16 March 2022

Mr Asika Wickramasinghe
Australian Securities & Investment Commission
Level 5, 100 Market Street,
Sydney, NSW 2000

Submission by email: marketsregulation@asic.gov.au

Dear Asika,

Consultation Paper 343: Crypto-assets as underlying assets for ETPs and other investment products (CP 343)

The Financial Services Council (**FSC**) welcomes the opportunity to provide comments to CP 343.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

Cryptocurrency interest in the Australian Market

We understand that there is interest in the Australian market for exchange traded products (ETPs) that invest in or provide exposure to cryptocurrency assets.

We also note the cautionary commentary that ASIC has provided in CP343 that "there is the real risk of harm to consumers and markets if these products are not developed and operate properly".[1]

As identified in CP343 the significant value increases in crypto-assets has attracted retail interest and investment into these assets, whilst at the same time there has been an "exponential rise" in crypto investment scam reports. Furthermore, Crypto-assets have also been identified as an area of concern for money laundering schemes with crypto-assets used in criminal activity.[2] This has created the consumer interest in investing in crypto-assets via regulated investment vehicle which holds the crypto-assets.[3] The regulatory settings for cryptocurrency investment products however are still developing globally

Given this context, we support ASIC taking a considered and measured approach in relation to the regulation of investments in crypto-assets.

[1] Paragraph 2, CP343.
[2] Paragraph 14, CP343.
[3] Paragraph 15, CP343.

Suitability of Crypto-assets and relevant factors to be established

We support the view set out in CP343 that crypto-assets are not a homogenous asset class and can operate differently.

ASIC has set out the relevant factors that crypto-assets should display to help identify if particular assets are an appropriate underlying assets for an ETP. This includes establishing the following factors;

> "(a) *a high level of institutional support and acceptance of the crypto-asset being used for investment purposes;*
>
> (b) *the availability and willingness of service providers (including custodians, fund administrators, market makers and index providers) to support ETPs that invest in, or provide exposure to, the crypto-asset;*
>
> (c) *a mature spot market for the crypto-asset;*
>
> (d) *a regulated futures market for trading derivatives linked to the crypto-asset; and*
>
> (e) *the availability of robust and transparent pricing mechanisms for the crypto-asset, both throughout the trading day and to strike a daily net asset valuation (NAV) price."*[4]

Given the unique attributes and risks involved with crypto-assets, the relevant factors identified by ASIC appear sensible and pragmatic. Features such as having a high level of institutional support, of a particular crypto-asset for investment purposes, and the availability of service providers, such as custodians, to support products that invest in relevant crypto-assets are important.

CP 343 proposes that Bitcoin and Ether are the only two crypto-assets identified as likely to satisfy these factors at present.[5]

There are mixed views amongst FSC members as to which crypto-assets could represent a suitable investment, with one perspective supporting the proposals set out in CP343 which identify Bitcoin and Ether as meeting the factors set out by ASIC.

Another perspective considers that, in recent years, Bitcoin has made considerable progress in terms of the number and quality of institutional-grade, regulated service providers offering market infrastructure for Bitcoin. In this context Bitcoin may have merit from an investment standpoint as a source of alternative asset diversification and as a hedge against potential inflation however, this view does not extend to other crypto-assets.

Risks involved

We would like to draw ASIC's attention to cryptocurrency asset risks identified by the European Central Bank and Bloomberg.

The European Central Bank has detailed are number of risks relating to crypto-assets in their paper including

[4] Proposal B1, Page 11, CP343.
[5] Paragraph 33, CP343.

(but not limited to) the counterparty risks a crytpo-ETP maybe exposed to in absence of a regulatory framework for participants who hold and trade crypto-assets. There are also risks related to pricing of crypto-ETPs given that the underlying cryptocurrency trades 24 hours a day and 7 days a week, as a result existing different crypto indices have their own price benchmark methodology they follow.

One perspective is that Crypto-ETPs, would offer limited advantage over trading underlying crypto asset as they are not diversified instruments like other ETPs; but instead pose the potential to introduce risk in the system. Retail investors may not fully understand the risks of trading in these products.

Bloomberg has also Identified a number of risks in their Bitcoin index benchmarking methodology which is included as Attachment A.

Environmental aspect of cryptocurrency is also something that shouldn't be undermined, per various sources on media, Bitcoin production is estimated to generate between 22 and 22.9 million metric tons of carbon dioxide emissions a year, which is between the levels of carbon dioxide produced by Jordan and Sri Lanka, a 2019 study in scientific journal Joule found.

While there are growing attempts in the cryptocurrency industry to mitigate the environmental harm of mining, there is no solution established so far.

In this regard, it would be helpful for ASIC to consider the potential risks involved with regulation of crypto-assets.

Exchange Traded Product (ETPs) Classification of crypto-assets

The FSC has also recently shared with ASIC the proposal for revising naming conventions for ETPs[6]. Under that proposal an ETP holding crypto assets would not be called an ETF (for example, a single cryptocurrency product would fall under Exchange Traded Instrument).

Recent market events have demonstrated the need for clearer distinctions between different types of ETPs. Single-commodity funds provide a very different experience to the more common well-diversified ETFs. In April 2020, at the time of a dramatic decline in oil prices, a 3x levered crude oil-linked exchange-traded note was wound up by the issuer. The timing for investors was unfavourable. While regulators have worked to promote transparency around these products, including disclosure requirements, they have not yet adopted a classification system that categorizes the risks and characteristics associated with different types of ETPs. Crypto currencies are not diversified instruments that Exchange Traded Funds are, and therefore should not be classified as such.

We would recommend that an exchange traded product investing in virtual currencies listed products should be classified to clearly highlight the risks involved for the benefit for all investors.

CP343 proposes that crypto-assets should be added as a new category of permissible underlying assets[7], as

[6] The FSC ETF naming convention proposal supports the following naming conventions being used - Exchange Traded Fund, Active Exchange Traded Fund, Exchange Traded Commodity and Exchange Traded Instrument which is generally the 'catch all' category where an ETF does not fall in the first three categories.

[7] ASIC notes that permissible underlying asset rules generally provide that the underlying assets of an ETP must comprise of

an 'eligible crypto-asset', for a number of reasons including that they can be categorised differently for different purposes, there is no industry or international consensus on categorisation and they can evolve in how they are structured and used over time.

Establishing a new category for eligible crypto-assets will also ensure that ETPs that have underlying crypto-assets consistently meet a minimum level of factors/requirements set out by ASIC.

Given the unique attributes of crypto-assets, we support the proposal of establishing a new 'eligible crypto-asset' category for ETPs that invest in these assets.

Other Issues

There is great interest from the funds management industry to ensure good consumer outcomes and in maintaining the trust and confidence of the sector. In this context we support a considered approach being taken in the regulation for crypto-assets and the following;

- the need to use reputable custodians for crypto-assets;
- having rigour and reliability around pricing;
- ensuring that experienced providers issue crypto-asset ETPs with a new asset kind, to cover crypto-assets, to be included in AFS Licences (either when applying for a new AFSL or variation to an existing AFSL); and
- crypto-asset ETP issuers using auditors with the relevant skills and experience to audit crypto-assets.

The custody proposals set out for crypto-asset include the requirement for Responsible Entities and custodians to have "appropriate compensation system in place in the event a crypto-asset held in custody for the RE's is lost."[8] This is critical to ensuring that crypto-currency ETP issuers meet both their legal obligations to have appropriate compensation arrangements in place as well as to ensure appropriate consumer protections.

We note that a Compensation Scheme of Last Resort (CSLR) is expected to be established in the coming period. To help reduce consumer risks first and foremost, as well as to reduce the potential future liabilities of a CSLR, it is essential that the risk of product failure and fraud is minimised which includes ensuring that product issuers have adequate financial resources and have appropriate compensation systems in place, including product issuers which invest in crypto-assets.

Kind regards,

Bianca Richardson
Policy Director, Investments and Global Markets

Attachment A – Bloomberg CFIX Methodology

securities, derivatives, debentures, bonds, currencies, or commodities that can be reliably priced.

[8] Page 51, CP343.