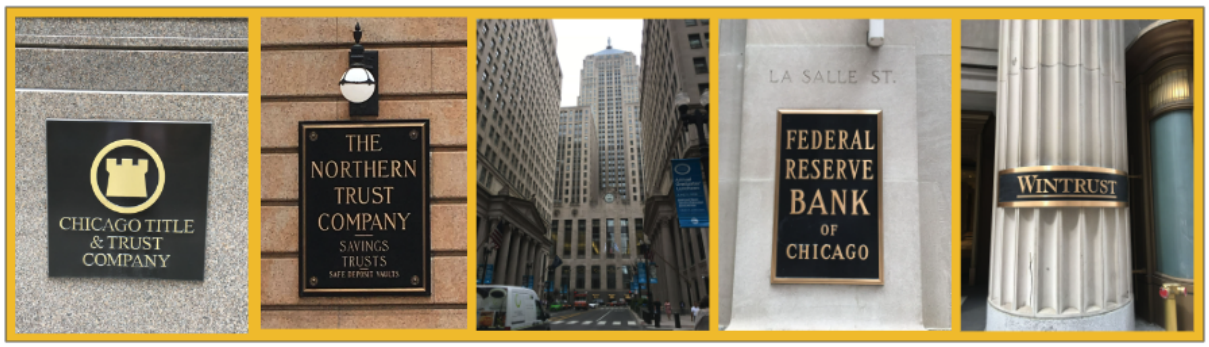
Blockchain Assets
CRYPTOASSET MANAGERS • EST 2017



Dear Investors,

Bolted to the front of pillared Chicago buildings are impressive brass plates setting out the services offered by the companies housed within. The service they provide is Trust. 'We need to talk about Trust'. Because Trust is at the core of the assets we invest in and it is foundational to the safety of our assets.

Our Fund had ZERO exposure to the now collapsed crypto exchange FTX. Yes, the value of our assets has been impacted. But our investment thesis holds. There have been no outages/hiccups with the operation of the blockchain assets we invest in and our assets are securely held.

In this news bulletin I revisit the Trust aspects of blockchain technology through the lens of the FTX fraud. I also set out how we secure our assets and why I feel that we have the best possible custodial solution available.

'FTX is not a crypto scam. It is a massive money laundering, Ponzi scheme fraud with a crypto wrapper. This has nothing to do with crypto. This shit needs to stop.'

Veteran short-seller Marc Cohodes (see here)

Trust Verification Systems

The notion of Trust underpins our financial systems and by extension the entire global economy. The Trust Verification model we have used for the last 250 odd years, is Subjective Centralised Trust.

It is Subjective because we rely on third parties (auditors and regulators) to assess the Trust and this by nature is a subjective process. It is Centralised because we rely on companies, like the ones with the brass plates, to keep our assets safe and our records accurate.

A fundamental weakness of this model is it's centralised nature. When there is a failure of the model blow-ups occur. Innocent people get hurt and sometimes the blow-ups are so significant that the entire global financial system can be put at risk. The collapse of Lehman's in 2008 exposed the systemic risk of the Subjective Centralised Trust model. In order to mitigate these risks a number of Capital, Disclosure and Risk regulations and laws were passed in jurisdictions across the world.

Our Subjective and Centralised Trust Verification model employs millions of people. It has been continuously refined and improved over centuries and it has created giant and highly profitable companies like BNY Mellon, Northern Trust and State Street, to name just a few.

Although far from perfect, the current system is the best we have on a large scale. However, as humans we continually seek to improve our safety and security and in the area of Trust Verification a new model was developed and implemented in 2009. This model is Objective Decentralised Trust and the first implementation of this model is Bitcoin.

Some people refer to public blockchains as trustless models. I prefer to think of them as Trust Verification models where the human trust has been swapped out for Trust in the Code. Let's examine this model a little bit.

The starting point is the code itself, after all the code is written by humans so we have to at some point trust a human. This is where the publicly available nature of the code is important. Not only can the public read the code they can, potentially, submit changes to the community to make amendments to the code. So if the code says that '...if x happens then y will be paid z…' we know that this is precisely what will happen. It is certain. We do not need a trusted third party to verify. This is the Objective part of the model.

But it is the decentralised nature of the model that is the major breakthrough. Because we now have the ability for multiple parties to simultaneously verify transactions at the same time, we do not need to rely on the centralised party and the verification structures around those centralised parties. It is much more difficult to organise a bunch of individuals to work together to commit fraud than it is for a single individual to cook the books. Thus far the Bitcoin network has never been corrupted. It has proved impossible to get sufficient co-ordination or control over the network to put through a corrupt transaction.

This is why many view an Objective Decentralised Trust Verification Model as superior to our current trust model. This is the main value proposition of public blockchain technology. We see Ethereum and Bitcoin as being two of the most important base layers for the future trust models of humanity.

The Blow-Up of FTX

The blow-up of FTX is a very old and sad story of human greed and incompetence.

FTX the exchange and it's related company Alameda Research (a related hedge fund) where centralised companies based in the Bahamas, they did not have any regulatory licences (US), they did not have independent Boards of Directors, they did not have externally published audits or indeed any audits at all. They did however have a great marketing machine and a front person who seemed to grab the attention of the rich and famous.

In November 2022 Sam Bankman-Fried (SBF) was on the front cover of the Australian Financial Review - Young Rich List glossy magazine. On 11 November 2022 his companies filed for bankruptcy after the discovery of a USD 10 billion dollar fraud. Then if that was not enough any remaining assets in the exchange were hacked (maybe by Sam?). The story continues.

This fraud was of the plain vanilla variety. Sam took (stole) client funds from the exchange, lent them to Alameda Research. Alameda invested the money in FTX tokens and other 'investments'. They over leveraged and made bad allocations. This happens all too often in the traditional financial world, no amount of regulation can prevent this, it is a failure of the centralised trust model.

This collapse is a short to medium term blow to the sector for sure and it is incredibly infuriating for a number of reasons. Primarily because of the hurt to a large number of innocent individuals. But beyond that it hurts our industry because of the profile Sam had built up with legislators and regulators in Washington and the US generally. Sam had been holding himself out as the best example of the crypto industry when in fact he was the opposite. His lying and cheating hoodwinked some of the most powerful people in the US Government. They will not, for a very long time, accept meetings from anyone in our industry. There is a real risk of knee-jerk harmful regulatory response.

It will clearly also set-back serious institutional adoption as naysayers and incumbents point the finger quite reasonably at our nascent industry.

The most frustrating thing about this is that we have Decentralised Finance (DeFi) protocols, crypto exchanges and other financial services which are already operating. It would be impossible to commit this type of fraud on these DeFi systems. The very purpose of blockchain technology is to swap out the 'trust Sam Bankman-Fried model' for the trust in the open source code model. Why then don't we use that for our own industry.

Caught in the Middle

With FTX Sam - now known as Scam Bankrupt-Fraud - had created a very lucrative and highly profitable toll bridge between the traditional and cryptoasset market places. FTX was a centralised on/off ramp to crypto. Many have done this without becoming frauds. Coinbase, Kraken, Custodia Bank, Anchorage and others have made very good business by providing on-ramp services. At the moment though, such businesses are caught in the middle of the centralised and decentralised worlds. It's all very well to have DeFi protocols accessible directly by billions of people, but in order to access them first fiat needs to be converted to crypto and for this we need on-ramps. Sadly there are more fraudulent players out there than responsible so the FTX thing will inevitably happen time and time again.

Where to next? Well I fear that we will have bad regulation that will not prevent fraud or protect investors and we will have more centralised exchanges defrauding investors. Humans tend to not learn from mistakes. But also we will see the crypto markets shrug off this set-back and move onto greater heights as the technology develops and adoption increases. In the longer term this new Objective Decentralised Trust Verification Model will become the default 'go to' system for financial services and there will be less need for human based trust. I remain optimistic about where this technology is heading and the hope that it brings for a better world.

How does the Fund hold it's assets

As a fiduciary the most important task we have is to keep the Fund's assets safe.

Self custody ('not your keys not your coins') is not really an option for a fund manager, there is too much risk and providing custody as a service, particularly for cryptoassets, is a specialised and complex business.

This means we need an institutional grade custody service provider. Even before I launched the Fund on 1 July 2017 I spent a significant amount of time finding and assessing the best custodial solutions. Back then there was only one properly regulated and insured custodian. A US company called Kingdom Trust. They became our first custody service provider.

Since then a number of regulated and institutional grade service providers have emerged (although none in Australia). But what does it mean to be 'institutional grade'? Well the most important criteria to consider is whether client assets are insulated from the bankruptcy of the service provider. Client assets should not be on the Balance Sheet of the service provider, they should be kept in segregated accounts and clients should never be considered as unsecured creditors in the event of a bankruptcy.

Our Fund's primary service provider is Anchorage Digital Bank National Association. Anchorage is a Federally Chartered Bank (see list here) and as such it is regulated by Office of the Comptroller of the Currency (OCC). Trust banks as they are known are subject to stringent controls including risk-based capital control adequacy assessments. They are expected to have a high degree of corporate oversight including an independent board with individual lines of responsibility for compliance, internal and external audits. The Board of

Anchorage can be seen here. Interesting note…Stanley Druckenmiller is an advisor.

Because of the separation of assets and other prudential requirements Trust banks are considered low risk institutions. However, in the event of a bankruptcy, the OCC would step in as receiver to secure and distribute client assets to applicable clients.

On top of this, we are able to view our assets on the blockchain as we have the public keys. We have set up notifications so that any movement of the assets is notified to us immediately.

Closing Comments

As I am writing this I am very aware of the juxtaposition of our investment thesis in investing Objective Decentralised Trust assets (Bitcoin, Ether etc.) but using for ourselves a Subjective Centralised Trust model (Anchorage and indeed the Unit Trust structure of our Fund).

The reality of the future is a blend of these systems. I do not see - at least in my lifetime - the complete removal of centralised trust for all our systems. But I do see a significant part of the system being decentralised. For example there exists already a blended service (refer to Canvas Connect) whereby cryptoassets are held by an institution grade custodian but at the same time the assets can be pledged or used in DeFi protocols to earn yield.

One thing FTX has shown us is that there is significant demand for cryptoassets and what we have learnt (again!) is to never trust centralised crypto exchanges. If you use them to buy assets, take your assets off the exchange and learn how to self custody or use a properly regulated service provider.

What I would like to see happen is for existing financial service providers including banks, to offer cryptoasset services. We almost saw this with the Commonwealth Bank. What I do not want to see happen is regulation of the assets themselves. We also do not need to regulate un-hosted wallets and DeFi protocols.

Finally, there is a big piece of work here for financial advisors. They should become familiar with this space and be allowed to advise, the absence of good advisors is one of the issues enabling bad actors like SBF to flourish.

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As always, please do not hesitate to contact me on 04 5090 0151 or at ian@bca.fund if you have any questions.

Best Regards

Ian Love
Founder and CEO

To the extent that any of the information which we have supplied to you may be deemed to be "general advice" within the meaning of the Corporations Act, we draw your attention to:- (a) in preparing, supplying or conveying such advice, we did not take into account your investment objectives, financial situation or specific needs; and (b) (before acting on the advice) the need to consider, with or without the assistance of an authorised representative, the appropriateness of the advice having regard to your investment objectives, financial situation or specific needs and any relevant Information Memorandum.