Crypto asset secondary service providers: Licensing and custody requirements

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1. Background

The crypto asset ecosystem has expanded rapidly in recent years, growing by 3.5 times in 2021 to US $2.6 trillion. More than 800,000 Australian taxpayers have transacted in digital assets in the last three years, with a 63 per cent increase in 2021 compared with 2020. This surge in retail consumer exposure to crypto assets has led to calls, including from some service providers, for additional regulation in Australia. Regulation would support consumer confidence and trust in the crypto asset ecosystem and provide regulatory certainty to support crypto businesses' investment decisions.

In December 2021, the Australian Government announced that it would consult on approaches to licencing digital currency exchanges and consider custody requirements for crypto assets, with advice to be provided to Government on policy options by mid-2022. The Government's proposed approach to licensing crypto asset secondary service providers (CASSPrs) and crypto custody requirements. The proposals recognise the growing importance of the crypto asset ecosystem to both the Australian and global economy, and the need for regulatory certainty to encourage innovation and competition. Any future legal framework should seek to give consumers greater confidence in their dealings with CASSPrs. On this basis, this paper identifies area for consideration that the Australian Government should be undertaken in developing any law or policy in this area.

Most jurisdictions are in the process of considering legislation to regulate this area. An exception is Singapore,[1] who have recently established laws to allow for the licensing of this

[1] Singapore,
https://www.parliament.gov.sg/docs/default-source/default-document-library/financial-services-and-markets-bill-4-2022.pdf
https://www.mas.gov.sg/news/parliamentary-replies/2022/reply-to-parliamentary-question-on-cryptocurrencies-and-defi
2022, MAS issued its "Guidelines on Provision of Digital Payment Token Services to the Public",
https://www.mas.gov.sg/-/media/MAS-Media-Library/regulation/guidelines/PSO/ps-g02-guidelines-on-provision-of-digital-payment-token-services-to-the-public/Guidelines-on-Provision-of-Digital-Payment-Token-Services-to-the-Public-PS-G02.pdf

sector. While in its infancy of being implemented, there is not enough information available to determine the gaps in the law.

2. Response

The is a general response only focuses on points of expertise and includes data flows, data protection, dispute resolution and transnational insolvency, by Victoria University. It take a regulatory view, rather than a view that an organisation currently operating in this sector might have. However, and while this submission has a narrow regulatory focus, more and urgent research is needed to reconciles policy issues of sovereignty, national security, economic development, consumer and general protections. In addition, more knowledge is needed to better understand and develop a risk matrix that is able to facilitate regulatory development. For example, there should be a schedule of risk analysis provided to ensure specific rules apply when this activity is undertaken with and in countries that pose a higher national and economic threat than others. Another way to view this risk framework is to better understand how nation states are using these emerging sectors to develop way to intrude on other countries sovereignty. This is undertaken by collecting and collating large quantities of personal and commercial information that will be used to redirect government's regulatory response, to the way that country want, rather than a country meeting their needs.

2.1 Insolvency

The International Association of Restructuring, Insolvency & Bankruptcy Professionals highlight that in the evolving market of cryptocurrency, bankruptcy trustees in the United States (US), for example, face the challenge of identifying both the owner and / or location of a debtor's cryptocurrency, which may prove even more difficult if the debtor attempts to hide such assets during the bankruptcy proceedings.[2] INSOL go further stating:

> Fortunately, the Bankruptcy Code in the US provides an incentive for a debtor to reveal its cryptoasset. In the US, the bankruptcy courts can release an individual debtor from personal liability for most debts in a chapter 7 bankruptcy by making a discharge order. After a discharge order has been granted the creditors of the bankruptcy cannot bring an action against the debtor. Unless there is an objection or a motion to extend the time to object, the bankruptcy court will issue a discharge order. Section 727 of the US Bankruptcy Code sets out the grounds for denying a chapter 7 discharge, including such cases where the debtor transfers, removes, destroys, mutilates, or conceals Bitcoin or any associated records. On the request of a trustee, creditor or the US trustee the bankruptcy court may revoke a chapter 7 discharge if the debtor fraudulently failed to report an asset or surrender it to the trustee.[3]

Where an insolvency professional is able to gain sufficient control over the cryptocurrency holding, the next issue is whether the distribution of the payments should be made in cryptocurrency or converted to fiat currency. This might not be an issue if the relevant

[2] International Association of Restructuring, Insolvency & Bankruptcy Professionals, Cryptocurrency and its impact on insolvency and restructuring, p 30.

[3] Ibid. 30.

security arrangements with creditors set out the specific amount of cryptocurrency that is attributable to discharging the debt of the creditor. However, where this is not the case the distribution process becomes difficult. Due to the volatile nature of the value of cryptocurrency, the point of valuation will be critical as the value is capable of drastically rising or falling. It may be the case that creditors may want their entitled portion of the cryptoasset to be converted to fiat money. In this scenario, the question of conversion arises. As with most things in life, cryptocurrencies are valuable to the extent that other participants are willing to accept them as payment, or will purchase them. Therefore, the insolvency professional needs to be aware of the impact a large disposal of cryptocurrency will have on the value of the asset. Without a credible strategy in the disposal of the cryptocurrency, the insolvency professional's actions could devalue the cryptoasset and this would be a breach of duty of the part of the insolvency professional who has a duty to consider the interests of the creditors as a whole. In order to avoid a situation where the actions of the insolvency professional are called into question by the creditors, it is advisable that any disposal or the decision to hold the cryptoasset is validated by an order of a Court with relevant jurisdiction. INSOL also state that:

> A good example of this is the insolvency of the cryptocurrency exchange MtGox. On 25 September 2018, the trustee, in consultation with the Court and the examiner, made a disposal of Bitcoin. The decision to implement a sale was heavily criticised as it resulted in the sale of roughly 35,841 Bitcoins for approximately USD 360 million. The sell-off was perceived as driving down the price of Bitcoin and it was claimed this was contrary to the trustee's duty to maximise and protect the value of the assets on behalf of the creditors. Had the trustee not consulted the Court prior to making this decision, it is likely that the criticism would have accelerated into litigation against the trustee.[4]

INSOL note that the volatility of the cryptocurrency market is an important factor which an insolvency professional must take into consideration for a liquidation plan over an estate which comprises of a significant holding of cryptoassets. As seen in MtGox, the trustee followed the Japanese bankruptcy rules which state that the claims are to be valued at the April 2014 Bitcoin market price; consequently, the trustee had priced the Bitcoins at their 2014 value of USD 483. The creditors, dissatisfied with this, petitioned the Court to reinstate civil rehabilitation proceedings (from bankruptcy proceedings) so that they could reclaim the cryptocurrencies at the value of the cryptocurrency in 2016, which had accelerated to USD 1.3 billion. Due to the increase in value of the Bitcoin, the Court reinstated the civil rehabilitation. The question of conversion of cryptocurrencies into fiat currency arose in a recent unreported criminal case in England, in the context of a seizure of Bitcoins from an individual who was convicted of drugs and money-laundering offences. The police applied to the Courts for an order permitting them to convert the cryptocurrency into sterling due to the volatility of the value of Bitcoin and its susceptibility to theft. The police submitted evidence in relation to two methods of conversion of the cryptocurrency: public auction (which has been successfully used in the US) and a Bitcoin exchange (which has been used by the Dutch police for over five years). The court held that the appropriate means of conversion was the approved Bitcoin exchange, as the fees for this method of conversion was lower and its effectiveness had been established. While what is stated above took place in relation to a criminal case, it is possible that an insolvency professional could present options to the Court in order to obtain directions as to the best method of conversion.

Claw Back Provisions

[4] Ibid.

In most jurisdictions, including the ones under review in this paper, an insolvency professional is provided with a set of clawback tools in order to challenge a reviewable transaction made within a certain period of time. Where a challenge is successful, the court will make an appropriate order to reverse the effect of the transaction, for example by setting aside a transfer and ordering the return of the assets. The returned assets or proceeds of such transaction would form part of the assets of the insolvent company and would be available for distribution to the creditors. In most jurisdictions it is yet to be tested whether the clawback powers available to an insolvency professional will apply also in the context of a cryptoasset. INSOL note however, it is likely that clawback powers would be applicable to crypto-transactions in most jurisdictions, unless there is a clear exclusion contained in legislation.

In re Hashfast Techs LLC, the trustee moved for partial summary a determination that Bitcoin constitute commodities, not currency, for the judgment (Motion) seeking two determinations from the court purpose of recovery under section 550(a) of the US Bankruptcy Code. 550(a) of the Bankruptcy Code provides that once a trustee has avoided a transfer, the trustee may recover, for the bankruptcy estate's benefit, either the transferred property or, if the court orders, the value of the property. The sought a determination that the bankruptcy estate was "entitled to [recover] either the Bitcoin or the value of the Bitcoin as of the transfer date or time of recovery, whichever is greater.[5] No equivalent has been tested in Australia.

Choice of law and jurisdiction

INSOL note and this is highly applicable to Australia, cross-border issues are common in corporate restructurings and insolvencies as most large corporates have operations or assets in several locations. Therefore important to understand that there is a disparity between the insolvency regimes of different jurisdictions. The distributed nature of cryptocurrency and Blockchain technology raises significant jurisdictional questions that will need to be considered. Due to the complexities of jurisdiction and choice of law in relation to cryptocurrencies, one could produce an entire paper on this topic alone. It is for this reason that the paper only deals with this topic at a very high level.[6] Further work is needed to compare Australia's approach, where there are complex consumer related issues, with that of the European Union's legal framework.

2.2 Individual Bankruptcy

This is area of the law is far from fully understood. Further and a longer term study is urgently needed to ensure Australia's bankruptcy laws deal with individual bankruptcy specifically.

2.3 Consumer and Data

The United Kingdom (UK)[7], in leaving the European Union have begun to think about their long term strategy for regulating this sector. Any regulation must ensure that the rights

[5] Ibid, p 32.
[6] Ibid.
[7] UK - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1032075/FRF_Review_Consultation_2021_-_Final_.pdf
https://www.bankofengland.co.uk/prudential-regulation/publication/2022/april/pra-business-plan-2022-23

afforded to a data subject under the Australian Privacy legislation is clear and accessible. This includes, but not limited to the right:

1. to request information about how your personal data are processed and to request a copy of that personal data.
2. to request that any inaccuracies in your personal data are rectified without delay.
3. to request that your personal data are erased if there is no longer a justification for them to be processed.
4. right, in certain circumstances (for example, where accuracy is contested), to request that the processing of your personal data is restricted.
5. right to object to the processing of your personal data where it is processed for direct marketing purposes.
6. right to data portability, which allows your data to be copied or transferred from one IT environment to another.

The above is significantly important where there are individuals acting across multiple jurisdictions, due to the highly fragmented approach to the regulation of personal data.

In March 2022 the United States established, Executive Order on Ensuring Responsible Development of Digital Assets.[8] The principal policy objectives of the United States with respect to digital assets are as follows:

> We must protect consumers, investors, and businesses in the United States. The unique and varied features of digital assets can pose significant financial risks to consumers, investors, and businesses if appropriate protections are not in place. In the absence of sufficient oversight and standards, firms providing digital asset services may provide inadequate protections for sensitive financial data, custodial and other arrangements relating to customer assets and funds, or disclosures of risks associated with investment. Cybersecurity and market failures at major digital asset exchanges and trading platforms have resulted in billions of dollars in losses. The United States should ensure that safeguards are in place and promote the responsible development of digital assets to protect consumers, investors, and businesses; maintain privacy; and shield against arbitrary or unlawful surveillance, which can contribute to human rights abuses.[9]

2.4 Conclusion

A further and more comprehensive study is required to ensure the current Australian insolvency framework provided for under the Corporations Act 2001, is suitable to deal with similar issues that have arisen in other jurisdictions.

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[8] United States,https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/
[9] Ibid.

Further work is needed to better understand the intersect of data and privacy laws with the transnational flow data that will be generated by this economic activity.

Further work is also required to better understand the interface with any proposed regulation and cybersecurity law.

Further work is also required to better understand the interface with any proposed regulation and artificial intelligence law.

There must be consideration of economic coercion by nation states that have a very different view of how the rules should be established. Such an approach by some countries poses a significant national security threat and can undermine Australian values and democratic principles. Victoria University has the expertise to work with the Australian Government, to develop a comprehensive regulatory risk framework to address these and other associated transnational and national risks.

The regulatory environment is moving rapidly, and below is a being outline if what the EU have begun in the last 2 months, which requires extensive and urgent research, to ensure Australia is developing a comparable framework.

Apr 2022, European Central Bank (ECB) call for expressions of interest for payment service providers, banks and other relevant companies to join an exercise to develop prototype user interfaces for a future digital euro payments system. Participants will be asked to collaborate with the ECB on the development of prototypes that address specific use cases for the payment process.

European Banking Authority (EBA) response to the EU Commission's call for advice on the review of the existing macroprudential framework. Among other things, the EBA concludes that the crypto-market, and banks' exposure to it, are currently not large enough to warrant the introduction of new macroeconomic tools to address them.

Victoria University has the expertise and experience to assist the Australian Government in developing the next phase of this proposal.