ASX Submission to the Senate Select Committee on Australia as a Technology and Financial Centre

August 2021

Senate Select Committee on Australia as a Technology and Financial Centre
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

By email to fintech.sen@aph.gov.au

Dear Committee,

We refer to our submission to the Committee dated 16 July 2021 in relation to section 2(h) of the Committee's Issues Paper – "*opportunities and risks in the digital asset and cryptocurrency sector*".

We mentioned in that submission that ASX would be participating in ASIC's consultation *CP 343 Crypto-assets as underlying assets for ETPs and other investment products* and that we would share our thoughts on the issues raised in CP 343 with the Committee at that time.

Attached in Annexure A is an extract of ASX's submission in response to CP 343 addressing issues relevant to the work of the Committee.

We would make the following observations in relation to the matters in Annexure A.

CP 343 was primarily directed to the regulatory framework that should apply in Australia to exchange traded products providing an exposure to the two dominant cryptocurrencies: bitcoin and ether. We have not included in annexure A our detailed responses to the specific questions raise in CP 343, as they are not particularly pertinent to the work of the Committee. We have, however, included some preliminary observations about the regulatory framework for cryptocurrencies and similar digital assets in Australia that we hope the Committee may find helpful.

We emphasise at the outset that our response to CP 343 was provided from the perspective of ASX as a licensed market operator with what ASIC has expressed as a "gatekeeper" role in relation to our exchange traded products market, and with some experience of compliance issues involving entities looking to take advantage of the level of public interest in cryptocurrencies and other digital assets. But these are issues that can come up whenever there is a rapidly growing industry, and not specific to digital assets. As we have previously commented to the Committee, ASX sees the benefits that technological innovation can bring to financial markets, and we see distributed ledger technology as potentially transformative, and our comments here should not be taken as reflecting on the many legitimate and innovative businesses involved in the development and promotion of digital assets and distributed ledger technology.

The comments that we make in this brief submission are specifically directed to the regulatory framework that should apply in Australia to the following categories of digital assets, namely:

- digital assets that are or are held out to be "cryptocurrencies";
- digital assets that are used to raise funds from investors to invest in any form of collective endeavour (eg through an "initial coin offering" (**ICO**) or an initial exchange offering (**IEO**)); or

- digital assets that are used for any other financial purpose (such as making a financial investment, managing financial risk or making non-cash payments).

For convenience we refer to these assets as "digital financial products".

The legal characterisation of digital financial products across the world is subject to considerable uncertainty that hinders both the legitimate development of these products and their effective regulation. In Australia, ASIC has pointed to that legal uncertainty in its Information Sheet 225 *Initial coin offerings and crypto-assets* (which ASX agrees with and endorses),[1] which lists four different types of financial product that an initial coin offering (**ICO**) might be, depending on how it is structured.

At the same time some digital financial products have experienced phenomenal growth in their price or value over some periods, creating a great deal of speculative interest in these products, particularly (but not only) among retail investors.

This combination of a lack of effective regulation and high levels of speculative interest among retail investors has attracted bad actors to associate themselves with the industry. This is well documented. In support of this view we would simply refer the Committee to the following materials on the MoneySmart website:

> https://moneysmart.gov.au/investment-warnings/cryptocurrencies-and-icos
>
> https://asic.gov.au/about-asic/news-centre/news-items/scam-alert-asic-sees-a-rise-in-crypto-scams/

In ASX's view, it is vitally important that a clear, effective and nationally consistent regulatory framework is put in place for digital financial products. That framework should include appropriate retail investor protections and a licensing regime so that bad actors can be excluded from the industry and participants in the industry can have clear and consistent requirements (for example) to have adequate systems and resources and to be appropriately capitalised.

We also think that it is in the interests of Australian investors that this regulation is consistent with the broader regulation of financial products and services in Australia. This includes bringing digital financial products within the remit of the same anti-money laundering and counter-terrorism measures that apply to all other types of financial products.

We think that the simplest approach is for a regulation to be made under section 764A(1)(m) of the Corporations Act extending the list of the products that are specified to be "financial products" in section 764A of the Corporations Act to include digital financial products.

In this regard, ASX would repeat the observation it has made in Annexure A:

> *Bitcoin and ether are often described as "cryptocurrencies". ASX notes that persons who advise on, deal in, underwrite, make markets in, or provide custodial services in relation to, foreign currency contracts are required to have an Australian financial services licence (**AFSL**) authorising them to do so. Similarly, exchanges that provide facilities to buy and sell foreign currency contracts require an Australian market licence (**AML**) authorising them to do so. ASX firmly believes that the same rules should apply to those with equivalent roles in the crypto-asset industry, at least where the crypto-assets are being used for financial product purposes (ie as an investment, a non-cash payment facility or for managing financial risk).*

Declaring digital financial products to be financial products for the purposes of the Corporations Act would bring with it a ready-made fit-for-purpose regulatory framework for these types of products. It would also enable ASIC to develop and impose appropriate licence requirements for organisations providing custodial services in relation to these products. As we identified in our submission to the Committee dated 16 July 2021 and again in Annexure A, digital financial products are peculiarly exposed to risks around loss or theft of keys and hacking, and having proper custodial arrangements in place is a pivotal concern.

Further, declaring digital financial products to be financial products for the purposes of the Corporations Act may assist in bringing them more clearly within the purview of our anti-money laundering and counter terrorism financing laws than is presently the case. Currently those laws only apply to digital currency

[1] Available at https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-assets/.

exchange providers. However, it is hard to see why those who provide 'designated services' in relation to digital financial products should not be subject to the same 'know your client' obligations and requirements to have risk-based measures to detect, prevent and report tax evasion, criminal activity, money laundering and terrorism financing as those who provide 'designated services' in relation to other types of financial products.

Our comments in this submission have been focused on those crypto-assets that are capable of being brought within the existing framework provided by financial services regulation. Crypto-assets that are designed in such a way as to not be susceptible to this form of regulation – for example, crypto-assets designed for anonymity of ownership, which are difficult to reconcile with important aspects of financial services regulation and anti-money laundering regulation – raise their own policy issues, and may be appropriate to be considered separately.

Yours sincerely,

Kevin Lewis

Senior Counsel, Regulatory Policy

Annexure A

Excerpt from ASX's submission in response to ASIC Consultation Paper 343 *Crypto-assets as underlying assets for ETPs and other investment products*

ASX Limited (**ASX**) welcomes the opportunity to make a submission to ASIC's Consultation Paper 343 *Crypto-assets as underlying assets for ETPs and other investment products* (**CP 343**).

As the primary exchange for quoting ETPs, LICs and LITs in Australia, ASX has a keen interest in the continued development of these markets, and supports ASIC's initiative in CP 343 to consider and consult on enhancements to the regulatory framework in Australia that may allow ETPs, LICs and LITs which have crypto-assets as their underlying investment (together, **crypto-asset funds**) and which meet certain criteria to trade on licensed exchanges.

Terms defined in CP 343 have the same meaning in this submission. …

Before it responds to the specific questions in CP 343, ASX would make some preliminary observations to set the context for ASX's submissions.

ASX agrees with ASIC that the high level of interest from both retail[2] and institutional investors in crypto-assets and the growing acceptance of crypto-assets into the investment mainstream warrant a reconsideration of the cautious approach that both ASIC and ASX have taken thus far to crypto-asset funds.

ASX also firmly believes that the regulatory framework for ETPs in Australia – including the regimes for the registration and regulation of issuers of managed investment products in Chapter 5C, and for the licensing and regulation of markets providing facilities to buy and sell ETPs in Part 7.2, of the Corporations Act – provides a solid regulatory foundation to underpin investments in crypto-assets via crypto-asset ETPs traded on regulated markets.

The need for a proper regulatory framework for crypto-assets generally

ASX notes the statements in paragraphs 23 and 24 of CP 343:

> *How crypto-assets are classified and regulated in Australia is a matter for government decision. As noted above, the Senate Select Committee on Australia as a Technology and Financial Centre is considering these questions.*
>
> *The proposals in this paper do not seek to pre-determine or pre-empt any government decision on how crypto-assets ought to be classified or regulated in Australia; nor do we express any opinion on how crypto-assets ought to be classified or regulated in Australia.*

ASX has some concerns about establishing a framework to allow the quotation of crypto-asset funds ahead of the regulatory framework for crypto-assets more generally being determined by the Government. In this regard, ASX would particularly note the observations by ASIC in paragraphs 13 and 14 of CP 343 that:

> *The rise in value of crypto-assets globally has seen a sharp increase in retail investor interest in investing in crypto-assets. In parallel, we have seen an exponential rise in the number of crypto investment scam reports received this year compared to previous years, and we continue to publish scam warnings like our overseas regulatory counterparts. The crypto-asset marketplace is technologically complex, online and global. These features lend themselves to unscrupulous operators seeking to defraud consumers.*
>
> *We also note and share the concerns of international standard-setting bodies and regulators globally regarding the use of crypto-assets in criminal activity, such as money laundering schemes.*

ASIC has clearly stated these concerns on the Moneysmart website and delivered a regulatory "shot across the bow" to the crypto-asset industry in Information Sheet 225 *Initial coin offering and crypto-assets*.

[2] See the studies by YouGov at https://www.afr.com/companies/financial-services/four-million-aussies-set-to-buy-into-crypto-20210608-p57z2g and Statista at https://www.statista.com/statistics/1223509/cryptocurrency-penetration-age-australia/referenced below in our response to Question B1Q1.

As ASIC would be aware, ASX has for some years expressed similar concerns to those expressed by ASIC, most recently in its *Listed@ASX Compliance Update No 06/19* dated 1 August 2019. Consequently, ASX has to date taken a very cautious approach to listing crypto-businesses and has not admitted any crypto-asset funds as ETPs, LICs or LITs.

If crypto-asset funds are allowed in Australia, that is likely to be perceived by some as a "softening" of the regulatory attitude to crypto-assets in Australia and also portrayed as a legitimisation of crypto-assets as appropriate investments for retail investors. ASX has some concerns that this may attract more bad actors into this space and lead to an uptick in crypto-based scams and other unscrupulous activity.

To counter this, in ASX's view, it is important that there is a proper regulatory framework for crypto-assets that includes a licensing regime so that bad actors can be prevented from entering, or required to leave, the industry, and retail investors have an appropriate level of regulatory protection against their activities. This licensing regime should apply both to service providers that advise on, deal in, underwrite, make markets in, or provide custodial services in relation to, these assets, and to exchanges that provide facilities to buy and sell these assets.

To achieve this end, a regulation could be made under section 764A(1)(m) of the Corporations Act extending the list of the products that are specified to be "financial products" in section 764A of the Corporations Act to include crypto-assets that meet certain criteria.

Bitcoin and ether are often described as "cryptocurrencies". ASX notes that persons who advise on, deal in, underwrite, make markets in, or provide custodial services in relation to, foreign currency contracts are required to have an Australian financial services licence (**AFSL**) authorising them to do so. Similarly, exchanges that provide facilities to buy and sell foreign currency contracts require an Australian market licence (**AML**) authorising them to do so. ASX firmly believes that the same rules should apply to those with equivalent roles in the crypto-asset industry, at least where the crypto-assets are being used for financial product purposes (ie as an investment, a non-cash payment facility or for managing financial risk).

The proposal that the regulatory framework for crypto-assets be incorporated into market operator rules

In a number of places in CP 343 (for example in paragraphs 31 and 88 and questions C1Q6, C2Q5 and D1Q4), ASIC proposes that aspects of the regulatory framework for crypto-asset funds may be built into the operating rules or listing rules of the licensed markets that admit those products to trade on their market.

ASX respectfully submits that this would not be optimal and that there is a need for a clear, consistent, robust, market-wide regulatory framework for crypto-asset funds that is administered by ASIC as the market regulator and the regulator of companies and managed investment schemes (**MIS**) in Australia. ASX's reasons for this view include:

- Licensed markets typically have only limited powers to investigate and take action in relation to non-compliance with their operating rules. They cannot conduct searches, seize evidence, examine people on oath or penalise people who don't co-operate. Their primary enforcement powers in relation to ETPs are in increasing order of seriousness: (1) to suspend trading in an ETP; (2) to terminate the admission of an ETP to trading status; or (3) to revoke the "approved issuer status" of the ETP issuer. Similarly, their primary enforcement powers in relation to LICS and LITs are: (1) to suspend trading in the LIC/LIT's securities; or (2) to terminate the listing of the LIC/LIT. None of these outcomes is likely to be particularly helpful if, for example, the issuer of an ETP absconds with the ETP's funds or a custodian of ETP assets defaults on its obligations. Further, while the threat by ASX to use these powers is often sufficient to convince an issuer to comply with ASX's rules, this is not always the case.

- The operating rules of a licensed market are only binding on the "participants" in that market, that is, the issuers of products quoted on that market and the brokers who transact business on that market. To the extent that the regulatory framework for crypto-asset funds needs to regulate the activities of others (for example, customers of brokers who might seek to manipulate the market for ETPs, or custodians of ETP assets), it is necessary for that to be a part of the general law rather than set out in market rules.

- There are multiple licensed markets in Australia, although presently only two of them can quote ETP products (ASX and Chi-X) and only 3 of them can list LICs and LITs (ASX, NSX and SSE). As ASIC notes in paragraph 35 of CP 343, the rules of these markets are "specific to each market". Embedding core components of the regulatory framework for crypto-asset funds in the operating rules or listing rules of

the different licensed markets invites a situation where different rules and standards get applied to different crypto-asset funds, depending on the market on which they are quoted. This may lead to regulatory arbitrage and sub-optimal regulatory outcomes. It also risks creating a "race to the bottom" in regulatory standards. Further, it is unlikely that retail investors will understand the nuances between the different standards and obligations that apply to different crypto-asset funds under different market rules.

- The ASIC Market Integrity Rules (**MIR**) provide, in ASX's view, a better regulatory mechanism for crypto-asset funds. The current MIR for equity markets apply a common set of regulatory standards across all licensed equity markets in Australia. They are administered by a single national regulator that is well-respected and has the expertise, surveillance systems and processes, and resources to set the rules and to monitor and enforce compliance with them. The MIR are able to regulate "the activities or conduct of persons in relation to financial products traded on licensed markets." ASX therefore does not see any reason why ASIC could not make MIR to regulate conduct in relation to crypto-asset fund products traded on licensed markets. Further, ASIC's ability to modify the MIR without the need for legislation would cater well for the novel and rapidly evolving nature of these products.

- Alternatively, it will generally be the case that the issuers of crypto-asset fund products will have an AFSL – in the case of an ETP or LIT through its responsible entity (**RE**) under sections 601FA and 766A(1)(d), and in the case of a LIC by virtue of sections 766A(1)(b) and 766C(5), of the Corporations Act. ASIC could use its power to impose conditions on AFSLs (section 914A) to mandate compliance by the AFSL holder with some or all of its proposed "good practice" guidance. Again, ASIC's ability to impose and modify AFSL conditions without the need for legislation would cater well for the novel and rapidly evolving nature of these products.

- ASIC acting through its powers to make and enforce MIR or to impose and enforce conditions on AFSLs would provide a robust, market-wide regulatory framework for crypto-asset funds and would address the shortcomings mentioned above vis-à-vis relying on the limited enforcement powers that market operators have to enforce compliance with their rules. It is also likely to lead to better regulatory outcomes than ASIC's proposed "good practice" guidance alone will do.

The need for a firmer regulatory foundation for custodians of crypto-assets

Organisations that carry on a business of holding financial products in Australia as custodian for others are required to hold an AFSL authorising them to provide that service. This gives ASIC direct regulatory oversight and enforcement powers over those custodians. …

[*However, because the categorisation of crypto-assets as financial products is unclear, custodians of those assets potentially fall outside of ASIC's regulatory remit. Recognising this, ASIC is proposing to provide "good practice" guidance for REs of crypto-asset ETPs about the custody arrangements they should have in place for those assets. It has also posed in questions C1Q6 and C2Q5 whether market operators should have rules imposing custody requirements on REs of crypto-asset ETPs. We have the following concerns with those proposals:*]

- Labelling something as "good practice" connotes that it is not a requirement and that a lesser standard may be acceptable. It is also potentially confusing for investors and industry participants since it gives no indication as to whether ASIC's guidance is merely recommended practice or whether ASIC will in fact take regulatory action against those who breach the guidance.

- While good practice guidance works well with good actors, it is likely to be ignored by bad actors.

- As mentioned previously, market rules are only binding on the participants in those markets. Custodians are not participants and therefore the rules of licensed markets do not apply to them. Hence licensed market operators are not able to fill any gaps in the current regulatory framework for custodians.

- While issuers of crypto-asset fund products are subject to the rules of the market on which those products are quoted, and so theoretically market operators would be able to impose rules on them specifying requirements for their custodial arrangements, most of those issuers are directly regulated by ASIC through the AFSL regime. ASIC has a much broader array of regulatory powers it can use to impose and enforce requirements directly against those issuers without using licensed markets, with their limited powers, as a "middle-man".