EY response to ASIC consultation paper 343

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

27 July 2021

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Consultation paper 343 "Crypto-assets as underlying assets for ETPs and other investment products"

Ernst & Young Australia is pleased to comment on the above consultation paper. We welcome the opportunity to contribute to ASIC's efforts to develop regulatory guidance in Australia.

We believe the proposals contained in the consultation paper would provide more meaningful information on exchange traded products and other investment vehicles in Australia that propose? to invest in, or provide exposure to, crypto-assets.

Our detailed responses to the questions raised in the consultation paper are provided in the appendix to this letter. We would be pleased to discuss our comments further with either yourself or members of your staff. If you wish to do so, please contact Darren Handley-Greaves on [redacted] or Scott Waller on [redacted]

Yours sincerely

Ernst & Young Australia

Appendix

Consultation paper proposal	Feedback requested	Feedback response
B1. We propose to work with Australian market licensees to establish the following factors as the basis to identify particular crypto-assets that may be appropriate underlying assets for an ETP: a. A high level of institutional support and acceptance of the crypto-asset being used for investment purposes b. The availability and willingness of service providers (including custodians, fund administrators, market makers and index providers) to support ETPs that invest in, or provide exposure to, the crypto-asset c. A mature spot market for the crypto-asset 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	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.	Yes - there is strong demand from retail investors for access to emerging asset classes in a way that protects investors from downside risk when self custody approaches are used. Recent market research by Kraken indicates that 4 million Australians intend to invest in crypto currency in the next 12 months - this represents 21% of the Australian population. Holding direct access to crypto by retail investors is technically challenging due to the requirement to setup a wallet, manage private keys, passphrases, and maintain software which is virus free. This results in heightened risk for retail investors who are uneducated on the processes and can be prone to making mistakes or being scammed by bad actors masquerading as legitimate exchanges or custody providers. In many cases, retail investors resort to leaving funds in un-regulated exchange custody wallets, which in in some instances has resulted in misappropriation of funds.
	B1Q2. Do you consider that crypto-asset ETPs should be cleared and settled through licensed Australian clearing and settlement facilities? Please provide details.	Yes - we see no reason why ETPs which hold crypto-assets as the underlying assets should not also be cleared and settled through Australian clearing and settlement facilities. The service "ASX Clear" provides clearing services for ASX listed ETPs. We expect this could be extended to ETPs which hold crypto-assets (assuming there is nothing in the ASX rules which prohibit crypto-asset ETPs from using the service). Settlement of ETPs is carried out by ASX's "CHESS" (Clearing House Electronic Subregister System). We see no reason why this should not extend to ETPs which hold crypto-assets at the underlying asset level.
	B1Q3. If you are a clearing participant, would you be willing to clear crypto-asset ETPs? Please provide your reasons.	N/A - we are not a clearing participant.
	B1Q4. If you are a trading participant, would you be willing to trade crypto-asset ETPs? Please provide your reasons.	N/A - we are not a trading participant.
	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?	Yes - we agree with ASIC's proposal. Please refer to B1Q6 and E2 for additional considerations when determining the appropriateness of crypto-assets as underlying assets for ETPs. We note that ASIC's initial scoping of allowable crypto-assets to be held in ETP's is in line with the Canadian markets allowable assets at this point in time.

Consultation paper proposal	Feedback requested	Feedback response
	B1Q6. Do you have any suggestions for additions or modifications to the factors in proposal B1? Please provide details.	A protocol review should be performed on the underlying crypto asset to assess its viability as an underlying asset for ETPs. The review should cover the consensus mechanism's integrity, and the centralised or decentralised nature of the blockchain and crypto-assets. An analysis of the historical and current hash rate and the number of nodes participating on the network should be performed to determine whether it is sufficiently secure from manipulation and attack from bad actors. Continuous monitoring of the protocols, major events and incidents involving the assets, and evaluation of the security of the asset should be performed to ensure continued appropriateness of underlying digital assets for ETPs. The auditability of the underlying ledger should also play a factor in determining the asset's appropriateness for ETPs, i.e. considering the availability of reputable block explorers and assessment tools over token instantiations For assets which are classified as tokens, smart contract code reviews should be performed to ensure the functionality and obligations of the token are sound and will be executed as expected.
	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.	No - we do not have further suggestions, however ASIC should consider its position on whether it will provide the market with a proactive view on crypto-currencies which meet the requirements of the framework or whether it expects the market to perform this assessment.
B2. We propose to work with Australian market licensees to establish a new category of permissible underlying asset for crypto-assets in their regulatory frameworks that, at a minimum, is consistent with the factors set out in proposal B1.	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?	Yes – we agree with the establishment of the new category for crypto-assets, however sub-categorisations of crypto-assets should be defined to appropriately treat the varying range of properties of different crypto-assets. For example, within this new asset class there are sub-groupings such as security tokens, crypto currencies, stable coins, governance tokens. Each of these have different approaches to generating value for their holders. ASIC should clarify what sections of the crypto market it is supporting. Additionally, it would be important that ASIC define minimum requirements each category of crypto-currency needs to meet, such as how decentralised the governance structures are. When it comes to tokens, we believe the assessment will need to include non-protocol related aspects on the security and functionality of the token code. These reviews are potentially triggered by events such as forking of the protocol, updates governance structures and smart contract revisions.

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B3. For crypto-assets, we propose the following good practices in relation to demonstrating a robust and transparent pricing mechanism: a. The basis of the pricing mechanism for crypto-assets held by an ETP should be an index published by a widely regarded provider that: i. Reflects a substantial proportion of trading activity in the relevant pair(s), in a representative and unbiased manner ii. Is designed to be resistant to manipulation iii. Complies with recognised index selection principles such as the International Organization of Securities Commission (IOSCO) Principles for financial benchmarks, the EU Benchmarks Regulation, or other internationally recognised index selection principles, and b. Pricing mechanisms which rely on a single crypto-asset spot market would be unable to achieve robust and transparent pricing.	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?	Yes - we agree. Additional consideration should be given to the reputation, reliability and liquidity of the exchanges used to obtain pricing, volume/liquidity and other data. There should also be processes in place to exclude prices which were not determined by the free market (such as restrictions on trading), or which report significantly different pricing data as compared to the average. The frequency of the disclosure of indicative NAVs for ETPs should also be considered to minimise any risk of arbitrage.
	B3Q2. Are there any practical problems associated with this approach? If so, please provide details.	Yes, potentially. The reliance on exchanges to report pricing exposes the pricing mechanism process to the vulnerabilities of these exchanges, such as fake trade volume pumps.
	B3Q3. Do you think crypto-assets can be priced to a robust and transparent standard? Please explain your views.	Yes - while crypto-assets are certainly more vulnerable to manipulation than traditional assets, due to the lower liquidity and heightened volatility and sensitivity to speculation, there is sufficient trade volume and a large enough number of market participants to establish transparent pricing. However, while certain crypto-assets may have the attributes necessary for robust and transparent pricing, this does not apply to all crypto-assets which may have lower liquidity, centralised management, or insufficient security.
	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.	No - no further pricing mechanisms to be considered here.
B4. We propose not to include any further expectations in INFO 230 in relation to crypto-asset ETPs.	B4Q1. Are there any other good practice expectations in INFO 230 that need to be clarified or modified to accommodate crypto-asset ETPs?	Yes - ASIC could give consideration to the product naming guidelines in INFO 230 and if a particular naming convention should be introduced for crypto-asset ETPs.
C1. We propose the following good practices for Res in relation to the custody of crypto-assets: a. The chosen custodian has specialist expertise and infrastructure relating to crypto-asset custody b. The crypto-assets are segregated on the blockchain. This means that unique public and private key(s) are maintained on behalf of the RE so that the scheme assets are not intermingled with other crypto-asset holdings	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.	Yes - however the coverage of the outlined good practices could be enhanced. We agree with the current drafted section around key management controls, however there is less coverage around other areas such as cyber and physical security. We propose, rather than restricting good practices to specific controls, ASIC may instead require key processes related to the custody of crypto-assets which REs and custodians must ensure are operating effectively. These areas could include but are not restricted to, key management, cybersecurity, physical security, access management, customer data privacy, change and release management, and third party management.

Consultation paper proposal	Feedback requested	Feedback response
c. The private keys used to access the scheme's crypto-assets are generated and stored in a way that minimises the risk of unauthorised access. For example: i. Solutions that hold private keys in hardware devices that are physically isolated with no connection to the internet (cold storage) are preferred. Private keys should not be held on internet-connected systems or networked hardware (hot storage) beyond what is strictly necessary for the operation of the product, and ii. The hardware devices used to hold private keys should be subject to robust physical security practices. d. Multi-signature or sharding-based signing approaches are used, rather than "single private key" approaches e. Custodians have robust systems and practices for the receipt, validation, review, reporting and execution of instructions from the RE f. REs and custodians have robust cyber and physical security practices with respect to their operations, including appropriate internal governance and controls, risk management and business continuity practices g. The systems and organisational controls of the custodian are independently verified to an appropriate standard–for example, through a SOC 2 Type II or equivalent report h. REs and custodians have an appropriate compensation system in place in the event a crypto-asset held in custody for REs is lost i. If an external or sub-custodian is used, REs should have the appropriate competencies to assess the custodian's compliance with RG 133.	C1Q2. Are there any practical problems associated with this approach? If so, please provide details.	The effort associated with complying with SOC2 or equivalent criteria may place a high operational burden on companies in this space who have operated with few compliance requirements to-date. Furthermore, obtaining external assurance over processes is a multi-phased process that takes time for an organisation to achieve. The number of custody providers in Australia who are in a position to meet these requirements may drive RE's to use offshore custody providers, impacting the viability of local operators. The unique risks associated with the management and custody of digital asset requires auditors who have demonstrated knowledge and experience in cryptography best practices. It would be prudent to have the auditing standards body stipulate the expectations for auditing firms to cover under the ISAE3000 standard for VASPs.
	C1Q3. Do you consider there should be any modifications to the set of good practices? Please provide details.	While the good practices are a good starting point, it could be expanded. We would recommend ASIC consider expanding the areas to cover processes including: proof of reserve; key compromise policy; sanitisation policy and key holder grant/revoke policies and procedures. Additionally, monitoring of addresses and of asset transfer procedures should also be considered. ASIC should consider whether there are mandatory requirements custody holders should meet in relation to the segregation of funds across wallets, geographies and storage mechanisms (i.e. hot, cold and deep cold storage policy requirements). Consideration should be given to the addition of independent reporting over asset balances or as a proof of reserve. In addition to SOC2, an ISO27001 or equivalent cyber security certification should also be held.
	C1Q4. Do you consider that crypto-assets can be held in custody, safely and securely? Please provide your reasons.	Yes - current reputable crypto custodians in this space issue annual SOCs reports/ISO 27001 assessments and other security reports. The standard expectation is for internal IT/cyber processes that align with industry standards such as NIST CSF, ISO 27001/2.
	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.	No further suggestions.
	C1Q6. Should similar requirements to proposal C1also be imposed through a market operator's regulatory framework for ETPs? If so, please provide reasons and how it could work in practice.	Yes - similar requirements should be made to maintain consistency in the requirements imposed on all market participants.

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C2. We propose the following good practices in relation to the risk management systems of Res that hold crypto-assets: a. If the RE undertakes trading activity in crypto-assets, it should do so on legally compliant and regulated crypto-asset trading platforms. For this proposal, we consider an appropriate baseline level of regulation to be know your customer (KYC) and anti-money laundering and counter-terrorism financing (AML/CTF) obligations b. The RE should ensure that authorised participants, market makers and other service providers that trade crypto-assets in connection with the product do so on crypto-asset trading platforms that meet the same standard as in proposal C2(a) c. The RE is responsible for ensuring its risk management systems appropriately manage all other risks posed by crypto-assets	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?	Yes - we agree with ASIC's proposal. In addition to being legally compliant and regulated, the crypto-asset trading platforms should be able to produce a SOC report or equivalent, to demonstrate to customers and the market their adherence to security protocols.
	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.	To date the crypto-asset trading platforms in Australia have largely been unregulated and are not required to hold an AFSL. The Senate Select Committee will be considering whether crypto-assets should be regarded as a financial product and therefore regulated. Any regulation needs to be considered in the context of the cost and burden to existing players and the impact it would have on those businesses currently operating, as well as the attractiveness for Australia as a destination for innovation. Consideration of a grace-period or safe-harbor would seem appropriate to allow necessary due diligence to be followed while developing an appropriate regulatory position beyond those outlined by ASIC, in what is still a new and emerging field.
	C2Q3. Are there any practical problems associated with this approach? If so, please provide details.	Crypto-assets are traded on an international level which means there may be issues with REs/fund managers wanting to trade in foreign jurisdictions who are not similarly regulated. With the proposal to have an AFSL, there may be issues in terms of ensuring overseas crypto-asset trading platforms have adequate licensing. For example, is there an option for an international participant to have an "equivalent/fast-tracked" AFSL?
	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.	Yes - refer to above response.
	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.	Yes – similar requirements to C2 should be made to maintain consistency in the requirements imposed on all market participants.
C3. We propose the following good practices regarding the RE's disclosure obligations in relation to a PDS for a registered managed investment scheme that holds crypto-assets:	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.	Yes - we agree with ASIC's proposal. However, we also note the practical difficulty in such disclosure given that the technologies that underpin the assets and the mechanics by which they operate often vary significantly. From the perspective of a PDS disclosure, it would be hard to disclose the technologies that underpin a portfolio of different crypto assets, for example.

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a. The RE should consider disclosing information about the unique characteristics of crypto-assets. This may include: i. The technologies that underpin crypto-assets, such as blockchains, distributed ledger technology, cryptography and others ii. How crypto-assets are created, transferred and destroyed iii. How crypto-assets are valued and traded, and iv. How crypto-assets are held in custody b. The RE should consider providing appropriate disclosure of the following and other risks: i. Market risk-historically, crypto-assets have demonstrated that their investment performance can be highly volatile and there is a risk that they could have little to no value in the future ii. Pricing risk-it may be difficult to value crypto-assets accurately and reliably given the nature of their trading and difficulty in identifying fundamentals iii. Immutability-most crypto-assets are built on immutable blockchains, meaning that an incorrect or unauthorised transfer cannot be reversed and can only be undone by the recipient agreeing to return the crypto-assets in a separate transaction iv. Increased regulation risk-both crypto-assets and their spot markets are largely unregulated at this moment. This may change in the future v. Custody risk-the private keys may be lost or compromised, resulting in crypto-assets being inaccessible or accessed by unknown third parties without authorisation vi. Cyber risk-the nature of crypto-assets may mean they are more susceptible to cyber risks, and		There should also be an obligation on the RE to consider disclosing how value is attributed to the crypto-assets.
	C3Q2. Are there any practical problems associated with this approach? If so, please provide details.	Yes - refer to the above response at C3Q1. In particular: ► Technology and operational variance mean that uniform disclosure is difficult ► It could be difficult to avoid technical language, which may not be appropriate for retail investors
	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?	Yes - ASIC could give consideration as to whether the below risks should also be included: **Systemic risk** A high degree of correlation between crypto-assets means the value of any particular asset is likely to be affected by volatility in other crypto-assets. **Political risk** Some major governments have indicated their disapproval of or banned the trading of crypto-assets. If more governments follow suit and ban or restrict the trading of crypto currency, this may have sudden impacts on the value of crypto-assets. **Manipulation risk** The value of crypto-assets may be more susceptible to manipulation than other asset classes. If persons of influence make statements about the benefits or drawbacks associated with any given asset or technology, this may cause significant short-term volatility. There is also a risk of "pump and dump" strategies associated with some crypto-assets. **Speculative investment** Certain crypto-currency assets may not have intrinsic value in the sense that they do not represent an interest in any assets or revenue. Pricing is based purely on market sentiment at any given time. **Cyber security risk** Crypto-currency protocols, wallets and instantiations created on top of protocols, such as tokens, are open to cyber security attacks which can compromise the integrity of the network and value of the asset.

Consultation paper proposal	Feedback requested	Feedback response
vii. Environmental risk-crypto-assets, especially those based on proof-of-work consensus mechanisms, by design require significant amounts of energy to operate		
C4. We propose not to issue any additional expectations about how the design and distribution obligations (DDO) can be met for investment products that invest in, or provide exposure to, crypto-assets.	C4Q1. Are there any aspects of the DDO regime that need to be clarified for investment products that invest in, or provide exposure to, crypto-assets?	No - we are not aware of any aspect of the DDO regime that needs to be clarified, noting that crypto-asset funds will be high risk and so product issuers will need to take care in determining their TMD and distribution conditions.
D1. We propose to work with market operators to establish that: a. The approach used to determine and classify appropriate crypto-assets for investment entities is the same as that set out in Section B for ETPs b. In respect of the admission process, to be considered to have a structure and operations that are appropriate for a listed entity, a LIC that invests a material amount in crypto-assets is expected to: i. Have a custody solution for its crypto-assets that is consistent with the expectations for custody set out in proposal C1 ii. Ensure it only trades crypto-assets on crypto-asset markets that are regulated in a manner consistent with proposal C2, and iii. Value crypto-assets held by the LIC using an approach that is consistent with expectations for pricing set out in proposal B3 c. In respect of the admission process, to be considered to have a structure and operations that are appropriate for a listed entity, a LIT that invests a material amount in crypto-assets should value crypto-assets held by the LIT using an approach that is consistent with expectations for pricing set out in proposal B3, and	D1Q1. Do you agree that crypto-assets are capable of being appropriate assets for listed investment entities on Australian markets? If not, why not?	Yes - we agree with ASIC's proposal. We do not see any reason why LICs and LITs should be treated differently to ETPs in relation to investments in crypto-assets. Please refer to our response in B1Q1.
	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?	Yes - we agree with ASIC's proposal that the same minimum standards applying to ETPs, as set out in Sections B and C, should also apply to LICs or LITs.
	D1Q3. Are there any practical problems associated with this approach? If so, please provide details.	A LIT or LIC investing in crypto-assets may not satisfy the current definitions of an "investment entity" under the market operator's listing rules, as they may not be considered to be "equity securities" under the market operator's regulatory framework. Market operators will need to consider whether their listing rules need to be revised to facilitate this new category of investment.
	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?	No further suggestions.
	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?	Yes - we agree that LICs and LITs should only be able to invest significant funds in crypto-assets if this is either set out in their investment mandate or with member approval. In respect of member approval, ASIC should consider whether the existing mechanisms under the listing rules of a market operator are sufficient or require further clarification and amendment (for example ASX Listing Rule 11.1 - proposed change to nature or scale of activities).

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d. The expectations for the admission of LICs and LITs set out in subparagraphs (b) and (c) above should also be ongoing requirements of listing (e.g. they should be imposed as a condition of listing). Note: Listed investment entities must also provide adequate disclosure at the time of listing (see paragraphs 69-75) and will be subject to DDO (see paragraphs 76-81).	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?	We do not have any particular view as to whether 5% is an appropriate materiality threshold. ASIC could have regard to the materiality thresholds mentioned in the ASX Listing Rules Guidance Note 12 as potentially triggering a significant change to a listed entity's activities, being 10% (under the former Australian accounting standards) and 25% as adopted by the ASX.
E1. We propose to establish a new asset kind that can be selected when applying for a new AFS licence, or a variation to an existing AFS licence, to operate a registered managed investment scheme which holds a particular kind of asset. This asset kind will cover crypto-assets.	E1Q1. Do you agree with our proposal to establish a new asset kind that will cover crypto-assets?	Yes - we agree with ASIC's proposal to establish a new asset kind that will cover crypto-assets. We expect that existing AFSL holders, who currently operate other kinds of registered schemes (including investing in Financial Assets) but who wish to also operate a registered scheme investing into crypto-assets, will need to vary their licence to include the authorisation to operate a registered crypto-asset scheme. Please also refer to our response in B2Q1.
	E1Q2. Do you consider that crypto-assets may be captured by the existing asset kinds? If so, please explain.	We agree that crypto-assets are not captured by any of the existing asset kinds that may be selected by an applicant who wishes to operate a registered scheme.
E2. When granting an AFS licensee's authorisation to operate a registered managed investment scheme which holds crypto-assets, we will restrict the crypto-assets the registered managed investment scheme can hold by reference to the factors set out in proposal B1. Accordingly, at this point in time, we consider that such authorisations could only be given to operate registered managed investment schemes that hold bitcoin or ether.	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)?	We agree with the regulator's approach to provide guidance to the market on assessment factors for the appropriateness of crypto assets. In order to reach a conclusion on which assets are appropriate, we believe a further, more detailed assessment of the sub-categories and attributes would need to be developed in order to categorically conclude bitcoin and ether are the only two. For expediency to the market, we agree with ASIC's approach of starting with the two largest crypto-assets. Restricting the investible crypto-assets of registered schemes to bitcoin and ether may limit the interest in the market: ► Issuers may be less keen to establish a new product given the limitations on the crypto-assets they can invest in and therefore limitations to investment strategy ► Investors are not able to benefit from the expertise of managers who are familiar with a broader range of crypto-assets. Bitcoin and ether can be accessed directly by retail investors through other means Please also refer to our responses in B1 and B2.

Consultation paper proposal	Feedback requested	Feedback response
	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?	ASIC should also consider giving further clarification to the below: ► The process for existing AFSL holders to vary their license to add the authorisation to operate a crypto-asset scheme, including whether additional information is required to be provided in respect of matters such as risks management systems (see below), RM competencies (see below) and custody of assets ► It would be helpful if ASIC could clarify what it would consider as relevant education, skills and experience for RMs such that the AFSL applicant would be considered to have the organisational competency to operate registered schemes which hold crypto-assets ► Processes need to be put in place by ASIC to facilitate an orderly entry into the market, (to ensure level playing field ► Requirements for the risk management systems and processes of the applicant to contemplate the specific risks associated with crypto-assets and have relevant controls in place to mitigate these risks

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ED None

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