HERBERT SMITH FREEHILLS

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Treasury's consultation paper on crypto asset secondary service providers

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Introduction

Herbert Smith Freehills (**HSF**) welcomes the opportunity to provide submissions in response to Treasury's consultation paper entitled "Crypto asset secondary service providers: Licensing and custody requirements" dated 21 March 2022 (**Consultation Paper**).

HSF is one of the world's leading commercial law firms, bringing the best people together across our 26 offices globally. We believe there is an important role for the private sector, and law firms in particular, to play in developing and implementing a framework in Australia for the appropriate regulation of crypto assets and related service providers.

We have a number of specialist practice areas, including market-leading experts in financial services and emerging technology, which are active in advising clients on the legal and regulatory issues arising in connection with crypto assets, blockchain and distributed ledger technology. Our cross-practice and multi-disciplinary Digital Law Group also provides bespoke advice and practical solutions to clients in this space. These experiences mean that we have a multi-dimensional perspective on the issues raised by new and emerging digital technologies and their impact.

We have had the benefit of insight into a number of proposed submissions of market participants, our clients and industry bodies and, accordingly, do not propose to address each question of the Consultation Paper in this submission in detail.

Drawing on our extensive experience in financial services regulation and in advising a range of clients in relation to the current state of crypto asset regulation in Australia including crypto exchanges, defi platforms, crypto brokers and DAOs, we make the following submissions, with a particular focus of the new regime which it is proposed in Consultation Paper would apply to CASSPrs against the backdrop of the existing financial services regulatory regime.

We do not express any views on behalf of the industry (either in support or against the proposals); we express views from a legal perspective only on the assumption that the proposals progress.

Summary

This submission includes general comments on the reform process, and more specific responses in respect of **questions 8-10** of the Consultation Paper. Specifically, we address:

- in section 1.1, our concerns with a separate licensing regime;
- in section 1.2, issues of uncertainty in classifying products with a separate regime and duplication of licences;
- in section 1.3, risk that the proportionate policy intent will not be achieved;

- in section 1.4, difficulties with the breadth of the scope of the regime;
- in section 1.5, the need for harmonisation with the current ALRC agenda;
- in section 2, submissions in relation to the broader imperative for holistic regulatory reform for the digital economy.

In summary:

1. In our view, clarity around the application of existing financial services regulatory regime in respect of crypto assets is a priority. Clear guidance for businesses involved in the crypto assets market in Australia will facilitate the international competitiveness of the Australian market, provide certainty for industry participants, and ensure adequate protections for consumers and investors.
2. We submit that the proposal to introduce a new licence and licensing regime which sits in addition to the current 4 licensing regimes that crypto-asset firms must consider, is contrary to the recommendations of the Wallis Inquiry, and should only be introduced where there is a justified policy rationale. In respect of crypto assets and activities that justify regulation to mitigate the same risks that underpin the existing financial services regime under Chapter 7 of the Corporations Act, that regime could be clarified and amended (with necessary adjustments were required recognising unique characteristics of crypto assets) rather than create a duplicate regime.
3. We submit that the proposal to define the scope of a new licence simply by reference to those crypto-assets which fall outside the AFSL regime will perpetuate the current market uncertainty and lack of transparency with the assessment of whether crypto-assets are 'financial products' or not. We consider it likely that firms will be compelled to obtain both an AFSL and a CASSPr to ensure coverage, and navigate this uncertainty.
4. We submit that the proposal to include fewer obligations on CASSPrs will not achieve its stated aim in circumstances where an entity is also required to hold an AFSL and may create regulatory arbitrage with firms deliberately structuring their products to fall within the CASSPr regime as opposed to the AFSL regime.
5. We submit that with the current definition of crypto-assets[1], a wide range of firms will be included in scope when there may not be a policy intention to capture them. Amongst other measures, we propose that clarity is provided on the application of the 'incidental' exemption at s763E of the Corporations Act; and
6. The decision on whether, and how, to regulate CASSPrs should be considered in light of broader policy reform initiatives including the Token Mapping Exercise and the current review of the structure of the AFSL regime in Australia being conducted by the ALRC. We submit that these proposals should be mindful of those reviews and aligned to their recommendations.
7. Promoting fair, transparent and orderly markets for crypto assets will require consideration of legal recognition of Decentralised Autonomous Organisations (DAOs). Treasury's current proposal is targeted at regulation of centralised secondary service providers. Given that arrangements in the crypto ecosystem can vary along a spectrum from centralised to decentralised, regulation will need to be clear about the assessment criteria in respect of which for when a regime will apply.

[1] This submission uses the term "crypto asset" for convenience but we hold concerns with the term. We note that this issue is being considered in more detail under numerous other submissions paper and we encourage further industry consultation on the nuances of those issues raised. In particular a preference for the term 'token' recognising the vast potential use cases, possibility for positive, zero or negative 'value', balancing technology neutrality etc. In particular, we support the issues raised in submissions by the Business Law Section of the Law Council of Australia, BADASL, and Mycelium.

1. Commentary on proposed and existing licensing regimes

1.1 Concerns with separate licensing regime

The Consultation Paper proposes to introduce a statutory licensing regime which would require any CASSPr that provides retail consumers with access to crypto assets which are not financial products to hold a CASSPr licence (**CASSPrL**). The CASSPrL would resemble the Australian Financial Services License (**AFSL**) administered by the Australian Securities and Investments Commission (**ASIC**) under Chapter 7 of the *Corporations Act 2001* (Cth) (**Corporations Act**), including as to the obligations imposed on licensees.

As Treasury is aware, following recommendations of the Wallis Inquiry, the AFSL regime was introduced as the regime for financial products and services, consolidating a range of product-specific licenses that previously existed into a single licence. This reform was considered necessary, amongst other reasons, because the need for multiple product-specific licences was considered a barrier to entry of new market participants and imposed unnecessary compliance costs and administrative burden on providers of multiple product types.[2] Multiple licensing regimes with different regulatory requirements also created confusion for consumers as to what they might expect from providers.[3]

In Australia currently, there are already a number of regimes and licenses that crypto-asset firms must consider including:

- AFS licensing regime administered by ASIC under the Corporations Act;
- Digital Currency Exchange registration regime administered by AUSTRAC under the Anti-Money Laundering and Counter-Terrorism Financing Act;
- Australian Credit licensing regime administered by ASIC under the National Consumer Credit Protection Act 2009;
- Purchased Payment Facility licensing regime administered by the RBA (through APRA) under the Payment Systems (Regulation) Act 1998.

We submit that introducing a further licence type (a CASSPrL), administered by ASIC, is not aligned to the recommendations of the Wallis Inquiry. Any decision to introduce new licence type should be considered very carefully, and supported by strong public policy case to do so.

Where a risk-based assessment of the crypto asset activities identify a justification for compliance with the licencing regime for financial products and services under Chapter 7 of the Corporations Act, the scope of the existing AFSL regime could be clarified and amended to apply in relevant circumstances. Crypto-asset firms then only need to obtain an AFSL if they are in scope (which would need to be clearly set out as discussed above, and ensure no regulatory overreach).

If Treasury is minded to introduce a new and separate licensing regime, to address some of our concerns outlined above, it might be achieved by providing in the relevant statutory provision (in a manner similar to the section 911A of the *Corporations Act* regarding the need to hold an AFSL) that: "*a person who carries on a crypto asset secondary service must hold a crypto asset secondary service provider licence covering the provision of the crypto asset secondary services*."

The term "CASSPr licensee" would simply refer to a person within the scope of that provision.[4] The term "*crypto asset secondary service*" would then be appropriately defined:

[2] Revised Explanatory Memorandum to the Financial Services Reform Bill 2001 (Cth) at [2.39].

[3] Revised Explanatory Memorandum to the Financial Services Reform Bill 2001 (Cth) at [2.40].

[4] Alternatively, it may be beneficial to distinguish between CASSPrs generally and "regulated CASSPrs", if the CASSPr licensing regime will only apply to a sub-set of CASSPrs.

- according to the specific services to be captured by the regime, which in our submission should be narrowly defined to crypto asset exchange services and custodian services; and
- in a way that clearly excludes any services (and businesses) that cannot justifiably be included in the licensing regime, as discussed in section 3.4 above, such as businesses that only have incidental interactions with crypto assets and are not exchanges or custodians.

The licence could then apply a core set of obligations to all CASSPrs, albeit with conditions allowing different CASSPrs to provide particular services (as under the AFSL regime), such as "crypto asset exchange services" and "crypto asset custody services".

1.2 Uncertainty and duplication

The Consultation Paper proposes that the need to hold a CASSPrL (alone or in conjunction with an AFSL) would turn on the legal status of the crypto assets dealt with by the CASSPr. That is, the question of whether a CASSPr would be required to hold a CASSPrL would turn on whether it is involved in crypto assets that are financial products (FPCAs) (for which an AFSL is needed) or crypto assets that are not financial products (Non-FPCAs) (for which a CASSPRL is needed), or both if there is a combination of assets.

Uncertainty in classification

Currently, there is no certainty on whether the definitions of "financial product" and "provision of a financial service" under Chapter 7 of the Corporations Act include crypto-assets or not. All of ASIC's limited commentary to date has asked the industry to determine for themselves whether a product is a crypto-asset.[5] The CASSPr regime would inherit much of the uncertainty surrounding those terms, noting they have often been the subject of calls for reform and simplification.

Under the current AFSL regime, it is often difficult for industry participants and their legal advisers to determine with confidence whether a particular crypto asset product or service falls within the scope of Chapter 7 as a regulated financial service or product, or whether they can rely upon an available exemption. If the question of whether a CASSPrL is required turns on the same criteria, it will involve the same difficulties and uncertainties.

Further work is required, to better understand the policy objectives in the context of the broader web3 ecosystem. Not all crypto assets will warrant regulation just as not all crypto assets justify inclusion within the financial product regulatory regime. We agree with Treasury's comment that key market failures intrinsic to financial products are not necessarily intrinsic to all crypto assets and much of the need for regulatory recourse required for financial products does not necessarily exist for many crypto assets in the absence of centralised service providers.

Relevant harms in the context of crypto regulation should be clearly identified in a technology neutral way (to the extent possible). In many examples of crypto asset use cases, the risk of harm arises from the activities carried out in respect of the tokens, rather than solely from the characteristics of the tokens. The 'Token Mapping Exercise'[6] has the potential to contribute valuable insight into how to regulate the tokens themselves, the entities involved with them, and the activities they carry out based on relevant criteria. Findings of the exercise should inform CASSPr regulation, however this exercise is not scheduled to be finished until the end of 2022.

Where a risk-based assessment of the crypto asset activities identify a justification for compliance with the licencing regime for financial products and services under Chapter 7 of

[5] Info Sheets 219, 225 and 230.

[6] Proposed and note in the Senate Committee 'Australia as a Financial and Technology Centre Final Report' and 'Transforming Australia's Payments System' Report of October and December 2021.

the Corporations Act, either there is an express statement in the Corporations Act or delegated legislation that existing types of financial products include certain types of crypto-assets, or existing (and future) crypto-asset products are clearly expressly categorised as a category of financial product (e.g. through the express inclusion method in the Corporations Act) – with appropriate exemptions, etc.

Uncertainty in exemptions

Following the above, the current regime in the Corporations Act has a general definition of what is regulated then a series of express inclusions, express exclusions, sometimes in either case by reference to delegated regulation, then there are separate instruments and Class Orders which typically address exclusions and industry-wide or firm-specific relief. Approaching the CASSPr regime in the way proposed (i.e. with Non-FPCAs), would need to consider whether crypto-assets which fall within express exemptions, Instruments or Class Orders fall within the CASSPr regime as Non-FPCAs.

Duplication

Those CASSPrs who obtain only the CASSPrL and not the AFSL, or vice versa, will continue to face the risk that they (or their legal advisers) have incorrectly characterised the crypto assets they deal in. This is a real risk given that civil and criminal penalties may apply where a CASSPr engages in conduct without holding the appropriate licence.

As a result, we anticipate CASSPrs may seek to mitigate the risk of failure to obtain the appropriate licence by defaulting to obtain both an AFSL and a CASSPrL to ensure they are permitted to deal both in FPCAs and Non-FPCAs. That is, the uncertainty inherited from the financial services regime may compel unnecessary regulatory duplication with the CASSPr regime. This is particularly so where the obligations under the AFSL and CASSPr regimes are proposed to be broadly the same, as they are.

Future-proofing certainty

The features and legal characterisation of existing crypto assets can evolve rapidly over time. For example, a crypto asset that was previously a Non-FPCA may evolve into an FPCA if additional utility is added, or if used in different ways (i.e. subject to different activities). For this reason, licencing should focus on the activities at a point in time, rather than merely the characteristics of a crypto assets at first issue.

By way of hypothetical illustration, if creators of an NFT project which originally involved selling NFT artworks to the public expanded the project to begin paying a monthly dividend to artwork holders based on a portion of sales of other NFTs, the artwork NFT may well turn from a Non-FPCA to an FPCA due to its potential treatment as a security. The nature of crypto assets, their utilities and the capabilities of distributed ledger technology are evolving so rapidly that firms may find themselves switching between regimes (AFSL and CASSPr). Therefore, there is a risk that a CASSPr setting out initially to deal only in Non-FPCAs may find itself inadvertently dealing in FPCAs over time without holding an AFSL. In practical terms, this may mean that a CASSPr holding only a CASSPrL may need to implement compliance monitoring to ensure that the crypto assets it deals within remain Non-FPCAs over time to ensure that they are not providing a financial service without an AFSL. Given the nature of crypto assets, any regime will need to be dynamic enough to address this fact, and to the extent possible, streamline the ultimate licensing regime to avoid unwarranted flipping between regimes, in circumstances where the substantive obligations of the AFSL and CASSPrL may be largely the same. This will be significant issue for the market in terms of timing for application for an AFSL, business interruption and resourcing.

1.3 Proportionate application not achieved

The Consultation Paper suggests that although there would be one CASSPrL licence type, "*the obligations would be graduated depending on the number and type of services offered*

by the CASSPrs"[7] and that "*ASIC would be empowered to grant relief from some or all of the obligations if warranted, on a case-by-case basis to ensure the regime remains agile and flexible*".[8]

Complying with higher standards for all business

As discussed above in section 3.2, we anticipate that many CASSPrs are likely to deal in a reasonably broad range of popular crypto assets (both Non-FPCA and FPCA) and as such would be required to obtain both an AFSL and CASSPrL and comply with the obligations pertinent under both regimes, absent a clear mechanism that prioritises one over the other.

Therefore, despite the CASSPr regime seeking to apply compliance obligations in a proportionate manner, this is unlikely to be achieved. If a firm needs is required to comply with the higher compliance obligations with the AFSL, they may choose to comply with the higher standards for their obligations under the CASSPr to avoid needing to have additional compliance resource to know when to comply with various obligations. Any proposed regulation will need to provide clear guidance on when and to whom it applies, as well as streamlined and efficient regulatory compliance to promote a proportionate, light touch and risk-based policy approach.

Consumer confusion

The Consultation Paper proposes that CASSPrs will not be subject to disclosure requirements yet some firms may have both a CASSPrL and an AFSL with disclosure obligations for the AFSL but not with CASSPrL. Therefore, some products will have public-facing disclosures but not others. This has the potential to create confusion and uncertainty both for licensees and the public and we have concerns with this approach.

For any CASSPr regime to promote certainty and confidence, all licensees should be subject to the same set of core obligations, unless there is a similar or mutual obligation for which they need to comply with as an AFSL holder. If this is considered unfeasible – for example, because the CASSPr regime may cover two entities with very different businesses and products – it raises the serious question of whether it is appropriate for a single licensing regime to cover both entities.

In the financial services context, a lack of clarity around the expectations and obligations applicable to different product issuers was one of the concerns that led to the consolidation of multiple licences into the single AFSL, under which the same set of core obligations apply to all licensees. The Revised Explanatory Memorandum to the *Financial Services Reform Bill 2001* observed consumers were "*disadvantaged*" where "*they cannot be certain that the conduct of the financial service provider meets minimum standards.*"

Under the AFSL regime, knowledge that all licensees are subject to a common set of obligations (including the obligation to ensure financial services are provided "efficiently, honestly and fairly") helps establish a consistent and reasonably clear set of minimum standards expected of licensees, regardless of the particular products they deal in. This benefits licensees because it increases certainty around their compliance obligations, and consumers because it enables them to expect minimum standards of all licensees.

Crypto-asset firms involved in FPCA will be required to have an AFSL, they will be subject to the same compliance, disclosure and conduct obligations as any other firm holding an AFSL, altered only based on the types of clients dealt with – retail and/or wholesale.

[7] At page 16.

[8] At page 17.

1.4 Concerns with the breadth of scope of the proposed regime

Before any CASSPr regime is implemented, further clarity is needed regarding the types of businesses that should come within the CASSPr regime (this includes clarity in respect of which tokens, which activities and which entities), and the underlying policy rationale for including those businesses.

It is clear from the Consultation Paper that the CASSPr regime would cover businesses that provide retail consumers with access to Non-FPCAs (including all secondary service providers who operate as brokers, dealers, or operate a market for crypto assets); provide safekeeping, custody, or storage of crypto assets on behalf of a consumer; and Virtual Asset Service Providers (as defined).

Taking into account the policy rationale stated in the Consultation Paper, care should be taken that the licensing regime does not over-extended to businesses where the licence regime is not supported by the policy rationale; that is, where a licensing regime of the kind proposed is unwarranted.

By way of illustration, there are many scenarios in which a business may "provide retail consumers access to non-financial product crypto assets" and it would be disproportionate to require them to be licensed and subject to the same obligations as an exchange or custodian (or, given the parallels with the AFSL obligations, a financial institution). These might include:

- A game developer who publishes a game for retail consumers in which a cryptocurrency can be used or exchanged as a resource within the game. That game developer may or may not also provide custody of crypto assets. In any event, it is not apparent that such a developer should be regulated like an exchange, custodian or bank. The need to obtain a CASSPrL and comply with the regime is likely to stifle innovation and Australia's competitiveness as a jurisdiction for developers.
- An Australian widget manufacturer who makes "real life" widgets might wish to take advantage of the unique commercial opportunities of NFTs and mint and sell a limited edition of "virtual widgets" to its customers, or a limited set of NFT versions of its widgets that are redeemable for the "real" widget at a future time. It may be difficult to justify barring such a business from use of NFT technology simply because they are not licensed and subject to the same obligations as an exchange.

In some circumstances involvement with crypto assets may be considered secondary to the main business activity. In relation to FPCA, under the Corporations Act, there is already the very limited ability for firms to exclude financial products where they are 'incidental' to the main business activity.[9] However, the application of this section in the Australian market is typically approached with caution given, again, its lack of transparency/uncertainty in its use. To ensure transparency and certainty for firms, it would be helpful to have greater clarification on the scope and application of the 'incidental' exemption under s763E, to identify when dealing with crypto-assets is not a firm's primary business model.

1.5 ALRC Review

The Australian Law Reform Commission (**ALRC**) is currently working with a view to reforming and simplifying Chapter 7 of the Corporations Act. Treasury could find itself implementing a structure to apply to crypto-asset firms only to then need to consider the approach again should the ALRC's reform proceed. Before any proposal is finalised, consideration is given to how it might be affected by the ALRC reform proposals

[9] S763E, Corporations Act.

1.6 Credit Regime

The Consultation Paper does not comment on any proposals relating to crypto-asset firms that offer defi lending products and their treatment under the NCCPA. We have therefore assumed that the Treasury is currently satisfied with the scope of the ACL regime and its application to defi lending products.

2. General principles

While we do not express any views on behalf of the industry (either in support or against the proposals) on the assumption that the proposals progress, we make the following submissions in respect of general principles for legislative reform.

Policy Objectives

Promoting Australia an attractive jurisdiction for innovation and investment for the digital economy should be a primary policy objective balanced against the need for risk-based approach to consumer protection. Given the cross-border nature of the technology and use cases of crypto assets, policy objective of pursuing international consistency and harmonisation should be considered to the extent appropriate to minimise unnecessary requirements or features of Australian regulatory regime and standards.

Holistic legislative reform

While we see the policy objectives as generally appropriate, it is important to recognise that the technology and associated use cases that are founding the digital economy will intersect with a wide range of existing legislative frameworks. Regulating parts of the ecosystem without the benefit of a coordinated approach will lead to inconsistencies and complexity that will undermine key policy objectives.

Any proposal to regulate CASSPrs and related policy objectives need to be considered holistically with other regulatory priorities across financial services (e.g. the current ALRC process), crypto assets, web3, digital economy, digital identity and more.

The Australian government should ensure that there is a level of coordination across all legislative reform processes relevant to the digital economy, to ensure no undue regulation, and minimise regulatory overlap.

Focus on activities rather than characteristics of token

The crypto asset reforms (including CASSPrs and the Token Mapping Exercise) will need to focus on the activities in respect of tokens that have the potential to cause harm, rather than merely assessing likely harm based on the nature or features of the token. The Token Mapping Exercise will be instructive of how CASSPrs should be regulated and as such should be prioritised and completed before introducing any CASSPr reforms.

Harmonisation

As a general principle, we support the need for harmonisation across legislative frameworks where possible. For this reason, we support one definition for crypto assets be developed to apply across all Australian regulatory frameworks, noting that it will be necessary for different statutes to regulate activities in respect of the common definition (or categories of crypto assets/activities) in nuanced ways as appropriate.[10]

Recognition for Decentralised Autonomous Organisations

Treasury's current proposal is targeted at regulation of centralised secondary service providers. Given that arrangements in the crypto ecosystem can vary along a spectrum

[10] Relevant to question 4 of the Consultation Paper.

from centralised to decentralised, regulation will need to be clear about the assessment criteria for when a regime will apply. In other words, what are the requisite characteristic for centralisation that trigger the regime, or conversely what constitutes sufficiently decentralised so as to avoid the risks of harm for which regulation seeks to address. Promoting fair, transparent and orderly markets will require consideration of other aspects of the crypto ecosystem in particular how laws apply to Decentralised Autonomous Organisations (DAOs).

In HSF's submission to the Third Issues Paper, Senate Select Committee on Australia as a Technology & Financial Centre, HSF recommended recognition of a new type of legal entity in the Corporations Act – DAO Limited (decentralised autonomous organisation). We reiterate this submission.

Addressing the need to provide legal recognition to DAOs is an important aspect of regulating crypto token in the digital economy. This legal recognition should grant limited liability and introduce concepts that guide application of the regulation based on a risk-based approach having regard to the degree of actual decentralisation and automation.[11]

There are likely to be unique characteristics and risks associated with DAOs and the tokens they issue that should be considered in the context of regulating CASSPrs who deal in DOA issued tokens.

This is an important part of the decision of whether or not to pursue a regulatory response, and its eventual design, and should be prioritised in parallel to ensure appropriate corporate oversight and guidance for this new business model manifesting in the digital economy. This is particularly relevant in the context of regulating activities in relation to crypto tokens and digital asset. Clarity and recognition as to the cross over between crypto tokens and digital asset and DAOs and their integration into existing regulatory regimes should be considered in line with Treasury's regulatory objectives[12].

Moving forward

We are pleased to provide this submission to the Department and would welcome the opportunity to discuss our comments further. We would also welcome the opportunity to participate in further consultation on these matters, and in particular in relation to Treasury's Token Mapping Exercise.

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[11] See for example the proposal of 'sufficiently globally decentralised organisation' discussed in the Blockchain and Digital Asset + Law submission or the proposal in relation to "Sufficiently Decentralised" in the submission from Mycellium.

[12] See Consultation Paper p 6.