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To whom it may concern

Australian Securities and Investments Commission

By email: [REDACTED]

Consultation Paper 343: Crypto-assets as underlying assets for ETPs and other investment products

CPA Australia represents the diverse interests of more than 168,000 members in over 100 countries supported by 19 offices globally. We make this submission on behalf of our members and in the broader public interest.

Our response to the consultation paper is detailed in the Attachment.

The availability of Exchange-Traded Products (ETPs) providing exposure to crypto-assets would provide investors with access to this growing class of assets, in a way which provides administrative consistency, convenience and verifiable confirmation to a standard which satisfies investors, authorities and auditors.

We welcome proposals to make these assets available to investors via ETPs. However, we recommend that caution be taken to ensure that investors are fully informed about the contents of these vehicles.

If you have any queries on this submission, please do not hesitate to contact Richard Webb, Policy Advisor Financial Planning and Superannuation at [REDACTED] or Dr. Jana Schmitz, Technical Advisor, Assurance & Emerging Technologies at [REDACTED]

Yours sincerely

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Response to consultation

Executive summary

Crypto assets are a new and growing area of the investment landscape. *Consultation Paper 343: Crypto-assets as underlying assets for ETPs and other investment products* (the “consultation paper”, CP 343) identifies a series of proposals which will see Exchange Traded Products (ETPs) such as Exchange Traded Funds (ETFs), managed funds and structured products available to retail investors, with trading and settlement conducted through licensed Australian markets.

CPA Australia generally supports the recommendations contained in this consultation paper. However, we have identified areas where we believe caution needs to be exercised and appropriate disclosure needs to be provided.

Our recommendations are contained in our responses to the proposals below.

Responses to proposals

Proposal B1

CPA Australia welcomes the proposal which will see ASIC work with Australian market licensees to establish particular crypto-assets as appropriate underlying assets for an ETP. However, we note that it is likely that the approval of crypto-assets for vehicles such as these will be unable to keep up readily with demand.

Generally, we welcome the availability of crypto-asset ETPs through licensed Australian markets. We also consider that licensed clearing and settlement facilities required for crypto-asset ETPs would offer administrative consistency to investors who are likely to use this type of asset. This would be similar to the standards expected of currently available ETPs containing more traditional assets, as well as other vehicles such as Listed Investment Companies (LICs) and Real Estate Investment Trusts (REITs).

We question the definition of an “asset” held by an investment vehicle used in the consultation paper. We are aware that presently, there are ETFs in operation which investors may presume hold the purported underlying assets, but which may include synthetic positions. Paragraph 35 discusses the possibility that an ETP may comprise derivatives which can be reliably priced, and Proposal B3 discusses the possibility that derivatives may be used for pricing purposes. However, CP 343 contains minimal discussion on this possibility.

We strongly recommend consideration be given to disclosure of synthetic positions being used for some or all the portfolio, due to the increased exposure to manager and counterparty risk. We do not agree that bundling these under the heading of ‘structured products’ is necessarily consistent with the existing treatment of ETFs, some of which may be substantially synthetic.

Disclosure standards that are specific to assets underpinning ETPs would also be welcomed. For example, if a fund holds an asset which is then used to generate secondary income, such as through “staking”, asset lending or other activities, it is in the interests of investors to know whether this is forming an additional fee for the responsible entity, or whether it needs to be factored into investment returns. Additionally, it raises questions over the appropriate index to benchmark performance against, as well as questions regarding the presence of related party transactions.

We believe that institutional support will come with the ability to have improved access and exposure to these assets – and with this will also come the availability of custodians, fund administrators and market makers to support ETPs. With the exception of index providers, we expect that the steps may be in the wrong order, by requiring the addressing of parts (a) and (b) prior to a determination that an asset may be appropriate to be held by an ETP.

Notwithstanding, we welcome the need for certainty in relation to mature spot markets, regulated trading in futures contracts over underlying crypto-assets, and robust and transparent pricing mechanisms. These are good bases for exchange traded vehicles holding future novel asset types, although we also note that listed investment entities holding property, infrastructure or other non-fungible assets would find it difficult to be listed under these requirements, where these trusts are not already in existence.

Proposal B2

This proposal suggests that there should be a new category of underlying asset to facilitate ETPs which invest in these crypto-assets. We note the possibility that non-exchange-traded products could be created at a wholesale level to house crypto-assets such as these which would not necessarily be subject to ASIC's oversight.

Additionally, we note that there have been a number of cryptocurrencies issued which appear, to a casual observer, effectively to be managed investment schemes (MISs), with the issued crypto-assets operating as portable investment units. It would be an interesting outcome if MISs were able to operate ostensibly as crypto-assets for regulatory purposes – or vice versa – creating the potential for regulatory arbitrage.

Finally, we are interested about how many layers are required to be in place for this proposal to be operational. For example, a fund which invests in assets through other vehicles – associated or otherwise – may have weaker links to the underlying assets themselves as the number of interposed vehicles between the ETP and the asset increases. We note that transparency projects presently underway in relation to superannuation funds, such as portfolio holdings disclosure, can involve just two layers, ending at one non-associated interposed entity. CPA Australia does not support this and believes that measures should be undertaken to enable full look-through for ETPs seeking to present themselves as funds holding eligible crypto-assets. As such, we agree with the approach suggested in INFO 230 for product providers to look through to the assets underneath. We would extend this to the investment contents of crypto-assets which operate in a similar way to MISs, particularly where the providers are holding out these assets as having investment backing.

Proposal B3

CPA Australia supports this proposal, which suggests that a number of practices be put in place to demonstrate a robust and transparent pricing mechanism:

- where pricing is determined by a robust index compliant with recognised index selection principles, which would be resistant to manipulation and reflect substantial trading activity; and
- which is not reliant on a single crypto-asset spot market.

We agree that pricing using these methods would provide a reasonable degree of certainty for valuations, both for issuers and market makers, as well as for analysts and investors. We note that pricing differences between markets is presently less than efficient, however, a robust approach to indexed valuations can remove most of these differences. Already, providers such as Chainlink are able to provide data collation of pricing at various sources. However, we also note that this pricing is only generally able to reflect the underlying assets.

As we explained in Proposal B1, there are likely to be portfolios structured synthetically, either fully or in part. It is possible that there may be differences between valuations based on an investment in actual assets, and an exposure derived via the use of derivatives, particularly where these are marked to market using a different valuation basis. Care needs to be taken to ensure that there are not great differences in valuation between, for example, synthetic positions and the equivalent position obtained with actual assets. We suggest that differences between synthetic and actual positions must be transparent, easy to understand, and able to be reconciled.

Proposal B4

Under this proposal, ASIC does not plan to update Information Sheet 230 (INFO 230) in relation to crypto-asset ETPs. CPA Australia generally agrees with this. However, there are things that can be done to enhance transparency and consistency.

We note that under proposal B3, positions obtained by holding certain crypto-assets will be valued through pricing obtained by an index mechanism. This is justified due to the unique challenges in pricing crypto-assets which are referred to in paragraph 40. However, derivatives may be valued in a way that does not necessarily match with the underlying position, given that these positions may be constructed for a future point in time, rather than for immediate valuation. For example, derivatives which are obtained over-the-counter from a specific source, might only be traded and cleared with that source and therefore may have a different valuation than market-traded derivatives. It is possible that the immediate valuation of a position obtained from such a source may not match with the position of the underlying assets obtained through the proposed index approach.

We believe that INFO 230 would benefit from guidance which seeks to clarify valuation and other differences between portfolios valued using different methods, as well as the disclosure requirements for portfolios constructed in such a way. Ultimately, whether the portfolio is constructed of crypto-assets or derivatives, consistency should be the aim

Proposal C1

This proposal suggests a number of good practices for Responsible Entities (REs) in relation to the custody of crypto-assets. CPA Australia supports these good practice guidelines.

We consider that one option available to custodians may be the use of smart contracts which adhere to the conditions of the legal contracts (e.g. time-locked for term contracts). This may provide additional automated failsafe mechanisms to protect assets and administration from errors and fraud.

Parts of the proposal discuss the use of separate multiple public and private keys, in particular, their use and storage, as well as the ability to use multi-signature or 'sharding-based' approaches to security. With such approaches come risks that those keys stored in digital wallets could be lost or stolen as a result of cyber-attacks, of error or the loss of key personnel. It is reasonable to expect that loss or theft will happen eventually, making awareness of this issue materially significant to potential guidance in this area. However, at a lower level, we consider that the express discussion in ASIC guidance of specific mitigation practices may result in lower security and increased risks. This may suggest that REs need to construct risk management frameworks specific to their circumstances.

Present practice in a number of larger MISs is to outsource asset custody to third parties who specialise in this area. We note that, as with all outsourced arrangements, this presents third party risk for which REs are ultimately accountable to their investors. We believe that insurance will need to be available to ensure that this risk is able to be appropriately managed.

In relation to asset security, we consider that the presence of features in crypto-assets such as 'master-keys' or 'back-doors' present too great a risk for approval as assets for inclusion in ETPs. If there are instances where the issuer of a token is able to block, reverse or force transactions, this necessarily reduces the ability of custodians to have control over the asset, meaning that ultimately, investor certainty can be compromised without any involvement from REs or their custodians. We do not support the ability for ETPs to contain assets which includes master key and back door features

Proposal C2

This proposal would require REs holding crypto-assets to undertake trading on legally compliant and regulated crypto-asset trading platforms, along with authorised participants, market makers and other service providers, and ensure that their risk management systems appropriately manage all other risks posed by crypto-assets. In this proposal, ASIC considers that an appropriate level of regulation is the know your customer (KYC) requirement and obligations under anti-money laundering and counter-terrorism financing (AML/CTF) requirements.

CPA Australia generally supports these requirements, but note that a variety of crypto-assets are unable to offer this base level of regulation, meaning that the trading platforms would need to provide this base level of regulation. However, we note the observation at paragraph 63, which suggests that there are not yet any crypto-asset trading platforms that are able to do so. This suggests that further work needs to be done to ensure that regulatory requirements are at a level that investors in more traditional ETPs, as well as regulators, would expect at a minimum.

Proposal C3

CPA Australia supports this proposal, which would require discussion in a Product Disclosure Statement (PDS) of the characteristics and risks of the crypto-assets comprising the portfolio of the ETP. While the characteristics at part (a) and the risks at part (b) resemble, superficially, types of information required to be produced in a PDS for a more traditional product, this proposal suggests very specific risks for inclusion. The inclusion of this more specific information will require REs to understand the features and limitations of the assets in the products and would require REs to be able to explain them to their investors.

We agree that the list of risks provided at (b) of this proposal should not be exhaustive, and that REs should provide details of additional risks as and when they become aware of them. We recommend that ASIC continues to update guidance regarding the risks inherent in these assets as they arise.

Proposal C4

CPA Australia notes this proposal, whereby there are no additional expectations in relation to how the design and distribution obligations (DDO) can be met in relation to ETPs investing or providing exposure to crypto-assets. Whilst we agree that the provision of these products should not materially impact existing requirements, as this is a new area, where new product-specific guidance is needed requirements should be updated as soon as possible.

Proposal D1

This proposal considers that, if listed investment entities invest in crypto-assets they should be subject to minimum admission criteria overseen by market operators that are equivalent to those proposed for ETPs in sections B and C of CP 343. CPA Australia generally supports this proposal noting that if differences exist between ETPs and listed investment entities, questions arise around fair competition and regulatory arbitrage.

We agree that equivalent standards should be in place for vehicles which are listed on markets, noting that investors may ultimately expect listed investment vehicles investing in crypto-assets to behave in similar ways to vehicles investing in more traditional asset classes.

Proposal E1

This proposal seeks to establish a new asset type, covering crypto assets, to be contained in new AFS licence applications or licence variations for MIS operators. CPA Australia generally supports this proposal. However, we re-iterate our previous comments regarding crypto-assets which resemble MISs. Additionally, we note that there is scope for shares in corporations to be traded as future tokens resembling crypto-assets and believe that it is important that these assets be properly defined to ensure that inadvertent regulatory gaps, overlaps or loopholes are not created.

Proposal E2

CPA Australia supports proposal B1 outlining the criteria by which crypto-assets are authorised to form the underlying assets of MISs, and therefore supports the proposed initial restriction to bitcoin and ether. However, we also note that, eventually, other crypto-assets are certain to be available to investors in ways which would satisfy the criteria in proposal B1. Additionally, other purpose-built devices, such as liquidity provider (LP) tokens, may need to be held transitionally in order to transact on specific crypto-assets. These devices may eventually need to be defined and approved for practical reasons, even if they do not necessarily meet the criteria in proposal B1.

Finally, as noted previously, care needs to be taken to ensure that there is certainty for investors with respect to the specific asset in which they are invested. We suggest that any uncertainty caused by licensing may require contingent planning to ensure that investors are not inconvenienced – or worse, out of pocket – as a result of a dispute between ASIC and an issuer.