Token mapping of crypto assets

The Treasury

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Westpac Banking Corporation

March 2023

WE ARE GROUP

Overview

Westpac Group (**the Group**) welcomes the opportunity to provide comments on the Government's consultation paper on the token mapping of crypto assets (**consultation paper**).

We strongly support the objective of the Government to improve clarity of the regulatory regime that governs crypto asset products and services (including further potential regulatory frameworks and / or licensing regimes). The regulatory regime needs to ensure that consumers are adequately protected while continuing to support innovation in this evolving landscape.

We highlight the following key considerations:

- The need to apply a functional approach to the regulation of crypto assets. The function and underlying characteristics of the crypto asset should define whether the asset is captured by existing regulatory regimes.

- Further consideration is needed in how decentralised, dis-intermediated crypto assets, products, and services are regulated. Existing regulation requires a legal entity or a person, but if a token or protocol is fully decentralised there is often no such person or entity present.

- The proposed regulatory framework needs to incorporate terminology and definitions that are consistent and well understood by the industry, regulators, and consumers.

- To reduce the risks of future failures, we need to proactively create a framework that deals with current risks such as consumer losses from fraud and scams but one that is also adaptive to managing the upcoming disruption from tokenisation of existing asset classes (e.g. banks deposits, bonds, carbon credits, etc).

- There needs to be a whole of government approach to the regulation of crypto assets and providers and the application of a framework that is consistent with regimes in other international jurisdictions. Government regulation should go hand in hand with industry led initiatives such as standards and guidelines.

We note and support the positions outlined in the Australian Banking Association's submission to this consultation.

Outlined below is our response to the questions in the consultation paper.

Thank you for the opportunity to provide comments on this consultation.

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

The role of Government is to provide regulatory certainty as to the treatment of crypto assets and the regulation of service providers by consistently applying suitable policy and regulatory frameworks that protect consumers while enabling innovation of the crypto ecosystem. These settings should be designed to ensure the crypto ecosystem operates in a fair, efficient, and competitive manner and that there are minimum standards of safety, transparency, and quality of the products and services offered to consumers. The settings need to ensure we maintain the integrity of the broader financial market and payment ecosystem and are able to manage potential systemic risks. To achieve this, there needs to be a whole of government approach to regulation across the various government agencies in Australia, including ASIC, APRA, ATO, AUSTRAC, RBA, and Treasury.

With other jurisdictions fast moving to regulate crypto assets (with some already regulating), there is a real opportunity to leverage the work done overseas to date and ensure Australia has a regulatory regime that provides certainty, instils trust in consumers but is also adaptive to rapidly evolving technologies and puts Australia at the forefront as a global leader in blockchain technologies.

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

We support the application of the principle of "same risk, same regulatory outcome" whereby functions that present similar risks would be regulated in the same way. Where a functionally equivalent product based on a crypto asset is caught by a regulatory perimeter, then the issuer of the product and service providers who support the functionality should also be captured by that regulatory regime. For example, where the function of a crypto asset that incorporates a particular token resembles that of a financial product, then the disclosure and licensing obligations and consumer protections of the *Corporations Act 2001 and ASIC Act 2001* should apply.

In addition to the application of the appropriate regulatory obligations, intermediaries should be required to have minimum financial requirements including capital requirements to ensure they have the ability to compensate where there has been consumer detriment from fraud and scams, in line with existing consumer protection laws.

Other potential safeguards for consumers and investors could include:

- Ensuring that digital currency intermediaries have a relationship with a licensed domiciled digital custody service provider in order to operate in the Australian market;
- A centralised licensing regime to ensure consistency in entrance criteria;
- Requiring customers' assets to be held in a segregated (ring-fenced) manner to protect against the insolvency of the intermediary; and
- Customers' fiat and digital assets held by intermediaries are periodically audited by an independent third-party auditor and disclosed to regulators.

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?**

Crypto intermediaries should be required to perform due diligence on any token that they list or product that they offer. Where a crypto asset is captured by a specific regulatory regime, then the disclosure obligations and consumer protections of that regime should apply.

In addition, exchanges should also be governed by certain financial requirements to protect against financial loss in the event of hack / theft for assets held in custody and organisational competence obligations to ensure representatives are adequately trained and competent to provide services.

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?**

Any definition of crypto token needs to consider its ability to uniquely represent something of value and reflect that it commonly relies on logic and actions embedded in the smart contracts and / or other supporting systems to perform a function. These considerations are essential in defining "crypto assets" and "token systems", which we are of the view should be expanded to represent a collection of tokens, smart contract, oracles, networks, protocols, and other relevant supporting systems.

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

The objective of the token mapping exercise should be to define how crypto products map to the functional perimeter. It is therefore important to have clear, precise, and consistent definitions that can be used to determine specific regulatory obligations. The current definitions outlined in the consultation paper are too ambiguous and seem to be used interchangeably. We also note that not all crypto products will meet the definitions within the Corporations Act 2001 around financial products as they are defined today. We suggest there would need to be clear review of that language as to whether it is fit for purpose given the nature of the crypto products looking to be used in the market.

5. **This paper sets out some reasons for why 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?**

While a bespoke token taxonomy will have limited value, there may be an opportunity to reference the work already done by the industry and regulators in other key jurisdictions to define the main classes of tokens. Grouping the main classes of tokens and then conducting the functional mapping exercise would allow for a better understanding of what existing financial services and markets, credit, payments, and prudential laws and regulation would apply. This will provide the necessary clarity for both the industry and regulators in Australia and would assist in dealing with the fluid and evolving nature of crypto assets, where depending on a context, a protocol token may also be a governance token - leading to different types of crypto assets and products built on top of them.

We outline below some suggested token groups for consideration:

- Central Bank Digital Currencies (issued by Australian Government or governments of other foreign nations - e.g. those held / used by Australian citizens in the future);
- Deposit Tokens issued by regulated entities (e.g. commercial banks or other deposit-taking entities);
- Stablecoins issued by non-regulated entities (e.g. USDC, USDT, and other);

- Tokenised financial instruments (e.g. bonds, non-deliverable forwards, and commodities);
- Tokenised real-world assets (e.g. property, hard / deliverable commodities, inventory and any other physical assets);
- Equity ownership tokens (e.g. digital instruments providing financial rights);
- Crypto currency tokens (e.g. BTC);
- Utility or service provider tokens (e.g. ETH); and
- Alternative asset tokens (art, video game assets, etc).

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

We do not support the creation of standalone regulatory framework that relies on a bespoke taxonomy. The Government should be conducting a token mapping exercise of the functional characteristics of crypto assets against existing financial service and markets, credit, payments, and prudential laws and regulations to assess whether they need amendment or change to better capture crypto products. Where crypto assets are determined to be outside the regulatory regimes, then consideration is needed as to whether it is appropriate to bring them in via legislative amendments.

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?

Refer to above.

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?

Legal ownership constructs and how they are conveyed to tokenised assets, especially when fractionalised, need to be carefully considered and resolved. We believe that reforms are necessary to create a legal framework to ensure that tokenised asset holders continue to have the same rights that they would have had over the original real-world ('tangible') asset.

Additionally, there needs to be a clear framework and accountability of "immobilised" real world assets. For example, if a real estate portfolio worth $100m is tokenised and fractionised to create 100 tokens worth $1m each. Investors buying these tokens need to be clear of their rights and obligations and the portfolio manager must be clear on how the underlying asset is managed and what its status is from the legal and taxation perspective.

A further consideration is whether tokenised assets should continue to represent the original function / purpose of the original asset. For example, a real-world asset can be tokenised to create a token that can be considered either a capital asset or stored-value facility (SVF) , depending on whether there is an ongoing yield stream, and this would impact the regulatory framework that would apply.

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?**

Crypto asset service providers should be required to be fully transparent with customers as to the arrangements underpinning the crypto token to ensure confidence, trust and ongoing stability of the industry. If a crypto asset is caught by a specific regulatory regime due to the "same risk, same regulatory outcome" principle, then the provider of the product should also be brought within the regulatory regime and the disclosures and consumer protections of that regime should apply.

If providers are intending to engage in high-risk transactions (e.g. leveraging crypto assets), then there needs to be full disclosure and a complete segregation of funds and assets to ensure consumers are protected from losses incurred by the provider. In addition to this, these providers should have the necessary financial requirements to ensure they are able to compensate consumers where there has been significant detriment caused by fraud and scams and other applicable criminal activity, in line with existing consumer protection laws.

Specific examples of initiatives and disclosures that would promote good consumer outcomes could include:

- Mandatory disclosure of on-chain wallet addresses;
- Illegal to co-mingle customer assets with intermediary firm's assets;
- Customer assets held on a 1:1 basis - i.e. unleveraged unless opted-in to specific derivatives / leverage product with own disclosures;
- Financial reporting for disclosed wallet addresses and assets held; and
- Independent periodic (regular, set intervals) auditing of assets in omni-bus wallet.

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?**

Where an intermediated crypto asset has similar functions and risks to a financial product, then the *Corporations Act 2001* and its obligations and protections should apply, even if the asset does not meet the current definition of a financial product. As mentioned above, we believe that as part of this mapping exercise, a thorough interrogation of the legislation (i.e. definitions such as financial product, agent, intermediaries, etc) is needed and any resulting amendments applied to ensure it is fit for purpose and adequately captures crypto assets and corresponding products and services.

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?**

Many of the current public blockchain networks are unsuitable or inappropriate for the hosting of tokenised real-world assets as they may not be able to provide sufficient guarantees around settlement finality and security. This is due to the immaturity of the underlying technology (e.g. regular outages), the lack of nodes in operation on the network, and the fact that the networks are being controlled by too few parties or parties with vested interests.

Given the risks and complexities associated with public crypto networks and the lack of consumer understanding of the associated risks, responsibility should fall on the licenced intermediary to ensure that they only put customer assets on suitable networks.

Some measures that could be used to assess the suitability of a specific public crypto network include:

- The extent of distribution of the network, including number of nodes in operation;
- Transparency provided through blockchain explorers;
- Support of the network by digital asset custody infrastructure technology platforms;
- Governance functions for the network (dictating control / domination of the network);
- Speed of execution of the network;
- Finality of transactions / settlement;
- Transaction costs for market participants; and
- Project activity including the ongoing efforts to keep the network secure and modern.

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?

While intermediated crypto assets are linked to intangible property, there will be some that are linked to tangible property. This includes both tokenised real-world assets as well as native digital assets[1].

If consumers are investing in intermediated crypto asset products, then the existing disclosure and licencing rules should apply (product disclosure statements, etc) and product issuers should be accountable for the accuracy of those disclosures.

In addition, providers of such tokens should be liable to compensate consumers in the event of loss from fraud and scams.

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?

Financial marketing and promotions play an important role in the financial decisions made by individuals. Consumers are influenced by the substance and presentation of promotions, which can have a significant impact on whether they decide to engage with a particular service provider or use a particular product.

[1] On-chain green bond issuance of the Government of the Hong Kong Special Administrative Region of the People's Republic of China, 16 February 2023, https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/02/20230216-3/#:~:text=The%20Government%20of%20the%20Hong,Green%20Bond%20Programme%20(GGBP).

We note that Australia already has the Australian Consumer Law and equivalent provisions within the *ASIC Act 2001* in place looking to limit misleading and deceptive conduct and placing the consumer in the forefront of the mind of issuing companies. We suggest this regime (tailored if need be) could equally apply to those entities within the crypto ecosystem. If the regime requires some tailoring, then there is an opportunity to leverage and closely align the Australian framework with emerging international standards (e.g. BCBS) and regulations in key jurisdictions around the world (e.g. the United Kingdom).

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?**

As previously noted, we consider crypto assets to include smart contracts along with tokens, oracles, and other supporting mechanisms and these should be assessed using the functional perimeter test.

One regulatory mechanism that could be explored is the development of standards or guidelines that govern the design framework of smart contracts. An accredited industry body would publish auditable and verifiable smart contracts standards and blueprints to allow digitisation of various classes of securities. The standards would support the industry and establish a minimum bar for security and capabilities within smart contracts. This approach has been applied in other jurisdiction such as Switzerland, where the local bank Cité Gestion tokenised its own shares on public Ethereum blockchain in January 2023. The tokenised shares of Cité Gestion were produced using the CMTAT, an open-source smart contract issued by the CMTA [Geneva-based Capital Markets and Technology Association, which had just recently published market guidelines].[2]

In addition, to the development of standards, a requirement could be imposed on firms to ensure that independent auditors have audited the smart contract for selected token types before they are issued to certain categories of end consumers.

These changes would need to go hand in hand with broader government-led reforms including the creation of a similar legislative regime to Germany's Electronic Securities Act (eWpG) which would ensure parity between traditional and digitally native products.

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?**

No comments to add.

[2] https://www.finews.com/news/english-news/55454-cite-gestion-taurus-tokenization-stock.

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?**

If AMMs are fully disintermediated and their underlying protocols sound (i.e. audited and secured) then they have the potential to be lower in risk and able to drive greater market transparency and competition. As more asset classes are tokenised, it is likely that AMMs will become a necessary and common part of the crypto ecosystem. This is not dissimilar to the experience in other electronically traded financial markets (e.g. foreign exchange). Given the potential rise in usage, any distributed exchanges (e.g. Uniswap) that develop and offer mature AMM capabilities will need to be regulated like other token exchange services.

Overall, the regulatory framework for crypto assets not only needs to manage current risks in the crypto ecosystem but will need to be flexible and able capture and manage emerging risks, while continuing to enable innovation in the sector.