Aqualis

Consultation Paper - Response

Closing date for submissions: 27 May 2022

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The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate

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This document is a response to the Treasury Consultation Paper "*Crypto asset secondary service providers: Licensing and custody requirements*" dated 21-March, 2022 and submitted by Discidium Pty Ltd as service provider to the AqualisDAO.

Aqualis

25 May 2022
Director – Crypto Policy Unit Financial System Division

The Treasury
Langton Crescent
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By email: crypto@treasury.gov.au

To: Director – Crypto Policy Unit Financial System Division

Consultation Paper - *Crypto asset secondary service providers: Licensing and custody requirements*

AqualisDAO, a permissionless, Decentralised Finance (**DeFi**), open protocol welcomes the opportunity to provide this submission to The Treasury via its consultation into crypto assets licensing and custody requirements.

There is no doubt that the crypto asset sector has been evolving at a rapid pace. Individuals across the world have now entered the crypto space, either interacting with centralised/custodial service providers (CeFi) or decentralised/non-custodial (DeFi) crypto business models. Equally, many institutions have begun facilitating the purchase and sale of cryptocurrencies offering - as well as delivering some centralised custody services and are now looking for ways to get involved in decentralised/open finance.

It is apparent that the exponential growth in DeFi is not only driven by crypto native firms, but also by investment firms, venture capitalists, ongoing protocol innovation and individuals. The entry of traditional institutions into the DeFi space will be a breakthrough in the industry's maturation and will support the progress towards widespread adoption. DeFi is intended to transform the current centralised global financial infrastructure by introducing an online ecosystem based on Web3 technology adoption - underpinned by blockchain networks and a decentralised model that relies on automated, compliant, trustless, and open-source protocols instead of the use of traditional financial intermediaries.

DeFi empowers individuals to retain more control over their assets compared to the traditional financial system and allows individuals the financial freedom to choose how to invest their assets without the need to rely on an intermediary. DeFi has the potential to create fairer, more transparent, and more liquid markets through completely new mechanisms, helping everyone to reduce fraud and front-running, resolving fragmentation and creating markets that are efficient, resilient, fair and equally accessible to all.

Given the unique, global and complex services crypto assets and DeFi in particular provide, the largest unknown relates to the current lack of global regulatory and anti-money laundering/know your customer (AML/KYC) guidance or potential frameworks. Proposed guidance and current crypto-market driven initiatives as sponsored by the Australian Government – The Treasury, ASIC, AUSTRAC, APRA and other regulator is timely welcomed. Similarly, other important cross-border initiatives, as promoted by the financial action task force (FATF) also seeks to provide clarity around how institutions could interact with crypto assets, DeFi applications and their impact on AML/KYC requirements. Nonetheless, there are still significant factors that need to be clarified.

AqualisDAO looks forward to working with the Australian and Global Regulators to seek further regulatory clarity in both, centralised and decentralised finance applications, thus the latter may take more time to evolve as authorities may need to design new regulation that considers novel, cross-border entity-less operational activity.

Further information about the AqualisDAO protocol can be found on its website and the whitepaper.

If there are any questions or concerns arising from this submission, please feel free to contact me at any time at [redacted]

Yours Sincerely,

Simon Zhang

Founder, CEO

About AqualisDAO

AqualisDAO is an open-source, decentralised finance (DeFi 2.0) Web3 protocol delivering efficiency in the stablecoin token-swap and lending market by using a multi-utilization strategy. The project also delivers a seamless cross-chain experience (*bridgeless cross-chain swaps*) which contributes to its zero-price impact mission. The protocol's smart contracts enable users to send native tokens in a single transaction across applications that live on various blockchains.

The AqualisDAO can only succeed with the power of people, robust decentralised governance, strong risk management framework and an active community. The project is governed by the AQL utility token where each DAO user's voting weight is calculated by their "Aqualis Power" (AP), which is a time-weighted measure of staked Aqualis Tokens based on time locked.

The DAO is used to make protocol changing decisions, from basic parameters such as platform fees to the strategic development of the protocol. Community members will be able to create and vote on proposals related to changes, improvements, or anything they would like to see with the Aqualis ecosystem. Each user's voting weight.

Basic parameters may be fully controlled by the DAO in the future whereas proposals will need to pass an initial voting stage before being approved by the team for further development.

To further incentivise users' vested interest in the platform's growth and success when voting on and initiating proposals, a small portion of protocol fees will be used to buy back and burn AQL governance tokens, along with another small portion redistributed to users proportional to their AP.

In the long run, the Aqualis team expects to see the DeFi space grow exponentially and foresees the need to establish an academy to help onboard both individual but specifically institutional users into a space that is growing increasingly complicated and to help ease global adoption of blockchain, DeFi products and Aqualis in particular.

AqualisDAO will always strive:

- To maintain and deliver ongoing value and full governance to the Aqualis community.
- To consistently work on new products to deliver innovations and better products for the community that benefits both the Aqualis and entire DeFi ecosystem.
- To position Aqualis as a blue chip in the global DeFi space.

The team at AqualisDAO and service providers recognise that the regulatory environment in Australia and other jurisdictions for crypto assets, DeFi and DAOs will continue to evolve in years to come. AqualisDAO regulatory responsibility is to remain abreast of these developments, so that:

- Any actual and / or potential changes or constraints impacting AqualisDAO, and the industry at large are well understood in advanced, and all regulatory guidance is planned and accurately applied as AqualisDAO builds its products and services so that any forthcoming or mandated regulation is proactively embedded (by design) within AqualisDAO's systems, processes, and procedures.
- The AqualisDAO's community, its members, network participants as well as other DAO communities can be properly informed of ongoing regulatory developments.
- AqualisDAO, and other DAO communities can continue to innovate.

Note: Discidium Pty Ltd as the service provider to the AqualisDAO has provide advice and have assisted in the preparation of this response.

Aqualis

Consultation Questions and Answers

To help inform consideration of a licensing regime for CASSPrs, the Government is seeking industry participants and stakeholder feedback on the following questions:

1. **Do you agree with the use of the term Crypto Asset Secondary Service Provider (CASSPr) instead of 'digital currency exchange'?**

   I. Yes, in terms of service providers that are structured under a traditional and domestic legal model, we do agree with the new term proposed (CASSPr) – this term identifies secondary service providers as represented in *Figure 1* of the Consultation Paper and includes brokerage services, dealers, crypto market exchanges and custody services in Australia.

   II. We do however point out that different elements of the crypto market are fully decentralizing their networks or protocols and new entities under which they globally operate may generally consider either:

      a. establishing an offshore structure to manage these protocols, or
      b. structures where no legal entity is associated with their Decentralised Autonomous Organisation model (DAO) - Many DeFi, NFTs, GameFi and other network protocols are being established using a decentralised ownership structure, through an innovative entity model known as a Decentralised Autonomous Organisation (DAO). These structures could represent a new (entity-less) category of organisation that operates on decentralised blockchain infrastructure with operations pre-determined in open-source code which is then enforced through smart contracts.

   Furthermore, as stated in the Consultation Paper, crypto assets, and the novel structures they are built upon can be programmed to provide a variety of different rights and features and have a significant number of expanding and novel use cases. This makes classification complex and uncertain and as example we note DAO-run structures / governance model which have the potential to revolutionise how people organise, collaborate and coordinate. However, their innovative organisational characteristics make most DAOs incompatible with the proposed Australian crypto asset legislation or any traditional legal entity structures.

2. **Are there alternative terms which would better capture the functions and entities outlined above?**

   "*Centralised Digital Asset Service Providers*" – where entities are expected and able to establish an Australian legal structure and governance framework to run their business.

3. **Is the above definition of crypto asset precise and appropriate? If not, please provide alternative suggestions or amendments.**

   I. If the intention to define a "**crypto asset**" as "*…a digital representation of value or contractual rights that can be transferred, stored or traded electronically, and whose ownership is either determined or otherwise substantially affected by a cryptographic proof",* then more consideration should be given to the actual underlying structures and governance models a crypto business is run under, especially those crypto platforms running Decentralised Finance (DeFi), GameFi - Play to Earn, Social protocols or Non-Fungible Token (NFT) operations.

II. AqualisDAO is of the opinion that Crypto assets can be broken down into three (3) different categories of assets delivering three (3) primary functions.

- Two functions of crypto assets can be defined as **store of value** and **medium of exchange - i.e. traded/transferred**, and these are well established functions in both, the crypto ecosystem, and traditional assets.
- However, a third function is that to **pass through values to holders -** consider benefits such as discounted platform fees, governance voting rights, utility tokens that grant rewards, rebates and network benefits to holders and sometimes monetary rewards passed onto token holders**. Pass through tokens** are where digital assets explore innovative concepts and governance structures unique to the blockchain networks, i.e DAO's that underpin the management of assets.

Along with token types and their inherent functions, it is also important to consider and understand the governing bodies and governance structures behind these crypto assets.

The governing body is the entity that issues and controls the function of a digital asset, ultimately defining the purpose and proposed value of a crypto asset. These range from centralized governments and organizations, like the government of the Bahamas - issuer of the CBDC, the Bahamian Sand Dollar to Decentralized Autonomous Organizations (DAO) and blockchain protocols like Ethereum (ETH) and Solana (SOL) .

4. Do you agree with the proposal that one definition for crypto assets be developed to apply across all Australian regulatory frameworks?

No, we do not agree with the proposal to have one way to capture the definition of all crypto assets – please see our reasoning in answer to questions 1 and 3 above.

5. Should CASSPrs who provide services for all types of crypto assets be included in the licencing regime, or should specific types of crypto assets be carved out (e.g. NFTs)?

It is our opinion that Decentralised (On-Chain) service providers should be carved out and a more fitting legal regime that takes into account their governance model be designed– these crypto assets include DeFi / non-custodial platforms, GameFi – Play to Earn, NFT's and others decentralised protocols. Furthermore, Decentralised platforms (i.e. NFTs) running under DAOs in Australia are currently not recognised as entities with neither a legal standing or limited liability, so these entities are unable to comply with the proposed regime / licensing.

6. Do you see these policy objectives as appropriate?

We agree to the extent of Centralised / Custodial service providers

7. Are there policy objectives that should be expanded on, or others that should be included?

We feel clarifying the objectives and/or options available to decentralised ecosystems and DAOs where these can attain existence as an entity in Australia can be of significant benefit to the development of decentralised ecosystems. This will also eliminate ambiguity and make the technology more accessible to the public, while mitigating the risks of regime-less and offshored structures.

Furthermore, decentralised finance applications are in fact bringing about great and unique built-in, compliance-by-design characteristics which in turn should enable regulators all over the world to not

only establish innovative ways and new approaches to regulate but also avoid duplicating or retro-fitting pre-existing regulatory frameworks that are designed for traditional or centralised financial institutions.

A unique opportunity for regulators to innovate is based on the fact that DeFi applications are **open-sourced by design**, and in many cases inherently compliant – such that regulators are able to leverage data from these open, public blockchains, protocols and networks – therefore enabled them to conduct supervisory activities by using advanced RegTech tools and deliver real-time compliance monitoring without necessarily having to rely on regulated firms to supply their data. For a more detail study in the area, please refer to the recent **Bank for International Settlements (BIS) Working Paper #811** on "Embedded Supervision" – which introduces a regulatory framework that provides for compliance in tokenized markets to be automatically monitored by reading the market's ledger. It is clear in this study that legislative and operational requirements of such approach – included as part of an overall regulatory framework - would help promote low-cost supervision, foster ongoing innovation, enhance privacy for all participants and could introduce a fair / level playing field for small and large firms.

Lastly, other policy objectives could also look to addressing issues with digital identity and the potential need for a new regulatory framework able to enable privacy-preserving KYC methods suitable for DAOs and DeFi applications. Developing new concepts for KYT – know your transactions and KYC **but without knowing your customer** and leveraging self-sovereign identity and **zero-knowledge proofs** **(zkKYZ**) technologies. Recent innovations in self-sovereign identity and zero-knowledge cryptography, along with smart ecosystem design, allow for a novel approach to KYC that protects the customer's privacy without reducing transparency. zkKYC technology removes the need for the customer to share any personal information with a regulated business for the purpose of KYC, and yet provides the transparency to allow for a customer to be identified if and when that is ruled necessary by a designated governing entity (e.g. regulator, law enforcement, community governance council/DAO).

8. **Do you agree with the proposed scope detailed above?**

Yes, we do – that is, the proposed regime *would not apply to decentralised platforms or protocols*, and it will only apply to:

- all secondary service providers who operate as brokers, dealers, or operate a market for crypto assets, and
- all secondary service providers who offer custodial services in relation to crypto assets.

9. **Should CASSPrs that engage with any crypto assets be required to be licenced, or should the requirement be specific to subsets of crypto assets? For example, how should the regime treat non-fungible token (NFT) platforms?**

Please refer to answers 1, 3, 4 and 7 above. We believe the requirement should be specific to subsets of crypto assets.

In the case of NFTs, DeFi protocols, DAOs and / or fully decentralised platforms we believe further consultation is required (see Question 7 above). We do acknowledge the various global developments and potential frameworks being considered by several jurisdictions – We also acknowledge the fact that organisational characteristics make most decentralised financial application and governance models (i.e. DAOs) incompatible with traditional legislation or entity structures.

Nonetheless, the continued progresses in decentralised innovation and the need to execute their business models has meant that many decentralised operations have been built using entity-less

structures, and now the operational complexity of these platforms/DAOs have grown considerably to include grant programs, staking and liquidity mining programs, treasury diversification efforts and many other workstreams. Given that entity-less DAOs and their underlying protocols and platforms lack legal existence, several challenges to real-life operations exist that frustrate legitimate efforts to operate and grow in a decentralised manner.

Australian regulators and The Treasury would agree that the unique characteristics of fully decentralised business models significantly limit the use of traditional entities models - including recent US developments such as the Wyoming's DAO law - as captured in the recent Braggs Report – these limitations also extend to current partnerships, NFP's, proprietary limited and trusts legal models.

Australia regulators may want to weigh a close view to some promising entity vehicles like USA based *Unicorporated Nonprofit Associations* (UNAs) which – in some form – could be suitable to provide a degree of legal standing to DAO's, who in turn, will help these new entities enact privacy policies, obtain legal consent of members and avoid corporate formalities incongruent with decentralisation. Note that an UNA is a legal entity separate from its members in determining and enforcing rights, duties and liabilities in contract and tort. UNAs can also own property and open bank accounts. Combining an UNA like structure with "embedded supervision" (see Section 7) it may provide an interesting regulatory framework suitable to Web3 enabled / decentralised networks and protocols.

10. **How do we best minimise regulatory duplication and ensure that as far as possible CASSPrs are not simultaneously subject to other regulatory regimes (e.g. in financial services)?**

The implications of regulatory duplication often include overlapping regimes and rule enforcement which may be inefficient. The relationship between Australian regulatory bodies ASIC, APRA, AUSTRAC, and others must be optimally designed to avoid regulatory duplication. It is fair to deduce that regulatory overlap, involving multiple regulators pursuing the same lines of legislation, cross-market surveillance, or investigation, is inefficient and wasteful of resources for any jurisdiction.

We note also that some crypto-driven and digital-enabled technologies may make some regulation redundant. Ironically, these same digital technologies can potentially and efficiently reduce regulatory duplication burden and help overcome barriers to cross-border transactions, thereby increasing choices for consumers and sales opportunities for firms and producers. Yet regulation, besides a potential of overlapping regimes is also generally limited to national borders, therefore creating problems for regulation across our national borders. A possible way to minimise regulatory duplication is to involve the Productivity Commission early in the process to help undertake a study / develop an issues paper into the current and crypto-driven emerging financial services sector and effective legislation – thereby helping design regulation that is capable of being satisfied and scaled without jeopardising any of the innovative benefits that decentralised financial innovation make possible – Nevertheless, keeping in mind that current regulations across Australia may pose unnecessary burdens or impediments on emerging crypto business models operating, or seeking to operate and invest, in Australia.

11. **Are the proposed obligations appropriate? Are there any others that ought to apply?**

We agree to the extent of Centralised / Custodial service providers

12. **Should there be a ban on CASSPrs airdropping crypto assets through the services they provide?**

- No, we do not believe there should be a ban on airdops. These are one of the most common methods employed by the token economy to raise awareness of a project, and also used for legitimate marketing activities. This is not to minise the risk for consumers where imitation digital

profiles and other airdrop "bots" are common as well which can be abused by scammers to steal consumers digital identities.

- The airdrop ecosystem is still evolving and there is here also an opportunity to use blockchain public data and regulatory automation to validate its legitimacy.

13. **Should there be a ban on not providing advice which takes into account a person's personal circumstances in respect of crypto assets available on a licensee's platform or service? That is, should the CASSPrs be prohibited from influencing a person in a manner which would constitute the provision of personal advice if it were in respect of a financial product (instead of a crypto asset)?**

    The regime for Centralised CASSPs should ensure adherence to a minimum standard of conduct and operational resilience and not necessarily enforcing or extending traditional financial product legislation to crypto assets. The new regime should also allow for relief from some or all the obligations if reasonable, this could be achieved on a case-by-case basis to ensure the regime remains "agile and flexible" - as rightly described in the Consultation Paper.

14. **If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?**

    N/A – AqualisDAO is a DeFi Provider.

15. **Do you support bringing all crypto assets into the financial product regulatory regime? What benefits or drawbacks would this option present compared to other options in this paper?**

    No, we do not support Alternative #1 - please refer to answers 1, 3, 7, 9, 10

16. **If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?**

    N/A – AqualisDAO is a DeFi Provider and we do not support this alternative.

17. **Do you support this approach instead of the proposed licensing regime? If you do support a voluntary code of conduct, should they be enforceable by an external dispute resolution body? Are the principles outlined in the codes above appropriate for adoption in Australia?**

    - AqualisDAO supports the self-regulation model for CASSPr.

    - The concept of a "**crypto self-regulatory organization**" (**SRO**) has been suggested by other cross-border jurisdictions as well as transnational crypto market participants – Given the core characteristics of self-regulatory organisations in that they tend to be market-driven and competitive; it can help deliver rules that are more flexible and responsive to market needs.

    - Given this competitive platform, self-regulatory organisations will tend to enhance service to the end customer and be conscious of the cost of regulation – that is to themselves and their customers.

    - Self-regulatory organisations can react quickly to changing circumstances which given our novel and dynamic token economy, it should incentivise growth and attract new investment which in turn creates jobs for the economy.

- SROs can leverage members' expertise and resources which in turn may allow for the creation of an environment where the regulatory infrastructure can be more flexible and nimbler.

- The US market and Wall Street specifically are familiar with SROs, which are 1) funded and 2) governed by their own members - they set rules and perform inspections with authority delegated by Congress and the SEC – i.e. FINRA - a private American corporation that acts as a self-regulatory organization that regulates member brokerage firms and exchange markets – the former name was the National Association of Securities Dealers (NASD), also an SRO.

- AqualisDAO agrees that AML/CTF obligations could continue to apply to Centralised CASSPr

18. If you are a CASSPr, what do you estimate the cost and benefits of implementing this proposal would be? Please quantify monetary amounts where possible to aid the regulatory impact assessment process.

N/A – AqualisDAO is a DeFi Provider and we do support this alternative (Self-Regulation). self-regulatory organisations will tend to enhance service to the end customer and be conscious of the cost of regulation.

19. Are there any proposed obligations that are not appropriate in relation to the custody of crypto assets?

Proposed Custody Obligations seem all appropriate –

20. Are there any additional obligations that need to be imposed in relation to the custody of crypto assets that are not identified above?

Potential Additional Obligations could include:

- If use of Smart Contracts – the need to be verified and audited
- Robust systems and practices for methods of asset storing, i.e. Hot / Cold Storage / Smart Wallet etc
- Cross-Chain requirements, i.e. holding assets across multiple chains
- Insurance – i.e hacks and other than compensation schemes

21. There are no specific domestic location requirements for custodians. Do you think this is something that needs to be mandated? If so, what would this requirement consist of?

No, by design blockchain and Web3 technologies are global infrastructures – any domestic location mandate will stifle innovation.

22. Are the principles detailed above sufficient to appropriately safekeep client crypto assets?

Yes, the principles seem appropriate

23. Should further standards be prescribed? If so, please provide details

As described in question 17 above, in the absence of regulatory certainty, custodians could take the initiative to set the market standard practices and establish self-monitoring mechanisms. For example, the Asian Securities Industry & Financial Markets Association (ASIFMA), a trade association in Asia with over 165+ members, released its best practices for Digital Asset Exchanges.

Equally, the Global Digital Finance industry membership body has released a document on "Crypto Asset Safekeeping and Custody."

24. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

AqulisDAO is a DeFi Provider

25. Is an industry self-regulatory model appropriate for custodians of crypto assets in Australia?

Yes, please see Answer to Question 23

26. Are there clear examples that demonstrate the appropriateness, or lack thereof, a self-regulatory regime?

Please see Question 17

27. Is there a failure with the current self-regulatory model being used by industry, and could this be improved?

28. If you are a CASSPr, what do you estimate the cost of implementing this proposal to be?

N/A – AqualisDAO is a DeFi Provider.

29. Do you have any views on how the non-exhaustive list of crypto asset categories described ought to be classified as (1) crypto assets, (2) financial products or (3) other product services or asset type? Please provide your reasons.

Please see Question 3 above for a very high level break down / categories of crypto assets and our reasons.

On a more granular level the crypt asset landscape can be Categorise as:

- Security Tokes – somewhere similar to traditional instruments like shares, debentures or units in a collective investment scheme
- Cryptocurrecies – i.e. BTC
- Stablecoins – includes Pegged and CBDCs
- Utility tokes – and subdivisions, i.e pass-through
- E-money tokens

For an even more granular view of the crypto landscape – please see here

30. Are there any other descriptions of crypto assets that we should consider as part of the classification exercise? Please provide descriptions and examples.

Please refer to Question 29

31. Are there other examples of crypto asset that are financial products?

- Science Blockchain, which is the first incubator in the world to be funded by its own tokenized compliant securities offering (token: SCI2) - The Science Blockchain Investor Dashboard can be found here

- Other Security tokens and Tokenised Stocks can be found in the STO Market Portal here

32. Are there any crypto assets that ought to be banned in Australia? If so which ones?

No, we believe no crypto assets should be banned, but rather focus our attention on further improving the legitimacy and adoption of cryptocurrencies by dedicating more resources towards public education on cryptocurrencies, in particular what people should look out for in terms of investment scams such as Ponzi schemes, giveaway scams and hacks.

Unfortunately, scams exist wherever there is an opportunity, and cryptocurrency is ripe with opportunity right now. Even in traditional finance, financial scams such as refund scams, romance scams and lottery scams are prevalent which leads us to believe criminal activity is inevitable, the best way to minimize its impacts is through public education and awareness.