31 May 2022

The Treasury
Langton Crescent
Parkes ACT 2600

To Whom It May Concern,

Re: Feedback on the Crypto asset secondary service providers: Licensing and custody requirements Consultation paper

The Emerging Payments Association Asia (EPAA) is the membership organisation concerned with payments across Asia. Our members include a wide range of payments stakeholders, ranging from global technology giants to major domestic payment service providers to new entrants. More information about the EPAA can be found on our website https://emergingpaymentsasia.org/.

We are pleased to offer our response to the "Crypto asset secondary service providers: Licensing and custody requirements" Consultation Paper released by Treasury on the 21 March 2022. The move to better regulate the crypto asset ecosystem is welcomed and we consider Treasury's contribution to be a good start.

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

EPAA believes that the most important consideration is to have clarity as to what types of entities and what types of activities are to be regulated under the regime. We believe that the term "Crypto Asset Secondary Service Provider" is an improvement over "digital currency exchange" as the new term better captures a wider range of intermediaries, such as those offering trading, brokerage and custody services, who provide services in respect to a wide range of crypto assets. A clear definition will provide a solid basis for regulation that can respond to future technological and commercial innovations.

We note that the use of the term "Secondary" was done to avoid regulating "primary" service providers, such as the crypto networks themselves, miners and validators. We would broadly agree with this approach as it would better ensure an appropriate and targeted approach on those actors that provide a service closer to a financial service. While some may argue that a decentralised construct or "mathematics" means regulation is not required, we would argue that regulation and the law should go to the substance of the legal and commercial relationships as opposed to the type of technology used.

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

At this point we are comfortable with the proposed terms. Alternatives, such as "Crypto Asset Service Provider – Secondary" may permit a clearer distinction from primary providers. Alternatively, the term "Intermediaries" could be used as opposed to "Secondary" to capture the operation of these service providers more precisely. However, EPAA makes no formal request for the term to change.

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

Crypto assets are defined in the Consultation Paper 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."

We would note that certain shared ledgers do not require cryptographic proofs. It may be possible to implement similar systems without cryptographic proofs on permissioned ledgers such as R3 Corda, DAH, Ripple and others.

At this point EPAA would not propose removing the second half of the definition as it would then capture a very wide range of non-crypto assets. However, we would advise Treasury to closely monitor market developments so that shared ledgers that choose to migrate away from cryptographic proofs for the purpose of avoiding regulation continue to be treated the same way within the regime. Once again, the substance of what is provided needs to be at the heart of the regulatory approach.

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

EPAA agrees that, ideally, a consistent definition for crypto assets should be developed and applied across Australian regulatory frameworks. This would lay the foundation for greater regulatory consistency, which would benefit crypto asset service providers looking to establish and operate in Australia.

We would also like to draw attention to the categorisation of crypto assets into financial and non-financial products. We would suggest the Treasury consider adopting taxonomy and approaches for crypto assets to be aligned to the asset's economic purpose and function; this offers greater regulatory clarity for crypto asset service providers, whose business models are likely to revolve around more specific use cases rather than "financial and non-financial" applications.

The UK and Singapore are examples of markets that have adopted a taxonomy based on economic purpose and function. While there are distinct differences between the two markets' approaches, a categorisation as such has helped to create clarity for the crypto asset industry and supported consumer understanding of the applications of various types of digital assets (e.g., for payment, securities, or utility).

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)?

We believe that for the most, for the most part, all tradable assets that are negotiable should be included. Broadly excluding an entire class of assets can undermine competitive neutrality and, as a result, create market distortions and unwanted arbitrage opportunities.

However, as noted above, we need to consider a better taxonomy of the economic purpose and function of the asset to determine whether it should be included. For example, unless an NFT comes with a set of rights that make them effectively financial products, they should be excluded. Trading of pure art NFTs on a platform like Opensea is generally not regulated in other jurisdictions and doing so would make Australia an outlier. Regulation should look at the substance of the asset, so digital art represented by NFTs should be regulated in the same way as art represented by physical media.

6. Do you see these policy objectives as appropriate?

EPAA agrees with the policy objectives to (i) minimise risks to consumers, (ii) support safe payments with regard to AML/CTF and (iii) provide regulatory certainty. We appreciate the focus placed on consumer protection and ensuring responsible service provision in the area of AML/CTF compliance.

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

EPAA offers the following additional points for further deliberation:

Innovation and global competitiveness: EPAA urge Treasury to consider its policy position on Australia as a global-regional crypto asset innovation centre and thought leader. While several markets are adopting crypto asset policies to strengthen consumer safeguards and mitigate risk, regulations are also being wielded to empower innovation and foster a thriving crypto asset industry. These bring investment, jobs, new technologies, and opportunities to any market. it is a critical moment for Australia to lay the ground for a fair and proportionate framework towards regulating crypt asset service providers; and a licensing regime which imbues consumer confidence and is a marker for a well governed crypto asset company.

Custody of the crypto asset: One major risk to consumers related to the custody of the crypto asset. There is the question of what happens if the provider is hacked, or if the asset is lost. Providers should be held liable for fraud and mistaken transactions, where grounds are legitimate, in a manner similar to how this is addressed in the ePayments Code. Lost assets should also be legally claimable from the provider and we do not see a government guarantee as necessary. We believe an ability to make claims through the courts will encourage the marketplace to seek crypto assets that have better governance and recourse, and could encourage other nations to adopt similar policies, making the overall market safer.

Harmonisation with financial services sector regulations: EPAA notes that Treasury is also considering reform to the payments licensing regime. The consultation paper largely signals the intent to regulate CASSPrs for non-financial products and elects not to discuss regulations for crypto assets that are deemed financial products on the basis that regulatory frameworks that are already in place. However, given the role of ASIC, the AFS license, and the use case of crypto assets in payments, it is critical to consider the effects of changes to the payments licensing regime on the crypto asset industry. EPAA encourages efforts in payments reform and crypto asset regulations drafting to proceed in parallel and responsible governmental parties engage in frequent dialogue to minimise inconsistencies.

Global collaboration: We also urge Treasury to work with neighbours especially in the region to allow for a safer cross-border operating environment. The crypto world is a global one, and nations need to work together to effect change.

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

The proposed scope would make CASSPrs to be regulated in a manner similar to the AFSL regime with AUSTRAC oversight remaining with AML/CTF compliance.

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?

Care needs to be taken so that AFSL-like requirements are only applied when necessary and new emerging technologies are not unnecessarily stifled, particularly before policymakers are able to properly understand the risks.

As we noted earlier, the regulation should look at the substance of the economic function and purpose of the asset and NFTs that function as digital art should be treated similarly as physical art, rather than as a financial product.

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 central problem that crypto tried to address was the inefficiency, lack of confidence and lack of diversity within the existing financial system. This, in turn, created a parallel but lightly regulated world, that should be subject to proportionate regulation. However, care is needed so that this regulation does not recreate the problems to innovation was trying to address. We need to balance efficiency, diversity and choice with safety in achieving a more effective and acceptable system, or we could find ourselves in a similar situation with even more radical alternate technology in the coming years.

Having accepted that premise, a unified approach that (a) simplifies the requirements to provide AFSL and/or CASSPr services that is (b) applies proportionate requirements is recommended, along with (c) a cross-border approach to ensure global harmonisation.

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

The definition of CASSPrs is very broad, with obligations generally applying to crypto traders, brokerage and exchanges. As noted above, any AFSL-like obligations must be fit for purpose and calibrated to the relative risks and impact on growth and innovation within the sector.

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

Airdropping is a useful and innovative approach to providing assets and should not be banned at the outset without a better understanding of which practices are unsafe. Airdropping was used successfully by state governments in the pandemic (e.g. NSW Dine and Discover), could be a feature of a government CBDC. On this basis, airdropping should not be blanket-banned from the outset.

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)?

The definition of CASSPrs in the paper is broader than just exchanges. Providing crypto advice, for the average person is akin to providing financial advice (savings are used to purchase them, there are risks, and unscrupulous players). Therefore, similar constraints may be required to provide crypto-advice, though as noted above calibrating with the risks and impacts on competition and innovation need to be carefully considered.

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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?

We stress the need to simplify the regulatory regime and advocate for a more level playing field between CASSPrs and AFSL. As such the "option 1" meets the second requirement but leads to inefficiency and lack of diversity as mentioned earlier due to the high bar of entry. If this option were selected, simplification of the process especially for start-ups should be considered.

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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?

We support, as mentioned a simplified approach. As a result, "option 2" meets our first measure but would fail on the second. That said, it is a mature process, and consideration should be given to simplifying compliance for some current AFSL categories along the lines mentioned here. Allowing a regulatory loophole, as this may do, for an AFSL equivalence service, opens an avenue that could harm consumers.

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

The practices listed are reasonable. More may be recommended as issues become more apparent. Regulators should be wary of excessive regulation of custodial services, because increasing costs mean that open-source or overseas solutions become more attractive to the detriment of consumers.

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

Transfers to external wallets could be recorded and reported as cross-border transactions, particularly if it cannot be ascertained if the external wallet is domestic or international.

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?

APRA tends to recommend data be held domestically if access is demanded through a legal mechanism, and as a result, domestic data is easier to access. While this is good regulatory practice, it may add to costs of data storage and governments should seek to enable treaties or government/commercial agreements that allow for statutory cross-border access to data.

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

The details outlined seem satisfactory for now but should be subject to review and improvement.

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

As noted, a missing piece is the recourse if assets go missing. An insurance benchmark may be set (e.g. 10% of assets held for example). Also, it is unclear what happens in the event of bankruptcy or internal fraud. There is significant common law on bankruptcy that may be hard to displace with legislation, so commercial secured creditor constructs may be the answer that supersede, and secondary creditor claim (including the Government) will aid these providers getting customer support.

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

Given the relatively reasonable measures suggested in the regulated model, these measures should be implemented in any self-regulated model. Consideration should be given to self-regulation to supplement or even replace explicit licensing over time as the sector matures.

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

Outside the crypto-world, self-regulated regimes have existed successfully in financial services for many years, though we would admit they (like regulated regimes) have both strengths and weaknesses. The payments space has operated reasonably effectively with industry self-regulation through bodies such as AusPayNet, though care needs to be given to ensure there are no barriers to entry are created via self-regulation.

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

Clearly failures of crypto exchanges/custody are a major issue and demonstrates improvement is required. Despite the absence of robust industry self-regulation within the crypto exchange / custody market at the current time, this does not mean that self-regulation cannot work in the future.

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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.

A simple definition could be: "A crypto asset is a financial product if it is highly negotiable, can be traded electronically to a broad market and is primarily intended for financial or economic purposes. A crypto asset is also a financial product if it is sold akin to a financial investment product."

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

As mentioned before, digital assets (that do not require cryptographic proof) through shared or permissioned ledgers should be included, though care needs to be taken so it is not too broad to capture other assets that have a digital form such as stored value, securities, bank accounts etc.

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

The ability for a crypto asset to be highly negotiable (like cash), tradable without physical carriage (like shares) and intended for financial or economic purpose makes them akin to financial products, that should be regulated in a similar way.

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

Crypto assets directly associated with illegal activity should be banned. (e.g. a crypto asset used for illegal activities or seeking to bypass sanctions).

EPAA thanks you once again for the opportunity to respond to your paper. We are more than happy to expand further on the items raised in this submission or to provide further education or information about the crypto asset sector. If you do have such questions, please feel free to contact our EPA Ambassador, Dr Brad Pragnell at brad.pragnell@34south45north.com .

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