30 June 2021

To the attention of:

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

Email: fintech.sen@aph.gov.au

Subject: Submission to Third Issues Paper

Dear Committee

We refer to the Third Issues Paper ("the Paper") published by the Committee on Australia as a Technology and Financial Centre (the "Committee") seeking industry feedback on the economic opportunities posed by blockchain technology and digital asset technology in particular, policy enhancement areas for the development of a comprehensive regulatory framework for cryptocurrency and digital assets.

We appreciate the opportunity to provide our industry perspective and share our experience as a global cryptocurrency exchange. Blockchain technology and virtual assets hold the promise of having a far-reaching impact on the financial services sector, bringing both opportunities for innovation and new risks. Technological innovation is one of the most influential developments currently affecting the financial sector.

Blockchain technology and virtual assets have the potential to test the boundaries of regulation. New technologies within this very nascent industry develop rapidly outside of traditional regulatory barriers. In the absence of internationally-agreed standards, regulators globally are challenged to develop an appropriate response. The highly dynamic nature of the cryptocurrency space requires ongoing refinements to regulations and supervision to ensure an appropriate balance between opportunities and risks. But ultimately the biggest challenge for policy makers in adopting a regulatory approach for blockchain technology and virtual assets is to ensure that regulations are both effective and efficient: effective in the sense that they resolve the problem they were introduced to address and efficient in the sense that they minimise both the direct compliance costs borne by those subject to the regulation and other costs which may be imposed on the public.

In many instances, the response by governments to the need to regulate a new industry is often to apply by default existing regulatory regimes that are not necessarily suitable to address the risks associated with a new ecosystem as the one that blockchain technology and virtual assets present. We encourage policy makers to carefully assess the risks that virtual assets pose and consider alternative regulatory approaches that are 'fit-for-purpose'. Striking the right balance between innovation and safety and soundness will be

critical in developing a regulatory framework befitting for the Australian market and to successfully achieve the goals that the Committee has set in the Paper.

In the table below, we provide an overview of our observations and recommendations pertaining to some of the most widely discussed regulatory matters around virtual assets, while simultaneously seeking for further guidance to provide regulatory certainty and ultimately promote compliance.

Compliance Area	Observations & Recommendations
1. Licensing regime	❖ Existing licensing/registration regime for Digital Currency Exchanges ("DCEs") are adequate. ❖ DCEs should only be regulated to address money laundering ("ML"), terrorism financing ("TF") and sanctions risks only. ❖ Cautious approach to the application of user protection measures or ring-fencing requirements to DCEs given the challenges that the industry faces to a) obtain 'Professional Indemnity Insurance'; and b) the de-banking approach adopted by Financial Institutions globally. ❖ Need for further guidance with regards to the application for an Australian Financial Services ("AFS") license, including the process and timeline. ❖ DCEs might face major challenges to comply with certain requirements imposed on AFS licenses (e.g. compensation requirements given the reluctance of insurance companies to underwrite the crypto space). ❖ Definitions of financial products set out in Info Sheet 225 are very broad and generate regulatory uncertainty. Need for a more detailed guidance as to how this would apply to different types of digital assets.
2. Travel Rule	❖ Need for a phased-approach regarding the implementation of the Travel Rule ❖ Set a reasonable timeline for the industry to comply with the Travel Rule ❖ Acknowledge the challenges associated with the implementation of a Travel Rule solution. ❖ Focus for the time being on transactions between VASPs only in line with the Financial Action Task Force ("FATF") guidance.
3. Stablecoins	❖ Development of a flexible, efficient and inclusive approach for the application of new and existing regulations for stablecoins ❖ Only a limited number of stablecoins should fall within the definition of 'e-money' or 'non-cash payment facility', provided that certain conditions are met. ❖ Where some or all stablecoins/other digital assets are classified as a financial product, regulators should advise whether the Travel Rule applies to these assets in line with the latest draft guidance from FATF.
4. Crypto derivatives	❖ Futures contracts referencing digital assets that are not considered a financial asset should not fall within ASIC's regulatory perimeter, in line with the regulatory approach adopted by other regulators.

These topics have been covered in detail below.

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1. Adequacy of the existing registration/licensing regime applicable to DCEs

We are of the view that the existing licensing/registration regimes in place for DCEs in Australia are sufficient and adequate and thus no additional licensing framework is required for the time being.

According to the FATF guidance, DCEs or the so-called virtual assets service providers ("VASPs") must be subject to licensing or registration requirements to enable governments and regulators to have effective oversight of VASPs for the purpose of mitigating ML/FT and sanctions circumvention risks. The AUSTRAC registration process for DCEs is in line with this FATF recommendation.

In addition, where the DCE provides a financial service as defined by the Corporations Act 2001, the DCE is subject to AFS licensing requirements. Other regulators such as Singapore's Monetary Authority of Singapore ("MAS") have also adopted a similar regulatory approach whereby VASPs are subject to AML/CFT & sanctions oversight only, unless the VASP is also providing products and services that fall within the securities laws umbrella, in which case the relevant VASP is required to apply for a license under the Securities and Futures Act ("SFA"). The Committee might have observed that the MAS has taken the view that VASPs should only be regulated for ML/TF and sanctions (except for those also subject to securities laws), as opposed to imposing user protection measures on VASPs, establishing the requirement to ring-fence customer funds, regulating VASPs for technology risks or any other areas of regulatory compliance. The MAS has previously explained that this is due to the fact that the cryptocurrency space is still a fairly nascent industry and subjecting VASPs to unduly burdensome regulatory requirements might stifle innovation. We recommend a balanced regulatory approach similar to the one that the MAS has adopted for VASPs, particularly considering the 'de-risking' approach undertaken by Financial Institutions globally, including the challenges to obtain Professional Indemnity Insurance.

However, it will be critical that the industry has a clear understanding on how the existing ASIC regulations will be applied to DCEs and in particular the following areas would require further guidance:

a) **Lack of clarity regarding the AFS licensing process and how it would be applied to DCEs.**
ASIC has stated that entities that provide a financial service in issuing financial products that involve virtual assets may require a new AFS license or a license variation, such as a new product authorisation. ASIC has further stated that applications for crypto-asset related financial products are more likely to be novel applications and that the assessment may take more time. *In our view, the industry needs a defined framework to streamline the licensing process so that new products can be offered in the local market within a reasonable timeline and without being subject to undue regulatory scrutiny.*

b) **A "one-fits-all" AFS licensing regime might not be adequate for DCEs that wish to offer financial products that involve virtual assets.**
DCEs face major challenges to comply with certain regulatory provisions established by ASIC such as compensation requirements under s912B with regards to the Professional Indemnity Insurance. We are cognisant that concerns regarding the integrity of cryptocurrency markets are a hurdle to mainstream and institutional adoption of digital assets, which may also be a key concern for regulators. Thus, we are overall supportive of compensation obligations to mitigate the risks and vulnerabilities associated with the space such as hacking, potential technical errors, fraud and other similar circumstances. These measures could have a positive impact in the ecosystem and

overall adoption of digital assets. However, the biggest constraint to comply with these requirements is the reluctance of the insurance sector to underwrite exposures in cryptocurrency and digital assets as a whole - this is likely a business decision as opposed to a regulatory limitation for insurers. *As such, DCEs should be provided alternatives to comply with those compensation obligations, having in mind the risks and vulnerabilities mentioned above*.

c) **Application of Info Sheet 225 to stablecoins and tokens.**
The definitions of 'managed investment scheme', derivatives, securities and 'non-cash payment facilities' are very broad and almost guarantee that all stablecoins and tokens fall within the regulatory framework set out in Info Sheet. There is a risk that, where DCEs are unable to determine whether a specific token may trigger an AFS licensing requirement, that such asset is not ultimately offered in the local market to protect from regulatory breaches, unless the DCE has obtained an AFS license. Further regulatory clarity on this subject would have a great impact on the product offering as otherwise would likely exclude Australians from having access to a large number of virtual assets that are being offered elsewhere. *We suggest that Info Sheet 225 is updated to allow for a flexible framework for assessing stablecoin/tokens. See section 3 of this paper for further comment.*

2. Implementation of Travel Rule requirements

We are of the view that policy makers in Australia should adopt a phased-approach to the implementation of the Travel Rule as a country requirement and should cooperatively engage with the industry to ensure that it will be satisfactorily operationalised by DCEs in an inclusive manner.

In June 2019, the FATF provided guidance to countries for the implementation of the so-called 'Travel Rule' (i.e. Recommendation 16 of the FATF Standards on virtual assets) which requires VASPs to collect and securely transfer originator and beneficiary information associated with cryptocurrency transactions between VASPs.

In July 2020, FATF highlighted the fact that some progress could be observed in the development of technological solutions to enable the implementation of the Travel Rule for VASPs, even though there remain issues to be addressed by the public and private sectors. The FATF expectation was that by July 2021 jurisdictions would have had time to implement travel rule solutions globally. However, the vast majority of the FATF member countries are yet pending the transposition of Recommendation 16.

It is noted that AUSTRAC has recently announced that the Australian government is weighing how it can extend AML/CFT regulation to cryptocurrencies, including whether to implement FATF's Travel Rule. While this decision would be aligned with the approach adopted by other jurisdictions such as Singapore and Switzerland, AUSTRAC must be cognisant of the challenges associated with the implementation of this Recommendation and therefore provide a reasonable timeline for the industry to comply with the Travel Rule. Herein we detail some of them:

a) The Travel Rule requirements vary significantly across countries:

- Different transaction thresholds for reporting (e.g. USD3,000 in the US - to be presumably changed to USD250, 1,000CHF in Switzerland, SGD1,500 in Singapore).

- Collection and transfer of data requirements may vary: for instance in the US it is only required to collect and share the transaction data with the counterparty VASP for transactions above the stipulated threshold, while in Singapore data must be collected and transfer irrespective of the threshold, although for transactions above SGD1,500 additional data is required to comply with the Travel Rule.
- Data retention requirements may differ, including number of years for record keeping - in some jurisdictions all transaction data collected in compliance with the Travel Rule requirements must be retained, while in others it may only require to retain beneficiary data above certain thresholds and/or depending on whether the transaction is cross border or not.
- In some jurisdictions, proof of ownership of non-custodial wallets has also been implemented as part of Travel Rule compliance or have attempted to do so. Establishing such a requirement virtually guarantees that the evidence available to law enforcement today will be placed outside their reach tomorrow.

b) Lack of regulatory guidance may lead to a substantially different operationalisation of requirements at the reporting entity level.

c) Data privacy regulations may be in conflict with Travel Rule requirements. There are certain countries such as Japan where international data sharing poses a major challenge for Travel Rule compliance. Regulators must ensure that country regulations are not conflicting to prevent reporting entities being in breach of local regulatory obligations.

d) Sunrise problem: As stated above, to date only a few FATF member countries have implemented the Travel Rule as part of their country regulations, while the vast majority have adopted a more cautious approach pending additional FATF guidance. This has resulted in the inconsistent implementation of the Travel Rule across countries bringing additional challenges for VASPs to comply with the Travel Rule when the counterparty of a transaction is potentially linked to a VASP in a country that is yet not required to comply with the Travel Rule. This requires VASPs in Travel Rule compliant countries to develop frameworks that determine whether the VASP shall “accept, reject or suspend” a transaction where there is missing counterparty information. As it would be expected, each VASP may adopt a very different approach.

e) The practical effect of pushing the Travel Rule forward is that for each transaction the relevant VASP is required to conduct a pre-screening of the wallets involved in the transaction to identify whether the counterparty wallet is a hosted or non-hosted wallet. Where the counterparty wallet is a hosted wallet, the VASP must further discern whether the wallet is from a jurisdiction that is in compliance with sanctions regulations, but also whether it is in a jurisdiction that has implemented the Travel Rule. This screening process relies on third-party blockchain analytics providers. Additionally, this system requires integration with a Travel Rule solution which assists in identifying whether the counterparty VASP has implemented the same Travel Rule solution or one that is interoperable with the Travel Rule solution implemented by the relevant VASP in order to transfer the transaction data. This requires advanced integrations with 3rd party service providers in a real-time manner, including corresponding connections to core transaction processing systems and user interface touchpoints to ensure the correct workflow processes– a major undertaking for any VASP’s product and engineering teams.

f) There are also technical limitations associated with the implementation of the Travel Rule. For instance, where the wallet of a counterparty of a transaction is hosted by a VASP that has not transferred the relevant data to the beneficiary institution, the receiving VASP, in an attempt to comply with the Travel Rule, must determine whether the virtual assets can be credited to the customer's wallet, freeze those assets, or whether the transaction should be rejected. If the beneficiary VASP decides that the transaction should be rejected, the assets are to be refunded to the originating VASP, and it could occur that the sending wallet address is not configured to receive any assets - this is indeed very common in the cryptocurrency space where wallet addresses are generated for a single transaction. Given that it is not possible to identify whether the sending address is configured to receive any assets or not, the beneficiary VASP would be unable to refund the assets to the relevant wallet address as doing so could pose legal liability if the assets are 'sent back' and eventually lost.

g) There are a number of vendor solutions in the market that seem to assist with Travel Rule compliance. The biggest concern associated with this is that VASPs are integrating different solutions globally which present interoperability challenges and thus, it would impair the effectiveness of the solution and overall compliance with regulatory requirements.

The need to ensure consistency with other regulatory arrangements across jurisdictions is paramount. In addition, the industry has joint efforts to develop solutions that can operationalise the Travel Rule requirements, yet the effectiveness of these solutions require 'network effect', that means that the effectiveness of any of the market solutions to date will depend not only on the technical features of the solution to satisfy regulatory requirements across countries but also on the degree of adoption by VASPs globally and the interoperability with any other solutions in the market.

3. Regulatory approach to Stablecoins

We are of the view that ASIC should adopt a flexible, efficient and inclusive approach for the application of new and existing regulations for stablecoins and that not all stablecoins fall necessarily within ASIC's regulatory parameter.

No internationally agreed taxonomy or classification of crypto assets exists to date, including no commonly agreed definition of stablecoins. The Financial Stability Board (the "FSB") has stated that the so-called stablecoins are a type of crypto-asset '*that aims to maintain a stable value relative to a specific asset, or a pool or basket of assets to other assets*'[1].

The regulatory approach that lawmakers and regulators have adopted across different jurisdictions varies in terms of scope and substance. Depending on the features of the asset, stablecoins may fall into different regulatory classifications - it could be a financial product such as a security or a derivative, including a managed investment scheme, it could also be considered 'e-money', or a crypto asset outside of ASIC's regulatory perimeter similarly to a 'digital payment token' under Singapore's Payment Services Act ("PSA") 2019 or an 'unregulated token' under the UK's FCA regulatory framework.

[1] FSB addressing the regulatory, supervisory and oversight challenges raised by "global stablecoin" arrangements: Consultative document, April 2020

The design features of the stablecoin may vary depending on whether the stablecoin is backed by any assets (e.g. by fiat currencies or a basket of assets, including commodities), whether the value of the stablecoin is pegged to one or more fiat currencies, a commodity, etc. or whether the price is stabilised using an algorithm to increase or decrease the supply as needed to maintain a stable price. Other features of the stablecoin are based on the redemption rights or nature of the claim against the issuer that the stablecoin holder has (e.g. whether the holder has any legal rights to the assets held in reserve, if any).

ASIC has provided regulatory guidance detailed in Information Sheet 225 ("Info Sheet 225") which establishes the obligations under the Corporations Act 2001 ("Corporations Act") and the Australian Securities and Investments Commission Act 2001 ("ASIC Act") applicable to, inter alia, stablecoins. As a general rule, it is stated that a stablecoin constitutes a financial product if it involves a managed investment scheme, a security, a derivative or a non-cash payment facility. Where a stablecoin is, or could be, considered a financial product, this may trigger the requirement to hold an AFS License.

Stablecoins & e-money

Only stablecoins that are used for making payments that are widely accepted by third party merchants, other than the issuer should probably be classified as 'e-money' or as a 'non-cash payment facility', and thus qualify as a financial product. This type of stablecoin would be aligned with the so-called global stablecoin arrangement that has the potential to generate financial stability risks, as stated by the FSB.

Some lawmakers are of the view that stablecoins fulfill the definition of 'e-money' and should be subject to the regulatory regime applicable to 'e-money'. Under ASIC's regulatory framework, e-money is considered a financial product which is covered under Regulatory Guide 185 on 'non-cash payment facilities' ("RG 185").

E-money is commonly understood as a digital representation of fiat currency used to electronically transfer value that has a legal tender status. This is the reason why e-money has been configured to be used as follows: a consumer purchases e-money from a business to enable such a user to make money transfers or purchase goods or services from participating individuals and merchants which accept such e-money. Indeed, e-money stands as an excellent instrument that serves as cash replacement in the wake of e-commerce and online transactions.

Similarly, stablecoins have the potential to be used for making payments in a wide variety of contexts without first being converted to fiat currency, or even to another virtual asset (e.g. bitcoin) and substitute fiat currency in acting as a store of value that can be saved, redeemed and exchanged for fiat currency. The use of such stablecoin must be adopted by third parties other than the issuer and must be widely adopted in order for such stablecoin to operate as 'e-money'. This type of stablecoin would be in line with the type of 'global stablecoin arrangements' that the FSB refers to in its consultative document issued on 14 April 2020[2]. In the abovementioned consultative document, the FSB raises awareness as to how such types of global stablecoin arrangements have the potential to generate wider issues, from challenges to governments' currency monetary policy to data privacy concerns, including competition and taxation issues. For stablecoins to be accepted as a viable alternative to fiat currency, and therefore to be classified as 'e-money', they must first integrate into our current financial and payment infrastructure and ensure that

[2] FSB Paper on Stablecoins April 2020

where it is widely adopted and has the potential to generate financial stability risks that such stablecoin is subject to stricter global regulation.

The first generation of crypto assets (e.g. bitcoin) have not consolidated their use as a payment or medium of exchange - the price volatility has played a key role in raising some skepticism among the public from that perspective. Ultimately, any stablecoin is intended to offer price stability relative to any other crypto asset and increase transparency while reducing the transaction fees inherent to fiat currency transactions so that it can be used as a payment or medium of exchange. However, in reality, the most common use of stablecoins at this point of time is for crypto traders to move between investment positions seamlessly and create leveraged positions, without added volatility. Indeed, it can be observed that, for instance stablecoins that have been designed to be pegged to a single fiat currency (e.g. US Dollar) and maintain 1-to-1 ratio with the fiat currency in terms of value, even when they are issued at its redemption price, the stablecoin may trade on cryptocurrency exchanges at a premium or discount, creating opportunities for speculative profit (e.g. if purchased at a discount and immediately redeemed for $1 or if sold at a premium without redeeming). As such, stablecoins, despite their purported stable value, have the ability to fluctuate in price. This has been supported by the Bank of International Settlements ("BIS") which recently stated that "*the value of stablecoins against reference assets may still fluctuate more than existing digital instruments like e-money*.[3]" In this regard, the Monetary Authority of Singapore ("MAS") has also stated that "*where the value of the electronically stored monetary value is determined by the market, for example through the trading of the electronically stored monetary value on an exchange, such electronically stored monetary value is not e-money and instead may be a digital payment token (i.e. a virtual asset under FATF's definition).*[4]" This is the reason why we are of the view that the vast majority of the stablecoins that currently exist in the market function as the type of crypto asset that would most likely not qualify as 'e-money' and as a matter of fact would probably even fall outside of ASIC's regulatory perimeter.

It is observed though that in Australia the current definition of a 'non-cash payment facility' ("NCP facility") in the Corporations Act which covers electronic money is broad and "*may inadvertently catch arrangements not intended to be regulated as NCP facilities*"**,** as expressly recognised by ASIC on RG 185 on NCP facility. Therefore we suggest that the NCP facility definition is revised and reflects more accurately the scenarios where stablecoins should be classified as electronic money and, thus be subject to the NCP facility's regulatory umbrella. In doing so, there are a number of factors that should be taken into consideration, as illustrated below.

a) Whether the stablecoin is pegged to one or more fiat currencies or a basket of assets

For instance in Singapore, the MAS defines e-money as "*a digital representation of fiat currency, which encompasses the monetary value of that fiat currency that it is denominated in*"[5]. In its current definition, e-money can only be pegged to a single currency, but not multiple currencies[6]. Stablecoins by design may be pegged to one single fiat currency, although not necessarily always the case, and this has been sufficient grounds for lawmakers to consider in some instances classifying stablecoins as 'e-money' as opposed to classifying such asset as a digital payment token (i.e. a virtual asset under FATF's definition or

[3] BIS Working Paper No. 905 on Stablecoins issued in Nov 2020
[4] MAS Response to Consultation Paper P021-2017, issued on 19 November 2018
[5] MAS Consultation Paper on the scope of e-money and Digital Payment Tokens
[6] This is currently being revised by the MAS with the intention to potentially expand the definition of e-money to cover assets whose value is pegged to more than one fiat currency.

unregulated token in the UK). In our view, this could have unintended consequences and set a rather undesirable precedent. Whether a stablecoin has been pegged to a fiat currency or not should not be a defining item and ultimately the decision factor that could determine in isolation from the overall purpose, market use and features of the stablecoin whether the asset should be classified as 'e-money' or not.

b) Whether the stablecoin constitutes a claim on the issuer

A defining characteristic of e-money that would typically differentiate e-money and virtual currencies refers to the extent that e-money represents a claim on the issuer. For instance, the FCA defines 'e-money' as "*monetary value as represented by a claim on the issuer which is stored electronically, including magnetically, issued on receipt of funds for the purpose of making payment transactions and which is accepted as a means of payment by persons other than the issuer*.[7]" The claim of the holder of e-money on the e-money issuer for the monetary value of the e-money is indicative of contractual rights of the e-money holder against the e-money issuer, that a stablecoin holder does not necessarily have (e.g. non-collateralised stablecoins). As the MAS stated, "*e-money is paid in advance under a contract for the provision of a service*.[8] In this sense, the relationship between the customer and the e-money issuer is a purely contractual one, governed by a sale and purchase agreement by which fiat currency is exchanged for e-money. A claim to electronic money then refers to a claim for redemption, in the case of the e-money holder, and a claim of conversion, in the case of the third party that accepts the electronic money - this is possible on the basis that they will be able to claim from the e-money issuer a sum of funds equivalent to the sum of money they would have received thad they been paid in cash. While this is true for e-money, it is not necessarily observed for stablecoins.

In the case of e-money, the relationship between both parties is purely contractual and a claim on the issuer is interpreted as a claim for redemption, failing which would lead to a breach of contract. This would explain why it is typically a requirement that e-money issuers segregate customer funds so that they are fully protected, yet not a requirement applicable to virtual assets in most, if not all, jurisdictions with sound financial systems. However, for stablecoins it can be observed that stablecoin issuers do not necessarily guarantee any right of redemption or exchange of the stablecoin for fiat currency, which may ultimately impair the stablecoin holder's ability to redeem for fiat currency.

We recommend efforts are made to delineate the regulatory boundaries of the 'non-cash payment facility' definition and how this would apply to stablecoins, based not only on the design features, but also on the economic purpose of the stablecoin, including on the risk of generating financial stability risks.

Stablecoins & securities laws

We suggest that clarifying ASIC's regulatory perimeter with regards to the different types of stablecoins, based on their design features and their economic purpose, will be critical for the industry to understand the compliance obligations that are applicable to this type of asset offering. In view of FATF's most recent draft guidance, we recommend that AUSTRAC defines whether the Travel Rule requirements would apply to digital assets that are classified in Australia as a traditional financial asset (e.g. a security or a derivative).

[7] https://www.fca.org.uk/firms/payment-services-regulations-e-money-regulations#2
[8] Frequently Asked Questions (FAQs) on the PSA, issued on 4 October 2019

Whether a stablecoin could constitute a financial product such as a security, a derivative or a managed investment scheme has been a subject of extensive discussion across jurisdictions and among policy makers globally for the last few years, in an attempt to provide regulatory certainty for stablecoin issuers, investors and VASPs. Info Sheet 225 establishes the criteria to determine whether a stablecoin and other digital assets for that matter could potentially be classified as a managed investment scheme.

ASIC should provide further guidance on how the concept of 'common enterprise' should be applied to stablecoins and other digital assets, particularly with regards to those that might lack a central governance body. We are of the view that not all stablecoin structures would necessarily satisfy the 'common enterprise' prong (e.g. MakerDAO's Dai stablecoin).

On these grounds, we recommend the development of additional guidance for DCEs and stablecoin/token issuers to understand in which scenarios the definition of 'managed investment scheme' would be applicable to the asset given the considerations raised above.

The same would apply to the definition of 'security' and/or 'derivative' under the Corporations Act. We recommend that additional guidance is developed that delineates the scenarios where stablecoins should be classified as a financial product. For instance, the vast majority of stablecoins/tokens do not confer any ownership interest in the project or entity, where there is a central governance body. Holding the stablecoin or token does not necessarily provide any claim against the income stream or any corporate or unincorporated entity, payable in sum certain or otherwise, and or any interest payments to be paid by the developers team to holders of the asset, including no maturity date.

Policy makers globally are starting to distinguish stablecoins and their respective regulatory classification based on the features of the asset but also on the risks posed by the relevant asset. For instance, the Swiss Financial Market Supervisory Authority ("FINMA") has raised that where the redemption claim attached to the stablecoin is dependent on price developments (e.g. a stablecoin pegged to a basket of assets), and the underlying assets are managed for the account and risk of the issuer, this would not be indicative of a 'managed investment scheme'[9]. FINMA has further stated that "if a stablecoin merely evidences an ownership right of the token holder, it generally does not qualify as a security.

While some of the design features of the stablecoin, such as the rights that are conferred to the holder, may be used as the basis to determine the legal and regulatory classification of the stablecoin, there are regulators such as FINMA that have set "*the focus on the economic function and purpose of a stablecoin ("substance over form')*" to establish the most suitable regulatory approach to these assets[10]. Kraken is of the view that ASIC should set the focus on the economic purpose of the stablecoin (e.g. payment tokens/e-money, investment tokens or trading purposes) to determine the regulatory treatment of these assets.

According to the Financial Action Task Force ("FATF"), so-called stablecoins could be classified either as virtual assets or as a traditional financial asset (e.g. a security) depending on the design of the stablecoin[11]. 'Virtual asset' is the term that the FATF uses to refer to a digital representation of value that can be digitally

[9] FINMA Guidance on Stablecoins
[10] FINMA Guidance on Stablecoins
[11] FATF Report to G20 on so-called Stablecoins, June 2020

traded, or transferred, and can be used for payment or investment purposes, that is a crypto asset and other digital assets that do not function as legal tender. According to FATF, virtual assets do not include digital representations of fiat currencies, securities and other financial assets.

Indeed, the FATF does not intend for an asset to be both a virtual asset and a traditional financial asset at the same time, as set out in its most recent public consultation issued in March 2021,[12]. FATF further states that "*in cases where a jurisdiction determines that an instrument should qualify as a traditional financial asset, authorities should consider whether the existing regime governing traditional financial assets of that type can be appropriately applied to the new digital assets in question. [...] That is, jurisdictions should ensure that digital products and services which do not qualify as virtual assets and virtual assets service providers ("VASPs") are adequately covered by the frameworks under which they will fall instead and adjust their national law or regulations as needed if not*". The FATF Recommendations apply similarly to both virtual assets and traditional financial assets, however Recommendations such as 10 and 16, Customer Due Diligence and the Travel Rule respectively would not apply to stablecoins that are classified as a traditional financial asset, as stated by FATF. As such, if it is determined that stablecoins and/or other digital assets in Australia should be classified as a financial product (irrespective of the design features and/or economic purpose of the asset), VASPs/DCEs will require guidance as to how to apply certain regulatory requirements such as the Travel Rule for any transactions involving stablecoins or any other digital assets falling within ASIC's regulatory parameter.

We recommend the development of a sound regulatory approach to stablecoins, following the principle 'same risk, same regulatory outcome', and ensure that it is not disproportionate or overly burdensome to entities particularly where end users are aware of the risks (particularly where the activities do not give rise to financial stability risks)[13]. The regulatory approach should reflect international standards and be fit for the future in order to promote innovation and industry growth.

Stablecoins and other digital assets are an attempt to harness the benefits of virtual assets and a 'one-size-fits-all' approach could put in jeopardy the potential for this new asset class to create opportunities for innovation. Adopting a regulatory, supervisory and oversight approach that is proportionate to the risks that these assets may pose is paramount to strike a balance between innovation and regulation.

4. Regulatory approach to crypto derivatives

We are of the opinion that crypto derivatives referencing virtual assets that are not a financial product and that are offered by a DCE are not subject to ASIC's regulatory oversight, in line with the MAS regulatory approach.

In Australia, 'derivatives' are defined under the Corporations Act 2001 - Sect 761D and constitute a 'financial product'. ASIC has provided additional guidance on Info Sheet 225 regarding 'what is a derivative' and clarified that "a 'derivative' is a product that derives its value from another 'thing' which is commonly referred to as the 'underlying instrument' or 'reference asset'. The underlying instrument may be, for example, a share, a share price index, a pair of currencies or a commodity, including a crypto-asset.

[12] FATF Draft Guidance for a Risk-Based Approach to Virtual Assets and VASPs, March 2021
[13] HM Treasury Consultation on Cryptocurrency regulations

Therefore, as a general rule, crypto derivatives offerings are considered a 'financial product' in Australia and therefore any DCE registered with AUSTRAC that intends to offer these products to Australian customers will be required to obtain an AFS license. ASIC has further clarified that this regulatory requirement would apply even for those derivatives referencing crypto assets that are not considered a financial product, that is for instance a futures contract on Bitcoin.

ASIC's regulatory approach to crypto derivatives differs from the approach that other regulators have adopted. For instance, in May 2020 the MAS stated that only crypto derivatives offered by an Approved Exchange ("AE") would be subject to regulatory oversight[14]. The MAS view is that crypto derivatives as a general asset class are "*not suitable to be legitimised and accorded a regulatory status at this point in time*" unless these are offered by an AE, which is "subject to the highest regulatory scrutiny to set standards that will be appropriate for these products.

MAS further stated that it does not intend to include, within the regulatory scope of the SFA, crypto derivatives "*that are not offered by an Approved Exchange"* (i.e. traded on other types of trading platforms such as on Recognised Market Operators or unregulated trading platforms or over-the-counter on a bilateral basis) or crypto derivatives referencing virtual assets that do not fall within the SFA umbrella (i.e. futures on Bitcoin or Ether, among others). The reason why the MAS does not regard it necessary or appropriate to regulate at this point of time crypto derivatives offered by non-AE within the scope of the SFA (with the exception mentioned above) is because "*Payment Token derivatives (aka crypto derivatives) as a general asset class do not pose systemic risks to the financial system. Therefore it is not critical to regulate Payment Token Derivatives unless they are offered by an entity that is systemically important*"[15]. The MAS justified this regulatory approach following some observations made by the FSB indicating that "*crypto-assets do not pose material risks to global financial stability*[16]"

The MAS also stated with regards to non-AE platforms offering crypto derivatives that "*it is presently unclear that most platforms are generally ready to develop and adopt processes and controls that are sufficiently robust to ensure the reliability and efficiency of transactions in Payment Token derivatives*." Despite the lack of regulatory oversight on non-AE crypto derivatives offerings, the MAS is closely monitoring the evolution of crypto derivatives in the market.

Indeed, the largest crypto derivatives markets are offered from unregulated markets, making up over 90% of the average daily volume on Bitcoin-Dollar, and almost 100% of volume outside of Bitcoin and Ether. Where the Committee is of the view that all crypto derivatives must be subject to ASIC's regulatory oversight irrespective of whether the futures contracts reference virtual assets that are not considered financial products, we recommend the establishment of a regulatory regime for DCEs that is competitive, flexible, and ready to adapt to market and consumer needs.

[14] Approved Exchange ("AE") refers to systemically important trading platforms regulated under the Securities and Futures Act. There are currently four Approved Exchanges in Singapore: Asia Pacific Exchange Pte Ltd., ICE Futures Singapore Pte Ltd., Singapore Exchange Derivatives Trading Limited, and Singapore Exchange Securities Trading Limited.

[15] Consultation Paper on Crypto Derivatives Nov 2019

[16] https://www.fsb.org/wp-content/uploads/P180318.pdf
https://www.fsb.org/wp-content/uploads/P310519.pdf

This concludes our submission to the third issues paper. We thank you again for the opportunity to submit our observations and recommendations. We welcome any question and the opportunity to discuss this in further detail with the Committee.

Your sincerely,

Jonathon Miller
Managing Director
Bit Trade Pty Ltd (trading as Kraken Australia Digital Asset Exchange)
Kraken.com