

## **Avoiding the Wholesale De-banking of Australian Cryptocurrency Exchanges**

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This submission seeks to assist Australia's planning for regulating cryptocurrency exchanges ('**Crypto Exchanges**'), based on a survey of lessons from other jurisdictions regarding the issue of de-banking of Crypto Exchanges by banks. It outlines how regulation be can set, so that banks feel safe providing general services to the Crypto Exchange sector in Australia.

Those lessons from other jurisdictions and some further recommendations are outlined in **Appendix 1**. The Australian de-banking problem itself is outlined in **Appendix 2**.

### **Executive Summary**

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#### **Stage 1. Australian financial regulators and AUSTRAC should:**

1. Work together with Crypto Exchanges, to collect evidence regarding the various operating models for Crypto Exchanges.
2. Use this evidence to create:
  - a. an AML-compliance licensing regime in line with their operating model to offset the banks' AML fears. That regime should:
    - differentiate centralised and decentralised Crypto Exchanges;
    - differentiate custodian and non-custodian Crypto Exchanges; and
  - b. an AML-compliant self-certification system.
    - Crypto Exchanges could have a self-certification process akin to a Code of Custodianship learning from both "B-Corps" and Australia's Super industry.

Decentralised (and some non-custodial) Crypto Exchanges are not able to be regulated by a licensing regime, though they could opt-into a self-certification system.

#### **Stage 2. Australian financial regulators:**

1. Should hold off heavily regulating DeFi;<sup>1</sup> and
2. ASIC should consider ongoing consumer protection guidance regarding DeFi products.

In summary, AML/CTF concerns should be surmounted at the customer on-boarding stage but there should be enough regulatory room for future innovation.

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<sup>1</sup> Decentralised finance (DeFi), essentially refers to the provision of financial services without an institutional middleman, for example via a public blockchain rather than through a bank.

This licensing/certification process should help to remove specific AML/CTF fears held by banks in Australia (see **Appendix 2**), as Crypto Exchanges would be licensed or certified according to the type and nature of the Crypto Exchange to offset the banks' AML/CTF fears.

Crypto Exchanges that comply with AML/CTF must have access to bank accounts in Australia.

Regulators and Crypto Exchanges should work together to both offset 'Know Your Customer' ('**KYC**') concerns for banks (Stage 1) and create flexible guidance (Stage 2) that allow new and innovative crypto products to be launched in Australia.

## **Stage 1. Create an AML-compliant licensing regime and an AML-compliant self-certification process for Crypto Exchanges**

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### **1. Regulators should first work with crypto FinTechs to establish policies outlining the various operating models for Crypto Exchanges**

This is a diverse and dynamic industry built around a new financial technology with diverse stakeholders and motivations driving its evolution.

Policy choices that benefit the purchasers of cryptocurrencies also interest those who seek to profit from the trade of cryptocurrencies. Licensing Crypto Exchanges as AML-compliant in some form will encourage institutional money to enter the industry locally (see the US example in **Appendix 1**).

### **2. Australia's Crypto Exchanges licence regime or self-regulatory system should differentiate Crypto Exchanges**

Crypto Exchanges are not all as decentralised as Satoshi Nakamoto, bitcoin's unidentified founder(s), may have hoped. They should be regulated differently depending on how they on-board and off-ramp fiat currencies and how they operate. In creating a licensing system or self-regulatory system regulators should differentiate:

1. Centralised<sup>2</sup> and Decentralised Exchanges (DEXs);<sup>3</sup> and
2. Custodial and non-custodial<sup>4</sup> Crypto Exchanges as their systems are vastly different. Non-custodial are those exchanges where ownership of the underlying assets is never revoked and tends to live in the wallet being used.

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<sup>2</sup> See eg, Hugh Renaudin, 'Decentralized and Centralized Exchanges: Who Will Win the Race?', *Nasdaq* (Web Page, 5 November 2020) <<https://www.nasdaq.com/articles/decentralized-and-centralized-exchanges%3A-who-will-win-the-race-2020-11-05>>.

<sup>3</sup> DEX users execute transactions without intermediaries, as all transactions are authenticated by the network's community. DEXs are exchanges with no central location for the storage or management of the underlying technology. See eg Simon Taylor, 'What Is a Decentralised Exchange?', *Medium* (Blog Post, 6 August 2018) <<https://medium.com/@sytaylor/what-is-a-decentralised-exchange-e2b86e844fe9>>.

<sup>4</sup> See eg, Izgi Arda Ozsubasi, 'Non-Custodial Wallets Enable Private, P2P Crypto Trading in 2021', *AIMultiple* (Web Page, 27 April 2021) <<https://research.aimultiple.com/non-custodial-wallet/>>.

In DEXs, transactions occur in a genuinely decentralised manner, as funds are stored in a trader's own personal wallet. DEX traders pay substantially higher network fees known as 'gas' because the operational infrastructure of the exchanges requires additional steps for verification and posting transactions to the exchange network.<sup>5</sup>

It is important to note that DEX and some non-custodial<sup>6</sup> Crypto Exchanges may not be able to be regulated.

Further, DAOs<sup>7</sup> may enable DeFi applications to have a voting regime that does not require regulatory intervention. KYC requirements may already be part of the internal operations of DEXs.

Hong Kong's opt-in approach to Crypto Exchange regulation currently creates a two-tiered system allowing room for those DEX operators favouring decentralisation to 'opt-out'. Australia should study this model as well as Estonia's model in developing this regime (see **Appendix 1**).

Further, currently, if a Crypto Exchange does not handle fiat currency and only exchanges one digital currency for another digital currency, it will not be a designated service under the Australian AML/CTF Laws<sup>8</sup> and may not have access to traditional banking services. Yet Crypto Exchanges that sell DeFi products may need an AFSL authorised by ASIC to obtain banking services under that AFSL. This causes great uncertainty.<sup>9</sup>

Finally, when creating a Crypto Exchange licence regime, Australia should carefully review the Financial Action Task Force's ('**FATF**'), broad definition path of regarding Virtual Assets and Virtual Asset Service Providers ('**VASPs**') (see **Appendix 1**). This wide approach may lead to unclear regulation of Crypto Exchanges in Australia.

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<sup>5</sup> See 'What Is Gas?', *ETH Gas Station* (Web Page, 31 July 2019) <<https://ethgasstation.info/blog/what-is-gas/>>.

<sup>6</sup> DEX and non-custodial Crypto Exchanges such as Uniswap cannot be subject to regulation if there is no identifiable contact for a government official.

<sup>7</sup> Decentralised Autonomous Organisations are organisations that 'function without hierarchical management', through the interaction of users with smart contracts: see 'What Is DAO?', *Cointelegraph* (online) <<https://cointelegraph.com/ethereum-for-beginners/what-is-dao>>.

<sup>8</sup> 'Designated services' are defined under s 6 of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).

<sup>9</sup> Whether a crypto asset fits within the existing Australian financial regulatory framework depends on the particular characteristics of the crypto asset offering. Different licences may be required, depending on the nature of the Crypto Exchange. Whether a Crypto Exchange requires an Australian Financial Services Licence ('AFSL') will depend on how the exchange is structured and what digital currencies or assets are offered. If a Crypto Exchange provides a financial service, or the cryptocurrencies listed are financial products, then it will require an AFSL. DeFi products such as staking, lending and inflationary protocols will likely require an AFSL licence. Australian Securities and Investments Commission, *Initial Coin Offerings and Crypto-assets* (INFO 225, May 2019) <<https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-assets/>>. See also: James Evers, 'ASIC Wants Policy To Define "Regulatory Perimeter" for Crypto Assets', *The Australian Financial Review* (online, 22 April 2021) <<https://www.afr.com/companies/financial-services/asic-wants-policy-to-define-regulatory-perimeter-for-crypto-assets-20210422-p571f6>>.

### 3. Australia should differentiate custodian and non-custodian Crypto Exchanges, learning from the Australian super industry

Moving the crypto industry into a regulated space will mean further adoption by the giant fund managers and regulated brokers and investment banks.

Australia could learn from custodian principles in the highly and uniquely regulated Australian superannuation industry. Applying this specialised knowledge in licensing/certifying Crypto Exchanges could make Australia a leader in regulating Crypto Exchanges globally.

This means that where applicable '[p]rudent stewardship of those assets is primarily the responsibility of the trustee of each fund, but the custodian is integrally involved in both the safekeeping of the assets and the production of information flows.'<sup>10</sup> (I am working further on this issue in a larger paper).

### 4. Crypto Exchanges could have a self-certification 'Code of Custodianship'

Introducing an operating model self-certification process may properly incentivise Crypto Exchange operators to disclose material information regarding their operations such as their incorporation of centralised cryptocurrency clearing practices. Again, Australia should study the custodian principles in the Australian superannuation industry.

This Code of Custodianship could be very loosely akin to a B-Corp certification, whereby unregulated Crypto Exchanges self-certify (let's call it "C-Corp") that they meet all AML standards and open themselves up to a certification audit by their own "C-Corp" community members, thereby attracting further institutional investment.<sup>11</sup> Banks would conduct their own AML/CTF checks but this certification would provide a baseline. Japan provides a relevant reference point here (see **Appendix 1**).

Lastly, Australia should consider making all AUSTRAC registrations of Crypto Exchanges public for retail investors to view. However, Australia's system may need to evolve further.

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<sup>10</sup> For instance related to securities trade confirmations and asset valuations, necessary for the trustee to discharge its duties to members and to government bodies. Such as the Australian Prudential Regulation Authority ('APRA') and the Australian Tax Office. Custodians also increasingly provide (directly or through agents) ancillary services such as Securities lending, deposit-taking, foreign currency dealing and proxy voting. See: M Scott Donald and Rob Nicholls, 2015, 'Bank custodians and systemic risk in the Australian superannuation system', *Journal of Banking and Finance: Law and Practice*, vol. 26, p. 25.

<sup>11</sup> 'Certification Requirements', *Certified B Corporation* (Web Page, 2021) <<https://bcorporation.net/certification/meet-the-requirements>>. There are no financial services B Corps in Australia (other than ethical equity investors). A more formal licence similar to the Restricted ADI licence might be closer to a tangible option for consideration: Australian Prudential Regulation Authority, *ADI Licensing: Restricted ADI Framework* (Information Paper, 4 May 2018) <<https://www.apra.gov.au/sites/default/files/information-paper-adi-licensing-restricted-adi-framework-20180504.pdf>>.

## **Stage 2 – Observe the emergence of DeFi without over-regulating quickly**

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Light-handed regulatory policies in this space are a necessity born of the experimental blockchain technology itself. This is relevant to the wider de-banking issue as the growing market for secondary trading poses marked difficulties for developers seeking to comply with legal AML standards and/or create platforms that are truly decentralised.

It is suggested that Australian regulators hold off heavily regulating DeFi but perhaps ASIC could provide ongoing DeFi consumer protection guidance like the UK.<sup>12</sup>

Australia could look to the EU who may emerge as a leader in regulating DeFi. The task of co-ordinating numerous European jurisdictions, makes the EU regulator one to watch in 2021 and beyond. The EU's very recent regulatory changes could amount to being a gateway to mass adoption or too much regulation.<sup>13</sup>

DeFi is the new arena for the leading Crypto Exchanges, due to its highly liquid nature and the ability of DeFi products to attract new capital. The speed of liquidity associated with this evolving new development in blockchain based technologies is important to its unique popular appeal. As yields in traditional finance remain close to zero, crypto will prosper on the ability to generate attractive yield for liquidity providers.

DeFi expedites the proliferation of crypto-to-crypto exchanges. A vast ecosystem of decentralised protocols that operate at multiple levels removed from Australian dollar-denominated markets makes record keeping complex. Also, infrastructure challenges that limited early blockchain protocols are now better understood by investors as the technology matures and newer use cases emerge.

DeFi is not the same as traditional finance as users cut out the middleman and interact directly, peer-to-peer. Transaction safety is ensured by smart contract technology and flows of funds are fully auditable on chain. Transactions remain anonymous and no KYC is needed or performed.

Thus, crypto-to-crypto investments are mostly out of the reach of regulators. There is no regulation governing these products, including AML and KYC requirements. Decentralised projects are mostly operated without a licence in most jurisdictions, regardless of where the end-user is based. With regard to taxation, handling of DeFi assets remains not clearly outlined in most jurisdictions.

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<sup>12</sup> See for example a UK guidance on taxing Crypto Assets: HM Revenue & Customs, *Cryptoassets Manual* (Internal Manual, 8 April 2021) < <https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual> >.

<sup>13</sup> Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and Amending Directive (EU) 2019/1937 COM/2020/593 final <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593&ref=hackernoon.com>>; Patrick Hansen, 'New Crypto Rules in the European Union – Gateway for Mass Adoption, or Excessive Regulation?', *Stanford Law School* (Blog Post, 12 January 2021) <<https://law.stanford.edu/2021/01/12/new-crypto-rules-in-the-eu-gateway-for-mass-adoption-or-excessive-regulation/>>.

DeFi companies intentionally remain outside of regulation and in many cases it is questionable that they will submit to regulation. It will be the choice of those companies based on commercial realities and their connections with institutional investors and other stakeholders, yet a proposed self-certification system may find currency.

### **Concluding remarks**

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The blockchain protocol represents an affirmative attempt to eliminate the intermediaries that have centralised transactions.

A one-size-fits-all system may not offer a solution to address regulatory concerns in cryptocurrency markets. To attempt developing a regulatory framework for Crypto Exchanges in Australia, regulators should consider the diversity of exchanges to create clear and precise guidelines to attract jobs, funds and investment.

Australia has a vibrant community of strong and passionate supporters of a decentralised future. There are questions that should be asked by regulators, so that crypto pioneers in Australia, the believers, the sceptics and the non-committal can progress as this borderless global revolution, is born of an open source technology.

Blockchain's ideological underpinnings mean that joking memes can and will lead to unthought-of innovations and new products that re-shape lives.

Despite the differing motivations for crypto hobbyists, speculators, enthusiasts, and careerists, the architecture for the technology and blockchains such as Ethereum remain open source and will continue to develop via experimentation with digital cartoon cats and new DeFi financial products powered by liquidity on speed.

## **Appendix 1. Short summary of the applicable lessons from abroad**

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Governments and financial regulators around the world are still assessing whether and how to regulate Crypto Exchanges. Insufficient investor protection and money laundering risks pose particular concerns. Other jurisdictions are already regulating digital currency exchanges. Here is a brief summary of key findings.

**1. The Financial Action Task Force ('FATF'):** an international body that sets standards for AML/CTF, has published its updated '*Draft Guidance on a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers ('VASPs')*' ('**Draft Guidance**')<sup>14</sup> for public consultation.

The key point is that FATF considers the ranges of VASPs widely and this may offset innovation. Decentralised Exchanges (DEXs), certain decentralised application owners and operators, crypto escrow services and certain non-fungible tokens (NFTs)<sup>15</sup> are considered VASPs.<sup>16</sup>

*Key takeaway: this is a crucial point as Australia should differentiate between the spectrum of VASPs globally and the licensing paths chosen / those that avoid licensing paths.*<sup>17</sup>

*Australia would benefit from carefully reviewing FATF's path of regarding VASPs so widely, which may offset any gains in making Australia a hub of innovation. As a leading financial services market, Australia should encourage an ecosystem for developers in Australia with regulatory clarity.*

**2. Hong Kong (HK):** Some of the world's largest Crypto Exchanges operate in HK. HK created a licensing regime for Crypto Exchanges in 2018-2019. In March 2021, HK-based OSL became the first fully licensed exchange in the region, holding both type 1<sup>18</sup>

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<sup>14</sup> See Financial Action Task Force, *Draft Updated Guidance for a Risk-based Approach to Virtual Assets and VASPs*, Doc No FATF/PDG(2020)19/REV1, 19 March 2021 <<https://www.fatf-gafi.org/media/fatf/documents/recommendations/March%202021%20-%20VA%20Guidance%20update%20-%20Sixth%20draft%20-%20Public%20consultation.pdf>>.

<sup>15</sup> NFTs are digital assets that represent items such as art, GIFs and videos. NFTs contain built-in authentication and are held on blockchains.

<sup>16</sup> Stablecoins are also virtual assets and will be subject to the FATF Standards. VASPs are construed widely for the purposes of FATF's 'Travel Rule'. The 'Travel Rule' concerns the 'application of the FATF's wire transfer requirements in the VA context'. Essentially, this means that in transactions involving VA, ordering institutions must 'obtain and hold required and accurate originator information and required beneficiary information and submit the information to beneficiary institutions'. This required information includes the originator's name, account number, address/national identity number/customer identification number/date and place of birth; and the beneficiary's name and account number. The Travel Rule is yet to be legislated in Australia. See Financial Action Task Force (n 14) [155], [157].

<sup>17</sup> Crypto Exchanges with connections to Australia fall into the following categories, for example:

Pro-licencing: Eg. Independent Reserve, CoinJar, Living Room Of Satoshi.

More avoidant: Eg. Hardblock

Completely bypass licensing by being non-custodial: Eg. LocalCryptos.com.

<sup>18</sup> Type 1 licences concern securities. See OSL, 'OSL Receives License from Hong Kong Regulator, Becomes World's First SFC-Licensed, Listed, Insured & Big-4 Audited Digital Asset Trading Platform' (Press Release, 15 December 2020) <<https://osl.com/en/in-the-news/press-releases/20201215licensed>>.

and type 7<sup>19</sup> licences required for VASPs<sup>20</sup> to be fully compliant with the proposed legislation. The licences allow VASPs to manage securities and crypto assets, including the ability to list security token offerings.<sup>21</sup>

In HK, Crypto Exchanges had to opt-in to join a regulatory sandbox; build a Crypto Exchange and then demonstrate regulatory compliance to obtain a licence that could only serve professional investors.

There are plans as of May 2021 that Crypto Exchanges operating in HK will have to be licensed by the regulator and will only be allowed to provide services to professional investors.<sup>22</sup> Local HK FinTech and crypto industry associations have opposed regulation stopping exchanges from offering services to retail investors, warning this would drive exchanges out of HK and push investors onto unregulated venues.

*Key takeaway: HK's approach is currently an opt-in approach (though this may change). Crypto Exchanges can choose to be licensed. This should be considered in Australia as a way to encourage the bigger players to have a regulatory edge for attracting institutional investors.*

*However, only allowing regulated Crypto Exchanges to serve professional investors like HK is problematic. The definition of 'professional investor' is very important in this speculative and highly volatile market.*

*Stopping local retail investors investing in Australian crypto products will slow product experimentation. Crypto Exchanges have a strong retail investor base that need guardrails but investors have continued to invest in unregulated markets regardless.*

**3. Singapore:** Crypto Exchanges must register under the Accounting and Corporate Regulatory Authority in the city-state. Then the licence for the exchange must be issued by Monetary Authority of Singapore ('**MAS**') under the Payments and Services Act licence. Crypto Exchanges can have retail investors as clients.

*Key takeaway: there are 3 types of licences available for Crypto Exchanges domiciled in Singapore. They are organised according to the amount of money being transacted per month or day.<sup>23</sup> This could also be considered for an Australian AML-CTF licensing*

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<sup>19</sup> Type 7 licences concern automated trading service regulated activities. See OSL, 'OSL Receives License from Hong Kong Regulator, Becomes World's First SFC-Licensed, Listed, Insured & Big-4 Audited Digital Asset Trading Platform' (Press Release, 15 December 2020) <<https://osl.com/en/in-the-news/press-releases/20201215licensed/>>.

<sup>20</sup> This phrase emanates from FATF for businesses that provide crypto services to customers.

<sup>21</sup> 'Obtaining License for Cryptocurrency Exchange in Hong Kong', *Law & Trust International* (Web Page) <<https://lawstrust.com/en/licence/finance/crypto-license/hong-kong/>>; Sam Reynolds, 'Hong Kong's New Crypto Exchange Laws Will Be Embraced—with VPNs', *Forkast* (Web Page, 5 November 2020) <<https://forkast.news/hong-kongs-new-crypto-exchange-laws-will-be-embraced-with-vpns/>>.

<sup>22</sup> Alun John, 'Hong Kong to Restrict Crypto Exchanges to Professional Investors', *Reuters* (online, 21 May 2021) <<https://www.reuters.com/technology/hong-kong-restrict-crypto-exchanges-professional-investors-2021-05-21/>>.

<sup>23</sup> Those wishing to obtain a licence must fulfill the following requirements, no matter which licence is chosen: Have an office in Singapore; Comply with the FATF 'Crypto Travel Rule'; Comply with comprehensive AML/CFT requirements and reporting duties; Pay annual fees; and have an administrative structure, including a CEO, a chairperson and a board of directors.

regime.

**4. United States (US):** Trading of cryptocurrencies is regulated at both federal and state levels in the US. AML compliance and other US Federal regulations must be followed. In March 2021, the Treasury Department announced that it will require any transfer worth USD\$10,000 or more to be reported to the IRS.<sup>24</sup>

In May 2021, JP Morgan took the lead in banking US Crypto Exchanges. One bank could fill that void in Australia. Perhaps by working with regulators to create a regulatory sandbox, one bank could come forward and take a commercial advantage in the space. If an Australian bank is unwilling, then perhaps ING or a bank with connections to Europe or other regulatory jurisdictions may lead the way.

*Key takeaway: the US approach is to stop the wholesale de-banking of an industry.<sup>25</sup> JP Morgan and parts of the private sector have embraced the commercial opportunity. This is a big victory for US-based crypto entrepreneurs previously at risk of de-banking.*

**5. United Kingdom (UK):** Crypto Exchanges need to register with the Financial Conduct Authority ('FCA'). The UK government created a dedicated taskforce in 2018 to deal with cryptocurrencies. That taskforce defined three types of cryptocurrencies and three ways in which crypto assets are used.<sup>26</sup> There is an additional requirement for AML/CFT and taxation considerations.

*Key takeaway: The regulator outlines categories of tokens which are and which are not subject to regulation.<sup>27</sup> This submission suggests licensing Crypto Exchanges according to their type. The UK taxonomy offers guidance about existing crypto products. The UK regulator also provides regular guidance on crypto industry developments and these guidances should be followed closely.<sup>28</sup>*

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<sup>24</sup> US Department of the Treasury, *The American Families Plan Tax Compliance Agenda* (Report, May 2021) 21 <<https://home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf>>.

<sup>25</sup> Recent legislation in Wyoming includes the creation of 'special purpose depository institutions' as a new form of bank. Wyoming-chartered special purpose depository institutions ('SPDIs') are banks that receive deposits and conduct other activity incidental to the business of banking, including custody, asset servicing, fiduciary asset management, and related activities. SPDIs will likely focus on digital assets, such as virtual currencies, digital securities and digital consumer assets. Legislation adopted 4 May 2021, effective 1 July 2021 – see *Digital Assets-Amendments*, ch 91, 2021 Wyo Sess Laws <<https://www.wyoleg.gov/Legislation/2021/HB0043>>.

<sup>26</sup> The taskforce identified three different types of cryptocurrencies—exchange tokens, utility tokens, and security tokens—and considered that crypto assets are used in three different ways:

1. As a means of exchange, functioning as a decentralised tool to enable the buying and selling of goods and services, or to facilitate regulated payment services.
2. For investment, with firms and consumers gaining direct exposure by holding and trading cryptoassets, or indirect exposure by holding and trading financial instruments that reference cryptoassets.
3. To support capital raising and/or the creation of decentralised networks through Initial Coin Offerings (ICOs).

These purposes are not mutually independent, and the type of cryptocurrency may change.

<sup>27</sup> 'Regulatory Approaches to Cryptoassets: United Kingdom', *Library of Congress* (Web Page, 30 December 2020) <<https://www.loc.gov/law/help/cryptoassets/uk.php>>;

'Cryptocurrency Regulations in the UK', *Comply Advantage* (Web Page)

<<https://complyadvantage.com/knowledgebase/crypto-regulations/cryptocurrency-regulations-uk-united-kingdom/>>.

<sup>28</sup> The Kalifa Review of Fintech was published on 26 February 2021 and made several recommendations to the UK government regarding the regulation of crypto assets and international engagement.

**6. Estonia:** Estonia is considered one of the pioneers to have introduced legalisation for blockchain and crypto-based businesses. Since 10 March 2020, one can apply for a single cryptocurrency licence<sup>29</sup> and provide services for the storage and exchange of cryptocurrencies.<sup>30</sup> Two different services fall into this category: a virtual currency wallet service provider and a virtual currency exchanger.<sup>31</sup>

1. Crypto wallets and custodian services
  - The first category of services includes the generation and storage of encrypted customer keys.
2. Crypto Exchanges
  - The second category of services is the cryptocurrency exchange for fiat money or vice versa, or cryptocurrency for another cryptocurrency.<sup>32</sup>

*Key takeaway: a single cryptocurrency licence is an official permission to conduct a regulated cryptocurrency business in Estonia. A key recommendation is that Australia look at Estonia's model for regulating Crypto Exchanges, custodial and non-custodial distinctions should be made.*

**7. South Korea:** In April 2021 it was reported that no Crypto Exchanges had applied for South Korea's VASP licence.<sup>33</sup> The most important qualification for VASP registration in South Korea is an official partnership with a local commercial bank. Out of the some 200 exchanges in South Korea only the country's four largest Crypto Exchanges, known as the 'Big 4', have established banking partnerships so far.<sup>34</sup>

*Key takeaway: this provides some evidence that governments should not force a relationship between a Crypto Exchange and a commercial bank.*

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The introduction of 'a new UK regime for the regulation of cryptoassets' falls under the Kalifa Review's Recommendation 1.2.2 'Promote the digitisation of financial services'. A 'functional and technology-neutral approach' to the regulation of cryptoassets is recommended, starting with focussing on the use of stable tokens as a means of payment, before considering further cryptoasset market actors or tokens. See HM Treasury, *Kalifa Review of UK Fintech: Final Report* (Report, February 2021) 30 <[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/978396/KalifaReviewofUKFintech01.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978396/KalifaReviewofUKFintech01.pdf)>.

<sup>29</sup> The National Financial Intelligence Unit (FIU, or *Rahapesu Andmehüroo*, RAB) is responsible for granting a crypto-license in Estonia. For activities in the field of crypto services, in accordance with the Law on the Prevention of Money Laundering and the Financing of Terrorism, a license called a *single cryptocurrency licence* is required.

<sup>30</sup> To commence a crypto exchange business in Estonia, the exchange must be registered under Estonia or a registered branch office in Estonia, follow KYC procedures, etc. Also, the exchange must obtain a license under MLTFPA ( Money Laundering and Terrorist Financing Prevention Act).

<sup>31</sup> Previously, they required two different licences, now merged into the *Virtual Currency Service Provider Licence*.

<sup>32</sup> Using the terminology from the *Money Laundering and Terrorist Financing Prevention Act 2017* (Estonia) <<https://www.riigiteataja.ee/en/eli/ee/511122019005/consolide/current>>, § 70(1)4 provides that an 'authorisation' is required for 'providing a virtual currency service'.

<sup>33</sup> Felix Im, 'South Korea's Top Financial Regulator Suggests All Crypto Exchanges Could Be Shut Down', *Coindesk* (online, 24 April 2021) <<https://www.coindesk.com/south-koreas-top-financial-regulator-suggests-all-crypto-exchanges-could-be-shut-down>>.

<sup>34</sup> *Ibid*.

8. **Canada:** Crypto Exchanges are subject to the Canadian securities law. AML and money services business laws are also applicable to Crypto Exchanges operating in Canada, or with Canadian clients.<sup>35</sup>

*Key takeaway: regulating Crypto Exchanges as money services business ignores the different types of Crypto Exchanges ie DEXs. A technology-neutral approach may not be beneficial.*

9. **Japan:** Japan has a progressive regulatory atmosphere for Crypto Exchanges. The exchanges have to be registered with Japan's FSA (Financial Services Agency). Crypto Exchanges must establish a separate institution that will operate under the Virtual Currency Exchange Licence in order to handle virtual currencies.<sup>36</sup>

*Key takeaway: banks are not allowed to handle any business that has to do with cryptocurrencies. In Japan, a virtual currency exchange should establish a self-regulatory organisation that is certified by the FSA.<sup>37</sup> Australia should consider this approach as self-regulation may amount to soft-law or quasi legality for Crypto Exchange operators seeking institutional investors.*

10. **Switzerland:** Cryptocurrency exchanges are legal in Switzerland as long as they are licensed and regulated by the Swiss financial regulator FINMA.<sup>38</sup> Crypto Exchanges have two different licences to choose from: a FinTech Licence and a Banking Licence.

It is a technology-neutral approach.<sup>39</sup> For example, some sections of the *Act to Adapt Federal Law to Developments in Distributed Ledger Technology ('DLT Act')*, which entered into force on 1 February 2021, serve to 'establish a legal basis for the trading of rights through electronic registers, provide rules for the segregation of crypto-based assets in the event of bankruptcy, and add a new licence category for distributed ledger technologies ('DLT') trading systems.'<sup>40</sup>

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<sup>35</sup> Eva Markowski Belmont, 'Why Canada's Regulatory Crackdown on Unregistered Cryptocurrency Exchanges Is Good News for Investors', *Siskinds* (Blog Post, 13 April 2021) <[https://www.siskinds.com/canadas-regulatory-crackdown-on-unregistered-cryptocurrency-exchanges/?utm\\_source=Mondaq&utm\\_medium=syndication&utm\\_campaign=LinkedIn-integration](https://www.siskinds.com/canadas-regulatory-crackdown-on-unregistered-cryptocurrency-exchanges/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration)>.

<sup>36</sup> The only exception made for banks that handle cryptocurrencies is that the cryptocurrency business should be peripheral. 'License for Virtual Currency Exchange Services', *SME Japan* (Web Page) <<https://www.smejapan.com/japan-business-guides/company-incorporation-summary/business-licenses-in-japan/license-for-virtual-currency-exchange-services/>>.

<sup>37</sup> The Financial Services Agency is a Japanese government agency and an integrated financial regulator responsible for overseeing banking, securities and exchange, and insurance sectors.

<sup>38</sup> The Swiss Financial Market Supervisory Authority or 'FINMA' is Switzerland's financial regulatory authority overseeing Switzerland's financial markets and service providers.

<sup>39</sup> In its *"Payments on the Blockchain"*, FINMA provides information about this technology-neutral application of the regulation to payment transactions on the blockchain. Financial Institutions under the regulatory authority of FINMA are only allowed to transfer crypto assets to other wallets (such as self-hosted wallets) that are owned by a beneficiary whose ID has already been KYC verified. Financial Institutions are also only allowed to receive digital assets from these customers. See FINMA, *Payments on the Blockchain* (Guidance 02/2019, 26 August 2019) <<https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/4dokumentation/finma-aufsichtsmittelungen/20190826-finma-aufsichtsmittelung-02-2019.pdf?la=en>>.

<sup>40</sup> Jenny Gesley, 'Switzerland: New Amending Law Adapts Several Acts to Developments in Distributed Ledger Technology', *Library of Congress* (Web Page, 3 March 2021) <<https://www.loc.gov/law/foreign-news/article/switzerland-new-amending-law-adapts-several-acts-to-developments-in-distributed-ledger-technology/>>.

This legislative amendment increases legal certainty by prescribing specific laws for the regulation of DLT (although the legislation does not use the term DLT, but rather provides a description of the characteristics of DLT), whereas previously more general law was applied to regulate the transfer of DLT rights.

*Key takeaway: Australia should reject a technology-neutral approach. This submission has advocated for an approach that understands Crypto Exchanges and distinguishes them accordingly, rather than a technology-neutral approach.*

**11. Thailand:** As of July 2021 Crypto Exchanges must verify their customers' identities through a 'dip-chip' machine that requires clients to be physically present.<sup>41</sup>

*Key takeaway: this is an example of an AML requirement Australia could consider in Stage 1.*

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<sup>41</sup> Kevin Helms, 'Thailand's New Cryptocurrency Regulation Requires Users To Be Physically Present To Open Accounts', *Bitcoin.com* (online, 3 May 2021) <<https://news.bitcoin.com/thailands-new-cryptocurrency-regulation-requires-users-physically-present-to-open-accounts/>>.

## **Appendix 2. Background: The Australian Crypto Exchange De-Banking Problem**

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De-banking is the removal of banking services to a company by a bank. Banks can withdraw banking services from a business and surrounding personal accounts for various reasons such as money laundering and criminal conduct. Banks are, understandably, highly sensitive to the reputational damage that accompanies being implicated in a money laundering or terrorist financing incident. Currently under Australia's anti-money laundering and counter-terrorism financing ('**AML/CTF**') laws, banks have a broad discretion to close bank accounts.

Australia's *AML/CTF Act*<sup>42</sup> does not impose requirements on a reporting entity to close accounts or terminate a business relationship, yet a bank may need to make a compliance decision on the risks of banking a particular business. This provides banks with a level of autonomy in their initial compliance decision-making.

Under the AML/CTF regime, individual reporting entities<sup>43</sup> must make their own risk-based decisions on how best to identify, mitigate and manage AML/CTF concerns. This may involve account closures in some high-risk cases. There are ongoing concerns about the possible de-banking of remitters and Crypto Exchanges on AML/CTF grounds from regulators.

Crypto Exchange operators should also be registered with AUSTRAC for AML/CTF compliance. There are believed to be about 450 Crypto Exchanges operating in Australia.<sup>44</sup>

### **The AML/CTF regime in practice**

The broad discretion afforded to Australian banks to de-bank may conflict with Australia's Open Banking aspirations that seeks to make banking products more competitive for consumers.

There are potential competition issues relating to industry-wide bank account closures. However, de-banking where non-bank firms that compete with banks are being dropped as clients by traditional banks, often citing risk or regulatory concerns, is potentially anti-competitive behaviour. De-banking occurs in the sense that FinTechs have been stopped from gaining access to the payment infrastructure because they pose a commercial threat to the major banks.

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<sup>42</sup> *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) ('*AML/CTF Act*').

<sup>43</sup> A 'reporting entity' is defined by the *AML/CTF Act* to mean a person who provides a financial service, bullion, gambling service, or prescribed service, as designated by the *AML/CTF Act*: see *AML/CTF Act* (n 42) ss 4 (definition of 'reporting entity'), 6.

<sup>44</sup> Dominic Powell, 'Trading Bitcoin without Protection: Crypto Exchanges in Regulatory Hole', *The Sydney Morning Herald*, (online, 29 March 2021) <<https://www.smh.com.au/business/companies/trading-bitcoin-without-protection-crypto-exchanges-in-regulatory-hole-20210527-p57vix.html>>.

This commercial threat to banks is real. For some crypto assets, the transfer of assets is processed for a few cents. A bank transfer can often cost two hundred dollars for that same transfer.

So too is the AML/CTF risk for banks. In recent years Australian banks have faced major fines for breaching anti-money laundering and anti-counter-terrorism financing rules.<sup>45</sup> Further, Australia's 'Big 4' banks are all Australian Stock Exchange listed entities, (and with high retail share ownership in Australia), and they may be unwilling to take a risk on the Crypto Exchange industry without regulatory guidance. Regulatory guidance should, as a result, be drafted in a way that is consistent with the *AML/CTF Act*.

As it stands, Adrian Przelozny, CEO of Australian Crypto Exchange, Independent Reserve suggested that 'you're basically relying on people doing the right thing just because they want to do the right thing'.<sup>46</sup>

Nevertheless, a refusal to supply banking services to the Australian Crypto Exchange industry could also create a regulatory risk for the banks. Such refusal to supply could amount to an abuse of a dominant market position by one or more of Australia's major banks.<sup>47</sup> This regulatory uncertainty could make Australia an unattractive destination for an innovative Crypto industry to grow further.

The ABA<sup>48</sup> concurred with the ACCC<sup>49</sup> finding that the denial of bank services to non-bank suppliers (de-banking) should be addressed by the adoption of 'a scheme through which international money transfers suppliers can address the due diligence requirements of banks, including in relation to AML/CTF requirements' and that the proposed regulation should be globally consistent.<sup>50</sup>

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<sup>45</sup> See eg AUSTRAC, 'AUSTRAC and Westpac Agree to Proposed \$1.3bn Penalty' (Media Release, 24 September 2020) <<https://www.austrac.gov.au/news-and-media/media-release/austrac-and-westpac-agree-penalty>>; AUSTRAC, 'AUSTRAC and CBA Agree \$700m Penalty' (Media Release, 4 June 2018) <<https://www.austrac.gov.au/austrac-and-cba-agree-700m-penalty>>.

<sup>46</sup> Powell (n 44).

<sup>47</sup> Essentially, the test is whether the refusal of a service will lead to a 'substantial lessening of competition' in a relevant market. The entity refusing to supply a service must have 'substantial market power' but more than one bank could have substantial market power concurrently (*Competition and Consumer Act 2010* (Cth) s 46).

<sup>48</sup> The Australian Banking Association is the trade association for the Australian banking industry.

<sup>49</sup> The Australian Competition and Consumer Commission is the competition regulator in Australia.

<sup>50</sup> The Senate Select Committee on Australia as a Technology and Financial Centre, *Second Interim Report* (Report, 2021) [5.53]

<<https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Freportsen%2F024560%2F0008;query=Id%3A%22committees%2Freportsen%2F024560%2F0000%22#fn75>>.