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Director – Crypto Policy Unit
Financial System Division
The Treasury
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By email: crypto@treasury.gov.au

Dear Director

Token Mapping Consultation Paper: Gilbert + Tobin submission

Gilbert + Tobin welcomes the opportunity to comment on Treasury's consultation questions in relation to the *Token Mapping – Consultation Paper* dated 3 February 2023 (**Consultation Paper**). Attached to this letter are our responses to questions raised in the Consultation Paper, as well as background commentary to assist Treasury with its next phase of consultation.

We welcome the opportunity to discuss the matters in this letter with Treasury.

Yours faithfully

Gilbert + Tobin

Background

Gilbert + Tobin advises a broad range of providers in both crypto asset and crypto asset adjacent industries and our clients include some of the most recognised global and domestic providers and projects. Our industry experience sits behind our responses to Treasury's questions and our submission reflects the experiences, challenges, opportunities and client feedback that we have observed and received in our role in the industry over many years.

We recognise Treasury's efforts in the Consultation Paper to distil a technical and conceptual framework for testing the regulatory status of crypto assets against existing regimes. In addition to our responses to Treasury's questions, we make the following observations in a hope that it may assist Treasury with its next phase of consultation.

Policy objectives

- We note that, unlike previous Treasury consultation papers, Senate committee reports, and consultations stemming from the United Kingdom (**UK**) and the European Union (**EU**), the Consultation Paper does not set out any clear policy objectives, including as it relates to the desire for Australia to become a global leader in crypto assets. It would assist the market to understand the Government's policy objectives for the crypto industry (particularly given the change in Government in 2022).

- Australia initially took a proactive role in the regulation of crypto assets, notably through the implementation of an anti-money laundering and counter-terrorism financing framework for digital currency exchange providers in 2018. However, Australia's reputation in this respect has waned and the lack of clear regulation and the 'regulate by enforcement' approach being taken by Australian regulators is causing businesses to move to alternative jurisdictions with clear policy positions and regulatory guidance. Unfortunately, this has also caused projects to move to jurisdictions with less robust regulatory systems where Australian consumers are still able to access these services, but without appropriate protections.

Regulatory acceptance

- Consumer protection is at the core of regulation and the regulatory discourse in the crypto industry over the past year (at least) has purportedly focussed on the protection of consumers. Outcomes-driven consumer protection and consumer-centric product and service design are also fundamental pillars that drive crypto businesses. We encourage Treasury (as it enters its next phase of consultation) to construct regulation having regard to the fact that consumers want to engage with crypto assets and that businesses want to meet that demand in a safe and compliant way.

- We commend Treasury on the guidance set out in the Consultation Paper in relation to analysing crypto offerings against the existing financial services regime. We would suggest that this

guidance aligns with the approach that is already taken by many advisers, confirms that some crypto assets are captured by Australia's financial services regime, and highlights that in many instances it is unclear whether the regime applies.

- However, it has not been considered whether it is in fact possible for crypto products and services that may be captured to be offered in a manner that is compliant with the regime, and the Australian Securities and Investments Commission (**ASIC**) has not provided definitive guidance regarding its expectations for crypto businesses to enable them to comply with the obligations under an Australian financial services licence (**AFSL**).

- ASIC's 'regulate by enforcement' approach, by which ASIC can direct a business to cease an offering without any clear legislative or judicial basis, together with an apparent reticence to engage with or progress assessments for businesses dealing with crypto assets that are seeking an AFSL is problematic and in the absence of a policy objective and clear regulation is exacerbating the flight to offshore jurisdictions, with mixed consumer protection outcomes and lost economic opportunity.

Technological neutrality

- We agree that technological neutrality is a fundamental principle underpinning many Australian regulatory frameworks. As noted in Treasury's 2022 consultation paper '*Crypto asset secondary service providers: Licensing and custody requirements'* (**CASSPr Paper**), regulation exists to manage relationships between service providers and consumers where there is a level of information asymmetry and trust. The purpose of a technology neutral approach to regulation is to achieve this outcome irrespective of the technology used to create and govern that relationship.

- We submit that while technological neutrality is important, this should not be at the expense of addressing technical nuances that are specific to the crypto ecosystem and which may change the nature of consumer risk. Concepts of overarching 'purpose' or 'function', while very important, should not be applied in a manner that suggests an understanding of the underlying technology and associated risks is not necessary.

- The Consultation Paper recognises that intermediated services, which are characterised by trust and information asymmetry, are fundamentally different to disintermediated (or public) services that are designed to obviate these characteristics. The Consultation Paper does not address how Treasury proposes to regulate disintermediated systems.

- Further consideration should be given to centralised businesses that provide access to disintermediated services (eg, interfaces for public staking services). While there is a level of intermediation, this model often does not change the rights or obligations of consumers with respect to the services being accessed and is comparable to a technology service.

Consultation gaps

- We recognise the purpose of the Consultation Paper is to construct a framework against which crypto tokens and services can be mapped against the existing financial services regime. However, we consider it also highlights significant gaps, such as:
  - crypto asset services that are not captured under the existing financial services regime;
  - intermediated crypto assets (including wrapped assets and other assets);
  - public smart contracts (including interoperability, economic and cooperation based smart contracts); and
  - network tokens (including cryptocurrency and general purpose tokens).

Responses to questions

1 What do you think the role of Government should be in the regulation of the crypto ecosystem?

As the Consultation Paper notes, the role of Government "*includes identifying the appropriate level and form of intervention in free and competitive markets*". In financial services and markets, this has focussed on "*(i) rules to ensure markets are fair, efficient and competitive; (ii) standards to ensure the safety and quality of the products and services; or (iii) measures that encourage or discourage certain activities*." The Government's role in regulation should have due regard for these constructs. It is not Government's (or any regulator's) role to impose opinions around the desirability or merits of an industry; that is a matter for the market.

In relation to the crypto ecosystem, the Government's role in regulation should focus on:

- ensuring an appropriate balance between consumer protection and innovation, to allow Australia to be an attractive market that is competitive with comparable jurisdictions while also upholding consumer protections and good outcomes; and
- instilling industry (eg, financial institutions) and consumer confidence in crypto businesses that operate in Australia subject to considered and commensurate regulation.

The success or failure of the crypto ecosystem should not depend on whether the Government is convinced by the transformational technology offered in this space. This should be defined by how the market wants to use the technology and responding to it in a manner that allows for innovation without unnecessarily impeding its adoption.

As noted in the Final Report of the Senate Select Committee on Australia as a Technology and Financial Centre:

> "*Government's role is not to pick winners but to provide a steady framework within which innovation can thrive. Governments and regulators the world over are grappling with the best way to bring digital assets within a suitable regulatory framework. While there is a need for regulation to ensure trust in the industry and protect consumers, the global nature of digital businesses means that overly burdensome requirements in a jurisdiction such as Australia will simply drive companies elsewhere. As such, there must be a balance between bringing digital assets into the regulated world and preserving their dynamism."*

2 What are your views on potential safeguards for consumers and investors?

As the Consultation Paper notes, to the extent there is an identifiable party that is an 'investor' under an arrangement for a financial investment function, that arrangement would already be subject to the existing financial services regulatory regime, which has safeguards in place to manage that relationship.

Where the existing financial services regime does not apply, Australia's existing consumer law would apply, including the broad protections regarding misleading and deceptive conduct, false or misleading representations and unconscionable conduct. However, as set out in the Background, we consider there is a gap, particularly as it relates to crypto asset services that are not already captured under the existing financial services regime. Any new regulatory framework should be commensurate with the risk profiles in the crypto industry and the events over the past year highlight incremental safeguards that can assist with protecting consumers in the context of centralised crypto providers. Such measures should be implemented urgently and include:

- **Custody:** requirements for centralised providers that take control of consumer assets. This would include requirements for safe custody of assets that are segregated from the provider's core business to ensure such assets are not subject to misappropriation and are insolvency remote;

- **Disclosure:** requirements for centralised providers that issue, sell or otherwise deal with or on behalf of consumers in relation to crypto assets. This would include requirements relating to the provider disclosing balanced information to consumers about the crypto assets to allow them to clearly understand the product or service and the associated benefits and risks. Such statements would be subject to the existing Australian consumer law; and

- **Conflicts of interest:** requirements for centralised providers that issue, sell or otherwise deal with or on behalf of consumers in relation to crypto assets to manage and (if required) disclose any conflicts of interest they may have.

These safeguards would provide immediate support to the crypto industry, and to the extent that Treasury wishes to conduct consultation in relation to a more fulsome regime, these measures could be implemented as an interim code of conduct for businesses engaging in crypto asset services.

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3 Scams can be difficult for some consumers to identify.

(a) Are there solutions (e.g. disclosure, code auditing or other requirements) that could be applied to safeguard consumers that choose to use crypto assets?

(b) What policy or regulatory levers could be used to ensure crypto token exchanges do not offer scam tokens or more broadly, prevent consumers from being exposed to scams involving crypto assets?

We note the existence of scams is not exclusive to the crypto industry. Scams in financial services and consumer credit arise despite laws and regulation.

A clear regulatory regime that differentiates regulated providers from unregulated providers, implementing the above measures and maintaining and developing the educational content available in relation to scams would assist.

4 The concept of 'exclusive use or control' of public data is a key distinguishing feature between crypto tokens/crypto networks and other data records.

(a) How do you think the concepts could be used in a general definition of crypto token and crypto network for the purposes of future legislation?

(b) What are the benefits and disadvantages of adopting this approach to define crypto tokens and crypto networks?

We agree the concept of 'exclusive use or control' of public data is a distinguishing feature between crypto tokens and some other data records. However, it is possible for a token holder to delegate the use and control of their data to third parties without relinquishing their ability to use or control the associated crypto token and this concept ('exclusive use or control') should be properly considered.

We encourage Treasury to also consider the importance of cryptography (as set out in paragraph 34 of the Consultation Paper), as this is also a distinguishing feature of crypto tokens and networks. Cryptography is directed towards security controls that hinder the ability to unilaterally change digital information.

We also encourage Treasury to consider the definitional aspects adopted for crypto tokens (or assets) and networks by other jurisdictions, such as the UK and the EU. An important pillar of regulating global digital businesses is cross-jurisdictional harmony such that Australia's regulatory regime is not considered to be incompatible or an unnecessarily burdensome. We note in response to the CASSPr Paper that a number of participants identified the 'CASSPr' terminology as being out of step with other jurisdictions and may cause confusion. Similar consideration should be applied here.

5 This paper sets out some reasons for why a bespoke 'crypto asset' taxonomy may have minimal regulatory value.

(a) What are additional supporting reasons or alternative views on the value of a bespoke taxonomy?

(b) What are your views on the creation of a standalone regulatory framework that relies on a bespoke taxonomy?

(c) In the absence of a bespoke taxonomy, what are your views on how to provide regulatory certainty to individuals and

businesses using crypto networks and crypto assets in a non-financial manner?

We agree that a broad interpretation of crypto assets may have some benefits when applying existing regulatory frameworks (particularly where there is a relationship between identifiable parties), or in relation to services that may be agnostic to the features and functions of the underlying assets (eg custody for safe keeping with no execution services).

However, we suggest this is a significant departure from the approach taken in other jurisdictions, particularly in the UK and the EU. As set out in our response to Question 4, cross-jurisdictional alignment is important, and we encourage Treasury to consider whether there are lessons from those jurisdictions that can be applied to Australia's taxonomy.

We consider it will be inevitable that a bespoke taxonomy is required in relation to certain crypto assets that have features and risk profiles that differ to other assets. This is a recognised approach in regulatory frameworks. For example, although Australia's existing financial services regime includes the general definition of 'financial product', it also captures other financial products that have specific structures, features or risks that require regulation. Other jurisdictions have elected to treat stablecoins as a bespoke asset class, given their features, risk profile and intended use by consumers. We submit this should also apply in the Australian context.

This approach will be particularly important where there may be features of a crypto asset that do not correlate to an 'arrangement' between identifiable parties. Regard will need to be had to the asset itself and how to manage any risks associate with its features, rather than the terms of the relationship between identifiable parties (as the Consultation Paper suggests).

While it may not be possible to create an exhaustive, bespoke crypto taxonomy at this stage (particularly given the breadth and evolving nature of the crypto asset industry), there are already numerous mature crypto assets that have distinct features and risk profiles that necessitate specific regulation (as discussed). We encourage Treasury to review the approach in other jurisdictions.

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6 Some intermediated crypto assets are 'backed' by existing items, goods, or assets. These crypto assets can be broadly described as 'wrapped' real world assets.

(a) Are reforms necessary to ensure a wrapped real-world asset gets the same regulatory treatment as that of the asset backing it? Why? What reforms are needed?

(b) Are reforms necessary to ensure issuers of wrapped real-world assets can meet their obligations to redeem the relevant crypto tokens for the underlying good, product, or asset?

The use of the term 'wrapped' may be appropriate in the context of digitising real world assets, however, we encourage Treasury to not conflate this with other forms of 'wrapping' that take place in the crypto ecosystem to provide interoperability between blockchains (eg, wBTC).

We commend Treasury's comments in the Consultation Paper regarding the distinction between a crypto token and a crypto system. We consider this to be important in the context of wrapped assets, as there should be clarity regarding the regulation of a token as distinct from the regulation of a system (or arrangement).

As Treasury notes in paragraph 77 of the Consultation Paper, there may be situations where rights do not flow with the crypto token. That is, the issuer of the wrapped asset has control of the underlying item, good or asset pursuant to the relationship with the initial token holder. However, it may also be the case that the issuer is using tokens as a digital representation of such rights with respect to the initial token holder, and the transfer of the token does not result in the initial token holder's rights flowing to a subsequent token holder. For example, there may be limitations as to who may redeem a stablecoin for the fiat currency supporting that stablecoin. In this scenario, we consider the initial creation of the wrapped asset as between the issuer and initial token holder should receive the same regulatory treatment as the asset backing it. This is because the risks and features of the arrangement remain the same, albeit that technology is used to represent the arrangement. However, the regulatory treatment of the token or intermediaries may be different with respect to subsequent holders.

We do not consider the existence of a crypto token should, by default, increase the regulatory burden applied to an underlying arrangement. Regard should be had to the additional risks actually created or alleviated by using the technology. If the crypto token is a stablecoin and the underlying asset is fiat currency, or the crypto token is representing a share or an interest in a managed investment scheme (**MIS**), there should be requirements in place to ensure the issuer can meet its redemption obligations (or, as in the case of an MIS, such requirements remain). However, if that crypto token were a concert ticket and the only obligation relates to a one-off access to a concert, the issuer's obligations are resolved as a matter of contract.

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7 It can be difficult to identify the arrangements that constitute an intermediated token system.

(a) Should crypto asset service providers be required to ensure their users are able to access information that allows them to identify arrangements underpinning crypto tokens? How might this be achieved?

(b) What are some other initiatives that crypto asset service providers could take to promote good consumer outcomes?

To the extent that a crypto asset service provider is dealing in an intermediated token system the provider should be required to ensure consumers receive sufficient information to understand the

product, the service and the associated benefits and risks (see our response to Question 2 regarding disclosure). To the extent the provider does not know the terms of the arrangement, this should also be made clear to consumers as an identifiable risk.

8 In addition to the functional perimeter, the *Corporations Act* lists specific products that are financial products. The inclusion of specific financial products is intended to both: (i) provide guidance on the functional perimeter; (ii) add products that do not fall within the general financial functions.

(a) Are there any kinds of intermediated crypto assets that ought to be specifically defined as financial products? Why?

(b) Are there any kinds of crypto asset services that ought to be specifically defined as financial products? Why?

We have chosen not to respond to these questions.

9 Some regulatory frameworks in other jurisdictions have placed restrictions on the issuance of intermediated crypto assets to specific public crypto networks. What (if any) are appropriate measures for assessing the suitability of a specific public crypto network to host wrapped real world assets?

We do not consider this a priority for Treasury at this time.

10 Intermediated crypto assets involve crypto tokens linked to intangible property or other arrangements. Should there be limits, restrictions or frictions on the investment by consumers in relation to any arrangements not covered already by the financial services framework? Why?

Please see our response to Question 6.

11 Some jurisdictions have implemented regulatory frameworks that address the marketing and promotion of products within the crypto ecosystem (including network tokens and public smart contracts). Would a similar solution be suitable for Australia? If so, how might this be implemented?

Please see our response to Question 2.

12 Smart contracts are commonly developed as 'free open-source software'. They are often published and republished by entities other than their original authors.

(a) What are the regulatory and policy levers available to encourage the development of smart contracts that comply with existing regulatory frameworks?

(b) What are the regulatory and policy levers available to ensure smart contract applications comply with existing regulatory frameworks?

We do not have any comments on this question in the context of the current consultation, apart from noting that Treasury should consider these having regard to any existing regulatory regimes that apply to open source software and applications – is Treasury proposing to regulate software or protocols? If so, we would welcome the opportunity to discuss this with Treasury.

13 Some smart contract applications assist users to connect to smart contracts that implement a pawn-broker style of collateralised lending (i.e. only recourse in the event of default is the collateral).

(a) What are the key risk differences between smart-contract and conventional pawn-broker lending?

(b) Is there quantifiable data on the consumer outcomes in conventional pawn-broker lending compared with user outcomes for analogous services provided through smart contract applications?

As set out in the Background, there are fundamental differences and risks between arrangements that rely on relationships between parties (where technological neutrality is important) and arrangements that involve users interacting with technology. Regulation of the former relates to understanding and managing the relationship (ie, ensuring counterparties can fulfil on their obligations), regulation of the latter relates to understanding and managing the technology (ie, ensuring the technology is operating as intended). We encourage Treasury to consider this distinction in considering any regulation that may impact smart contracts, and we would welcome the opportunity to discuss this further.

14 Some smart contract applications assist users to connect to automated market makers (AMM).

(a) What are the key differences in risk between using an AMM and using the services of a crypto asset exchange?

(b) Is there quantifiable data on consumer outcomes in trading on conventional crypto asset exchanges compared with user outcomes in trading on AMMs?

Please see our response to Question 13.