

Crypto asset secondary service providers: Licensing and custody requirements

Submission From Zerocap Pty Ltd



May 2022

www.zerocap.com

Zerocap Pty Ltd is registered with AUSTRAC as a DCE Service Provider (DCE100635539-001)

Zerocap Pty Ltd is a Corporate Authorised Representative (Representative Number 001289130) of Gannet Capital Pty Ltd (ACN 139 264 690; AFSL 340799)

Intro

Zerocap is a market-leading digital asset firm with an “investment bank” model, providing unique and tailored digital asset investment products, custody and advisory to investors and institutions globally.

Zerocap provides a full-service model for crypto asset needs, served by a team of seasoned professionals with a deep understanding of digital asset technology, institutional trading and portfolio construction.

Zerocap sets a high standard for governance and compliance in the crypto industry, as evidenced by licensing, auditing, institutional backing and a unique insurance policy from Lloyd’s of London.

Founded in Melbourne, Australia, Zerocap has global operations and has processed over a billion dollars of spot crypto assets for their client base.

Our vision has always been to bridge the gap between the emerging crypto asset space and traditional finance. Fundamental to bridging this gap is the provision of a regulated environment for Zerocap and aout clients to operate in. We are excited to work more closely with the Treasury and regulators as the asset class and industry grows and matures.

This document is in response to The Treasury’s consultation paper found at: <https://treasury.gov.au/consultation/c2022-259046>

Consultation Questions & Answers

1. Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?

It's fine (albeit clumsy to read/write), but why not use the term Virtual Asset Service Provider (VASP) as defined by the FATF and adopted elsewhere in the world? Generally speaking, widely-adopted standards are useful as they enable interoperability more easily.

2. Are there alternative terms which would better capture the functions and entities outlined above?

Virtual Asset Service Provider (VASP).

3. Is the above definition of crypto-asset precise and appropriate? If not, please provide alternative suggestions or amendments.

Consider "...a digital representation of value or contractual rights **or obligations** that can be transferred..."

There may be a situation where the recipient of a token has an obligation attached to it (e.g. a token representing borrowed collateral).

4. Do you agree with the proposal that one definition for crypto assets be developed to apply across all Australian regulatory frameworks?

Yes, but with caution to avoid a one-size-fits all approach when regulating crypto assets.

5. Should CASSPrs who provide services for all types of crypto assets be included in the licensing regime, or should specific crypto assets be carved out (e.g., NFTs)?

CASSPrs who provide services for all types of crypto assets should be included in the licensing regime, however, we have a suggestion to consider.

Different types of licensing may be more appropriate in differentiating different types of service providers. For example, similar to existing ADIs and AFSLs:

1. **Authorised Cryptocurrency Deposit-Taking Institutions (ACDI)**, bank-like custodians, savings and lending services providers for cryptocurrency assets, including the issuance of credit cards or mortgage and personal lending based on cryptocurrencies as a medium of exchange.
2. **Australian Cryptocurrency Financial Services (ACFS)** licenses for activities relating to financial services, including asset management, brokerages, exchanges, and investment consultancy services.

6. Do you see these policy objectives as appropriate?

Not entirely, please see below.

7. Are there policy objectives that should be expanded on, or others that should be included?

The idea to minimise risks to consumers is excellent, however, since the list of operators would also serve non-retail clients such as corporations and institutions, the proposal seems to lack coverage. We consider that it may be useful to have differentiation between retail service providers and sophisticated investor/wholesale client-only service providers.

8. Do you agree with the proposed scope detailed above?

Yes, however we are cautious to avoid a situation where all liability is simply shifted to a secondary service provider that is interacting with a decentralised platform or protocol (on behalf of a consumer).

Also noting that the term “secondary service providers” can be confusing on coverage. For example, what if a provider issues cryptocurrency bonds backed by a corporation’s credit? Is that considered a primary product or a secondary product? Since the bond issuance is primary and has never existed anywhere else prior.

9. Should CASSPrs that engage with any crypto assets be required to be licensed, or should the requirement be specific to subsets of crypto assets? For example, how should the regime treat non-fungible token (NFT) platforms?

CASSPrs that engage with any crypto assets be required to be licensed, however there should be different subcategories or tiers of licenses for various purposes.

Bank-like commercial entities that serve the entire consumer universe with deposit-taking and balance sheet management activities such as a mortgage or personal lending in cryptocurrencies can be licensed in a similar way as a commercial bank or an ADI, perhaps as an Authorised Cryptocurrency Deposit-Taking Institution (ACDI).

A service provider on advisory, sale, and brokerage of investment products can be licensed under an AFSL-like licence.

A tiered structure can also mean retail service providers should be monitored and regulated differently from wholesale/institutional only service providers.

The actual service provided and the target customer should be the main considerations in determining the licence requirements, however similar to RG146 the underlying asset(s) would also be a determining factor.

10. How do we best minimise regulatory duplication and ensure that, as far as possible CASSPrs are not simultaneously subject to other regulatory regimes (e.g. in financial services)?

Similar to the traditional finance industry, different licenses and regulations imply different kinds of institutions and operators. This should be the same for cryptocurrency services providers.

11. Are the proposed obligations appropriate? Are there any others that ought to apply?

They seem appropriate, however, with regards to:

(2) maintain adequate technological, and financial resources to provide services and manage risks, including by complying with the custody standards proposed in this consultation paper; what defines “adequate” requires further discussion and consensus.

(5) maintain minimum financial requirements including capital requirements; does this imply tiered capital arrangements similar to the ADI licence requirements, or simply a percentage of the overall AUM as a buffer?

(8) take reasonable steps to ensure that the crypto assets it provides access to are “true to label” e.g. that a product is not falsely described as a crypto asset, or that crypto assets are not misrepresented or described in a way that is intended to mislead; CASSPrs should also take reasonable steps to ensure that clients are making informed investment decisions.

(11) “be regularly audited by independent auditors;” it should be acknowledged that generally speaking, the blockchain is a public ledger; anyone can audit it at any time. It may not in all cases be necessary to subject all CASSPrs to paid (costly) independent auditing.

12. Should there be a ban on CASSPrs airdropping crypto assets through the services they provide?

No, airdropping could be part of a promotional marketing campaign. Unless evidence shows the movement has a “boiler room” effect on end-users, marketing activities should not be banned by a blanket rule.

13. Should there be a ban on not providing advice that takes into account a person’s personal circumstances in respect of crypto assets available on a licensee’s platform or service? That is, should the CASSPrs be prohibited from influencing a person in a manner which would constitute the provision of personal advice if it were in respect of a financial product (instead of a crypto asset)?

Yes, however, there should be segregation between companies targeting retail customers compared to sophisticated investors/wholesale clients. Secondly, a KYC onboarding list that requires gathering information on an end-user’s crypto

investment experience, risk tolerance level, duration of investment, and target return on investment would be good for the industry.

14. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

The implementation cost should be manageable for existing, well-organised firms that have had good practice all along. However, as an incentive to construct a world-leading industry, government subsidisation and fiscal policy benefits would attract investment into this space.

For Zerocap, the cost should be negligible as we have championed standards and regulation, already operate as a CAR under a (wholesale) AFSL, and meet all the proposed obligations. However, we recognise that we are an exception, not the norm.

15. Do you support bringing all crypto-assets into the financial product regulatory regime? What benefits or drawbacks would this option present compared to other options in this paper?

No. The original intention of cryptocurrency was to be an alternative medium of exchange; treating all cryptocurrencies as financial instruments is not a good best solution.

Also note that payment options via credit, debit, and BNPL offerings have already been employed to facilitate cryptocurrency transactions. Thus, transactional and bank-like services should be outside the financial products category.

16. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

We do not have an estimate at this point.

17. Do you support this approach instead of the proposed licensing regime? If you do support a voluntary code of conduct, should they be enforceable by an external dispute resolution body? Are the principles outlined in the codes above appropriate for adoption in Australia?

No. We don't feel this approach will scale to adequately protect consumers as the industry grows over the coming years, and ultimately may have compatibility issues with other jurisdictions and international standards, which harms the Australian industry's ability to conduct business.

However, the framework for what would otherwise be self-regulation should exist as a code of conduct for the industry. This is important as it provides additional consumer confidence in the market outside in addition to any regulation in place.

18. If you are a CASSPr, what do you estimate the cost and benefits of implementing this proposal? Please quantify monetary amounts where possible to aid the regulatory impact assessment process.

No cost as we already do this.

19. Are there any proposed obligations that are not appropriate in relation to the custody of crypto assets?

Yes, however:

(2) "ensuring that consumers' assets are appropriately segregated;" the definition of "appropriately" is important. Sometimes it is necessary to provide an omnibus account due to operational costs and efficiency (quality of service).

(3) "maintain minimum financial requirements including capital requirements;" does this imply tiered capital arrangements similar to the ADI licence requirements, or simply a percentage of the overall AUM as a buffer?

20. Are there any additional obligations that need to be imposed in relation to the custody of crypto assets that are not identified above?

No.

21. There are no specific domestic location requirements for custodians. Do you think this is something that needs to be mandated? If so, what would this requirement consist of?

No.

22. Are the principles detailed above sufficient to appropriately safekeep client crypto assets?

Yes.

23. Should further standards be prescribed? If so, please provide details

No.

24. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

For Zerocap, the cost should be negligible as we have championed standards and regulation, already operate as a CAR under a (wholesale) AFSL, and meet all the proposed obligations. However, we recognise that we are an exception, not the norm.

25. Is an industry self-regulatory model appropriate for custodians of crypto assets in Australia?

No. We don't feel this approach will scale to adequately protect consumers as the industry grows over the coming years, and ultimately may have compatibility issues with other jurisdictions and international standards, which harms the Australian industry's ability to conduct business.

26. Are there clear examples that demonstrate the appropriateness, or lack thereof, of a self-regulatory regime?

An example against the appropriateness of a self-regulatory regime would be QuadrigaCX's failure in Canada in 2018.

27. Is there a failure with the current self-regulatory model being used by industry, and could this be improved?

It is currently sufficient, however it will not scale as the industry grows and we will ultimately see more significant failures and consumer losses.

It should also be noted that most sophisticated investors and wholesale clients that we talk to (HNWIs, family offices and institutions) want to deal with a regulated entity; which we are, hence the reason why we are the market-leader in the wholesale and institutional space.

28. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

No cost as we already do this.

29. Do you have any views on how the non-exhaustive list of crypto-asset categories described ought to be classified as (1) crypto assets, (2) financial products, or (3) other product services or asset types? Please provide your reasons.

Fungible coins and tokens employed as a medium of exchange should be labelled as cryptocurrencies, just like the use of AUD or USD. Examples could be stablecoins issued by ADIs, 100% backed by physical currencies in circulation.

NFTs and other non-fungible assets can be considered valuable assets or IP since they represent the ownership of a scarce item.

Financial and investment-related crypto assets deployed for investment purposes can be classified as financial assets or financial instruments.

30. Are there any other descriptions of crypto assets that we should consider as part of the classification exercise? Please provide descriptions and examples.

No.

31. Are there other examples of crypto asset that are financial products?

Derivative or off-balance sheet instruments can be classified as financial products.



32. Are there any crypto assets that ought to be banned in Australia? If so which one?

As a blanket statement, no, nothing should be banned but there should be rules in place for responsible service from providers.

