

# Summary of ASIC Report REP 705

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Response to submissions on CP 343:  
Crypto-assets as underlying assets for ETPs  
and other investment products

30 October 2021

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## Executive Summary

Following the Senate Select Committee's final report on Australia as a Technology and Financial Centre, published Wednesday 20 October 2021, ASIC has released its response (REP 705) to submissions on Consultation Paper 343 (CP 343) concerning crypto-assets as underlying assets for investment products such as exchange traded products (ETPs).

The report details key issues that arose out of the submissions to CP 343 and ASIC's response in relation to good practice for ETPs, listing investment companies and listed investment trusts.

### **In REP 705, ASIC's proposals are two-pronged:**

1. Operationalising their licensing proposals with modifications in light of feedback received; and
2. Publishing good practice guidelines for market operations and product issuers (INFO 224 and INFO 230).

Below is a summary of ASIC's key proposals:

1. Crypto-assets will only be permissible underlying assets where at least some part of the trading activity that helps inform the price of the ETP referencing that crypto-asset, is subject to (a) a legal requirement to reduce price manipulation risk and (b) oversight by a financial markets regulator.
2. Presently, only bitcoin (BTC) and ethereum (ETH) are likely to satisfy the proposed factors that a market operator should consider when determining whether a crypto-asset may be a permissible underlying asset for ETPs admitted to its market.
3. Collectively classifying crypto-assets as commodities is not the most appropriate way to facilitate ETPs that provide exposure to crypto-assets and thus should not be classified as such.
4. There should be no imposed requirements on Responsible Entities (RE's) of registered schemes that hold crypto-assets to engage an Australian domiciled custodian; however, REs should ensure that their systems and operations properly account for any specific risks to the offshore custody of crypto-assets.
5. Irrespective of whether the crypto-assets in question are financial products or not, a custodian holding those assets on behalf of the RE of a registered scheme is not required to hold an AFS licence but will be required to meet financial requirements, generally meaning holding net tangible assets of \$10 million.

6. A new 'crypto-assets' asset kind should be created, 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.

### ***Stakeholder feedback and concerns***

ASIC reported that there was “near unanimous” support for ETPs and other investment products that provide exposure to crypto-assets being facilitated within the regulatory framework administered by ASIC, and that respondents were largely supportive of their proposals outlined in CP 343.

ASIC noted that some common concerns raised from stakeholders included:

- (a) concerns that needing a regulated futures market for trading derivatives linked to the crypto-asset was too restrictive;
- (b) requests for clarity on whether these factors apply to crypto-assets that are also financial products;
- (c) requests for clarity on how a high level of institutional support and acceptance ought to be determined; and
- (d) suggestions for additional factors or modifications to the wording of the proposed factors.

### ***Suitability of crypto-assets and identifying features***

Importantly, ASIC has indicated in INFO 230 that it will only consider a crypto-asset to be a permissible underlying asset where “at least some part of the trading activity that can help inform the price of the ETP referencing that crypto-asset is” subject to:

- a legal requirement to reduce price manipulation risk; and
- oversight by a financial markets regulator.

In CP 343, ASIC proposed that a market operator should only determine that a crypto-asset may be a permissible underlying asset for ETPs admitted to its market if it is satisfied that (all factors must be met):

- (a) there is a high level of institutional support and acceptance of the crypto-asset being used for investment purposes;
- (b) service providers (including custodians, fund administrators, market makers and index providers) are available and willing to support ETPs that invest in, or provide exposure to, the crypto-asset;
- (c) there is a mature spot market for the crypto-asset;
- (d) there is a regulated futures market for trading derivatives linked to the crypto-asset; and

(e) robust and transparent pricing mechanisms for the crypto-asset are available, both throughout the trading day and to strike a daily net asset valuation (NAV) price.

In ASIC's view, presently only BTC and ETH are likely to satisfy all of the above factors. Furthermore, the existence of a regulated futures market was held to support the *high level of institutional support and acceptance* and *mature spot market* factors.

### ***Application to crypto-assets that are financial products***

ASIC clarified in INFO 230 that market operators only need to consider the above factors when assessing the appropriateness of crypto-assets that are not financial products.

Crypto-assets that are financial products are immediately subject to the requirements of the *Corporations Act 2001 (Cth)* (Corporations Act) relevant to that class of financial product, and market operators may determine that a particular financial product crypto-asset is a permissible underlying asset on the basis that the relevant class of financial product is a permissible underlying asset.

However, in all circumstances, the market operator must be satisfied that permitting the crypto-asset as an underlying asset is consistent with maintaining a fair, orderly and transparent market.

### ***Level of required institutional support and acceptance***

ASIC has set out in INFO 230 a number of optional considerations that market operators may rely on to determine if and to what extent they adopt any of ASIC's recommendations in their product admission assessment process.

Crucially, factor (b) has been changed in INFO 230 to the "availability and willingness of *reputable and experienced* service providers to support ETPs that invest in, or provide exposure to, the crypto-asset". This is an important distinction which raises the required threshold of experience and standing for service providers.

### ***Classification of crypto-assets as commodities***

ASIC does not consider that "collectively classifying crypto-assets as commodities is the most appropriate way to facilitate ETPs that provide exposure to crypto-assets", and market operators should have processes put in place to satisfy themselves that accepting a crypto-asset as an underlying asset is consistent with ASIC's scope of maintaining a fair, orderly and transparent market.

One reason provided for this classification was that crypto-assets are not a homogenous asset class, and the rights, features and risks of crypto-assets (including protocols) can vary greatly and also change over time.

## **Categorisation**

In CP 343, ASIC suggested that market operators should establish a new underlying asset class for crypto-assets in market operator rule frameworks, as this approach:

- (a) reflects the unique nature and characteristics of crypto-assets;
- (b) helps address uncertainty regarding the classification and permissibility of crypto-assets under market operator rules; and
- (c) provides a basis for market operators to establish further rules and procedures in relation to crypto-asset products as this area develops and matures.

ASIC noted that some supporters disagreed with this approach, submitting that crypto-assets are capable of being supported within existing market operator rule frameworks or that the UK Financial Conduct Authority (FCA)'s approach should be adopted. ASIC does not propose to adopt the FCA's approach, noting such adoption in the Australian context is a matter for the Australian Government.

### ***Issue of double regulation***

Some respondents expressed concerns that crypto-assets that were also financial products would be 'double regulated' if they were caught by both this new category and the category applicable to the relevant class of financial product.

However, ASIC clarified in INFO 230 that the new proposed category would not apply to crypto-assets that are financial products. It was proposed that market operators should assess applications for products referencing these assets on the basis that the relevant class of financial product is a permissible underlying asset.

## **Responsible entity (RE) obligations**

### ***Custody***

In CP 343, ASIC proposed good practices for REs in relation to the custody of crypto-assets, including appropriate safeguards for security of private keys, transaction signing, governance, organisational controls and compensation systems.

ASIC reiterated that appropriate safeguards by an asset holder, which can be the RE or a separate custodian, are necessary to protect the assets of the scheme against potential threats, including but not limited to cyber-attacks, loss, theft and other fraudulent activity.

A distinction was made between ASIC's good practice guidelines for the custody of crypto-assets set out in INFO 223 and legal requirements that apply to the custody of crypto-assets held by a scheme set out in the Corporations Act and relevant class orders.

ASIC noted that it does not consider that the proposed good practice guidelines should be cemented in the legislation because, it submitted, no changes are required to the current legal framework to ensure RE's obligations to provide safe and secure custody of crypto-assets held by a registered scheme. Further, it was submitted that what is good practice will change over time, and therefore a flexible approach is required to adjust good practice as needed.

Furthermore, ASIC submitted that it would not be appropriate to mandate a domestic custodian requirement because Australian domicile requirements for custodians are not imposed in respect of other asset classes and it would lead to a reduced choice for REs and therefore may "unfairly restrict competition".

However, if an overseas-based custodian is used, ASIC recommended that REs should ensure that their systems and operations properly account for any specific risks to the offshore custody of crypto-assets.

This may include a consideration of whether the use of offshore custody impacts risk management arrangements including business continuity plans, operational risks heightened by time zone differences and internal and external audit functions.

### ***AFS licensing requirements***

Irrespective of whether the crypto-assets in question are financial products or not, a custodian holding those assets on behalf of the RE of a registered scheme is not required to hold an AFS licence.

ASIC noted that: "An RE or another person engaged by it to hold assets of a registered scheme does not need to hold an AFS licence authorising it to provide a custodial service for this purpose. This is because holding those assets is not a custodial service under s766E(3)(b) of the Corporations Act. Holding assets is part of the operation of the registered scheme by the RE."

### ***Appropriate compensation systems***

ASIC submitted that it is good practice for REs to have access to an arrangement which compensates members of the scheme in case the scheme's crypto-assets are lost. However, the precise nature of the arrangement, including what is covered, how much is covered, and its form (ie in relation to insurance, asset protection plans or compensation fund) are matters for the RE to determine.

### ***Cyber security and controls standards***

Pursuant to RG 133, all asset holders must have an adequate organisational structure, capacity and resources to perform core administrative activities. ASIC has not mandated

particular standards in relation to the cyber security practices and controls environments of custodians.

Ultimately however, having appropriate cyber security practices and controls environments will be key matters for custodians, and it is good practice to have independent verification of the custodian's cybersecurity practices and its control environment. REs should ensure that a proposed custodian's controls environment is independently verified to an appropriate standard through, for example, a SOC 1/2, GS 007 or similar certification.

### ***Risk management***

In CP 343, ASIC proposed good practices in relation to risk management systems of REs holding crypto assets, including that any crypto-asset trading carried out by an RE or its service providers should take place on platforms that are subject to Know Your Customer (KYC) and anti-money laundering and counter-terrorism financing (AML/CTF) obligations.

INFO 225 sets out that an RE should be satisfied that any crypto-asset trading platform it relies on:

- is a digital currency exchange (DCE) provider registered with the Australian Transaction Reports and Analysis Centre (AUSTRAC), or is regulated by one or more laws of a foreign country giving effect to the Financial Action Task Force recommendations relating to customer due diligence and record-keeping; and
- its implementation of risk-based AML/CTF systems and controls is supervised or monitored by a body empowered by law to supervise and enforce the customer due diligence and record-keeping obligations.

### ***Disclosure***

ASIC stated in CP 343 that they were not proposing to mandate matters for disclosure. Ultimately, REs must determine what is appropriate disclosure in the context of the characteristics, operations and risks of their product.

In INFO 225, ASIC also clarified that the environmental impact associated with some crypto-assets is only a relevant matter for disclosure to the extent it could affect the value of crypto-assets held by the scheme—for example, if it could negatively impact market sentiment.

### **Listed investment entities**

In Section D of CP 343, ASIC proposed that listed investment entities which invest a material proportion of investors' funds in crypto-assets should be subject to the same

minimum standards as crypto-asset ETPs. However, market operators are best placed to address concerns regarding the details of the approach.

In practice, this would mean that:

- LICs and LITs only invest a material amount of investors' funds in crypto-assets which meet the factors set out in proposal B1 of CP 343; and
- in order to have a structure and operations appropriate for a listed entity, a LIC/LIT that invests a material amount in crypto-assets would be subject to the same minimum standards as to pricing, risk management and custody as ETPs that invest in crypto-assets.

The feedback in relation to the above proposals was mostly positive. Some stakeholders noted that the implementation of minimum standards for LICs and LITs should be determined in the context of each market's rule framework, and that the "over 5%" materiality threshold proposed in CP 343 was too low.

Interestingly, ASIC noted that product issuers may have a greater level of interest for ETP structures for crypto-asset products than for crypto-asset LICs or LITs.

## **AFS Licensing**

### ***New asset kind***

In CP 343, ASIC proposed to establish a new asset kind called 'crypto-assets' 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.

As noted above, ASIC did not agree with submissions that all crypto-assets (or all crypto-assets that are financial products) should be classified as commodities.

Conversely, ASIC prefers a standalone crypto-asset category that can be applied to ASIC's licensing asset kinds. The proposal is that, when seeking authorisation to operate registered managed investment schemes that will hold crypto-assets, the applicant should select:

- for crypto-assets that are not financial products, the 'crypto-asset' asset kind; or
- for crypto-assets that are financial products, the asset kind which corresponds to the crypto-asset's class of financial product.

ASIC proposed the following definition of "crypto-asset" for this purpose:

*"a digital representation of value or rights (including rights to property), the ownership of which is evidenced cryptographically and that is held and transferred electronically by:*

*(a) a type of distributed ledger technology; or  
(b) another distributed cryptographically verifiable data structure.”*

### ***License restrictions***

Per CP 343, when granting an AFS licensee authorisation to operate a registered managed investment scheme which holds crypto-assets, the crypto-assets that it would be able to hold would be restricted by reference to the factors set out in proposal B1 of CP 343. Following this approach, ASIC would only issue authorisations for BTC and ETH.

Notably, stakeholders were generally opposed to this idea, on the basis that:

- the criteria to identify the appropriate crypto-assets is restrictive;
- it would result in entities continuously needing to update their licence authorisations as permitted asset evolve; and
- ASIC would have issues keeping pace with the rapidly evolving crypto-asset landscape.

Therefore, ASIC did not adopt this approach.

Under the new approach (set out in INFO 225) AFS licensees, provided they have the appropriate authorisations, will be able to operate schemes that hold any crypto-asset.

Under this process, applicants proposing to operate registered schemes that hold crypto-assets will apply for ‘named scheme’ authorisation (whether the scheme holds one or more crypto-assets). This authorises the licensee to operate only the specific crypto-asset registered scheme(s) named on the licence.

Applicants are expected to operate two named crypto-asset registered schemes for at least two years before ASIC will consider granting them broader ‘kind scheme’ authorisation for crypto-assets. The ‘kind scheme’ authorisation will allow the licensee to operate multiple crypto-asset schemes without needing to vary the licence with each new scheme.

ASIC will take a strict, case-by-case approach to granting licences, focusing on matters we outlined in INFO 225. Registered schemes seeking admission as ETPs or LITs will still need to limit themselves to the relevant market’s permissible underlying crypto-assets, meaning that this approach mainly affects unlisted registered schemes.

Furthermore, there may be circumstances where ASIC will impose restrictions on what crypto-assets may be held.