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Submission on Treasury's consultation paper *Crypto asset secondary service providers: licensing and custody requirements*

1 Introduction

Allens welcomes the opportunity to make this submission on Treasury's consultation paper *Crypto asset secondary service providers: Licensing and custody requirements* (***Consultation Paper***), issued on 21 March 2022.

Allens has advised clients who are engaging in, or seeking to engage in, activities related to crypto assets, to assist them navigate the Australian regulatory landscape. Through this work we have observed where the current regulatory requirements serve crypto asset secondary service providers (***CASSPrs***) well, and also where we consider it could be improved both to assist CASSPrs in meeting regulatory obligations as well as to achieve broader policy objectives, including better consumer protections in this area.

This submission is limited to our views on the design of a potential licensing regime for CASSPrs and we provide our comments on a general basis rather than in response to any particular questions in the Consultation Paper.

2 The proposed definition of 'crypto asset' is potentially both too narrow and too broad and will need to be refined

The Consultation Paper refers to the following definition of crypto asset: '…*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.*'

The definition is important because obligations will apply to those who provide services in relation to these assets.

We think that the above definition is potentially too narrow as well as being too broad. The reference to a 'digital representation of value or contractual rights' limits the scope of the definition and will exclude some crypto assets which should also be subject to a licensing regime. First, not all crypto assets will necessarily represent contractual rights – some crypto assets will carry no legal rights of themselves which can be exercised by the holder. There may be a use case for crypto assets to function as indicia of title to interests in property, in which case they will represent proprietary rather than contractual rights, but this may depend on the terms of arrangements which surround the crypto assets. Second, the expression 'digital representation *of* value' is ambiguous as to whether it requires the crypto asset to have a connection to something else that has value, or if it is intended to mean that the crypto asset itself is 'capable of having value'.

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If the former, we note that this is not the case for many crypto assets, which may have no connection to anything of value (in contrast to some 'stablecoins' which may be backed by fiat currency or other underlying assets).

At the same time, the definition potentially casts a very wide net and may capture types of crypto assets which it would not be appropriate to regulate through a licensing regime. For example, crypto-assets which only have utility within a closed environment such as a game or an app may pose lower risks from a consumer protection perspective and so it may not be appropriate to capture issuers or service providers of such assets within the proposed licensing regime. However, we understand that an objective of the definition may be to cast the net broadly, and the licensing and broader regulatory regime may then provide exceptions or exclusions for certain types of assets.

Having regard to the above issues, we consider that the formulation of the definition should be informed by the 'token mapping' exercise and a closer examination of the features and functions of various types of crypto assets. Following this work, it may be appropriate to refine the definition to either include or exclude certain types of assets, or alternatively provide for a broad definition but also to calibrate the application of the regulatory regime more appropriately for certain assets by modifying the application of the regime to such assets through specific modifications of the regulatory obligations or exclusions.

3 Defining crypto assets as personal property under legislation would provide additional certainty

Creating a statutory definition of 'crypto asset' also provides an opportunity to confirm, in legislation, that crypto assets are personal property capable of being dealt with like any other personal property.

While we think that at least some crypto assets have the characteristics of property at common law,[1] we also think that a provision similar to section 1070A of the *Corporations Act 2001* (Cth) (***Corporations Act***), adapted to apply to crypto assets, would be of value to confirm this position as a matter of statute and provide those dealing in crypto assets with greater confidence to undertake transactions (eg, lending secured by crypto assets) and greater certainty as to how the courts would treat crypto assets should a matter ever need to be litigated. It may be appropriate to exclude certain types of crypto assets from this deeming provision, although it is not immediately apparent what characteristics should justify exclusion.

We note that the ATO treats cryptocurrency as personal property for the purposes of revenue law[2] and authorities in other common law jurisdictions already treat crypto assets as personal property.[3]

Treasury should also consider whether any other provisions in Part 7.11 (Title and Transfer) of the Corporations Act could be adapted to provide regulatory certainty in relation to title to and the transfer of crypto assets.

4 A single definition of crypto assets across all regulatory regimes would create certainty and simplicity but may not be well adapted to all regulatory regimes

In principle, we think that a single definition of crypto assets applying across all relevant regulatory regimes may create regulatory certainty and simplicity.

However, further consideration should be given to whether having a single definition may create a need to define subcategories of crypto assets in particular legislation where, for example, a particular regulatory regime should regulate only certain kinds of crypto assets or crypto assets with specific or limited characteristics or functions. For example, the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (***AML/CTF Act***) currently only applies to 'digital currency' which relevantly must be

[1] See *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175, accepted in Australia in *Re Toohey; Ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327.
[2] See, for example, Taxation Determination 2014/26, which states that Bitcoin is a 'CGT asset' for the purposes of subsection 108-5(1) of the *Income Tax Assessment Act 1997* (Cth).
[3] See in particular paragraphs [55] to [58] of *AA v Persons Unknown* [2019] EWHC 3556 (Comm), and paragraphs [123] to [125] of *Ruscoe v Cryptopia Limited (in liquidation)* [2020] NZHC 728.

'interchangeable with money'.[4] The Explanatory Memorandum to the AML/CTF Amendment Bill 2017, which introduced this definition, provided that it was intended to 'exclude such things as loyalty programs (e.g. frequent flyer programs) where points may not be redeemed as money, and game money or credits issued by the operators of massively-multiplayer online role-playing games where its use is limited to a specific community.'[5] If a single definition is to be adopted, we think it will still be important to consider the purpose of each regime and whether it is appropriate from a regulatory perspective to apply the same requirements across all types of crypto assets. To the extent it is not, it may be necessary to exclude certain assets or modify the application of regulatory regimes to those assets.

5 The definition of CASSPr requires amendment

Although not the subject of any question in the Consultation Paper, we think that the definition of the activities to be regulated under the proposed CASSPr licence will materially affect how well the CASSPr licensing regime fulfils its policy objectives. As such, it should be addressed at the same stage as the definition of 'crypto asset' and the obligations to apply to CASSPr licensees.

While the definition of CASSPr provided in the Consultation Paper is workable for the purposes of the Consultation Paper, we think that the definition will require significant modification before being enacted in legislation.

CASSPr is defined as follows in the Consultation Paper:

> 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.

We note the following issues with the definition:

- paragraphs (i)-(iii) all appear to relate to the transfer of a crypto asset to another person (whether or not for consideration) and could be consolidated, potentially by adopting the 'apply for, acquire, issue, dispose of' language from the definition of 'dealing in a financial product' in section 766C of the Corporations Act;
- the use of the expression 'financial services' in paragraph (v) of the definition should be clarified. 'Financial service' is already defined in section 766A of the Corporations Act and section 12BAB of the *Australian Securities and Investments Commission Act 2001* (Cth) (***ASIC Act***) in a way that, for the most part, requires a financial product in relation to which a service is provided. However, the proposed new CASSPr licence regime would apply in relation to crypto assets some of which may not be financial products as that term is currently defined. If the term is being used in a more general sense to refer to services in relation to crypto assets that may be connected to finance, then we suggest a different term be used to avoid confusion. If the term does refer to 'financial services' as currently defined in the Corporations Act, the inclusion of this item in the definition appears redundant as a CASSPr that provides financial services will in most cases be subject to the existing Australian financial services licence (***AFSL***) regime and conduct obligations under the ASIC Act;

[4] See definition of 'digital currency' under s5, AML/CTF Act.
[5] AML/CTF Amendment Bill 2017, page 16, paragraph 27.

- paragraph (v) of the definition is also limited to services in relation 'an issuer's offer and/or sale of a crypto asset'. This has the effect of limiting the CASSPr licensing regime to primary sales of crypto assets (eg, soliciting purchasers for a crypto asset) and excluding from it secondary sales of those same services. We think there would be a benefit of increased regulatory certainty if the CASSPr licensing regime were to cover financial-type services in relation to primary and secondary sales of crypto assets, by deleting references to 'the issuer' in paragraph (v) of the definition; and
- advice in relation to crypto assets is not covered in the CASSPr definition. It would be helpful if Treasury could confirm if advice to consumers (akin to financial product advice) is intended to be regulated under the CASSPr licensing regime as it is under section 766B of the Corporations Act and section 12BAB(5) of the ASIC Act. Many consumers rely on advice from service providers in undertaking transactions in relation to crypto, which opens up the potential for consumer harm if advice providers engage in misconduct. If advice in relation to crypto assets were regulated in the same way as financial product advice, consumers would benefit at least from access to AFCA dispute resolution and, if legislated, a compensation scheme of last resort that would protect them against the insolvency risk of the advice provider. There may therefore be a policy justification to include providers of advice in relation to crypto assets in the CASSPrs regime.

We further suggest that, in defining the subjects of the new licensing regime, it would be desirable to set out a reasonably specific list of activities that will be regulated under the regime, similarly to how 'financial services' are defined in section 766A of the Corporations Act and section 12BAB(1) of the ASIC Act.

6 The inclusion of CASSPrs in the current AFSL regime could achieve better outcomes

We agree with the proposition in the Consultation Paper that a licensing regime for crypto asset service providers could provide regulatory clarity and signal quality to consumers. However, we are concerned that creating a separate licensing regime which would apply only to crypto assets would duplicate obligations for CASSPrs who provide services in relation to both financial product (eg, AFSL-regulated) and non-financial product crypto assets.

Without further exemptions or relief, AFS licensees wanting to provide services in relation to crypto assets (that are not financial products) will need to obtain a CASSPr licence. Likewise CASSPr licensees wanting to provide equivalent services in relation to crypto assets which *are* financial products will need to obtain an AFSL.

This will have the effect that crypto asset industry participants will continue to face the difficult challenge of determining whether or not particular crypto assets are financial products to determine which regime should apply to them.

We consider that Treasury's policy objectives of:

- minimising consumer exposure to operational, custodial and financial risks in relation to the use of CASSPrs;
- supporting the AML/CTF regime;
- protecting against community harms associated with criminals and their associates owning or controlling CASSPrs;
- providing regulatory certainty regarding the treatment of crypto assets and CASSPrs; and
- providing a quality signal to consumers

could be better achieved by regulating crypto assets within the AFSL regime.

Our reasons for this view are that:

- the services proposed to be regulated by the CASSPr licensing regime would be 'financial services' if the crypto assets involved were financial products;
- many crypto assets, despite not being financial products, serve (or are capable of serving) the same purpose as financial products – being a means through which consumers allocate their savings and through which capital is allocated in the economy;
- deeming all crypto assets to be financial products will remove the difficult challenge for industry participants of trying to determine whether a particular crypto asset is a financial product or not. To the extent that it is considered inappropriate to apply the full AFSL regime to certain types of crypto assets, this can be addressed by providing specific exemptions or modifications for these assets, or allowing ASIC to exercise an exemption and modification power to ensure the regime is flexible and adapts to changes in the types of crypto assets brought to market over time;
- the AFSL regime already provides for the regulation of custodians of financial products and imposes substantially similar obligations to those proposed in the Consultation Paper for custodians of private keys – we think that these could be adapted, or supplemented with requirements specific to holding private keys, to apply to custodians of crypto assets;
- the AFSL regime minimises consumer exposure to the risk of loss through mandatory external dispute resolution membership and, subject to limited exceptions, professional indemnity insurance for licensees who provide financial services to retail clients;
- regulating crypto assets as financial products would subject CASSPrs to the design and distribution obligations in Part 9.8A of the Corporations Act, providing additional protection to consumers dealing in crypto assets; and
- in our experience, we observe that the AFSL regime is widely known throughout the industry and viewed as a signal of the quality of a provider of financial services.

Since the proposed obligations for CASSPrs are substantially similar to the obligations applying to AFS licensees (and Australian market licensees), we think that creating a standalone licensing regime is likely to result in unnecessary duplication and overlap of regulation. To the extent that Government intends for less stringent obligations to apply to CASSPrs or for certain kinds of crypto assets to not be subject to regulation, this can be facilitated by specific relief or exemptions. Exemptions and modifications applying to particular activities or products are a common feature of the AFSL regime and we do not think that having exemptions and modifications applying in relation to particular crypto assets or crypto assets generally would make the AFSL regime any more complex than it currently is.

We also think that regulating crypto assets through the AFSL regime would promote innovation in the crypto asset industry as licensees will not be confined to 'financial product' or 'non-financial product' pathways depending on the particular licence they had initially chosen to acquire. The AFSL regime is already risk-based and 'technology neutral', satisfying the two 'foundational principles' identified in the Consultation Paper.

We also question the reasoning in the Consultation Paper that the presence or absence of a trust-based relationship distinguishes crypto assets from other financial products. Trust-based relationships in relation to the purchase of a financial product apply only to issuing (or sale amounting to indirect issuing) of a financial product by its issuer. After the financial product is issued or first sold by its issuer, subsequent sales do not involve the issuer of the product. However, the AFSL regime does not hesitate to regulate secondary services that do not involve the issuer of a financial product, such as advice, dealing in secondary markets, market-making and custody in relation to financial products. Accordingly, we do not consider this a distinguishing feature of a crypto asset that would mean it could not be regulated by the AFSL regime.

Lastly, we are unsure how a separate CASSPr licensing regime would complement the AML/CTF regime any better than the current AFSL regime. Currently, to the extent that AFS licensees are subject to obligations under the AML/CTF Act, those obligations arise because the financial services that they provide are also 'designated services' under the AML/CTF Act. We would expect the same to apply to services regulated under a standalone CASSPr licensing regime. It may be that the 'designated services' under sections 5 and 6 of the AML/CTF Act need to be amended to cover the particular services that the Government is intending to capture in relation to the ML/TF concerns of crypto assets (but this is not dependent on the AFSL regime).

7 Crypto asset custody obligation can be adequately provided for through the current AFSL regime

We support the proposed obligations that are to apply to custodians of crypto asset private keys. However, as above in relation to other obligations proposed to apply to CASSPrs, we think that the proposed obligations for custodians of private keys can be provided for within the AFSL regime.

A number of the obligations proposed in the Consultation Paper – holding assets on trust for the consumer, ensuring that consumers' assets are appropriately safeguarded, complying with minimum financial requirements, ensuring that the custodian has the requisite expertise and infrastructure, processes for redress and compensation for loss of crypto assets and the obligations relating to the selection and oversight of third-party custodians – reflect obligations applying to custodians of financial products under ASIC class orders CO 13/761 and CO 13/1410. We think that other obligations in the Consultation Paper which are unique to crypto asset private keys could be incorporated into the AFSL custodial and depository services regulatory regime by amendments to these class orders or the imposition of licence conditions.

Further, by focusing on the storage of private keys, the Consultation Paper does not address other ways in which custodial services may be provided in relation to crypto assets. Rather than holding consumers' private keys, custodians may instead hold consumers' crypto assets in aggregated wallets legally owned by the custodian. Such arrangements pose similar risks to the storage of consumers' private keys – if the private key for the custodian's aggregated wallet is compromised, the crypto assets held for consumers are vulnerable to loss.

Contacts

We would be pleased to discuss any aspect of our submission if that would be helpful to Treasury. Please contact Simun Soljo on [redacted] David Rountree on [redacted] or Victoria Eastwood on [redacted].

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