



29 July 2021

Mr Nathan Bourne

By email: [REDACTED]

Dear Mr Bourne

Re: Crypto-assets as underlying assets for ETPs and other investment products

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on ASIC's consultation paper on crypto assets as underlying assets for ETPs and other investment products.

AFMA welcomes ASIC's work in this area as an effort to find a sensible balance in an emerging, complex and in some cases, high risk area. We support a technology neutral principles-based approach which we understand is ASIC's intention.

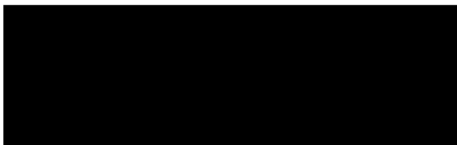
AFMA's members approach the issue from a range of perspectives including that of wholesale banks, retail brokers, and providers of custodian and related services. We believe this diversity of perspectives assists the balance of our positioning on these complex issues. We note there are a range of positions on the direct involvement of individual firms in the crypto-asset related products.

The last 12 months has seen a continued increase in the pace of developments related to Central Bank Digital Currency (CBDC). Depending on the detail of the technical implementation of these currencies, they could well fall within the ASIC definition of crypto-asset. As such it is important that the framework for responding to crypto-assets is developed in a way that allows for ready adoption of government-backed fiat currencies in CBDC form. These assets particularly when issued by major jurisdictions are, in contrast to the crypto-assets discussed in the paper, fundamentally different in a nature as they are a state backed asset which relies on traditional trust and confidence in a nation state's government finances and standing.

We also note the importance of Australia linking in with developments internationally particularly to taxonomies with a view to harmonisation.

We thank you for considering our comments in the attached submission. Please feel free to contact us for more information via the Secretariat.

Yours sincerely



Damian Jeffree
Senior Director of Policy

General Comments

AFMA would argue that *some* crypto-assets do fall within the 'financial product' definition of the Corporations Act and accordingly come within the existing regulatory space. Different types of crypto-assets can have different characteristics, and should arguably be regulated differently to manage different risks and to avoid regulatory arbitrage. A significant higher level question is how crypto-assets relate to traditional financial products and financial market infrastructure.

Crypto-assets by their very nature were intended to be disruptive of the traditional financial product sphere and in some ways are reminiscent of the sea shell currencies that were used to our north into modern times. In practice unbacked crypto-assets are simply a series of numbers without any tie to assets or entitlements. Knowledge of one of the numbers in the series is popularly known as 'owning a coin', but of course there can be no claim of ownership of the number itself. This knowledge is worth in the most fundamental sense what people are willing to pay for it and its value might be better considered speculative rather than intrinsic.

Using regulated market infrastructure could mitigate some of the risks associated with direct investment in crypto-products and provide enhanced regulation and disclosure. For example, it could reduce fraud and exchange failure risks which have been substantial issues in the crypto-asset space.

However, it is important to note that inclusion in ETP structures will not reduce the inherent value and safety risks for investors. If demand falls away for the products themselves their inclusion as an underlying for a derivative or trading them on an exchange will not assist in the maintenance of value.

It is important the contemplated regulation of crypto-assets and their indirect inclusion in exchanges is not seen as giving the Australian public reassurance about their value which in any sense suggests that they might have a reliably enduring intrinsic rather than transitory trading value. The principle of a caveat emptor must prevail, and investors must be made responsible for their decision to put their money into crypto-assets or related financial products.

On the basis the people should be able to freely invest as they see fit, and take responsibility themselves for that investment decision without potential for socialisation of losses if they eventuate, and given the manifest desire of many people to trade in crypto-assets, it would be better on balance if this is done through trustworthy firms and infrastructure rather than ephemeral entities operating at the fringes.

B1Q1 Do you consider that crypto-asset ETPs should be available to retail investors through licensed Australian markets? Please provide details, including data on investor demand where available.

Members report to AFMA that they see significant interest from retail investors in having crypto-assets available through licensed Australian markets. Statistical data at an aggregate level is not yet available. The basis for saying that there is significant demand come through our individual members who are responding to client requests. In this sense this is a demand driven market rather than a product driven market.

B1Q2 Do you consider that crypto-asset ETPs should be cleared and settled through licensed Australian clearing and settlement facilities? Please provide details.

Our initial understanding is that some participants could or would participate in trading, clearing and settling crypto-asset ETPs and some would not. Of those that would not this can be due to home jurisdiction regulatory restrictions, internal policies and business model. At this time clearing and settlement failure has not been seen as a significant risk for trading on platforms.

B1Q3 If you are a clearing participant, would you be willing to clear crypto-asset ETPs? Please provide your reasons.

N/A.

B1Q4 If you are a trading participant, would you be willing to trade crypto-asset ETPs? Please provide your reasons.

N/A

B1Q5 Do you agree with our approach to determining whether certain crypto-assets are appropriate underlying assets for ETPs on Australian markets? If not, why not?

At a high-level we agree that firms should use reasonable metrics to determine whether crypto-assets are suitable given existing requirements to act as underlying assets for ETPs in the Australian markets.

We agree that for inclusion in ETPs it may be appropriate for a high level of institutional support and acceptance. We note that there is the risk that institutional support and acceptance may change over time, particularly given the risks associated with increased regulation of crypto-assets which some economists consider likely.

We agree that a mature spot market is necessary for products to be considered for inclusion in ETPs. A mature spot market is essential to the functioning of portfolio ETP products.

We are concerned that the requirements for (d) a regulated futures market for trading derivatives linked to the crypto-asset and (e) the availability of robust and transparent pricing mechanisms for the crypto-asset, both throughout the trading day and to strike a daily net asset valuation (NAV) price, may be too prescriptive.

The availability of a regulated futures market seems somewhat arbitrary is a reasonably high bar for crypto-assets to cross and may not be aligned with the types of future risk hedging arrangements that may be used in relation to crypto-assets such as those offered by decentralised finance (DeFi).

While robust and transparent pricing mechanisms are necessary for striking accurate and reliable NAVs, these type of strike pricing mechanisms go hand in hand with well-developed spot markets. Specific

mechanisms for pricing from these markets typically follow the need rather than necessarily pre-dating the products that require them. They can be designed in conjunction with the product if there is a sufficiently well-developed spot market.

B1Q6 Do you have any suggestions for additions or modifications to the factors in proposal B1? Please provide details.

We would suggest reconsidering the requirement for a regulated futures market and for the pricing mechanisms to pre-exist for the product to proceed.

B1Q7 Do you have any suggestions for alternative mechanisms or principles that could achieve a similar outcome to the approach set out in proposal B1? Please provide details.

Please see our comment above.

B2Q1 Do you agree that a new category of permissible underlying asset ought to be established by market operators for crypto-assets? If not, why not?

AFMA supports that crypto-assets should be a distinct asset class for regulatory purposes. In AFMA's view it may be efficient to consider whether crypto-assets that have reliable links to inherent value (such as CBDCs, settlement payment coins created by banks etc.) should be treated separately to assets that may have no intrinsic value.

B3Q1 Do you agree with the good practices in proposal B3 with respect to the pricing mechanisms of underlying crypto-assets? If not, why not?

AFMA has extensive experience with financial benchmarks as a former designer and administrator. We note that achieving good benchmark design is challenging and we caution against being overly prescriptive. We agree that pricing mechanisms should be designed to be resistant to manipulation.

The proposals in B3 reflect the bias of the IOSCO Principles towards trades over executable prices. AFMA has long maintained that executable prices (where that execution can be done in adequate size) is a sound foundation for benchmarks. The process that led to the IOSCO Principles was not ideal and while many of its recommendations are sound some elements such as the preference for trades over executable quotes was not well supported by theory and reality.

B3Q2 Are there any practical problems associated with this approach? If so, please provide details.

Manipulation is an important risk to manage particularly in unregulated markets. Typically for trade-based benchmarks this would be in relation to trades without change of beneficial ownership, or pre-arranged circular trading. Using executable prices in size creates a natural cost to those seeking to manipulate as they must maintain artificial pricing typically by trading at a loss.

While we share ASIC's concerns around pricing off unregulated markets, a ban on using a single asset spot market may not necessarily address these risks. In theory, a single market if sufficiently heavily traded, could provide a robust pricing mechanism for a trade-based benchmark. Multiple markets may be required where trading is thin for trade-based benchmarks, but two may not be sufficient.

Executable pricing in sufficient size may not require multiple markets with appropriate protocols around size, timing, availability etc.

B3Q3 Do you think crypto-assets can be priced to a robust and transparent standard? Please explain your views.

There are challenges in pricing crypto-assets to a robust and transparent standard but with appropriate design and safeguards these challenges may be possible to meet.

B3Q4 Do you consider that a more robust and transparent pricing standard is achievable in relation to crypto-assets? For example, by using quoted derivatives on a regulated market. Please explain and provide examples where possible.

Please see our comments above.

B4Q1 Are there any other good practice expectations in INFO 230 that need to be clarified or modified to accommodate cryptoasset ETPs?

AFMA makes no comment.

C1Q1 Do you agree with our proposed good practices in relation to the custody of crypto-assets? If not, why not? Please provide any suggestions for good practice in the custody of crypto-assets.

AFMA holds that requiring physical separation may be too prescriptive and not in line with the latest technical developments for crypto-asset custodianship.

C1Q2 Are there any practical problems associated with this approach? If so, please provide

details.

See our comment above.

C1Q3 Do you consider there should be any modifications to the set of good practices?
Please provide details.

The protection of electronic information has been core to the function of the finance industry for many years. Crypto-assets being in practice a large number or a series of digits (e.g. 000000000019d6689c085ae165831e934ff763ae46a2a6c172b3f1b60a8ce26f), present a tractable security challenge for custodians.

In the case of experienced regulated custodians they will be best placed to determine their own security arrangements.

C1Q4 Do you consider that crypto-assets can be held in custody, safely and securely? Please provide your reasons.

AFMA is advised that secure custody is possible with appropriate information security safeguards.

C1Q5 Do you have any suggestions for alternative mechanisms or principles that could replace some or all of the good practices set out in proposal C1? Please provide details.

Regulated custodians will be best placed to determine appropriate security measures.

C1Q6 Should similar requirements to proposal C1 also be imposed through a market operator's regulatory framework for ETPs? If so, please provide reasons and how it could work in practice.

AFMA makes no comment.

C2Q1 Do you agree with our proposed good practices in relation to risk management systems for REs that hold crypto assets? If not, why not?

C2Q2 Are there any other regulations (other than KYC and AML/CTF) that should form part of an appropriate baseline level of regulation for crypto-asset trading platforms used by REs and connected service providers? Please provide details.

C2Q3 Are there any practical problems associated with this approach? If so, please provide details.

C2Q4 Are there any other matters related to holding crypto-assets that ought to be recognised in

the risk management systems of REs and highlighted through ASIC good practice information? Please provide details and any specific proposals.

C2Q5 Should similar requirements to proposal C2 also be imposed through a market operator's regulatory framework for ETPs? If so, please provide reasons and outline how it could work in practice.

AFMA makes no comment.

C3Q1 Do you agree with our proposed expectations regarding disclosure obligations for registered managed investment schemes that hold crypto-assets? If not, please explain why not.

We raise no objections but note that excessive technology-related disclosures could be counterproductive as due to the associated complexity it may mask the more important risks associated with an underlying lack of inherent value for unbacked assets, which in most cases is likely the greatest source of risk.

C3Q2 Are there any practical problems associated with this approach? If so, please provide details.

C3Q3 Are there any additional categories of risks that ought to be specified by ASIC as good practice for disclosure in relation to registered managed investment schemes that hold crypto-assets?

AFMA makes no comment.

C4Q1 Are there any aspects of the DDO regime that need to be clarified for investment products that invest in, or provide exposure to, cryptoassets?

We are not aware of any at this time.

D1Q1 Do you agree that crypto-assets are capable of being appropriate assets for listed investment entities on Australian markets? If not, why not?

D1Q2 Do you agree with our proposed expectations for LICs and LITs that invest in crypto-assets to ensure equivalent standards are applied by market operators? If not, why not?

D1Q3 Are there any practical problems associated with this approach? If so, please provide details.

D1Q4 Are there additional standards which ought to apply via market operators to LICs or LITs that invest in crypto-assets? If so, what are these expectations and why should they apply?

D1Q5 Should LICs and LITs only be able to invest significant funds in crypto-assets if this is either set out in their investment mandate or with member approval? If not, why not?

D1Q6 For the purposes of this proposal, we consider a material investment is where an entity invests or plans to invest more than 5% of its funds in crypto-assets. Should another materiality threshold apply?

For consistency AFMA agrees that managed investment fund and LICs and LITs should be able to hold ETPs. There should be a level playing field between these investment vehicles in providing access to crypto-assets.

In relation to the Section D questions, AFMA follows the principle that the market should be allowed to innovate and make commercial decisions based on investor demand. We go back to our General Comments at the start, that while inclusion in structures such as LICs and LITs can reduce risks associated with market failures (exchange failures, fraud etc.) it does not change the character or risks of the crypto assets themselves.

E1Q1 Do you agree with our proposal to establish a new asset kind that will cover crypto-assets?

E1Q2 Do you consider that crypto-assets may be captured by the existing asset kinds? If so, please explain.

E2Q1 Do you agree with our approach to restrict the crypto-assets a registered managed investment scheme is authorised to hold (e.g. to bitcoin or ether)?

No, we do not believe ASIC should specify particular crypto-assets as this is not compatible with a principles-based approach. We note there is risk that ASIC will increase its exposure risk in naming particular crypto-assets, particular where these may have no intrinsic value.

E2Q2 Do you consider there are any other aspects of the AFS licensing regime that need to be clarified or modified to accommodate investment products that invest in, or provide exposure to, crypto-assets?

AFMA makes no comment at this time.