits of crypto assets combined with the liquidity available to listed entities provides great potential value to portfolios. The market and pricing mechanisms are efficient for appropriate crypto assets to be included in these listed pools.

D1Q2 Do you agree with our proposed expectations for LICs and LITs that invest in crypto-assets to ensure equivalent standards are applied by market operators? If not, why not?

Yes, taking into account the following comments from section B.

1. Remove the need for a regulated futures market.
2. Add requisite liquidity depth to "marture spot market", given the supply challenges when any underlying asset is placed into an ETP.
3. Add key local service provider requirements - a regulated custodian and market makers in this jurisdiction.

D1Q3 Are there any practical problems associated with this approach? If so, please provide details.

There are very few financial services licensed cryptocurrency exchanges globally. Most, as in Australia, operate solely under AML CTF regulations. Furthermore, the few exchanges that do hold financial services licenses only receive a fraction of the volume. To mandate that regulated exchanges can only be used in these products presents challenges to source and hedge deep liquidity.

D1Q4 Are there additional standards which ought to apply via market operators to LICs or LITs that invest in crypto-assets? If so, what are these expectations and why should they apply?

As previously mentioned, local regulated custodians would be preferable for holding assets of LIC/LITs given local regulatory oversight.

D1Q5 Should LICs and LITs only be able to invest significant funds in crypto-assets if this is either set out in their investment mandate or with member approval? If not, why not?

Risks and investment approaches should be clearly outlined in any fund, and this should include a clear investment mandate around assets, clearing houses and custody.

D1Q6 For the purposes of this proposal, we consider a material investment where an entity invests or plans to invest more than 5% of its funds in crypto-assets. Should another materiality threshold apply?

We would consider materiality around the fund's single asset volume and holdings as a function of the total market cap of each asset. This ensures that any one firm is not able to manipulate/move pricing.

5. E AFS Licensing

New asset kind

E1Q1 Do you agree with our proposal to establish a new asset kind that will cover crypto-assets?

Agree with the approach, however we would urge that existing license holders that are able to trade and deal in derivatives, are automatically afforded a crypto asset license. Crypto assets are volatile and hold liquidity challenges at times. Derivatives, when traded on leverage, hold a very similar pricing and risk profile.

At the very least there would need to be a grace period for existing license holders and their CARs that are operating managed investment schemes which invest in crypto-assets.

E1Q2 Do you consider that crypto-assets may be captured by the existing asset kinds? If so, please explain.

Derivatives hold very similar risk profiles to crypto assets in terms of volatility and trading considerations. Whilst we agree that crypto assets should have their own asset kind in terms of AFS regulations, as stated above - these should implicitly be automatically afforded to those holding a license to trade and deal in derivatives.

E2Q1 Do you agree with our approach to restrict the crypto-assets a registered managed investment scheme is authorised to hold (e.g. to bitcoin or ether)?

Disagree - there are many opportunities in the space far beyond bitcoin and ethereum, and present avenues for risk adjusted and diversified return profiles for investors outside of equity and property markets. Risks of trading alternative coins/assets need to be outlined in the PDS in detail, and operators of these MIS's should be held to account for any promises that damage retail investors. The legal framework for retail protections is strong - and we don't believe that genuine fund managers who are able to mitigate risk on alternative coins/assets and generate value for investors should be penalised. Furthermore, the market cap of the entire industry has ballooned, and there is an abundance of opportunities that can be captured with a limited risk profile.

E2Q2 Do you consider there are any other aspects of the AFS licensing regime that need to be clarified or modified to accommodate investment products that invest in, or provide exposure to, crypto-assets?

As mentioned previously, custodial providers should have minimum standards to ensure counterparty risk is negated to the maximum possible extent.

ZEROCAP

Crypto Asset Firm
for Private Clients