



# Treasury Consultation Paper on ICOs in Australia The Technology, The Market, and The Regulation of ICOs

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Table of Contents

*Introduction* ..... 3

*Background*..... 9

*What is a Token Sale (ICO) in Australia?*..... 9

*Digital Assets Classes currently being exploited via an ICO*..... 11

*What is a Security under Corporations Act 2001 (Cth)?*..... 14

    Equity—Shares in the Promoter ..... 15

    Debenture ..... 15

    Interest in a Managed Investment Scheme..... 16

*What should a Promoter do to avoid a securities classification?*..... 22

*Economic Burden*..... 24

    Financial Burden on Start-ups..... 24

    Economic burden upon Australia ..... 27

*The Role and Possible Value of an ICO Code of Ethical Conduct* ..... 29

*Conclusion* ..... 30

*POSSIBLE MODEL ICO CODE OF CONDUCT* ..... 41

*INTRODUCTION* ..... 41

*DEFINITIONS*..... 42

*PRINCIPLES, RULES AND GUIDANCE* ..... 42

    OBEY THE LAW..... 42

    GENERAL OUTLINE OF AN ICO/TGE DOCUMENTATION ..... 42

    PUBLIC INTEREST, HONESTY AND INTEGRITY ..... 43

    PERSONAL RESPONSIBILITY ..... 43

    RESPECT THE RIGHTS OF CLIENTS ..... 43

    COMPETENCY ..... 43

    FAIR TRADING ..... 44

    CO-OPERATION, SUPPORT AND WHISTLEBLOWING..... 44

    MONEY LAUNDERING AND TERRORIST FINANCING ..... 44

    POLICIES AND PROCEDURES ..... 44

## Introduction

1. We would like to thank the Department of Treasury for this opportunity to make a submission to the issued consultation document dealing with ICO and digital tokens in Australia<sup>3</sup>.
2. The issue of ICOs has globally captured many stakeholders' attention. We know that access to finance is one of the main challenges for start-up organisations.<sup>4</sup> This challenge has traditionally been approached through various funding mechanisms such as:
  - a. Friends and family contributions which can lead to
  - b. Seed funding which after a period of time can lead to
  - c. Venture capital raisings which may be staged into series A, Series B and Series C funding
  - d. Trade sales or an IPO
3. In the last 10 years a fifth option has emerged which is known as crowd source funding. Crowd funding is directly impacting how entrepreneurs are bringing new products to market. According to Stanko and Henard crowd funding allows entrepreneurs to tap into markets directly and obtain real time feedback on product development and improvements.<sup>5</sup> It is an example of the sense and respond model as originally proposed by Bradley and Nolan.<sup>6</sup>
4. In the last three years in the blockchain environment a sixth option has arisen which is generally referred to as an ICO. This method, similar to crowd funding, has a direct

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<sup>3</sup> We would like to acknowledge the comments provided by Dr. Alan Davidson, University of Queensland. Notwithstanding this, any errors or omissions remain with the authors. Further, we intend to use the term "Digital Token" in this submission. A Digital Token is also referred to in the literature as a "cryptoasset". See Financial Conduct Authority "Guidance on Cryptoassets". Consultation paper CP 19/3 January 2019.

<https://www.fca.org.uk/publication/consultation/cp19-03.pdf> <Accessed 25 February 2019>, and also KPMG "Institutionalization of cryptoassets", November 2018, <https://assets.kpmg/content/dam/kpmg/us/pdf/2018/11/institutionalization-cryptoassets.pdf> <Accessed 25 February 2019>.

<sup>4</sup> European Commission—Directorate-General for Research and Innovation, "Assessing the Potential for Crowdfunding and other forms of alternative finance to support research and innovation", Final Report, 2017 <https://publications.europa.eu/en/publication-detail/-/publication/3190dbeb-316e-11e7-9412-01aa75ed71a1/language-en/format-PDF/source-search> <accessed 22 February 2019>

<sup>5</sup> Stanko, M., and Henard, D., "How Crowd Funding Influences Innovation", MIT Sloan, Management Review, Spring 2016.

<sup>6</sup> Bradley, S.P., and Nolan, R.L., "Sense and Respond Capturing Value in the Network Era" Harvard Business School Press 1998.

connection with end users but instead of pre-selling some future product, the promoter tries to entice participants to either pre-purchase a soon-to-be-available service through the release of an access digital token or sell a digital token as a cryptoasset<sup>7</sup> which they hope will increase in value once the promoter's software platform has been released to the public. The major incentive for the advancement of ICOs globally is the ability for promoters to raise capital value without a corresponding dilution of equity or the requirement to repay the value raised. In addition, they can ignore the perceived requirement<sup>8</sup> to comply with securities regulations along with the international reach of ICOs as they are published via the internet.

5. There is currently no set formula for running ICOs and there is substantial variation in what is disclosed in ICO documentation. This lack of consistency in disclosure within ICOs has caused concern for regulators around the world as the lack of full disclosure is open to abuse, especially by scammers. Normally promoters of ICOs issue a whitepaper and possibly a yellow paper. A yellow paper, which is less used, is a document that sets out in detail the development and deployment of the technology for the proposed blockchain-dependent service. The most notable yellow paper was released by the Telegram messaging app.<sup>9</sup> This particular yellow paper was 132 pages in length and went into great detail in what was involved in their proposed service from a highly technical perspective. A yellow paper is, in effect, the proposed technical specification of the solution. Generally, a yellow paper is only for those persons who are technically trained and so it has limited commercial appeal. However, a whitepaper is a document that is fundamentally the sales pitch. It sets out the value proposition as follows:

- The problem which the promoter's solution will solve
- The advantage that a blockchain solution brings in solving the problem
- The relationship of the proposed digital token, in a blockchain deployment, to the proposed solution

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<sup>7</sup> There are other types of cryptoassets which will be explained further on in the submission.

<sup>8</sup> It is argued in the submission that there is a false belief (perception only) that an ICO does not require the lodgment of relevant documentation with a jurisdictional regulator because the artefact on offer does not fall within the ambit of Securities Regulation.

<sup>9</sup> The Telegram ICO raised just over in value US\$1.7 billion.

<https://thenextweb.com/hardfork/2018/01/09/telegram-ico-white-paper-leak/> <accessed 22 February 2019>

6. The value proposition will set the scene as to why the token purchaser should contribute to the relevant project. The whitepaper will usually also include the following sections:
  - A roadmap for platform development
  - The division of the value raised, which is usually set as a percentage of all that is raised, such as:
    - How much do the core team receive for their involvement?
    - How much is to be expended on platform development and the timeline for such development?
    - How much is to be retained as a reserve for future developments?
  - A budget of expenditure that is tied to the roadmap;
  - A team of core personnel involved including advisors to the ICO—the list usually includes short abstracts on each person.
7. Since there is no established framework for information contained in whitepapers their lengths vary greatly. Some whitepapers have been as short as 14 pages with others in excess of 80 pages. But the length of the whitepaper is irrelevant compared to the content. Does the whitepaper fully disclose the risks involved in the project? Can it be determined that potential participants can make informed decisions about the risks involved in the project?
8. ICOs remain beneficial despite recent declines in the values raised (comparing calendar years 2017 and early 2018 to late 2018). The UK Financial Control Authority, in its discussion paper,<sup>10</sup> noted that in 2018, there was “a significant reduction in capital raised in ICOs compared to the 2017 amount and the global ICO funding was US \$65 million in November 2018 compared to over US \$823 million in November 2017”.
9. Much of this reduction in capital value raised has been attributed to the numerous promulgated statements by various regulators concerning prosecutions for securities violations.<sup>11</sup> Further, some regulators have commenced prosecutions against

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<sup>10</sup> See note 3 above.

<sup>11</sup> The International Organisation of Security Commissions (IOSCO maintains an extensive website detailing a vast majority of promulgations issued by jurisdictional security regulators concerning cryptoassets and ICOs. <https://www.iosco.org/publications/?subsection=ico-statements> <Accessed 21 February 2019>

organisations that they believe have issued ICOs without complying with their respective jurisdictional regulatory regimes. For example, on 20 February 2019, the SEC in the USA entered into a consent undertakings with Gladius LLC.<sup>12</sup> The central issue here was that Gladius Networks placed the issued digital token (GLA Token) on a digital token exchange that had acted as a secondary market and thus the GLA Token could not be classified as a Pure Utility Token; instead it was a security.<sup>13</sup> The consequence of this action by Gladius Networks was that there would be a reasonable expectation by the various participants of some future benefit. That is, “the purchaser of the GLA Token would have had reasonable expectations of obtaining some future profit based upon Gladius’s efforts to create a “marketplace” using proceeds from the sale of GLA Tokens and to provide investors with liquidity by making GLA Tokens tradeable on secondary markets”<sup>14</sup>. In particular, the Gladius principals and agents:

discussed technical issues, operational questions about the Gladius Network, and prospects for investment returns from the GLA Token on blogs, social media, online videos and online forums. For example, on Gladius Web Pages, Gladius principals and agents stated that ‘as more websites join, the value of the Token should rise with demand’<sup>15</sup>

10. As will be explained below, the test in the USA known as the Howey test is a subjective test based upon the expectation of some benefit in favour of the participant, which in this case was aligned to an appreciation in the value of the GLA Token.
11. Another reason for the decline in ICOs is the growing maturity of the market place and the increased professional involvement of knowledgeable advisors. Initially the digital token market principally comprised people who were knowledgeable in cryptography but gradually the market expanded to include the general public. The transition to the general public has been attributed to the press who publicised the increased value of Bitcoin and other cryptocurrencies. Many early adopters of Bitcoin and Ether drove that market into a frenzy through the fear of missing out (FOMO).<sup>16</sup>

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<sup>12</sup> In the Matter of Gladius Network LLC; Release No. 10608/February 20, 2019.

<sup>13</sup> The position on Pure Utility Tokens is discussed below at p.9.

<sup>14</sup> See note 12 above. See paragraph 3 of the consent undertaking.

<sup>15</sup> Id, Paragraph 21 of the consent undertaking.

<sup>16</sup> The term FOMO was created by Patrick J. McGinnis “The 10% Entrepreneur”, Penguin Books, 2017.

12. The market has matured and become quite sophisticated over the last 3 years in what it considers investable projects. Anecdotally, this sophistication has in part been driven by the various publications which have indicated that a substantial proportion of ICO projects failed to deliver on projects or promoters were scammers who never intended to deliver. Bendetti and Kostovetsky<sup>17</sup> in their study noted that of the 4003 ICO projects they studied only 44.2% were still active in the fifth month after the closing of the ICO. This study also identified that in aggregate for US\$12 billion in value raised via these 4000 ICOs. Consequently, it is little wonder that security regulators are concerned about operations of ICOs globally.

13. As a result, FOMO has substantially subsided, and the market now looks for substance in project developments and compliance with legal structures. In particular markets now investigate:

- The value proposition of the platform from both a utility perspective and an economic perspective
- How blockchain advances the platform as opposed to other more traditional data repository technologies. In other words, why blockchain?
- How intended digital tokens fit within platforms, so are they:
  - Stored Value Tokens<sup>18</sup> or
  - Security tokens or
  - Pure Utility Tokens or
  - Hybrid Tokens, that is, security tokens with some functional utility included?<sup>19</sup>

14. Various global regulators have indicated that ICOs are substantially covered by current securities regulation but in doing so we suggest that these same regulators have incorrectly addressed why and under what circumstances digital tokens will be classified as a security. In essence, many of the guidance notes and publications issued by these global regulators have in fact confused the market, which has resulted in a

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<sup>17</sup> Benedetti, H., and Kostovetsky, L, “Digital Tulips? Return to Investors in Initial Coin Offerings” 20 May 2018 [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3182169](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3182169) <accessed 23 February 2019>

<sup>18</sup> In the Financial Conduct Authority Consultation paper CP 19/3 the equivalent classification to a “Stored Value Token” is referred to as an “Exchange Token”. See also UK “Cryptoassets Taskforce final report”, October 2018 [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/752070/cryptoassets\\_taskforce\\_final\\_report\\_final\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf) <accessed 22 February 2019>

<sup>19</sup> For an alternative classification scheme see BIS Working Papers No. 765, “Beyond the doomsday economics of ‘proof of work’, in cryptocurrencies,” Jan 2019, <https://www.bis.org/publ/work765.htm>.

reduction in legitimate ICO deployment. Moreover, these same regulators have attempted to metaphorically fit a square peg into a round hole since not every digital token neatly fits within the securities frameworks that currently exists. ICO promoters are continually developing new functional aspects for digital tokens that cause continued uncertainty in the market place, which results in interpretation gaps arising. Certainty in the law, especially in commercial law, is imperative.<sup>20</sup>

15. Clearly, there is a regulatory balancing act involved. Security regulators are primarily focused on ensuring stable markets and consumer protection, especially for retail investors. It has been estimated that nearly 81 percent of all ICOs issued up to September 2018 either completely failed or were substantially delayed in the delivery of their platform or were promoted by scammers<sup>21</sup>. This is a major concern for security regulators globally as their role is to administer regulatory frameworks that have been evolved over long periods of time. Gradual adjustments occurred over time as mischiefs were identified. Unfortunately, not all digital tokens issued via ICOs fit within the current regulatory frameworks.
16. If a promoter designs a particular digital token that is to be released via an ICO<sup>22</sup> and that relevant digital token fails to fit within the current securities framework then, because of that regulatory gap, scammers will try to take advantage to the disadvantage of consumer investors. This submission argues that it may be prudent to consider a *new asset* class that can specifically address digital token deployment, marketing, and regulatory gaps. As noted in the UK's Cryptoassets Taskforce Final Report<sup>23</sup>

This [the Cryptoasset market] is a new and fast-paced market with complex and opaque products, and distinguishing whether a cryptoasset falls within regulation can be difficult.

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<sup>20</sup> Brathwaite, J., "Rules and Principles: A theory of Legal Certainty", (2002) 27 Aust Journal of Legal Philosophy 47.

<sup>21</sup> <https://www.zerohedge.com/news/2018-07-09/icos-81-scams-and-500-million-lost-investment>

<sup>22</sup> For example, the scenario discussed below concerning a digital film access token does not fit within the current securities framework.

<sup>23</sup> UK Government Cryptoasset Taskforce – Final Report, October 2018. At Paragraph 2.32.

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/752070/cryptoassets\\_taskforce\\_final\\_report\\_final\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf).

17. Before, we deal with the questions raised in the Consultation paper we set out the background position currently dealing with ICOs and securities law, which reviews in part what other jurisdictions have undertaken or proposed to undertake.

## Background

18. In the last 24 months, many blockchain entrepreneurs globally have undertaken the issuance of various digital tokens via token generation events (TGE) or initial coin offerings (ICO).<sup>24</sup> Entrepreneurs engaged in ICOs are generally referred to as promoters or sponsors. Because of these new ways raising virtual capital, many jurisdictional regulators such as the SEC in the USA and ASIC in Australia, take a keen interest to actively monitor the promotion of digital token sales. The principal concern of these regulators is what kind of digital token is being offered via an ICO.<sup>25</sup> If it is an offering of a security then it requires appropriate documentation being lodged with the relevant regulator.

## What is a Token Sale (ICO) in Australia?

19. There is no settled definition of what an ICO is but the following is a start:

a commercial mechanism whereby a promoter publishes, usually via the internet, a set of documents that are intended to promote the creation and distribution of a defined digital token with the consideration to support the transaction being some other artefact (a Stored Value Token such a Bitcoin or Ether) that is provided by a potential participant and the value generated via the ICO is used to integrate the issued digital token as a central functional element of the platform that the promoter wishes to develop.

20. The defined digital token is usually structured by the promoter so that it does not fall within the scope of an equity, debenture, or an investment contract (otherwise known in Australia as an interest in a managed investment scheme), though this is not always

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<sup>24</sup> TGE is actually a more correct terminology as ICO implies that the issued token is some form a digital coin which in the vast majority of issued tokens to date is not the case. A virtual coin is really a Stored Value Token which can be used to transact some business with third parties. Most digital tokens are not designed for this functionality. This is discussed more fully below.

<sup>25</sup> For the sake of consistency, the term ICO will be used as it is what is used in the Consultation paper.

the case especially if the ICO is structured as a security token offering (STO), in which case the relevant digital token is intended by the promoter to be a security and the promoter will comply with the relevant regulatory framework governing securities.

21. The term ICO is really a misnomer as many of the digital tokens issued to date do not have the necessary characteristics of a “coin” or digital currency<sup>26</sup>. The vast majority of digital tokens would not fall within the ambit of a Stored Value Token. In fact, many of the current issued digital tokens are either a Security Token, a Pure Utility Token or a Hybrid Token which has the characteristics of both a security and a utility.
22. There are basically 4 types of digital tokens that a promoter can offer via an ICO:
  - (a) A digital token that can be used as a free form of barter transferable value between holders of the digital token and third-party merchants. This is the case with Bitcoin as this digital token is not supported by anything but market sentiment. This is generally referred to as a Stored Value Token.
  - (b) A digital token which takes the form of a security as defined by the Corporations Act 2001 (Cth); whether it is an equity token or a debenture token or an interest in a managed investment scheme token. This is generally referred to as a Security Token.
  - (c) A digital token which can later be utilised by participants as consideration of a pre-sale of a service that will be developed employing the proceeds raised via the Token Sale. This is generally referred to as a Pure Utility Token.
  - (d) A digital token which can later be utilised by a participant as consideration of a pre-sale of a service but also has the characteristics of a security. This is generally referred to as a Hybrid Token.
23. A security token, which is explained in more detail below, can be variously:
  - The issuing of some equity in the promoter
  - The issuing of a debt or convertible note to cover the capital raised by the promoter
  - The issuing of an investment contract, or more specifically in Australia, an interest in a managed investment scheme

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<sup>26</sup> At Law this would be known as a “Humpty Dumptyism” as in most cases there is no coin or a metaphorical coin. There are actually very few stored value tokens. For an explanation of “Humpty Dumptyism”, see Lord Atkins in *Liversidge v Anderson* [1941] UKHL 1

- A derivative of any of the above.
24. A number of security regulators in various jurisdictions have decided that digital tokens issued via an ICO can in certain instances be classified as an investment contract, or more particularly under Australian law, an interest in a managed investment scheme, which warrants them being classified as a security.
25. To comply with the law, any issuing of a security to greater than 20 people and/or organisations in any 12-month period and the amount raised exceeds AUS\$2 million in a rolling 12-month period will require registration of certain documentation (prospectus) with the Australian Securities Investment Commission, unless the investors are classified as sophisticated investors. Further, if the issued digital token is an investment in a managed investment scheme, the promoter, who will be the designated responsible person, will also need to have an Australian Financial Services License.
26. This documentation must be in a particular form and provide extensive detail regarding what is being raised and on what the raised funds are to be expended. Chapter 6D of the Corporations Act details the requirements of fund raising through the issuing of a prospectus (see in particular Division 4: DISCLOSURE REQUIREMENTS). Consequently, the costs involved in issuing a security digital token can be prohibitive, especially for technology-based start-ups. It is for this reason that many start-ups choose an ICO in the hope that what they are not offering a security digital token via the ICO documentation.

#### Digital Assets Classes currently being exploited via an ICO

27. There are four basic types of digital assets currently being economically exploited. These are, as mentioned above, Stored Value Tokens, Security Tokens, Pure Utility Tokens and Hybrid Tokens.
- (a) *Stored Value Tokens* are digital tokens that simply store value in a similar way fiat currency encompasses value. From an economic perspective whether a digital token can amount in functional equivalence to fiat currency depends on the extent to which it possesses all of the following characteristics:
- A. Does the digital token act as an artefact to store value?
  - B. Does the digital token act as a medium of exchange?

C. Is the digital token a unit of account?<sup>27</sup>

Of course, stored value tokens are not supported by government or central banks. But, similar to fiat currency, digital tokens represent value, the difference being that the value of digital tokens is only supported by market sentiment, similar to the value of gold.<sup>28</sup>

Stored value tokens can be traded and be used to buy multiple services. Examples of store value tokens are Bitcoin, Ether, and Bitcoin Cash. It is generally accepted by regulators that a stored value token is not a security though it could be covered by other regulatory frameworks such as Non-Cash Payments Facility obligations and Anti-Money Laundering and Counter Terrorism Financing regimes.

It is interesting that William Hinman, the SEC Director of the Division of Corporation Finance, has publicly stated that even though “Ether” was initially issued under the control of the Ethereum Foundation and was at the time of issuing a security, due to the decentralisation of the Ether token, it is no longer a security but will be classified as a Stored Value Token<sup>29</sup>. This then raises a conundrum as to whether the later decentralisation absolves the contravention of the Securities Act 1933 when the digital token was first issued. It is this type of confusing statement that causes major problems in the market place and in particular for advisors in the area. Further the SEC has made it clear that if they conclude that a digital token is a security then they will not only prosecute the promoter but also the professional advisors. This has a two-fold impact in that advisors are now taking a very conservative approach in the provision of their advice and the increased use of off-shoring to unscrupulous persons who operate from less regulated and less credible environments, noting that the publication of an ICO will be via the internet which is in effect boundless from a jurisdictional perspective.

(b) *Security Tokens* are any digital tokens that will fall within the securities framework under the Corporations Act. There is nothing in the Corporations Act, that requires a share for example in a company (a security) to be represented in a particular manner. That is, a share has traditionally been represented by a physical share

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<sup>27</sup> Ali, R., “The Economic of Digital Currencies”, Bank of England. Quarterly Bulletin, Q3, 2014.

<sup>28</sup> [https://en.m.wikipedia.org/wiki/Gold\\_fixing](https://en.m.wikipedia.org/wiki/Gold_fixing)

<sup>29</sup> <https://www.sec.gov/news/speech/speech-hinman-061418>

certificate, but this representation is tradition only and is not prescribed by law. A share could be represented by a digital token whereby the rights attaching to the relevant digital token are built into the blockchain platform. The same applies to other types of securities such as debentures and interests in a managed investment scheme. Basically, a security is a set of intangible rights that are captured within some represented artefact which are covered by the Corporations Act.

- (c) *Pure Utility Tokens* are digital assets/digital tokens that are designed as a proprietary payment currency for a platformed service. A Pure Utility Token is designed as a core component of the promoter's platform, as it is a payment mechanism for the service that is to be provided through the platform. In other words, Pure Utility Tokens are internal to the platform and generally cannot be used as payment mechanisms for third party services. Thus, their utility is captured within the platform. The difficulty for promoters of Pure Utility Tokens is that they often want to place their respective digital token on some digital token exchange which really defeats its utility component as that action raises participants' expectations of capital appreciation, which in turn is a benefit that does not restrict itself to its utility functionality. From a commercial perspective, a Pure Utility Token should have limited appeal in the market place unless the platform being developed has in itself substantial market interest. For example, the Power Ledger token.<sup>30</sup> The interest generated should relate to the platform and not the token granting access to the token. But even if the platform has market appeal there is always the possibility that participants could over-subscribe and desire to dispose of their respective excess digital tokens. For example

Consider a promoter, A, who issues TOKEN A which can only be used on Platform A. Person X acquires 200 TOKEN A but, in the end, only has use of 144 TOKEN A and wishes to dispose of the remaining 56 TOKEN A in his/her possession. Only promoter A can list the TOKEN A on a digital token exchange whereby Person X can exchange the 56 TOKEN A tokens for either some fiat or

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<sup>30</sup> See Power Ledger, *Why does Power Ledger need tokens?* *Medium* October 1, 2017, <https://medium.com/power-ledger/why-does-power-ledger-need-tokens-92d8b9781536>. But there are questions concerning whether the Power Ledger Token is in fact a hybrid token especially as it has been listed on a number of digital token exchanges and its intrinsic value has appreciated.

other listed digital tokens. Does the listing of the TOKEN A by promoter A change the characteristic of TOKEN A from a Pure Utility Token to a security token?

From a business perspective, a Pure Utility Token has limited commercial value in the market place, unless the platform to be developed has great potential which captures the imagination of the potential participants. This could have been the impetus for the Ether Foundation's ICO in 2014. The marketing of their ICO centred on the development of a smart contract platform that would use as its nexus the blockchain structure then being used to support Bitcoin. But as noted above, the Ether token is no longer a Pure Utility Token but has transformed itself into being classified as a Stored Value Token, which as noted by the SEC is not a security.

(d) *Hybrid Tokens* are digital tokens which have both utility functionality but also possess the characteristics of a security token. From a precedence perspective all Hybrid Tokens will firstly be classified as a security and then classified for its utility. The rationale for this precedence is that all regulators have a primary obligation to ensure a stable market and the protection of the retail-consumer investor and as such a security will always have precedence over utility. If this were not the case, then there would be a loophole for nefarious activity by that sector of the community who thrive off unscrupulous practices.

#### [What is a Security under \*Corporations Act 2001 \(Cth\)\*?](#)

28. The law is specific when dealing with the protection of investors in the raising of capital through the issuing of a security. The Corporations Act purports to apply to many kinds of financial products as diverse as shares, debentures, and interests in managed investment schemes, options over such securities, insurance and superannuation products and a varied range of derivatives including exchange traded options and futures contracts over commodities or other financial products or indices.

29. The two principal definitions of securities within the Corporations Act are:

- (a) Section 92 of the Corporations Act (see Appendix A)
- (b) Section 761A of the Corporations Act. (see Appendix B)

## Equity—Shares in the Promoter

30. In general, if properly created by the promoter, a digital token should not amount to any equity in a body corporate, nor should it amount to a loan forming a debenture, nor should it create a legal or equitable right to a share or debenture. The substantial purpose of an ICO is to raise capital value without sacrificing any equity in the promoter. That is, to not be classified as an equitable interest in the promoter, the promoter must ensure the digital token that is going to be issued has the following actual attributes:
- (a) No voting rights are to be attached to the issued digital token, and in particular no voting rights that affect the business operations or management structure of the promoter
  - (b) No share in profits generated by the promoter either as a whole or directed to some specific project or platform solution
  - (c) No right to participate in any capital distribution in the promoter or the project if either is later dissolved.
31. The position of “excluded securities” will generally not apply to any proposed issuance of the digital token. Essentially, an “excluded security” concerns a retirement village scheme, which is unlikely to have any application to an ICO.
32. Hence, a digital token should not be classified as an equity provided all of the following characteristics are present:
- (a) The digital token does not grant the holder any equity in the promoter
  - (b) There are no voting rights granted to the holder of the digital token
  - (c) The holders of the issued digital tokens cannot participate in any profits that may be generated by the business operations of the promoter
  - (d) No dividends will be issued to the digital token holders
  - (e) The digital tokens are independent of the promoter
  - (f) The digital token holder has no rights attaching to any winding up of the promoter or the dissolution of the project or platform.

## Debenture

33. The next issue to be determined is whether a digital token could be classified as a debenture. Again, a substantial purpose of an ICO is to enable the promoter to raise

the capital value without any requirement to repay back to the participants the value raised. A debenture is a structured debt arrangement which would require any person or organisation that issues such a product being required at some point in time to repay the debt in accordance with the terms and conditions of the loan arrangement. It is also usual for the debenture to involve an interest component to be paid as recompense for the loan arrangement or in some cases a fixed fee being paid to the debenture holder.

34. It is unlikely that a digital token will include a requirement for the issuer to redeem the issued digital token. If there was a condition of redemption attaching to the issued digital token, then a chose in action is created through the digital token. Further, neither the promoter nor digital token holder must have the right either as a push or pull option to buy back the issued digital tokens as this could be interpreted as a right of redemption and thus the digital token could be classified as a debenture.
35. Hence, the digital token should not be classified as a debenture provided the digital token has the following characteristics:
  - (a) the issued digital token must not include any debt structure created through the issuance of the digital token. That is, there must not be a right in favour of the digital token holder of any interest component either as a percentage of the value of the token or a fixed payment recompense for the digital token.
  - (b) There must not be a right of redemption attaching to the issued digital token. The digital token holder must not have the right to force the promoter to later buy back the digital token at its issue value.

#### Interest in a Managed Investment Scheme

36. The final issue, therefore, revolves around what is an “interest in a managed investment scheme”. In the United States, the SEC has issued a number of guidance notes concerning ICOs. The first of the guidance notes dealt with the failure of the DAO<sup>31</sup> (Decentralised Autonomous Organisation), which involved the raising of approximately US\$150 million in value and the subsequent syphoning off without authority of approximately US\$50 million in value through an error in the code that supported the DAO. The raising of the initial value was made by just over 16,000

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<sup>31</sup> <https://www.sec.gov/litigation/investreport/34-81207.pdf> <Accessed 22 February 2019>

people who resided across many jurisdictions. The promoters of the DAO had not registered any documentation in any jurisdiction. The functional structure of the DAO permitted voting rights by participants and the potential to participate in future profits.

37. The SEC determined that the investment in the DAO was in effect an investment in an investment contracts and thus was a security. As discussed below, the characteristics of an investment contract as determined by the US Supreme Court (*SEC v. Howey and others*) and the characteristics of an interest in a managed investment scheme as defined in section 9 of the Corporations Act are similar.
38. According to the SEC, any structure that accommodates voting rights to holders of digital tokens or has a right to participate in a profit-sharing arrangement is an investment contract under the relevant US legislation and as such will be classified as a security. Jay Clayton, SEC Commissioner, in early 2018 testified before a US congressional committee that every token sale to date (during the calendar year 2017) had in the opinion of the SEC been a sale of a security and that the SEC intended to take a more active investigative and monitoring role including the possible instigation of prosecutions<sup>32</sup> Further, the SEC indicated that any digital token that has the following characteristics (based on the Howey Test) will be regarded as an investment contract and thus as security:
- (a) The pooling of value
  - (b) Into a managed environment such as a scheme, business or project
  - (c) Whereby the participants have little or no say in the management of the project
  - (d) The participants have an expectation of some tangible benefit from their participation.
39. It is notable that the focus of this test is the *expectation of a participant* and not the activities of the promoter. Consequently, if a promoter desires to not fall within the scope of the Howey test, the promoter must address a participant's possible expectations. In other words, at least in the USA, promoters, if they do not want to be covered by the Howey test, should use language that either dampens or removes entirely any expectation of any tangible benefit from their participation. The phrase

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<sup>32</sup> <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission> <Accessed 22 February 2019>

“tangible benefit” has been interpreted widely and is primarily concerned with some financial benefit either directly or indirectly. For example, in describing these characteristics, the SEC has noted that if the promoter indicates that the digital token will increase in value then that benefit alone will mean that the issued digital token will be classified as an investment contract and thus a security under the US regulatory framework (*Securities Act 1933*). The SEC also noted that if the promoter indicates that a digital token will be issued at a discount, including a pre-sale, then it automatically follows that the digital token will increase in value when later digital tokens are issued post-pre-sale and hence the digital token will be classified as a security. This position can be easily understood as falling within the confines of the Howey test.

40. In December 2017, the SEC issued an order (generally known as a Munchee Order<sup>33</sup> as it was directed at the Munchee ICO) which required the promoter of the Munchee ICO to repay to all of its participants the sum of US\$15 million, which had been invested by its participants. Even though the white paper had clearly expressed that the MUNCH Token was not a security and extensively explained the utility of the MUNCH Token, other published material indicated that the MUNCH token was in fact an investment contract. The SEC had determined that other marketing material indicated that the value of the MUNCH Token would likely appreciate due to the efforts of the Munchee promoter and thus there would be an expectation in the eyes of the participant of some capital profit which meant the MUNCH Token was an investment contract. Consequently, not only is the language of the white paper important but all promotion material should be viewed carefully before it is released to ensure consistent messages are promoted. The principal difference between US and Australian law on this issue is that the test in the US is a subjective one focusing on the *participants having an expectation of some tangible benefit from their participation*<sup>34</sup> whereas in Australia the test is an objective one that focuses on the *benefits produced by the scheme*<sup>35</sup>.

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<sup>33</sup> <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>

<sup>34</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)

<sup>35</sup> Definition of Managed Investment Scheme; *Section 9 Corporations Act 2001 (Cth)*

41. On 28 September 2017, ASIC issued a guidance note on ICOs and the issuance of digital tokens to Australian residents. This guidance note was later updated in May 2018<sup>36</sup>. A major aspect of the guidance note concerns the position of whether a digital token could be classified as an interest in a managed investment scheme. Consequently, it is important to understand when a digital token issued via an ICO would fall within the ambit of an “interest in a managed investment scheme”.
42. *Section 9 of the Corporations Act* defines in part a “Managed Investment Scheme” as follows:

*“managed investment scheme ”* means:

- (a) a scheme that has the following features:
- i. *people contribute* money or *money’s worth* as consideration to *acquire rights ( interests ) to benefits produced by the scheme* (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
  - ii. *any of the contributions are to be pooled*, or used in a common enterprise, *to produce financial benefits, or benefits consisting of rights or interests in property*, for the people (the *members* ) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);
  - iii. the *members do not have day-to-day control over the operation of the scheme* (whether or not they have the right to be consulted or to give directions); or (Emphasis added) ... (other aspects of the definition have been omitted as they are irrelevant for this discussion)

43. Thus, to paraphrase the above: a *managed investment scheme* is a scheme whereby people contribute their money or money’s worth (other Stored Value Tokens such as Bitcoin or Ether) to obtain some benefit produced by the scheme in a pooled environment which will result in a financial benefit (some accrued appreciation in the value of the issued digital token), or other benefit consisting of rights or interests in

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<sup>36</sup> ASIC information sheet (INFO 225) gives guidance about the potential application of the *Corporations Act 2001* to entities that are considering raising funds through an initial coin offering (ICO) and to other crypto-currency or digital token. <https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-currency/> <accessed 22 February 2019>

property and where the participants do not have day-to-day control over the operation of the scheme.

44. As identified in the SEC Munchee order,<sup>37</sup> if the promoter publicises that the value of the digital token will increase then it will be classified as an investment contract which under Australian law equates to an interest in a managed investment scheme and thus a security. The same could also occur where during the ICO sale period different pricing models are implemented such as discounting for early investors or large investors. Discounting could easily create an expectation by a participant that later issuance of digital tokens automatically gives rise to a capital appreciation and thus a financial benefit from the scheme.
45. Hence, the holder of a digital token must not acquire some pooled rights in some external property or any first party property that is identified as being appreciable property. Each holder of a digital token individually and independently holds their acquired digital tokens which can be used in the operations of the developed platform at some future date once the application has been developed and thus be a Pure Utility Token and it is arguable should not be classified as a security. The promoter must ensure that the digital tokens become a core component and be integrated in the operational aspects of the promoter's platform. It is akin to a pre-sale of a service in which a participant can later use the relevant digital token in the developed platform.
46. Consequently, the promoter must make a choice as to how a digital token is to be marketed and ultimately used within the developed platform. If it is classified as a security, then there will be a taxation benefit as the capital raised will not be taxable income. But if the capital raised is a pre-payment of some future service that is to be delivered through the proposed platform that the pre-sale amount will be taxable income. A promoter cannot have it otherwise. That is, a promoter cannot expect to avoid taxation and also securities implications.
47. If holders of digital tokens only have an interest in their respective digital token and not in some external property to which the pooled interest is aligned, then the digital token should not be classified as an interest in a managed investment scheme

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<sup>37</sup> The essential facts supporting the Munchee order corresponds with the essential facts detailed in consent undertaking In the Matter of Gladius Network LLC; Release No. 10608/February 20, 2019. See note 12 above.

48. If the market independently of the promoter's activities decide post-closing of the white paper that the value of the digital token should increase, or such value is driven by third parties who wish to acquire the digital token, then does this event by itself impact the promoter's legal status as being compliant with the law? What is important are the activities of the promoter prior to the closing of the ICO and not post-event activity, unless such activities could readily imply an increase in value, but the test should be objectively determined. This position has never as far as I am aware been argued or discussed with any securities regulator and as such remains just an argument and not a final legal position.
49. Hence, in order to avoid a digital token being classified as an interest in a managed investment scheme the rights attaching to the issued digital tokens must have the following characteristics:
- (a) no voting rights attaching to the digital tokens
  - (b) no right to participate in any profit sharing
  - (c) the promoter must not manage any scheme or business or property on behalf of the holder of such digital tokens
  - (d) The promoter must not in any marketing material including any white paper prior to the closing of the ICO indicate that the issued token will increase in value
  - (e) The promoter should only develop the relevant platform and ensure that the platform is able to provide some service which require the use of the issued digital token
  - (f) The digital tokens must be property in their own rights and be independent of any other property and not relate to any interest in some other property.
50. But there are substantial risks involved in this approach. For example, if a Pure Utility Token is promoted that does not fall within the scope of an interest in a managed investment scheme, or as an equitable interest in the promoter or as a debenture issued by the promoter, then what rights will a participant have if the promoter fails to deliver on the project or is later wound up? The digital token may not be a security that is recognised under the Corporation Act and so the participant will not be able to participate in any liquidation of assets or the participant may not fall within the scope of being classified as a creditor to the promoter. Since there is currently no regulatory

framework that deals with this aspect, we suggest a new asset class should be considered that deals with this eventuality.

51. Based on the above, what is the position if the promoter has developed a sought-after platform through which access is restricted to those parties who possess a particular digital token and a benefit arises through the use of the platform then it is arguable that such a digital token should not be classified as a security. For example, a film production company promotes an ICO whereby it issues a number of digital tokens with the sole purpose of making a new film. Further, the film, once completed, will only be released via an online platform such as Netflix. If access to view the film were restricted only to those persons possessing the digital token, then it is unlikely that such a digital token would be classified as a security. The digital access only permits viewing access and not to any of the underlying rights associated with the film. Now assume the digital token allows multiple viewing opportunities and person A has seen the film 3 times but the digital token permits 5 viewing opportunities. Should person A be permitted to dispose of the remaining 2 viewing opportunities via some open digital token exchange? Does this possible transaction change the character of the film access digital token from a utility token to a security token? Note that the holder of the digital token only has a viewing right and not any interest in the intellectual property rights that will subsist in the completed film. Further what is the position if the film is a massive success noting that there are a capped number of access right digital tokens issued and no new digital tokens will be later issued? The market demand could increase the value of the relevant digital token; does this fact change the character of the digital token? Possibly so if the promoter holds a reserve number of digital tokens and has placed the reserve on a digital token exchange and continues to actively promote the film for greater market penetration.

#### What should a Promoter do to avoid a securities classification?

52. If a promoter is intending to issue a digital token as part of an ICO within Australia and desires for such digital tokens to not be classified as a security, then the relevant digital token should have the following characteristics:
- (a) The digital token must be a fundamental and core component of the promoter's platform, in other words it must have fundamental utility attached to it

- (b) The digital token must not have any voting rights attached to it
- (c) The holders of the digital token must not be able to participate in any profit sharing or anything akin to a dividend mechanism
- (d) The holders of the digital token must not be guaranteed any return on investment such as a payment of interest or the payment of a management fee in favour of the participant otherwise it could be interpreted as a debenture
- (e) There must not be any rights of redemption attaching to the digital token, otherwise again it could be interpreted as a debenture
- (f) There must not be any indication by the promoter that the value of the digital token will increase as this could easily be interpreted as being an interest in a managed investment scheme. The rationale for this position is that the regulator (SEC and ASIC) could take the view that such increase could be due to the activities of the promoter and so a managed investment scheme exists.

53. The above rules are obviously complex and, in many cases, difficult to understand and determine. From a start-up's position the expense involved in complying with the current regulatory framework is prohibitive and therefore many start-ups are pursuing other jurisdictions to launch their ICOs. The Federal Government needs to determine the value of innovation being developed domestically as compared to buying in the same innovation because it has been developed outside of Australia. Aligned with this must be the protection of the retail investor so that appropriate protections are in place.

54. We suggest that the current regulatory framework creates uncertainty in the market place and is expensive to comply with and results in a stifling of domestically developed innovation. As noted above, ASIC has issued an official guidance note on ICOs which states that each ICO will be assessed individually in respect of whether the relevant digital token is or is not a security as defined under the Corporations Act. A clear and thorough analysis of the characteristics of each type of digital token is required to be undertaken and importantly how the digital token is to be implemented. No labelling within a white paper will suffice as ASIC will want to understand how the relevant digital token was implemented in order for it to not be classified as a security. That is, it will be irrelevant as to what the promoter calls its

token. What will be important is how the digital token is used and what functionality it holds within the relevant platform.

55. If Australia wishes to taken advantage of this new type of capital-raising, then there needs more certainty in the law and at the same time substantially less complexity. For example, if an ICO is really dealing with an interest in a managed investment scheme, then is it necessary for the promoter to also have an AFSL? Should a digital token be classified as a financial product that warrants the promoter to also obtain an AFSL? In some cases that may be appropriate, but should this be a blanket requirement? If the answer is no, then what are the criteria for exemption from an AFSL?

56. The economic advantage from a promoter's perspective is that the promoter does not dilute the equity in their organisation, nor will they be required to repay any value raised back to any participants but in doing so there must be proper disclosure so that there are some protective measures in place for the retail investor. For example, if a promoter successfully promotes the creation of a Pure Utility Token but fails to deliver the promoted platform the retail purchaser could be left with no recourse. Thus, a systemic risk could arise which could undermine the whole Australian ICO commercial environment. The balance here is the regulatory regime should not stifle the advancement of innovation but at the same time there needs to be some protection available to the retail investment sector. The failure to develop a purpose-built legal structure with the goal of ensuring legal certainty to cover ICOs could result in a systemic failure in the retail investment sector, as well as a decline in an Australian domestic innovation environment and the possible the off-shoring of future innovation that should have occurred in Australia.

## Economic Burden

### Financial Burden on Start-ups

57. The above identifies that current securities law is very extensive, far reaching and cost prohibitive from a start-up's perspective. There are doubts as to the proper classification of a digital token. This lack of certainty may not ultimately be in the best economic interest of Australia. Taking into consideration the societal benefit of current securities framework in ensuring stable markets and retail and consumer

investment protection there arises a substantial financial burden placed upon start-ups in complying with the extensive reach of the Corporations Act. This could result in two positions:

1. A reduction in the development of new innovation that could otherwise benefit Australia both domestically and internationally from export revenue
  2. The migration of various start-ups to foreign jurisdictions whose ICO regulatory framework is more attuned to start ups and the financing of new technologies
58. The Corporations Act was recently amended (inclusion of Part 6D Crowd Source Funding) to assist start-ups in raising small amounts of capital. It would be interesting to see if there have been any economic studies concerning the number of organisations that have utilised this mechanism to raise small amounts of capital and how successful they have been.
59. The current crowd source funding regulatory framework has its own disincentives which makes it unattractive to blockchain start-ups as a capital raising mechanism. The crowd source funding mechanism is restricted to small equity raisings. The major advantage of undertaking an ICO is that the promoter wants to retain its equity stake and does not want to dilute it. Consequently, this capital raising mechanism will not encourage blockchain organisations to raise capital in Australia under this framework. It should be possible to create a new asset class that addresses “digital tokens” per se.
60. A further restriction contained in the Crowd Source Funding structure is that the amount raised must not exceed \$5 million. This restriction will generally be too small for a blockchain project. It is highly likely that even a small blockchain project will be budgeted to expend over the first 2 years more than AUS \$5 million.

For example, a small blockchain project budget would need to cover at least the following expenditure over a 2-year period:

Description of activity	Qty	Cost per unit per year (AUS\$)	Total Cost per year	On Cost at 22.5 %	Total cost over 2 years
Project Manager	1	\$160,000	\$160,000	\$36,000	\$392,000
Systems Architect	2	\$120,000	\$240,000	\$54,000	\$588,000
Software Engineers	10	\$100,000	\$1,000,000	\$225,000	\$2,450,000
UX & UI Engineers	1	\$100,000	\$100,000	\$22,500	245,000
Software Verification and Testing Engineer	2 for second year only	\$80,000	\$160,000	\$36,000	\$196,000
Total staff costs for 2 years			\$3,871,000		

61. On top of development costs there are the following business costs for 2 years:

description	Amount per year	Total cost for 2 years
Rent	\$80,000	\$160,000
Consumables (amenities)	40,000	\$80,000
Equipment	100,000	\$200,000
Total		\$440,000

62. Total operations cost without a contingency fee for 2 years on a small software development project will be near \$4,311,000. If a contingency fee of 10% is included, then the first 2 years of operations will be estimated to be in the vicinity of \$4,742,100. This brief budget only relates to development costs and does not consider marketing and promotions expenditure. Marketing and Promotions expenditure could in themselves easily exceed many millions of dollars. Therefore, if the government does want to encourage Blockchain start-ups to raise capital in Australia then we suggest that a new asset class be recognised, and the amount permitted to be raised should be about \$10 million.

#### Economic burden upon Australia

63. At the 2015 Davos World Economic Forum (WEF), the WEF survey indicated that approximately 10% of GDP will be stored on blockchain by 2027.<sup>38</sup> Admittedly, this is an estimate but even if it is overstated by 100% that would still result in a 5% GDP stored value on blockchain. This alone is a substantial value capture. Further, it should not be under estimated that blockchain is an immature technology that is developing at a rapid rate.

64. New technology advances are occurring daily. For example, it has been noted by many sectors that Bitcoin for instance is a slow verification financial solution (about 7 transactions per second compared to VISA that accounts for more than 40,000 transactions per second). One technology advance that is starting to get substantial attention in the Bitcoin environment is the development of the Lightning Network, which could theoretically increase the throughput of Bitcoin transactions to more than 1,000,000 transactions per second.<sup>39</sup> This is just one advance. If Australia was able to establish a favourable blockchain environment which included the accommodation of ICOs in a proper regulated environment, then we are confident that major economic benefits will flow. If Australia does not accommodate a blockchain friendly environment for capital raisings, then it is likely that Australia will become a

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<sup>38</sup> World Economic Forum, 2015, Deep Shift: Technology Tipping Points and Societal Impact. [http://www3.weforum.org/docs/WEF\\_GAC15\\_Technological\\_Tipping\\_Points\\_report\\_2015.pdf](http://www3.weforum.org/docs/WEF_GAC15_Technological_Tipping_Points_report_2015.pdf).

<sup>39</sup> See What is the Lightning Network? <https://cointelegraph.com/lightning-network-101/what-is-lightning-network-and-how-it-works#what-is-the-lightning-network>

substantial importer of fin-tech solutions which can only disadvantage Australia's balance of payments.

65. Many jurisdictions have established various government working groups to investigate the economic value of ICOs and some have already enacted specific regulation to administer ICOs that are being published from their jurisdiction. The UK Government's Cryptoasset Taskforce in their final report noted that:<sup>40</sup>

ICOs have the potential to present a range of opportunities, including:

- *Supporting innovation and competition:* ICOs seek to fund new innovative business models, products and services
- *Improving efficiency:* ICOs directly link cryptoasset issuers with investors, which has the potential to substantially streamline the capital raising process
- *Address financing gaps:* Many start-up ventures encounter substantial difficulties in raising initial funds for their project. ICOs can bridge the gap for early stage projects
- *Building a new investor and customer base:* The global accessibility of ICO taps into new sources of capital that would otherwise not be available

66. Consequently, many jurisdictions are actively trying to entice innovators to establish their business operations in the locality. In doing so a number of jurisdictions that have developed or are in the process of developing specific regulatory frameworks concerning ICOs. Many of these jurisdictions are economically small. Malta, Gibraltar, and Bermuda are examples. These jurisdictions do not have the international financial credibility of Australia. Further some jurisdictions have banned the issuance of ICOs in their jurisdictions. China is a prime example.

67. In September 2018, the French financial market regulator AMF (l'Autorité des Marchés Financiers) proposed a new regulatory framework for ICOs and this proposal was accepted by the French parliament. The AMF proposal involves the concept of an ICO visa which requires a promoter to lodge their ICO documentation to the AMF for review. The relevant documentation must have certain protections stated for the benefit of potential participants such as:

- (a) A description of the project related to the ICO and its roadmap

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<sup>40</sup> See note 3.

- (b) The rights conferred by the token
  - (c) The legislative court in the case of disputes
  - (d) The economic purpose and use of funds collected during the ICO
68. The French regulatory framework states that foreign organisations will not be accepted in France. All applicants must be incorporated in France as this is designed as an attempt to attract more projects to incorporate within France.
69. Thus, there is no uniform position when dealing with ICO regulatory structures. For policy reasons it is essential that no ICO framework damages the reputation of Australia:
- (a) as a credible transparent location to do business
  - (b) as a location where organisations recognise the high regulatory financial markets which encourages them to operate in Australia
  - (c) as a high integrity location that discourages scammers to operate within
  - (d) as a strong consumer protection environment

#### The Role and Possible Value of an ICO Code of Ethical Conduct

70. As identified in the Department of Treasury's 2017 document, concerning industry codes of conduct<sup>41</sup>:
- Prescribed industry codes are a special feature of the Competition and Consumer Act 2010 that can be used to guard against unfair and opportunistic conduct that can distort markets, impair Australia's entrepreneurial and innovative capabilities and harm consumers. Codes can play a role in getting the balance right by putting in place necessary regulations to foster the effective operation of the industry.
71. Industry codes of conduct are usually developed by an industry association. They can be self-regulatory otherwise known as voluntary or they can be prescribed as being mandatory. In general industry codes of conduct as self-regulatory in nature as the federal government is disinclined to prescribe a mandatory framework unless there has been a noted failure in compliance with a voluntary code of conduct that warrant a prescriptive approach.

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<sup>41</sup> Department of Treasury, « Industry Code of Conduct Policy Framework” 2017

72. Currently, there does not exist an Australian industry ICO code of conduct. There have been other jurisdictions that have promulgated ICO codes of conduct<sup>42</sup>. But the development of ICO Codes of Ethical Conduct in many jurisdictions are substantially immature in development. With this mind we have taken the liberty of drafting a sample approach as a starting point to an ICO Code of Ethical Conduct for the Australia environment (See Appendix). We believe that the Australian Digital Currency Association would be best placed to be the industry association to prepare a final ICO code of ethical conduct.

73. The Australian Consumer Law (ACL) can be of assistance as well. Section 21 of the ACL deal with unconscionable conduct and section 22 of the ACL details a number of matters that the court can take into consideration in determining if an organisation has acted in an unconscionable manner. In particular paragraphs (g) and (h) are relevant.

(g) the requirements of any applicable industry code; and

(h) the requirements of any other industry code, if the customer acted on the reasonable belief that the supplier would comply with that code

74. We suggest that an ICO industry code of conduct would be appropriate in the circumstances. It may also be appropriate for the Government to monitor the advancement and compliance of such a code over a 12 month period to determine the effectiveness of such a code in protecting the retail investor.

## Conclusion

75. In conclusion, we reiterate a statement made by Vitalik Buterin who is one of the founders of Ethereum:<sup>43</sup>

It would be a mistake to underestimate the value of ICOs or to say that they are a bad thing. ICOs are interesting because they enable monetization for open-source projects, something that doesn't happen often. I created Ethereum itself with an ICO. What we are

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<sup>42</sup> For example, Switzerland : « Crypto-Valley – ICO Code of Conduct”,

<https://cryptovalley.swiss/codeofconduct/>

<sup>43</sup> <https://www.financemagnates.com/cryptocurrency/news/ethereum-founder-vitalik-buterin-ico-bubble/>

seeing lately is that people are taking this idea too far, and there are projects that issue a coin not because it makes sense to issue a coin but because they have a product they can sell and raise money.”

76. There are a number of benefits that ICO can provide but at the same time there does need to be some regulatory involvement. The statistics of failure and delayed projects in too alarming so we suggest that a new asset class should be recognised in the Corporations Act. This asset class should deal specifically with digital tokens and how they can be issued through an ICO.
77. The above only address the background material as exposed in the consultation paper. There are other areas in dealing with digital tokens which we have not touched upon as they are not directly associated with the consultation paper. For example, we have not turned our attention to the possibility of the issuance of an Australian central bank digital currency. Even though many jurisdictions have openly stated that they intend to issue such a digital token there are a number of economic dangers that currently exist.

Treasury Key Questions from “Initial Coin Offerings: Issues Paper” January 2019

Number	Question	Response
<b>Definitions and Token Categories</b>		
1.1	What is the clearest way to define ICOs and different categories of tokens?	<p>An ICO is a commercial mechanism whereby a promoter publishes via the internet a set of documents that are intended to promote the creation and distribution of a defined digital token with the consideration to support the transaction being some other artefact that is provided by a potential participant and the value generated via the ICO is used to integrate the issued digital token as a central functional tenant of the platform that the promoter wishes to develop. The defined digital token is usually though not always structured by the promoter so that it does not fall within the scope of an equity, debenture, or an investment contract (otherwise known in Australia as an interest in a managed investment scheme).</p> <p>Irrespective of what a promoter labels their digital token, a digital token should be classified as either:</p> <ul style="list-style-type: none"> <li>• A Security Token</li> <li>• A Stored Value Token</li> <li>• A Pure Utility Token</li> <li>• A Hybrid Token.</li> </ul>
<b>Drivers of the ICO Market</b>		
2.1	What is the effect and importance of	The value of a Pure Utility Token has very limited commercial value as most participants expect their

	<p>secondary trading in the ICO market?</p>	<p>acquired digital tokens will be able to be traded via some secondary market. The role of a secondary market is vital from a commercial perspective. If a promoter is to be successful in their ICO then a secondary market is imperative. Consequently, if a secondary market is available then there is a greater likelihood that the initial market will participate and acquire the promoted digital token. But there does need to be some clarity as to the classification of a digital token. For example, does the listing of a Pure Utility Token convert that token into a Hybrid Token as there could arise an increase in value of the relevant token due to market forces.</p>
<p>2.2</p>	<p>What will be the key drivers of the ICO market going forward?</p>	<p>A succinct set of rules governing the promotion, and issuance of digital tokens should be established. The current framework is too difficult to manage, and it is suggested that a new asset class be created that only deals with digital tokens. In this regard the management of issuing an ICO should be simplified otherwise other highly respected jurisdictions like France will become ICO preferred locations havens. Further there needs to be clarity with post ICO digital token disposal through secondary markets.</p> <p>The position of secondary markets is not restricted to AML/CTF regulations. It may be optimum for digital token exchanges to be registered not only with AUSTRAC but also ASIC as a digital token.</p> <p>An ICO code of conduct would assist in self regulating the sector which could be monitored by ASIC.</p>
<p><b>Opportunities and Risks</b></p>		

3.1	How can ICOs contribute to Innovation that is socially and economically valuable?	<p>ICOs are usually, though not mandatory, associated with open source projects. Open source projects have in some cases in the past lacked structure in their development and have relied upon the good will of volunteers. There have been some spectacular failures in volunteer projects like the heartbeat vulnerability that caused substantial consternation in the commercial sector in 2016. This vulnerability arose because a missing comma in the relevant code. Being based on volunteers there are time constraints and in some cases a lack of due attention to detail. ICOs have been able to formalise the development of new open source innovative projects.</p>
3.2	What do ICOs offer that existing funding mechanisms do not?	<p>In short, the ability to raise capital value without a loss of equity in the Promoter and global reach.</p>
3.3	Are there other opportunities for consumers, industry or the economy that ICOs offer?	<p>Yes but what is meant by the term “opportunity”. We assume you are referring to financial benefits though blockchains can be used for non-financial environments. For example, it should be understood that blockchain solutions are not the panacea for all problems. Many current technologies are better suited for many current problems without the deployment of a blockchain solution. The FITS model is a simple analysis methodology which can assist in determining whether a blockchain solution could be beneficial. FITS stands for:</p> <p style="padding-left: 40px;">(a) Fraud: if the environment has some history of fraudulent activity then a blockchain solution may be an advantage</p>

		<p>(b) Intermediary: if there is some time delay from the start of a transaction to the end of a transaction due to the involvement of intermediary third parties then a blockchain solution may be an advantage</p> <p>(c) Through put: if the number of transactions per second is substantial then a blockchain solution may not be an advantage at the present time but as noted above new technology solutions like the lightning network may shortly overcome this issue</p> <p>(d) Stable Data: if the churn rate of data is relatively small then a blockchain solution may be an advantage. An example of this is in identity management. A blockchain solution could assist in preservation of privacy and creating an environment where access to a person’s private identity can be controlled by that person. Hence a direct non-financial benefit is available.</p>
3.4	How important are ICOs to Australia’s capability to being a global leader in FinTech?	If Australia does not act, then other jurisdictions like France for example will take up a dominant position which could be detrimental to Australia being classified as a global fin-tech leader. Another jurisdiction that has encouraged a strong Fin-Tech environment is Singapore. If Australia does not take some positive action, then Singapore will become the south East Asian leader in fintech development.
3.5	Are there other risks associated with ICOs that policy makers and	YES. Most ICOs are published via the internet. It will be too difficult and time consuming and costly for an organisation to register in every jurisdiction that it

	regulators should be aware of?	may accept capital value from. IOSCO is a prime organisation that could establish a set of harmonised rules that member jurisdictions could adopt including the handling of prosecutions from other IOSCO members. That is, if the SEC raised a complaint to ASIC that an Australian ICO promoter was suspected of being a scam or not following the rules then ASIC would act upon such complaint, even though the complained activity may be external to Australia. ASIC should if it is able to take a lead in an IOSCO project covering the development of a set of international regulatory harmonisation rules.
<b>Regulatory Framework in Australia</b>		
4.1	Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?	YES, IF this does not occur then problems will arise which could cause substantial damage to the retail investor community.
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?	It does but there are gaps and as such a new asset class should be established which will have the required checks and balances.
4.3	What, if any, adjustments to the	A new asset class should be recognised in the Corporations Act which deals with ICOs and digital

	<p>existing regulatory frameworks would better address the risks posed by ICOs?</p>	<p>tokens per se. In doing so, any changes to the Corporations Act should be subject to an economic study to ensure that a financial burden is not created on start-up that may wish to utilise the relevant new provisions. The Government may also want to consider the possibility that any capital value raised can only be expended in Australia and not outsourced to lower paid economies. All IP if any (noting it may be an open sourced project) must reside in Australia. Such obligations will create a knowledge and experience base for future developments which will enhance Australia's reputation as being a fintech friendly location.</p>
4.4	<p>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?</p>	<p>YES but it will still require ASIC to monitor the environment. The recent Financial Services Royal Commission identified a number of failures by the relevant regulatory authorities. The Banking sector has had an industry code of practice in place for many years but as was note it was really a lip-service document. The same could be said for other industry associations in the financial services sector. ASIC in particular could have acted but did not. So, ASIC should approve an ICO code of conduct and should be required to monitor the effectiveness of its compliance.</p>
4.5	<p>Are there other measures that could be taken to promote a well-funded ICO market in Australia?</p>	<p>Encouraging Government (all three tiers) to participate in facilitating various technology hubs. Improving telecommunications capacity through the NBN. Not being too restrictive on crypto research as this environment is crypto heavy in its use.</p>

<b>Taxation Treatment of ICOs</b>		
5.1	Does the current tax treatment pose any impediments for issuers in understanding capital raising activities through ICOs? If so How?	Yes and No. If a promoter issues a Security Token, then there should be a nil tax impediment but if the promoter issues a Pure Utility Token then there will arise a tax imposition. The questionable issue is how to treat a Hybrid Token and it will possess the qualities of both a security token and a utility token. This is a policy issue as there could be substantial taxation revenue foregone. The rate of this tax imposition could/should be reduced so as to encourage participation by the retail investor. This also could encourage institutional investors to dip their figurative toes in an ICO even if it was a small amount.
5.2	Is the current tax treatment of token appropriate for token holders?	Even though we are not experts in Taxation law we do believe that the taxation treatment of digital tokens is appropriate.
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?	This is beyond our particular expertise.

## APPENDIX A

### SECTION 92 DEFINITION OF “SECURITY”

Section 92 defines a security as follows: –

(a) Subject to this section, **securities** means:

- a. debentures, stocks or bonds issued or proposed to be issued by a government; or
- b. shares in, or debentures of, a body; or
- c. interests in a managed investment scheme; or
- d. units of such shares;

but does not include:

- f. a derivative (as defined in Chapter 7), other than an option to acquire by way of transfer a security covered by paragraph (a), (b), (c) or (d); or
- g. an excluded security.

(b) The expression **securities**, when used in relation to a body, means:

- a. shares in the body; or
- b. debentures of the body; or
- c. interests in a managed investment scheme made available by the body; or
- d. units of such shares;

but does not include:

- e. a derivative (as defined in Chapter 7), other than an option to acquire by way of transfer a security covered by paragraph (a), (b), (c) or (d); or
- f. an excluded security.

The term “Body” is defined in section 9 of the Corporations Act to mean:

**“body”** means a body corporate or an unincorporated body and includes, for example, a society or association.



## APPENDIX B

### SECTION 761A DEFINITION OF "SECURITY"

A. Section 761A of Chapter 7 of the Corporations Act defines a "security" as follows:

**"security "** means:

- (a) a share in a body; or
- (b) a debenture of a body; or
- (c) a legal or equitable right or interest in a security covered by paragraph (a) or (b); or
- (d) an option to acquire, by way of issue, a security covered by paragraph (a), (b) or (c); or
- (e) a right (whETHER existing or future and whETHER contingent or not) to acquire, by way of issue, the following under a rights issue:
  - (i) a security covered by paragraph (a), (b), (c) or (d);
  - (ii) an interest or right covered by paragraph 764A(1)(b) or (ba); or
- (f) a CGS depository interest; or
- (g) a simple corporate bonds depository interest;



## APPENDIX C

### POSSIBLE MODEL ICO CODE OF CONDUCT

#### INTRODUCTION

1. THE PURPOSE OF THIS CODE OF ETHICAL CONDUCT (THE CODE) IS TO SPECIFY BEST PRACTICE RULES AND PROVIDE GUIDANCE ON STANDARDS OF ETHICAL CONDUCT FOR ANYONE WHO IS WRITING, ADVISING, ISSUING OR PROMOTING AN INITIAL COIN OFFERING (ICO) WHICH MAY ALSO BE KNOWN AS A TOKEN GENERATION EVENT (TGE). THIS CODE INCLUDES ETHICAL PRINCIPLES AS WELL AS ADDRESSING SPECIFIC INDUSTRY ISSUES. THIS CODE SHOULD BE INTERPRETED BROADLY, RATHER THAN BY NARROW OR STRICT INTERPRETATION.
2. <INSERT ASSOCIATION NAME> IS THE PREMIER VIRTUAL CURRENCY ASSOCIATION IN AUSTRALIA THAT PLAYS A VITAL ROLE IN PROMOTING THE LAWFUL USE OF VIRTUAL CURRENCIES AND DIGITAL TOKENS AND THE EDUCATION OF THE PUBLIC IN WHAT A VIRTUAL CURRENCY/DIGITAL TOKEN IS AND HOW TO LEGALLY TRANSACT BUSINESS THROUGH THE USE OF VIRTUAL CURRENCIES AND DIGITAL TOKENS.
3. A FUNDAMENTAL GOAL OF <INSERT ASSOCIATION NAME> IS TO CONTRIBUTE TO THE SOCIAL GOOD OF SOCIETY THROUGH THE LAWFUL PROMOTION OF BEST PRACTICE THAT INVOLVES DIGITAL TOKENS AND VIRTUAL CURRENCIES.
4. THE OBJECTIVE OF THE CODE IS TO MAINTAIN AND IMPROVE ETHICAL BEHAVIOUR IN THE PROMOTION OF ICO/TGE DOCUMENTATION.
5. THE CODE APPLIES TO <INSERT ASSOCIATION NAME> MEMBERS AND IT IS HOPED THAT IT WILL EXTEND TO ALL NON-MEMBERS AS WELL SO THAT THE GENERAL CONSUMER CAN HAVE CONFIDENCE IN WHAT THEY MAY INTEND TO PURCHASE VIA AN ICO/TGE.
6. THE CODE IS ADMINISTERED BY <INSERT ASSOCIATION NAME>. THE CODE HAS BEEN DEVELOPED IN CONSULTATION WITH STAKEHOLDERS. THE ADMINISTRATION AND EFFECTIVENESS OF THE CODE IS MONITORED AND REPORTED. THE CODE IS AND WILL BE REVIEWED ON AN ANNUAL BASIS TO ENSURE IT REMAINS EFFECTIVE AND DEALS WITH CURRENT ISSUES. <INSERT ASSOCIATION NAME> MEMBERS WHO INTEND TO ISSUE AN ICO/TGE SHOULD INFORM CLIENTS (WHERE REASONABLY PRACTICABLE AND IN A MANNER REASONABLE FOR THE CIRCUMSTANCES) OF THE CODE AND OF THEIR RIGHT TO REPORT A BREACH OF THE ICO/TGE CODE TO <INSERT ASSOCIATION NAME>.
7. BREACHES OF THE CODE WILL BE DEALT WITH THROUGH THE <INSERT ASSOCIATION NAME> COMPLAINTS AND DISCIPLINE SYSTEM. IT IS INTENDED THAT THE COMPLAINTS AND DISCIPLINARY SYSTEM IS ACCESSIBLE, INDEPENDENT, REASONABLE, FAIR, EFFECTIVE AND ACCOUNTABLE. A BREACH OF THE CODE INCLUDES NON-COMPLIANCE WITH THE CODE'S RULES AND GUIDANCE, AND



FOR UNSATISFACTORY PROFESSIONAL CONDUCT AND PROFESSIONAL MISCONDUCT NOT SPECIFIED IN THIS ICO CODE.

## DEFINITIONS

8. “UNSATISFACTORY PROFESSIONAL CONDUCT” INCLUDES CONDUCT OF AN <INSERT ASSOCIATION NAME> MEMBER IN THE PERFORMANCE OF ACTIVITIES THAT ARE NOT OF THE STANDARD AND DILIGENCE THAT A MEMBER OF THE PUBLIC IS ENTITLED TO EXPECT OF AN <INSERT ASSOCIATION NAME> MEMBER.
9. “PROFESSIONAL MISCONDUCT” INCLUDES UNSATISFACTORY PROFESSIONAL CONDUCT THAT INVOLVES A SUBSTANTIAL OR CONSISTENT FAILURE TO REACH OR MAINTAIN A REASONABLE STANDARD OF COMPETENCE AND DILIGENCE, AND CONDUCT JUSTIFYING A FINDING THAT THE MEMBER IS NOT A FIT AND PROPER PERSON TO CONTINUE TO BE AN <INSERT ASSOCIATION NAME> MEMBER.
10. UNSATISFACTORY PROFESSIONAL CONDUCT AND PROFESSIONAL MISCONDUCT MAY INCLUDE FOR EXAMPLE BUT IS NOT LIMITED TO CONTRAVENTION OF LAWS, AND REGULATORY AND SELF-REGULATORY REQUIREMENTS GOVERNING THE CONDUCT OF AN ICO/TGE.

## PRINCIPLES, RULES AND GUIDANCE

### OBEY THE LAW

11. THE FIRST PRIORITY OF MEMBERS IS TO OBEY THE LAW AND COMPLY WITH THE <INSERT ASSOCIATION NAME> ICO CODE OF ETHICAL CONDUCT.
12. MEMBERS MUST OBEY THE JUST AND REASONABLE LAWS OF THE COMMUNITY, INCLUDING LEGISLATION, STATUTORY RULES, AND REGULATORY AND SELF-REGULATORY REQUIREMENTS GOVERNING THE CONDUCT OF THE VIRTUAL CURRENCIES AND ICO/TGE.

### GENERAL OUTLINE OF AN ICO/TGE DOCUMENTATION

13. EVERY ICO/TGE DOCUMENTATION ISSUED BY A MEMBER **MUST AT A MINIMUM COMPLY** WITH THE FOLLOWING:
  - a. DETAILS OF THE KEY PERSONNEL WHO ARE INVOLVED IN THE PROMOTION OF THE ICO/TGE;
  - b. DETAILS OF THE KEY ADVISORS INVOLVED IN THE DEVELOPMENT AND PROMOTION OF THE ICO/TGE DOCUMENTATION;
  - c. A STATEMENT DESCRIBING WHETHER THE DIGITAL TOKEN THAT WILL BE ISSUED IS OR IS NOT A SECURITY;
  - d. A STATEMENT AS TO WHETHER A MINIMUM CAP (SOFT-CAP) WILL BE INVOLVED (THAT IS THE MINIMUM AMOUNT THAT NEEDS TO BE RAISED FOR THE PROJECT TO PROCEED);
  - e. AN OUTLINE OF WHAT THE RAISED VIRTUAL CURRENCY IS GOING TO BE EXPENDED UPON;



- f. WHAT SMART CONTRACT ARRANGEMENTS HAVE BEEN IMPLEMENTED SUCH AS EVENT DRIVEN ESCROW ARRANGEMENTS;
- g. A STATEMENT AS WHAT IS TO OCCUR IF THE SOFT-CAP IS NOT RAISED;
- h. STATEMENT DEALING WITH PRE-SALES, AND SALES PURSUANT TO THE ICO/TGE AND WHEN THE SALE WILL BE OPEN TO THE PUBLIC THAT IS THE GO LIVE DATE;
- i. A STATEMENT DEALING WITH POST CLOSURE OF THE ICO/TGE COMMUNICATIONS TO ALL PERSONS WHO ACQUIRE THE RELEVANT DIGITAL TOKEN;
- j. A CLEAR STATEMENT WHEN THE ICO/TGE CLOSES;
- k. WHAT VIRTUAL CURRENCIES WILL BE ACCEPTED;
- l. WHETHER THE ICO/TGE IS PART OF A SERIES OF STAGED PUBLICATIONS OR IS IT GOING TO BE A ONE-OFF EXERCISE

#### PUBLIC INTEREST, HONESTY AND INTEGRITY

- 14. MEMBERS MUST ACT IN THE INTERESTS OF THEIR EMPLOYERS AND THE PUBLIC WHO MAY ACQUIRE DIGITAL TOKENS THROUGH AN ICO/TGE. MEMBERS MUST BE HONEST AND OTHERWISE NOT ENGAGE IN CONDUCT THAT WOULD BRING THE INDUSTRY INTO DISREPUTE. MEMBERS MUST BE UNBIASED IN THEIR ICO/TGE THAT THEY PROMOTE TO THE GENERAL PUBLIC.

#### PERSONAL RESPONSIBILITY

- 15. MEMBERS ARE PERSONALLY RESPONSIBLE AND ACCOUNTABLE FOR THEIR CONDUCT, MUST NOT DISCRIMINATE AGAINST ANY PERSON BECAUSE OF GENDER, RACE, OR RELIGION.

#### RESPECT THE RIGHTS OF CLIENTS

- 16. MEMBERS MUST PROVIDE ADEQUATE INFORMATION TO A CLIENT WHO HAS ACQUIRED A DIGITAL TOKEN EITHER THROUGH AN ICO/TGE OR BY OTHER LEGAL MEANS.
- 17. MEMBERS MUST RESPECT A **CLIENT'S** RIGHT TO PRIVACY AND CONFIDENTIALITY AND COMPLY WITH THE LAW IN RELATION TO THOSE RIGHTS (SUCH AS PRIVACY LAWS).

#### COMPETENCY

- 18. MEMBERS MUST TAKE REASONABLE ACTION TO ENSURE THAT THEY HAVE SUFFICIENT KNOWLEDGE OF SECURITIES LAW AND NON-CASH PAYMENTS FACILITIES LAW AND ANTI-MONEY LAUNDERING & COUNTER TERRORISM FINANCE LAWS IN ORDER TO PROPERLY UNDERTAKE THEIR BUSINESS ACTIVITIES.
- 19. MEMBERS MUST BE COMPETENT, CONSCIENTIOUS, EFFICIENT AND EFFECTIVE IN THEIR WORK. MEMBERS MUST MAINTAIN THEIR COMPETENCY THROUGH CONTINUING PROFESSIONAL DEVELOPMENT SO AS TO ENSURE THAT THEY



ARE AT ALL TIMES COMPLYING WITH THE LAW.

20. MEMBERS WHO ENGAGE EMPLOYEES MUST TAKE ALL REASONABLE ACTION TO ENSURE THAT THEIR STAFF ARE COMPETENT AND THAT THEIR CONDUCT AS EMPLOYEES IS CONSISTENT WITH THE CODE. PRINCIPAL MEMBERS MUST PROVIDE STAFF WITH INFORMATION, TRAINING AND SUPERVISIONS THAT ENABLES THEM TO COMPETENTLY DO THEIR WORK AND COMPLY WITH TO THE LAW IN THE PERFORMANCE OF THEIR PROFESSION IN DEALING WITH AN ICO/TGE.

#### FAIR TRADING

21. MEMBERS MUST COMPETE FAIRLY IN THE MARKET, INCLUDING NOT TAKING UNFAIR ADVANTAGE OF THE GENERAL PUBLIC AND NOT ENGAGING IN UNCONSCIONABLE CONDUCT. MEMBERS MUST NOT KNOWINGLY ENGAGE OR INDUCE ANOTHER PERSON TO ENGAGE IN CONDUCT THAT OR IS LIKELY TO MISLEAD OR DECEIVE IN AN ICO/TGE.

#### CO-OPERATION, SUPPORT AND WHISTLEBLOWING

22. MEMBERS MUST COOPERATE TO SERVE OF THE OBJECTIVES OF THE CODE.
23. IF A MEMBERS BECOMES AWARE OF ANY ILLEGAL CONDUCT THEN THEY SHOULD REPORT THAT CONDUCT TO AN APPROPRIATE AUTHORITY IN ACCORDANCE WITH THE LAW WHERE THEIR DISCLOSURE IS PROTECTED BY LAW.
24. MEMBERS MUST NOT DISCRIMINATE OR TAKE OTHER ADVERSE ACTION AGAINST A PERSON WHO DISCLOSES ILLEGAL CONDUCT OR A BREACH OF THE CODE.

#### MONEY LAUNDERING AND TERRORIST FINANCING

25. MEMBERS MUST COMPLY WITH THE LAWFUL POLICIES AND PROCEDURES OF THEIR ORGANISATION AND LAWS FOR THE PREVENTION AND DETECTION OF MONEY LAUNDERING AND COUNTER TERRORIST FINANCING.

#### POLICIES AND PROCEDURES

26. MEMBERS MUST HAVE APPROPRIATE ARRANGEMENTS FOR HANDLING CLIENT COMPLAINTS, INCLUDING (WHERE APPLICABLE) POLICIES AND PROCEDURES CONSISTENT WITH THIS CODE OF ETHICAL CONDUCT.