PiperAlderman

Submission to the Treasury – Consultation Paper dated 21 March 2022

1. Thank you for the opportunity to provide a submission to the Treasury in respect of the Consultation Paper dated 21 March 2022 (**Consultation Paper**).

2. The author leads the Piper Alderman Blockchain Group and is a lawyer admitted to practice with 17 years of experience, including over 5 years in full time blockchain and digital asset law. The author represents and advises leading digital asset exchanges located around the world and leading Australian blockchain, crypto and non-fungible token based projects as well as projects seeking to leverage emerging decentralised autonomous organisation technology to unlock greater consumer protection, innovation and jobs, including in Australia.

3. The author also serves on the Board of Blockchain Australia and makes this submission in his personal capacity, not on behalf of either of the partnership of Piper Alderman or on behalf of Blockchain Australia..

4. The present consultation is unusual in that it is industry requested, and industry led, a fact noted during consultation meetings. The author cannot recall any comparable situation where a technology or financial services industry in Australia has actively sought regulation to provide better protections for Australian users and certainty for an industry.

5. It is respectfully submitted that, in relation to such a fast moving and fast changing industry, regulation should be principles based, and attune to commercial and technological realities (while remaining technologically neutral) of this technology including the global nature of distributed ledger technology and blockchain. Recognising the global mobility of high tech workers and blockchain businesses is essential to the policy settings for this consultation.

6. Australia is seen as leader in blockchain and crypto, and many exchanges founded in Australia have developed best practice approaches which should provide a sound basis for a light touch regulatory approach. In particular, the best exchanges operating in Australia:

   6.1 use competent staff skilled in crypto-asset dealings;

   6.2 segregate client crypto-assets into third party or well considered storage (including cold storage), that is custody; and

   6.3 ensure they do not use client funds or crypto-assets for any business purpose.

7. These principles provide the core of what we suggest would be a ‘light touch’ regulatory approach and we submit these should underpin the regulatory framework, specifically:

   7.1 a licensing regime which is separate to the Australian Financial Services Licensing regime, that is, a bespoke and tailored licensing framework for centralised exchanges only; and

   7.2 mandated minimum qualifications and fit and proper person tests for those seeking licensing; and

   7.3 mandated custody of client crypto-assets, either third party or self custody, meeting most of the standards set out in the Consultation Paper in relation to custody of crypto-assets for exchange traded products (see below our comments on some potentially problematic requirements).

8. There has been very few failures of centralised exchanges in Australia to date, and news reports of bad actors and scams far outweigh reporting on the overwhelming lawful and positive use of crypto assets.

9. It is important to consider, when developing a regulatory framework, that bad actors involved in scams are unlikely to meet Australian requirements, and that the Australian offerings need to be commercial and competitive to ensure Australian purchasers of crypto assets are not lured to scams by the promise of lower cost services, or the offer of services which cannot be provided under Australian law (for example due to compliance costs or the unavailability of insurance or banking).

10. As such, the costs of compliance with a regulatory regime need to be carefully considered, so that the regulations deployed achieve the necessary goals while keeping Australia blockchain development competitive.

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

11. We do not. Digital Currency Exchange, as defined in the *Anti Money-Laundering and Counter Terrorism Financing Act* 2006 (Cth) is a well understood term with only "digital currency exchange business" being a part of the definition which could benefit from clarity.

12. A new, Australian specific, definition is only likely to cause confusion in our submission, and use of "Secondary" in the name may also be confusing to the market, as it implies carving out "Primary" service providers but does not explain what that is. Further, while decentralised exchanges are said to be outside this consultation, they would likely be considered "secondary" in many instances and consumers may think defi offerings are caught, when they are not.

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

13. Yes. Virtual Asset Service Provider, as defined by FATF,[1] is globally understood and suitable for use.

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

14. The crypto-asset space is moving and changing quickly so definitions are important. While reference to "assets which are transferred, stored or traded electronically" appears sound, we suggest adopting recognition of digital assets as a form of property, as *"property which is transferred, stored or traded electronically"*.

15. We submit that the FATF definition may provide useful guidance in relation to the definition of crypto asset and better align Australia with the international approach to defining crypto assets.

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[1] https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html

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

16. A baseline definition of crypto assets would act as a starting point for regulators in different areas, with such nuances as may be required (for example in respect of tax or financial services) being added to address specific needs of different areas.

17. It may well be impossible to keep a consistent definition across all the different regulatory aspects of crypto-assets over time, and a drive for consistency in definitions will have unintended consequences.

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)?

18. We submit that the initial licensing regime should be focused on the key area of risk: namely where a business is holding a client's money or crypto-assets. That circumstance gives rise to the greatest risk of loss for a client if the exchange fails.

19. Crypto-businesses which operate on "non-custodial" or "self-custodied" basis do not exhibit this kind of risk.

20. Both kinds of exchange business still must adhere to the Australian Consumer Law which prohibits misleading and deceptive conduct, such as a representation of an orders for the sale on a market or for dishonest conduct in the purchase of crypto assets.

21. It would risk violating technological neutrality, a stated purpose of the regulatory framework, to expressly carve out from a licensing regime particular types of crypto assets. Further, it is difficult to identify "types" or taxonomies of crypto assets in a way that is meaningful.

22. For example an NFT may represent a ticket to a show, a right to enjoy a piece of art, the copyright in a piece of art, royalty rights in a piece of art, or ownership in the art (or a piece of the art), or a share in a venture, depending on how the token is deployed and promised to be used (or how supporting smart contracts are coded).

23. Absent features which would render a crypto asset a financial product, crypto assets should be treated as digital property. As such, unless it is the intention of the government to regulate all online sales of digital representations of property (such as eBay and classified advertisements where there could be a component of cryptographic proof to an item being sold) the regulatory perimeter for licensing should rise where an exchange holds client assets and not turn on what "types" of crypto assets are offered. There is one exception to this, where an exchange offers crypto assets which are financial products, the exchange plainly needs to hold a suitable licence to deal in those financial products, and the compliance regime for those crypto assets should be reviewed and tailored to ensure there is a path for compliance for exchanges dealing in financial product crypto assets.

6. Do you see these policy objectives as appropriate?

24. We support policy objectives to mitigate the risk to consumers from:

    24.1 the operational risks, that is the processes and skills of the business operators; and

24.2 the custodial, that is the holding of client assets separate from business assets.

25. We assume protection from the "financial risks facing the use of [exchanges]" does not refer to the risk of fluctuation in value of the a crypto asset. To the extent this is referring to financial loss arising from an operational risk or custody risk, we support that policy objective.

26. We support the AML/CTF policy objective, but note that crypto-assets have a very small illicit usage and features of traceability which render them useful at preventing criminal use.[2] The "harms arising from criminals and their associates owning or controlling" exchanges are already addressed in the AML/CTF laws.

27. Regulatory certainty is key for all in the crypto industry, so long as that certainty arises from a principles based, "light touch" approach and so that compliance costs are minimised.

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

28. Yes, as noted above, the crypto industry is global, and a regulatory response must take into account the ease with which Australians can access overseas services and DeFi protocols which may never be practically subject to Australian regulation.

29. We submit a further policy objective should be for a competitive and innovative blockchain industry measured in the number of jobs and blockchain businesses headquartered and operating in Australia.

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

30. We agree, and submit that ASIC should provide a published list of any crypto assets they consider are financial products, with detailed reasoning of same, to meet the policy objective of regulatory clarity.

31. Where possible, duplication of the AFSL, AML and proposed exchange regime should be avoided, noting that financial services licence applications presently have lengthy processing times before ASIC.

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?

32. No, we submit the threshold should be one of custody, not type or subset of crypto-asset, in order for the regime to be flexible and accommodate future innovation. If an exchange custodies NFTs then the custody element of the exchange should attract licensing, not the type of crypto asset offered.

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[2] See for example the Chainalysis Crypto Crime Report for 2022.

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)?

33. We submit that a slow, careful, principles based approach will best minimise this risk, and as noted above, be assisted by very clear guidance from ASIC identifying specific tokens or token features which will cause a token to be treated as a financial product.

34. As a precursor to considering regulatory duplication, it may be useful to consider how compliance with any existing regimes is, or is not, possible. For example professional indemnity insurance has historically not been available to crypto asset providers and so any regulatory framework which has practical requirements that cannot be met will amount to a de facto ban.

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

35. We agree with a graduated approach to centralised exchanges being licensed and custody standards to be set.

36. As noted above, duplication of regulatory frameworks should be avoided and so where the Australian Consumer Law would already provide adequate protection via misleading and deceptive conduct provisions, those laws should be relied upon to give consumer protection without further duplication.

37. Given the need for significant further education in the crypto-asset space, that there is a serious risk that many of the proposed obligations could be ill-understood by regulators as new crypto-assets emerge and pose risks of disputes, including in relation to:

    37.1 What “technological and financial resources” would be required to manage risks by exchanges;

    37.2 What minimum capital requirements would be needed for exchanges; and

    37.3 What “true to label” descriptions would mean, particularly when crypto-asset projects evolve over time and token features may be added (or deleted) at a project level outside of an exchange’s control.

38. Given the level of education surrounding crypto-assets generally, and the workload ASIC faces, as well as the history of relief granted by ASIC in relation to financial services and the understandably conservative approach ASIC takes to such applications, we submit that a ministerial discretion on the standards applicable to the licensing regime would give greater agility and flexibility to the regime in addition to ASIC having power to give relief to the requirements on a case-by-case or industry wide basis.

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

39. Airdropping of crypto-assets is a technological means of delivering tokens to a wallet. It would violate technological neutrality to ban airdropping generally and could have unintended

consequences if, for example, a token is delivered to users who qualify for the token whether the token is simply a product, voucher, or other property. If a business is involved in a regulated activity and uses airdrops as part of that activity, then they would be regulated under that activity and the question does not arise.

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)?

40. This should be addressed in the same manner that any business selling a product may communicate with customers, that is subject to the obligations under the Australian Consumer Law.

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

41. Not applicable.

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?

42. Bringing all crypto-assets into the financial product regulatory regime would only be possible with substantial carve-outs or amendments to the compliance obligations faced by financial services businesses.

43. It would violate technological neutrality by treating tokens which are not financial products as if they were, and may amount to a de facto ban over a great many tokens, particularly where the tokens are non-fungible or fungible but for a limited purpose which is does not bear the indicia of a financial product (such a voucher for a discount, or a pre-payment for a service, or the right to cast a vote in a DAO).

44. The Legal statement on Cryptoassets and smart contracts published by the LawTech Delivery Panel in the UK[3] makes a compelling argument to treat crypto-assets as property, as they have all the indicia of property.

45. Regulating property in the form of crypto-assets as if they were financial products would have wide-ranging and unintended consequences and would not meet the policy objectives set out in the Consultation Paper.

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

46. Not applicable.

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[3] https://35z8e83m1ih83drye280o9d1-wpengine.netdna-ssl.com/wp-content/uploads/2019/11/6.6056_JO_Cryptocurrencies_Statement_FINAL_WEB_111119-1.pdf

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?

47. Self-regulation has to date served the crypto-industry well, and the failures of exchanges to date could (and should) have been addressed by potential breaches of the Australian Consumer Law.

48. However, the industry has clearly seen the benefit of certainty via a light touch regulatory approach and that call should be considered. Self-regulation would have less impact to the industry compared to viewing all crypto-assets as financial products, but would be inferior to the benefits that a light touch, principles based and genuinely technologically neutral licensing regime for centralised exchanges would have.

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.

49. Not applicable.

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

50. There items appear potentially problematic unless further details are made clear:

50.1 Just what capital requirements will be needed will be important to quantify for exchanges;

50.2 How independent verification of cybersecurity practices will balance the need for operational security; and

50.3 Compensation in the event of loss of assets, given that insurance is largely unavailable to crypto-asset businesses and industry funded schemes do not align incentives for reasons including:-

(a) Consumers are able to self custody crypto assets, something which they are unable to do with nearly all financial products custodied on their behalf;

(b) Compensation regimes make sense when consumers are forced into an arrangement which carries risk and consumers are unable to manage that risk; and

(c) If consumers have proper disclosure of the risk of loss, and can mitigate that risk by self custody of assets, the cost benefit analysis for a compensation scheme shifts as it may encourage risk shifting behaviour where consumers leave crypto assets on exchanges believing they can access such a scheme.

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

51. No.

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?

52. No, so long as there is a responsible person located within Australia who has responsibility and liability for compliance with the custody requirements, and offshore custody is handled in such a way that the orders of Australian Courts will be respected and obeyed.

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

53. Yes.

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

54. No comment.

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

55. Not applicable.

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

56. No, the leading exchanges which self-custody have been the leading voices in seeking regulation in part, we submit, to ensure that others are providing custody to a safe level. Given the importance of operational security and matters of confidentiality around cybersecurity a self-regulation model is difficult to justify.

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

57. There are blockchain based tools for custody which could be used to inform a self-regulation approach, but we submit for centralised exchanges a licensed approach is likely to result in superior outcomes.

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

58. See our response to Q25 above.

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

59. Not applicable.

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.

60. As noted above, we submit that all crypto-assets should be treated as property in the first instance, and then if a crypto-asset itself has an additional feature which renders it a financial product, then the crypto-asset would fall into that category.

61. Clear regulatory guidance setting out:

    61.1 what specific features render a crypto asset a financial product and why; and

    61.2 what specific compliance is required to meet the AFSL regime in handling or offering that product,

    is needed if Australia is to avoid de facto bans on certain crypto assets with particular features.

62. We submit that a feature based analysis is a superior approach and will give greater agility and fit for a regulatory regime. The descriptions of some crypto assets as a "used for" product leaves too much room for interpretation.

63. Despite the above, we submit that most of the list in the Consultation Paper are tokens which are not being described with features that are similar to financial products, with the exceptions of:

    63.1 crypto assets which replicate the functions of financial products; and

    63.2 potentially stablecoins or CBDCs.

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

64. See above our answer to Q29.

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

65. Crypto assets which offer a leveraged price performance appear likely to be derivatives but may need to be regulated in a bespoke way as they may be constructed from smart contracts or lack counterparties, so existing financial services regulation may not easily fit.

66. Crypto assets which represent shares in a company would be financial products, in the same way that share certificates if offered for sale in a way that binds the issuer to recognise the holder of the share certificate as the owner of the shares would likewise appear to be a financial product.

67. The common thread remains a token which represents a contractual right which is a regulated activity the subject of a licensing requirement. The greatest benefit for consumer protection at this time will be achieved by solving for the custodian risk around centralised exchanges.

68. While there should be excellent learnings (and education for all involved) from the token mapping exercise, regulatory change in this area should be considered, measured and take the time needed for the resulting framework to be world class and fit for purpose.

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

69. We submit that the approach of seeking to identify specific crypto assets which *"ought to be banned"* doesn't address the fact that Australia has a strong Australian Consumer Law which should be enforced against those who engage in misleading and deceptive conduct.

70. Regulators should consider publishing an explicit warning list naming projects for which complaints have been received.

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30 May 2022