

Crypto asset secondary service providers: Licensing and custody requirements

AFCA submission to Treasury consultation

June 2022

Contents

- 1 Overview 3
 - Key points 3
 - Licensing 3
 - Resolution of consumer complaints 3
 - Further considerations 4
- 2 AFCA’s perspective 4
- 3 Complaints 5
 - 3.1 Overview of complaint statistics 6
 - 3.2 Key statistics 7
 - 3.3 Observations 7
 - 3.4 Examples of complaints determined by AFCA 8
- 4 Systemic issues 8
- 5 Further considerations 9
 - 5.1 Compensation arrangements 9
 - 5.2 Potential gaps 9
 - 5.3 Need for clarity 11
- Appendix 1 – About AFCA 12
- Appendix 2 – Complaint summaries 13

1 Overview

AFCA¹ is the independent external dispute resolution (EDR) scheme for the financial services sector. This submission² provides feedback on the Treasury Consultation Paper dated 21 March 2022 *Crypto asset secondary service providers: Licensing and custody requirements*.

AFCA welcomes this initiative to enhance the regulation of crypto assets. We believe it is essential to establish clear legal responsibilities and provide strong consumer protection and confidence in this area. We acknowledge the need for a balanced approach to enable crypto businesses to thrive – with innovation, growth and competition – while creating a system that consumers can trust, where risks are managed and disclosed adequately.

Our feedback at this stage is in broad terms. We would be happy to provide any specific input that may be required and intend to participate in any consultation that may be conducted when reform proposals are formulated in more specific terms.

This submission draws on the experience of AFCA and its predecessor organisations, which have handled financial services complaints for more than 30 years.

Key points

Licensing

AFCA considers the introduction of tailored licensing requirements to enhance the regulation of crypto assets could, if designed appropriately, address the issues raised in the Consultation Paper.

Resolution of consumer complaints

An important element of consumer protection in Australia's financial services legislation is the right to make a complaint against a financial firm and, if necessary, pursue the complaint through EDR.

Current legislation ensures that most retail clients with complaints about financial services can access internal dispute resolution (IDR) processes that operate in accordance with regulatory standards set by ASIC³ and EDR services provided by AFCA. AFCA considers that equivalent arrangements should now be extended to protect consumers involved in crypto asset transactions. This extension should ideally be through appropriate licensing requirements or otherwise there should be, as a

¹ Appendix 1 provides a brief overview of AFCA. For comprehensive information about AFCA, see our website www.afca.org.au.

² This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.

³ See [ASIC's Regulatory Guide 271, Internal Dispute Resolution](#), released in September 2021.

minimum, direct requirements for businesses operating in the crypto field to meet IDR standards and hold AFCA membership.

Further considerations

If a decision is made to introduce the licensing regime proposed in the Consultation Paper, several matters will require consideration, including:

- ensuring there are compensation arrangements to support effective complaint resolution
- potential gaps in complaint resolution arrangements
- the need for clarity in regulation.

2 AFCA's perspective

AFCA does not create policy or develop the law or standards. We apply the law as it stands at the time of the conduct about which consumers complain.

An important objective of AFCA is to work with our members to resolve issues that give rise to complaints and to reduce the number of complaints submitted to AFCA.

To advance the resolution of financial services complaints, this submission provides information and feedback on certain points addressed in the Consultation Paper. We are not making particular recommendations as to how the regulation of crypto assets should be designed but note that we consider licensing would address many of the issues raised in this consultation.

AFCA is part of the framework providing consumer protection under Australia's financial services law, in which licensing is a key element. We regard licensing as a very effective mechanism to regulate conduct and clarify expected standards.

We acknowledge that the licensing regime proposed in the Consultation Paper includes complaint resolution requirements. Whether this regime is introduced or another regulatory approach is taken, we consider that consumers with complaints relating to crypto assets should have access to IDR and EDR arrangements equivalent to the arrangements already in place for consumers with complaints relating to regulated financial services. We believe retail clients should have this fundamental form of consumer protection. AFCA supports new technology and innovation in the financial sector and our complaint resolution processes are technology neutral.

AFCA can have voluntary members - as well as members required to join through licence conditions or directly by legislation - and does have some voluntary members at present. Such arrangements could be used as a model, if IDR and EDR requirements are imposed through licensing, or by specifying the requirements directly in legislation or a code of practice.

De-banking is not mentioned in the Consultation Paper but we note that businesses operating in the crypto field have identified this as a problem. AFCA considers that introduction of the proposed licensing regime could reduce the problem of de-banking as well as building consumer and business confidence in crypto assets and service providers. Licensing could help, for example, by requiring businesses to meet standards in areas such as custody of crypto assets, handling client funds and capital adequacy. This in turn could give banks the confidence they need to deal with these entities.

We would be happy to work with Treasury, regulators and other stakeholders to contribute to further developments and ensure our systems and processes will align with any new regulatory approach.

3 Complaints

AFCA is only able to consider complaints against financial firms that are members of AFCA. The vast majority of AFCA members are required to maintain AFCA membership under financial services legislation. For example, holders of Australian Financial Services (AFS) Licences and Australian Credit Licences and credit representatives are required by law to be AFCA members. Requirements for AFCA membership are also imposed on other financial services providers by legislation⁴ and codes of practice⁵.

Currently there are operators providing crypto assets or related services (such as exchanges) to consumers in Australia that do not hold an AFS Licence and are not otherwise required by law to be an AFCA member in relation to these products. In recent times a small number of these providers have, however, become voluntary members of AFCA, or have joined as a condition of their voluntary industry code.

As a result, to date, AFCA has only received a relatively small number of complaints relating to crypto assets.

When recording and tracking complaints, AFCA refers to the product 'cryptocurrency' defined as follows:

Cryptocurrency, such as Bitcoin and Ethereum, is an internet based virtual currency which is created and stored electronically. It uses strong cryptography to secure transaction records, to control the creation of additional currency, and to verify the transfer of currency ownership. Cryptocurrency units are sometimes called coins or tokens and typically do not exist in physical form (like paper money). It is also typically not issued by a central authority.

⁴ For instance, bankruptcy legislation requires a registered debt agreement administrator to be a member of AFCA.

⁵ Blockchain Australia's [Australian Digital Currency Industry Code of Conduct](#) is an example of a code that includes a requirement for EDR scheme membership. See clause 4.2.5.

Reflecting this approach, statistics in this section are for cryptocurrency complaints, meaning complaints relating to 'cryptocurrency' as defined above rather than 'crypto assets'⁶ (which is used extensively in the Consultation Paper).

This section refers to statistics as at 5 May 2022 for two periods:

- the financial year to date (FYTD) – 1 July 2021 to 5 May 2022
- since AFCA started operating – 1 November 2018 to 5 May 2022.

3.1 Overview of complaint statistics

AFCA's statistics for cryptocurrency complaints capture complaints where the product involved and in dispute is recorded as cryptocurrency. The statistics do not include complaints where a cryptocurrency transaction may have caused or played a role in the dispute, but the cryptocurrency product is not recorded as the disputed product.

This may be the case, for example, in a complaint against a bank that transferred money for a crypto transaction that led to a loss - in a scenario such as a scam or fraud perpetrated by a third party. A consumer who lost money in a scam may make a complaint about a regulated banking transaction where they cannot recover the loss from the perpetrator of the scam.

To date, AFCA has only received a relatively small number of cryptocurrency complaints. We received 162 cryptocurrency complaints in the FYTD. This figure does not, however, reflect the full extent of complaints concerning cryptocurrency, because:

- (as explained above) it does not include complaints submitted to AFCA in which cryptocurrency is not recorded as the product involved,
- cryptocurrency is largely unregulated, and
- businesses involved in cryptocurrency transactions may not be AFCA members required to provide access to adequate IDR processes and EDR.

While AFCA has received relatively few cryptocurrency complaints, we have seen an increase in other complaints about transactions involving cryptocurrency such as complaints about losses due to scams.

In the FYTD, service quality and unauthorised transactions have been the main issues in cryptocurrency complaints (in 20% and 17% respectively of complaints in that category). The prevalence of these issues has been, broadly, consistent since AFCA started operating in November 2018.

⁶ The concept of 'crypto assets', defined on page 2 of the Consultation Paper, is broader than 'cryptocurrency' as defined by AFCA.

3.2 Key statistics

Cryptocurrency complaints	FYTD	Since 1 Nov 2018
Received	162	350
Closed	169	308
% of closed complaints resolved at Registration	38%	32%
% resolved by agreement or in favour of complainant	59%	62%
Average time to resolve	79 days	78 days
Total compensation provided	\$190,768.59	\$741,836.24

3.3 Observations

From the limited sample of cryptocurrency complaints considered by AFCA, we can make the observations noted below.

- **Scams**

Scams are frequently the cause of the complainants' financial losses in cryptocurrency complaints.

- **Disclosure of fees for cryptocurrency conversion**

We have dealt with complaints relating to converting one cryptocurrency to another. In relation to these complaints we note that:

- > some exchanges operate like a traditional exchange and others operate more like a market maker
- > adequacy of fee disclosure can be a problem with some exchanges.

- **Consumer misunderstanding and confusion**

It is common for consumers to misunderstand, or be confused about, where and how to buy cryptocurrency. Problems have included:

- > a consumer being confused about whether they are trading a cryptocurrency or a derivative with cryptocurrency as its underlying instrument
- > consumers not appreciating that some cryptocurrency exchanges use a third party custodian (in the same way a superannuation fund does) and others do

not. Where a third party custodian is not used, consumers are unaware of the risk that their cryptocurrency can be lost if the exchange ceases operating.

We draw attention to the issue of disclosure and the related problems of misunderstanding and confusion referred to above. The description of the proposed licensing regime on pages 16 to 18 of the Consultation Paper does not make any reference to disclosure requirements. We are keen to understand any proposals in regard to crypto asset disclosure obligations as they develop, and we would welcome further consultation and engagement in this area.

3.4 Examples of complaints determined by AFCA

Appendix 2 sets out summaries of a selection of cryptocurrency complaints that have proceeded to a final decision by AFCA. The summaries show how particular issues were resolved and indicate the range of cryptocurrency complaints considered by AFCA.

Appendix 2 includes summaries of complaints in which the complainant sought compensation for:

- loss due to a scam (Summary 1)
- loss of a potential profit (Summary 2)
- loss from trading contracts-for-difference (Summary 3).

4 Systemic issues

As well as handling complaints, AFCA plays a role in the broader consumer protection framework by identifying, remediating and reporting systemic issues. Our role in relation to systemic issues is explained fully on our website and summarised in our publications.⁷

We use the term 'systemic issue' to refer to an issue likely to have an effect on consumers in addition to any person who has submitted a complaint to AFCA. A systemic issue may be raised in several complaints, a single complaint or otherwise be identified by information obtained by or provided to us.

In a very small number of complaints to date, we have identified several possible systemic issues relating to crypto assets. None of these matters, however, has resulted in a definite systemic issue being identified to date.

Key factors in this context are the relative lack of existing regulation in relation to crypto assets⁸ and the small number of crypto asset providers that are currently AFCA members.

⁷ See the [Operational Guidelines](#) to Rule A.17 of the AFCA Rules and pages 72 to 75 of our [2020-21 Annual Review](#).

⁸ On pages 7 to 9, the Consultation Paper outlines how crypto assets are regulated at present.

Systemic issues that we identify, investigate and report to the relevant regulator often reflect failure by a financial firm to meet regulatory obligations. At present they may only primarily arise in the crypto field from possible breaches of law relating to matters such as misleading or deceptive conduct. Regulators including ASIC also currently have a small jurisdictional scope in relation to crypto asset providers. Many other legal and regulatory obligations that apply across other financial service and product providers are not in place for crypto asset providers.

If regulation of crypto assets is enhanced, there will be more scope for timely and effective action to address inappropriate and systemic conduct through systemic issues reporting, remediation and appropriate regulatory action.

5 Further considerations

If a decision is made to introduce the licensing regime proposed in the Consultation Paper, it will be important to consider the matters noted below, which are relevant to complaint resolution.

5.1 Compensation arrangements

The Consultation Paper does not indicate whether the proposed licensing regime would, like the existing AFS licensing regime, impose requirements for adequate compensation arrangements.

We consider that, by requiring licensees to meet robust compensation requirements up front, the AFS licensing regime helps AFCA and the industry to reduce the risk of failures to pay determinations or fulfil other obligations to cover consumer losses.

Recent discussions have highlighted that professional indemnity insurance does not, alone, satisfy consumer compensation issues fully. It may be difficult for licensees to obtain affordable insurance and, when obtained, insurance may provide limited cover. Notwithstanding its limitations, we believe professional indemnity insurance performs a useful function in regard to consumer compensation.

AFCA's view is that the compensation requirements under section 912B of the Corporations Act are vital to support effective resolution of complaints against AFS licensees. Any new framework created to regulate crypto assets would need to incorporate an equivalent measure or another measure to achieve the same outcome. Due to the volatility of the crypto market, consumers can incur very large losses.

5.2 Potential gaps

Under the licensing regime proposed in the Consultation Paper, certain businesses operating in the crypto field would not need licences and would not need to meet requirements for IDR processes and EDR scheme membership. The licensing regime

would not apply to, for example, issuers of crypto assets or ‘decentralised platforms or protocols’.

We anticipate that multiple parties will be involved in the chain of transactions to deliver crypto assets to consumers. If a business in this chain is unlicensed, there could be a gap in complaint resolution services for consumers.

The position is different in ‘traditional’ fields of financial services. Generally, where multiple parties are involved in transactions, they are all covered by licences and AFCA membership. For example, insurance transactions may involve licensed insurers, brokers and advisers.

Two specific matters are outlined below.

- **There is no proposal to require custodians to be licensed**

The Consultation Paper explains that, under the proposed regime, licensees could outsource custody arrangements to third party custodians. These custodians would not themselves need licences and we understand they would not need to have any dispute resolution mechanisms in place. There is no suggestion that they would be required to join AFCA.

On page 20, the Consultation Paper says licensees would be liable for custody arrangements outsourced to third party custodians. An important question to consider is whether and on what basis any complaints relating to the conduct of the custodian could be brought against the relevant licensee.

For example, there is a question as to whether a third party custodian would act as the licensee’s agent. Where an unlicensed party caused loss to a complainant while acting as an agent of an AFCA member, AFCA may have jurisdiction to consider the complaint against the member.

- **AFCA cannot require non-members to participate or cooperate in complaint resolution**

The AFCA Rules enable us to require **members** to engage in the complaint resolution process or take specific action such as providing information. This is explained in our [Operational Guidelines](#).⁹

If the proposed licensing regime is introduced, it will be important to ensure complaint resolution will operate smoothly and effectively where complaints relate to a transaction involving multiple parties. Even if certain parties are not required to be licensed, they could be required to join AFCA.

⁹ See, for example, the guidelines to AFCA Rules A.9.1 and A.9.3.

5.3 Need for clarity

The current financial services legislation was developed before crypto assets began to emerge. The Consultation Paper states on page 7 that it is not sufficiently clear whether certain crypto assets are intended to be regulated as financial products. The Senate's recent 'Fintech Inquiry' established that this lack of clarity is a significant problem.¹⁰ One of its adverse impacts is to make resolution of crypto-related complaints more complicated.

With the recent emergence of crypto assets and the benefit of the current asset token mapping exercise, it may now be possible to develop legislation with greater clarity. We support action to clarify the regulation of crypto assets.

If introduced, the proposed licensing regime would operate with the existing regimes for licensing of financial services providers. As the Consultation Paper acknowledges on page 14, measures to prevent duplication of regulation would need to be added to the regulatory framework. A new set of questions – to determine whether the proposed regime or an existing regime applies in particular circumstances – would also need to be answered. It would be crucial to ensure lack of clarity does not arise again as a problem with any new legislation developed.

¹⁰ Select Committee on Australia as a Technology and Financial Centre. In committee's [Final Report](#), released in October 2021, see conclusion in para 6.25 and material in para 2.37-2.39 and 3.9-3.16.

Appendix 1 – About AFCA

AFCA is the independent EDR scheme for the financial sector. It replaced the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.

AFCA provides fair, independent and effective solutions for financial complaints. It does this not only by providing complaint resolution services free to consumers, but also by working with its members to improve their processes and drive up industry standards of service, thereby minimising complaints.

More broadly, AFCA plays a key role in restoring trust in the financial services sector. In addition to providing solutions for financial complaints, AFCA has responsibilities¹¹ to identify, resolve and report on systemic issues and to notify ASIC, and other regulators, of serious contraventions of the law. A separately operated and funded team within AFCA provides services to support independent committees that monitor compliance with several financial services industry codes.

AFCA's service is offered as an alternative to tribunals and courts to resolve complaints about financial firms made by individual and small business consumers. We consider complaints about:

- credit, finance and loans
- insurance
- banking deposits and payments
- investments and financial advice
- superannuation.

AFCA's role is to assist consumers to reach agreements with financial firms about how to resolve their complaints. We are impartial and independent.

If a complaint does not resolve between the parties, we will decide an appropriate outcome, including awarding compensation for losses suffered or substituting the trustee's decision in the case of a superannuation complaint.

¹¹ See [ASIC's Regulatory Guide 267](#) *Oversight of the Australian Financial Complaints Authority*.

Appendix 2 – Complaint summaries

Determinations of complaints are published in full on the AFCA website. The determinations can be accessed through this link – [published decisions](#).

This appendix sets out summaries of a selection of complaints relating to cryptocurrency that were determined by AFCA.

Summary 1 – Loss due to scam (Complaint 714920)

Complaint

The complainant, X, had an account with the financial firm's cryptocurrency trading platform.

X claimed that false representations made by a cryptocurrency mining system, MO, induced him to transfer Ethereum cryptocurrency from his account to MO.

After the transfer, MO stopped communicating with X and the transferred funds were lost. X believed MO was a scam.

X claimed the financial firm was responsible for the loss. He said the firm should have warned him that MO was a potential scam and should not have allowed the transfer. X sought compensation for his loss of \$13,200.

The financial firm said that, due to the anonymous nature of cryptocurrencies, it cannot identify recipients that are not using its platform or the owners of cryptocurrency addresses. The firm noted it warns against transfers to unknown recipients and provides adequate security recommendations to its customers.

Outcome

The Ombudsman found the financial firm was not responsible for X's loss as MO was not related to the firm. The firm was therefore not liable for MO's actions.

Under the Terms of Use of X's account, the financial firm assumed no responsibility for cryptocurrency funds transferred from its platform to another site. The Ombudsman was satisfied the firm also provided warnings of potential scams and could not have reasonably been aware X was the victim of a scam at the time of transfer.

Summary 2 – Loss of potential profit (Complaint 782653)

Complaint

The complainant, Y, held an account with the financial firm - a cryptocurrency exchange.

Y said he lost potential profits of approximately \$80,000 on 29 January 2021 because of system issues on the financial firm's platform.

Y also disagreed with having had to pay an \$800 conversion fee on a particular transaction (Doge-ADA) and said the financial firm unfairly removed \$30,000 worth of Doge coins from his account.

The financial firm said:

- third party social media caused an unprecedented demand for Doge trading on 29 January 2021 and its system could not connect to the Doge servers as a result
- all fees and charges were properly disclosed and applied and
- while there were technical glitches that caused Doge coins to be incorrectly credited to Y's account, the errors were reversed, and the \$30,000 worth of Doge coins in question was never owned by Y.

Outcome

The Ombudsman found in favour of the financial firm.

The Ombudsman considered that Y had not raised any concern that the conversion fee was incorrectly calculated, but instead suggested it was unfair. This claim was outside AFCA's jurisdiction and could not be considered. It was a matter relating to the level of a fee, within AFCA Rule C.1.2(a)(i).

Y failed to establish that the \$30,000 worth of Doge coins removed from his account ever belonged to him.

The Ombudsman noted the outage on the platform followed a tweet from Elon Musk that saw the price of Doge coins increase from \$0.023 to \$0.099. This created unprecedented demand for the coins.

The financial firm's terms and conditions made specific reference to periods of high market volatility. The firm was not liable for occurrences outside its control.

The Ombudsman found Y had not established his claim regarding the outage. While it was likely he would have bought Doge coins, there was no clear indication of the price at which he would have bought them or when or if he would have sold them.

Summary 3 – Loss from trading contracts-for-difference (Complaint 775233)

Complaint

The complainant, Z, applied for an online contracts-for-difference (CFD) trading account with the financial firm on 1 August 2020.

On 2 August 2020, Z bought and sold Ripple XRP contracts, suffering losses.

Z said the financial firm did not properly assess his suitability to trade CFDs and, had it done so, he would have not been allowed to open an account.

Z sought compensation for his losses.

The financial firm said Z passed its suitability assessment on the second attempt, was provided with warnings about the risks of trading CFDs and had access to a 'demo account' prior to trading on the live exchange.

Outcome

The Ombudsman found the financial firm adequately assessed Z's suitability to trade.

Z completed an online application form by supplying information including details of his trading experience and relevant knowledge. He indicated he had sometimes traded shares, bonds and commodities, but never traded over-the-counter or exchange traded derivatives. He had no relevant professional experience or qualifications. Despite this, Z passed the six multiple choice knowledge questions on his second attempt. The Ombudsman was satisfied this met the financial firm's obligations under ASIC's Regulatory Guide 227 and did not indicate Z was unsuitable to trade.

As Z did not have relevant professional experience or qualifications, had rarely traded and did not pass the assessment on his first attempt, the system gave him a risk warning as well as additional resources.

After acknowledging this warning, Z started trading on the demo account and, after depositing \$10,750, on the live account. There were five trades on the accounts between 11.29 am and 11:36 pm with similar results. The demo account had a loss of \$8,951.32 and the live account had a loss of \$8,988.07.