

## AVOIDING THE WHOLESALE DE-BANKING OF CRYPTOCURRENCY EXCHANGES IN AUSTRALIA

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*De-banking is the closure of banking facilities by a bank for reasons such as a risk of money laundering. De-banking the Australian Cryptocurrency Exchange ('Crypto Exchange') industry could mean that Australian banks fall foul of competition law. In 2021, an Australian Senate inquiry investigated how to regulate cryptocurrencies, including considering de-banking. This article outlines a possible system that reduces the risk to banks of providing banking services to the Australian Crypto Exchange industry. Regulators should continue to adopt a collaborative market governance approach, working with cryptocurrency financial technologies to survey Crypto Exchange operating models. Then they should create an operating model licensing regime and updated Crypto Exchange-specific anti-money laundering ('AML') compliance frameworks. That regime would differentiate both centralised and decentralised; and custodian and non-custodian Crypto Exchanges, streamlining this licensing regime for banks. An AML-compliant self-certification system for Crypto Exchanges unable to be licensed is another suggestion. On 20 October 2021, the final Senate Inquiry Report also recommended a similar licensing regime.*

'You're basically relying on people doing the right thing just because they want to do the right thing.'<sup>1</sup>

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1 Adrian Przelozny, Chief Executive Officer of Independent Reserve, Australian Cryptocurrency Exchange quoted in Dominic Powell, 'Trading Bitcoin without Protection: Crypto Exchanges in Regulatory Hole', *The Sydney Morning Herald* (online, 29 May 2021) <<https://www.smh.com.au/business/companies/trading-bitcoin-without-protection-crypto-exchanges-in-regulatory-hole-20210527-p57v1x.html>> ('Trading Bitcoin without Protection').

## I INTRODUCTION

The cryptocurrency exchange ('Crypto Exchange') industry, its players, products and the various ideologies driving its evolution are diverse. This dynamic industry is built around a new financial technology ('FinTech') driven (at least initially) by ideology that now has many distinct players and stakeholders. Crypto Exchanges are not all as decentralised as Satoshi Nakamoto,<sup>2</sup> bitcoin's unidentified founder(s) may have hoped. Accordingly, they could be regulated differently. The cryptocurrency industry and traders (retail, professional and institutional) and the banking industry would all benefit from a diversity of regulatory approaches.

This article is divided into three parts, below: Part II explains Australia's anti-money laundering and counter-terrorism financing ('AML/CTF') laws that can lead to de-banking and questions whether banks fall foul of competition law with regards to de-banking Crypto Exchanges. This article uses the AML/CTF lens. The issues of consumer protection and financial stability are other critical considerations and are noted in the context of the roles of the Australian Securities and Investments Commission ('ASIC') and the Australian Prudential Regulation Authority ('APRA'). Also, investor protections are provided by custodial mechanisms of assets and this issue is also considered in Part III. Further, the remit of the Australian Senate's Select Committee on Australia as a Technology and Financial Centre is also outlined. Part III explains why Crypto Exchanges cannot neatly fit into pre-existing regulatory categories for FinTechs by explaining the different types of Crypto Exchanges. Part IV poses some questions that could be asked by industry, regulators and banks, as well as providing some proposals on how Australia could regulate Crypto Exchanges to avoid the wholesale de-banking of Crypto Exchanges. These proposals are made with reference to recent international approaches to regulating Crypto Exchanges and custodian principles derived from the Australian superannuation industry. In collaborative market governance, policy and market forces are intertwined. An Australian collaborative market governance approach could distinguish Crypto Exchanges by type for AML/CTF compliance.

## II DE-BANKING IN AUSTRALIA

De-banking is the closure of a company's banking facilities by a bank for reasons such as a risk of money laundering. The key reason for de-banking practices in Australia is a risk of money laundering and terrorism financing. In recent years, major Australian banks such as the Commonwealth Bank of Australia ('CBA') and Westpac Bank ('Westpac') have faced major fines from the Australian financial crimes

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2 Satoshi Nakamoto is the name used by the presumed pseudonymous person or persons who developed Bitcoin: Satoshi Nakamoto, 'Bitcoin: A Peer-to-Peer Electronic Cash System', *Satoshi Nakamoto Institute* (Web Page, 31 October 2008) <<https://nakamotoinstitute.org/bitcoin/>>.

regulator, Australian Transaction Reports and Analysis Centre ('AUSTRAC')<sup>3</sup> for breaching AML/CTF laws.<sup>4</sup> Westpac's Chief Executive and Chairman stood down following the revelations of those systemic breaches of AML/CTF laws.<sup>5</sup> Westpac was forced to de-bank hundreds of business clients in 2019 for those breaches. The bank received a record \$1.3 billion fine for its breaches of AML/CTF laws.<sup>6</sup> Banks are now, understandably, highly sensitive to the reputational damage that accompanies being implicated in an AML/CTF incident.

However, where non-bank firms that compete with banks are de-banked as clients by banks, citing risk or regulatory concerns, this conduct could amount to anti-competitive behaviour.<sup>7</sup> For example, if FinTechs are stopped from gaining access to the payment infrastructure because they pose a commercial threat to the major banks. Nevertheless, this risk is no longer theoretical with regards to Crypto Exchanges and competition law. While no allegation of a substantial degree of market power employed by the banks against Crypto Exchanges has been found by Australian courts or the Australian Competition and Consumer Commission ('ACCC') to date,<sup>8</sup> persistent claims of anti-competitive behaviour (described below in section C) abound and were cited as a major concern by the 2021 Senate Select Committee on Australia as a Technology and Financial Centre ('Bragg Inquiry'). According to the Bragg Inquiry: '[t]his commercial threat to banks is real. For some cryptocurrency assets, the transfer of assets is processed for a few cents. A bank transfer can often cost two hundred dollars for that same transfer.'<sup>9</sup>

Still, Australian banks have been historically and remain risk-averse to serving the banking needs of the Crypto Exchange industry, viewing exchanges as a

3 The Australian Transaction Reports and Analysis Centre ('AUSTRAC') is a government agency responsible for monitoring financial transactions to identify money laundering, organised crime, tax evasion and terrorism financing: 'AUSTRAC Overview', *Australian Transaction Reports and Analysis Centre* (Web Page, 2 August 2022) <<https://www.austrac.gov.au/about-us/austrac-overview>>.

4 Charlotte Grieve, 'Westpac Announces Record-Breaking \$1.3b Fine', *The Sydney Morning Herald* (online, 24 September 2020) <<https://www.smh.com.au/business/banking-and-finance/westpac-announces-record-breaking-1-3b-fine-20200924-p55yno.html>>.

5 Clancy Yeates, 'Westpac Chief Brian Hartzler to Step Down in Wake of Scandal', *The Sydney Morning Herald* (online, 26 November 2019) <<https://www.smh.com.au/business/banking-and-finance/westpac-chief-brian-hartzler-to-step-down-20191126-p53e21.html>>.

6 Australian Transaction Reports and Analysis Centre, 'AUSTRAC and Westpac Agree to Proposed \$1.3bn Penalty' (Media Release, 24 September 2020).

7 Senate Select Committee on Australia as a Technology and Financial Centre, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (Second Interim Report, 28 April 2021) 89 [5.53] ('*Second Interim Report*').

8 The test of anti-competitive behaviour is whether the refusal of a service will lead to a substantial lessening of competition in a relevant market. Entities refusing to supply a service could amount to a misuse of substantial market power: *Competition and Consumer Act 2010* (Cth) s 46 ('CCA'). In this regard, the claim is that access to payment clearing is being restricted by banks for Crypto Exchanges. If there is coordination, this could amount to cartel conduct: at s 45.

9 Senate Select Committee on Australia as a Technology and Financial Centre, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (Final Report, 20 October 2021) 104 [4.89] ('*Bragg Final Report*'), quoting Max Parasol, Submission No 20 to Senate Select Committee on Australia as a Technology and Financial Centre, Parliament of Australia, *Senate Select Committee on Australia as a Technology and Financial Centre* (30 June 2021) 13.

reputational and compliance risk, due to a perceived lack of AML/CTF regulation.<sup>10</sup> In 2013, Westpac had also made headlines when it emerged that a \$6 billion money laundering operation was moving funds through three Westpac accounts. It was reported that Westpac had been ‘caught up in the ... biggest ever money laundering scheme’ following the United States (‘US’) Department of Justice’s crackdown on the Liberty Reserve Crypto Exchange, operating from Costa Rica.<sup>11</sup> Westpac was not accused of any misconduct, but the case demonstrated the potential reputational fallout associated with providing banking services for Crypto Exchange providers. This case has been instrumental in making Westpac and the other major Australian banks ‘highly risk-averse when it came to virtual currencies’.<sup>12</sup>

By 2015, Paul Jevtovic, then chief executive of financial crime monitor AUSTRAC, said disruptive forms of technology such as Bitcoin ‘were essential for local businesses to keep pace with international developments’ and that AUSTRAC ‘does not support the wholesale closure of accounts in high-risk sectors such as remittance providers and bitcoin exchanges.’<sup>13</sup> In the case of Crypto Exchange remittances, AUSTRAC has long been concerned that the industries may move underground or use the internet to base their operations offshore.<sup>14</sup> Wholesale de-banking of a sector or industry is also an AML/CTF concern, as regulators may lose visibility over ‘de-banked’ sectors. This is because they would no longer receive intelligence through Suspicious Matter Reports.<sup>15</sup> Further, de-banking also goes beyond cryptocurrencies, and the ACCC has said it is a problem in the foreign exchange market.<sup>16</sup> ASIC too has noted that: ‘ASIC is aware that debanking is an issue for fintech businesses, including those in the crypto-asset, payments, remittance and wealthtech sectors.’<sup>17</sup> Thus, ASIC regards the de-banking of Crypto Exchanges in Australia as highly problematic, if not anti-competitive behaviour, and made that clear to the Senate Inquiry.

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10 Jack Derwin, ‘Canberra Admits It Dropped the Ball on Crypto, Promising to Catch up with the Sector within 6 Months. One Exchange Says It May Be “Too Late”’, *Business Insider Australia* (online, 21 April 2021) <<https://web.archive.org/web/20211021012303/https://www.businessinsider.com.au/australia-crypto-exchanges-banks-regulation-2021-4>>.

11 ‘AUSTRAC Throws Regulatory Lifeline to “De-banked” Bitcoin Operators’, *University of New South Wales Centre for Law Markets and Regulation* (Web Page) <<https://clmr.unsw.edu.au/article/market-conduct-regulation/austrac-throws-regulatory-lifeline-to-%22de-banked%22-bitcoin-operators>> (‘AUSTRAC Throws Regulatory Lifeline’).

12 *Ibid.* However, Westpac’s website lists Crypto Exchange platform Coinbase on its ‘Our Partners and Portfolio’ page, which it describes as one of its ‘[s]tart-ups delivering innovation to Westpac and its customers.’: ‘Our Partners and Portfolio’, *Westpac* (Web Page) <<https://www.westpac.com.au/about-westpac/innovation/our-partners-and-portfolio/>>.

13 ‘AUSTRAC Throws Regulatory Lifeline’ (n 11).

14 *Ibid.* Essentially, AUSTRAC can provide a safe harbour rule that licensed exchanges can be treated as low risk if those exchanges meet their designated registration requirements.

15 ‘Suspicious Matter Reports (SMRs)’, *Australian Transaction Reports and Analysis Centre* (Web Page, 29 April 2021) <<https://www.austrac.gov.au/business/how-comply-guidance-and-resources/reporting/suspicious-matter-reports-smr>>.

16 Australian Competition and Consumer Commission, *Foreign Currency Conversion Services Inquiry* (Final Report, July 2019) 57.

17 Australian Securities and Investment Commission, Submission 61 to Senate Select Committee on Australia as a Technology and Financial Centre: Third Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (July 2021) 10.

Yet the risks for banks, both reputational and punitive, are real. In 2021, Crypto Exchange ACX allegedly disappeared with over \$10 million in clients' money.<sup>18</sup> Further, Melbourne-based MyCryptoWallet was reported to ASIC after users were unable to access funds invested through the platform.<sup>19</sup> Users also claimed that the operators of MyCryptoWallet pressured them to liquidate their investments into fiat currency, at prices of up to 10% below market value.<sup>20</sup> Actions such as these have led to the Crypto Exchange industry's calls for better regulation.<sup>21</sup> By June 2021, over 600,000 Australians have traded cryptocurrencies.<sup>22</sup> The Australian de-banking rules are explained in practice below.

## A AML/CTF Remit Applies to Exchange in Fiat Currencies

First, the Australian de-banking remit must be outlined. Cryptocurrencies are treated as legal property<sup>23</sup> and in 2017, the Australian Government declared that cryptocurrencies were subject to the *AML/CTF Act 2006* (Cth) ('*AML/CTF Act*'),<sup>24</sup> section 5.<sup>25</sup> The *AML/CTF Act* applies to a digital currency exchange ('DCE') with a geographical link to Australia.<sup>26</sup> Crypto Exchanges qualifying as reporting

18 James Frost, 'Collapse of Crypto Platform a Cautionary Tale', *Australian Financial Review* (online, 1 March 2021) <<https://www.afr.com/companies/financial-services/collapse-of-crypto-platform-a-cautionary-tale-20210228-p576hn>>.

19 Dominic Powell, 'Crypto Exchange Draws ASIC Attention after Users Raise Alarm', *The Sydney Morning Herald* (online, 6 April 2021) <<https://www.smh.com.au/business/companies/crypto-exchange-draws-asic-attention-after-users-raise-alarm-20210401-p57ft7.html>>.

20 Powell, 'Trading Bitcoin without Protection' (n 1).

21 Ibid.

22 Marion Rae, 'ATO Puts Cryptocurrency Traders on Notice ahead of Tax Time, Warning of Penalties', *7 News* (online, 28 May 2021) <<https://7news.com.au/business/tax/tax-office-puts-crypto-traders-on-notice-c-2952809>>.

23 Bitcoin (and cryptocurrencies that share its characteristics) are treated as property and subject to Capital Gains Tax ('CGT'): see 'What Are Crypto Assets?', *Australian Taxation Office* (Web Page, 7 July 2022) <<https://web.archive.org/web/20220709092328/https://www.ato.gov.au/individuals/Investments-and-assets/crypto-asset-investments/what-are-crypto-assets/>>. However, the Australian Tax Office ('ATO') interpreted that Bitcoin is a CGT asset for tax purposes, but transactions involving the transfer of Bitcoins do not attract Goods and Services Tax: 'GST and Digital Currency', *Australian Tax Office* (Web Page, 16 March 2018) <<https://www.ato.gov.au/business/gst/in-detail/your-industry/financial-services-and-insurance/gst-and-digital-currency/>>. In Australia, there is no consensus as to the general law nature of crypto-assets yet: see Julie Cassidy et al, 'A Toss of a (Bit)coin: The Uncertain Nature of the Legal Status of Cryptocurrencies' (2020) 17(2) *e-Journal of Tax Research* 168.

24 *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) ('*AML/CTF Act*').

25 A digital currency exchange ('DCE') provider in section 5, is defined as a 'registrable digital currency exchange service': Ibid s 5 (definition of 'digital currency exchange').

26 Ibid s 76D(1): 'A person may apply in writing to the AUSTRAC Chief Executive Officer ('CEO') for registration as a digital currency exchange provider.'

DCEs must register with the Australian Securities and Investments Commission ('ASIC') and:

- notify AUSTRAC of any changes or updates to their AUSTRAC registration;
- conduct regular compliance reviews;
- report various transactions to AUSTRAC, including International Funds Transfer Instructions ('IFTIs'), Suspicious Matter Reports ('SMRs') and Threshold Transaction Reports ('TTRs'); and
- comply with AML/CTF regulations.

See Jim Bulling and Michelle Chasser, 'Digital Currency Exchange Providers, Do You Need to Register with AUSTRAC?', *K&L Gates FinTech Law Watch* (Blog Post, 25 January 2018) <<https://www.fintechlawblog.com/2018/01/digital-currency-exchange-providers-do-you-need-to-register-with-austrac/>>.

entities ('RE')<sup>27</sup> under the *AML/CTF Act* must collect customer data for anti-money laundering ('AML') purposes for AUSTRAC.<sup>28</sup>

If a Crypto Exchange does not handle fiat currencies and only exchanges one digital currency for another digital currency, it will not be a designated service ('Designated Service').<sup>29</sup> This means it is not identified as posing an AML/CTF risk under section 6 of the *AML/CTF Act*. Also, if a Crypto Exchange does not handle fiat currency it may not have or may not require access to banking services. This will depend upon the Crypto Exchange's business model (though these businesses may, at least, require some access to a bank to pay bills such as running an office and paying staff).

However, it is important to note that Crypto Exchanges that sell decentralised finance ('DeFi')<sup>30</sup> and other crypto financial products may need an Australian Financial Services Licence ('AFSL') authorised by ASIC to obtain banking services under that AFSL, depending on the products that they offer for sale or exchange. Importantly, whether an AFSL is obtained may also affect that firm's prospects for obtaining banking services.<sup>31</sup> Therefore, although those types of Crypto Exchanges will not have the obligations imposed on fiat to digital currency exchanges, de-banking is still possible. Thus, AFSL licensing expands the scope of the de-banking issue. This causes additional de-banking uncertainty, but robust

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27 A reporting entity ('RE') is 'a person who provides a designated service' under the *AML/CTF Act* (n 24) section 5. Designated services are defined under section 6 of the *AML/CTF Act* (n 24), and encompass various financial services, bullion, gambling services and prescribed services. Section 6 table 1 item 50A of the *AML/CTF Act* (n 24) provides that the following is a designated service: 'exchanging digital currency for money (whether Australian or not) or exchanging money (whether Australian or not) for digital currency, where the exchange is provided in the course of carrying on a digital currency exchange business'.

28 Since 2018, Crypto Exchanges must register with AUSTRAC, in compliance with the *AML/CTF Act* (n 24) part 6A. Again, if a Crypto Exchange exchanges digital currency for fiat currency (whether Australian or not) or vice versa, that exchange must implement a risk-based AML/CTF Program that, outlines Know Your Customer ('KYC') and due diligence procedures; enrol as a RE with AUSTRAC and register on AUSTRAC's Digital Currency Exchange Register. Crypto Exchanges must identify and verify their users, maintain records, and comply with government AML/CTF reporting obligations, including reporting suspicious matters to AUSTRAC. Unregistered exchanges are subject to criminal charges and financial penalties. The CEO of AUSTRAC maintains the Digital Currency Exchange Register: see 'Cryptocurrency Regulations Around the World', *Comply Advantage* (Blog Post, 25 August 2022) <<https://complyadvantage.com/blog/cryptocurrency-regulations-around-world/>>.

29 Designated services are defined under section 6 of *AML/CTF Act* (n 24).

30 Decentralised finance ('DeFi') refers to the provision of financial services without an institutional middleman, for example via a public blockchain rather than through a bank. It is discussed extensively below in Part IV(D).

31 Whether a cryptocurrency asset fits within the existing Australian financial regulatory framework depends on the particular characteristics of the cryptocurrency asset offering. Whether a Crypto Exchange requires an Australian Financial Services Licence ('AFSL') will depend on how the exchange is structured and what digital assets are offered. If a Crypto Exchange provides a financial service, or the cryptocurrencies listed are financial products, then it will require an AFSL. DeFi products such as staking, lending and inflationary protocols will likely require an AFSL licence: Australian Securities and Investments Commission, 'Crypto-Assets' (Information Sheet No 225, October 2021). Digital assets meeting the definition of 'financial product' under section 9 of the *Corporations Act 2001* (Cth) ('CA') are subject to regulatory oversight by ASIC. Companies dealing with financial products need to hold an AFSL or an Australian Market Licence depending on the circumstances.

AML/CTF processes will help those Crypto Exchanges obtain an Australian bank account. Furthermore, and importantly, this article considers that some of those DeFi Crypto Exchanges will seek to adopt AML/CTF compliance procedures to attract institutional investors. These DeFi Crypto Exchanges do raise higher levels of AML/CTF concern for banks, due to the speed of transactions, but could opt-in to AML/CTF obligations that are adapted for the pace, scale and decentralised nature of their operations (discussed below in Part IV(E)).

Further, it was reported in May 2021 that there are over 450 Crypto Exchanges registered with AUSTRAC.<sup>32</sup> Yet AUSTRAC does not publish those names. As AUSTRAC publishes the names of remittance companies but not Crypto Exchanges, this is another important element of the anti-competitive banking arguments made by academics and the cryptocurrency industry.<sup>33</sup> Crypto Exchanges who are registered for AML/CTF compliance cannot prove that they are registered with AUSTRAC.<sup>34</sup> At a minimum, Crypto Exchanges who are registered for AML/CTF compliance could be made public, however those Crypto Exchanges might also plausibly argue that publication of their AUSTRAC registered-crypto business currently leads to further de-banking from risk averse banks.<sup>35</sup> This is why an AML/CTF licensing regime is one specific proposal made by this article and also why it would likely find support from many Crypto Exchange operators who find themselves being regularly de-banked by Australian banks. They are seeking further regulatory protection from constant de-banking.<sup>36</sup> The banking industry may also appreciate further certainty.<sup>37</sup> A possible new licensing regime for AML/CTF compliance might seem counter-intuitive, especially for the cryptocurrency industry, which has generally eschewed regulatory intervention, but, due to the banks' high level of autonomy in de-banking new-entrant FinTechs (discussed below), licensing of AML/CTF risk controls by AUSTRAC may be a viable option. That is, in fact, the conclusion that the 2021 Senate Inquiry *Final Report* came to by suggesting a new market licensing regime for Crypto Exchanges.

## **B The AML/CTF Regime: High Level of Autonomy for Banks**

Australia's *AML/CTF Act* does not impose requirements on a bank to close accounts or terminate a business relationship, yet a bank may need to make a compliance decision on the risk profile of a client business. This provides banks

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32 Powell, 'Trading Bitcoin without Protection' (n 1).

33 Darcy WE Allen et al, Submission No 67 to Senate Select Committee on Australia as a Technology and Financial Centre: Response to Third Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (19 July 2021) 19.

34 A search for Crypto Exchanges registered for AML/CTF compliance yields no results: see 'Remittance Sector Register', *AUSTRAC Online* (Web Page, 16 July 2021) <<https://online.austrac.gov.au/ao/public/rsregister.seam>>.

35 Allan Flynn, Submission No 57 to Senate Select Committee on Australia as a Technology and Financial Centre Submission, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (30 June 2021).

36 Ibid.

37 See Australian Banking Association, Submission No 30 to Senate Select Committee on Australia as a Technology and Financial Centre Submission – Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (30 June 2021).

with a level of autonomy in their compliance decision-making. Under the AML/CTF regime, individual REs such as banks must make their own risk-based decisions on how best to identify, mitigate and manage AML/CTF concerns. This may involve account closures in high-risk cases. Regarding new-entrant FinTechs, the lines between the threat of AML/CTF concerns and the commercial threat to the banks in Australia can be vague. For example, Australia and New Zealand Banking Group Limited ('ANZ') continues to provide transactional services for the payments 'unicorn' Airwallex, despite Airwallex being turned down by two major banks over money laundering compliance concerns.<sup>38</sup> (Founded in 2015, Airwallex, is one of the Australia's most high profile FinTech start-ups, as of March 2021 it has a \$3.3 billion valuation).<sup>39</sup> National Australia Bank ('NAB') terminated key banking services to Airwallex in 2018.<sup>40</sup> Reportedly, Airwallex was told by NAB the decision was part of a post-Financial Services Royal Commission policy to limit exposure to money services businesses, as there were red flags around Airwallex's customers and suspicious transaction patterns.<sup>41</sup> Airwallex subsequently unsuccessfully approached Citigroup Inc for banking services.<sup>42</sup> It should be noted that Airwallex's investors also include the venture capital arm of ANZ, and this prominent example clearly evidences the high-level of uncertainty surrounding which new-entrant FinTechs (not just crypto-related businesses) should be de-banked for AML/CTF concerns. In 2021, the Bragg Inquiry, an Australian Parliamentary Inquiry seeking to encourage financial innovation, investigated how to regulate cryptocurrencies, including considering this de-banking issue.

### C The 'Bragg Inquiry' and Anti-Competitive Forces?

The Senate Select Committee on FinTech and RegTech, chaired by Senator Andrew Bragg, was established in 2019 to strengthen the regulatory environment for FinTechs and Regulator Technologies ('RegTechs') in Australia. In its Second Interim Report, there were 23 recommendations of the Senate Select Committee on FinTech and RegTech, now renamed the 'Select Committee on Australia as a Technology and Financial Centre'.<sup>43</sup> The report also includes a standalone chapter on blockchain and digital assets, an area of continued focus for the Bragg Inquiry,

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38 Cara Waters, 'Airwallex Knocks Back SPAC Offers as Valuation Swells to \$3.3 Billion', *The Sydney Morning Herald* (online, 24 March 2021) <<https://www.smh.com.au/business/small-business/airwallex-heads-for-the-us-with-fresh-funding-valuating-it-at-3-3b-20210322-p57d1r.html>>.

39 Ibid. Airwallex has raised \$500 million investors (as of April 2021), including Square Peg Capital and the venture capital arm of ANZ Banking Group Limited: Charlotte Grieve, "'Denied": NAB, Citi Pulled Banking Services From Fintech Unicorn Airwallex Over Risk Fears', *The Age* (online, April 14 2021) <<https://www.theage.com.au/business/banking-and-finance/denied-nab-citi-pulled-banking-services-from-fintech-unicorn-airwallex-over-risk-fears-20210413-p57iv9.html>> ('Airwallex Risk Fears').

40 Grieve, 'Airwallex Risk Fears' (n 39).

41 Ibid. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, known as the 'Banking Royal Commission' was established in December 2017 by the Australian Government to inquire into and report on misconduct in the banking, superannuation, and financial services industry. The Banking Royal Commission's final report was made in February 2019: *Bragg Final Report* (n 9).

42 Grieve, 'Airwallex Risk Fears' (n 39).

43 *Second Interim Report* (n 7).



which specifically seeks to consider the issue of de-banking Crypto Exchanges.<sup>44</sup> The Bragg Inquiry sought to investigate how regulators are enforcing existing laws, and if de-banking was linked to an uncertain policy environment.<sup>45</sup> The ACCC was urged by both the government and the cryptocurrency industry to explore potential anti-competitive aspects of Crypto Exchange account closures in 2021.<sup>46</sup> This author understands that the Crypto Exchange industry in Australia is built on a house of cards without direct banking. Many Crypto Exchanges rely on two to three FinTechs to bank with the Australian banking system (notably Monoova<sup>47</sup> and Assembly Payments<sup>48</sup> (now known as Zai)). If those FinTechs were de-banked, then the Crypto Exchange industry would plausibly be at risk of collapse in Australia.

The Bragg Inquiry's *Select Committee on Australia as a Technology and Financial Centre Final Report* ('*Bragg Final Report*') would also be deeply disquieted by the issue of anti-competitive de-banking: 'Throughout the inquiry the committee has been concerned to hear about the de-banking of FinTech businesses, particularly those highlighted during this phase of the inquiry in remittance, payments and the digital assets sectors.'<sup>49</sup> In response, the *Bragg Final Report* would ultimately recommend a licensing regime as its first recommendation:

Recommendation 1

The committee recommends that the Australian Government establish a market licensing regime for Digital Currency Exchanges, including capital adequacy, auditing and responsible person tests under the Treasury portfolio.<sup>50</sup>

Furthermore, the *Bragg Final Report* notes that:

Firstly, it is clear that the current regulation of DCEs, which is generally limited only to registration with AUSTRAC, is inadequate for businesses that in some cases are dealing with asset volumes in the billions of dollars. A properly designed Market Licence for this sector will assist the sector to mature and create confidence.<sup>51</sup>

The first step in avoiding wholesale de-banking is to precisely delineate the different kinds of Crypto Exchanges through an amended or new licensing regime that considers those Crypto Exchanges that can more easily be regulated for AML/CTF compliance and those that are more difficult to categorise and regulate.<sup>52</sup> A licensing regime was proposed by the *Bragg Final Report*. Below is a proposal for how it could be implemented.

44 Ibid.

45 Andrew Bragg, 'Blockchain Australia Week' (Speech, 20 April 2021) <<https://www.andrewbragg.com/post/blockchain-australia-week>>.

46 'AUSTRAC Throws Regulatory Lifeline to "De-banked" Bitcoin Operators' (n 11).

47 'Monoova', *Monoova* (Web Page) <<https://www.monoova.com>>.

48 'Zai', *Zai* (Web Page) <<https://www.hellozai.com/>>.

49 *Bragg Final Report* (n 9) 142 [6.62].

50 Ibid 135 [6.16].

51 Ibid x.

52 This article does not enter into the debate about the taxonomy of cryptocurrencies but provides an explanation of the various forms of Crypto Exchanges. Today cryptocurrencies include a variety of coins such as altcoins, stablecoins and tokens: Capital.com Research Team, 'Types of Cryptocurrencies: Explaining the Major Types of Cryptos', *capital.com* (online, 1 November 2019) <<https://capital.com/types-of-cryptocurrencies>>.

### III TYPES OF CRYPTO EXCHANGES

The following explains why regulators should differentiate between (a) centralised and decentralised Exchanges ('DEXs'); and (b) custodial and non-custodial Crypto Exchanges. It also provides a very brief introductory background on blockchains, cryptocurrencies and smart contracts. Crypto Exchanges cannot neatly fit into pre-existing regulatory categories<sup>53</sup> and existing regulations are unlikely to offer a solution to address AML/CTF compliance concerns. As the blockchain protocol has developed, championed by differing aims and ideologies (those who favour decentralisation,<sup>54</sup> staunch libertarians,<sup>55</sup> and the speculators seeking to profit), no clear regulatory map has emerged and no jurisdiction has offered a defining path for regulating Crypto Exchanges. The growing market for what ASIC has termed secondary 'exchange-traded products'<sup>56</sup> (discussed in depth below) poses even greater difficulties for regulators and developers seeking to comply with AML/CTF legal standards and create platforms that are truly decentralised.<sup>57</sup> Nevertheless, despite the aspirations of Bitcoin's founding developers for cryptocurrencies to democratise finance, some Crypto Exchanges continue to rely on intermediation for important aspects of trade execution and settlement. Many of the earliest and largest cryptocurrency exchanges such as Coinbase (now listed on the Nasdaq) operate for profit businesses distributing profits to the entrepreneurs and investors who own the platform.<sup>58</sup> These platforms are proprietary, permissioned blockchain ledgers that execute transactions using efficient operational procedures that are not always transparent. These categories of Crypto Exchanges are enunciated further below and must be delineated and regulated accordingly for AML/CTF compliance.

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53 See, eg, M Todd Henderson and Max Raskin, 'A Regulatory Classification of Digital Assets: Toward an Operational *Howey* Test for Cryptocurrencies, ICOs, and Other Digital Assets' [2019] (2) *Columbia Business Law Review* 443 <<https://doi.org/10.7916/cblr.v2019i2.3423>>.

54 The blockchain protocol, a peer-to-peer transaction system without an intermediary was developed to avoid regulation and create transactions without a legacy financial institution: see Don Tapscott and Alex Tapscott, *Blockchain Revolution: How the Technology Behind Bitcoin Is Changing Money, Business, and the World* (Portfolio, 2016) 4–5. Part of this community also decries the greed of recent financial crises: Syed Omer Husain, Alex Franklin and Dirk Roep, 'The Political Imaginaries of Blockchain Projects: Discerning the Expressions of an Emerging Ecosystem' (2020) 15(2) *Sustainability Science* 379, 380 <<https://doi.org/10.1007/s11625-020-00786-x>>.

55 See Tapscott and Tapscott (n 54) 5.

56 With cryptocurrency asset exchange-traded products attracting significant attention globally, ASIC released 'Crypto-Assets As Underlying Assets for Exchange-Traded Products and Other Investment Products' (Consultation Paper No 343, July 2021) ('Consultation Paper 343') to consider how to regulate exchange-traded products. See generally Australian Securities and Investments Commission, 'ASIC Consults on Crypto-Asset Based ETPs and Other Investment Products' (Media Release 21-153MR, 30 June 2021).

57 ASIC holds the function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system: *Australian Securities and Investments Commission Act 2001* (Cth) s 12A(2).

58 Nathan Reiff, 'What are Centralized Cryptocurrency Exchanges?', *Investopedia* (Web Page, 27 August 2021) <<https://www.investopedia.com/tech/what-are-centralized-cryptocurrency-exchanges/>>.

As this article solely deals with the discreet issue of the AML/CTF regime in relation to ‘de-banking Crypto Exchanges in Australia’, further cryptocurrency taxonomies are beyond the scope of the article, because by defining the categories of Crypto Exchanges, this article also explains much about the properties of cryptocurrency products and how they could be regulated at the on-boarding stage for AML/CTF purposes, as well. Some brief background is provided here.

First invented as part of the digital currency Bitcoin, blockchain technology is a part of a wider category of distributed ledger technologies. Blockchain’s core innovation is that it uses a unique combination of cryptography, peer-to-peer networking, as well as economic incentives to enable networks to create distributed ledgers. To ensure the integrity of the ledger, and to scale the network, participants validating transactions on the network are rewarded with additional cryptocurrency assets. Cryptocurrencies are digital tokens which are not issued by governments or backed by commodities. Today a vast array of digital assets are traded on Crypto Exchanges, with their taxonomies and classifications under law an evolving field of study of itself.<sup>59</sup> The Bragg Inquiry wrote that categorising the various digital assets and tokens was beyond its scope and proposed a ‘mapping’ exercise to classify tokens exercise as per ‘Recommendation 3’.<sup>60</sup>

Many blockchains feature ‘smart contracts’, or self-executing digital agreements governed by software code. These smart contracts enable endless use cases, such as providing liquidity, lending and borrowing, and supply chain management. These contracts are executed through payments using the native tokens of that blockchain, so the value of those tokens increase as more people use its blockchain.<sup>61</sup> This article focuses on understanding why Crypto Exchanges and DEXs in particular are so unique and should be regulated differently for AML/CTF purposes.

The central argument of this article is that a new proposed licensing regime would create a designated risk profile for banks to avoid anti-competitive de-banking. Crypto Exchanges are a special type of FinTech that differ from usual payment FinTechs. This is outlined below when referencing how a Crypto Exchange is much more than a payments transfer company. Crypto Exchanges present a distinct and unique risk profile that presents a distinct challenge for all regulators, such as ASIC, to work through globally. See this article’s discussion in Part IV(D). Again, the categories of Crypto Exchanges are enunciated further below and must be delineated and regulated accordingly for AML/CTF compliance.

59 See, eg, Kelvin FK Low and Eliza Mik, ‘Pause the Blockchain Legal Revolution’ (2020) 69(1) *International and Comparative Law Quarterly* 135 <<https://doi.org/10.1017/S0020589319000502>>.

60 *Bragg Final Report* (n 9) vii. The de-banking issue was considered from the perspective of crypto exchanges and AML/CTF compliance.

61 Alexander Savelyev, ‘Contract Law 2.0: “Smart” Contracts as the Beginning of the End of Classic Contract Law’ (2017) 26(2) *Information and Communications Technology Law* 116, 121 <<https://doi.org/10.1080/13600834.2017.1301036>>; Kevin Werbach and Nicolas Cornell, ‘Contracts *Ex Machina*’ (2017) 67(2) *Duke Law Journal* 313, 320, 335, 353; Buwaneka Arachchi, ‘Chains, Coins and Contract Law: The Validity and Enforceability of Smart Contracts’ (2019) 47(1) *Australian Business Law Review* 40, 45.

## A Centralised Crypto Exchanges

Users deposit cryptocurrency funds *directly into a pooled wallet* that is controlled by the Crypto Exchange. Far from decentralised, the Crypto Exchanges takes custody of traders' deposited assets, and the exchange directly matches buy and sell orders.<sup>62</sup> Centralised accounts store customer funds. Coinbase, Gemini, and Binance are all well-known examples of centralised Crypto Exchanges.<sup>63</sup> As centralised exchanges, these Crypto Exchanges are also highly susceptible to hacks. In fact, hackers stole more than USD4 billion in cryptocurrencies, and an estimated USD125 million from centralised Crypto Exchanges in the first half of 2019.<sup>64</sup> While regulation of centralised Crypto Exchanges should focus on the risks of hacks or thefts, AML/CTF compliance should also now focus more on broker and custodian responsibilities (discussed below in Part IV). This is because centralised Crypto Exchanges can also act as broker-dealers, maintaining an inventory of cryptocurrencies and satisfying customer orders at the prices determined by the exchange.<sup>65</sup> In creating a custodian system (see below), these roles need to be delineated. For example, these exchanges can also permit off-chain transactions, and this creates concerns that they may not be at the best prices (as in the MyCryptoWallet example cited above).<sup>66</sup>

Crypto Exchanges already have a direct custodianship reference in fiat currency exchanges. Thus, the Crypto Exchange market is increasingly forming the same separations of parties as fiat currency exchanges to create the 'triumvirate of broker dealers,<sup>67</sup> qualified custodians, and exchanges working together'.<sup>68</sup> This presents a lucrative business for custodians able to ensure compliance, and in some cases offer services tailored to digital assets. As a result, centralised Crypto Exchange globally are adapting, by adding third party custodians or registering as custodians themselves. For example, Coinbase became a registered custodian in the US in June 2018.<sup>69</sup> Today both Gemini and Coinbase offer custody services. Custodians

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62 Reiff (n 58).

63 See, eg, Laura M, 'Gemini vs Coinbase: Is Gemini a Better Coinbase Alternative?', *BitDegree* (Web Page, 2 November 2021) <<https://www.bitdegree.org/crypto/tutorials/gemini-vs-coinbase>>.

64 Jeb Su, 'Hackers Stole over \$4 Billion from Crypto Crimes in 2019 So Far, Up from \$1.7 Billion in All of 2018', *Forbes* (online, 15 August 2019) <<https://www.forbes.com/sites/jeanbaptiste/2019/08/15/hackers-stole-over-4-billion-from-crypto-crimes-in-2019-so-far-up-from-1-7-billion-in-all-of-2018/?sh=2eaa9dac55f5>>.

65 'In the absence of a consolidated pricing index, traders may be unaware that the executed transaction price is higher than the average market price for the same cryptocurrency': Kristin N Johnson, 'Decentralized Finance: Regulating Cryptocurrency Exchanges' (2021) 62(6) *William and Mary Law Review* 1911, 1955 <<https://doi.org/10.2139/ssrn.3831439>>.

66 Off-chain transactions are the movement of value outside of the blockchain. On chain transactions are the transactions available on the blockchain and are visible to all the nodes on the blockchain network.

67 Other Crypto Exchanges are launching cryptocurrency portfolio building arms. For example, Coinbase acquired two broker dealer licences and a registered investment advisor ('RIA') licence in the United States ('US'). For information about RIAs: United States Securities and Exchange Commission, 'Investment Adviser Registration', *Investor.gov* (Web Page) <<https://www.investor.gov/introduction-investing/getting-started/working-investment-professional/investment-advisers-0>>.

68 Leslie Ankney, 'Why Custodians Are Coming to Crypto', *Forbes* (online, 14 March 2019) <<https://www.forbes.com/sites/leslieankney/2019/03/14/why-custodians-are-coming-to-crypto/?sh=12022f422284>>.

69 Rachel Wolfson, 'Custodial Solutions Are the Latest Innovation in Cryptocurrency Ecosystem As Seen By Coinbase and Others' *Forbes* (online, 20 September 2018) <<https://www.forbes.com/sites/>

like PrimeTrust, ItBit, and BitGo all offer a cryptocurrency custodian service.<sup>70</sup> Crypto Exchanges and custodial services are separate businesses. Many Crypto Exchanges also offer custodial services and regulators should delineate this point for AML/CTF purposes (discussed below).

However, the key point of this section is that in the case of centralised Crypto Exchanges, users deposit their cryptocurrency funds *directly into a pooled wallet* that is controlled by the exchange, unlike decentralised Crypto Exchanges. They should be regulated accordingly.<sup>71</sup> In decentralised Crypto Exchanges, an individual maintains custody until they swap their funds. Unless a person has sole access to their private keys<sup>72</sup> and is using a non-custodial wallet, someone is acting as custodian of those funds, such as in a centralised Crypto Exchange. Yet for DEXs and non-custodial Crypto Exchanges this problem is much more complex.

## B Decentralised Exchanges

DEXs are closer to ‘Satoshi’s’ original blockchain vision. DEX users execute transactions without intermediaries, as all transactions are authenticated by the network’s community.<sup>73</sup> Transactions occur *in a genuinely decentralised manner, as cryptocurrency funds are stored in the owner’s own personal wallet*.<sup>74</sup>

Traders connect hardware or software wallets to the DEX smart contract to execute transactions. Depending on the DEX framework, the trader either stores customer tokens or releases the customer’s tokens to the DEX smart contract until a particular trade is executed and settled.<sup>75</sup>

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rachelwolfson/2018/09/20/custodial-solutions-are-latest-innovation-in-cryptocurrency-ecosystem-as-seen-by-coinbase-and-others/#58bb831e171c>.

- 70 Australian cryptocurrency custodian service companies include companies such as Custodian Vaults. According to their website, ‘Custodian Vaults has entered into partnership with the blockchain and investments firm, Decentralised Capital, to set up Australasia’s first insured cryptocurrency vault.’: ‘Custodian Vaults Is Proud To Announce Its New Partnership with Decentralised Capital’, *Custodian Vaults* (Web Page) <<https://www.custodianvaults.com.au/news/custodian-vaults-is-proud-to-announce-its-new-partnership-with-decentralised-capital-to-set-up-australasia-s-first-insured-cryptocurrency-vault/>>.
- 71 Existing obligations operate for Managed Investment Schemes as discussed in Part IV(B). Australian Securities and Investments Commission, ‘Regulatory Guide 133: Funds Management and Custodial Services’ (Guide, 23 June 2022) (‘Regulatory Guide 133’).
- 72 A private key is a randomly generated binary number that is used to encrypt and decrypt information, and is only made available to the originator of the encrypted content. This private key is ‘all that is required to confirm a transaction’. A public key is a long numeric code that is cryptographically derived from a specific private key. The public key is available to many and is available in an online directory. ‘The public key must be paired with the corresponding private key for a transaction to be executed.’: Deloitte, *A Market Overview of Custody for Digital Assets Digital Custodian Whitepaper* (Report, June 2020).
- 73 Decentralised exchange (‘DEX’) users execute transactions without intermediaries, as all transactions are authenticated by the network’s community. DEXs are exchanges with no central location for the storage or management of the underlying technology. See, eg, Simon Taylor, ‘What is a Decentralised Exchange?’, *Medium* (Blog Post, 6 August 2018) <<https://medium.com/@sytaylor/what-is-a-decentralised-exchange-e2b86e844fe9>>; Mathieu Chabrieres, ‘What Is a Dex: Decentralized Exchanges Explained’, *Ledger* (Web Page, 9 October 2020) <<https://www.ledger.com/academy/crypto/what-is-a-dex-decentralized-exchanges-explained>>.
- 74 See above n 73.
- 75 Johnson (n 65) 1955 (citations omitted). See also Nuke Token, ‘How to Trade on a DEX (Decentralized Exchange)’, *Medium* (Blog Post, 25 June 2019) <<https://web.archive.org/web/20201010104217/https://medium.com/trivial-co/thoughts-on-decentralized-exchanges-and-real-world-usage-of-their-own-tokens-d0a6a16f5d3d>>.

Uniswap is (as of July 2021) the largest decentralised Crypto Exchange by volume and a leader in DeFi.<sup>76</sup> DEXs also provide increased security. Unlike a centralised Crypto Exchange, a DEX is not a single point of failure. Therefore, it is less susceptible to the various security concerns that ‘plague centralized [Crypto] Exchanges’.<sup>77</sup> However, DEXs may also need to form a partnership with another Crypto Exchange that ‘on-ramps’ fiat currencies.<sup>78</sup>

DEXs also deploy an internal governance protocol that is very different to centralised Crypto Exchanges, and this has significant ramifications for AML/CTF compliance. Unlike centralised Crypto Exchanges, DEX makers and takers act independently and ‘[a]ll transactions are authenticated by the network’s community’.<sup>79</sup> While the DEX protocol ‘does not support market orders’,<sup>80</sup> automated market-maker applications and liquidity pools ‘may approximate the benefits of market orders’.<sup>81</sup>

Instead, DEXs create liquidity pools, rather than rely on a market-maker to create liquidity. Traders stake tokens (lock up tokens to support the construction of a project they support) in a liquidity pool. ‘When a trade is executed, the reward for creating liquidity reverts to the pool and participants share the financial benefits of creating liquidity pro rata based on their contributions to the pool.’<sup>82</sup> DEX traders may however, pay higher transaction fees due to the operational mechanics of executing a trade on chain.<sup>83</sup> Importantly, ‘DEX traders pay substantially higher network fees known as ‘gas’ because the operational infrastructure of the exchanges requires additional steps for verification and posting transactions to the exchange

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76 In July 2021 Uniswap made the decision to de-list some tokens from its platform, citing ‘the evolving regulatory landscape’. It remains the largest decentralised Crypto Exchange by volume: Martin Young, ‘Uniswap Delists 100 Tokens from Interface, Including Options and Indexes’, *Cointelegraph* (Blog Post, 26 July 2021) <<https://cointelegraph.com/news/uniswap-delists-100-tokens-from-interface-including-options-and-indexes>>.

77 See Johnson (n 65) 1958. See also Jan Wozniak, ‘Thoughts on Decentralized Exchanges and Real World Usage of Their Own Tokens’, *Medium* (Blog Post, 18 September 2018) <<https://medium.com/trivial-co/thoughts-on-decentralized-exchanges-and-real-world-usage-of-their-own-tokens-d0a6a16f5d3d>>.

78 See, eg, Becky, ‘KyberSwap Dex Partners with Coindirect to Launch Fiat-to-Crypto Gateway’, *Coin Insider* (Blog Post, 9 July 2021) <<https://www.coininsider.com/kyberswap-dex-partners-with-coindirect-fiat-to-crypto-gateway/>>.

79 See Johnson (n 65) 1955.

80 This problem will require further discussion outside of this article. Possible regulatory guidance and intervention from ASIC may be required for some centralised Crypto Exchanges, where retail traders also pay market-taker fees. Maker-taker fees, also known as payment for order flow, provide liquidity providers with rebates for participating in markets. On legacy securities exchanges, for example, the market-taker structure of market pricing provides a transaction rebate to market-markers that provide liquidity ‘by “making” a trade’: Johnson (n 65) 1955. In this context, the market-maker posts a trade and the taker completes the transaction. The market-maker receives a rebate for introducing the transaction and the taker pays a fee to execute the transaction: ‘Market Makers and Market Takers Explained’, *Binance Academy* (Web Page, 29 June 2022) <<https://academy.binance.com/en/articles/what-are-makers-and-takers>>.

81 Johnson (n 65) 1956.

82 Ibid.

83 See Leslie Ankney, ‘No More Trading or Listing Fees? Decred Releases New DEX Proposal’, *Forbes* (online, 4 February 2019) <<https://www.forbes.com/sites/leslieankney/2019/02/04/no-more-trading-or-listing-fees-decred-releases-new-dex-proposal/#3929f8b235d9>>.

network.<sup>84</sup> Common approaches for matching buyers and sellers that a DEX may adopt are beyond the scope of this article,<sup>85</sup> but will require further analysis and possible future guidance by ASIC.<sup>86</sup>

### C Custodial versus Non-custodial Digital Asset Custody

Any possible new licensing and certification regime should also differentiate between custodial and non-custodial Crypto Exchanges. In the cryptocurrency space, retail investors have up until now had the option to hold funds in non-custodial wallets by learning the ins and outs of hot and cold wallet storage.<sup>87</sup> This may be risky, but the risks of lost keys, for example, are generally understood by retail investors.<sup>88</sup> Crypto Exchanges have a largely retail investor base that have continued to invest in unregulated markets regardless.<sup>89</sup> The needs of a retail cryptocurrency investor holding or trading cryptocurrencies are very different to large institutional investors and fiduciaries.<sup>90</sup> Custodians, on the other hand, secure millions of dollars in cryptocurrency in cold storage, such as hardware and paper wallets inside bank-grade vaults or safes.

Custody of digital assets can best be explained as follows: ‘having control of private keys on behalf of clients could be the equivalent to custody/safekeeping

84 Johnson (n 65) 1956. See also ‘What Is Gas?’, *ETH Gas Station* (Blog Post, 31 July 2019) <<https://ethgasstation.info/blog/what-is-gas/>>.

85 A common approach for matching buyers and sellers that a DEX may adopt is on-chain order books or off-chain order relay with on-chain settlement. With on-chain order books, the DEX hosts the order book on the Crypto Exchange. The DEX distributes orders across the network and the user releases custody of their tokens to the DEX smart contract: Johnson (n 65) 1956. Another approach involves a DEX using off-chain order relay with on-chain settlement. The trader allows the DEX contract access to their token balance. ‘The trader then creates an order specifying a desired exchange rate, expiration time, and cryptographically signs their exchange order with their private key.’ This order is not broadcast across the network but is sent across a communication medium: relayers. Relayers find a match and fill orders. They do not execute trades but recommend a best available price to a trader who then decides whether to take the order: Johnson (n 65) 1957.

86 Automated market-maker features in these platforms ‘may increase fairness and incorporate circuit-breakers to better govern trading dynamics’: Johnson (n 65) 1957.

87 Private keys held safely with no connection to the internet are known as cold wallet storages. Private keys held on internet-connected systems or networked hardware are known as hot wallet storages.

88 Rupert Neate, ‘Programmer Has Two Guesses Left to Access £175m Bitcoin Wallet’, *The Guardian* (online, 13 January 2021) <<https://www.theguardian.com/technology/2021/jan/12/in-bits-the-programmer-locked-out-of-his-130m-bitcoin-account>>. Also, infrastructure challenges the proposition that limited early blockchain protocols are now better understood by investors as the technology matures and newer cases emerge.

89 ‘[D]uring the quarter ending Dec 31 [2020], more than 90% of Coinbase’s revenue came from retail trades.’: Katherine Greifeld and Vildana Hajric, ‘Plumber Buying Doge Shows Retail Investors’ Power in Crypto’, *Bloomberg Wealth* (online, 20 April 2021) <<https://www.bloomberg.com/news/articles/2021-04-19/plumber-going-all-in-shows-retail-investors-rule-crypto-trading>>. During the COVID-19 pandemic, the number of retail investors investing in cryptocurrencies grew substantially: Sirin Kale, ‘“I Put My Life Savings in Crypto”: How a Generation of Amateurs Got Hooked on High-Risk Trading’, *The Guardian* (online, 19 June 2021) <<https://www.theguardian.com/lifeandstyle/2021/jun/19/life-savings-in-crypto-generation-of-amateurs-hooked-on-high-risk-trading>>.

90 See, eg, Wai Yee Wan, Andrew Godwin and Qinzhe Yao, ‘When Is an Individual Investor Not in Need of Consumer Protection? A Comparative Analysis of Singapore, Hong Kong, and Australia’ [2020] (March) *Singapore Journal of Legal Studies* 190; Husain, Franklin and Roep (n 54) 380.

services'.<sup>91</sup> What is important to the definition of custody is that when it comes to digital assets, custody services no longer concern the safekeeping of assets 'but rather the storage of cryptographic keys that control those assets'.<sup>92</sup> However, differences in technology between cryptocurrency and institutional platforms, as well as the applicable and still evolving regulatory framework(s), require a 'more holistic view of custody that goes beyond the storage of keys'. In short, the emerging definition of what is digital custody is 'more than a question of who holds the private key'.<sup>93</sup> This article cannot address each of those technological points affecting custody, but these issues are currently being further considered by ASIC (see below in Part IV(D)).<sup>94</sup>

Also, whether intentionally or not, some Crypto Exchanges have been acting as 'legal' custodians by default. This is because customers store funds in a wallet on the exchange, and the exchange holds custodial access. For many in 'Cryptoland', hearing the word 'counterparty' or 'third parties' is enough to offside the believers in true decentralisation. Yet, legally, when it comes to fiduciaries, a third-party custodian is required to meet compliance and legal requirements where they operate their business.<sup>95</sup>

There are crypto industry arguments that having a third party provide custody removes the autonomy and privacy of crypto market participants who want to hold and control their own assets – but the reality is that institutional market participants, especially those who manage other people's money, simply cannot do this from a regulatory and fiduciary standpoint.<sup>96</sup>

For example, Crypto Exchanges offering digital wallet solutions tend to be based on centralised databases that create a relationship between the investor and the Crypto Exchange digital wallet provider.<sup>97</sup> Therefore, a potential licensing AML/CTF arrangement in Australia could acknowledge the difference between a custodial and non-custodial Crypto Exchange as a gateway issue, with sub-categories depending on the particular Crypto Exchange's operations and then

91 European Securities and Markets Authority, the European securities regulator, quoted in Swen Werner, 'What Is Custody of Digital Assets?', *Global Custodian* (Blog Post) <<https://www.globalcustodian.com/blog/custody-digital-assets/>>.

92 Ibid.

93 Ibid.

94 See *ibid.* Werner also notes for example that permissionless blockchain networks typically assume that the private key controls the ability to spend the assets. Thus, a loss of those private keys amounts to the loss of the asset itself. There is no concept of a nominee wallet. Blockchains do not support the concept of an intermediary (every private key is assumed to belong to a beneficiary): Werner (n 91). Further, equating the storage of the private key to digital custody has limitations according to Werner (n 91), for example:

- 'Key storage without a robust procedure to utilise the key is meaningless.'
- '[T]here are different approaches ... to structure[ing] the protocols for the use of keys' (for example, the 'signing ceremony' can be used to reduce the reliance on a single party). 'There may be more than one key per token, or a single key simply may not exist' (for example, different parties hold a portion of the key and need a signing ceremony to transfer an asset, via a multi-signature arrangement).
- 'Institutional .... (typically permissioned) [blockchains] can have certain hierarchical structures or multi-signature agreements to reverse ... a transaction ... a governing node [can] be empowered to correct an entry in the database.'

95 Ankney (n 68).

96 BitGo Chief Compliance Officer Shahla Ali, quoted in Ankney (n 68).

97 Well-known Centralised Cryptocurrency Exchanges include Binance, Coinbase Exchange and FTX.



delineate key management practices for AML/CTF compliance accordingly. Furthermore, though global regulation for Crypto Exchanges is not fully defined, an AML-complaint custodianship system is a key step for institutional investment in cryptocurrency assets in Australia. As widespread adoption by institutional investors grows, the wholesale de-banking of Crypto Exchanges should be less likely. For example, in May 2021, JP Morgan took the lead in banking US Crypto Exchanges.<sup>98</sup> One bank could fill that void in Australia, perhaps by working with regulators to create a regulatory sandbox and create a commercial advantage in the space. If an Australian bank is unwilling, then perhaps Internationale Nederlanden Groep or a bank with connections to Europe or other regulatory jurisdictions could lead the way.<sup>99</sup> A regulatory sandbox<sup>100</sup> may be one way to trial the recommendations suggested below.

#### IV HOW SHOULD AUSTRALIA AVOID THE WHOLESALE DE-BANKING OF CRYPTO EXCHANGES?

The US example above has shown that Crypto Exchanges need not automatically be off-limits for banks. A survey of the policy and legal landscape in Australia compared to similar jurisdictions reveals that governments and financial regulators around the world are still assessing whether and how to regulate Crypto Exchanges. Investor protection and preventing money laundering are particular concerns.<sup>101</sup> The following discussion outlines a proposal for Australia based on an

98 The US approach is to stop the wholesale de-banking of an industry. JP Morgan and parts of the private sector have embraced the commercial opportunity. This is a big victory for US-based crypto entrepreneurs previously at risk of de-banking. Recent legislation in Wyoming includes the creation of ‘special purpose depository institutions’ (‘SPDIs’) as a new form of bank. Wyoming-chartered SPDIs are deposit-taking banks that also conduct other activity incidental to the business of banking, including custody, asset servicing, fiduciary asset management: Wyoming Banking Division, ‘Special Purpose Depository Institutions’, (Blog Post, 2021) <<https://wyomingbankingdivision.wyo.gov/banks-and-trust-companies/special-purpose-depository-institutions>>. Legislation adopted 4 May 2021, effective 1 July 2021; see *Digital Assets-Amendments*, ch 91, 2021 Wyo Sess Laws 1.

99 Australia should also pay attention to the European Union (‘EU’) who may emerge as a leader in regulating DeFi. The task of co-ordinating numerous European jurisdictions makes the EU a regulator to watch in 2021 and beyond. The EU’s very recent regulatory changes could amount to being a gateway to mass adoption or too much regulation: *Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-Assets, and Amending Directive (EU) 2019/1937*, [2020] OJ C (2020) 593 E/1; Patrick Hansen, ‘New Crypto Rules in the European Union: Gateway for Mass Adoption, or Excessive Regulation?’, *Stanford Law School* (Blog Post, 12 January 2021) <<https://law.stanford.edu/2021/01/12/new-crypto-rules-in-the-eu-gateway-for-mass-adoption-or-excessive-regulation/>>.

100 Australia’s current regulatory sandbox could support this proposal: see generally Anton N Didenko, ‘A Better Model for Australia’s Enhanced FinTech Sandbox’ (2021) 44(3) *University of New South Wales Law Journal* 1078 <<https://doi.org/10.53637/XCWH2963>>.

101 Other qualifications could be included for the type of licenses available for Crypto Exchanges. For example, Crypto Exchanges domiciled in Singapore are organised according to three types of licences, organised according to the amount of money being transacted per month or day. Crypto Exchanges are licensed by the Monetary Authority of Singapore and can have retail investors as clients: Parliamentary Replies, Parliament of Singapore, *Reply to Parliamentary Question on Crypto Asset Market* (Question No 869, Notice Paper 348/2021, 5 April 2021); *Payment Services Act 2019* (Singapore) s 6.

explanation of Crypto Exchange business models and some lessons from abroad. It should be noted that many of the lessons from abroad are fairly recent regulatory attempts and offer short runways for observation.

### **A Why Propose an AML/CTF-Compliant Licensing Model for Centralised Crypto Exchanges?**

The nature of the de-banking problem in Australia described above is precisely why this article has suggested a possible public AUSTRAC AML/CTF licensing regime for Crypto Exchanges and an AML/CTF compliance certification for those Crypto Exchanges that cannot be licensed as an appropriate model (see next section). The following section explains why licensing is appropriate and how it could work. Firstly, licensing is appropriate because it would stop any possible or alleged anti-competitive behaviour by banks de-banking new entrant FinTechs and support the development of Australia's cryptocurrency industry. Currently, Crypto Exchanges might pre-emptively hide AUSTRAC DCE registration<sup>102</sup> or evidence of Crypto Exchange business models from banks to avoid being de-banked<sup>103</sup> (thus the simplest possible de-banking avoidance option is for the register of DCE Crypto Exchanges registered by AUSTRAC to be made public along with remittance companies, to offset perceptions of anti-competitive de-banking). Yet, this article argues that the better option is to delineate Crypto Exchanges via operating model designations to help demarcate genuine AML/CTF risks faced by banks. Large Australian centralised Crypto Exchanges such as Independent Reserve also strongly favour licensing digital asset custody providers, in particular, to avoid business disruption caused by de-banking.<sup>104</sup> It was argued in their submission to the Bragg Inquiry that custody of assets should be 'limited only to businesses able and willing to adhere to the minimum standards [designated for digital asset custody providers] and these should be tested independently'.<sup>105</sup> The proposal in this article is also that custody of digital assets should be a key component of licensing categories for AML/CTF regimes.

Furthermore, the *Bragg Final Report* recommended that another key change would be to institute a new path of recourse for de-banked customers, centred around the newly established Australian Financial Complaints Authority, which would allow customers to appeal the banks' decisions. Common access should also be granted to the New Payments Platform, a move which would reduce the reliance of payments systems on the major banks and again evidence the nature of the anti-competitive problem.<sup>106</sup>

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102 DCEs are registered with AUSTRAC for AML/CTF compliance. Again, this registration is not made public.

103 See Bitcoin Babe Pty Ltd, Submission No 54 to Senate Select Committee on Australia as a Technology and Financial Centre: Response to Third Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (June 2021).

104 Independent Reserve Pty Ltd, Submission No 17 to Senate Select Committee on Australia as a Technology and Financial Centre: Response to Third Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (June 2021).

105 *Ibid* 1.

106 *Bragg Final Report* (n 9) viii.

Further, as it stands, AUSTRAC does not provide AML/CTF program templates, but only provides guidance resources to help companies comply with their legal obligations.<sup>107</sup> Banks decide if they are comfortable with the risks. Again, this is the crux of the de-banking issue. The current system is highly disruptive for Crypto Exchanges and other new entrant FinTechs seeking to comply with AUSTRAC's requirements while facing constant de-banking. AUSTRAC should still be responsible for monitoring and compliance but a public AML/CTF certification (licensing regime or a public registry) in some form to avoid unfounded de-banking is a useful step. Banks and Crypto Exchanges may also benefit from mandated standard compliance program templates from AUSTRAC. Part of a possible solution is that Crypto Exchange-specific compliance frameworks designed by AUSTRAC could be reconsidered in light of a new or an amended DCE licensing regime. Both are possible options. Then those registered Crypto Exchanges could rely on AUSTRAC to set the designated minimum standards. AML/CTF compliance would focus on clear broker and custodian responsibilities, such as reporting, and how those operators store and manage their clients' cryptocurrency assets. Crypto Exchanges can be extremely transparent and flows of funds are fully auditable on a blockchain.<sup>108</sup>

Another possible model would require changes under the *AML/CTF Act* to include new Designated Services definitions under section 6 of the *AML/CTF Act*. A new (possibly opt-in) Designated Service could include custodial, depositary or agency services that involve the safeguarding of private cryptographic keys on behalf of a person to hold, transfer and deal with digital assets where a condition of opting in is that customer due diligence and Know Your Customer ('KYC') procedures are met.<sup>109</sup> That is so those asset custody holders could be held to a higher standard. That could include minimum capital requirements, an external audit of custodial procedures, a responsible person, segregation of assets, and reporting requirements.

Alternatively, another option to be considered is that a new, special AFSL is required for operating a custodial digital asset business beyond registering with AUSTRAC to prevent unfounded de-banking of a Crypto Exchange, as AFSL compliance could offset further de-banking fears and the banks' risk profile. As noted above, holding an AFSL already helps Crypto Exchanges obtain banking services. Also, there may need to be further amendments made to the AFSL so that there is less de-banking uncertainty for those non-custodial Crypto Exchanges

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107 AUSTRAC takes great efforts to differentiate Crypto Exchanges and their unique AML/CTF standards: see 'Digital Currency Exchange Providers', *Australian Transaction Reports and Analysis Centre* (Web Page, 20 August 2021) <<https://www.austrac.gov.au/business/industry-specific-guidance/digital-currency-exchange-providers>>.

108 See, eg, Carla L Reyes, 'If Rockefeller Were a Coder' (2019) 87(2) *George Washington Law Review* 373, 379–82. See also Vishal Gaur and Abhinav Gaiha, 'Building a Transparent Supply Chain', *Harvard Business Review* (online, May 2020) <<https://hbr.org/2020/05/building-a-transparent-supply-chain/>>.

109 This was proposed by the Digital Law Association in its Senate Submission: Digital Law Association, Submission No 49 to Senate Select Committee on Australia as a Technology and Financial Centre: Third Issues Paper, Parliament of Australia, *Select Committee on Australia as a Technology and Financial Centre* (July 2021).

that do not need to hold an AFSL. These various approaches would mean that it is the responsibility of lawmakers and the Crypto Exchange industry to design compliance so that banks do not feel the need to de-bank the Crypto Exchange industry.

Licensing Crypto Exchanges as AML-compliant in some form is also critical for industry growth, as it will encourage institutional money to enter the industry locally. AML/CTF concerns should be surmounted at the customer onboarding stage. AUSTRAC and Crypto Exchanges would work together to surmount KYC concerns for banks.<sup>110</sup> It is further proposed below that Crypto Exchanges should be licensed or certified according to the type of Crypto Exchange. This dual licensing/certification process would help to remove the AML/CTF fears of banks. Crypto Exchanges that comply with AML/CTF laws should have access to bank accounts in Australia. Yet an AML-compliant self-certification regime will still be needed for those Crypto Exchanges that cannot be easily certified under AML/CTF laws.

## **B Toward a Dual AML-Compliant Licensing and an AML-Compliant Self-Certification Regime**

AUSTRAC, working together with Crypto Exchanges, could delineate the various operating models of Crypto Exchanges for banks. Then that evidence could be used to amend the existing DCE licensing regime or create a new licensing regime in line with Crypto Exchange operating models, as well as accompanying prescriptive Crypto Exchange-specific compliance frameworks to assuage the banks' KYC AML/CTF concerns. That regime should differentiate centralised and decentralised Crypto Exchanges and differentiate custodian and non-custodian Crypto Exchanges. This could be via a process of annual certification. Further, an AML-compliant self-certification system for those Crypto Exchanges that cannot be licensed should be encouraged.

Again, this licensing proposal is a viable option because while de-banking in Australia may either amount to anti-competitive behaviour (still legally unproven) by the banks or may be a prudent risk-averse approach, this proposed regime would further streamline AML/CTF reporting procedures for banks. And because Crypto

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110 *Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007 (No 1)* (Cth) rules

4.2.6–4.2.8 sets out the KYC and AML/CTF verification requirements:

4.2.6 AML/CTF programs must verify: (1) the customer's full name; and (2) either: (a) the customer's date of birth; or (b) the customer's residential address.

4.2.7 The information collected must be based on either reliable and independent (1) documentation or (2) electronic data, or (3) a combination of both.

4.2.8 An AML/CTF program must include appropriate risk-based systems and controls for the RE to determine whether, in addition to the KYC information referred to in paragraph 4.2.6 above, any other KYC information collected about the customer should be verified from reliable and independent documentation and electronic data.

Other jurisdictions are experimenting with other KYC methods. For example, as of July 2021, in Thailand, Crypto Exchanges must verify their customers' identities through a 'dip-chip' machine that requires clients to be physically present: Kevin Helms, 'Thailand's New Cryptocurrency Regulation Requires Users to Be Physically Present to Open Accounts', *Bitcoin.com* (online, 3 May 2021) <<https://news.bitcoin.com/thailands-new-cryptocurrency-regulation-requires-users-physically-present-to-open-accounts/>>.

Exchanges cannot neatly fit into pre-existing AML/CTF compliance mechanisms, Australia's Crypto Exchanges should be regulated differently depending on how they on-board and off-ramp fiat currencies and how they operate. Again, in DEXs, transactions occur in a genuinely decentralised manner as funds are stored in one's own personal wallets and all transactions are authenticated by the network's community. Non-custodial Crypto Exchanges are where personal ownership of the underlying assets is never revoked and the asset lives in a personal wallet. Some DEXs and non-custodial Crypto Exchanges may not be able to regulated. For example, DEXs and non-custodial Crypto Exchanges such as Uniswap cannot be subject to regulation if there is no identifiable contact for a government official. There is a lack of a tool set for regulators to deal with DEXs, but the breadth of business operations (captured under an AFSL) might still lead to de-banking of some aspects of the overall business operations.

Thus, in creating a Crypto Exchange AML/CTF licence regime, Australia should continue to carefully review the Financial Action Task Force's ('FATF') current broad working definition of regarding Virtual Assets and Virtual Asset Service Providers ('VASPs'). FATF, the international body that sets standards for AML/CTF, published its updated *Draft Guidance on a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers* ('Draft Guidance')<sup>111</sup> for public consultation until May 2021. The key point is that FATF's *Draft Guidance* considers the ranges of VASPs widely for the purposes of the FATF 'Travel Rule'. DEXs, certain decentralised application owners and operators, cryptocurrency escrow services and certain non-fungible tokens ('NFTs')<sup>112</sup> are all considered VASPs. The Travel Rule concerns the 'application of the FATF's wire transfer requirements in the VA [Virtual Asset] context', which means that in transactions involving Virtual Assets, ordering institutions must 'obtain and hold required and accurate originator information and required beneficiary information and submit the information to beneficiary institutions'.<sup>113</sup> This required information includes the originator's name, account number, address/national identity number/customer identification number/date and place of birth; and the beneficiary's name and account number.<sup>114</sup> The Travel Rule has yet to be legislated in Australia and the *Bragg Final Report* rejected doing so for now.<sup>115</sup> If Crypto Exchanges were overregulated under the wide FATF Travel Rule approach, ignoring the discussion of types of Crypto Exchanges above, this would likely stop Australia from becoming a hub of DeFi

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111 Financial Action Task Force, *Draft Updated Guidance for a Risk-Based Approach to Virtual Assets and VASPs*, Draft 6, Public Consultation, Doc No FATF/PDG(2020)19/REV1, 19 March 2021, 52 [155], [157].

112 NFTs are digital assets that represent items such as art, GIFs and videos. NFTs contain built-in authentication and are held on blockchains. See, eg, Robyn Conti and John Schmidt, 'What Is an NFT? Non-Fungible Tokens Explained', *Forbes Advisor* (Web Page, 14 May 2021) <<https://www.forbes.com/advisor/investing/nft-non-fungible-token/>>.

113 Ibid 52 [155], [157] (emphasis in original).

114 Stablecoins (cryptocurrencies pegged to an existing currency) are also subject to FATF Standards: Financial Action Task Force (n 111) 52–53 [157]–[158].

115 *Bragg Final Report* (n 9) 138 [6.39].

innovation.<sup>116</sup> The Travel Rule is far too expansive in its description of VASPs, making enforcement very difficult for products such as high-frequency automated trading. While this would hinder experimentation in the cryptocurrency industry, it would also send some Crypto Exchanges permanently underground as they would seek to avoid AML/CTF compliance. For now, the Bragg Inquiry made the decision not to enforce the FATF Travel Rule.<sup>117</sup>

Estonia is a useful reference, as Estonia's model for licensing Crypto Exchanges includes *custodial and non-custodial* distinctions. Estonia is considered one of the pioneers to have introduced legalisation for blockchain and crypto-based businesses. Since 10 March 2020 (the original dual-licensing regime began in 2017), applicants can apply for a single cryptocurrency licence and provide services for the storage and exchange of cryptocurrencies.<sup>118</sup> A single cryptocurrency licence is official permission to conduct regulated cryptocurrency business in Estonia. Two different services fall into this category: (1) Crypto wallets and custodian services (this includes the generation and storage of encrypted customer keys); and (2) Crypto Exchanges (fiat exchanges and cryptocurrency to cryptocurrency exchanges).<sup>119</sup> This provides direct evidence of a comparable licensing regime to be followed. Crypto Exchanges in Estonia have operated under a well-defined regulatory framework that includes strict reporting and KYC and AML/CTF rules. Under this system, Estonia has become one of the leading European countries in developing a strong cryptocurrency industry<sup>120</sup> and has heavily monitored and policed Crypto Exchange AML/CTF compliance. Non-compliance with AML/CTF rules has also resulted in regulators withdrawing hundreds of Crypto Exchange licences.<sup>121</sup>

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116 For example, in April 2021 it was reported that no Crypto Exchanges had yet applied for South Korea's FATF-compliant VASP licence, which had been in planning since late 2020 and in force since March 2021. The key qualification for VASP registration in South Korea is an official partnership with a local commercial bank. Out of 200 exchanges in South Korea, only the 'Big 4' largest Crypto Exchanges have established banking partnerships. See Felix Im, 'South Korea's Top Financial Regulator Suggests All Crypto Exchanges Could Be Shut Down', *Coindesk* (online, 24 April 2021) <<https://www.coindesk.com/south-korea-top-financial-regulator-suggests-all-crypto-exchanges-could-be-shut-down>>.

117 *Bragg Final Report* (n 9) vii.

118 The National Financial Intelligence Unit (*Rahapesu Andmebüroo*) is responsible for granting a crypto-licence in Estonia in accordance with the *Rahapesu ja Terrorismi Rahastamise Tõkestamise Seadus* [Money Laundering and Terrorist Financing Prevention Act] (Estonia) 26 October 2017 [tr Riigikogu] ('*Money Laundering and Terrorist Financing Prevention Act*'). In 2020, two different licences were merged into the *Virtual Currency Service Provider License*.

119 Using the terminology from the *Money Laundering and Terrorist Financing Prevention Act* (n 117), section 70(1)(4) provides that an 'authorisation' is required for 'providing a virtual currency service against a fiat currency'. For the definition of virtual currency service, see section 3(9). Section 3(10) provides that a 'virtual currency wallet service' means a 'service in the framework of which keys are generated for customers or customers' encrypted keys are kept, which can be used for the purpose of keeping, storing and transferring virtual currencies'.

120 See, eg, Priit Martinson, 'Estonia: The Digital Republic Secured by Blockchain', *PwC* (online, 2019) <<https://www.pwc.com/gx/en/services/legal/tech/assets/estonia-the-digital-republic-secured-by-blockchain.pdf>>.

121 Tanzeel Akhtar, 'Estonia Has Withdrawn Licenses from Over 1,000 Crypto Companies This Year', *Coindesk* (online, 16 December 2020) <<https://www.coindesk.com/estonia-has-withdrawn-licenses-from-over-1000-crypto-companies-this-year>>.

Another relevant reference is Hong Kong ('HK'), which created a licensing regime for Crypto Exchanges in 2018–19. Some of the world's largest Crypto Exchanges operate in HK. HK's opt-in approach to Crypto Exchange regulation currently creates a two-tiered system, allowing room for those DEX operators favouring decentralisation to 'opt-out'.<sup>122</sup> In March 2021, HK-based OSL finally became the first fully licensed exchange in the region, holding both Type 1<sup>123</sup> and Type 7<sup>124</sup> licences required for VASPs.<sup>125</sup> The licences allow HK-registered VASPs to manage securities and cryptocurrency assets, including the ability to list security token offerings.<sup>126</sup> As HK's approach is currently an opt-in approach (though this may change), Crypto Exchanges can choose to be licensed.<sup>127</sup> This opt-in system should be considered in Australia as a way to encourage the bigger Crypto Exchanges to have a AML/CTF and custodial regulatory edge for attracting institutional investors.

However, there were discussions in late May 2021 that Crypto Exchanges operating in HK will have to be licensed by the regulator and will only be allowed to provide services to professional investors.<sup>128</sup> This article's proposed licensing regime has cited HK's existing system as a possible reference point, but enforced licensing of all Crypto Exchanges would hinder AML/CTF reporting. Local HK FinTech and cryptocurrency industry associations have opposed regulation that stops exchanges from offering services to retail investors, warning that this would drive exchanges out of HK and push investors onto unregulated venues.<sup>129</sup> Australia's definition of 'sophisticated and professional investors'<sup>130</sup> is important in this speculative and

122 Kevin Helms, 'Hong Kong Now Offers Opt-In Regulation for Crypto Exchanges', *Bitcoin.com* (online, 6 November 2019) <<https://news.bitcoin.com/hong-kong-now-offers-opt-in-regulation-to-crypto-exchanges/>>. Dozens of Crypto Exchanges then operated in Hong Kong, including some of the world's largest such as FTX (which left Hong Kong in late 2021): Joanna Ossinger, 'Bankman-Fried's Crypto Exchange FTX Leaves Hong Kong for Bahamas', *Bloomberg* (online, 25 September 2021) <<https://www.bloomberg.com/news/articles/2021-09-24/bankman-fried-s-crypto-exchange-ftx-leaves-hong-kong-for-bahamas?leadSource=verify%20wall>>. Under the 'opt in' approach, exchanges can apply to be licensed by the markets watchdog Securities and Futures Commission, but this requirement is not mandatory currently (as of mid-2022, though this approach may change).

123 Type 1 licences concern securities. See OSL, 'OSL Receives License from Hong Kong Regulator, Becomes World's First SFC-Licensed, Listed, Insured & Big-4 Audited Digital Asset Trading Platform' (Press Release, 15 December 2020) <<https://web.archive.org/web/20210126004919/https://osl.com/en/in-the-news/press-releases/20201215licensed>>.

124 Type 7 licences concern automated trading service regulated activities: *ibid*.

125 This phrase emanates from FATF for businesses that provide crypto services to customers.

126 'Obtaining License for Cryptocurrency Exchange in Hong Kong', *Law & Trust International* (Web Page) <<https://lawstrust.com/en/licence/finance/crypto-license/hong-kong>>; Sam Reynolds, 'Hong Kong's New Crypto Exchange Laws Will Be Embraced – with VPNs', *Forkast* (online, 5 November 2020) <<https://forkast.news/hong-kongs-new-crypto-exchange-laws-will-be-embraced-with-vpns/>>.

127 See Alun John, 'Hong Kong to Restrict Crypto Exchanges to Professional Investors', *Reuters* (online, 21 May 2021) <<https://www.reuters.com/technology/hong-kong-restrict-crypto-exchanges-professional-investors-2021-05-21/>>.

128 *Ibid*.

129 *Ibid*.

130 Under chapter 6D of the *CA* (n 31), a sophisticated investor must have a gross personal income of at least \$250,000 over the last two years or have net assets of over \$2.5 million. A professional investor must hold an AFSL, or have or control gross assets of at least \$10 million or more. To show that you are a sophisticated investor, you need a Qualified Accountant's Certificate: see also 'Certificates Issued by a

highly volatile market. Stopping local retail investors investing in Australian Crypto products will slow product experimentation. On the other hand, DeFi continues to evolve without regulatory oversight and the greater the amount of value locked and transacted in DeFi, the greater the potential systemic risks to the Australian financial market. Thus, while only allowing regulated Crypto Exchanges to serve professional investors as is proposed in HK is highly problematic, Australia must find a balance between innovation and investor protections. These jurisdictions offer a direct reference for Crypto Exchanges licensed or certified according to the type of Crypto Exchange. Australia should study the taxonomies and approaches of Estonia and HK and seek to navigate between the licencing paths chosen by Crypto Exchanges and those that avoid licencing paths.<sup>131</sup> Estonia, in particular, created a system that attracted hundreds of Crypto Exchanges to register in Estonia and has maintained a strict AML/CTF system.

### C Existing Custody Principles Offer Useful Lessons for Centralised Crypto Exchanges

The current custodian requirements suggested by ASIC's Regulatory Guide: Fund's Management and Custodial Services ('Regulatory Guide 133') for managed investment schemes<sup>132</sup> is already being followed by some centralised and custodian Crypto Exchanges offering Managed Investment Schemes,<sup>133</sup> whereby the custodian is an incorporated entity and has the minimum level of net tangible assets<sup>134</sup> and adequate insurances.<sup>135</sup> However, ASIC now views cryptocurrency assets as sufficiently unique and that specialised infrastructure and expertise is

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Qualified Accountant' *Australian Securities and Investment Commission* (Web Page) <<https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/>>.

- 131 Crypto Exchanges with connections to Australia fall into the following categories: pro-licensing, eg, Independent Reserve, CoinJar, Living Room of Satoshi; more avoidant, eg, Hardblock; and those that completely bypass licensing by being non-custodial, eg, LocalCryptos.com.
- 132 'Regulatory Guide 133' (n 71). [RG 133.90] sets out minimum standards and related requirements for asset holders: at 25–6.
- 133 A Managed Investment Scheme is defined in the *CA* (n 31): at s 9 (definition of 'managed investment scheme').
- 134 Several obligations apply to responsible entities in relation to custody of the cryptocurrency asset schemes. First, REs must comply with 'Regulatory Guide 133' (n 71) and Australian Securities and Investments Commission, *ASIC Class Order – Holding Assets: Standards for Responsible Entities* (CO 13/1409, 27 September 2017). The 'scheme property' includes underlying cryptocurrency assets held by the scheme. Secondly, asset holders need to comply with financial requirements set out in Australian Securities and Investments Commission, 'Regulatory Guide 166: AFS Licensing' (Guide, 6 July 2022) and Australian Securities and Investments Commission, *ASIC Class Order – Financial Requirements for Responsible Entities and Operators of Investor Directed Portfolio Services* (CO 13/760, 29 April 2021). This means that the RE, or its custodian, will be required to hold minimum net tangible assets of \$10 million.
- 135 AFSL holders and responsible entities are reportedly having difficulty in sourcing appropriate insurance in Australia. Many insurers have specific cryptocurrency asset exclusions in their policies for investment management professional indemnity insurance: see John Bassilios and Kai Liu, 'Crypto Update: ASIC Seeks Consultation on Exchange Traded Products Investing in Crypto-Assets', *Hall & Wilcox* (Web Page, 2 July 2021) <<https://hallandwilcox.com.au/thinking/crypto-update-asic-seeks-consultation-on-exchange-traded-products-investing-in-crypto-assets/>>.



required by custodians to hold cryptocurrency assets securely (see next section).<sup>136</sup> Those Crypto Exchanges that provide custody must be treated according to a higher standard AML/CTF compliance. A survey of the current regulatory frameworks applicable to custodians<sup>137</sup> provides a useful starting point, but additional controls (discussed below) should be added to existing frameworks for Crypto Exchanges. Regulation of Australia's super industry is a direct reference point because it has always been managed by professional custodians.

The name 'custodian' is used to describe the services provided by those responsible for holding institutional client assets in the Australian market and globally.<sup>138</sup> To start, Australia can learn from custodian principles derived from the superannuation industry. Under Australian trust law, custody can be based on the concept of a 'bare trust'. This means that the custodian is not responsible for corporate actions and seeks instructions from the person (usually a trustee of a separate trust) for which the assets are held on trust.<sup>139</sup> There are no informal custody arrangements in Australia. They are formed on a trust basis (usually a bare trust). This means that where applicable, '[p]rudent stewardship of those assets is primarily the responsibility of the trustee of each fund, but the custodian is integrally involved in both the safekeeping of the assets and the production of information flows.'<sup>140</sup>

The primary legislation governing the operation of the superannuation system, the *Superannuation Industry (Supervision) Act 1993* (Cth) ('*SIS Act*'), offers a reference point of relevance to Crypto Exchanges. The *SIS Act* regulates the relationship between a superannuation fund trustee and a custodian only 'lightly'.<sup>141</sup> In the superannuation industry, the custodian must also hold the minimum level of net tangible assets prescribed in the *Superannuation Industry*

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136 'Consultation Paper No 343' (n 56).

137 Compliance controls for licensed custody providers can be found in Australian Securities and Investments Commission, 'Regulatory Guide 132 Funds Management' (Guide, June 2022).

138 The term 'custodian' is used in a range of legal and regulatory sources including the definition of 'custodial or depository services': *CA* (n 31) s 766E. Custody is defined as being the legal owner of securities (generally held through nominee structures) and acting on behalf of superannuation trustees, and responsible entities of registered and unregistered managed investment schemes and others who owe their duties to the beneficial owners of the securities held by the custodian.

139 Custodians are a major industry in Australia. They hold title to securities as property. Technically, these rights are choses in action. Most custodians today are trustees 'holding' securities by being the person registered on the securities register with the beneficial interest being held by someone else. These are typically bare trusts only acting on the direction of the beneficial owner or some other person appointed to give directions on its behalf, such as an investment manager. Custodians hold legal title (of shares or debentures) typically as a trust. Effectively, bare trustees hold no power to deal with the asset unless directed to do so. Custodians are also record keepers and reporters.

140 M Scott Donald and Rob Nicholls, 'Bank Custodians and Systemic Risk in the Australian Superannuation System' (2015) 26 *Journal of Banking and Finance Law and Practice* 25, 25 <<https://doi.org/10.2139/ssrn.2599409>>. Stewardship such as securities trade confirmations and asset valuations, it is necessary for the trustee to discharge its duties to members and to government bodies such as Australian Prudential Regulation Authority ('APRA') and the ATO. Custodians also increasingly provide (directly or through agents) ancillary services such as securities lending, deposit-taking, foreign currency dealing and proxy voting: at 27.

141 Donald and Nicholls (n 140) 33.

(*Supervision*) Regulations 1994 (Cth).<sup>142</sup> This regulation operates ‘mostly at the level of regulatory instrument’, such as the Prudential Standards<sup>143</sup> issued by APRA and Regulatory Guides<sup>144</sup> issued by ASIC. The regulator primarily responsible for overseeing compliance with the *SIS Act*, APRA, does not have formal, direct regulatory responsibility for custodians.<sup>145</sup> Yet, ASIC has regulatory responsibility for good market conduct and consumer protection.<sup>146</sup> Further, APRA does impose some specific targeted supervision on entities offering custodial services. ‘It has for instance issued a standard set of requirements of custodians acting for APRA supervised entities that covers issues such as the segregation of assets. It has also issued guidelines for the processes of appointment and monitoring by the trustee and the content of any custodial agreement.’<sup>147</sup> This existing approach is highly relevant for centralised Crypto Exchanges and could further assist centralised Crypto Exchanges regarding the professional services and AML/CTF compliance required of traditional custodial trustees to satisfy banks.

As noted above, in reality, centralised Crypto Exchanges are highly centralised offering trading venues and trade themselves, sometimes serving as broker dealers. If acting as custodian, the traditional financial regulatory model would require a separation of these roles.<sup>148</sup> ‘There is a need in crypto markets for custodians who are laser focused on one thing – the custody and security of customer assets.’<sup>149</sup> Stronger AML-compliant custodian principles will help institutional investment expand into the crypto sphere, but again ASIC has recently noted that new Crypto Exchange-specific regulations are still needed. The *Bragg Final Report* would also recommend a ‘bespoke’ custody or depository regime for cryptocurrency assets. Cryptocurrency asset custody under the remit of Australian regulators would act as a risk minimiser for local investors and encourage custodial businesses to be set up in Australia.<sup>150</sup>

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142 *Superannuation Industry (Supervision) Act 1993* (Cth) s 123.

143 APRA’s Prudential Standards set out minimum capital, governance and risk management requirements. The prudential practice guides provide direction on how institutions may adhere to these prudential standards: ‘Prudential Policy’, *Australian Prudential Regulation Authority* (Web Page) <<https://www.apra.gov.au/prudential-policy>>.

144 ASIC’s Regulatory Guides give guidance to regulated entities by explaining when and how ASIC will exercise specific powers under legislation (primarily the *CA* (n 31)).

145 Donald and Nicholls (n 140) 33.

146 Australia has a twin peaks system. The model is characterised by two equal and independent peaks. APRA is responsible for financial system stability and ASIC is responsible for good market conduct and consumer protection: ‘APRA and ASIC: A New Era in Cooperation’, *Australian Prudential Regulation Authority* (Web Page) <<https://www.apra.gov.au/apra-and-asic-a-new-era-cooperation>>.

147 Donald and Nicholls (n 140) 33.

148 For example, the way the Australian Stock Exchange provides clearing and settlement services: ‘Clearing Services and Pricing’, *Australian Stock Exchange* (Web Page) <<https://www2.asx.com.au/about/regulation/clearing-and-settlement-of-cash-equities-in-australia/clearing/clearing-services-and-pricing>>.

149 Ankney (n 68).

150 *Bragg Final Report* (n 9) 135–6.

## D Cryptocurrency Custody: ASIC's Consultation in Respect of AML/CTF Compliance for Cryptocurrency Assets

Regarding the specific compliance requirements of this dual AML-compliant licensing regime and an AML-compliant self-certification Crypto Exchange regime, in July 2021, ASIC began the process of seeking submissions on the subject of good market practice for cryptocurrency assets. ASIC noted that:

We consider that the unique characteristics of crypto-assets mean that specialised infrastructure and expertise is required by custodians to hold crypto-assets in safe and secure custody, and we propose to set out good practices in relation to the custody of crypto-assets. We recognise that custody offerings continue to evolve in line with developments in technology and changes in risks.<sup>151</sup>

This discussion is highly relevant to the wider de-banking issue, as the growing market for secondary 'exchange-traded products' trading poses marked difficulties for developers seeking to comply with legal AML/CTF laws and/or create platforms that are truly decentralised. ASIC released *Consultation Paper Number 343*, 'Crypto-Assets as Underlying Assets for ETPs and Other Investment Products' ('Consultation Paper 343') on the issue of how to regulate 'exchange-traded products' in July 2021. Consultation Paper 343 includes a proposal for custodial key management. ASIC proposed the following good practices for RE in relation to the custody of crypto-assets:

- (a) a custodian with 'specialist expertise and infrastructure relating to crypto-asset custody';
- (b) 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';
- (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.<sup>152</sup>

With regards to cyber security, it was suggested that (d) '[m]ulti-signature or sharding-based signing approaches are used, rather than 'single private key' approaches'. Sections (e)–(g)<sup>153</sup> proposed adequate reporting systems and cyber

151 'Consultation Paper 343' (n 56) 19 [51].

152 Ibid 41.

153 Ibid:

(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

security tasks. Section (h) proposed that ‘REs and custodians have an appropriate compensation system for crypto-assets held in custody that are lost’. Finally, section (i) proposed that ‘[i]f an external or sub-custodian is used, REs should have the appropriate competencies to assess the custodian’s compliance with RG 133’.<sup>154</sup> A possible dual AML-compliant licensing regime and a self-certification process for Crypto Exchanges, (along with Crypto Exchange-type specific compliance frameworks designated by AUSTRAC) could refer to on ASIC’s proposals regarding custodial AML/CTF compliance. ASIC’s approach in respect of cyber security such as multi-signature signing approaches, sharing and ensuring that custody over cryptocurrency assets will be welcomed by many.<sup>155</sup> However, the proposal for the chosen custodian to have specialist expertise and infrastructure relating to cryptocurrency asset custody should be further explicitly specified, including for DEXs. This is where a collaborative market governance approach is helpful. Cryptocurrency asset key management is unique and requires the industry and ASIC to continue to work together to set out best custodial practices for different types of Crypto Exchanges and ‘exchange-traded products’ as they evolve. The definition of digital custody will be important. AML/CTF compliance should focus on broker and custodian responsibilities, such as reporting. This could offset AML reporting concerns as the custodian plays an important role in AML/CTF reporting. Those custodial Crypto Exchanges could have more specific reporting requirements and this could offset a bank’s reporting concerns. Still, existing custodial principles are less appropriate for DEXs.

### **E DEXs, Decentralised Autonomous Organisations and AML/CTF Certification Possibilities**

The following section sets out some practical options to try and encourage some AML/CTF monitoring capabilities over a particular DEX. ASIC’s proposed regulatory guidance in Consultation Paper 343 focuses primarily on KYC and AML/CTF obligations for Crypto Exchanges.<sup>156</sup> It seems that ASIC’s primary concern is to ensure that RE have systems so that their cryptocurrency asset trading activity takes place on legally compliant and regulated cryptocurrency asset trading platforms. Yet, regulations other than KYC and AML/CTF compliance will need to form part of the baseline level of regulation for Crypto Exchange REs.<sup>157</sup> This is because DeFi is the new arena for the leading Crypto Exchanges (and beyond), thanks to the ability of DeFi products to attract new capital due to the highly

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154 Ibid.

155 There are also some who dispute whether sharding is a useful practice for blockchains, as splitting the network introduces an ‘additional attack vector’. This is one reason for the creation of the Solana blockchain: see Paddy Baker, ‘Sharding is a Major Security Risk, Warns Solana CEO’, *Crypto Briefing* (online, 29 August 2019) <<https://cryptobriefing.com/solana-ceo-sharding-risk/>>.

156 The proposal is for ASIC to establish a range of good practices for REs in relation to the risk management systems in respect of cryptocurrency assets: see ‘Consultation Paper 343’ (n 56).

157 ASIC’s proposed minimum requirements are to ensure that trading platforms which are utilised are based in jurisdictions with KYC and AML/CTF laws and comply with those obligations: see ‘Consultation Paper 343’ (n 56).

liquid characteristics.<sup>158</sup> Cryptocurrency products prosper on the ability to generate attractive yields for liquidity providers. Once a digital or fiat currency reaches a DeFi Crypto Exchange, it may be very hard to follow for the purposes of AML/CTF record keeping. The speed of liquidity associated with DeFi is important to its unique popular appeal.<sup>159</sup> Equally important is that it is often powered by non-custodial wallets.<sup>160</sup> DeFi expedites the proliferation of crypto-to-crypto Crypto Exchanges. A vast ecosystem of decentralised protocols that operate at multiple levels removed from Australian dollar-denominated markets make AML/CTF record keeping complex.<sup>161</sup>

For DEXs and non-custodian Crypto Exchanges, ASIC does not have formal, direct regulatory responsibility for cryptocurrency custodians but instead can only offer guidance and supervision. DeFi is not the same as traditional finance. In DeFi, users cut out the middleman and interact directly, peer-to-peer. DEXs and non-custodial Crypto Exchanges provide something closer to an escrow service. Transaction safety is ensured by smart contract technology and flows of funds are fully auditable on a blockchain. Transactions remain anonymous and no KYC is performed. Thus, crypto-to-crypto investments are mostly out of the reach of regulators, including AML/CTF and KYC requirements. Decentralised projects are mostly operated without a licence in most jurisdictions, regardless of where the end-user is based.<sup>162</sup> Yet again, this article posits that there are DEXs that may seek AML/CTF compliance for various reasons such as to attract institutional investors.

Further, a DEX would also likely have a Decentralised Autonomous Organisation ('DAO') system of governance. A DAO aims to be a completely self-efficient, decentralised governance model with all business processes written in the code, eliminating managerial involvement.<sup>163</sup> Proposed transparency, immutability, autonomous functionality and democratic voting for decision-making means that DAOs are organisations that are designed to function 'without hierarchical management'.<sup>164</sup> Thus, arguably and more abstractly, a DAO-nominated DEX

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158 ASIC considers that cryptocurrency asset exchange-traded products have 'novel and unique features' that require consideration of whether such products can support fair, orderly and transparent markets and comply with the Australian regulatory framework: Australian Securities and Investments Commission, 'ASIC Consults on Crypto-Asset Based ETPs and Other Investment Products' (n 56). See also 'Consultation Paper 343' (n 56).

159 See, eg, Hugh Renaudin, 'Decentralized and Centralized Exchanges: Who Will Win the Race?', *Nasdaq* (Web Page, 5 November 2020) <<https://www.nasdaq.com/articles/decentralized-and-centralized-exchanges%3A-who-will-win-the-race-2020-11-05>>.

160 See, eg, Cem Dilmegani, 'Non-custodial Wallets Enable Private, P2P Crypto Trading', *AIMultiple* (online, 24 August 2022) <<https://research.aimultiple.com/non-custodial-wallet/>>.

161 For example, where a particular DeFi secondary 'exchange-traded product' such as high-frequency trading involves a trading strategy which may rely on executing trades rapidly in real time, the stringent custodial requirements set out by ASIC may not provide sufficient flexibility to allow that strategy to be implemented. This issue must be resolved by ASIC for AML/CTF compliance to be more widely adopted.

162 Taxation handling of DeFi assets also remains unclear in most jurisdictions.

163 Wulf A Kaal, 'Blockchain-Based Corporate Governance' (2021) 4(1) *Stanford Journal of Blockchain Law and Policy* 3 <<https://stanford-jblp.pubpub.org/pub/blockchain-corporate-governance/release/1>>.

164 Decentralised Autonomous Organisations ('DAOs') are organisations that 'function without hierarchical management', through the interaction of users with smart contracts: 'What Is a Decentralized Autonomous Organisation, and How Does a DAO Work?', *Cointelegraph* (online) <<https://cointelegraph>.

custodian could act as a ‘trustee’ or fiduciary in the traditional legal sense. This would depend on the DAO’s internal protocols (the DAO would need to code for the concept of a custodian). Institutional investors (as well as regulators) will likely push for this level of custodial professionalism. Thus, a DAO-run financial market is a form of organisational governance that could foreseeably allow for AML/CTF reporting if requested and governance protocols support that request.

The range of services the custodian is expected to complete would on a practical level depend on the type of Crypto Exchange and the forms of DAO governance.<sup>165</sup> Therefore, it is recommended that AML/CTF questions should also depend on the type of Crypto Exchange and evidence of the nature of DAO governance. A DAO-governed DeFi application may also have a voting regime that does not require regulatory interventions. For example, the internal operations of DAO-governed DEXs may have internal KYC requirements. Again, DEX traders pay higher network fees known as ‘gas’ because the operational infrastructure of the exchanges requires additional steps for verification and posting transactions to the exchange network. Thus, the internal operations and governance protocols of DEXs with regards to KYC and AML/CTF requirements could assist in avoiding de-banking. Certain DEXs as noted above will seek banking services.

Existing internal structures could satisfy some of the custodian requirements. For some DAOs there would be multiple custodians appointed by the DAO. This is not to say the regulator would hold any regulatory control over the DAO but that banks could audit the AML/CTF requirements through a designated person or persons appointed by the DAO’s internal protocols. DEX and non-custodial Crypto Exchanges such as Uniswap cannot be subject to regulation if there is no identifiable contact for a government official. In these instances, the organisational structure required by ASIC for superannuation funds<sup>166</sup> cannot be replicated. Yet, if a particular Crypto Exchange is truly decentralised and DEX users execute transactions without intermediaries as all transactions are authenticated by the network’s community, perhaps adequate staffing capabilities for a DEX<sup>167</sup> as required by ASIC for managed funds (under Regulatory Guide 133) could be applied. These are practical options to try and encourage some monitoring capabilities over a particular DEX.

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com/ethereum-for-beginners/what-is-dao>. Examples of DAO business types include for-profit and non-profits, investor groups, trader groups, Dapp communities and developer teams, and DeFi protocol governance bodies.

165 DEX custodian services providers could be expected to provide settlement and safekeeping services, in the way custody banks earn fees by providing back-office services such as record-keeping and trade clearing to fund managers.

166 ‘RG 133.34 An asset holder must have an organisational structure that supports the separation of the assets held from its own assets and those of any other client or managed investment scheme’: ‘Regulatory Guide 133’ (n 71) 12.

167 ‘Regulatory Guide 133’ (n 71) 14 [RG 133.42]–[RG 133.45].

## F Final Proposal: DEX Crypto Exchanges Could Have a Self-Certification Code of Custodianship

In reality, DeFi companies intentionally remain outside of regulation and in many cases it is questionable whether they will actually submit to regulation. It will be the choice of those DeFi companies based on commercial realities and their connections with institutional investors and other stakeholders. Yet, a self-certification Code of Custodianship system may find currency for those exchanges touting their AML/CTF compliance credentials to institutional (and also retail) investors. It should be noted that these AML/CTF records can be assessed through open-source blockchain analysis.

One of the key challenges facing cryptocurrency asset custodians is striking the correct balance between crypto-to-crypto usability, key management and asset storage safety, and AML/CTF compliance. It is suggested that ASIC could only continue to provide ongoing DeFi consumer protection guidance for now, but could encourage an Australian AML/CTF compliance self-certification system for DEXs. While some decentralised (and some non-custodial) Crypto Exchanges are not able to be regulated by a licensing regime, they could opt-into a self-certification system. Introducing an operating model self-certification process may properly incentivise Crypto Exchange operators to disclose material information regarding their operations, such as their incorporation of centralised cryptocurrency clearing practices. Japan provides a relevant reference, although this is a nascent example. In Japan, a virtual currency exchange should establish a self-regulatory organisation that is certified by Japan's Financial Services Agency.<sup>168</sup> Australia could study this approach as self-regulation may amount to soft law<sup>169</sup> for Crypto Exchange operators seeking institutional investors. Japan's self-regulation model offers a direct reference for Australia in light of the discussion above regarding the nature of DeFi and the need for collaborative market governance for this emerging and largely unregulated way to trade crypto-to-crypto assets.

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168 The Financial Services Agency ('FSA') is the Japanese government agency and financial regulator responsible for overseeing banking, securities and exchange and insurance. On 30 April 2020, the FSA officially recognised the Japan Security Token Offering Association and the Japan Virtual Currency Exchange Association as self-regulatory bodies for conducting digital asset derivatives trading and security token offerings of cryptocurrencies: Omar Faridi, 'Japan's Financial Services Agency Recognizes the Nation's Virtual Currency Exchange and Japan STO as Self-Regulatory Bodies', *Crowd Fund Insider* (online, 1 May 2020) <<https://www.crowdfundinsider.com/2020/05/160880-japans-financial-services-agency-recognizes-the-nations-virtual-currency-exchange-and-japan-sto-as-self-regulatory-bodies/>>.

169 Oren Perez and others have developed a concept of 'fuzzy law' since the 1990s: Oren Perez, 'Fuzzy Law: A Theory of Quasi-Legal Systems' (2015) 28(2) *Canadian Journal of Law and Jurisprudence* 343 <<https://doi.org/10.1017/cjlj.2015.31>>. Perez refers to fuzzy law as 'quasi-legality', or soft law: at 343. Recent literature has provided, for example, an evaluation of the efficacy of self-regulation as soft law in the US tech sector: Adam Thierer, 'Soft Law in U.S. ICT Sectors: Four Case Studies' (2020) 61(1) *Jurimetrics* 79 <<https://doi.org/10.2139/ssrn.3777490>>.

Also, the Australian Custodian Services Association<sup>170</sup> ('ACSA'), the peak industry body representing members of Australia's custodial and administrator sector, could be extensively consulted in this process of creating a Crypto Exchange Code of Custodianship. The Crypto Exchange Code of Custodianship could act as an impartial expert body, effectively 'stewards' of Crypto Exchange industry, as ACSA are for the superannuation system. Learning from ACSA, the role of the potential 'Crypto Exchange Code of Custodianship' could be to:

- Assess the compatibility of proposed policy changes or legislation affecting Crypto Exchanges.
- Consult where required on issues referred to it by the Minister.
- Produce annual reports on the adequacy, performance and sustainability of the system. For example, while Australia could consider making all existing AUSTRAC registrations of Crypto Exchanges public for retail investors to view, the Crypto Exchange Code of Custodianship could also maintain this public registrar for consultation upon request.
- Conduct research and publish statistics.
- Make recommendations for improvements to the AML/CTF certification system.

However, as noted above, DEXs are reluctant to deal with regulators and this is why more abstractly, this 'Code of Custodianship' could be very loosely akin to a B-Corp certification,<sup>171</sup> whereby unregulated Crypto Exchanges self-certify that they meet all AML standards and open themselves up to a certification audit by their own community members.<sup>172</sup> Banks would conduct their own AML/CTF checks but this certification would provide a minimum baseline standard for reporting. This may be the best approach for creating a soft-law fiduciary role for decentralised 'DEX' Crypto Exchanges. In the absence of regulatory certainty, custodians could take the lead in setting AML/CTF standard practices and instilling self-monitoring mechanisms based on discussions with the regulator, their internal

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170 'Welcome to the Australian Custodial Services Association', *Australian Custodial Services Association* (Web Page) <<https://acsa.com.au/>>. Collectively, the members of ACSA hold securities and investments in excess of \$4.7 trillion in value in custody and under administration: Australian Custodial Services Association, 'Another Record as Assets under Custody Surge to \$4.7 trillion', *Adviser Voice* (online, 16 February 2022) <<https://www.adviservoice.com.au/2022/02/another-record-as-assets-under-custody-surge-to-4-7-trillion/>>. Members of the ACSA include National Australia Bank Asset Servicing, JP Morgan, HSBC, State Street, RBC Investor Services, BNP Paribas and Citi Transaction Services: 'ACSA Members', *Australian Custodial Services Association* (Web Page) <<https://acsa.com.au/page/ACSAMembers>>.

171 'Certified B Corporations are businesses that meet the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose. B Corps are accelerating a global culture shift to redefine success in business and build a more inclusive and sustainable economy.': see 'About B Corp Certification: Measuring a Company's Entire Social and Environmental Impact', *Certified B Corporation* (Web Page) <<https://www.bcorporation.net/en-us/certification>>.

172 This is an abstract idea as there are no financial services B Corps in Australia (other than ethical equity investors): They do operate in the US: see 'Process, Requirements and Fees', *Certified B Corporation* (Web Page) <<https://usca.bcorporation.net/process-requirements-fees/>>.



DAO-governance protocols and their investors.<sup>173</sup> A B-Corp-type model of self-certification – a Code of Custodianship – offers a baseline for AML-compliance according to the *AML/CTF Act*.

This proposed regime would allow in-house bank AML/CTF compliance teams to streamline their approach to distinguishing between bankable and un-bankable Crypto Exchanges. It should also incentivise Crypto Exchanges to improve their AML/CTF practices, knowing that banks can better understand their AML/CTF systems and have realistic AML/CTF targets to meet. Again, these AML/CTF records can be assessed through open-source blockchain analysis. A case-by-case, risk-based approach could apply, and while banks may find that some Crypto Exchanges with a record of exposure to illicit cryptocurrency assets are too risky to bank from an AML/CTF compliance perspective, other self-certified Crypto Exchanges would not hold constant unfounded fears of being de-banked.

## V CONCLUSION: AN AML/CTF CRYPTO EXCHANGE REGIME

The role of financial regulators is to encourage innovation whilst balancing the need to protect consumers and maintaining financial stability.<sup>174</sup> They should continue to work together to use that evidence to create a new or amended DCE licensing regime (as also recommended by the *Bragg Final Report*) in line with a Crypto Exchange operating model to specifically assuage the banks' KYC and AML/CTF concerns. That regime should differentiate centralised and decentralised Crypto Exchanges and differentiate custodian and non-custodian Crypto Exchanges for banks so that AML/CTF fears are removed. Further, an AML-compliant self-certification system for those Crypto Exchanges that cannot be licensed should be encouraged.

KYC and AML/CTF regulatory requirements should be applicable in Australia regardless of the digital or traditional nature of the asset, and adherence to these rules should be the focus for any new Australian licencing regime. The burgeoning cryptocurrency asset market means there is growing demand for secure custodianship principles. Regulators, custodians and investors can play a key role in developing the security and stability of the custody sector. Regulatory uncertainty will lead to capital flight from Australia. While regulatory certainty and the rule of law will provide confidence to innovators and investors in the Australian crypto industry. Yet regulatory arbitrage in cryptocurrency markets will continue to challenge regulators globally when legal definitions fail to 'track the underlying economic relationship between the parties, gaps arise,' creating

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173 There are precedents for this approach. For example, the Asian Securities Industry and Financial Markets Association, a trade association in Asia with over 100 members, released its best practices for Digital Asset Exchanges, and the Global Digital Finance industry membership body released its key takeaways on Crypto Asset Safekeeping and Custody: Asia Securities Industry and Financial Markets Association, 'ASIFMA Best Practices for Digital Asset Exchanges' (Paper, June 2018); Global Digital Finance, 'Crypto Asset Safekeeping and Custody: Key Considerations and Takeaways' (Paper, 20 April 2019).

174 As noted in 'Consultation Paper 343' (n 56) 12 [27].

an invitation for opportunistic behaviour.<sup>175</sup> In collaborative market governance, policy and market forces are intertwined. A collaborative market governance approach, starting by distinguishing Crypto Exchanges by type, licence and in the case of DEXs, encouraging public AML/CTF compliance self-certification, would benefit Australia's approach to AML/CTF compliance and offset de-banking of Crypto Exchanges.

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175 Victor Fleischer, 'Regulatory Arbitrage' (2010) 89(2) *Texas Law Review* 227, 243 <<https://doi.org/10.2139/ssrn.1567212>>: 'Regulatory arbitrage is a consequence of a legal system with generally applicable laws that purport to define, in advance, how the legal system will treat transactions that fit within defined legal forms.'