

# Crypto Asset Secondary Service Providers: Licensing & Custody Requirements

This submission has been prepared in response to the Treasury's Consultation Paper, 'Crypto asset secondary service providers: Licensing and custody requirements' dated 21 March 2022 ("Consultation Paper").

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## CRYPTO ASSET SECONDARY SERVICE PROVIDERS: LICENSING REQUIREMENTS

### 1. Background

The cycle is familiar. Tech nerds develop a technology that threatens to disrupt existing markets. Regulators scuffle to understand and tame the beast. This is currently happening in the financial world with the eruption of digital assets.

The momentum behind all things crypto is only becoming more powerful. Over 800,000 Australian taxpayers have transacted in digital assets in the past three years, with a 63% increase in 2021 compared with 2020. As such, a legal framework for the Australian crypto-sphere is starting to take shape.

Currently, there is no consensus on what a crypto asset is. Are they a currency, a commodity, a security, or their own unique asset class? The unclarity of crypto is an obvious worry for authorities because the crypto space is far from risk-free. Valuations can leap and plunge, legitimate tokens could potentially be stolen, exchange platforms have been hacked, which have all resulted in catastrophic losses for its consumers.

Regulation is a key driver of innovation in mature markets. However, regulating digital assets is no easy task. The newness of this space will require regulators to show unusual flexibility. King Irving will explore how authorities can navigate the technological terrain in relation to licensing.

King Irving is one of Australia's leading AFSL specialists with deep industry experience, we'll share our thoughts on how regulation is essential in legitimising crypto.

Economic stability cannot be achieved if transactions are falling between the 'regulatory cracks'. It's time for more adult supervision in the crypto market.

## 2. Regulation and Proposed Obligations

### Question 1

“Crypto asset secondary service provider” is defined as follows:

Any natural or legal person who, as a business, conducts one or more of the following activities or operations for or on behalf of another natural or legal person:

- i. exchange between crypto assets and fiat currencies;
- ii. exchange between one or more forms of crypto assets;
- iii. transfer of crypto assets;
- iv. safekeeping and/or administration of virtual assets or instruments enabling control over crypto assets; and
- v. participation in and provision of financial services related to an issuer’s offer and/or sale of a crypto asset.

Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of ‘digital currency exchange’?

Yes. The term ‘digital currency exchange’ is limited in its interpretation. It would be implied that a ‘digital currency exchange’ is a business that allows its users to trade cryptocurrencies or digital currencies for other assets, such as conventional money. The term ‘Crypto Asset Secondary Service Provider’ (CASSPr) is more suited to the vast array of services offered by those within the cryptocurrency space. The use of CASSPr allows for those functions that operate within the secondary space, such as investment services, trading infrastructure and post-trading infrastructure to be captured through the use of this term.

### Question 2

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

Simply using the general term ‘crypto’ could achieve the same outcome but would involve a transition in thinking for existing participants who may have pre-conceived ideas.

### Question 3

A “crypto asset” is defined by ASIC as: *“...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.”*

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

The issue surrounding the definition of ‘crypto asset’ starts at the interpretation of what is considered to be a ‘financial’ and ‘non-financial’ crypto asset. The Treasury has proposed that CASSPrs that deal in ‘non-financial crypto assets’ will be required to be licenced under the proposed licensing regime and those crypto assets that are considered to be a ‘financial product’ be obligated to be licensed under the financial services regime (Australian Market Licence and Australian Financial Services (AFS) Licence). However, the definition provided by the Australian Securities Investment Commission (ASIC) does not distinguish between a ‘financial’ and ‘non-financial’ crypto asset.

To overcome this issue, two definitions should be drafted. The definition of a “Financial product crypto asset” should incorporate the key characteristics expressed within ASIC Information Sheet 225, which provides a non-exhaustive checklist tailored for determining whether a crypto asset should be constituted as a financial product. The current definition should be used to define “non-financial crypto assets”. By adopting such definitions, it would considerably reduce the ambiguity associated between the adoption of the appropriate licensing regime.

#### **Question 4**

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

The use of a singular definition for “crypto assets” would allow for certainty within the Australian regulatory framework. The definition of “crypto assets” covers a wide range of cryptographic digital representations. By implementing a singular definition, it would allow its interpretation and application to be consistent across a number of regimes, including AML/CTF, tax and financial regulations. Multiple definitions of a single term results in greater ambiguity in its interpretation due to its reference being drawn from an alternate source of legislation that utilises the definition in a alternate context.

However, the issue of having a single definition of ‘crypto asset’ is being able to distinguish between a ‘financial’ and ‘non-financial crypto asset’, which under such interpretation would provide confusion as to which licensing regime would be considered appropriate.

#### **Question 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)?**

All CASSPrs that provide services for all types of crypto assets should be included within the licencing regime. Carving out certain types of crypto assets introduces unnecessary complexity. All crypto assets should be held to a high standard and be scrutinised by the CASSPr, ensuring that the services being provided to the consumer are of a high quality.

#### **Question 6**

**Do you see the policy objectives as appropriate?**

The proposed policy objectives that underpin a CASSPrs’ licensing regime are appropriate. The policy objectives provide for certainty, consumer protection and organisational competence to be at the core of the licencing regime for CASSPrs.

By mandating minimum standards of conduct for business operations and for dealing with retail consumers to act as policy guidelines, it would minimise the risks faced by consumers when dealing with CASSPrs, from an operational, custodial and financial perspective.

The implementation of the AML/CTF regime would protect consumers from the harms and risks associated from criminal and their associates owning, controlling or interacting with CASSPrs.

Providing consumers the ability to differentiate between those CASSPrs that provide high quality, operationally sound business operation against those who do not, allows for the provision of regulatory certainty of policy treatment of crypto assets and CASSPrs.

## Question 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?**

The proposed licensing regime for CASSPrs deal in crypto assets that do not meet the definition of a 'financial product' under the *Corporations Act 2001* (Cth) (Corporations Act). Whilst the proposed licencing regime will apply to all secondary service providers who operate as brokers, dealers, operate a market for crypto assets and offer custodial services in relation to crypto assets it will not apply to decentralised platforms or protocols.

In order to provide the greatest consumer protection and hold CASSPrs accountable for the services they provide, it is important that they be required to be licenced for all crypto assets that are considered non-financial products. Due to the high-risk nature of crypto assets, it is vital that clear guidelines are set that CASSPrs are required to follow in order to maintain the highest level of consumer protection and awareness.

Currently the definitions of 'financial product; or 'financial service' under the Corporations Act can be interpreted as broad, and those cryptocurrencies that hold similar features to existing financial products or securities will trigger the relevant regulatory obligations. Depending on the structure of the crypto asset and the rights attached to it, it may fall into a category of a generally defined financial product, which would be subject to the AFS licensing regime.

Those CASSPrs that offer crypto assets that can be classified as a financial product should be required to comply with the current regulatory requirements under the Corporations Act, which generally include, disclosure, registration, licensing and conduct obligations. Those CASSPrs that engage in non-financial crypto assets will be required to comply with the proposed tailored licensing framework. To reduce unnecessary complexity, all non-financial crypto assets should be included within the CASSPrs proposed licensing regime.

## Question 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)?**

Due to the complexity surrounding the adoption of the proposed licensing regime, there is bound to be inherent overlap with the current financial services licensing regimes (Australian Market Licence and AFS Licence). However, regulatory duplication can provide for additional protection for the benefit of the consumer.

The proposed licensing regime states that those that are dealing with 'financial product crypto assets' will be required to be licenced under the financial services licensing regimes, while those dealing in 'non-financial crypto assets' fall under the proposed CASSPrs licensing regime.

To combat regulatory duplication to prevent entities from having to be authorised under multiple licences, a tiered system may be beneficial. Those CASSPrs that will solely deal with 'non-financial product crypto assets' will be authorised and required to meet the regulatory requirements under the proposed licensing regime.

Entities that hold the authorisation to deal in 'financial product crypto assets' will hold a higher standard of authorisation under their required Australian Market Licence or AFS Licence. Being

authorised to deal in 'financial product crypto assets' would allow the entity to deal with both 'financial product' and 'non-financial product crypto assets'. These entities will be required to meet the regulatory and compliance obligations under their specified financial services licence.

Relief should be provided to those that hold an Australian Market Licence or an AFS Licence where there are additional regulatory and compliance obligations that CASSPrs are required to meet. This relief prevents the entity from having to obtain an additional licence to meet the regulatory and compliance requirements under the proposed regime.

Whilst there is inherent regulatory duplication under such a system, it does provide for additional protection for consumers and reduces the unnecessary bureaucracy required in having to apply for multiple licences.

#### Question 11

This regime would impose the following obligations on CASSPrs:

- 1) do all things necessary to ensure that: the services covered by the licence are provided efficiently, honestly and fairly; and any market for crypto assets is operated in a fair, transparent and orderly manner;
- 2) maintain adequate technological, and financial resources to provide services and manage risks, including by complying with the custody standards proposed in this consultation paper;
- 3) have adequate dispute resolution arrangements in place, including internal and external dispute resolution arrangements;
- 4) ensure directors and key persons responsible for operations are fit and proper persons and are clearly identified;
- 5) maintain minimum financial requirements including capital requirements;
- 6) comply with client money obligations;
- 7) comply with all relevant Australian laws;
- 8) take reasonable steps to ensure that the crypto assets it provides access to are "true to label" e.g. that a product is not falsely described as a crypto asset, or that crypto assets are not misrepresented or described in a way that is intended to mislead
- 9) respond in a timely manner to ensure scams are not sold through their platform;
- 10) not hawk specific crypto assets;
- 11) be regularly audited by independent auditors;
- 12) comply with AML/CTF provisions (including a breach of these provisions being grounds for a licence cancellation); and
- 13) maintain adequate custody arrangements as proposed in the next section.

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

Having drawn a majority of the obligations from the established financial services licence regimes with the addition of specific obligations designed for the adoption of crypto assets, the proposed obligations would be considered appropriate.

Whilst it is important that the proposed obligations ensure that CASSPrs are from an operational standpoint able to operate effectively and efficiently, the adoption of consumer protection-based obligations relating to ensuring scams are not being sold, crypto assets are not being hawked and having the entity audited on a regular basis provides relief for the consumer. The consumer is being offered a service that has sufficient capital requirements and does not feel preyed upon through any form of crypto asset scam or aggressive promotional activities.



## Question 12

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

'Airdrops' are primarily used for promotional activities to increase an uptake in new cryptocurrencies. Consumers receive free coins or tokens, that are 'airdropped' into their crypto wallet. This has become a common marketing tool from crypto service providers to promote awareness of its offerings and engage its customers into purchasing additional cryptocurrencies. This activity results in an increase in the value of the cryptocurrency and the supply of the token.

CASSPrs should be banned from 'airdropping' crypto assets due its predatory nature. Due to the high-risk nature associated with crypto-assets. CASSPrs may be incentivised by the developers of the crypto-asset to promote the project through an 'airdrop', which may ultimately lack the appropriate on-chain security which protects the funds. This allows the creators of the crypto asset to control the movement of the funds, which commonly results in 'pump and dump' or 'rug pull' scheme.

Whilst there are ethical issues surrounding the use of 'airdropping', its use may meet the hawking provisions. The action of airdropping crypto assets may constitute unsolicited contact, due to it taking place in real time, to which the consumer did not consent. By 'airdropping' crypto assets it takes away the consumers ability to have control over their decision to purchase that crypto asset. Once the consumer receives the 'airdropped' crypto asset it is likely they will feel obligated to purchase additional crypto assets due to the belief it value will only increase as a result of receiving free crypto assets. This promotional activity would be characterised as an aggressive tactic by CASSPrs in relation to the crypto assets they offer through their service.

## Question 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)?**

ASIC has cracked down on unlicensed operators following reports that individuals and corporations have provided financial product advice without an AFS Licence.

Those CASSPrs that wish to provide financial advice, whether it be general or personal advice, must only do so if they are qualified and licenced, not by individuals or corporations who neither hold an AFS licence, nor are an authorised representative of an AFS licensee.

Cryptocurrencies are widely considered to be a high-risk investment. If a CASSPr is found to be providing personal financial advice without the appropriate authorisations under its AFS licence, significant penalties should be imposed under section 911A of the Corporations Act. The Corporations Act currently imposes both criminal and civil penalties ranging into the millions of dollars for corporations that provide unlicensed advice.

### Question 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?**

The majority of crypto asset consumers are primarily using these products as a form of an investment. By bringing across all crypto assets into the financial product regulatory regime, those that deal in these products would fall under an established financial services licencing regime. Regulatory amendments would be required to be made the existing regimes in order to suit the innovative nature of crypto assets. As suggested, a tailored financial services regime may be adopted to apply different to certain products or services that are considered to be less onerous.

Those CASSPrs that are currently operating within the Australian crypto market would be required to attain authorisations under the appropriate financial services licence. This would cause an increase in upfront costs for innovative ventures and create a time lag for new crypto assets from entering into the market.

The benefits associated with bringing all crypto assets in the financial product regulatory regime outweigh the impediment of innovation and the increase in costs. Consumers will be provided additional protections as CASSPrs are required to meet the stringent compliance requirements associated under the financial services licencing regime.

### Question 17

**Do you support this approach instead of a 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?**

The common reason for self-regulation is the desire to raise industry standards. This is a means to exceed minimum legal requirements and enhance understanding and compliance with regulations. Raising the industry standards is often used to refer to the ability to deal with rogue players or poor reputation. Whilst it is important that the industry be involved in the development of code of conduct, we believe it is vital that there be strict regulation set. Whilst the implementation of a regulatory regime may impede innovation, it is vital that there be stringent protections for its consumers.

## **3. Proposed Custody Obligations**

Whilst we haven't addressed the custody question in depth. We are strongly of the view that the assets should be regulated under the financial services regime, in order to remove potential bias that will lead to an uneven playing field and have the potential to reduce confidence in the markets over all.