Division Head
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Initial Coin Offerings Issues Paper

We refer to Treasury's Initial Coin Offerings Issues Paper dated January 2019.

Baker McKenzie is pleased to provide the enclosed responses to the Consultation Questions. The document also provides additional observations that we believe may be useful to Treasury in formulating its approach to this evolving area of FinTech.

If you would like to discuss our responses or comments, please feel free to contact the undersigned.

Yours faithfully

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Encl
Consultation Questions

Introduction and overview

Baker McKenzie is pleased to provide the following responses and commentary in response to the thoughtful issues and questions raised in Treasury's Issues Paper.

As an overall approach, we have sought to focus on where we believe the market is going, rather than where it has been. Many of the questions in the Issues Paper are premised on ICOs being a stand-alone fundraising structure which is a viable alternative to more traditional equity or debt securities. That certainly would have been the impression given in late 2017 and early 2018, when billions of dollars were raised in these kinds of ICOs.

The problems with ICOs as a fundraising structure

However, since that time, and following a number of warnings from securities regulators around the world (including from ASIC), the popularity of ICOs as a fundraising structure has fallen heavily. It has become clear to investors that most ICOs had, at best, failed to deliver on overly inflated expectations or, at worst, were outright frauds or scams.

For either reason, investors in many ICOs have been left out of pocket, and without recourse to the promoters of the ICOs. The flaws in an ICO fundraising (from an investor's point of view) are arguably intrinsic to the nature of an ICO itself:

- First, the offer process is not conducted under the watchful eye of a securities regulator, such as ASIC. This has enabled bad practices to prevail, such as vague, unfounded forecasts in "white paper" offer documents; differential offer pricing for insiders and public investors; short deadlines and other high pressure sales techniques; and "pump and dump" conduct by promoters.
- Second, once coins or tokens are held, investors do not have the rights they might expect. A holder of a share, debenture, or unit in a unit trust has the protection of statutory corporate law and the benefit of a large body of case law regarding the fiduciary duties of directors and trustees. A holder of a token, on the other hand, typically has only vague, quite possibly unenforceable rights, and if the ICO is structured as a "utility token" to circumvent securities laws then the holder likely has no rights at all.

To add to the difficulty of recourse for investors is the fact that ICO issuers are often located in offshore "haven" jurisdictions without an easily accessible legal system.

The future: tokenisation

ICOs have issues as a vehicle for investors, which are not easily solved. However, the underlying technologies - blockchain, tokenisation, smart contracts - present a way forward for something with the potential for a more sustainable, more transparent, and ultimately larger legitimate market.

We believe that financial products in the form of tokenised assets (which can include traditional securities, such as shares or bonds, in the form of a token) and securities in token form will open new structures for financing companies, projects and assets, and create new markets for investors. There is the potential for Australia to be a global leader in regulating and encouraging markets for security tokens and other tokenised assets, which can bring benefits to issuers and investors in the form of:

- transparency of ownership and transactions, for the benefit of regulators and investors,
- near instantaneous transaction time and clearing, lowering risk for investors and market participants, and
- directly accessible by investors, lowering costs for issuers.
Australia has a global reputation for well regulated markets and a skilled workforce. This is an excellent starting point from which to develop regulatory settings that would enable a tokenised asset market to develop here, as a hub for global trading.

There may continue to be genuine use cases for pure utility tokens, and in that case the questions raised in the Issues Paper will be relevant. Our submission, however, follows the above thinking regarding the potential of future markets.

**Definitions and Token Categories**

1.1. **What is the clearest way to define ICOs and different categories of tokens?**

We consider that most tokens of interests to investors will be a form of security under Australian law, most likely an interest in a managed investment scheme or a derivative. Many tokens that are self-categorised as utility tokens are actually marketed on the basis of a forecast increase in value once a promised platform is built, meaning that in substance these are arguably security tokens as well.

A better approach, we submit, is to not try to draw fine distinctions between types of token, and instead seize the opportunity to take a lead in developing a regulatory framework for security token markets.

**Drivers of the ICO Market**

2.1. **What is the effect and importance of secondary trading in the ICO market?**

2.2. **What will be the key drivers of the ICO market going forward?**

As with most forms of investment, a liquid, trusted secondary market is essential for attracting investors to an ICO (or other form of tokenised asset offer). Unless Australian regulators develop a workable framework for token markets, Australian investors will continue to buy and sell coins and tokens on foreign-based exchanges, many of which are in jurisdictions with materially lower standards of investor protection.

We outlined above what we see at the key drivers for a future economic role for tokens that are issued and traded on a blockchain or distributed ledger. Tokenising illiquid assets such as real estate, agricultural assets, infrastructure projects, and even non-traditional assets such as valuable artworks, has the potential to open up new markets for investors and asset owners.

Being able to issue and trade these tokens on a transparent, well regulated exchange will not only facilitate investment into new Australian projects (thus creating jobs and supporting a range of service providers), but will also allow Australia to develop the technology and skilled professional industries to provide these services to global issuers.
Opportunities and Risks

3.1. How can ICOs contribute to innovation that is socially and economically valuable?

3.2. What do ICOs offer that existing funding mechanisms do not?

3.3. Are there other opportunities for consumers, industry or the economy that ICOs offer?

3.4. How important are ICOs to Australia’s capability to being a global leader in FinTech?

3.5. Are there other risks associated with ICOs that policymakers and regulators should be aware of?

The blockchain and distributed ledger technology underlying ICOs has the potential to make financial and investment markets more efficient, transparent, and accessible. This kind of innovation has potential to be significantly socially and economically valuable, even if ICOs (as such) may not. It is this underlying technology, and its potential future applications in financial markets, that could contribute to Australia becoming a global leader in FinTech if appropriate and facilitative regulatory settings can be developed.

We do not believe that ICOs, as they have been created and marketed to date, offer a net benefit to Australian investors. The lack of government regulation over token offers was promoted as a virtue of ICOs by issuers, and only later did it become apparent that this very feature left investors without the raft of legal protections that a regulated market brings with it.

The other key risk of ICOs that policymakers and regulators need to be alive to is that they can easily facilitate money laundering, due to common features of ICO design which include anonymity (to a greater or lesser degree, depending on the token) and having an issuer located in a lightly regulated haven jurisdiction. Bringing token markets into Australia’s regulatory framework will help regulators to apply stringent anti-money laundering rules.

Regulatory Frameworks in Australia

4.1. Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?

4.2. Do current regulatory frameworks enable ICOs and the creation of a legitimate ICO market? If not, why and how could the regulatory framework be changed to support the ICO market?

4.3. What, if any, adjustments to the existing regulatory frameworks would better address the risks posed by ICOs?

4.4. What role could a code of conduct play in building confidence in the ICO industry? Should any such code of conduct be subject to regulator approval?

4.5. Are there other measures that could be taken to promote a well-functioning ICO market in Australia?

As noted above, we believe that most historical use of ICOs has involved a token which is properly characterised as a form of security or financial product under Australian law, and that the future use case for the underlying technology will be in the realm of tokenised assets and tokenised securities.
**Problems with current regulatory frameworks**

Current Australian laws do not well serve the use of such technology for these purposes. There are fundamental assumptions made in the law which are inconsistent with blockchain and distributed ledger technology, and inconsistent with implementing things such as voting rights by way of smart contracts. These inconsistencies include:

- requirements for a central register of holders, which includes names and addresses and other personal data,
- rules regarding paper based transfers, and centralised transfer approval processes,
- rules regarding paper based voting procedures (such as proxy forms), and physical meetings of holders of shares or MIS interests,
- rigid structures, as either a body corporate or unit trust,
- concentrations of decision making power, and corresponding legal responsibility, in a board of directors or a responsible entity, which may preclude interesting uses of smart contracts for direct token holder decision making, and
- stamp duty laws which assume a "location" of a register or of a security.

**A better way**

We believe a better way is to create a regulated market framework for tokenised assets, tokenised securities, and security tokens (**Security Tokens**). The framework would have the following broad features:

1. **Market licensees as gatekeepers**: the ASIC-licensed operators of Australian based markets for Security Tokens would be responsible, as part of their licence conditions, for selection and admission of the Security Tokens that are permitted to trade. Similar to the regime for Crowd-sourced Equity Funding, putting the onus on licensees will give comfort to investors that the tokens traded on licensed markets have been vetted and are legitimate. We believe that specialised market licensees are better placed to make this assessment than regulators such as ASIC. Failure to enforce high standards of market conduct would place a market operator's licence at risk.

2. **ASIC as investor protection regulator**: ASIC would retain its broad consumer protection role under the ACCC's delegation of powers under the Consumer Law in relation to misleading conduct. ASIC's proposed product intervention powers (**PIP**) under the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018* could also be extended to Security Tokens, to give a more immediate ability to intervene in the market where there was an apprehension of significant harm to investors.

3. **Safe harbour for Security Tokens**: rather than try to apply current laws in order to make fine distinctions between security tokens, utility tokens, and cryptocurrencies, it would be clearer to create a safe harbour for Security Tokens which are admitted to and traded on a licensed market. The safe harbour would allow such Security Tokens to be offered and traded on the regulated market, without compliance with prospectus or product disclosure statement regulations for issue and sale.

This framework would have the advantages of:

- fostering innovation and not requiring Security Token issuers to structure themselves, their tokens and investor rights into rigid boxes for shares, debentures, or unit trusts,
- giving investors the benefit of new and evolving features of Security Tokens such as using smart contracts to vote on proposals or democratically drive the direction of an enterprise,
- giving oversight for the offer and marketing of Security Tokens to ASIC, both directly (under Consumer Law powers and potentially PIP powers), and indirectly by way of supervision of market licensees,
• providing a venue for the issue and trading of Security Tokens from Australian and global issuers, with a clear treatment under securities laws (unlike other jurisdictions where the security vs utility characterisation of a token remains an obstacle to clarity of treatment),
• bringing Australian investors back onshore and into a well regulated market framework, with oversight by trusted regulators,
• improving anti-money laundering regulation and oversight by having local participants involved in the market, and
• developing Australian expertise and skilled employment opportunities by creating a hub for regional and global markets for Security Tokens.

We do not consider that an industry code of conduct would have nearly the same benefits, especially because of the unclear regulatory treatment of Security Tokens in the absence of a regulated safe harbour.

Some kind of anti-avoidance provisions may be necessary, in order to avoid a traditional security offering being structured as a Security Token in order to avoid prospectus and product disclosure statement laws. However, we believe that at a practical level there would be no detrimental impact on the traditional IPO and listed company markets, as larger enterprises will still find a more predictable and liquid market for their equity by listing on markets such as ASX, and institutional investors are unlikely to divert their funds away from well understood stock exchanges in any significant degree.

Other legislative improvements

The nature of blockchains and distributed ledgers also means that laws which depend on the "location" of an asset are difficult to apply. Examples include the Personal Property Securities Act (PPSA), and State stamp duty laws.

Whether or not our above suggestions for Security Token regulation are taken up, we submit that legislative clarity around the location of tokens will promote legal certainty in Australia for a variety of purposes. Without even a central server to determine location in a true public blockchain, one option could be to use the governing law (if one is specified) of a Security Token. There may well be other feasible alternatives.

In addition, the status of a token as an "asset" is not entirely clear for the purposes of certain legislation, with the PPSA again being an example. To make Australia a more attractive jurisdiction for the development of blockchain and other new technologies, we submit that it would be helpful to introduce legislative clarity (for example, by way of expanded definitions where appropriate) as to the status of Security Tokens.

Tax Treatment of ICOs

5.1. Does the current tax treatment pose any impediments for issuers in undertaking capital raising activities through ICOs? If so, how?
5.2. Is the tax treatment of tokens appropriate for token holders?
5.3. Is there a need for changes to be made to the current tax treatment? If yes, what is the justification for these changes?

As noted in the Issues Paper, the tax treatment of ICOs will likely follow from the underlying rights, attributes and characteristics of the tokens that are issued. As such, it should follow that the tax treatment of ICOs is consistent with the taxation of other commercial transactions, financial products and capital raising mechanisms.
Given the broad potential usages of cryptocurrency tokens and that the existing tax rules are typically flexible enough to apply (i.e. tax laws take a broadly ‘substance over form’ approach), we do not consider there to be a strong argument for providing a new tax framework for tokens. Rather, we respectfully submit that more guidance and information from the Australian Taxation Office (ATO) on how the tax laws interact with ICOs would be appreciated by the market and advisors.

Due the wide variety of token structures that may be employed in an ICO (a selection being identified in the Issues Paper at “Tax implications for issuers”), there is a degree of uncertainty in the market as to the proper pathway to tax compliance for ICO issuers and token holders. The income tax, Goods and Services Tax (GST) and Capital Gains Tax (CGT) outcomes can all vary depending on the structure of the token and due to the nature of the ICO market, market participants (both issuers and holders) are often unfamiliar with taxation concepts and laws. Further, the global nature of the ICO and cryptocurrency market means that market participants may be fully or partially international and unfamiliar with the specifics of Australian taxation law.

Given the potential benefits of encouraging the ICO and cryptocurrency markets in Australia discussed above, we respectfully suggest that the ATO should consider providing further guidance and detail on the operation of taxation laws with respect to ICOs. While general guidance has been provided by the ATO with respect to tax issues arising in relation to cryptocurrencies (and in particular, Bitcoin) (available here) and the GST implications of transactions involving Bitcoin (available here), there may be a need to provide more detailed and specific guidance with respect to ICOs.

Similar to how ATO-issued Tax Rulings, GST Rulings and Interpretive Decisions provide guidance on the ATO’s view of the operation of an aspect(s) of taxation law, similar guidance and examples could be provided in relation to the interaction of taxation law and ICOs. In particular, we expect that the ICO market would benefit from further guidance in relation to:

- the extent to which, for income tax purposes, the proceeds of a token issued as a prepayment for a service may not result in derivation of assessable income until certain platform development milestones are met; and

- in respect of GST, whether the GST consequences should generally follow the characterisation of a token from an income tax perspective (e.g. a token acting as an equity interest not being subject to GST as an input taxed supply), as well as clarification on the way GST voucher rules may interact with ICOs.