Independent Reserve
The Cryptocurrency Exchange

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Director – Crypto Policy Unit
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Dear Director,

Thank you for the opportunity for us to provide a submission to Treasury in response to the Crypto asset secondary service providers: Licensing and custody requirements Consultation Paper 21 March 2022 (Consultation Paper).

We welcome and encourage the Government's commitment to support this rapidly growing industry by working towards fit-for-purpose regulation to foster innovation, investment and most importantly: provide protection for Australian customers.

Independent Reserve Pty Ltd (**Independent Reserve**) is a Digital Currency Exchange (**DCE)** that has been operating in Australia since 2013 and has been a proponent of regulation in the digital asset and cryptocurrency sector. Independent Reserve services hundreds of thousands of Australian customers each year. In the financial year ending 2021, Independent Reserve's total turnover on its platform alone exceeded AUD$5 billion; and total assets in custody is in the hundreds of millions of dollars. We welcome the focus on regulation in this industry to provide certainty for service providers such as independent Reserve and to enhance consumer protection mechanisms.

We support the implementation of common-sense legislation that addresses what we believe are the three most critical issues facing the industry:

1. Real protection for consumers using a custodian provider
2. Minimum standards for all secondary service providers in the crypto asset space
3. A licensing regime to enforce the standards custody and licensing provisions

Warm regards,

Duncan Tebb
Head of Risk and Operations

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Responses to Consultation Questions

Proposed terminology and definitions

Terminology changes

1. Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?
No, we do not agree with the use of the terms "CASSPrs". This term is not used in any other part of the world that we are aware of, to describe digital currency exchanges or any other digital currency service provider. The description "Virtual Asset Service Provider" (VASP) is an emerging term that is being used by large global task forces (FATF) and other regulatory regimes (Monetary Authority of Singapore). We do not believe it makes sense to diverge from a globally understood term.

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

As per the response to consultation question 1 above, "VASP" is our preferred term.

Proposed definitions

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

Yes, we agree with the definition as written; and note that it broadly aligns with other definitions provided by regulators in other jurisdictions (e.g. FCA in the UK).

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

Yes, we agree with the proposal. Differing definitions across different regulatory frameworks would only cause confusion and increase complexity in the industry. This would be at odds with one of the objectives of introducing legislation in Australia: To make Australia an attractive jurisdiction to build, invest and grow digital currency businesses.

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)?

Yes. An important element of creating regulation in the industry is to provide consumers who purchase and transfer assets to be protected. By excluding any type of crypto asset that can be traded, used to store value, used to store an entitlement, or transfer value/ownership, the licensing regime is leaving a certain sector of consumers with no protection. We do not believe there should be any specific crypto assets carved out of the proposed licensing regime.

Proposed principles, scope and policy objectives of the new regime

Policy objectives

6. Do you see these policy objectives as appropriate?

Yes, the three policy objectives are appropriate.

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

The policy objectives stated focus primarily, as they should, on ensuring consumer protection and security when dealing with service providers and ensuring service providers are fit, proper and well-capitalised.

An additional objective in framing the regulatory environment should be: Encouraging investment and growth in the digital asset sector in Australia.

We have seen a real-life example in Singapore where a regulatory body has put in place regulation that initially attracted interest from over 180 entities, resulting in over 160 formal applications. However, to date, only 11 applicants have received in-principle approval or been issued with a licence. This is chiefly due to two factors:

1. MAS requirements being among the strictest in the world, including a mandate to have a fully operational "travel rule" solution despite there being no globally agreed solution to the "travel rule" issue and very little adoption of service providers seeking to solve this problem
2. MAS banned advertising of crypto-related businesses in January 2022; where any for of advertising would be seen by a retail customer

This is an example of a regulatory body doing all the hard work to create legislation that was initially attractive to business, encouraged over a hundred businesses to incorporate new companies in Singapore and invest in Singapore. However, due to the way the legislation and other requirements (such as the advertising ban) have been rolled out and handled (with a heavy hand, no grace periods or adjustment periods), more than 100 firms have either been rejected by MAS or have chosen to withdraw their applications for a licence.

MAS had the opportunity to be a 'first-mover' in Southeast Asia and to become a digital asset hub for the region, but instead businesses are now pulling out of the country and there is very little investment into the country for digital asset businesses as of May 2022.

Further, one of the biggest Banks in Singapore: DBS, applied for a licence so it could enter the digital asset sector and potentially offer crypto services to its customer base; but due to the advertising ban and overly onerous requirements, DBS has chosen not to move ahead with providing digital asset services to customers.

https://www.businesstimes.com.sg/banking-finance/dbs-not-opening-crypto-services-to-retail-market-anytime-in-the-immediate-future

While consumers in Singapore are now, overwhelmingly, safer due to the restrictions in place for local operators of digital currency businesses, the lack of focus by the government and regulator on also making Singapore a good place for businesses to operate, has cost Singapore valuable overseas investment, local job creation and growth.

Interaction with existing AML/CTF regime

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

Yes.

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?

All digital asset service providers that handle customer assets and/or holds customer assets must be licensed. This should be a fundamental aspect of the regulation. Any asset captured by the definition provided in the “Proposed definitions” section of the Consultancy Paper (our response to consultancy question 3) should form the basis of the test whether a provider requires a licence.

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)?

The most important element of the proposed legislation will be the definition of “crypto assets” as contemplated at consultancy question 3. This definition must stand separate from any existing financial product as defined in the Corporations Act. If a particular asset has elements that fit the definition of a financial product, then existing legislation comfortably deals with that scenario and the asset will be a financial product. For the overwhelming majority of digital assets that do not fall under the current definition of a financial product, the definition of crypto assets must be defined under a new licensing regime that applies specifically to the sector.

Re-using the Corporations Act is going to have significant, unintended consequences, such as, for example if a PDS was required for a decentralised coin or if a market operator needed to provide continuous disclosure for underlying protocols it does not control and where the coin is simultaneously listed on hundreds of exchanges worldwide.

A stand-alone regime tailored to the unique elements of the digital currency industry is the only viable option.

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Proposed obligations on crypto asset secondary service providers

Proposed obligations

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

Broadly, we agree with the proposed obligations in the Consultation Paper and have some additional comments:

1. Dispute Resolution: We used to be a member of AFCA (Australian Financial Complaints Authority) to do the right thing by customers and to be a good corporate citizen. Unfortunately, we had to withdraw our membership due to an alarming lack of knowledge of the digital currency industry within AFCA. This lack of knowledge presented a significant risk to our business and did not support the customers when they required it.
   If external dispute resolution is mandated, we fully support this initiative, but this **must** be coupled with a commitment from the EDR scheme provider to have adequate knowledge of the crypto industry and how it operates
2. Regarding point (9) of the Proposed Obligations: We currently maintain, to the best of our ability, a list of known scams on our public website (https://www.independentreserve.com/blog/knowledge-base/protect-your-account) and provide warnings to customers on a number of screens while logged in.
   Careful application of this obligation is required because the overwhelming percentage of scam victims are willing participants in the **purchase** and **transfer** of their crypto assets to an offshore investment scheme. (They do not know it is a scam at this stage, but the customer intends to send their assets to the overseas investment platform). It is currently impossible for any exchange or crypto service provider worldwide to know who owns and operates every digital currency wallet address. Legislation regarding scams "sold through" a provider cannot make service providers liable for customers willingly sending digital assets to what eventually turns out to be a scam operator. Rather, a set of standards and practices (such as customer disclosures, warnings, etc) that crypto service providers must have in place at all times is more appropriate.
3. Custody requirements must require custodians to hold the private keys **in Australia**, controlled by **an Australian entity** to qualify as "Adequate custody arrangements"

12. Should there be a ban on CASSPrs airdropping crypto assets through the services they provide?

No.

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?

Yes, the provisions of the Corporations Act that apply to financial product advice should be applied to crypto assets.

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)?

Yes.

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

Initial legal framework, drafting of compliance manuals, licence applications etc. AUD$1m-$2m

On-going
2 additional compliance staff ~AUD$250k
Annual audit ~$100k

Alternative options

This paper also seeks views on the following alternate options.

Alternative option 1: Regulating CASSPrs under the financial services regime

15. Do you support bringing all crypto assets into the financial product regulatory regime?

No, this option is not supported.

What benefits or drawbacks would this option present compared to other options in this paper?

The benefits to using the existing financial services regime would be:

- Speed to implementation
- Keeping the regulatory environment simple

There are many drawbacks to using the existing financial services regime as described in the Consultation Paper. as an exchange, the biggest impost would be the obligation for our form to hold a Markets Licence to operate. Properly classifying the type of market licence required would require all crypto assets to be classified, meaning all digital asset tokens would need to be classified by ASIC (or rely on operators to do this themselves?). And may mean that a single operator would need multiple market licenses.

Further, decentralised tokens (such as Bitcoin) are not financial products under any global definition and more closely resemble traditional fiat currencies. In this case, the only licence required to offer trading services for currencies is an AFS licence, as FX providers today require only an AFS licence (and indeed no licence at all if the FX is settled immediately). This would mean that any exchange would need multiple market licenses, an AFS licence and be required to have individual risk disclosure statements, PDSs and client agreements for all classes of products it offers customers. This may fit the bill from a regulatory standpoint, however the cost to business, increased compliance complexity and the lack of clarity to customers would be untenable.

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

The legal costs and compliance costs to maintain a markets licence, AFS licence and multiple versions of PDSs, Client agreements and Risk Disclosures would be hundreds of thousands of dollars per year and multiple millions to establish in the first instance.

Alternative option 2: Self-regulation by the crypto industry

17. Do you support this approach instead of the proposed licensing regime?

No, this is not supported.

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?

Self-regulation is not appropriate for a sector the size and complexity of the crypto industry.

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.

Self regulation will not meet the policy objectives. This option should not be pursued.

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?

We agree with the proposed obligations, though we believe they do not go far enough. This is addressed in our responses below.

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

Yes, there are three critical areas not addressed in the obligations:

1. All custodians should be subject to periodic audit (suggest annually) to test, among other things:

- Key creation ceremony
- Transaction signing ceremony
- Cyber and physical security practices
- Maintenance of capital
- Full segregation between house and customer

2. The use of cold storage should be required by any custodian and a designated risk amount (dollar exposure or percentage exposure) must be maintained in cold storage at all times, unless completing a withdrawal at a customers' request

3. Third party custodians must not be in an overseas jurisdiction (further details in our response to consultation question 21)

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?

Third party custodians must not be located in an overseas jurisdiction. Almost all mass-loss events in the crypto industry have been due to misappropriation of private keys by hack of company systems/email or by employee misconduct. Points 10 and 11 in the proposed regulations do not provide Australian consumers any real security in a mass-loss event.

The overseas custodians will not be subject to the same obligations as locally based custodians and all that is required in obligations 10 and 11 is that the local operator is satisfied the practices and processes of the third party are adequate. This practices and processes of foreign domiciled custodians could fall well short of the robust systems required by obligations 1-9.

This situation means that a consumer in Australia could use a duly licensed local exchange and custodian, believing that due to regulation in Australia, there are thorough and robust controls in place to keep their digital assets secure as written in local law, when this could very well not be true.

Further, if there is a mass-loss event and a customer in Australia is using a duly licensed local operator, the customer would need to rely on the local operator making a successful claim for recourse cross-border to the third party. That third party may be in a hostile jurisdiction, or where Australia has no bilateral agreements in place (for example: Many global crypto businesses are incorporated in the Caymans and British Virgin Islands and operate in an opaque manner about who is the actual beneficial owner and responsible party of the custodian entity). A cross-border loss claim would leave an Australian consumer out of pocket for their digital assets; and needing to launch local legal proceeding in a foreign jurisdiction to gain any form of recourse or rely on the local provider to launch this legal action on their behalf.

It is also unclear what court would have jurisdiction over assets held offshore should a dispute arise, for example in family court proceedings. It is crucial to remember that digital assets are bearer instruments and ultimately those who control the private keys have final control of the assets. The adage of "not your keys, not your Bitcoin" holds a lot of truth.

If Australian crypto providers can use foreign domiciled custodians and the local operator does not control the assets or private keys, then the remaining obligations placed on local digital currency service providers to have a licence, audits, IT security etc. just boil down to window-dressing if legislation cannot protect Australian consumers' assets. Assets **must** require a local operator to have Directors and operations in Australia where direct legal recourse can be undertaken and local operators have control of the assets.

Private keys must be held in Australia, by an Australian-based firm, with local directors. Anything else does not protect Australian customers adequately and renders any other consumer protection measures created by the proposed framework effectively meaningless.

There is precedence for this type of arrangement. The ASX Settlement participant application requirements:

https://www.asx.com.au/documents/rules/asx_settlement_guidance_note_01.pdf

Section 5 - ASX imposes significant additional requirements on any firm with overseas operations and mandates a minimum commitment and presence in Australia. ASX does not generally allow any firm to operate as a settlement participant as an entirely foreign firm, there must be capital and operations in Australia.

Other submissions Treasury receives may seek to draw further parallels to the traditional financial product custodians being located overseas; and there being no issue with the current arrangement. This comparison is fundamentally flawed in that traditional financial products **are not** bearer instruments. There is a centralised register of owners of assets, often maintained by a market operator or a specialist registry.
If a custodian goes into administration or immediately closes, the assets do not cease to exist, the register of holders of the financial products still exists and provides owners with legal claim to the assets.
Further, those traditional products are generally traded on a centralised exchange (or exchanges if dual-listed); a user at a custodian cannot 'take'

Crypto assets are **bearer instruments.** If you hold the private key, you have full control of the assets. If an overseas custodian ceases operations and the private key is missing, those assets are not recoverable regardless of whether a register of owners exists or not. And if a malicious actor at that custodian 'takes' the assets, they can be sold anywhere in thee world. Regulation in Australia **must** provide protection to consumers for their assets **and** make local companies and directors responsible for maintaining the highest standards of custody and security.

There will be some commentary from other crypto service providers in Australia that will make submissions to Treasury that local custody is not viable because the relevant expertise does not exist in Australia. Independent Reserve are confident that Australia is well-positioned from a capital, infrastructure, and capability perspective to support a local digital asset custody industry.

As an example, Independent Reserve currently holds hundreds of millions of dollars of digital assets on behalf of over 250,000 customers and has been doing so for over nine years, without a single security incident. This is a track record that compares favourably with any digital asset custodian in the world and is proof that custody can and should be done locally in Australia.

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

As per our response to 20 and 21, the only way to appropriately secure customer assets is to impose obligations on custodians and also have the custodians to maintain local capital and on-going operations in Australia and for the private keys to the crypto assets to be held in Australia.

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

This has been covered in our responses to consultancy questions 20 + 21

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

Any reputable firm currently operating in Australia should already be meeting most of the proposed obligations already.

The cost to implement the proposal (assuming our additional proposals are accepted) would be:

- Cost of annual audit
- Additional full time compliance officer

These costs could easily be borne by our firm if implemented tomorrow.

Alternate option: Industry self-regulation

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

Definitely not. Self-regulation is completely inappropriate for an industry that is holding billions of dollars of customer assets.

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

You need look no further than any mass-loss event globally in terms of crypto. Losses are either total, complete, with no form of recourse or they are ‘communal’ - where every holder loses a proportional amount of their assets. With self-regulation, this situation would not change. No regulatory regime should accept either of these outcomes as acceptable for customers in Australia

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

Absolutely. The only hurdle to entry into the Australian crypto industry is an ACN and registration with AUSTRAC. After those hurdles are cleared, a firm can start accepting funds from customers and start holding potentially millions of dollars in assets.

Any codes of practice are purely voluntary. In fact, only three firms are certified by Blockchain Australia (ours being one of them), leaving **hundreds** of others operating with no scrutiny whatsoever.

By no measure is this acceptable.

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

This will cost no firm anything, they will simply not self-police. This option must be discarded.

Early views sought on token mapping

General comment: Seeking to extensively classify every crypto coin and token under a particular classification is a colossal task. As of March 2022, it is estimated that there are close to 18,000 crypto tokens. How will ASIC (or another government body) manage to classify and re-test 18,000 tokens on a regular basis to ensure the tokens are classified appropriately and continue to remain classified appropriately?

Further, it is not desirable for the industry to wait for the corporate regulator to come to a view on a new token (for example, an Air Drop) before any services can be provided by secondary service providers.

In the list of sub-categories/descriptions, it is not clear what value the sub-classifications will provide the regulator or the industry. Is it intended that there could be different rules applied to each sub-category of crypto token?

A far more palatable option is to start with a broad classification being "Crypto asset" and prohibiting any undesirable traits (such as privacy coins) and prohibiting any tokens that meet the definition of a "Financial product". A period of learning and observation by the appropriate government regulator can then determine if there is a need to further sub-classify a particular class of crypto token.

29. Do you have any views on how the non-exhaustive list of crypto asset categories described ought to be classified as

(1) crypto assets

All digital assets should, as a baseline, be classified under a single umbrella of a “Crypto asset”. Only if that particular asset displays characteristics that would bring it into the definition of “Financial product” should it cease to be classified as a “Crypto asset”.

(2) financial products or

As per response above

(3) other product services or asset type? Please provide your reasons.

Please refer to our general comment for this section, above our response to consultancy question 29.

30. Are there any other descriptions of crypto assets that we should consider as part of the classification exercise? Please provide descriptions and examples.

No. At this early stage of industry regulation, we do not believe a comprehensive token mapping exercise will have any material benefit to industry or the regulator.

31. Are there other examples of crypto asset that are financial products?

This should be the responsibility for the entity providing services for a particular token to ensure it is not captured by the definition of a financial product.

32. Are there any crypto assets that ought to be banned in Australia?

Yes

If so which ones?

Any token that operates based on complete anonymity. We firmly believe in the use of AML/CTF regulations and the ability to identify actors in transactions., Privacy tokens cannot, by their nature, be supported at this stage.