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Blockchain Bites: AU Senate Crypto Report – Recommendation 1: Licensing for DCEs, Recommendation 2 – Minimum custody standard for digital assets, AFR Young Rich List Crowded with Crypto

Michael Bacina, Barbara Vrettos, and Luke Misthos of the Piper Alderman Blockchain Group bring you the latest legal, regulatory and project updates in Blockchain and Digital Law.

Australian Senate Crypto Report – Recommendation 1: Licensing for DCEs

The long awaited Senate Select Committee into Australia as a Financial and Technology Centre's Final Report provides supportive policy towards a range of digital asset matters. In a series of notes we will unpack the recommendations from the report, first of which relates to licensing of Digital Currency Exchanges (DCEs):

> The committee recommends that the Australian Government establish a market licensing regime for Digital Currency Exchanges, including capital adequacy, auditing and responsible person tests under the Treasury portfolio.

DCEs currently operate without a specific regulatory framework beyond an obligation to comply with registration requirements with AUSTRAC, Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) requirements and the very consumer centric Australian Consumer Law as well as other laws applying to all businesses. Numerous submissions to the committee submitted the AUSTRAC registration process was a low bar, with universal standard applying to DCEs.

The committee felt that digital currency exchanges holdings billions of dollars worth of their customers assets should be subject to auditing obligations, capital adequacy obligations and a more rigorous verification process.

Those involved in the digital asset space are calling for regulation to instill greater consumer confidence in the industry to promote growth. The report notes concerns about scams and Recommendation 1 presumes a licensing regime will demonstrate that comprehensive consumer protections are in place.

The final shape of the licensing requirements for DCEs will help show whether this presumption will meet the difficult balance of "light touch" regulation and consumer protection to help promote the growing Australian digital asset exchange space.

Australian Senate Crypto Report – Recommendation 2 – Minimum custody standard for digital assets

The Senate Select Committee into Australia as a Financial and Technology Centre's Final Report has considered whether there should be government regulated custodial or depository arrangements for digital assets. While custodial and depository services are rapidly emerging for digital assets, many believe it is important they are subject to specific, regulatory requirements. Recommendation 2 states:

> The committee recommends that the Australian Government establish a custody or depository regime for

digital assets with minimum standards under the Treasury portfolio.

The recommendation reflects the need echoed by submitters for clear regulatory guidance in relation to custodial and depository services. While some choose to store their digital assets in a ‘cold wallet’ like a hard drive, there is always the potential of throwing out millions worth of crypto-currency. Third-party custodians allow for greater security and separation from ones own private keys as well as specialised insurance and protection.

Under current regulations, there is no specific framework for digital asset custody. ASIC’s Regulatory Guide 133 Funds management and custodial services: Holding assets (RG 133) outlines minimum standards for asset holders to ensure they meet their obligations under their Australian Financial Services Licence (AFSL) but does not specifically catered to digital asset custodians.

The Final Senate Report seeks to build on Australia’s well-established custodial services infrastructure which currently holds approx. AUD$4 trillion in value. Some submissions suggested a combination of the existing foundations, law, and policy, including RG 133, allow for adequate custody at present. Those familiar with the attributes of private keys understand the capacity, capability and resource requirements and that the key difference between digital assets and others, when custody is considered, centers on control of private keys.

Other argued that a separate set of standards and licensing requirements for businesses should be deployed with a minimum standards that any company dealing in the custody of digital assets would have to follow. ASIC’s consultation paper 343 (CP343) offers sensible technological guidance including that:

- specialist expertise and infrastructure should be used for digital asset custody;
- segregation of crypto assets on blockchain should be used;
- private key generation and storage should occur in a way that minimises risk of unauthorised access;
- multi-signature or sharding based storage should be deployed;
- practices for receipt, validation, review, reporting and execution of instructions should be used; and
- robust cyber and physical security practices be put in place.

Ultimately, the Final Report finds that digital asset custody arrangements present unique risks not analogous to traditional assets, principally the risk of exposure of private keys and speed with which digital assets can be moved. The introduction of a regulated framework for custodial or depository companies, if it adopts the best practices developed by existing digital asset exchanges, will likely enhance consumer confidence, help reduce the risk of exchange collapses, encourage investment and help spur on Australia’s already significant custody industry.

ASIC sets a positive trajectory for an Australian Bitcoin ETF

Following the close of Consultation Paper 343: Crypto-assets as underlying assets for exchange traded products (**ETPs**) and other investment products in late July, ASIC’s view on an Australian Bitcoin ETF has been revealed. ASIC has released guidance outlining their response and updated a number of existing regulatory guides. ASIC’s response provides insight into ASIC’s view about best practice for crypto-assets entering the regulated space noting the near unanimous support for ETPs and other investment products that provide exposure to crypto assets.

In a media release detailing the update, ASIC Commissioner Cathie Armour said:

> Crypto-assets have unique characteristics and risks that must be considered by product issuers and market operators in meeting their existing regulatory obligations.

ASIC’s Report 705 outlines specific responses and submissions received, and significant changes have been made to INFO 225 and INFO 230. These include references to monitoring standards, custody of crypto-assets, pricing methodologies, disclosure and risk management where listed products are involved.

Report 705 is separated into 4 categories, being:

1. Meeting INFO 230 ‘Exchange traded products: Admission guidelines’ expectations;
2. Responsible entity obligations;
3. Listed investment entities; and
4. AFS Licensing for a new kind of asset.

Despite Commissioner Armour’s statement, in accordance with ASIC’s long standing regulatory policy the guidance attempts to remain technology neutral. This means limited reference to technology specific crypto asset requirements.

ASIC prefers to issue guidance around best practice and leave the decision for admitting listed ETPs backed by crypto-assets to the market operators.

However, a key exception to this is the new category for AFS Licensing for registered managed investment schemes with the introduction of a crypto-asset specific category.

ASIC challenged submissions which noted the UK approach recognising crypto-assets given they carry the indicia of property but didn't give any specific reason why crypto-assets would not, absent other indicia, be simply treated as property. Oddly, ASIC stated that submissions had not convinced ASIC why crypto-assets should be treated as property as a starting point. The UK Jurisdiction Taskforce publication on this point is filled with reasoning on this front and it is disappointing to see ASIC fail to engage with what could have strengthened the legal standing of crypto assets generally.

ASIC notes commodities are not an existing asset kind in licensing frameworks and Said that designating crypto-assets as commodities would not solve the licensing issue.

ASIC has thus established 2 kinds of authorisations for applicants to apply for if they wish to operate a registered managed investment scheme holding digital assets, being either a:-

- a 'named scheme' authorisation (whether the scheme holds one or more crypto assets) which means the licence holder would only be able to operate a specifically identified scheme; or
- a 'kind scheme' authorisation for applicants who have operated 2 named schemes for at least two years. Once granted this will allow licensees to operate multiple crypto-asset registered schemes without needing to vary their license with the introduction of each new scheme.

At present these options are only available for holding BTC or ETH.

Also of note are:

- Key features which have been identified for market operators to consider when approving ETPs;
- ASIC is not limiting crypto asset custodians to Australia and is not changing the existing class order regarding custody of scheme assets; and
- ASIC is not mandating any specific disclosures in disclosure documents relating to crypto assets.

This is an important shift for the regulation in crypto assets in Australia. The timing of the release is in quick succession with the Final Report of the Senate Select Committee into Australia as a Financial and Technology Centre's Final Report. It will be interesting to see whether the Final Report is the impetus for other regulators to issue guidance in the near future.

AFR Young Rich List Crowded with Crypto like never before

The Australian Financial Review has published its annual Young Rich list with a stunning line up of Australian crypto royalty appearing this year.

Notable inclusions include:

Four Warwick brothers (possibly the most family members ever in the Rich List) with well known crypto personality and Synthetix founder Kain Warwick taking the number 7 spot, with an estimated AUD$879M net wealth. Keiran Warwick, co-founder of blockchain game Illuvium, took the number 22 spot. Aaron Warwick, also of Illuvium, at number 26, and Grant Warwick (another co-founder of Illuvium) at . Three of the Warwick brother's wealth are tied up almost exclusively in the Illuvium token ILV which in January was USD$50 and is trading at USD$900 today.

Other notable crypto personalities on the Rich List include Fred Schebesta at number 29, co-founder of Finder, who recently published a book on building a global empire as well as self described crypto-anarchist Sergei Sergienko, at number 60, who has been building blockchain businesses like Chronos and Timex for years and most recently was involved in the launch of a play-to-earn gaming guild CGU.

Larry Diamond of ZIP also features on the list, and is crypto adjacent with ZIP planning on integrating crypto trading within their ZIP wallet in the future. The AFR is even selling an NFT of the cover of the AFT Magazine to raise money for charity (see here). Kinsey Cotton (no. 47) has a mention for his investment in xBullion

Blockchain and crypto continue to build and go from strength to strength and as government regulation gives larger investors and financial services companies greater understanding and confidence, it looks like the AFR's Rich Lists are going to feature a growing number of those building wealth in the digital asset space.