



Commonwealth
Bank

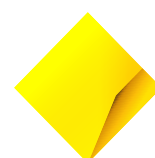
Crypto asset secondary service providers: Licensing and custody requirements

Response to Federal Treasury consultation

May 2022

Table of contents

1. Introduction	3
2. The role of regulation	4
2.1 Principles	4
3. Assessing the models for regulation	5
3.1 Benefits of all crypto assets being classified as financial products	6
3.1.1 <i>Readily implementing an integrated regulatory framework for crypto assets</i>	6
3.1.2 <i>A consistent framework for consumer protection</i>	6
3.1.3 <i>A consistent and cohesive approach to market efficiency</i>	7
3.1.4 <i>Mechanisms that encourage innovation can be leveraged</i>	7
3.2 Subsidiary policy considerations	7
3.2.1 <i>Use of crypto assets as a means of payment</i>	7
3.2.2 <i>Regulation of private keys</i>	7
4. Conclusion	8



1. Introduction

Commonwealth Bank welcomes the opportunity to respond to Federal Treasury's consultation on licensing of activities related to crypto assets. The Australian Government has a timely opportunity to set pragmatic regulatory safeguards that enhance trust and integrity of crypto assets.

We note the Australian Government's Digital Economy Strategy has as one of its key objectives to unlock economic value from the use of Distributed Ledger Technology (DLT), across a range of business sectors. The Government has identified an estimated annual business value that could flow globally from blockchain of over US\$175 billion by 2025. In the Australian context, the Government's *National Blockchain Roadmap* highlights the potential of blockchain technology across the Australian economy. It has been estimated that Australian crypto-asset related economic activity could grow from \$2.1bn in 2021 to \$68.4bn in 2030, and its workforce could grow from 11,000 workers in 2021 to over 200,000 in 2030.¹

In December 2021, the Australian Government highlighted the need for the regulatory framework governing crypto assets to evolve, given the rapid acceleration in the number of Australians actively investing. The Government announced a set of commitments to increase regulatory oversight of crypto-related activities, noting as a key objective of its reforms to place Australia among a handful of leading digital economies globally.

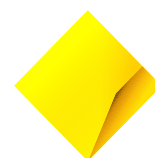
CBA sees great potential flowing from crypto assets and DLT, with applications to a wide array of activities across the economy and society. Among the many benefits we anticipate will flow from increased use of DLT include new and augmented product and service offerings: better protections against fraud; lower cost regulatory compliance, and a suite of other productivity enhancements that will contribute meaningfully to national prosperity.

It is important to note though that the growth of crypto assets introduces new risks to consumers and the broader financial system. By currently operating at the fringes of the financial system, crypto assets pose fundamental questions regarding:

- Privacy as all transactions are recorded on the blockchain, potentially challenging anonymity if public, and increasing exposure to coding errors and cyber risks;
- Consumer protection given the lack of standards on product disclosures and access to recourse;
- Stability and safety of some crypto assets given that money used to purchase these assets may not be protected to the same extent as an ADI and might be at risk depending on safety and liquidity of underlying assets. The recent collapse of stablecoin Terra (UST) illustrates this point where the algorithmic stablecoin that was supposedly pegged to the dollar collapsed over 90% in one week triggering volatility in crypto markets and resulting in millions of investors losing their investments
- National interest given that cryptocurrencies present potential mechanisms for tax avoidance or the facilitation of crime; and
- Confidence in the payments ecosystem given the potential increased liquidity risk as well as the impact payments in crypto assets could have on the effectiveness of monitoring and reporting of breaches of sanctions, and AML / CTF laws by payment facilitators.

CBA was among the first Australian companies to initiate trials and pilots to explore the value of DLT. In 2015, CBA experimented using distributed protocols to facilitate payments internally among its subsidiaries. In 2018, we ran a pilot using DLT, smart contracts and the internet of things, to facilitate shipments of agricultural exports. In 2019, in partnership with the World Bank, we issued the world's first

¹ Cryptocurrency and the distributed digital economy in Australia, EY, December 2021



blockchain-based bond. We have also been actively collaborating with the Reserve Bank of Australia to explore the potential use and implications of a wholesale form of central bank digital currency (CBDC).

In 2021, CBA announced it would launch a pilot offering that would allow retail customers to have exposure to crypto assets through the CommBank app. We believe financial institutions can play an important role in addressing this area of rapidly increasing customer interest, in ways that appropriately consider evolving community expectations and key drivers of risk.

2. The role of regulation

CBA strongly supports the Australian Government's efforts to provide regulatory certainty, consumer protections, and ensure financial stability in addressing the issues associated with crypto assets. Policy settings and the emerging regulatory framework needs to strike a balance between providing consumer protections while enabling innovation and unlocking Australia's potential to emerge as a leader in the digital assets space.

A rapidly growing number of Australians have embraced digital assets linked to DLT. According to CBA analysis, there are now over 3 million investors in cryptocurrency. We estimate that Australians transferred more than \$20 billion to digital currency exchanges (DCEs) in 2021, which is an eight-fold increase on 2020, with growth continuing in 2022.

Some investing in crypto-assets may not fully understand the nature of risks to which they are exposed, and may assume that regulation governs commercial activity in the sector to guarantee minimum standards in cases where it does not. At the same time, companies operating in the sector may not be regulated to require them to invest adequately in processes, risk management and technology to protect customers against harm as other financial institutions are required to do under existing regulatory settings.

In 2021, the failure of MyCryptoWallet and ACX caused over \$50m to be owed to consumers, with limited recourse.² In the first half of 2021, Australians reported \$35m in losses due to crypto-related scams.³ In the absence of a mechanism allowing regulators to monitor participants in the sector and intervene where necessary, these losses will continue to multiply, in line with the rapid growth of investment in this asset class more broadly.

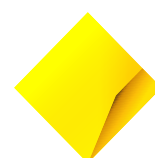
2.1 Principles

The policy and regulatory environment should provide consumers with heightened confidence, enable and encourage crypto asset innovation, and ensure Australians can benefit from the economic gains flowing from these rapidly evolving technologies. To this end, CBA welcomes the underpinning principles and policy objectives outlined in the Government's paper, namely that a licensing regime for CASSPrs should:

- 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

² <https://www.theguardian.com/technology/2021/dec/12/the-search-is-on-for-50m-in-lost-cryptocurrency-after-two-australian-exchanges-collapse>

³ Targeting scams, ACCC report, June 2021



- 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.

CBA believes that an additional policy objective should be to maintain financial stability which includes not compromising confidence that Australians have in our financial system and ensures that the evolution of crypto assets does not undermine key foundations of the way our economy operates such as the use of monetary policy.

Consumers must be able to readily inform themselves of the risks associated with crypto investments. Companies must have clarity on what is expected of them by regulators. They must operate at a standard that meets community expectations and be held accountable for any harm they cause in the same way as financial institutions are currently accountable, including by having avenues for dispute resolution and redress.

Regulators must have mechanisms to intervene where service providers are failing to take adequate steps to address business continuity, liquidity, capital management, appropriate market conduct, quarantining of customer funds, financial crime and fraud, and are failing to adequately inform customers of key risks. Armed with transparency, they must also be empowered to act proactively where they see systemic risk accumulating, to protect the integrity and stability of the financial system.

Given the pace of change in the sector and rapid consumer adoption, swift and meaningful action is required to address a multiplying set of risks. The regulatory framework must allow for a future where crypto assets play a far greater role in the economy than is currently the case.

New regulations should be no more burdensome than required to achieve the public policy objectives Government has identified with respect to these assets and the sector.

3. Assessing the models for regulation

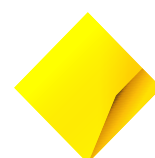
Treasury's paper *Crypto asset secondary service providers: Licensing and custody requirements* examines a number of options with respect to regulating activities related to crypto assets in Australia.

The primary proposal in the Treasury paper is that not all crypto assets should be regulated as financial products. Instead, those that have features that meet the existing definition of a financial product should continue to be classified as such, meaning activities in relation to those assets, like custody and creating a market, would be covered by existing law within the Corporations Act and associated regulations. Then, for other crypto assets that do not meet the current definition of a financial product, a separate bespoke regime would be established, to regulate activities like custody and exchange as they relate to those investments.

We note the Treasury paper also identifies some other alternative approaches. One of these is that all crypto assets could be brought into the existing financial services regime, by defining them as financial products. The paper notes that regulatory requirements could be graduated, as currently occurs in relation to financial services, where basic banking products are treated differently from derivatives.

Considering the advantages and disadvantages of both, CBA views the preferable regime being the option whereby crypto assets are regulated as financial products and associated services captured by relevant sections of the Corporations Act.

To the extent that certain digital assets do not fall within the definition of financial products, CBA proposes that these digital assets should be regulated under existing consumer protection laws.



The key advantages we see from adopting this option are outlined below.

3.1 Benefits of all crypto assets being classified as financial products

3.1.1 Readily implementing an integrated regulatory framework for crypto assets

If the Government classified all crypto assets as financial products, then a new bespoke regime for activities associated with a subset of crypto assets would not be needed. Instead, a new class of product could be added to the existing financial product regime, as has been done a number of times since the Corporations Act was legislated.

Regulation of financial products in Australia aims to ensure investor protection, effective competition, market integrity and risk management. If the current framework was applied to crypto assets, these objectives would be enshrined in a consistent manner.

The existing Corporations Act framework is well established and embedded. Whilst CBA agrees with the Australian Law Reform Commission that the complexity of the existing framework is currently problematic and in need of simplification and streamlining generally, in CBA's view the Corporations Act framework does provide an existing regime with sufficient flexibility under which a new regulatory regime for crypto assets and the associated services could be established more readily. The speed of implementation appears highly material to Government's policy objectives, given the rapid increase in the number of Australians engaging with these assets and the related accumulation in risk exposure.

Many businesses in the sector have operations relating to a variety of crypto assets, some of which are currently classified as financial products and some which are not. Having parallel regimes importing similar but not identical requirements would have the potential for creating unnecessary duplication, unintended consequences, inefficiencies and consumer confusion in relation to where their protections reside and where they may seek remediation and/or compensation.

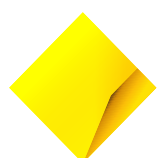
CBA recognises that regulating crypto assets as a financial product under the Corporations Act is not the perfect solution to the challenge of installing regulatory safeguards on crypto assets. However it is, in our view, the most pragmatic and direct route to a framework addressing the emerging risks posed by crypto-assets outlined above. CBA views that the existing regime can be adapted without significant changes to recognise the unique characteristics of crypto assets.

3.1.2 A consistent framework for consumer protection

Regardless of what the technical legal characterisation of a crypto asset is, it is highly likely that consumers will not make the distinction between those which are regulated as financial products and those which are otherwise regulated (or unregulated). Accordingly, it is also highly likely that they will not understand differences in consumer protection offered. This will lead to consumers making decisions based on incorrect assumptions.

Ensuring financial services with respect to all, and not just some, crypto assets are covered by the Chapter 7 regime ensures consistent and fair standards on financial resources for the relevant activities, competence, skills and experience for those services and adequate systems for training and supervision.

Given many investors may be expected to reach a conclusion that an investment in crypto assets is engaging with a financial market, we see benefit in extending consistent consumer protections across the suite of these assets. A bespoke regime that governs the activities of custodians and dealers in a subset of crypto assets will not deliver uniform benefits for consumers. In particular, such a regime would not provide investors with clarity as to their protections and provide inconsistent information regarding risk.



A single regulatory regime for the advisers and other intermediaries with whom consumers interact is the most likely to support effective consumer protections. A single licensing regime was created for advice and sales of financial products in Australia, as a response to the complexity of different requirements for different products (such as securities, futures, insurance and foreign exchange). Adding another regime with separate obligations and licence for advising a retail investor will add to complexity.

3.1.3 A consistent and cohesive approach to market efficiency

Rigorous market misconduct provisions are crucial for ensuring market integrity, allowing for effective price discovery and risk management functions. If insider trading and market manipulation regulations are applicable only to some crypto-assets and not others, then the trust and trustworthiness of the crypto asset industry in Australia will be impaired.

3.1.4 Mechanisms that encourage innovation can be leveraged

If all crypto assets are deemed to be financial services, this will allow for the leveraging of existing mechanisms in the regulatory framework that encourage innovation, within defined risk appetites, such as the regulatory sandbox overseen by ASIC. Further, if the sandbox was expanded by the Government to bring it more in line with overseas equivalents (such as allowing existing financial service providers to gain access), it could also be further enhanced by incorporating flexibility regarding innovation using crypto asset technology.

3.2 Subsidiary policy considerations

A number of other policy considerations appear relevant to Government's decisions with regard to regulating crypto assets.

3.2.1 Use of crypto assets as a means of payment

As crypto assets continue to evolve, consumers will increasingly use them as a means of payment. It is estimated that 2,300 US businesses accept bitcoin, including large consumer brands like Microsoft, PayPal, the US National Basketball Association and Hockey League, KFC, Subway and Pizza Hut.⁴

As crypto payments become more mainstream, consumers will see them in a similar way to traditional payments. If the risks of crypto payments are not managed appropriately through regulation, this could impact the confidence consumers have in the overall payment ecosystem.

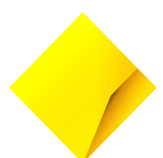
CBA believes that crypto wallets that facilitate crypto payments should be required to hold a licence under the Transforming Australia's Payments System reforms that the Australian Government has committed to putting in place⁵. CBA looks forward to engaging with Government further on these matters as part of formal consultation on the payments reforms.

3.2.2 Regulation of private keys

The private key for crypto assets is critical in being able to transact with that asset. CBA strongly supports the Government's proposal to impose minimum custody standards on CASSPrs who hold and safeguard the private keys for their customers' digital assets, and agrees that the proposal should apply the mandatory, principle-based obligations set forth in the consultation paper. In other words, CBA asserts

⁴ Cyber Security Industry Advisory Committee, Exploring Cryptocurrency March 2022, 8.

⁵ <https://treasury.gov.au/publication/p2021-231824>



that custodians of the private key should be accountable to the retail investor just like custodians of traditional assets are today. That is, the entity with the direct customer relationship should not be liable for custody if the custodial services are provided by a regulated third party; a regulated custodian should be liable for the custody services it provides.

CBA does not agree with the view advanced by some that government should force local custody. Given the borderless nature of crypto assets—and increasing sophistication and security of cloud-based storage platforms—local custody constraints would hamper competition, denying Australian consumers choice and access to mature service offerings that exist internationally.

4. Conclusion

CBA strongly supports the objective of the Australian Government to improve clarity about the regulatory regime that governs the commercial delivery of services related to crypto assets. The most important objectives of this work appear to be that consumers are appropriately protected; that Australia can harness the valuable benefits from the underlying technology in a way that meets the expectations of the community, and that regulators can be empowered to intervene if the fundamentals of the economic and financial system are at risk at any point.

There are a number of ways to implement policies supportive of the above goals, as is evident from the approaches of peer jurisdictions internationally. CBA believes that there is much merit in applying the well-established regime in the Corporations Act. This would allow Government to act swiftly in response to a rapidly multiplying set of risks, and would aid consistency across the legislative and regulatory framework, in the interests of consumers and businesses.

Regardless of the path taken to regulate crypto assets, and CBA acknowledges that there are challenges in attempting to classify crypto assets as financial products or non-financial products as the case maybe be, it is paramount that the principles articulated above remain consistent.

CBA looks forward to further discussions with Government in relation to this dynamic and promising area of economic activity.

