27 May 2022

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

Via email: crypto@treasury.gov.au

Crypto asset secondary service providers: Licensing and custody requirements

The Financial Services Council (FSC) is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians.

The FSC welcomes the release of the Treasury consultation paper into the regulation of crypto asset secondary service providers, given the growing exposure to digital assets by Australians.

We agree that financial and product innovation should be welcomed, and as much as possible should not be inhibited. We understand that the use case of digital assets continues to evolve and expand beyond digital currency, and as a society we have only begun to glimpse the ways digital assets will revolutionise and make more efficient the way we do business, transact, and engage in entertainment.

As crypto matures as an asset class, a growing number of investment funds will want to explore exposure to digital assets for retail investors. There are already crypto exchange traded funds on the ASX.

The primary aim of any reform should be to provide confidence to participants in the crypto industry including crypto asset secondary service providers (CASSPrs), particularly consumers. A clear regulatory framework will encourage benefits from the continued innovation and evolution in the uses of digital assets and blockchain technology.

We submit as an overarching concern that the government should be mindful about avoiding regulatory arbitrage and gaps in consumer protection, when creating a parallel crypto licensing regime to the Australian financial services licensing (AFSL) regime.

There is a risk that the creation of a new crypto licensing regime could leave retail consumers without the benefit of protections, built overtime under the financial services regulatory framework. The financial services regime has also evolved in recent years to place greater reliance on the product issuer to ensure that products are designed and distributed within an appropriate target market for consumers. Where a CASSPr can be characterised as providing a financial service, consumers should not be left without the benefit of various disclosure obligations, and major reforms like the Design and Distribution Obligations. Just because a

product is on the blockchain or is called “crypto”, this should not automatically mean that the crypto service provider is subject to an alternative regime if it can be characterised as a financial product.

Closely connected to this, the Government should provide clear classification of digital assets. Clarity is needed by industry participants as to what digital assets constitute financial products. The key risk is that the introduction of an alternative licensing regime will be accompanied with wide uncertainty as to what falls within it. Clear classification of digital assets by the Government and regulators is key to providing regulatory confidence in the industry as to what assets should be captured by the AFSL regime or under the proposed regime.

We recognise that it may take time for the use case of a blockchain protocol to stabilise. Therefore, a separate crypto licensing regime may also have merit as a form of temporary safe harbour, allowing CASSPrs to proceed in the market with confidence as the use case of the underlying crypto asset evolves while protecting consumers at risk from novel digital assets. After a period of time, a determination should be made by ASIC as to whether the underlying crypto asset is a financial product or not, highlighting the importance of Treasury’s token mapping exercise.

The FSC supports the aim of proving a clear regulatory framework for digital assets. Continued reliance on uncertain guidance from regulators will not provide the confidence needed to participants in the digital asset sector and the financial services sector. Greater regulatory certainty will allow participants to proceed with confidence about their legal obligations, enabling growth in the sector.

We submit for Treasury’s consideration some high-level principles that we believe the government should consider as it seeks to provide a regulatory framework for crypto secondary service providers.

1.0 The importance of the AFS regime consumer protections

We agree that at this stage, what the Treasury paper defines as ‘crypto asset secondary providers’ (CASSPrs) are the proper focus of any regulation, rather than the digital assets themselves. This is analogous to the financial services regime, which regulates financial services rather than financial products themselves.

We support the policy position stated by Treasury that where a crypto service provider can be characterised as providing a financial service, they should be regulated under the existing regulatory regime and be required to hold an Australian Financial Services licence. There are already in existence crypto exchanges and dealers in crypto derivatives and tokenised securities, and providers who facilitate payments in crypto. On the horizon, there will be greater use of smart contracts built on digital assets, where the protocol includes trigger conditions for the execution of financial agreements like lending and borrowing. Intermediaries promoting and providing access to these services should all be licensed as financial services.

We also support the avoidance of duplication, so that a service provider is not subject to both the financial services regime and Treasury’s proposed crypto licensing regime. Where a crypto service provider is providing a financial service, they should not also be subject to an alternative crypto licensing regime. Conversely, where a crypto service provider is not dealing in or making a market in a financial product, it should only be subject to the proposed CASSPr regime. Greater clarity from Government and regulators about the classification of digital assets will be important in avoiding duplication and preventing regulatory arbitrage between a crypto licensing regime and the AFS regime. The risk we see is if a CASSPrs provides a

service that may arguably be characterised as a financial service, but they use the option of being licensed under a CASSPrs to avoid the consumer protection obligations that come under the AFS regime. A CASSPr providing a financial service should not be able to use a separate licensing regime to avoid AFS licensing obligations.

The financial services regime has been designed to protect consumers from the harm that can be occasioned from informational asymmetry that results in consumers making choices without proper rational consideration for their risk appetite. This informational asymmetric risk continues to exist where digital assets are purchased with the hope of financial return. The current experience of digital assets is their high volatility in value, with the potential for large losses for retail consumers. Where people are encouraged to buy digital assets as an investment in the hope of a financial return, they should be well appraised of the risks involved.

We welcome that Treasury's proposed licensing regime contains obligations that mirror the financial services regime in important areas, such as a duty to do all things to ensure that services covered by the licence are provided efficiently, honestly and fairly, ensure appropriate qualifications for personal, have adequate technological and financial resources to manage risks, and that crypto assets are not provided in a misleading and deceptive manner.

However, AFS regime protections designed to address information asymmetry and ensure the appropriate design and distribution of products only to suitable consumers would not be available to a consumer purchasing a digital asset via a CASSPrs providing a financial service under Treasury's proposed regime. Important AFS obligations missing from the proposed CASSPrs regime which financial services providers are subject to include:

- The aid of informed decision making for consumers and advisors via various disclosure requirements such as the provision of a Product Disclosure Statement[1] and Financial Services Guide[2]. The provision of a PDS provides consumers with information about the significant benefits and risks associated with holding the product, significant characteristics, rights and obligations, and the extent to ESG considerations are taken into account.[3] The provision on an FSG provides certain information about the financial services entity at a level a person would reasonably require for the purpose of making a decision whether to acquire financial services from the providing entity as a retail client.[4]
- Obligations for advertising material directed toward retail clients to indicate that a PDS is available and that a person should consider the PDS.[5]
- The Product Design and Distribution obligations with the need to determine an appropriate target market for the product, create a target market determination, and take reasonable steps to ensure that retail distribution of the product complies with the target market determination.[6]

[1] *Corporations Act 2001* (Cth) ss1012A-1012Cs
[2] *Corporations Act 2001* (Cth) ss941D, 942B, 942C
[3] *Corporations Act 2001* (Cth) s1013D(1)
[4] *Corporations Act 2001* (Cth) ss942B(3) and 942C(3)
[5] *Corporations Act 2001* (Cth) s1018A
[6] *Corporations Act 2001* (Cth) Part 7.8A

- Obligations with the provision of financial product advice[7] and the Future of Financial Advice reforms such as education, training[8] and duties toward clients[9].
- Remedies for investors that arise from the breach of license[10]. As well as compensation arrangement and adequate capital obligations for financial service licensees to compensate persons for loss or damage suffered because of breaches of the AFS regime[11] This includes an obligation to be a member of the Australian Financial Complaints Authority (AFCA)[12], which retail consumers can have recourse to.
- Cooling off period for financial products[13] (1019B).
- The ability for ASIC to exercise its Product Intervention Power where there is the risk of significant detriment to consumers.[14]

We also welcome the proposed custody obligations for a CASSPr under a crypto licensing regime, in the same way managed investment schemes have obligations in relation to custody. We note that custodians licensed under the current AFS regime may be incentivised, with a clear framework allowing digital assets to be held in custody, to begin providing custody for digital assets managed by fund managers. Confidence in custody arrangements will provide greater incentive for the take up of digital assets as an underlying asset class in financial services provided by fund managers.

Where a CASSPr that is providing a financial service may also be characterised as providing a managed investment scheme, (where an investor contributes money or money's worth with the intended generation of a financial return or benefit, and the investor has no day to day control over the use of the money to generate the return)[15], then as well as the obligations listed above, there is a risk that in not registering as a responsible entity, the following gaps exist in consumer protection:

- General fairness obligations toward members of the scheme.[16]
- Liability by the RE for loss or damage resulting from contravention of Ch 5C, including by officers and employees.[17]
- Requirement to hold scheme property on trust and separate from the property of the RE.[18]
- Requirement to have a compliance plan, implement a compliance monitoring system[19] and establish a compliance committee where less than half of its directors are independent[20].

---

[7] *Corporations Act 2001* (Cth) Part 7.7 Div 3, Part 7.7A
[8] *Corporations Act 2001* (Cth) Part 7.6 Div 8A
[9] *Corporations Act 2001* (Cth) ss961B(1), 961G, 961H, Part 7.7A Div 4
[10] *Corporations Act 2001* (Cth) ss961M and 1022BB
[11] *Corporations Act 2001* (Cth) ss912B and 912A(1)(d)
[12] *Corporations Act 2001* (Cth) s912A(2)
[13] *Corporations Act 2001* (Cth) s1019B
[14] *Corporations Act 2001* (Cth) Part 7.9A
[15] *Corporations Act 2001* (Cth), s9
[16] *Corporations Act 2001* (Cth) s601FC
[17] *Corporations Act 2001* (Cth) ss601FD and 601FE
[18] *Corporations Act 2001* (Cth) ss601FC(2) and 601FC(1)(i)
[19] *Corporations Act 2001* (Cth) s601HA(1)
[20] *Corporations Act 2001* (Cth) s601JA

- Requirement to report to ASIC any breach of the *Corporations Act 2001* that relates to the scheme and has had, or is likely to have, a materially adverse effect on the interests of members.[21]
- Liability to scheme members for loss or damage arising from a contravention of Ch5C[22] and the ability of the court to impost liability on any person involved in a contravention of Ch5C.[23]

Recommendation 1: CASSPrs should fall under AFSL regime where they can be characterised as a financial service. Government should be mindful of the risk of regulatory arbitrage and the risk that consumers do not have the benefit of disclosure and design and distribution protections that the AFS regime affords.

2.0 Allowing for the evolution of digital asset use cases by a CASSPr licensing regime

The key question when regulating crypto service providers is whether they are providing a financial service. A financial service is provided under section 766A(1) of the *Corporations Act* if, among other things, a person deals in a financial product, makes a market for a financial product, operates a registered scheme, provides a custodial or depository service or provides a crowd funding service. Thus, whether a crypto provider is providing a financial service depends on whether the digital asset they are dealing in or making a market for meets definition of a financial product under section 763A of the *Corporations Act 2001.* Under section 763A(1), a financial product is a facility through which, or through the acquisition of which, a person makes a financial investment, manages financial risk or makes non-cash payments.

The issue is that there can be difficulty in determining whether the use of a digital asset is a financial service under the current *Corporations Act 2001* definition of a financial product. There are clearly crypto products that are used to make a financial investment or make payments. However, the use of digital tokens can change over time, with expanding use cases. A digital asset may be characterised as a security to begin with, such as a form of equity raising for a protocol, but later evolve to do other things such as unlocking certain functionalities within an application or game. Likewise, the opposite situation can occur where there are other digital assets that may not start out as a financial product, but their use case later meets the criteria for a financial product.

There is emerging consensus around Bitcoin and other similar crypto token being best characterised as commodities rather than securities[24],analogous to gold, able to be bought and sold and used as a store of value and an accepted method of payment. They can be characterised at the very least as property with rights attached.[25] For instance, Non-Fungible Tokens (NFT) which represent ownership through the tokenisation of physical and digital assets and recording the transfer and ownership on the blockchain. In such cases, this may be like a security, but in other cases the acquisition of such items to make a financial

[21] *Corporations Act 2001* (Cth) s601FC(1)
[22] *Corporations Act 2001* (Cth) s601MA
[23] *Corporations Act 2001* (Cth) s1325
[24] See Reserve Bank of Australia, C*ryptocurrencies* (Web Page) <https://www.rba.gov.au/education/resources/explainers/cryptocurrencies.html>
[25] See UK Jurisdiction Taskforce, *Legal Statement on Cryptoassets and Smart Contracts* (November 2019)

investment or manage a financial risk may arguably be merely incidental to a facility where it is reasonable to assume that the main purpose of the facility is not a financial product purpose.[26]

While we don't propose to analyse individual digital asset cases here, we believe that the proposed crypto licensing regime should be linked to the existing financial services regime, with mechanisms for substantiation and transition, balancing the need to allow for innovation and consumer protection.

Recognising that it takes time for a blockchain protocol to mature into a stable use case, we recognise the need to allow for secondary providers to proceed with confidence in the dealing and market making of tokens as this evolution occurs. As the protocol evolves, network participants should not be left without a measure of protection. Protection is particularly important as retail consumers are introduced to novel digital assets and are at risk of consumer harm through uninformed speculation.

We submit there is merit in the proposal of a safe harbour, allowing crypto asset secondary service providers a time period where, if it is unclear whether the facility they are providing can be characterised as a financial service, they can be licensed under Treasury's proposed CASSPrs licensing regime with associated obligations. It would be in a similar spirit to the regulatory sandbox allowed for FinTech products, where a 24-month exemption may be granted from the requirement to hold an AFSL in order to test new financial services in the market, with the key difference that CASSPrs would still need to be subject to a licensing regime. This safe harbour allows for innovation and protocol evolution without certain disclosure and product design and distribution obligations, while still providing a measure of consumer protection.

We submit that the CASSPrs licensing regime should at least include an obligation for useful disclosure that outlines the significant benefits and risks associated with holding the digital asset. Disclosure would be a lighter touch, allowing for innovation and the discovery of whether the digital asset is being used as a financial product or not over time, while aiding in informed decision making for retail consumers.
After a period of time, CASSPrs should be subject to an ASIC audit, where ASIC must determine whether the facility provided can be characterised as a financial product. As part of this audit, ASIC should be required to publicly consult via a submission process. If they are determined by ASIC to be a financial product, and therefore that the CASSPrs is providing a financial service, then the CASSPrs will be required to transition into the AFSL regime.

The appropriate time period for this safe harbour and a transition period to the AFSL regime can be the subject of further consultation with industry. It could involve a yearly audit by ASIC up to a maximum time period, after which the facility provided by the CASSPrs must be determined as a financial service or not. ASIC can utilise its existing powers to exempt an entity from the AFSL regime and declare that a specified facility is not a financial product for the purposes of Ch7.[27]

As mentioned, we support the proposed token mapping exercise as key to regulating CASSPrs, as this will help provide clarity on the use cases of digital assets over time. Classification of the use cases of crypto assets will enhance ASIC's capability to determine whether a CASSPrs should be licensed as a financial services provider or not.

[26] *Corporations Act 2001* (Cth) s763E(1)
[27] *Corporations Act 2001* (Cth) s765(2)

We note that Government will face a greater challenge with the growth of Decentralised Finance (or De-Fi), as it is not clear who the 'regulated person' should be. It is conceivable that decentralised protocols could be applied to managed investment schemes and superannuation, where individuals' share of an investment fund is recorded on a blockchain, and a decentralised protocol dictates the parameters of investment decisions for individuals who own a piece of the investment protocol. This will be important for policymakers to consider who should be held responsible as this space evolves, particular in light of the risk that participants in such a De-Fi protocol would not be shielded by protections for consumers provided by the financial services regulatory regime, or a separate CASSPrs licensing regime.

Recommendation 2: The proposed CASSPrs regime should be linked to the AFSL regime, where entities who are licensed under the CASSPrs regime should be subject to an ASIC audit after a period of time (to be determined). ASIC must, after public consultation, determine whether the CASSPr is providing a financial service. If ASIC determines that they are, they should be required to transition into the AFSL regime.

The CASSPrs licensing regime should include disclosure obligations similar to the disclosure obligations under the AFSL regime.

If you wish to follow up on this submission or have any questions, please contact Chaneg Torres, Policy Manager at ctorres@fsc.org.au.

Yours sincerely,

Chaneg Torres
Policy Manager