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Director, Crypto Policy Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

To whom it may concern,

Subject: Crypto Asset Secondary Service Providers: Licensing and custody requirements

Thank you for providing Labrys with the opportunity to give feedback on this paper.

Labrys is not a Crypto Asset Secondary Service Provider (CASSPr), however, we will be impacted by the proposed changes and would like to provide perspective on the broader implications for the rest of the industry.

Founded in 2017, Labrys is Australia's largest onshore blockchain development agency. Our customers, including ASX-listed Downer EDI, The Solomon Islands Government, NEM Foundation and more, contract us to build their blockchain solutions. For CASSPrs, Labrys has built crypto-asset exchange software for Sydney-based PrimaryMarkets' unlisted securities exchange, Cloud Nalu's Hawaiian Bitcoin exchange and Tracer DAO's Pool Swaps protocol. We also work with many small-scale start-ups. Labrys is 100% Australian owned and operated with 32 full-time employees working from our Brisbane office.

The blockchain industry will be one of the fastest-growing industries and has the potential to generate more Australian jobs than nearly any other sector over the next decade. However, recent downturns in the global economy have signalled headwinds for the near-term future. We must ensure that through poor timing we don't drown the industry in red tape before it can get out of its infancy.

If the proposed changes pass without adjustment, they will **introduce considerable additional costs to CASSPrs**. Whilst this paper asks established CASSPrs to estimate their compliance costs, it is **more important to assess what the cost will be for a new start-up**.

These costs will not only affect CASSPrs but **solutions providers like Labrys who will have to raise costs to develop compliant solutions**. For many businesses these additional costs will be too much, preventing them from starting their companies, **lowering industry competition and reducing customers for businesses like Labrys**. Businesses that can stomach the increased up-front costs will need to pass these costs on to their customers. A cost that international CASSPrs will not have. This will result in spreads and transactional costs on Australian CASSPrs being higher than international CASSPrs, resulting in many **Australian consumers moving their capital outside the country to even riskier CASSPrs** than what exists in Australia today.

Labrys recommends that the regulator consider reducing the financial burden associated with compliance or taking a voluntary approach so that in the pursuit of better safety for consumers, they do not end up with a less competitive industry and a greater deal of funds in riskier CASSPrs than what exists at present.

Thank you for the opportunity. We hope that you will give thought to our feedback.

Yours faithfully,

Lachlan Feeney
CEO

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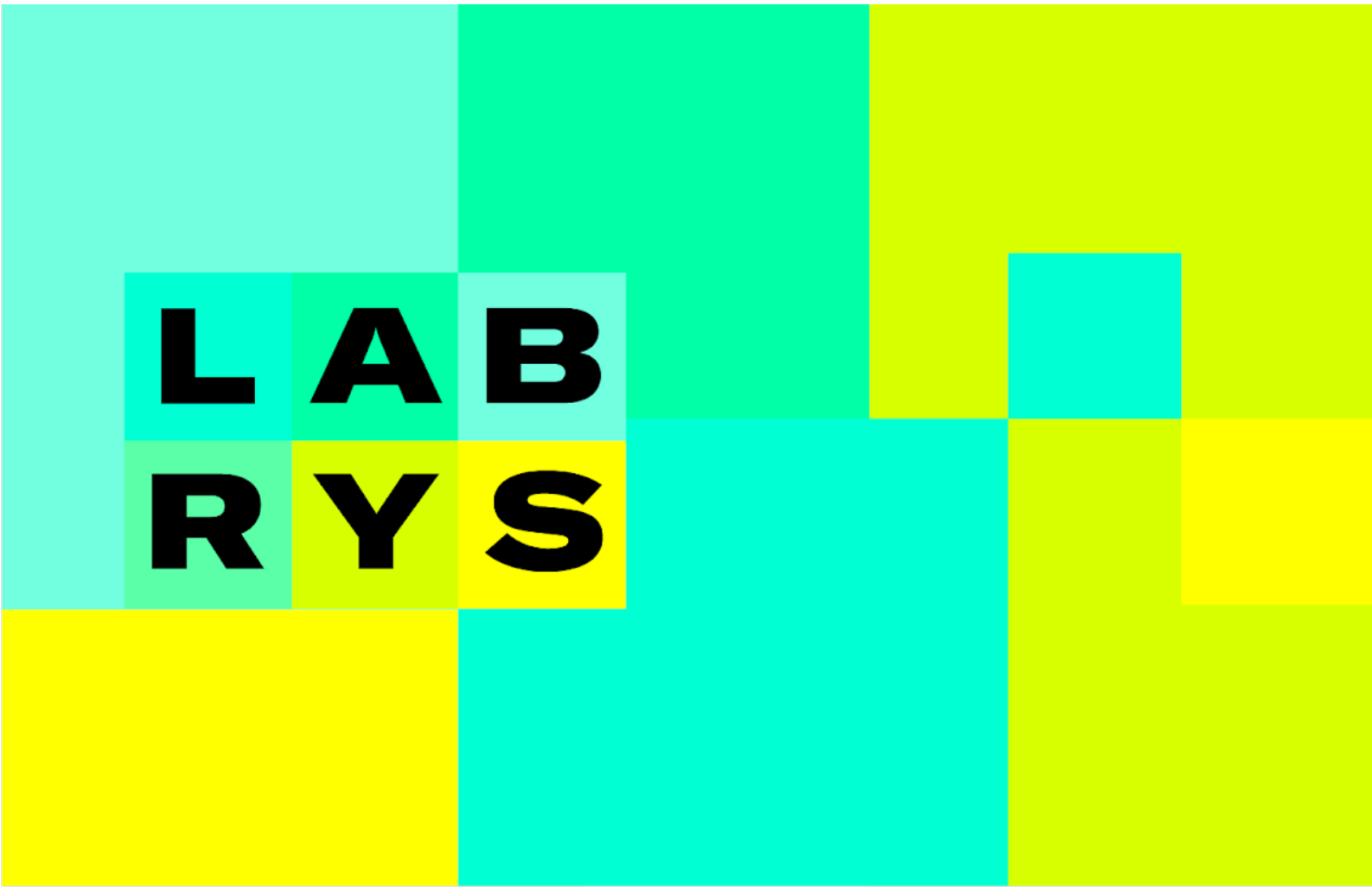
Crypto Asset Secondary Service Providers: Licensing and Custody Requirements



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Consultation Responses

Provided below are Labrys' responses to the consultation questions. In the interest of submission guidelines, Labrys has attempted to keep responses short. If the Treasury would like Labrys to expand on any of its answers, we would be happy to do so.

Labrys has not included answers to questions: 14, 16, 18, 24 and 28 as these are directed at CASSPrs. In these questions, established CASSPrs are asked to estimate the cost of compliance. Compliance costs should be assessed on the cost of a new start-up to comply not for an established CASSPr to comply. Established CASSPrs have an incentive to understate this cost.

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

No. The broadness of the term opens the opportunity to regulate beyond the intentions of this proposal. The CASSPr definition includes any business conducting "exchange" or "transfer of crypto assets". It is not possible to create a blockchain solution that does not fall under this definition therefore all DeFi protocols, non-custodial wallets, NFTs, etc... fall under this definition.

Page 14 of the paper clarifies that the proposal is to only regulate a subset of CASSPrs. Labrys agrees that regulation is needed for the subset definition provided on page 14. We hope that it considers that this broad definition will make it easier to capture unintended businesses in future regulatory proposals causing confusion and unnecessary burden.

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

Labrys prefers "Digital Currency Exchange" over CASSPr, however, would go further to propose "Custodial Digital Currency Exchange". We believe this term best reflects the businesses intended to be regulated by this proposal.

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

Yes.

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

Labrys has no concerns with the definition, however, there are concerns that a broad definition applied across all Australian regulatory frameworks presents an opportunity for overreach and application of regulation to unintended assets and business.

5. Should CASSPrs who provide services for all types of crypto assets be included in the licensing regime, or should specific types of crypto assets be carved out (e.g. NFTs)?

The licensing regime **must not** apply to all types of crypto assets. Instead of applying the regime to all assets except those identified as excluded, the government should conduct its token mapping exercise and explicitly identify the types of crypto assets that are included in the licensing regime.

Very few NFT focused exchanges exist in Australia. US-based Opensea currently holds a near-monopoly on the NFT exchange market. They provide the best NFT exchange experience to customers and focus solely on NFTs. More competition, not less, is desperately needed in this market.

If the proposed licensing regime includes NFTs before Australian start-up NFT marketplaces are established, compliance costs will prevent them from entering the market. Due to their foothold, the existing Australian digital currency exchanges will expand their fungible token trading platforms – which are highly unsuited to the exchanging of NFTs – to support NFT

trading. These are likely to be sub-optimal solutions for their purpose but will capture the market nonetheless due to government-imposed barriers to entry for new participants, a cost that did not exist when the existing Australian digital currency exchanges first started.

Blockchain is one of the fastest-changing industries on the planet. NFTs did not exist a few years ago. If this proposal were created a few years ago it would not have considered NFTs. Types of crypto assets that do not exist today will likely exist in a few years, and these assets may not make sense to fall under the licensing regime.

Labrys **strongly recommends** that the government explicitly state the types of crypto assets included in the proposed licensing regime and that the list should be as minimal as possible.

6. Do you see these policy objectives as appropriate?

- minimise the risks to consumers from the operational, custodial, and financial risks facing the use of CASSPrs. ~~This will be achieved through mandating minimum standards of conduct for business operations and for dealing with retail consumers to act as policy guardrails;~~ (Solutions to the objective should not be included in the objective).
- support the AML/CTF regime and protect the community from the harms arising from criminals and their associates owning or controlling CASSPrs; and
- provide regulatory certainty about the policy treatment of crypto assets and CASSPrs with the intent of encouraging investment in the industry in Australia, and provide a signal to consumers to differentiate between high quality, operationally sound businesses, and those who are not.

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

No. Only as above.

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

Yes.

9. Should CASSPrs that engage with crypto assets be required to be licensed, or should the requirement be specific to subsets of crypto assets? For example, how should the regime treat non-fungible token (NFT) platforms?

The regime must only apply to specific subsets of crypto assets that are explicitly specified by the government. As per answer to question 5, the NFT market is not yet sufficiently matured and applying licencing regime at this time will stifle competition in the Australian market. The same logic applies to crypto assets that do not yet exist.

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)?

Labrys believes that ensuring all crypto assets determined to be financial products are exempt from these new proposed regulations is the correct approach.

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

- Obligation # 2: The government should refrain from stating custody solution specifics and require instead that CASSPrs adhere to current industry best practices as further clarified in answers to questions 19 onwards.
- Obligation #5: This is likely to be the most burdensome obligation proposed in the paper and the most responsible for stifling future innovation. It is unclear what the capital requirements will be set to. If such requirements were in place previously, Australian digital currency exchanges that exist today may never have started. However, now established, it is in the interest of these organisations to raise this capital requirement and to understate its impact on new start-ups.

- Obligation #8: Regulators will need to consider the impact of this obligation on crypto asset hard-forks. For example, is it misleading for tokens such as Bitcoin Cash (a fork of Bitcoin) to represent itself as Bitcoin if these tokens more closely resemble Bitcoin as described in its whitepaper than Bitcoin itself?
- Obligation #11: The term "regularly" must be defined, and the cost of this obligation must be considered.

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

No. Airdrops have become one of the fairest, most democratised ways to distribute crypto assets. Initially, crypto assets would be distributed through ICOs where teams would reserve large portions of tokens for themselves, and wealthy investors would purchase the rest. Then the industry moved to liquidity mining where crypto assets are distributed to those who are providing a service (liquidity) to the platform.

Airdrops distribute tokens retrospectively based on which users have contributed most to the service. Retrospective airdrops encourage businesses to build their product first and airdrop later, rather than selling tokens before a product exists and running with the money. Airdrops reward small users who might not have access to large sums of capital. Airdrops such as ENS, Optimism and UniSwap are great examples of this.

Whilst not all perfect, blanket banning airdrops would be anti-consumer and anti-small investor. Airdrops are an example of self-regulation by the industry finding better models to distribute crypto assets and reduce the likelihood of scams and rug-pulls. If Australian investors know Australian CASSPrs are not allowed to provide them with airdrops, you will see a flight of capital out of the country to international CASSPrs and non-custodial wallets disadvantaging Australian CASSPrs on the global stage.

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)?

No. Other industries can influence the sale of (non-financial) products without taking into consideration a person's personal circumstances. There is no reason to unjustly target the crypto industry with this ban when it does not apply to other industries. Such a ban should only be considered when the crypto asset is deemed a financial product.

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?

No. Most crypto assets are not financial products. The financial product regulatory regime is highly unsuited to the crypto industry. This would result in an enormous unnecessary burden to crypto start-ups and, for many crypto assets, would not result in any significant benefit to consumers. The financial product industry is mature, crypto is not. Bringing all crypto assets into the financial product regulatory regime would be death by red tape to the industry.

17. Do you support this approach instead of the proposed licensing regime? If you do support a voluntary code of conduct, should they be enforceable by an external dispute resolution body? Are the principles outlined in the codes above appropriate for adoption in Australia?

Labrys proposes a 2-phased alternative. In phase 1, full compliance with the new licensing regime would not be mandatory. However, all CASSPrs who are not fully compliant with the proposed licensing regime obligations would be required to clearly display on their products that they are not compliant with the proposed obligations and that using their product may put your funds at higher risk compared to compliant CASSPrs. This non-mandatory

compliance phase would run for a short period (e.g. 4 years) to allow the industry to mature and to assess the real costs of full compliance.

Before the end of phase 1, the regulator would assess, with the involvement of industry, the impact of the licensing regime, make any necessary adjustments and then from a set date would require mandatory compliance from all CASSPrs. During phase 2, the regulator may also start with lower obligations and increase them over time. For example, setting a low capital requirement in year 1 of phase 2 and increasing this capital requirement each year until reaching the desired level.

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

- Obligation #3: As per the answer to question 11, the suitability of capital requirements depends on the level of capital requirements which is not clear. This may become immensely burdensome to start-ups.
- Obligation #8: This may become burdensome for new entrants. Cybersecurity firms are likely to increase pricing for such verification services in the event of a mandate.
- Obligations #10 & 11: These obligations should be as light as possible as CASSPrs. It should be encouraged to outsource custody to providers specialised in this field. Cybersecurity and digital asset custody best practices are forever changing. CASSPrs whose primary focus is anything but solely custody will never be able to keep up with the security levels of specialists.

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

No.

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?

No. Mandating domestic custody would significantly weaken crypto asset custody security and likely result in greater loss of funds long-term. The most advanced crypto asset custodians with the best cybersecurity are all international. Mandating domestic custody would ban the most secure providers and require Australian firms to utilise less-secure custody options.

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

Yes. However, the biggest reduction in custody risk would be achieved by incentivising outsourcing to experienced crypto asset custody providers.

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

No.

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

Yes. Proposed custody obligations are likely to be burdensome on new entrants to the industry and likely to do little to improve security whilst custody is still managed internally. The regulator may achieve similar results with lower costs by encouraging outsourcing.

Similar to the answer to question 17, if the obligations proceed, Labrys recommends a phased approach whereby custody requirements are not mandatory for a period of time. However, non-compliant CASSPrs must clearly display to users that they are not compliant and that users' funds are at higher risk. Mandatory compliance would follow at a set date in the future once the impact of the voluntary phase has been properly assessed.

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

The success of the industry without a mandatory regulatory approach to date speaks for itself. Whilst there has been a loss of funds, security practices at digital currency exchanges today are unrecognisable from those a decade ago. Technology improvements will be the primary driver of increased custodial security over the next decade regardless of what practices are mandated by regulators.

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

No. As above, The security of crypto assets will increase as security technology improves, not necessarily at the declaration of a regulatory body or government mandate. Crypto asset custody is a lucrative business and as competition increases and technology improves, it will be cheaper and easier to securely custody crypto assets.

It is possible soon that storage of private keys and mnemonics are no longer the primary way to secure crypto assets with the advancement of account abstraction and social recovery smart contract wallets. Such advances in technology may render many of the proposed custody obligations obsolete.

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, (2) financial products or (3) other product services or asset type? Please provide your reasons.

The financial product regulatory regime is poorly suited for regulating crypto assets. It adds an unnecessary burden with little benefit for the crypto industry. Only crypto assets that replicate the functions of a financial product should be considered financial products with all other tokens falling under crypto assets which should be regulated individually and not under any other circumstances within the financial product regime.

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.

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

No.

32. Are there any crypto assets that ought to be banned in Australia? If so which ones?

No crypto assets or types of crypto assets should be outright banned. When Bitcoin was first used it was in many cases for illegal purposes, however, if the technology was banned in its infancy the entire blockchain industry would not exist today. Any ban on evolving crypto asset types, e.g. privacy tokens, will only slow down valuable innovative technology solutions in other areas e.g. zero-knowledge proofs for better ownership and control over one's data online.