SUBMISSION TO TREASURY ON *CRYPTO ASSET SECONDARY SERVICE PROVIDERS: LICENSING AND CUSTODY REQUIREMENTS* CONSULTATION PAPER

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This submission focuses on the proposals in the *Crypto asset secondary service providers: Licensing and custody requirements:* Consultation paper dated 21 March 2022.

Multiple regulatory regimes problem

The aim to ensure that providers are not subject to multiple regulatory regimes (p14 of Consultation Paper) is a good one but is challenging. It is submitted that the approach adopted of setting up proposed separate regulation for Crypto Asset Secondary Service Providers (CASSPs) may not necessarily achieve the aim and itself creates potential for duplication. This is because the variety of crypto assets (as noted on p23 of Consultation Paper) is so great that many of these are in fact likely to be financial products under the broad rubric of s763B (financial investments) and s763D (non-cash payment facilities)[2] or other sections of the *Corporations Act 2001* (Cth) (the *Corporations Act*).[3] The reasons why many crypto assets may already fall under FS regulation are discussed at length in an article on regulation of cryptocurrency published in the Federal Law Review in 2019 by Professor Paul Latimer and myself.[4] One of these reasons is that cryptocurrency might be seen as a facility through which a person 'makes non-cash payments' within the meaning of *Corporations Act* s763A and s763D.

Unless these types of assets are specifically excluded from the provisions, many providers of crypto assets may be caught by financial product and financial service (FS) regulation under the *Corporations Act* as well as by the new CASSP regulation. Yet the other option of

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[2] See Paul Latimer and Michael Duffy, 'Deconstructing digital currency and its risks: Why ASIC must rise to the regulatory challenge' (2019) 47(1) *Federal Law Review* 121, 135-137

[3] The view of ASIC on Initial Coin Offerings was that an ICO could trigger many areas of financial services law as a managed investment scheme, an offer of shares, an offer of derivatives, a non-cash payment facility and, depending what is stated and done, could constitute misleading or deceptive conduct: See ASIC, Initial Coin Offerings (Information Sheet 225, September 2017) <http://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings/#what>.

[4] Paul Latimer and Michael Duffy, 'Deconstructing digital currency and its risks: Why ASIC must rise to the regulatory challenge' (2019) 47(1) *Federal Law Review* 121, 127 and 134.

specifically excluding various crypto assets from FS regulation itself raises problems as set out below.

Dangers of removing crypto assets from financial services regime

If crypto assets are specifically removed from regulation as financial products, this may have unintended consequences which may include the following:

(a) Risk of public harm through lack of regulatory protections. For example, the proposed obligations on p16 of the Consultation Paper make no reference to financial market conduct such as market manipulation and insider trading.[5] If crypto assets are removed from the financial product regime they would also be removed from the financial product market licensing regime and there would be no penalties for such conduct. Given human nature and historical experience of unregulated financial products, it is very likely that at some point, such conduct will emerge, which would be at the expense of market integrity and with possibly adverse results to some crypto asset owners/crypto product consumers.

(b) Another problem may be a lack of disclosure standards for crypto assets. Admittedly these standards and provisions are somewhat prolix under FS provisions of the *Corporations Act* (and, as a separate matter, could do with some simplification[6]) however it is not entirely clear what disclosure standards would be applied to crypto assets under the proposals, as pages 16-18 do not appear to include proposed disclosure standards. While the general prohibition of misleading and deceptive conduct in s18 of the *Australian Consumer Law* may be a 'fallback' for excluded products, this is well short of the detailed product disclosure standards of the *Corporations Act*. Good and adequate disclosure is essential and has been shown to be essential to (a) protect investors and (b) enable efficient operation of markets in products.

Further, any removal of crypto assets from FS regulation will give a significant competitive advantage to crypto assets over traditional financial products and assets which may be both (1) unfair to heavily regulated traditional products and assets and (2) likely to cause distortions in financial product markets. This may infringe the goal of competitive and technological neutrality referred to on page 12.

What about crypto assets *primary* service providers?

Another issue appears to be that, by specifying 'secondary' service providers, the proposal invites the conclusion that anyone who can define themselves as a 'crypto asset *primary* service provider' may have an argument to escape regulation under the new proposal.

As noted at page 13 of the Consultation Paper, the *primary* service might, admittedly, in some cases be merely an open block chain that is not necessarily a facility supplied by any particular person or entity. In that sense, there may be no provider or issuer in the traditional

[5] Latimer and Duffy above n 2, 133.

[6] The Australian Law Reform Commission (ALRC) has in fact been recently tasked to look at such simplification along with other matters. See ALRC, *Financial Services Legislation: Interim Report A* (ALRC Report 137) 30 Nov 2021 https://www.alrc.gov.au/publication/fsl-report-137/

sense.[7] Further, to the extent that there are such persons or entities who are providers or issuers,[8] they will often be located offshore as cryptocurrencies have not generally originated in the Australian jurisdiction. It may be that regulation of crypto asset *primary* service providers is contemplated to take place separately as a later matter and perhaps that is implied by the mapping exercise on page 23-24. However, the language of page 13 suggests otherwise in its implication that such assets are transparent and not prone to market failure. Any idea that primary crypto assets need no regulation may have disappeared with the recent collapse of various primary crypto assets in the form of 'stablecoins',[9] apparently due to intrinsic faults in design.

It follows that were primary crypto assets to be created in the Australian jurisdiction, there may then be a question whether the adoption of the moniker of '*secondary* service providers' will remove regulatory flexibility to regulate persons or entities that might be described as crypto asset '*primary* service providers'.

Regulatory uniformity and consistency

There is something to be said for the notion of regulatory uniformity and the benefits of the broad financial product descriptions in s763B, 763C and 763D. It appears that the definition of 'financial product' in the *Corporations Act* was always intended to be flexible and sufficiently adaptive to encompass new innovations and technological developments so as to give certainty to financial market participants.[10] This underlying policy suggests a desire for uniformity in regulation. Further, there are always dangers of inconsistency and unfairness when the law develops in different directions for different persons and sectors.

Admittedly, financial services regulation (FSR) in the *Corporations Act* is at times overly complex, prolix and prescriptive – insufficiently relying on general concepts that can be developed and applied by courts to different situations through the ordinary development of the common law.[11] Nevertheless, it is submitted that this is a strong argument for simplifying

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[7] Latimer and Duffy above n 2, 134. See also Parliament of Australia, Senate Economic References Committee, *Digital currency-game changer or bit Player*' August 2015 ('Dastyari Committee Report') [43].

[8] Notwithstanding its status as a decentralised project and the assertion that no one owns or is responsible for it, there are various persons or entities associated with Bitcoin for example, such as the developers (known, apparently pseudonymously, as Satoshi Nakamoto and Martti Malmi), owners of the domain, sites and persons supplying Bitcoin Core software, sponsors, service and other contributors: see https://bitcoin.org/en/about-us#owntxt-title. As to Nakamoto see Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* <https://bitcoin.org/bitcoin.pdf>.

[9] See e.g. Ryan Browne, 'Tether withdrawals top $10 billion as regulators raise alarm about stablecoins' CNBC https://www.cnbc.com/2022/05/23/tether-usdt-stablecoin-withdrawals-top-10-billion.html

[10] Latimer and Duffy above n 2, 132-133. See also Baxt, Black and Hanrahan, above n 95,109-110. See also Kevin Lewis, 'When is a Financial Product Not a Financial Product?" (2004) 22 *Company & Securities Law Journal* 103 (focusing on bills of exchange and promissory notes).

[11] Such general concepts include proscription of 'misleading and deceptive conduct' (though mandating conduct in provision of services by acting 'honestly efficiently and fairly' which courts have been able to develop and apply to particular situations, is an example of such a useful, general concept in FSR).

FS law generally (and it is noted that the ALRC is currently looking at doing this[12]) rather than an argument for excluding various products from the regime.

In another but analogous context (i.e. the question of how to regulate a newly developing practice or industry) it is noted that such exclusion in the form of bespoke FS regulation was initially proposed for the practice of third-party litigation funding by the ALRC[13] but that government decided to go with conventional financial services regulation rather than create a separate regime.

It is further noted that there is capacity for a level of exclusion or relief through ASIC Class Orders, Grants of Relief and Regulatory Guides setting out ASIC's approach (as noted on p17 of the Consultation Paper).

Overall, the approach of 'comprehensive regulatory coverage unless excluded' seems a more foolproof approach than 'general exclusion followed by a new regime to try and cover the excluded products or sector'. The latter is much more likely to see problems and issues 'fall through the cracks' rather than be comprehensively covered.

The self-regulation option

Self regulation can have certain benefits,[14] and is sometimes seen as a form of private ordering or market self-organising. Clearly there will be both advantages and disadvantages of self-regulation for all stakeholders.[15] Self-regulation might take the form of an industry code and/or membership of a professional organisation.

Self-regulation codes are however unlikely to approach the breadth of protections for investors that are provided under regulatory legislation. Further, self-regulation will give a significant competitive advantage to crypto assets over traditional assets which may be both (1) unfair to heavily regulated traditional assets and (2) likely to cause distortions in financial product markets. This may infringe the goal of competitive and technological neutrality referred to on page 12.

Conclusion and a way forward

Given what has been said, it is submitted that the main proposal should be rejected and that the Alternative Option 1 of regulating CASSPs under the FS regime should be adopted as the preferred option. Comprehensive and consistent regulation is less likely to see misconduct 'fall through the regulatory cracks'.

The industry and its players can then make the case to ASIC for exemptions, class orders and other regulatory relief as required. And no doubt there will be good reasons for various sorts of relief. This has generally been the approach in relation to regulation of third-party

[12] ALRC above n 5.

[13] ALRC, *Inquiry into Class Action Proceedings and Third-Party Litigation Funders* Discussion Paper June 2018, [3.4] p44

[14] See, e.g. Christine Parker, *The Open Corporation: Effective Self-regulation and Democracy* (Cambridge University Press, 2002).

[15] For a summary of the arguments, see Anthony Ogus, 'Rethinking Self-regulation' (1995) 15 *Oxford Journal of Legal Studies* 97.

litigation funders which approach therefore creates a useful precedent that can be applied in this circumstance.

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