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Senate Economics Legislation Committee Inquiry:
Digital Assets (Market Regulation) Bill 2023 to the Senate Economics Legislation Committee

To the committee,

Thank you for the opportunity to make a submission into this inquiry. Kraken is one of the world's oldest and largest global digital asset businesses, founded in 2011 as one of the first exchanges to offer spot trading. Kraken's services are subject to regulatory licences and permissions as applicable in the jurisdictions in which we operate. Kraken is trusted by over 10 million traders and institutions around the world. We offer professional, around the clock online support to our customers, who trade more than 185 digital assets and multiple different fiat currencies, including GBP, EUR, USD, CAD, CHF and AUD. Kraken services Australian clients via a local subsidiary Bit Trade Pty Limited (trading as Kraken Digital Asset Exchange) and is registered with AUSTRAC as a Digital Currency Exchange (DCE100575789 001).

Customer asset protection and security are core to our culture and operating model. We are consistently named one of the most secure places to buy and sell crypto due to the robust security protocols we have in place to safeguard customer assets. Moreover, we believe that the opportunities and risks of investing should be accurately conveyed to consumers, and we apply high standards including proactive disclosures about risks and fee structure.

Cryptoasset regulation is accelerating globally, and we are at a critical juncture for determining the future regulatory treatment of cryptoassets and centralised service providers in cryptoasset markets. We agree that Australian consumers and investors should benefit from safeguards when investing in cryptoassets, and that now is an appropriate time to be considering the role of regulation in delivering those safeguards.

On this basis we have identified some key points regarding potential cryptoasset exchange and custody obligations for the Committee to consider when developing regulation, which we develop further in the document attached.

We are also supportive of the Bill's focus on international coordination. As a global business we note the operational and business impacts of multiple jurisdictions around the world setting their own rules and local subsidiarisation requirements. We would therefore encourage the Treasury to consider implementing equivalence style arrangements where appropriate to enhance cross border market access and Australian competitiveness on the global stage.

We would be very happy to provide further information on any of the points raised or to meet with you to discuss if helpful.

Kind regards on behalf of the Kraken Team

Jonathon Miller
Managing Director, Australia, Kraken

1. Exchange regulation

We believe that trading venues should take steps and be able to evidence how they provide transparent and fair access, fair, orderly and efficient trading, and avoid conflicts of interest. To facilitate this, we have identified the following good practices and principles that we believe should be adhered to:

a. Issuance and disclosures

Kraken applies high level standards of market disclosures about risks and fee structures in our terms of services, including implementing risk disclaimers. We only admit tokens to trading that pass our legal and security assessments, and admit fewer tokens than many of our competitors. We think that building trust on the basis of clear, accurate information and sound processes is a key driver for our business to expand.

On this basis, we believe that it is sensible for trading venues to develop detailed content requirements without requiring explicit regulatory approval or notification at every step, including before admission to trading.

b. Conflicts of interest

Conflicts of interest are not unique to cryptoasset companies. In some respects the integration of activities in the crypto sector reflects the growth of the industry from technology origins. In other respects, it reflects efforts to achieve commercial synergies and scale similar to economic motivations in the traditional financial services sector where multiple services are offered out of single legal entities. More fundamentally, integration within crypto service providers can also reflect a desire to reduce intermediary layers.

These observations aside, it is clear that integration may also create potential conflicts of interest. Internal controls and governance are critical to managing these conflicts. We think investments in talent and processes are critical markers of good governance in this regard, including appropriate investments in and funding for legal, accounting and compliance teams.

As a general observation, it is difficult to identify and control through regulation every conflict of interest on an ex ante basis, i.e., through narrow and prescriptive regulation about activities and corporate structure. This has important implications when it comes to designing the overall regulatory approach.

That being said, there are ways to help disclosure and manage conflicts. For instance, as part of authorisation processes, firms should be expected to proactively identify the main conflicts of interests present across their activities, and how they have managed them. The adequacy of governance and controls should be a key test of authorisation on an initial and ongoing (i.e, supervisory) basis. For example, trading venues that operate a broker or even a market maker should be able to demonstrate clearly that their trading entity operates according to fair and equal market rules, and does not enjoy any preferential access to information (e.g. order flow). Similarly, venues or trading entities that offer custodial services should evidence that assets they are safeguarding are not used inappropriately or without the customer's knowledge and consent.

Some specific conflicts of interest may require proactive regulatory intervention. Whilst Kraken does not issue a token or stablecoin, recent market events have demonstrated the potential consequences when exchanges that issue their own tokens also hold them as collateral on their balance sheet, and trade them on open markets. In the interests of broader crypto market integrity and competition, and given the potential for significant market abuse, we believe that venues that issue their own token should be subject to stricter requirements around managing conflicts of interest, preventing market abuse, and establishing good accounting and prudential practices.

c. Market abuse

We take market abuse seriously and have invested significantly to ensure we have dedicated teams, tools and processes for screening and will continue to augment our capabilities in line with industry best practice and future regulatory requirements. We believe that prudential, conduct, operational resilience and reporting requirements can go a long way to help to improve market integrity and consumer protection and tackling market abuse. We have invested heavily in personnel and processes and will continue to do so in line with future obligations.

We observe that regulation is inconsistent globally at present; jurisdictions applying different definitions (or traditional financial services frameworks) to cryptoassets can make it difficult for service providers to align and coordinate around information sharing and enforcement. With regards to focused requirements, it is important to align with global approaches and design rules that are calibrated to the risks presented by specific operating models. We look forward to engaging with the Australian regulators on these technical elements of regulation in the near future.

Notwithstanding these challenges, we agree that crypto service providers should be obliged to conduct market surveillance to deter bad actors to ensure that markets are fair and open, similar to traditional financial markets. We believe that obligations around detecting and disrupting market abuse should be commensurate with a firm's role in a token ecosystem. Whilst trading venues play an important central role in addressing abusive behaviour, we believe that obligations to manage inside information and conduct appropriate market surveillance should not start and end with trading venues; they should also extend to other actors in the ecosystem as practical and appropriate. Some specific views are set out below:

- Access to inside information: We consider that, typically, trading venues have limited access to insider information and that the issuers and developers of cryptoassets are generally more likely to hold advantageous information (e.g. announcements around partnerships or improvements to technology) and obligations to manage this information should be applied. Importantly, trading venues can be limited in their ability to identify insider trading in instances where the exchange is only partially involved (e.g. where an insider buys an asset on a Defi protocol before selling on a centralised exchange).

- On the role of intermediaries: We do not think mandatory surveillance roles for intermediaries are necessary as this would potentially undercut one of crypto's most significant value propositions (disintermediation); however, where brokers or third parties are involved in facilitating customer flow or market transactions they should face obligations and expectations consistent with their role in the ecosystem (i.e, the risks they can see and manage).
- Data sharing protocols: Information sharing between trading venues is important and one that we want to see implemented effectively. We want to see consistent application of the rules when it comes to market abuse: market integrity can be undercut by forum and venue shopping by bad actors. At present, when an exchange acts in good faith to remove a bad actor, there is little or nothing to stop them from opening an account on another exchange. Regulators will have a key role to play in overseeing the development of new systems and to ensure that firms sharing information in good faith are not subject to unreasonable commercial or legal risk.

2. Custody regulation

Kraken supports a 'race to the top' when it comes to custody we believe that custodians should be properly resourced and set up for robust operational resilience and security, backed by appropriate governance and processes to keep customer assets safe. This includes maintaining the highest security standards and securely holding assets in cold storage where appropriate.

Our views on specific aspects of custody are as follows:

a. Storage of cryptoassets

On the storage of cryptoassets, a bias towards cold storage for security purposes is sensible but some flexibility should be built into the framework. We believe that regulation should be carefully designed to ensure that operational processes and consumer access to their assets are not interrupted or blocked by 'cold mandates' that are too strict or inflexible. While cold storage could be a baseline regulatory expectation, transfers to hot wallets should be permitted where they are needed to meet client and market demands.

It is important to avoid unintended consequences. Restrictive rules around cold storage could mean that users struggle to withdraw their crypto in the time they would expect, i.e., as they might exceed any hot wallet thresholds or balances. Liquidity is another important consideration around the approach to storage. Full mandates around cold storage could actually create liquidity and operational risks (i.e., by impacting the ability to fill hot wallet requests or redemptions in a timely manner). It can be time consuming to move from cold to hot storage, and in some instances custodians will want to be able to rebalance across hot and cold to honour withdrawals without undue restriction.

b. Recordkeeping and segregation of customer assets

It is paramount that customers trading on an exchange know that their assets are not being re used without consent or mixed with the reserves of the trading venue and/or custodian. Rehypothecation or re use of customer assets without appropriate permissions, disclosure and transparency should not be permitted.

These outcomes can be achieved without mandating separate and individual wallets and addresses for each client. Omnibus structures can support appropriate and reliable levels of operational segregation. 'Omnibus' and 'segregated' are not antonyms.

We believe that omnibus account structures should be permitted subject to robust controls to ensure that client assets are fully segregated from house/proprietary assets and clearly allocated to specific client accounts. Maintaining omnibus wallets enhances security and operational efficiency because it reduces the number of on chain addresses and transfers, which reduces overall security exposure (the 'attack surface') while also reducing operational risk. Indeed, omnibus structures have precedent in traditional financial services for similar reasons (i.e., because they increase operational efficiency while reducing operational risk).

c. Reconciliations

We believe that custodians should be required to run real time reconciliation of on chain assets and customer activity. They should be required to address, within a reasonable time period, any inconsistencies across these balances.

Importantly, these reconciliation processes should be performed separately for each cryptoasset that is traded and held in custody; no fungibility or cross counting across unique and discrete cryptoasset balances should be permitted. Put differently, balances should be calculated on the basis of the asset in question, without fungibility across different assets (e.g., across stablecoins linked to the same underlying asset). Failing to apply this rigorous 1:1 approach to assessing balances can result in market or basis risk being introduced into the calculation of net assets and liability (i.e., the introduction of a gap between overall customer claims and overall balances in custody).

These reconciliation processes should include off chain activity. It is important to reconcile off chain customer activity with on chain balances this is something custodians can and should do. Without this, reconciliation of balances is not based on the whole picture of assets and liabilities.