Crypto asset secondary service providers:

Licensing and custody requirements

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1 Introduction

The consultation paper, proposing regulation of a set of entities designated as *Crypto Asset Secondary Service Providers (CASSPrs)*, reflects concerns over consumer protection when engaging with the "crypto eco-space". CASSPrs are described as institutions which: provide custody and storage services; provide exchange, brokerage and dealing services; and operate a market – where those activities are focused on "crypto assets. The latter are, in turn, distinguished by the underlying role of blockchain technology and cryptography. It is true that such entities (CASSPrs) provide the primary interface with the crypto eco-system for the retail sector. It is via the activities of that group of entities that many of the problems of consumer protection can arise, since direct interaction of individuals with blockchain transactions is generally difficult, necessitating a role for such agents, brokers and intermediaries. However, that will not prevent potentially much consumer harm arising from involvement of individuals or entities in the crypto eco-system. Here I refer particularly to the potential for poorly-informed consumers to expend large amounts on purchases of crypto currencies (such as BitCoin, Ether, etc), or such things as non-fungible tokens (NFTs) which is nothing more than a relatively new style of gambling/speculation.

While I believe that a case for regulation of the crypto ecosystem can be justified on consumer protection grounds, I am not convinced that the focus on CASSPrs is the right approach. (Like the old joke about a traveller asking from how to get to a particular destination (in this case good regulation of the crypto ecosystem) the advice given is "not to start from here"). There are several reasons which include: the unsuitability of regulation focused on institutional classifications rather than on economic fundamentals; a need to first better identify the diverse components of the crypto ecosystem for which different regulatory approaches may be appropriate; consideration of whether crypto characteristics are primarily

"back office" considerations such that traditional regulation focused on the economic functions involved can be adapted or extended to the crypto space rather than involving separate specialised regulation. In a nutshell, is there anything special about the crypto space that warrants separate specialised regulatory arrangements – including the need to bring a group of intermediaries under a specialised licensing regime?

2 Putting the Cart before the Horse

The consultation paper notes that the Treasury will engage in a "mapping exercise" to identify the wide (and growing) range of components of the crypto eco-system. As it notes, as well as (a vast number of) crypto-currencies the eco-system includes various forms of "tokens". As well as NFTs which provide some form of (generally poorly defined) ownership/entitlement rights to something, there are tokens which provide entitlements to products or services, Initial Coin Offerings (ICOs) which raise funds for some business enterprise and may involve some equity/shareholder stake, and Stable Coins which offer a "guaranteed" redemption value.

CASSPRs may be involved in roles as intermediaries, brokers, agents, advisers in connecting retail customers with any or all of these components of the crypto eco-system. But given the vastly different characteristics of these components (other than the use of blockchain and cryptography) applying a common regulatory approach to institutions engaged in some or all of these runs the risk of inappropriate regulation.

To illustrate consider purchases of crypto currency and of stable coins.

The former is primarily (if not exclusively) a form of gambling/speculation. The purchaser obtains no rights other than to have their identity placed anonymously (via the public/private key mechanism) on a ledger and to transfer that right to another party. Admittedly, there may be cases where the crypto currency can be used to purchase goods and services, but that is, and is likely to remain, a minor role. The purchaser has taken a position the value of which may increase or fall, depending only on demand by other potential purchasers relative to supply. (In that regard, it is a form of gambling unlike many other cases where the outcome of some event (a horse race, result of a lottery, etc) determines gain or loss).

In this regard, the role of a CASSPR providing access to (selling and buying) crypto currency facilities, can be likened to the role of a local newsagent with a franchise to act as an agent for a lottery. Individuals can take a position in the lottery via purchase at the newsagent, and receive any payouts via the newsagent. Where a CASSPR provides advice about, and access to, a range of crypto currencies this can be thought of

a similar to a comparison website – of which many exist for a range of products and services (as well as for financial services). When a CASSPR takes on an "intermediary" role, whereby the value of the individual's position in the crypto currency is conditional on the safe-keeping role of the CASSPR, it is akin to acting as a trustee.

What these comments aim to show is that while there may be no exact equivalent in traditional activities and regulatory arrangements, the appropriate regulation does not necessarily involve treating CASSPRs as being involved in the financial system, nor according crypto currencies the status of a financial product. Rather, extant regulations from outside the financial sector (such as for trustees, operators of comparison website, etc) may be appropriate and adaptable to CASSPRs – and the principle of regulation being technologically neutral would suggest considering that option.

In contrast, Stable Coins would appear to be much more akin to a financial product, since a promise is being made of redeemability at a specified value. (It may not be a fixed amount in fiat currency, but fixed relative to the value of some other financial asset(s) – including gold). There are a range of ways in which Stable Coins might be structured, one of which is involves operating much like a bank with holdings of diversified assets partly funded by equity (capital) provided by the operator. If a CASSPR acts as an agent for such a "quasi-bank" then regulation such as applies to agency arrangements made by banks would seem appropriate. Such activities, and regulation, could be confined to a specialised subsidiary of a CASSPr, rather than involving regulation applied to the whole CASSPR. It should be noted that unless the CASSPr is itself offering stable coins (off chain) this does not obviate the need for thinking about regulating the on chain offer in a way similar to that of bank regulation. However, in that regard, the prohibition of non-ADIs from offering deposits at call, or issuing debentures with less than 31 days maturity, would mean that regulating a stable coin issuer as an ADI would create a non-level playing field vis a vis finance companies and other non-ADIs and raise issues around inclusion in the Financial Claims Scheme.

RECOMMENDATION 1: COMPLETION OF AN INITIAL "MAPPING EXERCISE" TO IDENTIFY TYPES OF CRYPTO PRODUCTS AND SERVICES IS NEEDED BEFORE EMBARKING ON REGULATION (AND ONGOING "MAPPING" WILL BE NECESSARY TO DEAL WITH NEW INNOVATIONS).

RECOMMENDATION 2: WHILE SOME CRYPTO PRODUCTS MAY HAVE CHARACTERISTICS OF FINANCIAL PRODUCTS AND SERVICES, NOT ALL DO, SUCH THAT DESIGNATION OF CRYPTO PRODUCTS AND SERVICES AS FINANCIAL PRODUCTS AND SERVICES AND APPLICATION OF FINANCIAL REGULATION SHOULD BE STRICTLY LIMITED.

3 The irrelevance of "Crypto" for regulatory distinctions

The consultation paper is premised on the assumption that there is something different about use of blockchain (distributed ledger) and cryptography that requires special regulation for service providers engaged in the eco-system. As the paper notes, crypto "assets" are a subset of digital assets, where the latter arguably includes ownership recorded on some form of electronic edger, proof of ownership checked by cryptographic means (such as password verification), and may also involve access and transfer of ownership via non-electronic means. Adopting such a definition of digital assets means that bank deposits, managed funds, etc., which can be accessed via the internet are digital assets.

The question then arises, why should there be different treatment of crypto assets and associated service providers from other digital assets and associated service providers? (Note that I have argued that many of the crypto items, including crypto currencies, do not warrant designation as financial assets). In my view there is no reason for differential regulation. The nature of the ledger involved in recording ownership and the method of verifying ownership are essentially "back-office" activities, not relevant to the fundamental characteristics of the asset in question.

Thus, for example, if some Stable Coin was to be designated as similar to a bank deposit, it could be appropriate to have the issuer of that Stable Coin registered as an ADI and subject to the prudential regulation applying to ADIs. Differences in the nature of back office activities and the risks arising, would then be subject to operational risk regulation – which can be tailored by APRA to reflect the specific nature of those risks. However, ADIs are also engaged in making loans – which is not a fundamental activity of a Stable Coin issuers, making the ADI designation less appropriate.

Alternatively, and preferably, an issuer of a Stable Coin could be treated as offering a Stored Value Facility (SVF) – consistent with the recent recommendation of the Council of Financial Regulators (2020) to introduce such a designation. This would also facilitate Stable Coin issuers participating in the domestic payments system. This differs from designation as an ADI by excluding those funds from coverage by the Financial Claims Scheme (FCS). This would create a level playing field (ensuring competitive neutrality) relative to non-ADIs at the expense of differentiating Stable Coin issuers from banks. Given that some issuers of Stable Coins are likely to be foreign based, making domestic regulation difficult, designation as a SVF rather than an ADI would seem preferable. SVF regulation by ASIC and APRA would likely preclude many attempts to offer stable coins involving unsuitable asset portfolios or algorithmic methods for achieving stable value from being designated as SVFs.

Similar arguments apply in the case of Initial Coin Offerings (ICOs) which involve the raising of funds for a business enterprise with some (variety of) promises attached to coin ownership regarding returns,

governance rights, access to products/services of the issuer. The rights promised might be structured in a novel way and involve issuance processes which are different to traditional fund raising activities. But this implies a need to amend/augment existing regulations, and is not something that demands specific regulation based on the "crypto" (blockchain, cryptography) features.

CASSPrs may also operate markets in which individuals may buy or sell crypto currencies or other crypto-based tokens. Most regulation of market operators has occurred in the financial sector, with the markets being for financial assets or derivatives based upon those assets. But markets can be provided (often by government authorities) for what appear to be non-financial assets, such as markets for the trading of water rights or carbon credits. In practice, carbon credits have been designated as financial products, while the ACCC's recent inquiry into the Murray-Darling Water Basin did not advocated designating water rights as a financial product. It would thus seem possible to designate the rights inherent in crypto currencies either as a financial product or not – with markets correspondingly coming under the regulatory auspices of ASIC or the ACCC. To avoid giving crypto currencies unwarranted credence as financial products, the latter approach is warranted.

RECOMMENDATION 3: "CRYPTO" IS NOT A CHARACTERISTIC WHICH WARRANTS SPECIAL REGULATION RATHER THAN AMENDMENTS TO OR AUGMENTATION OF TRADITIONAL REGULATION.

RECOMMENDATION 4: IF STABLE COINS ARE TO BE TREATED AS A FINANCIAL PRODUCT THEN THEY SHOULD BE REGULATED UNDER THE PROPOSED STORED VALUE FACILITY (SVF) MODEL RATHER THAN DESIGNATED AS ADIS.

RECOMMENDATION 5: CRYPTO CURRENCY MARKETS SHOULD NOT BE REGULATED UNDER THE FINANCIAL MARKET OPERATOR REGIME, BUT UNDER THE AUSPICES OF THE ACCC – WHICH MAY REQUIRE DEVELOPMENT OF REGULATIONS FOR MARKETS OPERATING IN NON-FINANCIAL PRODUCTS.

4. Consumer Perceptions and Financial Product Designation of Crypto Products

Designation of Crypto products, such as crypto currencies, as a financial product would mean that they and associated service providers would fall under the auspices of ASIC for financial consumer protection. If such a designation is not made, the general consumer protection laws as administered by the ACCC would apply.

Designating crypto products as financial products provides them a credence which in many cases is not appropriate and can influence consumer perceptions inappropriately. Some crypto products and services may warrant designation as financial products and services – but that is not related, at all, to their crypto nature. Rather it is because they have properties which mean they provide fundamental economic

services to their users. In this regard it is worth referring to the generally accepted economic functions of a financial system which Merton, for example, listed as

1. *a payments system for the exchange of goods and services*

2. *a mechanism for the pooling of funds to undertake large-scale indivisible enterprise*

3. *a way to transfer economic resources through time and across geographic regions and industries*

4. *a way to manage uncertainty and control risk*

5. *price information which helps coordinate decent, ralized decision-making in various sectors of the economy*

6. *a way to deal with the asymmetric information problems when one party to a financial transaction has information that the other party does not*

Merton, and others, have advocated for a *functional approach to financial regulation*, such that equivalent regulation applies to financial products and services providing the same economic functions. Implementing such an approach has proven problematic, but a focus on economic functions rather than "back office" features of crypto products may help identify appropriate regulatory treatment of the crypto eco system. It is clear that some of the crypto products and services do provide some of these economic functions. Identifying the economic functions of crypto products rather than focusing on the "crypto" feature seems more likely to lead to a suitable regulatory approach

RECOMMENDATION 6: DESIGNATING CRYPTO PRODUCTS AND SERVICES AS FINANCIAL PRODUCTS MAY INAPPROPRIATELY ELEVATE CONSUMER INTERPRETATIONS ABOUT THE SAFETY AND UTILITY OF SUCH PRODUCTS

RECOMMENDATION 7: FOCUSING ON THE ECONOMIC FUNCTIONS PERFORMED BY CRYPTO PRODUCTS RATHER THAN THEIR "CRYPTO" FEATURE IS LIKELY TO PROVIDE A FIRMER FOUNDATION FOR THOSE PRODUCTS DEEMED SUITABLE FOR DESIGNATION AS FINANCIAL PRODUCTS.

5. The shortcomings of Institution-based Regulation

The shortcomings of a regulatory approach based on institutional classifications is well known, and these are likely to be even more severe when the classification involves a group of diverse entities operating in a number of different spheres.

Shadow banking is perhaps the best known example, in which the credit creation activity of banks is also undertaken by non-prudentially regulated entities. There is no reason to expect that things would be different in the case of CASSPrs – with shadow (or ghost) entities (perhaps referred to as "Caspers" like

the friendly ghost!) emerging to undertake functionally equivalent activities outside the boundaries of the regulation.

<u>RECOMMENDATION 7: DO NOT ADOPT AN INSTITUTION-BASED APPROACH TO REGULATION AS IMPLICIT IN THE PROPOSED CASSPR APPROACH, BUT INSTEAD FOCUS ON THE ECONOMIC FUNCTIONS BEING PERFORMED AND IDENTIFY WHETHER EXTANT REGULATION CAN BE ADAPTED OR EXTENDED TO THE CRYPTO APPROACH TO PERFORMING THOSE ECONOMIC FUNCTIONS.</u>

6 Consumer Protection and Financial Regulation

The standard approach to financial regulation involves dichotomising it into a prudentially regulated sector where promises made to investors are highly likely to be met, and a less regulated sector where investors/participants bear the consequences of their decisions. Of course, for that to work well, participants need to be well-informed and cognisant of the risks they are taking. It is also necessary to have some degree of trust in counterparties, with a claimed advantage of the crypto sector being that pre-determined computer based algorithmic processes mean that operations are possible in the absence of trust. In practice, and particularly so in the crypto-world, well informed consumers are not the norm, and claims of a lack of need for trust in the crypto world are overblown particularly with the important role played by intermediaries such as CASSPRs.

There have been two main types of approach for protecting gullible consumer/investors. One, failed approach, has been what I term an EAD approach involving financial Education, Advice, and Disclosure. The alternative has been the "benevolent paternalism" approach of preventing the supply and distribution of unsuitable financial products to unsophisticated financial consumers.

Simply banning retail investors from involvement in certain markets, has been one mechanism involved in benevolent paternalism, although many such investors (including SMSFs) now appear able to meet the relatively liberal criteria for classification as wholesale investors. But, barring fraudulent inducements and advice leading to agreeing to such classification (where compensation schemes may provide some protection) resulting risk-taking should be purely "on the investor's head". (Note that any compensation schemes require product producers and distributors to be members of the scheme – which does not currently apply to crypto asset providers).

Banning investors from purchasing and holding unsuitable crypto products seems highly unlikely to work. That requires issuers/producers to be subject to some form of national jurisdiction such that penalties can

be applied on issuers not adhering to the rules. Unfortunately, most issuers are from other jurisdictions – or more precisely are in the virtual world where geographical residency can be obfuscated or hidden.

The other mechanism is regulatory oversight and banning of unsuitable products, such as enshrined in the Design and Distribution Obligations (DDOs) and Product Improvement Powers (PiPs) – temporary banning – recently introduced and administered by ASIC. The Libertarian ethos of the crypto sector hardly lends itself towards becoming enmeshed in this world of regulation via registering as producers of financial products.

If crypto currencies are not designated as a financial product then consumer protection would rely on enforcement of Australian Consumer Law by the ACCC. There appears to be little reason to expect that regulation of that form would be any less appropriate than regulation by ASIC arising from designation as a financial product.

RECOMMENDATION 8: REGULATE CRYPTO CURRENCIES AND RELATED PRODUCTS, SERVICES AND SERVICE PROVIDERS UNDER THE PROVISIONS OF AUSTRALIAN CONSUMER LAW, RATHER THAN DESIGNATION AS FINANCIAL PRODUCTS - EXCEPT IN THOSE CASES WHERE PROMISES ARE MADE OF FINANCIAL OUTCOMES OR RIGHTS WHICH INVOLVE SPECIFIED AMOUNTS OF FIAT CURRENCY OR TANGIBLE ITEMS.