

Crypto asset secondary service providers

Licencing and custody requirements
Consultation paper

July 2022

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Executive Summary

Executive Summary

KPMG Australia (KPMG) welcomes the opportunity to provide a submission to Treasury's consultation on Crypto asset secondary service providers: Licencing and custody requirements (the consultation).



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As the consultation paper states, the crypto asset ecosystem has expanded rapidly in recent years, and there have been calls for additional regulation in Australia to both support consumer confidence and provide regulatory certainty to crypto businesses and service providers.

Recent events and extreme fluctuations in the crypto asset market highlight the risks involved for investors and participants. While this consultation and submission focus on the regulation of crypto asset secondary service providers (CASSPrs), we note that this on its own will not mitigate all risks to consumers. Other factors, including the volatility of assets themselves, can also present risks.

The crypto ecosystem is extensive and rapidly changing, and there are many varied players involved. KPMG considers that in order to develop an appropriate regulatory framework, it is critical to undertake a classification exercise in order to better understand the different categories of crypto assets and the type of regulation required for each.

In this submission KPMG supports the development of a single definition for crypto assets and encourages alignment with other international definitions such those used by the Financial Action Task Force and/or the OECD. KPMG recommends a token mapping exercise be undertaken, developed, and be used to inform the application and relevance of specific proposed obligations on CASSPrs. KPMG also recommends that the proposed regulatory regime adopt a uniform and consistent regulatory framework to safeguard private keys.

This submission outlines seven recommendations at section one and addresses the consultation questions at section two.

If you would like to discuss the contents of this submission further, please do not hesitate to reach out. KPMG looks forward to continued engagement with the Treasury as it develops a regulatory framework in this area.

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Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

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Recommendations

KPMG Recommendations

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Recommendation 1

KPMG supports the development of a single definition for crypto assets and encourages alignment with the definition used by the Financial Action Task Force given the likely adoption of these definitions by the OECD. This definition may need to be adapted following the completion of token mapping.

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Recommendation 2

KPMG considers that international providers who deliver secondary services to consumers in Australia from overseas should be included in the Australian regulatory framework.

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KPMG Insights

Regulation of crypto asset secondary service providers

Proposed definitions

KPMG supports the development of a single definition of crypto assets to be applied across the spectrum of regulatory frameworks. However, consideration should be given to definitions being adopted and developed globally. In this regard, KPMG supports alignment with the definitions used by the Financial Action Task Force (FATF) and note also likely adoption of those definitions by the OECD in its discussion paper on the Crypto-Asset Reporting Framework (CARF).¹

Limiting the definition of crypto asset secondary service providers (CASSPrs) by reference to 'natural or legal persons' may result in certain bodies not being brought within the scope of the rules. The emergence of Decentralised Autonomous Organisations (DAOs) could result in this definition being too narrow if they are not considered a legal person. We note that the consultation paper outlines an intention to further consult on DAOs, and suggest that this could be considered in conjunction with the consultation to come.

KPMG notes the following further differences between the proposed definition of crypto assets and that proposed by the OECD in the CARF:

- The CARF relies solely on 'representation of value' and does not include a reference to contractual rights.
- The CARF definition includes reference to reliance on cryptographically secured distribution ledger technology. The proposed definition refers to 'ownership' being determined or affected by a cryptographic proof.

In our view the proposed definition should include a reference to distributed ledger technology. A question remains whether it is appropriate for the proposed definition to incorporate the legal concept of ownership.

In our view a practical approach may be to adopt a broad definition of crypto asset, then use a token mapping or classification exercise to draw appropriate boundaries around different elements of the regulatory framework.

KPMG recommends that the definition adopted will need to be revisited as part of the token mapping exercise, and may need to be aligned with the outcome of that process.

It may ultimately be the case that a consistent definition will not be workable across all regulatory frameworks, however, the application of various regulatory frameworks to crypto assets will be relevant to the token mapping exercise.

We note the comments in the consultation document noting regulation may be difficult to enforce on large international providers delivering secondary services from overseas. In our view, the distributed and global nature of these services should not be a basis for excluding them from regulation in Australia. Similar regulatory regimes prohibit certain conduct when dealing with Australian investors irrespective of the location where the conduct takes place.

KPMG considers that domestic providers will benefit from regulatory guidance and cooperation in upholding consumer protections and enhancing market integrity.

Recommendation 1

KPMG supports the development of a single definition for crypto assets and encourages alignment with the definitions used by the Financial Action Task Force given the likely adoption of these definitions by the OECD.

Recommendation 2

KPMG considers that international providers who deliver secondary services to consumers in Australia from overseas should be included in the Australian regulatory framework.

¹ <https://www.oecd.org/ctp/exchange-of-tax-information/oecd-seeks-input-on-new-tax-transparency-framework-for-crypto-assets-and-amendments-to-the-common-reporting-standard.htm>

Policy objectives

We note the policy objectives outlined in the consultation paper to underpin a licensing regime for CASSPrs:

- Minimise the risks to consumers from the operational, custodial, and financial risks facing the use of CASSPrs. This will be achieved through mandating minimum standards of conduct for business operations and for dealing with retail consumers to act as policy guardrails.
- Support the AML/CTF regime and protect the community from the harms arising from criminals and their associates owning or controlling CASSPrs.
- Provide regulatory certainty about the policy treatment of crypto assets and CASSPrs, and provide a signal to consumers to differentiate between high quality, operationally sound businesses, and those who are not.

KPMG supports these objectives and considers that an enhanced regulatory regime will bring a number of additional benefits, including better regulatory certainty, increased transparency of information, and improving the quality of services by setting a minimum standard for service providers.

We also note that in developing the licensing regime for CASSPrs, consideration should also be given to other key regulatory pillars such as anti-money laundering (AML), tax and financial stability, and consumer protection.

Recommendation 3

KPMG supports the policy objectives outlined in the consultation paper to underpin a licensing regime for CASSPrs.

Regulatory interaction with existing regimes

KPMG supports the consultation paper's proposal of capturing CASSPrs within existing financial services and regulatory regimes. We believe broader encompassing regulation in the first instance will prove for greater certainty, uniformity, and minimal regulatory duplication.

However, we would also consider that some products, services, or offerings may require lesser or greater regulation in line with the risks associated with the product. In this instance, we are of the view that exclusions and 'carve-outs' provisions to the proposed regime are in the best interest of CASSPrs and consumers depending on the nature, characteristics, and risk to consumers of the specific crypto assets.

As detailed in this submission, we believe the token mapping exercise will form a foundational role in defining crypto assets and the corresponding regulatory requirements for those assets.

This approach would also provide guidance for government regulatory bodies in determining the assets subject to oversight and reporting (e.g., AUSTRAC, ASIC, etc). We believe adopting a broader top-down approach will also clarify scope for regulatory agencies and reduce uncertainty in the alignment and enforcement of existing regulatory requirements.

Recommendation 4

KPMG supports alignment with existing regulatory regimes but notes that some products services, or offerings may require more or less regulation in line with the risks associated. The token mapping exercise will be important in defining different assets and the corresponding regulatory requirements.

Proposed obligations on crypto asset secondary service providers

Proposed obligations on crypto asset secondary service providers

KPMG considers that it is difficult to assess whether the proposed obligations are appropriate and reasonable before a token mapping exercise has been undertaken. Different categories of assets, and therefore the CASSPrs offering those assets, may require differing levels of regulations depending on the level of risk.

Following broader regulation, a risk-based approach may be required in order to determine the appropriate level or extent to which requirements and obligations are imposed on the varying types of CASSPrs. Another approach may be to qualify investors' capacity to understand the risks involved, in a manner similar to securities markets, where a 'sophisticated investor'² is given an exemption under the Corporations Act to buy financial products without a regulated disclosure document such as a prospectus or product disclosure statement.

In order to minimise regulatory burden, it is important to ensure any obligations and requirements introduced are appropriate according to the type of asset, service, or product being provided and captured under the regulatory regime. This will enhance regulatory certainty and limit the risks to consumers, without imposing unduly challenging requirements. Furthermore, greater transparency on the roles that CASSPrs can play is critical to support consumer confidence and mitigate potential risks.

We are of the view that several categories of provider may exist within the framework and be held accountable under any proposed regulatory framework. Accordingly, depending on the nature of the CASSPrs (i.e. exchange, broker, investment protocol etc), the specific obligations may be varied for each. For example, some categories might include:

- Those with custody of crypto assets.
- Those who are market makers.

- Those who are crypto brokers or trading intermediaries.
- Those who offer entirely decentralised and non-custodial services.
- Those participating in decentralised autonomous organisations (DAOs).

In respect of non-custodial services, it may be impractical to impose and enforce any regulatory regime given the potential absence of any individual entity or source of control or ownership within these services.

That is not to preclude entirely the regulatory oversight of such non-custodial and decentralised services, but rather to capture regulatory oversight in key consumer access or on-ramp points, such as CASSPrs.

Key areas of CASSPrs which KPMG consider should follow a risk-based regulation scheme include:

- Ensuring listed token projects by crypto exchanges are audited, classified or differentiated from other offerings (i.e. mapped products), and subject to additional consumer protection requirements (i.e. disclaimers or warning); subject to a more stringent audit, review and approval process.
- Mandating transparency, independence, and disclosure of interests in crypto exchanges to avoid conflict of interest (e.g. promoting own books, front running on market making, or otherwise manipulating a market).

It is important to ensure that any regulation imposed achieves an appropriate balance of minimising risks without stifling innovation or driving activity outside of cooperative or well-intentioned stakeholders within the industry (i.e. dark web and criminal enterprise).

² <https://moneysmart.gov.au/glossary/sophisticated-investor>

Airdrops

With specific respect to airdropping activities, KPMG does not believe a blanket ban on this activity would be appropriate. Without imitating the application of any proposed regulation of CASSPrs, it is impractical to prohibit airdrops to wallets on-chain. Airdropping is typically the means used by projects to directly market to consumers within an ecosystem or blockchain. Accordingly, our view is that CASSPrs under a custodial wallet scheme should be required to seek consumer consent and preferences with respects to airdropping unless it is otherwise prohibited by regulation or direction. We note that seeking informed consent could be challenging if consumers have a limited understanding of what they are consenting to, therefore a classification approach as outlined above based on consumers' risk (e.g. sophisticated investor) would be beneficial.

Advice

KPMG is of the view that professional advice in relation to acquiring any crypto asset should be subject to regulatory oversight. Accordingly, it is our view that activities such as strategic planning, investment advice, targeted promotion, general promotion, and solicited or unsolicited recommendations be treated as advice and be subject to the relevant regulatory requirements.

Withstanding the difficulty this may impose on providers of financial advice, we are of the view that above activities are not dissimilar in nature to the issuance of other advice but for the foreign nature, technical complexity, and regulatory uncertainty of the space. In addition, given the high susceptibility of consumers to these differentiating factors of crypto assets and financial advice, the advice should be regulated on the basis of consumer protection and overarching objectives in the first instance.

We are also of the view that any difficulty encountered by professional financial advisors could be overcome in the shorter term through recognised qualifications and licensing, similar to other classes of regulated assets.

Without limiting the above, we share the view that the proposed regulation should encourage broader consumer information and awareness. Accordingly, KPMG considers that the dissemination of factual information in isolation should not be prohibited on the basis that the factual and impartial information would ultimately serve to benefit and protect consumers. Consideration of advertising requirements, disclosure documentation and client qualification to ensure that a customer fully understands the products could warrant further exploration.

The costs for CASSPrs of implementing proposed obligations would largely vary depending on their size and existing infrastructure. Depending on the extent of requirements imposed on CASSPs, implementation costs could vary significantly depending on the organisational flexibility and existing infrastructure.

Recommendation 5

KPMG recommends a token mapping exercise be undertaken, developed, and be used to inform the application and relevance of specific proposed obligations on CASSPrs.

Alternative options

While KPMG believes the regulation on this industry needs to be appropriately balanced, we consider that a self-regulation model would not be appropriate for crypto asset services.

Further, decentralisation underpins most infrastructure in this environment, with on-chain pseudonymity obscuring parties to transactions. Therefore, any self-regulation would likely fall to centralised digital currency exchanges (DCEs) which may not effectively achieve regulatory requirements.

Recommendation 6

KPMG considers that a self-regulation model would not be appropriate for crypto asset services.

Proposed custody obligations to safeguard private keys

Due to the relatively complex and technical subject matter, it may be unclear for consumers to understand the custody of private keys³ or actual rights to ownership / control of cryptographic assets held by CASSPrs. It is common for CASSPrs to solely manage the custody of customers' private keys and effectively control and own cryptographic assets (i.e. custodial wallets⁴) without any direct traceable control or ownership attributable to customers at the on-chain level. This is further complicated by the outsourcing of key management services to third party providers.

In essence, both instances detailed above do not provide customers with any control or traceable ownership of digital assets held within a wallet, but instead give rise to an entitlement to a claim against the digital assets held and managed by the CASSPr. This can carry its own risks. For example, US crypto exchange Coinbase has recently added a risk disclosure stating that if the company were to file for bankruptcy, the court might treat customer assets that the exchange is custodian for as their own assets.⁵

However, withstanding such limitation, the underlying value of utilising a custodial wallet is to manage and reduce the risk of loss arising from the accidental loss of access (i.e. losing private keys) or theft which may otherwise be at greater risk if customers were solely responsible. As a result, customers are willing to trust custody holders and managers (i.e. CASSPrs) to appropriately protect and safeguard access to private keys.

Those customers willing to solely manage their own private keys, will typically utilise non-custodial⁶ services to perform any trading or exchange of cryptographic assets.

Given the technical complexity and risks associated with managing private keys, KPMG believes custodial wallet schemes play a significant role in protecting consumers against accidental loss or theft. However, we also note the responsibility and trust placed in CASSPrs by consumers who adopt custodial key management systems.

Accordingly, the proposed custody obligations would be reasonable to impose on CASSPrs, particularly considering the risk and consequential impacts which may arise in the event of any loss of private keys.

It is our view the regulation of key custody and management should consider implementing a risk-based approach to limit impacts of regulatory burden on innovation smaller enterprise. These considerations may be informed by a range of factors (including but not limited to):

- Portfolio exposure and diversity of custodial holdings.
- Total assets under custodial holdings.
- Size of customer base subject to custodial holdings.
- Any combination of the above.

Given the importance of key custody in events of loss or theft, consumer awareness and information regarding risk is essential. Accordingly, it is our view that mandatory disclosure or awareness is required to assist users in understanding, comprehending, and accepting the relevant risks of any key custody management scheme.

Recommendation 7

KPMG recommends the proposed regulatory regime adopt a uniform and consistent regulatory framework to safeguard private keys, with a risk-based approach to determining the extent and variability of any proposed obligations imposed on CASSPrs.

³ A private key is a variable in cryptography used with an algorithm to decrypt data. In a simple sense, the private key acts in a similar manner to a password which enables the private key owner to access, authorise, and transact with cryptocurrency wallets (or public key) on a blockchain.

⁴ Custodial wallets refer to the maintenance and storage of private keys by DCEs or CASSPrs on behalf of customers. In essence, the private key is not necessarily shared with the customer and the wallet remains in the custody and control of the DCE or CASSPr.

⁵ Coinbase Quarterly Report 10 May 2022, page 83: <https://d18rn0p25nwr6d.cloudfront.net/CIK-0001679788/89c60d81-41a2-4a3c-86fb-b4067ab1016c.pdf>

⁶ Non-custodial wallets or services refer to instances whereby the duties of managing and storing private keys is performed by the end-user or customer. In this instance, the private keys are not shared with exchanges and control is solely attributable to the holder(s) of the private keys.

Early views on token mapping

Specifying classes of crypto assets

As noted earlier in this response, KPMG considers this token mapping exercise critical in ensuring the right level of regulation applies to different categories of crypto assets.

We also recognise the complexity in seeking to classify crypto assets given the ability for assets to serve multiple functions or purposes and the potential for this to change over time.

KPMG considers that the following categories could arise when classifying assets according to their function or purpose:

- Payments tokens which predominately serve as a means of exchange and digital financial currency.
- Utility tokens (e.g. access to a football game, good/services or other right/benefit).
- Hybrid – combination of both. Could be used as a payment token currency but also utility.
- Security/equity (and/or asset) token – which provide interests similar to shares, units, debt or property assets.

- Non-fungible tokens (NFTs) which are predominantly used as a means of ensuring digital scarcity, uniqueness, and utility. NFTs can also have characteristics of being another token and as such, should also be appropriately categorised by its function or purpose other than simply/solely by possessing the characteristic of being 'non-fungible', for example a utility token (where the NFT grants access to some type of utility) or security token.

Further to the above, it may be worth considering whether to distinguish between collateralised and non-collateralised assets. This could impact the risk profile of the token and therefore be taken into consideration in a risk-based regulatory approach.

We also note that New Zealand's Inland Revenue Department (IRD) has classified crypto assets into the following categories: payment tokens; security tokens; and utility tokens.⁷

⁷ <https://www.ird.govt.nz/cryptoassets/about>

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July 2022. 912416032ISV