27 May 2022

Director- Crypto Policy Unit
Financial Systems Unit
The Treasury
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Dear Director,

Australian Custodial Services Association Submission on Crypto asset secondary service providers: Licensing and custody requirements

The Australian Custodial Services Association (**ACSA**) is the peak industry body representing members of Australia's custodial and investment administration sector. Our mission is to promote efficiency and international best practice for members, our clients, and the market. Members of ACSA include NAB Asset Servicing, J.P. Morgan, HSBC, State Street, BNP Paribas Securities Services, BNY Mellon, Citi, Clearstream and The Northern Trust Company.

Collectively, the members of ACSA hold securities and investments in excess of AUD $4.7 trillion[1] in value in custody and under administration for Australian clients comprising institutional investors such as the trustees of major industry, retail and corporate superannuation fund, life insurance companies and responsible entities and trustees of wholesale and retail investment funds. Those institutional investors are responsible for a sizable proportion of the money invested and held for Australian retail investors. ACSA member services are therefore integral to supporting the investment and retirement savings of a large part of the Australian population.

ACSA recognises that crypto and other digital assets are emerging rapidly in Australia as both an asset class and a fungible "currency" that can change the nature of trading, settlement, transacting and safekeeping for traditional assets, new digital assets, and digital contracts. A key priority for ACSA is ensuring that future regulation allows for efficient and effective market operations that ensure adequate investor protection, particularly for institutional and wholesale investors.

ACSA has formed an industry taskforce made up of ACSA members with local and global experience relating to crypto assets licensing and custody which enables ACSA to provide unique input to the Crypto asset secondary service providers: Licensing and custody requirements consultation.

DETAILS OF SUBMISSION

ACSA has provided a detailed response to the Crypto asset secondary service providers (CASSPrs): Licensing and custody requirements consultation paper in Appendix A.

[1] As at 31 December 2021, https://acsa.com.au/page/IndustryStatistics

ACSA believes regulations and laws should look through the technology, and crypto assets should be treated similarly to comparable traditional financial products, with similar licensing, disclosure, and other requirements. To the extent entities provide a service in respect of a crypto asset which meets the definition of financial product, they should comply with the existing relevant regulatory regimes.

Key themes in ACSA's submission include:

- Future regulation and laws being consistent in approach and terminology with other key global jurisdictions and existing Australian regulations and laws.
- Acknowledgement of existing AFSL license regimes and obligations
- Consistency in licensing outcomes and regulations across AFSLs and CASSPrs.
- Licensing requirements recognising the different roles that AFSLs and CASSPrs fulfil in trading, settlement, and safekeeping of assets.

ACSA agrees that the policy objectives for regulating crypto assets and CASSPrs are sound. Legal and regulatory certainty is critically important for institutional investors and service providers to enable market confidence and deliver appropriate foundations for consumer protection.

ACSA believes crypto asset categorisation should be based on the nature of and unique characteristics of a particular crypto asset. There could be unintended consequences from a broad catch all definition of crypto assets and therefore exclusions or tests are required.

ACSA agrees that the definition of crypto assets be defined consistently by all Australian regulatory regimes and would support ASIC working with other regulators such as the Australian Prudential Regulation Authority (APRA), the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Australia Taxation Office (ATO) on a common approach. While there is no one global standard, ACSA also support a principle of global harmonisation of the classification of crypto assets.

CASSPrs should be specifically licensed as fund managers, investment advisors, custodial banks, or other analogous traditional roles, as appropriate, in a similar way to existing Australian Financial Services Licensing (AFSL) regimes. ACSA's position is that the AFSL regime be the licensing regime for custodians providing crypto asset custody services. ACSA believes Treasury should consider authorising crypto assets as a subset of products to those holding existing financial service licenses (such as the product authorisation for carbon emission units).

Efficient market operations for traditional financial products have resulted in ACSA members being contracted to provide a range of ancillary services such as investment process outsourcing, fund accounting, valuation and unit pricing services which are not directly related to trading, settlement, asset protection or safekeeping activities of a custodian. It is important that such asset "administration services" not be caught in regulation by virtue of the fact that they may include ancillary services for crypto assets and remain consistent in regulatory form with traditional financial products.

Care in drafting regulatory responses to crypto assets and CASSPrs is recommended to ensure that providers also operating with traditional financial products are not subject to multiple regulatory regimes, differential obligations, and further that financial institutions with existing licenses should not be at a competitive disadvantage in comparison to CASSPrs.

ACSA supports the proposal to apply mandatory, principles-based obligations to CASSPrs who maintain crypto asset custody capabilities for investors (either themselves or via third parties). ACSA believes consideration should be given to applying obligations consistently with comparable traditional financial

products. Regulations and laws must recognise institutional investment requirements and concepts such as trusts, nominee and omnibus holdings, bankruptcy remoteness and limited liabilities for custodians.

ACSA does not support domestic location requirements as this would hinder the ability to achieve scale and Australian markets to maintain international competitiveness.

Finally, ACSA believes regulations and laws should ensure obligations are appropriate to the role of custodians including exclusions for custodians monitoring in areas such as investment product suitability and detection of scams as examples.

Thank you again for the opportunity to participate in this consultation. Please contact me if you have any comments about this submission.

Yours sincerely

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About ACSA

www.acsa.com.au

Custodians provide a range of institutional services, with clients typically favouring a bundled approach to custody and investment administration. Solutions may include traditional custody and safekeeping, investment administration, foreign exchange, securities lending, tax and financial reporting, investment analytics (risk, compliance, and performance reporting), investment operations middle office outsourcing and ancillary banking services.

These services represent key investment back-office functions – often representing the client's asset book of record and essential source data in relation to the investments they hold.

The key sectors supported by ACSA members include large superannuation funds and investment managers, as well as other domestic and international institutions.

ACSA works with peer associations, regulators, and other market participants on a pre-competitive basis to encourage standards, promote consistency, market reform and operating efficiency.

Note: The views expressed in this letter are prepared by ACSA for the purposes of consideration by Treasury in response to Crypto asset secondary service providers: Licensing and custody requirements and should not be relied upon for any other purpose. The comments in this letter do not comprise financial, legal or taxation advice and should not be regarded as the views of any particular member of ACSA.

Appendix A.

Terminology changes

While the Senate Select Committee used the term 'digital currency exchange', the Government considers a more suitable, precise term to be a Crypto Asset Secondary Service Provider or "CASSPr". Exchanges are only a subset of entities that provide services to consumers within the crypto asset ecosystem. There are many other relevant secondary service providers, including brokerage services, dealers, and custody services.

Consultation questions

To help inform consideration of a licensing regime for CASSPrs, the Government seeks stakeholder feedback on the following questions:

1. Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?
2. Are there alternative terms which would better capture the functions and entities outlined above?

Questions 1 and 2

ACSA believe there should be different regulations, licensing requirements, and responsibilities for different types of service providers (CASSPrs). An appropriate policy response would extend beyond just crypto asset exchanges, but like traditional asset ecosystems, roles and responsibilities should be discretely and clearly defined. By grouping all CASSPrs together there is likely to be obligations and unintended consequences on those providers.

The regulatory approach should seek to 'look through' the technology and apply regulation consistently, based on the risks associated with the service subject to the regulation. Qualifications, licencing requirements, and responsibilities for entities and services should be analogous to similar entities and services of traditional financial products.

A bank providing custody services such as settlement and safekeeping services should have different regulations than a broker providing dealing services or an exchange infrastructure. Post-trading services for crypto assets should be termed, Crypto Asset Custody. This is an industry term that would be easily understood and aligns with traditional financial product settlement and safekeeping and would recognise expertise in crypto assets.

ACSA notes that the CASSPrs definition includes safekeeping and or administration of crypto assets. ACSA recommend that administration related to crypto assets be clearly. It is important that traditional financial product administration services, that today are contracted services and not regulated services within AFSL licensed activities of a custodian, such as outsourced services, fund accounting or valuation services, are not captured as regulated activities by virtue of the fact that they relate to crypto asset administration.

Licensing and regulation consideration should extend to whether the services are provided inhouse within an exchange infrastructure group or on a third-party basis. Inhouse, book-entry services

conducted by or defined by regulation as crypto assets should be excluded from regulatory oversight given, they are not used by third parties as financial products.

Further, the licensing regime should give consideration on the reach and/or inclusion of the decentralised nature of certain digital assets and entities providing access to decentralised dealing including crypto asset issuers. In recent Singapore regulation, the policy framework recognised creators, owners or operators who maintain control or sufficient influence over decentralised finance and systems arrangements. This should include ongoing business relationships whether exercised via smart contracts or voting protocols.

Proposed Definitions

A "crypto asset" is defined by ASIC as: "…*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*."[2]

It is proposed that one definition of crypto assets would be applied across all Australian regulatory frameworks. This definition will capture all possible crypto assets that may be subject to the AML/CTF regime, tax, financial and other regulation in Australia.

3.	Is the above definition of crypto asset precise and appropriate? If not, please provide alternative suggestions or amendments.
4.	Do you agree with the proposal that one definition for crypto assets be developed to apply across all Australian regulatory frameworks?
5.	Should CASSPrs who provide services for all types of crypto assets be included in the licencing regime, or should specific types of crypto assets be carved out (e.g., NFTs)?

[2] Australian Securities and Investment Commission, *Consultation Paper 343 - Crypto-assets as underlying assets for ETPs and other investment products*, ASIC, 2021, accessed 1 March 2022.

Questions 3 and 5

ASIC's definition of crypto assets includes key references like those used by EU and US regulators. Crypto asset definitions should where possible reflect global harmonisation. ACSA notes that while global harmonisation is encouraged there is yet no single golden standard for the definition of crypto asset across global regulators, any regulation in Australia should enable flexibility and the assurance of continued policy revision.

ACSA believes that a single definition for all purposes is not appropriate when considering regulatory coverage. Some crypto asset's function neither as a 'representation of value' (as they are not linked to any underlying asset and do not have a fixed dollar value) nor as a representation of 'contractual rights' (as digital assets may provide no contractual rights against a counterparty). Further work will be required to come up with an adequate definition.

It is important that regulations should look through the technology. ACSA believes crypto assets categorisation should be based on the nature of and unique characteristics of the crypto asset and not whether cryptographic proofs are used in the transfer of value. It is recommended that detailed consideration be given to categorization of crypto assets be part of the mapping exercise and any regulatory policy response. There could be unintended consequences from a broad catch-all definition of crypto assets.

We note that various other regulators and policy makers have defined "tests" for which assets must meet requirements for inclusion in regulatory frameworks e.g. The US Securities and Exchange Commission's Howey test categorises asset that meet certain criteria as securities and therefore be caught by existing regulations. Likewise, the Basel Committee on Banking Supervision recently consulted on classification conditions as it sought to implement capital requirements against crypto assets. It sought to establish where there were unique risks associated with crypto assets.

There could be several asset types that meet ASIC's definition of crypto assets that ACSA believes require appropriate categorisation, such as e-money tokens or stablecoins that reference underlying fiat cash. We note that the Australian Prudential Regulatory Authority (APRA) is considering possible approaches to the prudential regulation of payment stablecoins under the regulatory framework for stored-value facilities[3]. On the other hand, traditional crypto asset such as Bitcoin or Ethereum may have different policy and regulatory considerations to other digital assets which may not or should not be regulated. However, where assets do carry a risk, it is important that the regulations of CASSPrs not create regulatory arbitrage where consumers would not be protected or be subject to lower protection thresholds that other crypto assets or traditional financial products.

There are several asset types that could meet ASIC's definition of crypto assets that ACSA believes should be excluded from the definition of crypto assets:

[3] APRA Letter: Crypto-assets - Risk management expectations and policy roadmap

- Asset related tokens which reflect an underlying asset where the regime that already applies to the underlying product, service, or asset should apply as far as practical.
- Financial instruments e.g., digital native security that would otherwise be captured as "financial products" to be regulated as traditional security.
- Derivatives products where they may be issued for both financial and crypto assets but be regulated from primary derivates regulation.
- Tokens that are used solely for the internal bookkeeping records of a financial institution.
- Non-fungible tokens (NFTs) which proxy unique assets or digital collectibles.

To the extent entities provide a service in respect of a crypto asset which meets the definition of financial product, they will need to comply with the existing relevant regulatory regimes. ACSA recommend that providers are not subject to multiple regulatory regimes. To the extent any crypto asset offers any features that replicate financial product or offering, the CASSPrs involved with that crypto asset should have the proper regulatory license with regards to the analogous financial product or offering.

The definition of crypto asset should exclude tokens that are used solely for the internal bookkeeping records of a financial institution ("Book Entry Tokens"). Book Entry Tokens cannot be transferred outside of a closed internal network of one or a select number of financial institutions. These include applications such as deposit tokens issued by banks to reflect deposits in their accounts. Book Entry Tokens should be viewed as a method of (and equivalent to) book entries for financial institution systems that happen to be designed using an internal blockchain in lieu of a more traditional structure. Requiring licensing of Book Entry Tokens would restrict innovation and development of more efficient internal systems. Such internal systems are already subject to regulatory review and oversight as part of the normal supervisory process of such financial institutions. We note that the proposed definition of crypto asset would otherwise capture Book Entry Tokens and subject the internal book and record keeping systems of financial institutions to additional regulations that should not be otherwise applicable. We suggest limiting the scope of the definition of crypto asset to that "is or is intended to be a medium of exchange accepted by the public", or "can be used as payment for goods or services provided to an unspecified person and can be purchased or sold to or from an unspecified person".

Question 4

ACSA would strongly agree that the definition of crypto assets be defined consistently by all Australian regulatory regimes and would support ASIC working with other regulators such as the Australian Transaction Reports and Analysis Centre (AUSTRAC), APRA and the Australia Taxation Office (ATO) on a common approach.

The definition of "crypto asset" must ensure that it can be captured within other regulations and laws, not just be consistent. For example, the definition must be able to be captured appropriately within accounting standards and the definitions of financial arrangements to facilitate any tax considerations relating to the treatment of an asset within recognised investment vehicles, such as Managed Investment Trusts (MITs), Attributed Managed Investment Trusts (AMITs), Superannuation Funds and Investment Companies. Tax reviews related to the treatment of "crypto assets" will be critical to ensure there is no disadvantage or arbitrage between investment vehicles used for crypto investment exposure and direct investment.

We reiterate the need for appropriate categorisation and exclusions as noted above.

Policy objectives

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.

Consultation questions

6. Do you see these policy objectives as appropriate?

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

Question 6

Yes, the stated policy objectives are appropriate. Regulations should look through technology, and crypto assets should be treated similarly to comparable traditional financial products, with similar licensing, disclosure, and other requirements.

ACSA believes CASSPrs should be separately licensed as fund managers, investment advisors, custodial banks, or other analogous traditional roles, as appropriate rather than as a single service provider grouping. Existing licensing regimes should be acknowledged and extended for CASSPr activities to reduce regulatory burden on existing AFSLs.

The lack of suitable regulation for CASSPrs may result in regulatory arbitrage as service providers of traditional financial products may be subject to different regulations, laws and licensing obligations. As a result, investors may be exposed to different protections and different risk frameworks across different types of financial products, including crypto assets, which may or may not be in the best interests of the investors or lead to confusion as to the minimum standards of investor protection.

CASSPrs already licensed as existing financial institutions should not be subject to “double” license requirements for engaging in crypto asset activity that is analogous to their existing licenses. “Crypto assets” should be authorised as a subset of products to those holding existing AFSLs, like the product authorisation for carbon emission units. Financial institutions with existing AFSLs should not be at a competitive advantage or disadvantage in comparison to digitally native crypto asset providers.

Legal and regulatory certainty would encourage participation of already regulated custodians in the ecosystem. Regulation and policy should be principles-based as the technology evolves but be prescriptive where necessary and needed for regulatory certainty. Policy and regulations should look at global best practices for organisations to be able to scale with the broader crypto asset ecosystem. Any bespoke policy or regulation will increase costs to investors. The licensing regime should seek also to achieve global harmonization so that Australia can remain a competitive financial market. Policy should ensure full inclusion of all actors in the ecosystem and should consider active policy to remove uncertainty that has led to de-banking, and, finally, should not stifle innovation.

Regulatory considerations should include both consumer protections and regulatory and legal certainty for institutional service providers and investors. Regulatory policy should consider risks to consumers who invest in crypto assets as well as for their institutional service providers, including superannuation funds or investment fund issuers, who would seek investment in crypto assets. Legal and regulatory certainty remains a critical investment criterion for institutional entities.

Specifically, for crypto asset custodians of retail investors that invest into listed funds directly or via platforms, it is noted that the fund itself should be regulated and ensure that investor protection and risk disclosures are explicit.

Minimum standards are not a new concept, but those minimum standards should be reflective of the nature of risks related to crypto assets. Minimum standards will ensure that the safety and security of crypto assets are adequate and should be consistent with those applied to traditional financial product investor protection, if not greater, given the increased risk profile of certain crypto assets. Any minimum standards being imposed should be subject to further consultation.

Question 7

The policy should be expanded for legal and regulatory treatment of institutional concepts of trust and nominee holdings as they apply in the context of crypto assets. This is especially true where the crypto asset is not analogous to a traditional asset. As for regulatory consistency, taxation treatment of analogous products should be consistent.

As noted, the definition of “crypto asset” must ensure that it can be captured within other regulations and laws, not just be consistent. For example, the definition must be able to be captured appropriately within accounting standards and the definitions of financial arrangements to facilitate any tax considerations relating to the treatment of an asset within recognised investment vehicles, such as Managed Investment Trusts (MITs), Attributed Managed Investment Trusts (AMITs), Superannuation Funds and Investment Companies. Tax reviews related to the treatment of “crypto assets” will be critical to ensure there is no disadvantage or arbitrage between investment vehicles used for crypto investment exposure and direct investment.

Interaction with existing AML/CTF regime

The existing regulation of AML/CTF administered by AUSTRAC is well known and understood. AUSTRAC will remain the AML/CTF supervisor for CASSPrs that provide designated services under the AML/CTF Act. However, to achieve regulatory efficiencies and minimise duplication, consideration will be given to

how the existing AUSTRAC registration requirements may be integrated with the new regulatory model proposed in this paper. A licensing framework with robust fitness and propriety checks that ensure that criminals and their associates are kept out of the sector could fulfil the purpose of AUSTRAC's existing registration framework.

Consultation questions

8. Do you agree with the proposed scope detailed above?
9. Should CASSPrs that engage with any crypto assets be required to be licenced, or should the requirement be specific to subsets of crypto assets? For example, how should the regime treat non-fungible token (NFT) platforms?
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)?

Question 8

Clarity is needed on how AML/CTF, know-your-customer and know-your-transaction requirements would apply to CASSPrs and their regulated activities. Otherwise, there is broad agreement that when crypto assets act as a means of payment they should be monitored.

Further analysis will be required to the extent to which, the AML/CTF Act will be amended to align with the broader definition for "CASSPr" in the Consultation Paper or as a result of industry feedback and global harmonisation. It should be noted that self-regulation cannot be extended for AML/CTF purposes.

There needs to be clarity on when a crypto asset is seen as a holding rather than a cash type transaction that will be monitored by AUSTRAC and how international transactions (non-AUD) may be treated. Alternatively, the AUD leg to fund the original purchase of a crypto asset should only be captured.

Like the matter of crypto asset definitions, clarity is sought on exclusions from AUSTRAC reporting. For example, NFT as "collectibles" and investable assets would not be currently licensed and should be excluded from AML/KYC requirements.

Questions 9 and 10

Subject to necessary exclusions to the definition of crypto assets and categorizations as discussed in response to Question 3 and 5, ACSA believes CASSPrs should be appropriately licensed under the AFSL regime. ACSA believes CASSPrs should be separately licensed as exchanges, brokers, fund managers, investment advisors, custodial banks, or other analogous traditional roles as appropriate, rather than as a single service provider grouping. To the extent that a crypto asset offers any features that replicate a financial product, the CASSPrs involved with that crypto asset should have the proper regulatory license consistent with the analogous financial product or offering.

The licensing regime should contemplate the full requirements and obligations. New entrants into the market should obtain the necessary AFSL licence and all licensees should be expected to meet the

obligations and minimum standards of that licence, irrespective of whether they may be a traditional financial product custodian. Any additional licence obligations of the crypto custodian should be an extension to existing licences where traditional financial product custodian seek to extend services to crypto assets.

Many, if not most, CASSPrs already hold an AFSL or otherwise have an affiliate with an AFSL, meaning that there is likely to be some duplicate licensing if a new CASSPr license is created. Services relating to a crypto asset which meets the definition of a financial product and provides a service relating to a crypto asset would be required to hold both an AFSL and a CASSPr licence. Licensed entities should not be subject to "double" license requirements for engaging in crypto asset activity that is analogous to their existing licenses. Existing licensees should not be at a competitive disadvantage in comparison to digitally native crypto asset providers if duplicative licensing and regulation applies.

Given the nature of crypto assets there is a need to ensure that there is appropriate infrastructure, information security, controls, audit, cyber security, operational risk management, AML/CTF, etc.. These are important features of existing regulation and laws for investor protection as well as protection of the custodians' shareholders.

Licensee regulations should make provision for market and technology evolution which may change the nature of crypto assets. For example, where excluded crypto assets become financial products, they should be migrated to the CASSPr regime. Further, the regulation should make provision for "crypto asset" custodians to manage risks regarding the safekeeping and usage of any key related to intangible assets, such as NFTs.

Proposed obligations

This regime would impose the following obligations on CASSPrs:

(1) 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.

(2) maintain adequate technological, and financial resources to provide services and manage risks, including by complying with the custody standards proposed in this consultation paper.

(3) have adequate dispute resolution arrangements in place, including internal and external dispute resolution arrangements.

(4) ensure directors and key persons responsible for operations are fit and proper persons and are clearly identified.

(5) maintain minimum financial requirements including capital requirements.

(6) comply with client money obligations.

(7) comply with all relevant Australian laws.

(8) 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

(9) respond in a timely manner to ensure scams are not sold through their platform.

(10) not hawk specific crypto assets.

(11) be regularly audited by independent auditors.

(12) comply with AML/CTF provisions (including a breach of these provisions being grounds for a licence cancellation); and

(13) maintain adequate custody arrangements as proposed in the next section.

The first seven obligations are similar to obligations that are applied under the financial services regime and go towards ensuring minimum standards of conduct and operational resilience.

ASIC would be empowered to grant relief from some or all the obligations if warranted, on a case-by-case basis to ensure the regime remains agile and flexible.

More work will be needed to define the scope and application of these obligations if they are implemented in legislation along with the necessary powers needed for the regulator e.g., to grant, vary and cancel licences.

Regulatory guidance would supplement the law to provide additional clarity about the application of obligations. The regime would likely rely on similar supervisory and enforcement mechanisms to the AFS licensing regime. For example, compulsory information gathering powers, civil and criminal penalty provisions.

More information on the financial requirements, hawking prohibition and custody requirements are outlined below.

Consultation questions

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

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

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)?

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

Question 11

ACSA believes there should be clear delineation of the roles and responsibilities of a crypto asset custodian from that of the crypto exchanges, brokers, dealers. Whilst there may be obligations that apply to both, regulatory obligations should be segregated to allow for CASSPrs only fulfilling one role. Wholesale, AFSL licensed custodians for traditional financial products would not be an exchange, dealer, or broker under their existing license. Alternatively, a group entity may have separate AFSL licensed legal entities that may provide those services and would need to amend their respective license for any additional crypto asset capabilities.

The obligations for exchanges or those involved in market-like operations should cover broader tests

than those currently included, such as a requirement for on market operators or dealers to be monitored as "Fit & Proper" persons, for controls on front running, obligations on conflict management and transparency. Other considerations should include market protections including crypto asset listing and protecting markets against "pump and dump' schemes which would impact trading behaviours ad consumer interests.

s912A(1)(g) of the Corporations Act 2001 requires an external dispute resolution (EDR) arrangement through membership of the Australian Financial Complaints Authority (AFCA) if financial services are provided to retail clients. We suggest that the CASSPr obligations be aligned with s912A(1)(g) of the Corporations Act 2001 to only require EDR arrangements when services are provided to retail clients defined by the Corporations Act 2001.

Item (8-true to label) do not apply to the role of traditional financial product custodians. ACSA considers this to be the obligation of the issuer or distributor not a crypto asset custodian and that regulatory guidance should include detail on how a CASSPr, to which this obligation applies, evidence if a crypto asset is "not" true to label and what action should be taken and by whom. The regulation should also be clear on what liability may arise if action is not taken.

Items (9-scams) and (10-not hawking) do not apply to the role of traditional financial product custodians. ACSA considers this to be the obligation of the issuer or distributor not a crypto asset custodian. Where there is an obligation applicable to CASSPrs, the regulation needs to include guidance on how CASSPrs may identify scams on their platforms and respond to such incidents.

On independent audit requirements, ACSA requests that existing AFSL holders may satisfy this obligation through annual FS70 audits, with appropriate extension, to comply with the CASSPr obligations.

In many instances, issuers of crypto assets will deal directly with consumers, and we believe the regime should address the obligations of issuers and not just of service providers.

Question 12

We do not believe that airdrops should be banned. However, just as the issuers of traditional financial products should be aware of the suitability of the financial product for its consumers and perform KYC/BSA/AML/sanction's screening on its consumers, CASSPrs should only airdrop crypto assets to entities that have accepted the crypto asset and are legally eligible to receive such crypto asset.

As CASSPrs should comply with AML/CTF provisions, recipients of the crypto asset should have passed the appropriate KYC requirements and meet the regulatory requirements applicable to the financial product that is analogous to the crypto asset being airdropped (e.g., being a "Sophisticated Investor" or a "Professional Investor", as appropriate).

If the custodian receives unsupported crypto assets (that is beyond the obligations set out in any contract between the parties) in a wallet maintained for a customer via airdrop, the custodian should not be responsible for the unsupported airdropped crypto asset.

Question 13

ACSA members do not provide personal advice relating to traditional financial products and do not expect to be providing personal advice for crypto assets. However, there should not be regulatory arbitrage opportunities between a crypto asset and its analogous traditional financial product. To the extent the analogous financial product to the crypto asset includes limitations on influencing potential advisors, CASSPrs offering such crypto asset should be held to the same advisory and advertisement standards.

CASSPrs acting as issuers or financial advisers should be the target of regulation regarding personal advice because they are the interface between retail clients and crypto assets. Issuers of crypto assets will deal directly with consumers, and ACSA believes regulations should address the obligations of issuers rather than other CASSPrs.

Question 14

Costs cannot be estimated. Depending on the minimum standards, the alignment of the Australian regime with other international markets and the ability to create scale, control, and operational efficiencies at a global level, as well as the risk and liability of the crypto custodian will influence the cost to implement and the costs to investors/consumers.

CUSTODY

Alternative options

This paper also seeks views on the following alternate options.

Alternative option 1: Regulating CASSPrs under the financial services regime

Under this option, all crypto assets could be brought into the existing financial services regime by defining crypto assets as financial products under section 764A of the Corporations Act and the financial services regime tailored to achieve the appropriate outcomes for crypto assets.

The Government (or the regulator) could be provided with powers to exempt or "carve out" particular crypto assets which do not warrant regulation under the financial services regime in a risk-based manner.

Under this option CASSPrs that provide a trading venue would be subject to the Australian market licensing regime. Entities operating as brokers – by forwarding clients' orders to a third-party exchange for execution – would be licensed under the AFS licensing regime and comply with the associated obligations. Other entities would need to comply with the relevant obligations under financial services regimes. There is flexibility in how this option could be implemented. For example, the Government could tailor the financial services regime to apply differently to different products or services. For example, basic banking products are subject to less onerous requirements than derivatives.

This approach could lead to a delay before new crypto assets could be excluded from the regime, which may impede innovation. Some CASSPrs would be subject to much higher financial requirements (for instance under the market license), as well as navigating compliance with numerous parts of the regime.

Consultation questions

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?

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

Question 15

Regulators should approach crypto assets with the expectation that when mapped and categorised, many can operate within existing regulatory frameworks. Some adjustments or exclusions may be required on a case-by-case basis. New regulations should only be implemented where are crypto asset constitutes new risk or activities that cannot be aligned to traditional assets.

Extending the AFSL regime to crypto assets has the advantage that it would accelerate regulatory certainty. Service providers and ASIC are familiar with the requirements under the regime, and the regulator is set up to assess licence applications. This would be the first step in regulatory certainty that would encourage institutional providers to the space.

When considering Bitcoin, ACSA requests further consideration be given as to whether Bitcoin, and other crypto assets with similar characteristics, should be considered as a separate asset class, as carbon units are recognised as a separate asset category to recognise the nuances of the asset.

It may be that some assets should be excluded from the licensing regime, where they involve little or no risk for consumers, such as book entry tokens, or where, for analogous assets today, they are not regulated, such as collectibles or their digital equivalent, NFTs. There could be unintended consequences if specific crypto asset considerations and nuances are not considered.

Whether or not all crypto assets are brought into the financial product regulatory regime, there should not be regulatory arbitrage between the crypto asset and the analogous financial product.

Consumers of either the crypto asset or the financial product should be equally protected. CASSPrs offering such crypto asset and financial institutions offering the financial product should be on a regulatory even playing field.

As discussed above, the licensing regime must be fit for purpose and be subject to necessary exclusions and categorization of crypto assets. Detailed consideration should be given to the exclusions and categorization of crypto assets as part of any token mapping exercise and any regulatory policy response.

Question 16

The need for regulatory certainty is paramount. Whilst the desire for innovation is important, crypto custodians will need to review any innovation in a controlled and thorough manner.

Changes to technology, process or controls need to be budgeted and planned for. Standardisation across the market is also important. With clients transitioning from one crypto asset custodian to another, the services, controls and treatment of the obligations should be uniform. The regulators and crypto custodians need to work together to refine how lead times can be reduced to lessen the impact on innovation.

At this stage, costs cannot be estimated. Depending on the minimum standards, the alignment of the Australian regime with other international markets and the ability to create scale, control and operational efficiencies at a global level, as well as the risk and liability of the crypto asset custodian will influence the cost to implement and the costs to investors/consumers.

Alternative option 2: Self-regulation by the crypto industry

Under this option, industry would develop a code of conduct for crypto asset services. This could be approved by a regulator and meet minimum regulatory policy goals like those proposed above – such as in respect of consumer protection and AML/CTF.

The 'Global Digital Finance Principles for Token Trading Platforms'[4] and Blockchain Australia's 'Australian Digital Currency Code of Conduct'[5] provide useful starting points for a voluntary code of conduct.

The existing regulatory regime for AML/CTF obligations would continue to apply.

This approach is closer to the US and UK, who do not specifically regulate crypto assets (excluding for AML/CTF) unless they are securities or financial products. Both jurisdictions are considering additional obligations for crypto assets.

Consultation questions

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?

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.

Question 17

ACSA does not support self-regulation by industry. A self-regulatory regime may not be able to provide the regulatory certainty that would be required for investments to be made by traditional regulated asset owners/investors (e.g., superannuation funds), or support regulatory certainty to attract highly regulated service providers to the space.

ACSA believes it is essential that all custodians, traditional financial product and crypto asset custodians, compete on an even playing field. Self-regulation is not likely to provide adequate protections for consumers as traditional asset custodians that are licensed and regulated as AFSLs.

Question 18

At this stage, costs cannot be estimated. Depending on the minimum standards, the alignment of the Australian regime with other international markets and the ability to create scale, control and operational efficiencies at a global level, as well as the risk and liability of the crypto asset custodian will influence the cost to implement and the costs to investors/consumers.

[4] Global Digital Finance, *A Code of Conduct Principles for Token Trading Platforms*, GDF, 2019, accessed 1 March 2022.

[5] Blockchain Australia, Code of Conduct, BA, 2021, accessed 1 March 2022.

Proposed Custody obligations to safeguard private keys.

Minimum custody standards can ensure that service providers manage the custody risks facing their clients' holdings, and in so doing support consumer confidence. A proposal for requiring minimum standards for the safe custody of crypto assets by CASSPrs is set out below.

Proposed obligations

The proposal is to apply mandatory, principles-based obligations to CASSPrs who maintain custody (either themselves or via third parties) of crypto assets on behalf of consumers.

These 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 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.

These principles-based obligations are designed to afford consumers necessary protections in relation to custody, whilst not restricting custodians to specific technology or prescribed requirements that evolve over time. They will also be applied in a manner that is proportionate to the nature, scale, and complexity of each custodian's operations.

Consultation questions

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

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

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?

22.	Are the principles detailed above sufficient to appropriately safekeep client crypto assets?
23.	Should further standards be prescribed? If so, please provide details
24.	If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Question 19

ACSA strongly supports mandatory, principles-based obligations to CASSPrs who maintain custody (either themselves or via third parties) of crypto assets on behalf of consumers.

ACSA request that current AFSL custody exemptions apply for crypto asset custodians, including exemption from the minimum financial requirements including capital requirements if the CASSPr is a body regulated by APRA, as defined in s3(2) of the Australian Prudential Regulation Authority Act 1998, and are not required to comply with s912A(1)(d) of the Corporations Act 2001.

We request that compliance with APRA Prudential Standard CPS 234 be sufficient in relation to cyber and physical security practices of CASSPrs that are APRA-regulated entities.

Similar to liability regarding traditional financial product custody, ACSA requires liability to be limited to losses caused by the fault of the crypto asset custodian in the event that crypto assets held in custody are lost. The liability should be limited to failure of the crypto asset custodian to meet its standard of care, fraud on the part of the custodian, willful misconduct, or gross negligence.

Crypto asset custodians should not be liable to vet or approve any smart contract for all of its hidden features.

Crypto asset custodians should not be strictly liable for any loss, especially given the potential for losses caused by the nature of a public blockchain. It would exclude losses attributed to forks, adverse judgments and regulatory or government actions.

Failure of regulation to limit obligations to the appropriateness of the role of crypto asset custodian may discourage traditional financial product custodians from providing services in this area, or it may encourage crypto asset custodial offerings from special purpose vehicles designed to limit damages, neither of which is desirable from a customer protection perspective.

While the concept of trust is indicated, specific consideration should be given to the nature of institutional provision of services, including operation of nominee holding structures and also give consideration to omnibus holdings.

Question 20

Additional obligations or considerations for crypto asset custody include the asset treatment in consideration of use and for insolvency treatment of the CASSPr.

Consideration should be given to prevent the crypto asset from being drawn into the bankruptcy estate of the CASSPr. Crypto assets on deposit in a custodial account with a CASSPr should not form part of the CASSPr's bankruptcy estate in the event of the insolvency of the CASSPr.

ACSA notes there have been recent industry treatments which have seen crypto asset holders treated as “general creditor”.

Special consideration should also be given to the ability to control a crypto asset in the event of service providers insolvency including the ability to facilitate security treatment of crypto assets. This should seek to establish who has control in the instance of key sharing, nature of and exercise of operational control of keys when they may be held independently or exercised through administrator rights.

Non-bank CASSPr custodians should have limitations on their ability to use, hypothecate, rehypothecate crypto assets. If crypto assets do form part of the bankruptcy estate of non-bank CASSPr custodians, such custodians should properly disclose the risk to their customers.

Consideration should be given to restricting certain assets to bank CASSPr custodians. For example, collateral/reserve amounts backing stablecoins should be held in bank custody. Such collateral/reserves should be held in accounts titled to the benefit of the stablecoin holders.

ACSA cautions the use of prescriptive technology references in policy formulation. As an example, the consultation paper focuses on custodians of customers' private keys. However, in practice, custodians may store customer crypto assets in keys issued by the custodian or in aggregated wallets. Similarly, crypto asset custody may operate through sub-custody networks. A customer's crypto assets may not be held in association with a customer's private key. Following consultation, the final obligations may be imposed on crypto asset custodians whether holding the crypto assets in connection with a customer's private keys or not.

Question 21

No, ACSA does not believe domestic location requirements should be mandated. Custodians currently are global and would leverage global platforms, controls, staff etc. The obligations being principles-based should allow organisations to develop the optimal global location outcomes relevant to the crypto asset. This further supports not limiting custody functions to domestic capabilities. Given the 24/7 global nature of the market for crypto assets, domestic location requirements increase the difficulty of managing post trade requirements for the operations of the crypto asset and the markets.

If the CASSPr custodian is a bank subject to supervision by APRA, no further requirements should be necessary.

Question 22

Yes, provisions for safe custody are broadly sufficient noting additional responses to question 20.

In addition, crypto assets not supported by a CASSPr custodian (through contractual obligations) should not become a safekeeping obligation of a CASSPr custodian. If such “uncontracted” crypto assets are ledgered to a wallet maintained by CASSPr custodian for a customer, the CASSPr custodian should have no liability for maintaining the “uncontracted” crypto asset.

Crypto assets are not credited to a digital wallet in a traditional sense. Determining whether a crypto asset has been allocated to a wallet requires querying the individual ledger for such digital asset. The CASSPr custodian may not have connectivity to the ledger of the unsupported crypto asset to know that such unsupported crypto asset has been ledgered to the wallet or to interact with such crypto asset.

For example, if the CASSPr custodian only agrees to support Bitcoin and if Binance Coin (BNB) is dropped into the wallet, the CASSPr custodian might not have connectivity to the BNB smart contract/ledger to know if the BNB has been ledgered to the custodian wallet or to instruct movements in BNB. Thus, the CASSPr custodian should not be liable if the BNB is lost or irretrievable, and the custodian should not have to report on the deposit of BNB. Connecting to each and every crypto asset poses risks to CASSPr custodians. Querying whether a smart contract had ledgered anything to a CASSPr custodians' wallets requires the CASSPr custodian to submit a list of its wallets to the smart contract. In the event the smart contract was created by a bad actor or a sanctioned entity, sending such a list creates a potential vulnerability to the CASSPr custodian.

Question 23

Regarding further standards, ACSA raises only that certain principles may need to be considered in the context of crypto assets, for example, effective operation of the control environment and practices, whilst leveraging the full innovation capabilities of crypto assets.

ACSA believes the treatment of issuers of asset-backed tokens and the role of holding assets that are linked to the tokens should also be captured in the regulatory frameworks for CASSPrs. Consideration should be given to crypto assets that have underlying holdings, such as stablecoins, and relevant issuer obligations in that regard. For example, the responsibility of custodians holding the underlying asset linked to the asset-backed stablecoins should only extend to safeguarding the asset, and the issuers of the asset-backed stablecoins should be subject to the regulatory requirements around authorization, licensing, fit and proper requirements, AML/CFT requirements, etc. Placing additional burden on the custodian would disincentivise custodians from offering services for the underlying asset.

Question 24

Costs cannot be estimated. Depending on obligation and minimum standards, the alignment of the Australian regime with other international markets and the ability to create scale, control and operational efficiencies at a global level, as well as the risk and liability of the crypto custodian will influence the cost to implement and the costs to investors/consumers.

Alternate option; Industry Self- Regulation

Consultation questions

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

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

27.	Is there a failure with the current self-regulatory model being used by industry, and could this be improved?
28.	If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

Question 25

Self-regulation would not support regulatory certainty for institutional investors or for regulated service providers to act in the space.

Regulatory enforcement needs to be in place at least in the short term, and potentially adjusted as greater nuance of crypto assets is defined.

Question 26

ACSA is not aware of any clear examples that would demonstrate appropriateness or otherwise of a crypto asset self-regulation regime.

Question 27

ACSA has no observations on this question.

Question 28

Costs cannot be estimated. Depending on obligation and minimum standards, the alignment of the Australian regime with other international markets and the ability to create scale, control and operational efficiencies at a global level, as well as the risk and liability of the crypto custodian will influence the cost to implement and the costs to investors/consumers.