Crypto experts praise Bragg's tech report

Jessica Sier

Local experts say Senator Andrew Bragg's crypto recommendations will turbocharge Australia's innovation industry, giving operators and investors comfort to try new things with regulations to protect them, but some are still sceptical of the government's capacity to deliver.

The final report of the Australia as a Technology and Financial Centre (ATFC) committee, tabled on Wednesday night, was largely met by an enthusiastic community describing it as "forward-thinking" and "thoughtful and thorough".

"It's a report that could make sure people and companies have the resources and governance to operate a cryptocurrency industry well," said Adrian Przelozny, chief executive of Independent Reserve, an Australian cryptocurrency exchange.

"Regulations weed out the players that aren't taking it seriously, protects consumers and gives us a chance to really grow the industry here."

The committee recommends Treasury establish a custody or depository regime and a market licensing regime for exchanges, including capital adequacy, auditing and responsible person tests. As it stands, crypto exchanges have no capital requirements, auditing requirements or minimum security levels.

"While international custodians have done a great job in supporting our businesses, custody falling under the remit of Australian regulators acts as a risk minimiser for local investors," said Caroline Bowler, chief executive at BTC Markets, a crypto exchange.

While Singapore, which has a licensing regime for crypto exchanges, was cited as an example throughout the report, some pointed to the risks of overbearing regulation.

"It must be said that the introduction of an onerous market licensing and/or crypto asset custody-deposit regime could risk driving these businesses offshore," said Jonathon Miller, managing director of Kraken Australia, an exchange with operations in almost 190 jurisdictions.

One of the most significant recommendations – that decentralised autonomous organisations or DAOs be recognised under the Corporations Act – has been met with amazement.

"This is quite an extraordinary inclusion," said Joni Pirovich, co-founder and director of the Digital Law Association. "The implications of providing limited liability protection to groups of people wanting to work together will open doors in ways we can't quite imagine yet."

A DAO is a way of organising people and automating the contracts that bind them. They are used to co-ordinate financial contributors from around the world on a common project, but Australian law does not recognise them. If a corporation is a collection of employment and administrative contracts, managed by a board of directors for shareholders, then a DAO automates the management of those contracts and offers a way for the collective group of shareholders to make decisions about how their investments are spent.

"These are very forward-thinking recommendations," said Michael Bacina, a partner at Piper Alderman.

"They aren't about forcing something through, they are about starting a process with integrity."

Some applaud the recommendation but are sceptical of whether it will ultimately be adopted.

"Inventing a new type of company structure based on software code is a hugely complex proposition." said Nick Abrahams, global co-leader, digital transformation practice at Norton Rose Fulbright.

"We are talking about the most significant change in corporate entity law since the introduction of the limited liability company in the 1800s. This will not happen quickly as it is a contentious proposition."

Regarding bitcoin mining, which uses large amounts of energy, the committee suggests local miners receive a company tax discount of 10 per cent if they source their own renewable energy.

"The digital asset mining incentive is a well thought-out recommendation which will incentivise both renewables and digital asset mining in Australia," said James Manning, chief executive of Mawson Infrastructure, an Australian-based cryptocurrency miner.

"It's a win-win for both industries."

The report also noted the unclear tax treatment for crypto transactions, recommending the capital gains tax regime be amended so that digital asset transactions create a CGT event only when they genuinely result in a clearly definable capital gain or loss.

As it stands, many digital asset transactions take place several steps away from a crypto-to-fiat-currency trade, with the tax treatment unclear.

"There are a large number of people triggering capital gains, or loss, events without realising it – and definitely not accounting for it," Mr Bacina said.

Elizabeth Morton, research fellow of the RMIT Blockchain Innovation Hub, agrees, adding reform will offer clarity for taxpayers and confidence in the tax system as a whole.

"We see an urgent need to ensure the tax system achieves balance in simplification, reflective of a digitally driven economy, encouraging tax compliance and protecting tax revenue from the risk of leakage," Dr Morton said.

The urgency of crypto regulation in Australia remains a pertinent theme, with prices hitting record highs yesterday and the US paving the way for retail investors to gain access to bitcoin through ETFs.

Mark Carnegie, venture capitalist and co-founder of the MHC Digital Asset Fund, said the recommendations were strong but timing was important.

"The speed at which we're trying to actually implement regulatory change, and the speed with which this technology is changing, are just poles apart," Mr Carnegie said. "If we get legislation implemented and taxation certainty by the end of FY 2021, I will host a party at Bondi Icebergs for everyone!"

Andrew Bragg's final report of the Australia as a Technology and Financial Centre committee has largely been met with enthusiasm. PHOTO: JAMES BRICKWOOD

From page 16

Rise and rise of the crypto arbitrageurs

in 2006. More recently he'd teamed up with Mike Gilbert, another experienced derivatives trader at Ark International.

Maddock had thought of trading cryptocurrencies, but when Gilbert heard Nicolaides was returning to Australia from Zurich, where he traded long-dated options for UBS, they seriously pursued the prospect of tweaking their trading systems and applying them to the world of cryptocurrencies.

Two years later, they've set up a digital asset fund that's applying traditional finance arbitrage to the decentralised finance world. But it wasn't easy – aspects of trading and money management that are taken for granted in finance proved complex and challenging in the crypto world.

"In reality, the underlying mechanics of what we're trying to do is no different than if we were trading other markets. It's just more volatile," says Nicolaides, who carries the title of head of digital assets trading at Digital Asset Funds Management, the crypto funds management arm.

He's in cargo shorts, sandals and a T-shirt. It's his first day back in the office after lockdown and he's reacquainting himself with his surroundings.

What he welcomes more than anything is volatility. DAFM operates a $50 million market-neutral fund, powered by algorithms, that takes no directional view on cryptocurrencies. Instead, it seeks to profit from anomalies that exist in the crypto derivatives market.

"We could be trading any asset class in the world with this kind of strategy; we just recognise this is a space that has way more opportunities than any other asset class," says Nicolaides.

When bitcoin and other currencies are going haywire, those anomalies are accentuated and DAFM's trading systems go into overdrive. That's what happened in the fund's first month, May, when it gained 29 per cent.

Since then, as crypto has ground higher, the arbitrage fund's monthly returns have been more muted, but positive. It is up just shy of 40 per cent since its inception five months ago.

Nicolaides explains that the way their semi-autonomous system trades cryptocurrencies is "analogous to a rubber band that's being stretched".

When there's order, the market gets more and more stretched and traders take on more leverage to capture the gains in a rising market. But "at some point, it snaps.

When tradfi becomes defi ... Bringing some aspects of traditional finance arbitrage to the world of decentralised finance has proved complex and challenging.

It's still a juvenile and inefficient market.
Dan Nicolaides,
Digital Asset Funds Management

"When there's a big rally, you have this FOMO, where people are putting on more positions and are prepared to take more leverage. That makes it more interesting, but it's when we're putting on smaller positions rather than realising profits," Maddock says.

They're not shorting the market. In fact, they have an index tracking option that tracks bitcoin and other cryptocurrencies that was down almost 20 per cent at September 30 since its May inception.

Instead, they're capitalising on large funding rates that exist in the crypto derivative markets that reveal themselves in price differences between exchanges and derivative contracts.

"It's still a juvenile and inefficient market. You would think a lot of the pricing anomalies would kind of disappear over time, but we've been looking at it for a while now and it shows no sign of that," Nicolaides says.

For instance, the fund will hold a position in spot bitcoin and be shorting a futures contract that expires in a month that has a 2 per cent higher price. As the expiry nears, those prices should converge.

Interestingly, these large funding rates are one of the central criticisms of the bitcoin futures ETFs that have been approved for launch. A holder of the ETF could lose about 15 per cent a year in rolling costs as the futures price falls to converge with the spot price.

The anomalies exist because there's a "dearth of dollars in the crypto world", Nicolaides says.

In the traditional world, a hedge fund or an investment bank can borrow dollars at around 1 per cent or even less if they pledge certain assets. They can use these funds to make small but almost certain trading profits as prices inevitably converge with time.

In the crypto world, there's plenty of speculative capital but not nearly enough to take the other side, especially when there's disorder and dislocation.

The result is large spreads between futures contracts and exchanges that arbitrageurs with deep pockets, patience or effective trading systems can capture.

Tweaking their semi-autonomous systems from trading share options and futures to trade crypto hasn't been easy. For instance, they've had to modify some circuit breakers. If a Nikkei futures contract gaps by 1 per cent, it either means the world is about to end or their data feed is corrupted. That forces the algorithm to shut trading down. However in crypto, bitcoin can gap by more than that in normal trading, so the system's levels of tolerance have been modified.

"It's got a heartbeat system set up so there has to be a trader that's actually paying attention to it at all times," Colin Pickup, the head of technology, says.

They have also had to program their system to deal with inverse futures, where, unlike in traditional markets, contracts are not paid out in dollars, but in bitcoin.

Gilbert explains that the team has spent decades being dished out costly lessons in the tradfi (traditional finance) world, so they feel well-equipped to handle the nuances of defi (decentralised finance).

But are they cryptocurrency zealots? Is this the future of finance?

"There's a range of opinions at the firm," Maddock says.

"We're among the most evangelical, but when we're talking to investors, we're neither here nor there because [the fund] is market neutral."

They are, however, awestruck by how rapidly a new financial system with exchanges and derivatives is connecting a new digital world.

"When Coinbase listed, it was at a higher market cap than the CME, which is insane," says Gilbert, referring to the global derivatives marketplace. And Coinbase, Maddock notes, doesn't even offer derivatives, which have far more turnover.

"This is a genuinely new asset class that wasn't there 10 years ago," Nicolaides says. There are sceptics, evangelists and those in the middle, he says. But in all markets, new and old, the middle is often the sweetest spot.