SUBMISSION PAPER.

IN RESPONSE TO THE TREASURY CONSULTATION ON CRYPTO ASSET SECONDARY SERVICE PROVIDERS: LICENSING AND CUSTODY REQUIREMENTS

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EXECUTIVE SUMMARY

The regulation of the crypto industry is an important step for both the local and global crypto industry. As we have seen with other industries (most notably new energy), uncertainty stifles innovation and a clear pathway to regulation provides the strongest foundation for true innovation, growth, consumer protection and a competitive market.

It is critical that the CASSPr regime contemplated in the Consultation Paper is developed in conjunction with the token mapping exercise and Australia's approach to decentralised autonomous organisations (**DAOs**). This is because the issues that have been raised are complex and require careful consideration as to how best to structure the regulatory regime to avoid unnecessary duplication, reflect the interconnectedness with financial services, minimise regulatory arbitrage and allow flexibility for future products and services, given the rapid pace of change.

In this submission, we outline our recommendations for the CASSPr regime. In our view, the options presented for regulation all present challenges and instead we propose a new alternative, which is a hybrid of Option 1 and Option 2.

This alternative proposes a separate CASSPr regime within the Corporations Act that utilises the existing licensing framework and includes additional obligations for advisory and brokering services undertaken by licensees. In our view, this approach provides:

+ the greatest flexibility for current crypto providers to expand their business into traditional markets and for traditional businesses to expand into crypto assets;
+ reflects the realities of the provision of services in relation to crypto assets;
+ delineates between financial products and crypto assets;
+ imposes obligations commensurate with the risks;
+ mitigates licensing and regulatory duplication;
+ promotes regulatory certainty; and
+ provides appropriate consumer protections.

A key detail missing in the Consultation Paper is the proposed transition pathway to regulation. The changes proposed are significant and industry and regulators alike will need time to digest and implement the required changes. It is critical that industry is provided with a clear roadmap and that transitional arrangements contemplate allowing CASSPrs to continue trading after the transition date, provided they have applied for a CASSPr licence.

ABOUT THE FOLD LEGAL

The Fold Legal is an industry-focused firm, providing specialist regulatory, corporate and commercial advice to financial services and credit businesses.

We have been helping businesses innovate and grow since 2002. We're known for our technical expertise and industry knowledge which we use to provide practical solutions for our clients.

Our expertise in financial and credit services is recognised by our rankings in Chambers and Partners Asia-Pacific and FinTech Legal Guides. Reflecting our commitment to client service, we have also won Best Law & Related Services Firm (<$30mil) across a number of specialist categories, based on direct feedback received from our clients.

The Fold Legal is deeply steeped in the fintech space since early 2013 and has been actively involved in the crypto industry since 2015.

We are technical specialists that have a broad and deep understanding of blockchain technology, crypto assets, exchanges, DAOs, alternate platforms and crypto product and service offerings. Our crypto knowledge combined with our financial services expertise is market leading. We use our industry knowledge and expertise to deliver practical, compliant and innovative solutions for our clients. We have worked with crypto exchanges, miners, crypto payment businesses, crypto platforms, DAOs and crypto token issuers to design innovative and compliant offerings.

The Fold Legal is a partner and/or member of Blockchain Australia, Fintech Australia and Insurtech Australia.

The Fold Legal is part of Halo Group Holdings, which is also the holding company of Hamilton Locke Lawyers, Emerson CoSec, Source, MacMillan Trade Marks and Compliance for Business, delivering essential corporate services across legal, governance, risk and compliance, helping businesses grow and thrive.

RESPONSE TO CONSULTATION QUESTIONS

PROPOSED TERMINOLOGY AND DEFINITIONS

Question 1 – Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?

Proposed Definition:

Any natural or legal person who, as a business, conducts one or more of the following activities or operations for or on behalf of another natural or legal person:

i. *exchange between crypto assets and fiat currencies;*
ii. *exchange between one or more forms of crypto assets;*
iii. *transfer of crypto assets;*
iv. *safekeeping and/or administration of virtual assets or instruments enabling control over crypto assets; and*
v. *participation in and provision of financial services related to an issuer's offer and/or sale of a crypto asset.*

The proposed definition of CASSPr covers the key crypto services provided to customers whether by digital currency exchanges or other service providers, such as crypto asset brokers, crypto asset wallets and certain investment platforms. However, we note that there are a range of other services provided by digital currency exchanges or other service providers that are not currently contemplated and which will not necessarily be caught by the definition of "financial services" under the *Corporations Act 2001* (Cth) (**Corporations Act**), for example crypto margin trading, staking, yielding, trade execution, investment platforms and advisory services. Regard should be had as to whether the definition of CASSPrs should contemplate any of these services and, if so, what requirements should apply. For example, if a person were to provide advice in relation to crypto assets, of the sort which would otherwise meet the definition of "financial product advice" if provided in relation to financial products, should the activities of such a person in this respect fall within the definition of CASSPrs.

In addition, we are unclear as to the intent behind "participation in and provision of financial services related to an issuer's offer and/or sale of a crypto asset". In our experience, most crypto assets are not regulated financial products as currently defined in the Corporations Act and it is unclear what financial services would be provided in relation to the offer or issue of such crypto assets. If a crypto asset is a regulated financial product, then in our view, this should be sufficiently addressed (and is more appropriately addressed) by the current financial services regime in the Corporations Act, and such activities do not need to be contemplated within the definition of a CASSPr.

Further, the definition of a CASSPr and the operation of the regime does not appear to include any Australian geographical nexus requirements. We would suggest that a geographical link that aligns the regime more closely with the geographical link requirements for financial service providers in section 911D of the Corporations Act or those found in section 6(6) of the *Anti-Money Laundering and Counter Terrorism Act 2006* (Cth) (**AML / CTF Act**) is appropriate.

The definition of CASSPr will only apply to centralised crypto asset businesses as the definition includes the requirement of a "person", whether natural or body corporate. However, we are seeing the proliferation of decentralised finance (**DeFi**) and DAOs in the crypto industry. In our view, it is critical that the regulation of decentralised platforms be considered at the same time as the regulation for CASSPrs. This is necessary to maximise innovation, minimise regulatory arbitrage, enhance consumer protections and ensure that we do not see a disproportionate outflow from CASSPrs to DAOs (whether DEXs or otherwise). It is possible that some DAOs may be caught by the CASSPr definition if those DAOs are not sufficiently decentralised, and management may be imputed on key participants. This is something that will need to be considered and highlights the need to take a holistic approach to the regulation of crypto.

In addition, as crypto is becoming more commonplace, many consumers are now looking to access DeFi (including NFTs, games and staking) and the primary way to access these services continues to be using decentralised wallets. Decentralised wallets, such as the commonly used MetaMask, would fall outside of the definition of a CASPPr. We expect that many exchanges that fall within the definition of a CASSPr who are not willing, or unable, to subscribe to the additional proposed requirements for custody providers are more likely to integrate the service with a decentralised wallet. This needs to be considered in light of the proposed custody requirements, which are considered in further detail below.

Question 2 – Are there alternative terms which would better capture the functions and entities outlined above?

The definition could be shorter and the words "Digital currency business", "Crypto asset business" or "Crypto provider" could be used with the same definition. It is worth nothing that "DCE" and "Digital Currency Exchange" will remain the prominent terminology used in the industry and by consumers given its widespread adoption and the AML / CTF Act requirements.

Question 3 – Is the definition of crypto asset precise and appropriate? If not, please provide alternative suggestions or amendments.

Proposed definition:

> *Crypto asset is a digital representation of value or contractual rights that can be transferred, stored or traded electronically, and whose ownership is either determined or otherwise substantially affected by a cryptographic proof.*

We think that this definition has been drafted to be intentionally broad and would capture all types of crypto assets. We argue that the definition as proposed already captures NFTs, as well as all fungible crypto assets, including governance and utility tokens. If the intention is to exclude certain crypto assets, then this would need to be done by way of exempt issuers, activities or providers as opposed to changing the definition itself. Otherwise, this would create unnecessary complication.

The only changes we suggest making to the definition is to remove the reference to "contractual" and simply include "rights". This is because some rights attached to tokens may not fall within the typical legal definition of contractual rights because of the operation of smart contracts.

In addition to this definition, it is critical that a token mapping exercise is undertaken to identify which tokens involve, or are likely to involve, the provision of any financial products, having regard to their specific features or rights. To date, tokens have been treated as commodities and are a type of intangible property. Regulators have provided very little instructive guidance on the types of tokens or token features that may cause a token to be regulated as a financial product. This has caused significant uncertainty in the Australian market. While ASIC has issued INFO Sheet 255[1] on crypto assets, this document merely identifies the common types of financial product definitions that may apply to crypto assets and does not indicate what would result in a token coming within the definition of one of those financial product categories. Ultimately, if regulators are of the view that certain tokens or types of tokens are always regulated financial products, then we recommend that regulators (like ASIC) prepare detailed guidance as to what rights and features may give rise to a crypto asset being a financial product. Any such guidance provided must detail with the specific rights and features that the crypto asset must possess to be the type of crypto asset which is a financial product, as well as explain why each of these rights and features amounts to the crypto asset being a financial product.

[1] https://asic.gov.au/regulatory-resources/digital-transformation/crypto-assets/ as at October 2021

It is possible that as part of the token mapping exercise different categories of crypto assets are identified based on the assessment of the different rights attached to different crypto assets. Depending on the outcome of this exercise, it may be worthwhile developing different categories of crypto assets with their own unique definitions for distinguishing purposes. For example, there may be a regulatory need to impose additional requirements on a crypto asset because of a certain feature of the token, but where it does not fall within the current definition of a financial product.

Question 4 – Do you agree with the proposal that one definition for crypto assets be developed to apply across all Australian regulatory frameworks?

In our view, the proposed definition is suitable for the CASSPr regime. It is always preferrable for definitions to be consistent across legislative and policy frameworks. While we are of the view that this definition of crypto assets could be used for various legislative purposes, regard will need to be had before universally adopting this definition. This is because global and local policy settings may change and this may impact how crypto assets should be defined in all circumstances or specific circumstances.

Ultimately, the legislative or regulatory intent should drive the nature of the definition.

It is common practice for different definitions to be developed and used across different Australian regulatory regimes. In our view, a more appropriate position should be to ensure that the definition is fit for the purposes in which any regulatory framework is to be using it. As an example, this may mean that a different definition is drafted for use for regulated payments compared with the definition that is used for the purposes of a licensing and custody regime.

Question 5 – Should CASSPrs who provide services for all types of crypto assets be included in the licensing regime, or should specific types of crypto assets be carved out (e.g. NFTs)?

We do think it is prudent for regulation to cover all types of crypto assets. The NFT market has grown substantially in recent years in Australia and the value of NFTs have risen significantly. NFTs are used for a variety of purposes – including collectibles (i.e. art), in-game assets, event ticketing and experiences. In our view, NFTs (regardless of their use or purpose) should be subject to the same level of regulation as other regulated crypto assets. This is because the risks to consumers in relation to NFTs are no different to any other crypto asset being regulated. If NFTs were to be excluded, a large value-based market will not be subject to any form of regulation.

It is worth noting that including NFTs within the definition will only cover a small subset of the market in Australia. This is because most NFT trading occurs on decentralised exchanges and using decentralised wallets.

The definition of crypto assets will also capture stablecoins. It is critical that regulation of stablecoins is further considered given the role stablecoins play with on / off ramps and prospects for future use as an alternative payment. Not all stablecoins are equal, and fiat backed stablecoins are critical to the efficient operation of crypto markets, and its connection with traditional markets. Recent events with TerraUSD have demonstrated this. As part of this exercise, regard will also need to be had as to whether any crypto assets are "currency". To date, the RBA is of the view that Bitcoin and other like cryptos assets are not currency.[2] This does need further assessment in light of countries like El Salvador and Ukraine accepting Bitcoin as legal tender.

[2] "What is Money?", Reserve Bank of Australia, What is Money? | Explainer | Education | RBA Note, however, that El Salvador has recently recognised Bitcoin as currency.

PROPOSED PRINCIPLES, SCOPE AND POLICY OBJECTIVES OF THE NEW REGIME

Context

Question 6 – Do you see the policy objective as appropriate?

This paper proposes the following policy objectives to underpin a licensing regime for CASSPrs:

- *minimise the risks to consumers from the operational, custodial, and financial risks facing the use of CASSPrs. This will be achieved through mandating minimum standards of conduct for business operations and for dealing with retail consumers to act as policy guardrails;*
- *support the AML/CTF regime and protect the community from the harms arising from criminals and their associates owning or controlling CASSPrs; and*
- *provide regulatory certainty about the policy treatment of crypto assets and CASSPrs, and provide a signal to consumers to differentiate between high quality, operationally sound businesses, and those who are not.*

We believe that the overarching policy objectives are appropriate, specifically the need to ensure that there is regulatory certainty and appropriate protections for Australian holders of crypto assets. To ensure this is the case, regard should be had as to whether the proposed licensing regime should include a fit and proper person test like that which currently exists for Australian financial services licensees (**AFSL**) under section 913BA of the Corporations Act and Australian credit licensees. Otherwise, responsibility for ensuring that criminals and their associates do not own or control a CASSPr will most likely lie with AUSTRAC.

It is also worth noting that the imposition of a licensing regime may drive participants in the industry out of Australia or lead to the proliferation of decentralised solutions, which is outside the purview of ASIC and AUSTRAC. For this reason, it is critical that any proposed regulation is fit for purpose and commensurate with the risk.

Question 7 – Are there policy objectives that should be expanded on, or others that should be included?

We think that it is critical that one of the policy objectives is to promote innovation in Australia and to ensure that that the regulatory response does not stifle innovation. This objective is currently missing from other legislation and needs to be included given the potential growth and opportunity the crypto industry presents.

Additionally, another policy objective should be to minimise regulatory duplication, particularly in areas where there is likely to be substantial overlap between licensing regimes.

Question 8 – Do you agree with the proposed scope detailed above?

Scope

The proposed licensing regime will apply to:

- *all secondary service providers who operate as brokers, dealers, or operate a market for crypto assets, and*
- *all secondary service providers who offer custodial services in relation to crypto assets.*

The proposed scope of the licensing regime does not adequately mitigate the risks that the Consultation Paper is intending to mitigate. The intention of the Consultation Paper is to mitigate the risk that arises from counterparties; however the Consultation Paper limits itself in only regulating CASSPrs that deal with retail consumers. The counterparty risk applies equally to both retail and wholesale clients and there is no clear rationale as to why wholesale clients are not afforded similar protections. We would expect that there is a clear preference for

institutional and wholesale customers (to be dealing with an exchange or custody provider that is subject to the regulatory regime that would apply to retail customers) so that they are able to mitigate the same conduct risks.

Under the current financial services regime, market licensing and custodial and depository services apply to all consumers and not just retail consumers. We do not see why this proposed licensing regime should be any different. Extending the application of the regime to wholesale consumers will help build and maintain system and market integrity and ensure all crypto assets are subject to the same market and custodial protections. Regard will need to be had as to the extent to which the CASSPr regime and obligations should be applied to wholesale consumers. However, as a baseline, we think that the licensing regime should contemplate the provision of custody and market services to wholesale consumers. However, it may not be appropriate to extend all the consumer protections contemplated by the CASSPr regime to wholesale consumers and an approach consistent with that currently adopted by the financial services regime for wholesale clients should be considered. This approach will balance streamlined regulatory obligations for wholesale customers while maintaining market integrity.

Failing to regulate the provision of services to wholesale clients may see industry develop wholesale client only solutions. If so, this will lead to a two-tier industry - lessening competition both in terms of price and services.

Additionally, the definition of a wholesale client in Chapter 7 of the Corporations Act has not been altered in over 20 years, meaning that threshold requirements to be considered a wholesale client have not varied significantly despite 20 years of economic growth, wage growth and financial services practice. We have concerns that many consumers can qualify as a wholesale client when they do not have the financial sophistication to make the informed decisions that are required. This is a broader regulatory issue which is amplified when customers are trading in crypto assets.

Lastly, we recommend that the scope be clarified to make it clear that a CASSPr may provide one, or both, of the services outlined and that each operates as a separate authorisation.

Question 9 – Should CASSPrs that engage with any crypto assets be required to be licensed, or should the requirement be specific to subsets of crypto assets? For example, how should the regime treat non-fungible token (NFT) platforms?

As outlined in question 5 above, we think it is prudent for the licensing regime to cover all types of crypto assets, including NFTs.

The Consultation Paper notes that different licensing obligations will apply to different subsets of crypto assets, the best example being crypto assets that are also financial products, where instead the existing financial services regime will apply.

It is unclear how the proposed licensing regime will interact with the financial services regime for crypto assets that also meet the definition of a financial product. We suspect the intent is that these crypto assets will need to comply with the financial services laws and that the CASSPr will need to hold an AFSL with the requisite authorisations. However, this should be made clear. This is particularly important in relation to capital, insurance and client money requirements imposed on licensees. For example, is the proposed calculation methodology for the capital requirements based on all crypto assets regardless of whether those assets may also be financial products.

We also posit that all crypto assets (regardless of whether those assets meet the definition of a financial product) should be subject to the same custodial requirements. This is a simple solution that will encourage CASPPrs to properly store and safehouse crypto assets in a manner that is consistent with the asset. Of course, crypto assets that are also financial products will need to meet the additional requirements in the Corporations Act and those who provide financial services in respect of those assets will need to hold the requisite AFSL authorisations. However, we contend that the custodial and depository services requirements in the Corporations Act should not apply to these

crypto assets. This is because, as currently drafted, the custodial and depository services do not readily contemplate or cater for financial products that are crypto assets, and therefore it is more appropriate that all crypto assets should be subject to the **same** custodial requirements (that is, those designed and proposed specifically for crypto assets), regardless of whether those crypto assets are also financial products or not.

Question 10 – How do we best minimise regulatory duplication and ensure that as far as possible CASSPrs are not simultaneously subject to other regulatory regimes (e.g. in financial services)?

It appears that the overarching intention of the CASSPr regime is to create a regime whereby CASSPrs can continue operating as they have been, but to include some rigour in the systems and practices of the CASSPr to provide additional protection to consumers.

The Consultation Paper suggests that a CASSPr would need to either hold a new market/custody licence (CASSPr licence) for dealing in crypto assets that are not financial products. The market in Australia has matured to the point that, almost universally, CASSPrs are either already dealing in financial products, whether these are financial product tokens, payment products, yielding through a managed investment schemes, developing derivatives, or developing some other kind of financial product, building out plans to do so, or they are looking to see what the future regulatory position will be before deciding how to pursue new products and services, given the considerable cost and time required to obtain a licence. This creates challenges when it comes to avoiding duplication while also implementing a new regime, given that DeFi and traditional finance are increasingly intertwined. For example, many CASSPrs are looking to add payment functionality to digital wallets, while others are developing securities trading alongside the crypto vertical, and these common financial services use cases show how crypto is converging with mainstream offerings. Increasingly, crypto is seen as just another class of investment to be offered in parallel with other investments. We are seeing this through the desire of banks and broking houses who offer share trading platforms, to offer also crypto trading to their customers.

Many CASSPrs are also intentionally designing product and services so that they do not fall within the definition of a financial product or service to avoid the increased AFSL requirements that apply, and in particular, to avoid the 'first mover' problem, as the first business to enter a regulated environment will be at a competitive disadvantage as compared to CASSPrs who do not have that same regulatory burden. In some cases, this is having the perverse outcome of CASSPrs offering more limited products with reduced functionality, or less than ideal market offerings, to avoid technically meeting the definition of a financial product. We think that this practice is likely to continue, if a CASSPr licensing regime is implemented that is not integrated with the existing AFS licensing regime (in some capacity), but may be exacerbated, as CASSPrs will now not only be avoiding the creation of an unlevel playing field but will be avoiding duplicative regulatory burden that will be imposed if they need to hold multiple licences. Integrating the CASSPr regime into the AFS licensing regime will immediately end deliberate efforts to artificially structure products to avoid AFS licensing.

Further, many traditional financial services providers are also moving into the crypto industry. This interconnectedness and intersection between traditional financial services and crypto assets does pose potential duplication issues for those businesses.

If the CASSPr regime is implemented as a separate regulatory and licensing regime, then the overwhelming majority of CASSPrs will need hold both an AFS licence to deal in traditional financial products as well as a CASSPr licence to offer both the market and custody services in relation to crypto assets. Likewise, some AFS licensees will also need to obtain a CASSPr licence. With many CASPPrs proposing to move into regulated payments, they are additionally likely to require the new streamlined payments licence that has been outlined in the Review of the Australian Payments System – Final report dated 30 August 2021. We understand that Treasury is also working on implementing the recommendations from this final report and is aware of the importance that crypto assets are likely to play for the future of payments.

In our view, it is critical that any regulatory duplication is minimised as much as possible to promote innovation, reduce unnecessary regulatory burden and to discourage regulatory arbitrage. This can only be achieved by minimising the number of licensing regimes that may apply to a CASPPr.

Whilst it may be easier from a regulatory perspective to implement a new licensing regime through a separate piece of legislation, there are many benefits by streamlining the process for CASSPrs and bringing them into the existing AFS licence regime. There are numerous ways to implement the CASSPr licensing regime within the AFS licencing regime, some more complex than others.

If the definition of "financial product" was amended to include "crypto assets", then this raises significant complexity especially considering the intention to implement a "light touch" regulatory regime. This is because not all crypto assets are financial products and presently a crypto asset must separately meet the definition of one of the financial products in section 762A of the Corporations Act, to be caught by financial services regulation.

If crypto assets were instead included in the definition of a "financial product", then:

+ Parts of Chapter 5 of the Corporations Act;
+ All of Chapter 7 of the Corporations Act; and
+ The *Australian Securities and Investments Commission Act 2001* (Cth),

will automatically apply to crypto assets unless those requirements are specifically excluded. For example, the Retail client protections of best interests duty, financial services and product disclosure requirements, design and distribution obligations and anti-hawking may, depending on how it is implemented, apply to crypto assets if it is included in the definition of "financial product". Given the number of requirements that are proposed to apply to crypto assets, we contend that it will be a complex task to ensure that all requirements and obligations that should not apply to crypto assets are specifically excluded or amended for crypto assets, in line with the intent of the CASSPr regime. If the exclusions are not properly implemented, then this will engender confusion and lead to regulatory overreach by increasing the regulatory requirements on CASSPrs instead of implementing the intended "light touch" approach.

A better alternative would be to include crypto assets within the existing AFS licensing regime, but without including crypto assets within the definition of a financial product. The simplest way of achieving this is to create a new Part in Chapter 7 of the Corporations Act for the CASSPr regime, somewhat similarly to custodial and depository services. This Part will need to include specific definitions for "crypto asset", "crypto asset market services" and "crypto asset custody services". These definitions should not replicate the definition for "financial product" or "financial services" but rather should be specifically designed to capture the proposed regulated services for CASSPrs. This new Part will also need to capture the proposed obligations that will need to apply to CASSPrs (see question 11 below).

The advantage with this approach is that the "crypto asset market services" and "crypto asset custody services" could then become new and separate authorisations in an AFSL for CASSPrs, but subject to the obligations currently proposed for CASSPrs, such that CASSPrs are not subject to all AFS licensing obligations, only those relevant to crypto assets under the CASSPr regime. This would reduce the number of licences and legislative duplication without compromising either the CASSPr regime or the financial services regime. It would also provide flexibility for:

+ CASSPrs to limit their activities to "crypto asset market services" and "crypto asset custody services";
+ CASSPrs to expand their activities to financial services;
+ AFSL holders to limit their activities to financial services; and
+ AFSL holders to expand their activities to "crypto asset market services" and "crypto asset custody services".

Integrating into the existing AFSL regime also invites the opportunity to consider whether "advising" on crypto assets should be a regulated activity. In our view, there is a strong argument that it should be.

At present, given the proposed ambit of the CASSPr regime, there is an obvious gap in that anyone can provide "advice" to anyone, including retail consumers, that they should invest in crypto assets, without needing to meet any standards whatsoever. While there are existing asset classes that are excluded from the advice regime, such as real property and investment advice on crypto assets, which are volatile, it seems more akin to investment advice on securities than advice on real property.

For completeness, we note that consumers are already familiar with the existing AFSL regime and that a holder of an AFSL is regulated. There is a marginal risk that customers will be of the view that CASSPrs will be subject to the same standards that apply to other financial services. However, in our view, this can be readily accommodated with a standard disclaimer warning (like the advertising warning in section 1018A of the Corporations Act) to address this. In addition, holding two separate licences may engender consumer confusion and it will be unclear what is covered by each licence. An existing example of this is the AFSL and credit licence regimes; consumer credit products sit with credit licensing regime, while margin lending, essentially an investment loan product, sits within the AFSL regime.

As a final point, we think it is critical that the definition of “crypto asset market services” contemplate the different exchange services in Australia. Under financial services laws, a provider can either:

+ “Make a market” under section 766D of the Corporations Act, which requires an AFSL authorisation; or
+ “Operate a market” under section 767A of the Corporations Act, which requires either a Tier 1 or Tier 2 markets licence.

In our experience, most exchange act as a broker to fill an order for crypto assets, or they match buy and sell orders, and this latter activity will involve operating a market. However, other exchanges also act as the counterparty to trades and this will involve making a market. Clarification should be made that the market services that are provided in relation to crypto assets (that are not financial products) cover both the matching of customers for a trade and in situations where the CASSPr is acting as a counterparty to the transaction. However, regard should be had as to whether the capital requirements should be varied depending on the type of market service carried out by a CASSPr. We think that it is critical that this type of market licence is not the same as the existing market licence regime. Instead, it must be designed to reflect the way crypto markets operate and how trades are executed on crypto exchanges. For example, settlement and clearing, as well as volatility levers, would not be appropriate for crypto assets which can be traded 24 hours a day without settlement and subject to significant volatility. A Tier 1 or Tier 2 markets licence would not be appropriate for crypto market providers and a bespoke markets licence should be created that sets appropriate capital adequacy requirements and market trading rules.

PROPOSED OBLIGATIONS ON CRYPTO ASSET SECONDARY SERVICE PROVIDERS

Question 11 – Are the proposed obligations appropriate? Are there any others that ought to apply?

Proposed Obligations

1. *This regime would impose the following obligations on CASSPrs:*
2. *do all things necessary to ensure that: the services covered by the licence are provided efficiently, honestly and fairly; and any market for crypto assets is operated in a fair, transparent and orderly manner;*
3. *maintain adequate technological, and financial resources to provide services and manage risks, including by complying with the custody standards proposed in this consultation paper;*
4. *have adequate dispute resolution arrangements in place, including internal and external dispute resolution arrangements;*

5. *ensure directors and key persons responsible for operations are fit and proper persons and are clearly identified;*
6. *maintain minimum financial requirements including capital requirements;*
7. *comply with client money obligations;*
8. *comply with all relevant Australian laws;*
9. *take reasonable steps to ensure that the crypto assets it provides access to are "true to label" e.g. that a product is not falsely described as a crypto asset, or that crypto assets are not misrepresented or described in a way that is intended to mislead*
10. *respond in a timely manner to ensure scams are not sold through their platform;*
11. *not hawk specific crypto assets;*
12. *be regularly audited by independent auditors;*
13. *comply with AML/CTF provisions (including a breach of these provisions being grounds for a licence cancellation); and*
14. *maintain adequate custody arrangements.*

We broadly agree with the obligations that are set out above. Greater clarity is needed to understand specifically what the capital requirements in obligation 5 for CASSPrs. We are concerned to make sure that the capital adequacy requirements are appropriate and do not impose an unnecessarily burdensome requirement on CASSPrs, to cause undue industry consolidation.

Recently, we have seen ASX Clear require exchange traded funds that invest in Bitcoin to hold margins to cover the settlement risks at 42% relative to the 15% or less margin for other ETF products.[3] We would be quite concerned if capital adequacy requirements were set unreasonably high, such that they are disproportionate to the risk level or otherwise exceed the requirements that are placed on other exchange traded products.

We also question the anti-hawking requirements that are proposed for crypto products. Crypto assets are not financial products and are not sold in a manner that is typical of the products that are currently subject to the anti-hawking regime. Whilst transactions related to crypto assets can be conducted using real-time interaction, we do not anticipate that hawking will occur in the traditional sense with crypto assets. The Corporations Regulations[4] currently exclude a wide range of financial products and situations from the hawking requirements, and transactions relating to crypto assets do not immediately create any hawking risks. Hawking requirements should only apply to crypto assets that are otherwise financial products and to which anti-hawking obligations already apply. Further, no detail has been provided about the types of crypto assets that will be subject to anti-hawking and the rationale for why. We note also that it seems contrary that crypto assets should be subject to anti-hawking, while at the same time there would be no regulatory protections offered to consumers receiving advice on crypto assets. Typically, financial products that are subject to anti-hawking are the types of products for which retail clients could benefit from receiving advice. While we consider it unnecessary to impose anti-hawking rules because of the way in which crypto assets are traded, if there is a regulatory concern that if crypto assets are complex enough that consumers could be disadvantaged if crypto assets were to be hawked, then there would seem to be a real argument that consumers would benefit from the regulatory protection that applies when they receive personal advice.

We note that there is a requirement for key persons and directors to satisfy ASIC that they are fit and proper persons. We would expect this to mostly replicate the regime that applies to both the current AFS licensing and credit licensing regimes. There has been no indication as to whether there will be any organisational competency requirements for key individuals in the business and how these will be assessed and determined. The existing ASIC

[3] https://www.afr.com/chanticleer/why-bitcoin-etfs-are-grounded-20220413-p5ad3t

[4] Regulation 7.8.21A of the Corporations Regulation 2001 (Cth).

RG 105 requirements are not appropriate for CASSPrs as it would be impossible for an individual to satisfy options 1-4. Greater clarity is required to understand how ASIC intends to assess that CASSPrs have in place the proper organisational structures and staffing capabilities to meet the requirements of operating the licence.

Additionally, there is no requirement for CASSPr licence holders to maintain adequate risk management systems. The Consultation Paper is drafted on the basis of reducing the potential risks to consumers, however the obligation to maintain a risk management framework is not a requirement. We suggest that a risk management obligation exist that is commensurate with the types and extent of the risks faced by CASSPrs.

Question 12 – Should there be a ban on CASSPrs airdropping crypto assets through the services they provide?

No, there should not be a ban on airdropping crypto assets. Airdropping may be required to enable customers to continue to hold their crypto asset due to forking or a move to another blockchain. Airdropping in and of itself is not a financial product or financial service. CASSPrs will need to ensure that any crypto asset that is airdropped is not a financial product. Provided the crypto asset is not a financial product, airdrops do not give rise to any new or different risks from other exchange services. Further, once a token has been airdropped to a consumer, there is an ability to transfer airdropped tokens out of a CASSPr platform, to sell or otherwise trade the token. These would be regulated services that are captured under the definition of a CASSPr i.e. "crypto asset market services". To the extent that any airdropping is occurring on or interacting with decentralised platforms, the operation of the CASSPr regime will not extend to it.

Question 13 – Should there be a ban on not providing advice which takes into account a person's personal circumstances in respect of crypto assets available on a licensee's platform or service? That is, should the CASSPrs be prohibited from influencing a person in a manner which would constitute the provision of personal advice if it were in respect of a financial product (instead of a crypto asset)?

In our view, personal advice in relation to crypto assets should be regulated. We outline below how advice should be regulated given the likely services provided by AFSL holders and CASSPrs. We also think it is important to distinguish between personal advice and general advice.

CASSPrs that provide advice

We note that the definition of CASSPrs does not contemplate any advisory services in respect of crypto assets. For CASPPrs, this is appropriate and does not raise any significant issues, where those crypto assets are not financial products. This is because the CASSPr regime is concerned with execution and custody services for crypto assets. We would not expect most CASSPrs to be in the business of considering an investor's personal circumstances before advising them on crypto assets, given the significant resourcing and time constraints. However, CASSPrs may publish content about crypto assets that is factual information or provide other content which could be general advice.

We do not think it is appropriate for a CASSPr to provide personal advice and this should instead be limited to AFSL holders operating with a new authorisation for providing advice (as outlined below). We do think that CASSPrs should be permitted to provide general advice to customers about crypto assets. Given the work that many CASSPrs do in educating the wider market on crypto assets, the line between factual information and what would be considered general advice is very narrow. We would expect that in the course of operating a CASSPr it would be difficult to provide educational content without providing general advice.

If a CASSPr wished to provide personal advice about crypto assets, then, in our view, it should opt in to the requirements that we outline below, which should apply to AFSL holders.

AFSL holders

Financial advisers are in the business of providing advice. We believe that if financial advisers wish to advise retail clients on crypto assets, such advice should be subject to the regulatory regime for personal advice that applies to any other financial product. To achieve this, we recommend that new a new definition of "crypto asset advice" is included in the financial services regime, which AFSL holders can obtain an AFSL authorisation for enabling AFSL holders to provide general and personal advice in relation to crypto assets. Importantly, the provision of a "crypto asset advice should be subject to the same disclosure and protections that currently apply to general and personal advice in respect of financial products. However, it is important that crypto assets are not included within the definition of a financial product for the reasons outlined in our response to Question 10.

The risk with not regulating advice, and not prohibiting it, is that there becomes an obvious gap in that general and personal advice on other investment products is regulated, but not on crypto assets. This creates regulatory arbitrage and could incentivise financial advisers to recommend crypto assets because no best interests duty or Statement of Advice obligations will apply. Additionally, as conflicted remuneration obligations will not apply, financial advisers could also be incentivised to negotiate commission structures with any willing CASSPrs, even further incentivising the recommendation of crypto assets over regulated financial products. This could result in poor outcomes for consumers who rely on ASIC to regulate the conduct of those who provide investment advice.

Further, crypto assets are readily forming part of a broader asset class and investor mandate to deliver a balanced portfolio and, while some financial advisers have been reticent to include crypto assets on their approved product lists, many clients are expecting their financial advisers to advise them on crypto assets as part of a broader investment strategy. Crypto assets would certainly form part of a satellite investment to provide the investor access to a broader investment strategy which would enable further diversification. For example, other investments that currently sit as part of a satellite investment include art and other collectables. Technically, any advice provided in respect of crypto assets that are not financial products will not be caught by the Corporations Act or subject to any of the AFSL obligations. This means any AFSL holder, or their representatives may provide financial advice in relation to crypto assets but not be required to comply with any of the best interests duty or other obligations in respect of that advice. In our view, if crypto assets form part of investment advice, that advice should be subject to regulation to create regulatory symmetry with CASSPrs. This approach would also legitimise the provision of advisory services by AFSL holders and their representatives, who have been cautious to include crypto assets on their approved product lists given the uncertainty as to regulation.

It is possible that financial advisors or other AFSL holders may provide broking and trade execution services to customers in relation to crypto assets. Such broking and trade execution services would be caught by the definition of the CASSPr and require these persons to hold a CASSPr licence. This would give rise to unnecessary licence duplication and a better approach would be to include a new definition for "crypto asset broking" in the financial services regime that could be added as an AFSL authorisation. This authorisation would cover dealing 'by applying for on behalf of another' in relation to crypto assets. We would contend that any financial advisor with this authorisation, would be exempt from the requirement to hold a CASSPr licence to the extent that their services are limited to either advice on and / or broking crypto assets. This is because these AFSL holders will be subject to licensing requirements and a higher standard of care under the AFSL regime.

Question 14 – If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Not applicable.

ALTERNATIVE OPTION 1: REGULATING CASSPRS UNDER THE FINANCIAL SERVICES REGIME

Question 15 – Do you support bringing all crypto assets into the financial product regulatory regime? What benefits or drawbacks would this option present compared to other options in this paper?

Please see our response to question 10 above.

Question 16 – If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Not applicable.

ALTERNATIVE OPTION 2: SELF-REGULATION BY THE CRYPTO INDUSTRY

Question 17 – Do you support this approach instead of the proposed licensing regime? If you do support a voluntary code of conduct, should they be enforceable by an external dispute resolution body? Are the principles outlined in the codes above appropriate for adoption in Australia?

No. We do not believe that the self-regulation model is an appropriate model for addressing the risks that have been identified in the submission paper. A voluntary code of conduct, like what has been developed in the Buy-now, Pay-later (**BNPL**) industry has had limited adoption by the industry and has not instilled confidence from consumers. The self-regulation model continues to open the industry up to criticism and distrust for lack of regulation for consumers. Further, it also encourages a back-door approach to regulation, with ASIC seeking regular information from unregulated participants to maintain a watching brief on industry.

Question 18 – If you are a CASSPr, what do you estimate the cost and benefits of implementing this proposal would be? Please quantify monetary amounts where possible to aid the regulatory impact assessment process.

Not applicable.

PROPOSED CUSTODY OBLIGATIONS TO SAFEGUARD PRIVATE KEYS

Question 19 – Are there any proposed obligations that are not appropriate in relation to the custody of crypto assets?

Proposed Obligations

The proposed obligations would include:

1. *holding assets on trust for the consumer;*
2. *ensuring that consumers' assets are appropriately segregated;*
3. *maintain minimum financial requirements including capital requirements;*
4. *ensuring that the custodian of private keys has the requisite expertise and infrastructure;*
5. *private keys used to access the consumer's crypto assets must be generated and stored in a way that minimises the risk of loss and unauthorised access;*
6. *adopt signing approaches that minimise 'single point of failure' risk;*
7. *robust cyber and physical security practices;*
8. *independent verification of cybersecurity practices;*
9. *processes for redress and compensation in the event that crypto assets held in custody are lost;*
10. *when a third-party custodian is used, that CASSPrs have the appropriate competencies to assess the custodian's compliance necessary requirements; and*
11. *any third-party custodians have robust systems and practices for the receipt, validation, review, reporting and execution of instructions from the CASSPr.*

In addition to the commentary that we have provided in question 11, and to the extent applicable, we broadly agree with the proposed obligations.

In relation to obligation 4, greater clarity would be required as to what ASIC determines to be a custodian with the requisite expertise and infrastructure. We would not expect any traditional custodians that have not dealt in crypto assets to have the expertise or the infrastructure to store crypto assets. We would therefore assume that custody for crypto assets will be handled primarily by centralised wallet providers or directly by centralised exchanges. However, there is no clarity on whether, and how, existing CASSPrs will meet this qualification.

There is a significant risk that any CASSPr that does not meet the requirements can simply outsource the custody arrangements to a third party regulated custody provider or otherwise rely on a decentralised wallet for the provision of services. It would be challenging for a CASSPr to be able to ensure that any decentralised wallet is able to provide custody services in accordance with the standards that would otherwise apply to a centralised custodian. It would be impossible to prohibit the use of a decentralised wallet on a platform, whether this is directed by a customer or by the CASSPr. As discussed throughout this paper, decentralised wallets are typically required to access games, NFTs and decentralised exchanges. We agree that to the extent that a CASSPr is outsourcing the custody requirements to another CASSPr, the outsourcing CASSPr will need to ensure that it complies with obligation 10 and 11. However, the obligations applying to an outsourcing CASSPr should not extend to a custody provider that is not also a licensed CASSPr.

Obligations 7 and 8 provide that certain cyber and physical security measures need to be in place and that cyber security measures need to be independently verified. We would expect that the obligations in this respect will exceed the requirements that are placed on AFSL regulated custody providers. It is important for CASSPrs to understand what standard of cybersecurity is required. We note that the positions in ASIC INFO 225 in relation to cybersecurity standards, however we note that these are good practice examples and not mandatory obligations, which is likely to mean that many CASSPrs would be unwilling to meet these standards.

Obligation 9 provides that there is a requirement to provide adequate redress and compensation in the event of a breach. The Consultation Paper does not provide any detail as to what the compensation requirements will be. ASIC notes in INFO225 that appropriate compensation may take the form of insurance or a compensation fund. It would not be appropriate to apply arrangements like those found in RG126 for AFS licensees and the specific requirement for custody service providers in RG146 to hold $5m of professional indemnity insurance. There is very limited appetite in the insurance market to provide professional indemnity insurance for crypto businesses and there is no indication that this position will change, even if a licensing regime is implemented. Careful consideration is required to ensure that CASSPrs can maintain compensation arrangements that are reasonably available to them. For example, it may be sufficient for CASSPrs to hold a bond or otherwise use stable coin reserves (self-insurance). A bond approach was used when the financial services regime was first introduced for AFSL holders and we contend that this is also suitable for the CASSPr regime, until we see the development and maturation of an insurance market which provides adequate cover and reasonable premiums to crypto businesses.

Question 20 – Are there any additional obligations that need to be imposed in relation to the custody of crypto assets that are not identified above?

As discussed above, the custody obligations should extend to protect custody providers that provide services to retail and wholesale investors.

Question 21 – There are no specific domestic location requirements for custodians. Do you think this is something that needs to be mandated? If so, what would this requirement consist of?

As we have outlined, there is a risk that a CASSPr will not be able to meet the regulatory and capital requirements to provide custody services. This creates a risk that there will not be sufficient access to custody services in Australia. We have outlined in this submission that the CASSPr licensing regime should be limited to businesses with an Australian geographic link. We have also flagged that many CASSPrs and customers may use established decentralised wallets to obtain custody services.

We do not think that there is an inherently greater risk in using an overseas or decentralised custody provider. This is because the risk of loss or theft will be present regardless of whether custody is provided onshore or offshore. However, we do note that it will generally be easier to seek recovery and take action against a custody provider located in Australia, given proximity and local law protections.

At present, AFSL holders can use offshore custodians and we do not see why this cannot equally apply to CASSPrs, subject to implementing appropriate controls and measures. If sufficient risk controls are not implemented for the use of offshore custody providers, there is a risk that CASSPrs will need to seek recovery via foreign laws, which creates complexity and can take time (which is not ideal for crypto assets given the way in which loss events may occur). Generally, cross border recovery is difficult, but it is likely to be particularly difficult for crypto asset loss events.

To ensure that custody standards are maintained where custody is outsourced or offshored, outsourcing requirements could be implemented that require certain minimum standards in any custody agreement, like a streamlined version of APRA CPS 231 Outsourcing. The standards cannot be too onerous as many global providers are unlikely to fundamentally change their terms to cater for the Australian market. We have certainly seen this with software providers to APRA regulated entities and how they manage data.

However, any outsourcing standard should consider imposing appropriate risk measures and controls in place to:

+ protect private keys from hacking or fraud; and
+ enable direct access and recovery of private keys in certain events (i.e. escrow and disaster recovery arrangements) to avoid issues associated with recovery.

Importantly, the outsourcing standard needs to be sufficiently robust as CASSPr are unlikely to secure insurance that would adequately cover these types of loss events.

We also think it would be worthwhile clarifying whether a CASSPr will require a custody authorisation if it outsources custody (like what is currently in place for AFSL holders) and what impact this will have on the capital requirements for custodial services and the CASSPr obligations.

Question 22 – Are the principles detailed above sufficient to appropriately safekeep client crypto assets?

As noted, the custody requirements should extend equally to assets held by both wholesale and retail clients.

Question 23 – Should further standards be prescribed? If so, please provide details

Please see our response to Question 21 in relation to outsourcing standards.

Question 24 – If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Not applicable

Question 25 – Is an industry self-regulatory model appropriate for custodians of crypto assets in Australia?

As outlined in Questions 17 and 18, the self-regulatory model is not appropriate.

Question 26 – Are there clear examples that demonstrate the appropriateness, or lack thereof, a self-regulatory regime?

As outlined in Questions 17 and 18, the self-regulatory model is not appropriate.

Question 27 – Is there a failure with the current self-regulatory model being used by industry, and could this be improved?

There is no current failure of the self-regulatory model. However, to instil greater confidence in the custody of crypto assets, regulation is largely welcomed by industry. The risk lies with restricting access to custody services from overseas providers and decentralised wallets.

Question 28 – If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Not applicable.

TOKEN MAPPING

Question 29 – Do you have any views on how the non-exhaustive list of crypto asset categories described ought to be classified as (1) crypto assets, (2) financial products or (3) other product services or asset type? Please provide your reasons.

Please see our response to Questions 4 and 5 above in relation to token mapping, particularly providing guidance and considering the impact of stable coins. As outlined above, we think that a more prudent approach to the token mapping exercise is for ASIC to provide detailed guidance on the rights and obligations that will result in a crypto asset falling in any of the different types of financial products. Additionally, ASIC should provide detailed analysis as to why crypto assets with these rights and obligations meet the definition of the financial products product.

Question 30 – Are there any other descriptions of crypto assets that we should consider as part of the classification exercise? Please provide descriptions and examples.

No.

Question 31 – Are there other examples of crypto asset that are financial products?

No.

Question 32 – Are there any crypto assets that ought to be banned in Australia? If so which ones?

No.