# Response to Treasury Consultation Paper on Crypto asset secondary service providers: Licensing and custody requirements


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## A. General Observations:

1. **Excluding Primary Providers:** Excluding primary providers from the regulatory regime is interesting. There are risks that they introduce that may warrant protection, albeit these risks could be addressed by not necessarily requiring controls of secondary providers. The consultation paper suggests that because relationships between trading partners are 'trustless', there is less risk involved and misses the point that this trust is instead invested in the primary provider's technology, trust-building, and incentive mechanisms. It will be necessary for regulatory controls to ensure consumer awareness to ensure consumers do not falsely believe primary crypto-asset platforms and services are risk-less.

2. **Treating Crypto Assets separately to Financial Assets:** Treating crypto assets as a different class to financial products doesn't address ordinary circumstances where crypto assets also provide financial asset capabilities (e.g. store of value or investment). The referenced UK and US approach of noting that some CAs are financial products is relevant. A regulatory approach that accommodates for AND rather than OR would be prudent and avoid creating a parallel regulatory regime for crypt assets acting like financial assets.

3. **On excluding non-financial assets from the regulatory regime:** Excluding non-financial assets from significant regulatory regimes would be appropriate—E.g. game and NFT utility tokens for loyalty etc. Financial levels of regulation of these classes of non-financial CAs would be costly overkill.

4. **Participating in the global regulatory context:** As CAs are inherently operating in globalised decentralised/distributed contexts, any regulatory regime should be designed with a view to regulatory harmonisation with at least key trading partners and D10 economies. Taking an Australian-only centric regulatory approach would be a folly given that these CA are inherently cross-border. Australia should participate in regulatory leadership on CA regulation and not be a follower.

5. **Addressing systemic resilience (vs a regulatory regime targeting only individual risks):** Given the complexity and interconnectivity of risk in the CA space, there should be a regulatory focus on systemic resilience and individual risk management (including appropriate resilience-building controls). Examples of resilience-based controls include regulator systemic risk mapping across the sector by nominated regulatory owner much like is currently performed by the RBA for

systemic financial system risk (and controls such as their recently implemented CORIE financial sector cyber exercise program).

6. **Systemic resilience and risk controls**: The objectives noted in the discussion paper discuss risk reduction though it should also note the importance of building the system resilience of the sector in Australia. This may warrant controls targeted at systemically important providers or levered by regulators to not put all the emphasis on levering regulatory controls on CASSPrs. This latter point is critical as the decentralised nature of crypto-assets and services is accentuated over the period ahead. Levering all controls through CASSPrs risks regulatory disintermediation as the blockchain ecosystem decentralises as new products and services are brought to market. Consequently, not all controls need to be implemented by the CASSPrs and may exist with financial providers offering CAs, and regulators themselves. Such controls to be considered include:
    - Mandated kill switches to enable regulators to limit contagion from crises
    - Regulatory node and auditor access to CASSP systems and transactions
    - Consumer awareness and education measures
    - Mandated transparency of decision rights and accountabilities for CASSPs

7. **Crypto Asset taxonomy**: The taxonomy should facilitate regular adaption and updates. The proposed taxonomy should note the concept of 'Over the top utility NFTs' (where third party benefits accrue to token holders, eg. Third parties afford benefits to holders of specific utility NFTs – such as Qantas platinum NFT holders to get additional benefits from third party retailers and service providers)

8. **Notable crypto-asset token characteristics suggesting the need to avoid broad-brushed regulatory coverage**[1]: The variable and non-binary nature of crypto-asset tokens warrant consideration when developing a regulatory regime. Specifically, characteristics of token that a regulatory response should accommodate are noted below. Importantly, the variable and evolving nature of digitally defined tokenised crypto assets warrants a strong argument to keep away from simple black letter in-scope/out-of-scope statements:
    - Because something is a utility token, might not mean it's not also a financial product (and vice versa)
    - Tokens represent a bundle of rights and conditions on those rights, and those conditions or limitations can be highly variable similar to license limitations in contract law (e.g. transferrable or not, reusable or not, time-limited validity or not, etc)
    - What a token represents can change over time, even on a per-token-instance basis and even for fungible tokens (e.g. for limited-use utility tokens)
    - What a token represents is usually initially defined by its issuer, though in principle a token could take on a different meaning in use within/from a community of users
    - What a token represents is not usually defined in the token smart contract itself
    - Making smart contract behaviour consistent with limitations on the rights associated with a token is not a given and can be tricky to get right when tokens are issued, and even harder to fix afterwards

[1] These characteristics reference feedback provided by Dr Mark Staples, Data61.

## B. Consultation Questions

### Terminology Changes

**1. Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?**

- While I support the term' Crypto Asset Service Provider (CSSPr), I feel the word 'Secondary' can be unnecessarily limiting and not reflective of the risks inherent to blockchain-based assets that warrant addressing by a regulatory regime.
- I do support the term CASSPr or CASPr over the term 'digital currency exchange' as the latter term seems too specific and limiting.

**2. Are there alternative terms which would better capture the functions and entities outlined above?**

- See comment in 1 above, preferring CASPr over CASSPr.

### Proposed Definitions

**3. Is the above definition of crypto asset precise and appropriate? If not, please provide alternative suggestions or amendments.**

- I am comfortable with this definition of a crypto asset from ASIC.
- There is value in defining a 'crypto-financial asset' as a crypto sub-class of a financial asset. It would inherit the broader definition of a financial asset and also possess the definitional attributes of a crypto asset as defined by ASIC – namely; it would be a "...*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*."

**4. Do you agree with the proposal that one definition for crypto assets be developed to apply across all Australian regulatory frameworks?**

- Supported. Significantly, this standardised definition approach should also extend to the more specific term 'crypto-financial asset'.

**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)?**

- Only crypto-financial assets should be included in the regulatory licensing regime. Other crypto assets should not be included unless included explicitly at a later point. The critical risk, for now, is crypto-financial assets, and these should be brought into the scope of the regulatory regime.
- The danger of including all crypto-assets unless they are expressly excluded means that new and innovative crypto assets will be potentially over-regulated or inappropriately regulated,

preventing their development and innovation in Australia. Examples include burgeoning game based crypto assets and marketing utility tokens that are of growing interest to broad swathes of the retail sector (e.g. utility NFTs as part of next-generation customer loyalty schemes).

### Crypto Asset Secondary Service Providers

**6. Do you see these policy objectives as appropriate?**

- I consider these policy objectives appropriate.

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

- Consider extending the second objective to encompass criminals using CASSPrs. Ie. Change "support the AML/CTF regime and protect the community from the harms arising from criminals and their associates owning or controlling CASSPrs" *to* "support the AML/CTF regime and protect the community from the harms arising from criminals and their associates owning, controlling or consuming the services provided by CASSPrs."
- The proposed regime does not address risks associated with primary blockchain providers due to an apparent assumption that the 'trustless' nature of inter-party dealings comes without risk. Such risks do exist, and trust is still embedded in such contexts. However, the trust is shifted from counterparties to the platforms and incentive mechanisms embued in the primary distributed ledger mechanism. If the mechanics of these primary platforms fail (e.g. a primary platform cryptographic or operational failure), then risks will crystalise for Australian participants. There is an argument that CASSPrs should provide some educational awareness to consumers of the risks of primary blockchain services. Increased consumer awareness will minimise the likelihood of failures in primary blockchain services, adversely affecting consumer confidence in secondary service providers and the overall blockchain ecosystem in Australia.

### Interaction with the existing AML/CTF Regime

**8. Do you agree with the proposed scope detailed above?**

- Agreed. No further comment.

**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?**

- Per response to question 5, only crypto-financial assets should be regulated and not NFT platforms etc., unless they are explicitly added to the regulatory regime.
- I see no reason for NFT tokens to be added to the regulatory regime UNLESS they meet the definition of a crypto-financial asset (see the response to question 3 above for further elaboration).

### Proposed Obligations on Crypto Asset Secondary Service Providers

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)?**
    - Having regulators work together to harmonise regulatory control regimes will be crucial. In the context of financial regulation, members of the DLT working group of the Australian Council of Financial Regulators (CFR) chaired by the Governor of the RBA should develop and mandate a harmonised regulatory control regime for crypto-financial assets in Australia. Using the existing CFR will minimise the risk of non-harmonised financial system regulation of crypto-financial assets.

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

    - Add the following obligations:
        - Appropriate security measures and response protocols are in-place for CASSPrs – aligned to existing regulatory security protocols (e.g. APRA's mandatory reporting requirements)
        - Transparency of decision rights, accountabilities and incentives for all off-chain governance-related matters for full transparency of investors and participants in CASSPr-provided services.
        - Demonstrate adoption of global standards for good governance of distributed ledger systems, including the ISO Technical Specification for Governance of Blockchain and DLT systems – ISO/TS 23635.
    - Recommend future work between government, industry and researchers to explore the emergent risks and control responses for the arrival of global decentralised, autonomous CASSPRs that could circumvent the regulatory regime implemented in Australia to the disadvantage of regulatory compliant Australian CASSPr participants.

12. **Should there be a ban on CASSPrs airdropping crypto assets through the services they provide?**
    - Blanket bans risk discouraging Australian innovations in non-financial crypto assets such as utility NFTs.
    - Any ban should be limited to crypto-financial assets (as discussed in responses to questions 3 and 5 above).
    - Rather than a blanket ban, regulators should have the opportunity to specifically deny the availability of specific crypto asset airdropping if they deem an unacceptable risk of adverse consumer or investor outcomes.

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)?**

    - This ban should only occur for crypto-financial assets and not all crypto assets on a licensee's platform or service. This would ensure it is consistent with the provision of financial advice generally and not create an alternative financial advice regulatory regime.

14. **If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?**
    - The cost of implementation will be higher if the regulatory regime accommodates all crypto-assets and not just crypto-financial assets.

- The cost to participant and downstream service providers who are otherwise not providing crypto-financial assets (e.g. existing retail organisations looking to offer utility NFT loyalty program capabilities) will be onerous and likely diminish the potential for significant global competitive advantage for Australian organisations that would otherwise be dragged into an all-encompassing Australian crypto asset regulatory regime (vs a more risk-targeted crypto-financial asset regulatory regime).

### Alternative Option 1: Regulating CASSPrs under the financial services regime

**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?**

- I do not support bringing all crypto-assets into the financial product regulatory regime. This would result in
    - the need to replicate some of the financial product regulatory regime for crypto regulation (creating a harmonisation challenge), and
    - also mean that non-financial products and services that happen to use aspects of distributed ledger and blockchain technology would also be brought into a potentially costly and onerous regulatory regime. For emerging classes of blockchain and DLT services (such as utility marketing NFTs and gaming NFTs), this will entail significant regulatory impost for no real consumer benefit while also preventing competitive disadvantage to Australian organisations looking to compete globally in these emerging fields of the blockchain economy.

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

- The cost of this implementation will be higher if it extends to encompass non-crypto-financial assets.
- This cost will be borne by service providers that are not envisaged to fall within the proposed regulatory regime; examples include existing retail organisations looking to explore utility NFTs for their loyalty schemes and gaming providers looking to allow users to trade NFT objects move them between gaming platforms.

### Alternative Option 2: Self-regulation by the crypto industry

**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?**

- I do not support a self-regulating licensing regime.

**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.**

- The cost of self-regulation is not negligible. These costs include reduced consumer and market participation due to reduced consumer confidence in the Australian industry and increased risk in the sector resulting in higher investment risk and associate credit costs.

- Global investor and consumer participation are also likely lower than if a practical and well-rounded regulatory regime was established, owing to greater global investment and consumer and counter-party confidence in regulated Australian participants in the global blockchain economy.

### Proposed custody obligations to safeguard private keys – proposed obligations

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

- None noted.

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

- Obligation to ensure consumers and participants are made aware of the risks of underlying primary and secondary service providers, acknowledge these risks and are recommended to see additional financial advice if uncertain of any of these risks.

**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?**

- Similar to data sovereignty, regulated custodians should be obliged to ensure physical custody in Australian domiciled data centres. NB. this is more than reasonable now given the broad range of secure data centres and cloud providers offering secure data residency in Australia. It also limits the risk of future custody threats caused by geopolitical tensions.

**22. Are the principles detailed above sufficient to appropriately safekeep client crypto assets?**

- Subject to feedback to questions 20 and 21 above, yes.

**23. Should further standards be prescribed? If so, please provide details**

- Subject to feedback on questions 20 and 21 above, no other standards are noted.

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

- The only costs of recommendations in 21 are the cost of migration and ongoing operation in an Australian-domiciled data centre. These are now relatively negligible. Global providers such as AWS and Microsoft Azure provide the ability to manage data across multiple jurisdictions where there are parallel data residency requirements in other jurisdictions.

### Alternate option: Industry self-regulation

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

- No. This does not reflect industry feedback.

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

- Self-regulation in other fields, such as price protection and anti-competitive corporate behaviours, suggests some form of targeted regulatory oversight I warranted for financial crypto-assets.

**27. Is there a failure with the current self-regulatory model being used by industry, and could this be improved?**

- The current self-regulatory model does not provide the investor or consumer certainty and has allowed negative behaviour both locally and from international participants to harm the reputation of the local sector, reduced the investment appetitive to fund innovative differentiation in the Australian industry and prevented broader consumer participation.

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

- As noted in response to question 18, the cost of self-regulation is not negligible. These costs include reduced consumer and market participation due to reduced consumer confidence in the Australian industry and increased risk in the sector resulting in higher investment risk and associate credit costs.
- Global investor and consumer participation are also likely lower than if a practical and well-rounded regulatory regime was established, owing to greater global investment, and consumer and counter-party confidence in regulated Australian participants in the global blockchain economy.