CRYPTOASSETS – Trust and Custody

By Ian Love, Founder and CEO, Blockchain Early Opportunities Fund

The collapse of cryptoasset exchange FTX in November 2022 highlighted again the risk of leaving cryptoassets on unregulated exchanges. In this article I consider the Trust aspects of investing in blockchain technology through the lens of the FTX collapse.

Trust Verification Models

Our 'Subjective Centralised' Trust verification model relies on third parties (auditors and regulators) to verify the trust we place in centralised institutions. The collapse of Lehman's in 2008 exposed the systemic risk of this model. Each time there is a failure, the model is refined and improved. Over centuries this model has created esteemed trust companies like BNY Mellon, Northern Trust and State Street, to name a few.

This system is the best we have on a large scale. However, 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 new model is a paradigm shift, it is based on 'Objective Decentralised Trust' and the first implementation of this model is the Bitcoin public blockchain.

Some people refer to public blockchains as trustless. 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 this is precisely what will happen. 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. We do not need to rely on the centralised parties 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.

An 'Objective Decentralised Trust Verification Model' 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 FTX Collapse

On 1 November 2022 Sam Bankman-Fried was on the front cover of the Australian Financial Review - Young Rich List glossy magazine. On 11 November 2022 his companies filed for bankruptcy. The blow-up of FTX is an all too common story of a '...complete failure of corporate control...' and '... the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals...'.

One thing FTX has shown us is that there is significant demand for cryptoassets and what we have learnt (again!) is to never trust unregulated centralised crypto exchanges.

Custody and Cryptoassets

When I launched the Blockchain Early Opportunities Fund on 1 July 2017 there was only one properly regulated and insured Custodian. Since then a number of institutional grade service providers have emerged (although none in Australia).

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.

Where to next

Financial service providers are beginning to offer cryptoasset services to their clients. This can now be done in

a compliant manner. In the US we are seeing companies like Fidelity Digital offering Bitcoin and Ether to their clients via their platforms. According to Blackrock CEO, Larry Fink, the next big wave will be tokenised securities.

There is a significant opportunity here for existing investment advisors to expand their offerings and inform their clients about the dangers and opportunities of this emerging technology. It is not too early for advisors to become familiar with this space and be prepared to advise clients. The absence of good advisors is one of the reasons bad actors like Sam Bankman-Fried and FTX were able to flourish.