

Monochrome Asset Management

Response to ASIC Consultation Paper 343

“Crypto-assets as underlying assets for ETPs and other investment products”

27 July 2021

Australian Securities and Investments Commission

Email: 

ASIC Consultation Paper 343

“Crypto-assets as underlying assets for ETPs and other investment products”

Introduction

1. This submission, prepared by Derek Henningsen LL.B. (Hons) is made on behalf of Monochrome Asset Management Pty Limited ACN 647 701 246 (“Monochrome”). Monochrome is the Corporate Authorised Representative of Non Correlated Capital Pty Ltd ACN 143 882 562 (“NCC”) (CAR No. 1286428).
2. The author is currently the Head of Legal & Compliance at Monochrome and has worked in financial services and fin-tech since 1999, with experience across a range of legal, risk, compliance and governance roles, primarily with boutique, mid-sized and institutional asset managers. He has practised law for over a decade with positions including ‘Head of Legal & Compliance’ and ‘General Counsel’. He has been involved in digital currencies since 2017, and in 2018 he established the registered digital currency exchange, Huobi Australia Pty Limited, the Australian operations for the world’s then third largest cryptocurrency exchange provider, Huobi Global.
3. Via the Monochrome Investment Trust, an unregistered managed investment scheme issued by NCC, Monochrome offers the Monochrome Bitcoin Fund, providing certified wholesale investors access to a pure-play passive exposure to Bitcoin. With a team of over 100 years of combined experience in traditional financial markets, funds management, and digital asset trading, Monochrome offers wholesale investors access to Bitcoin via a familiar investment vehicle without the requirement to engage with new technologies.
4. Monochrome is currently in the final stages of launching an Ethereum based unregistered managed investment scheme for wholesale investors and was in the process of preparing an application for a pure-play Bitcoin exchange traded fund when ASIC issued its consultation paper CP 343. Monochrome intends in due course to apply for approval to launch a Bitcoin ETF.
5. The author acknowledges the assistance of Michael Bacina, Partner, and Christopher Lyons, Partner, at Piper Alderman in preparing this submission.

6. Monochrome recognises the time and thought that ASIC has put into CP343. The blockchain and digital assets industry will benefit from this engagement with ASIC. With positive engagement, Australia can build a place at the forefront of this nascent industry, creating jobs and wealth for everyday Australians into the 21st century.
7. Australians have been able to buy and sell digital assets on local and overseas digital currency exchanges for many years. As noted above, the author established the local operation for a large foreign digital asset exchange provider in 2018. Before founding Monochrome Asset Management, Mr Jeff Yew, CEO of Monochrome, established Binance Australia in 2019, a local independent arm of the world's largest digital asset exchange operator, Binance. Binance Australia¹ quickly grew to become the largest Australian DCE by trading volume². Both Huobi Australia and Binance Australia were operated in line with the legal requirements attendant to DCEs, including, amongst other things, registration with AUSTRAC and conducting KYC checks on customers.
8. However, in the context of the volumes of money being transacted on a daily basis on these and other exchanges to which Australian retail investors have largely unfettered access, Monochrome is of the opinion that the current level of regulatory oversight and controls exposes retail investors to real risk of financial loss.
9. Whilst the infrastructure around DCEs, and generally the client experience, has improved from the author's initial experience in 2017, there is still a significant technological hurdle to overcome in purchasing and trading digital assets on DCEs and in the safe storage of digital assets thereafter. Signing up to an exchange, passing KYC checks, funding the account, transacting, navigating transferring and safely storing private keys are all important steps that must be taken. Making mistakes at any juncture, but particularly in relation to the storage of private keys, can be catastrophic.
10. In addition to the functional steps, merely identifying credible service providers can be incredibly difficult. There are numerous examples of exchanges being subject to hacks by external parties and thefts of client funds by unscrupulous exchange operators³.

¹ InvestbyBit Pty Ltd t/a Binance Australia

² <https://coinmarketcap.com/> - trading period July 2020 to July 2021

³ Mt Gox private key theft 26 - <https://www.wired.com/2014/03/bitcoin-exchange/>; QuadrigaCX, where a DCE founder operated a ponzi scheme and died, creating confusion over whether the keys had been lost - <https://newsinteractives.cbc.ca/longform/bitcoin-gerald-cotten-quadruga-cx-death>; Cryptopia exchange hack and subsequent theft by former employee - <https://www.stuff.co.nz/national/crime/124249161/assets-worth-62000-allegedly-stolen-from-liquidated-company-cryptopia#:~:text=Cryptopia%20went%20into%20liquidation%20in%20May%202019%20after%20a%20hacker,theft%20in%20New%20Zealand%20history>.

11. As observed by ASIC, Monochrome notes that there is interest in, and demand for, Australian-based digital asset ETPs. Canada has led the way with the successful introduction of Bitcoin and Ethereum based ETFs, which have drawn in large flows in short periods of time.
12. Digital asset based ETPs, if implemented properly, which could be within the existing legal and regulatory framework with some small modifications in approach, would provide retail investors with the benefit of protection under Corporations Act 2001 (Cth) (the “Act”) and easy access to the asset class in a safe, regulated, and well understood structure.
13. Before providing responses to ASIC’s specific questions in CP343, which are located in the Appendix to this letter, Monochrome notes the following:
 - i. Where a digital asset has the features of a financial product per the Act, as set out in ASIC’s INFO225, it should be treated as that financial product. However, where a digital asset does not have the features of a financial product, and properly has the characteristics of a commodity, the natural categorisation of that digital asset should be one of a commodity. This approach is more efficient and effective than creating a new ‘eligible crypto-asset’ category and eliminates the need for market operators to change their operating rules and for AFS licensees to apply for licence variations (as proposed at paragraph 37 of CP343). It would ensure a greater level of consistency in the treatment of digital assets globally, assisting Australian based providers of financial services to the digital asset economy in marketing their products and services to the world.
 - ii. Existing ETP frameworks currently accommodate commodities. Digital assets that are not financial products, and which share the characteristics of commodities, should therefore be naturally identified as commodities, and the current framework for commodities-based ETPs should be used.
 - iii. In CP343 ASIC has identified the robustness of digital asset custody as critical to being able to properly operate within the existing ETP framework. Custody of digital assets is a highly technical endeavour requiring specialised infrastructure and technical expertise. Monochrome is of the opinion that whilst local custody is preferred, in the current absence of qualified, institutional-grade, custodians being based in Australia, ETP operators should select such custodians that have subjected their security controls to a detailed audit (e.g., SOC2 or other controls audit similar to GS007). Overseas custodians should be in jurisdictions similar to Australia, with a strong legal framework and the rule of law, with custodian agreements complying with the requirements of RG133.

- iv. Regulators and media outlets from time to time refer to digital assets as being a refuge for criminal elements in society and that money laundering is rife in the digital assets ecosystem, when the reality is quite the opposite⁴. Rather than being an effective method of disguising transactions, the immutable and open nature of blockchains and other digital asset platforms makes them a poor tool for criminals and in fact an excellent tool for police to identify the movement of funds as they move through the illicit economy. It would benefit the digital assets ecosystem were ASIC to draw on recent research in relation to the use of digital assets in criminal activity and use specific examples to better educate retail investors.

Yours faithfully,

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⁴ Chainalysis, "The 2021 Crypto Crime Report" (February 16, 2021) - (<https://go.chainalysis.com/rs/503-FAP-074/images/Chainalysis-Crypto-Crime-2021.pdf>);
The False Narrative Of Bitcoin's Role In Illicit Activity -
<https://www.forbes.com/sites/haileylennon/2021/01/19/the-false-narrative-of-bitcoins-role-in-illicit-activity/?sh=368dce313432>

Appendix

Q No	Question	Response
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.	<p>Yes. Digital assets are a nascent asset class and, whilst volatile, provide investors (retail and wholesale) access to the first new asset class since the 1600s when equities came into being.</p> <p>There is clearly great demand for digital assets to be made available via ETPs.</p> <p>Currently, retail investors can access digital assets via a range of options, including online registered Australian Digital Currency Exchanges, unregistered overseas exchanges, decentralised exchanges, crypto ATMs, to name a few.</p> <p>Trading across five of the largest DCEs that provide access to retail investors saw combined trading volume in excess of AU\$32B over the period 30 July 2020 to 21 July 2021⁵; however as noted in the Introduction, there are significant hurdles (both in terms of technological and in security and safe storage) for investors to navigate. Offering retail investors access to digital assets through a fully regulated ETP overcomes these hurdles and provides all investors simple and secure access to this new asset class.</p> <p>In terms of the anticipated take up of digital asset backed exchange traded notes, contracts and ETPs, the experience overseas is instructive.</p> <p>In Europe, these structures have seen a five-fold increase in assets under management in</p>

⁵ <https://coinmarketcap.com/> - BTC Markets: \$7.14B; Independent Reserve \$2.43B; Coinjar 2.42B; Kraken \$0.378B; Binance AU \$20.08B

		2020, to €2.3B ^[13] and three funds held over €100 each at the end of 2020 ^[14] , whilst in Canada, which has been at the forefront of digital asset backed ETPs, there are now 19 ETPs, with one Bitcoin based ETF growing by US\$823M in the first three weeks of public trading, and the largest US-based wholesale fund holding in excess of US\$22B in assets as at 26 July 2021.
B1Q2	Do you consider that crypto-asset ETPs should be cleared and settled through licensed Australian clearing and settlement facilities? Please provide details.	Yes. Digital asset ETPs backed by commodities analogous digital assets should be cleared and settled as per other commodities based ETPs.
B1Q3	If you are a clearing participant, would you be willing to clear crypto-asset ETPs? Please provide your reasons.	N/A
B1Q4	If you are a trading participant, would you be willing to trade crypto-asset ETPs? Please provide your reasons.	N/A
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?	Yes. We agree that ASIC has identified at B1(a)-(e) the important criteria to determine the appropriateness of digital assets to be made available in ETPs.
B1Q6	Do you have any suggestions for additions or modifications to the factors in proposal B1? Please provide details.	<p>It would be helpful if ASIC would provide clear guidance that:</p> <ol style="list-style-type: none"> 1. licensed custodians may offer crypto custody services for crypto commodities under their existing AFSL authorisations; 2. in the absence of insurance service providers providing insurance coverage

		<p>to digital asset-related businesses, that a bond or other form of compensation scheme will be acceptable; and</p> <p>3. registered Australian Digital Currency Exchanges and digital currency overseas exchanges that have similar standards in terms of AML/CTF obligations are recognised in terms of the spot market for digital assets.</p>
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.	Refer to response at B1Q6
B2Q1	Do you agree that a new category of permissible underlying asset ought to be established by market operators for crypto-assets? If not, why not?	<p>No. As set out above, we submit that where digital assets display the characteristics of commodities, that they should be treated as commodities and that where they display the characteristics of a financial product that they should continue to be treated as financial products (per INFO225).</p> <p>Creating a new crypto asset type, when the current regulatory framework can support the use of commodities analogous digital asset backed ETPs, would on its face appear to be making a policy decision on the treatment of digital assets, which runs counter to the objectives identified at 36(c).</p>
B3Q1	Do you agree with the good practices in proposal B3 with respect to the pricing mechanisms of underlying crypto-assets? If not, why not?	Yes. We agree with ASIC's identified good practices in relation to robust and transparent pricing of digital assets.
B3Q2	Are there any practical problems associated with this approach? If so, please provide details	No. We commend ASIC on its approach.

<p>B3Q3</p>	<p>Do you think crypto-assets can be priced to a robust and transparent standard? Please explain your views.</p>	<p>Yes. For the same reason that digital assets are generally poor for use in the illicit economy, the open nature and immutability of public blockchains provides a level of robustness and transparency not hitherto seen in other asset classes.</p> <p>We note that, whilst there are currently no Australian based digital asset benchmarks, there are numerous indices in operation in overseas jurisdictions, including:</p> <ol style="list-style-type: none"> 1. The CME Group's Bitcoin Reference Rate (BRR) and Bitcoin Real-Time Index (BRTI), both registered benchmarks under the European Benchmarks Regulation (EU BMR) 2. the NYSE Bitcoin Index (NYXBT) 3. S&P Dow Jones Indices launched a Cryptocurrency Index Series including S&P Bitcoin Index, S&P Ethereum Index and S&P Cryptocurrency MegaCap Index (measuring Bitcoin and Ethereum) 4. the range of new indices announced by S&P as recently as 13 July 2021 covering in excess of 240 digital assets. <p>Finally, whilst pricing transparency for an Australian based digital asset backed ETPs is a novel issue to solve, Canada has approved 19 ETFs that use a range of indices.</p>
<p>B3Q4</p>	<p>Do you consider that a more robust and transparent pricing standard is achievable in relation to crypto-assets? For example, by using quoted derivatives on a regulated market. Please explain and provide examples where possible.</p>	<p>We support the approach outlined by ASIC including the use of quality indices.</p>

B4Q1	Are there any other good practice expectations in INFO 230 that need to be clarified or modified to accommodate crypto asset ETPs?	INFO230 would benefit from specific reference to digital assets, particularly that commodity analogous digital asset ETPs are treated as per other commodity ETPs; and that licensed custodians may custody digital assets.
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.	Yes.
C1Q2	Are there any practical problems associated with this approach? If so, please provide details.	Refer to response at C1Q3
C1Q3	Do you consider there should be any modifications to the set of good practices? Please provide details.	Given the state of the insurance market vis-a-vis digital asset enterprises, it should be clarified that a bond or other form of compensation programme beyond insurance is acceptable.
C1Q4	Do you consider that crypto-assets can be held in custody, safely and securely? Please provide your reasons.	<p>Yes. Appropriate physical and IT security in the creation and storage of private keys is critical, as is security and whitelisting of addresses when transacting digital assets, and the use of cold storage of digital assets, amongst other things.</p> <p>Professional institutional grade custodians operate in overseas jurisdictions and have well established, audited and auditable, security controls processes and procedures.</p>
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.	Ensuring custodians' security controls have been subject to recent strong security controls audit (e.g., GS007 or SOC2 or similar standard).

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	Market operators are capable of reviewing the efficacy of digital asset custody during the listing application process. This is assisted where the security controls of qualified custodians have been subject to a high level controls audit (refer C1Q1).
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?	Yes. We agree with ASIC's proposed good practices.
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. Baseline of KYC, with attendant obligations under AML/CTF legislation, is sensible to mitigate exposure to criminal activities.
C2Q3	Are there any practical problems associated with this approach? If so, please provide details.	We observe no practical problems with this approach.
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.	REs should document their funds flow processes for the movement of assets; whitelist approved addresses for the transfer of digital assets; establish processes that minimise human input to the extent practicable; enforce proper segregation of funds using professional institutional-grade custodians that have had their security controls audited to a high standard (e.g., GS007, SOC2 or similar).
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	No further suggestions.

	outline how it could work in practice.	
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.	We broadly agree with ASIC's proposals regarding disclosure. Risk disclosure in PDSs should be adequate and specific to the particular digital assets. It is important to draw distinctions between different digital assets as different digital assets have different risk profiles and have different environmental footprints etc.
C3Q2	Are there any practical problems associated with this approach? If so, please provide details.	No. It is fair and reasonable to have comprehensive, but well balanced, risk disclosure for digital asset based ETPs as per other financial products.
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?	Care should be taken with specifically mandated risk disclosures, as there is the potential for perceived risks, as created and/or perpetuated by the media and picked up by regulators and others in positions of influence, to diverge from the actual risks associated with digital assets or particular digital assets.
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 further suggestions.
D1Q1	Do you agree that crypto-assets are capable of being appropriate assets for listed investment entities on Australian markets? If not, why not?	No further suggestions.
D1Q2	Do you agree with our proposed expectations for LICs and LITs that invest in crypto-assets to ensure equivalent standards are	No further suggestions.

	applied by market operators? If not, why not?	
D1Q3	Are there any practical problems associated with this approach? If so, please provide details.	No further suggestions.
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?	No further suggestions.
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?	No further suggestions.
D1Q6	For the purposes of this proposal, we consider a material investment is where an entity invests or plans to invest more than 5% of its funds in crypto-assets. Should another materiality threshold apply	No further suggestions.
E1Q1	Do you agree with our proposal to establish a new asset kind that will cover crypto-assets?	No. As noted above, digital assets that share the same properties as commodities should be treated as such and digital assets that are financial products should continue to be treated as financial products.
E1Q2	Do you consider that crypto-assets may be captured by the existing asset kinds? If so, please explain.	Refer to response at E1Q1

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)?	<p>We agree with ASIC's sensible approach to the assessment of the suitability of digital assets for inclusion in ETPs as set out at Proposal B1 and agree that Bitcoin and Ethereum currently meet those requirements.</p> <p>We have no further comment.</p>
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?	We submit that it should be clarified, via an update to RG133, that licensed custodians can custody digital assets under their existing authorisations.