

3 March 2023

Director
Crypto Policy Unit
Financial System Division
Treasury
Langton Crescent
PARKES ACT 2600

By email: crypto@treasury.gov.au

Dear Treasury,

We welcome the opportunity to submit a response in relation to the proposed token mapping consultation paper, February 2023 (Consultation Paper).

These initial steps in regulating digital assets serve a significant opportunity to discuss what appropriate legislative frameworks are required to:

- provide regulatory certainty to support the continued growth of the industry;
- protect consumers;
- promote competitive offerings;
- facilitate technology development and innovation; and
- help solidify Australia as a competitive market that can grow and attract talent.

We have considered some of these matters in our previous submission as The Fold Legal in response to the Treasury's "Crypto asset secondary service providers: Licensing and custody requirements" Consultation Paper, 21 March 2022 (**Previous Submission Paper**).

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As we noted in the Previous Submission Paper, embarking on legislative change of this kind is no small feat and it is essential that we take the opportunity to ensure that any proposed legislative framework meets its intended objectives and provides industry with a clear and appropriate transition pathway.

We note that we have also contributed heavily to the submissions submitted by Blockchain Australia and Fintech Australia.

We would be happy to discuss any aspects of our submission with the Treasury and we look forward to the outcome of the consultation process.

Yours faithfully,

Submission Paper

In response to Treasury's Consultation Paper on Token Mapping – February 2023

About Hamilton Locke - Funds and Financial Services

Hamilton Locke is Australia's fastest growing law firm, which is focused on transforming the traditional approach to corporate and commercial legal services. Hamilton Locke is a full service offering corporate law firm, which is a part of the HPX Group, that delivers essential corporate services across legal, governance, risk and compliance helping businesses grow and thrive.

The Funds and Financial Services team at Hamilton Locke (formerly, The Fold Legal) has become one of the go-to firms for cryptocurrency, blockchain, fintech and insurtech businesses seeking regulatory advice. Our Funds and Financial Services team is also one of Australia's largest as a result of the merger between The Fold Legal and Hamilton Locke.

We are known for our technical expertise and industry knowledge, which we use to provide practical solutions for our fintech, cryptocurrency and digital asset clients. Our expertise in financial and credit services is recognised by our ranking in Chambers and Partners Asia-Pacific and FinTech Legal Guides. Reflecting our commitment to client service, we also won Best Law & Related Services Firm (<\$30mil) across several specialist categories in the past 3 years based on direct feedback from our clients.

Collectively, we have been deeply steeped in the fintech space since early 2013 and we continue to strengthen this experience as one of Australia's largest and most diverse financial services practice.

We are technical specialists that have a broad and deep understanding of blockchain technology, cryptocurrencies and digital assets, exchange, Decentralised Autonomous Organisations (DAO), alternate platforms and cryptocurrency products and service offerings. Our knowledge of cryptocurrencies and digital assets, combined with our traditional financial services expertise, is market leading. We use our industry knowledge and expertise to deliver practical, compliant and innovative solutions for our clients. We have worked with cryptocurrency and digital asset exchanges, miners, cryptocurrency and digital asset payment businesses, cryptocurrency and digital asset platforms, DAOs and token issuers to design innovative and compliant offerings.

We are a partner and member of Blockchain Australia, FinTech Australia and InsurTech Australia.

This submission was led by Jaime Lumsden (Partner), Nicholas Pavouris (Associate) and Annabelle Parmegiani (Lawyer) with support from the Funds and Financial Services team at Hamilton Locke.

Executive Summary

The regulation of the crypto industry is an important step for both the local and global crypto industry. As we have seen with other industries (most notably new energy and payments), uncertainty stifles innovation, and a clear pathway to regulation provides the strongest foundation for true innovation, growth, consumer protection and a competitive market.

We generally support Treasury's position that the regulatory regime should be included as part of the existing financial services regime, where there is a financial purpose / function for the crypto asset or service. We have noted throughout our submission where we believe it is appropriate for there to be no additional regulation (i.e. where there is no financial purpose such as in ticketing, privacy and digital art). We consider that some of the existing definitions of financial services / products need to be amended e.g. where they refer to "a person" as a criteria for meeting the definition, as often there is no person in blockchain contexts. Some new categories of financial services or products may need to be developed e.g. in relation to intermediated staking / yielding (other than on a SaaS basis). We do not think OTC spot trades of crypto tokens should be a financial service (consistent with the treatment for OTC spot trades of foreign currency).

We support Treasury's objectives in trying to reduce scams and fraud when transacting with crypto. We suggest that consideration be given to disclosure doubling as consumer education by requiring (or at least allowing) it to be made by way of video explainers and "how to" content (which is more consistent with the target audience for those engaging with crypto). We believe that the key regulatory safeguard for consumers will end up being in the design of the custody requirements. We believe that the crypto custody provisions should focus on decreasing the ability for scammers to access digital assets, increasing the ability for a regulator to pursue the theft of digital assets stolen by a project (i.e. rugging), impose minimum standards for storage of private keys, and provide regulation for outsourcing custody obligations. We recommend caution in attempting to regulate to eliminate scams as this may simply result in an over-regulated environment which stifles innovation and forces providers and consumers into jurisdictions they consider more friendly or accessible.

In terms of taxonomy, we think that whilst it is important for there to be an overarching general definition of crypto tokens and networks, there may need to be considerable granular taxonomy developed. How much of this is required is impossible to determine at this stage and we believe that ultimately Treasury must create as much taxonomy as is required to achieve the outcome that is required. That said, we consider it appropriate to start with a high-level principles-based taxonomy and develop more granular definitions if required e.g. to give effect to exemptions.

In relation to wrapped real-world assets, our view is that no reforms are needed, because based on our consideration of various types of tokens (as outlined in this submission) consumers:

- already have the protections of the underlying asset (because they own it);
- only have a right to exchange the token for the underlying asset, so do not have the protections of the underlying asset (and should not, because such protections do not flow through to the holders of other such instruments that are not on the blockchain) and the consumer may also have access to financial services regulatory protection (where the token is a regulated derivative); or
- should not have the protections of the underlying asset (because of the limited nature of the right of the consumer to that asset).

We understand that the pathway to regulation for this industry will be quite iterative and we welcome this and believe that it is for the benefit of all to take the appropriate time to ensure that the long-term implications of such significant regulatory reform are appropriately considered.

Submission

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

The Government is ultimately responsible for regulating the crypto ecosystem in Australia. The Government already plays an extensive role in regulating the industry. We think it is worth being clear that, as noted in the question, crypto is an ecosystem and as such a majority of players and products offered within that system are already regulated by existing legislation because that legislation applies to the specific use cases. Whilst we believe that the Government can do more in regulating parts of the ecosystem, it is imperative to understand that it is difficult for the Government to try and regulate an entire industry with multiple use cases across a number of fields as though each use case is the same. In saying this, we believe that the regulatory response of Government needs to be purpose built and provide a clear understanding of what kinds of crypto use cases the Government is seeking to regulate and which are already adequately protected under an existing legislative framework.

We support the Government's intention to develop technology neutral regulation. The crypto industry evolves at a fast pace, which may inhibit the Government's ability to constantly update and renew regulation. We believe that technology neutral regulations are the only appropriate path to developing future-proof regulations. Such regulations provide the Government the opportunity to position Australia as a global leader in regulating crypto and driving innovation.

We believe that the Government should primarily be regulating the industry in order to:

- encourage innovation and supporting new Australian business;
- ensure that products developed are safe for consumers; and
- ensure that markets are fair and efficient.

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

Including the appropriate crypto assets and services into the existing financial services regime may afford consumers some additional protections but we suggest that improvement to consumer outcomes also requires increased consumer education. Many crypto product offerings are already captured by existing consumer protection laws contained in general consumer law protection and, where certain crypto assets or services amount to financial products or credit products, the protections afforded and managed under the existing financial services and credit regime also apply. However, even with the existing and not insignificant consumer protection regime, consumers are often at risk of harm as they do not understand the risks of their financial investment. Consumers are often most at risk when dealing with novel or complex financial products that have a high level of risk, such as options or contracts for difference, and some crypto assets and services have similar levels of complexity. Disclosure may be part of the solution, but we already know that disclosure is often ineffective. We suggest that consideration be given to disclosure doubling as consumer education by requiring (or at least allowing) it to be made by way of video explainers and "how to" content (which is more consistent with the target audience for those engaging with crypto).

Further, any regulatory change will have limited impact on protecting Australian consumers from offshore service providers. The proposed regulations will only target those business that carry on business in Australia or who are directly inducing customers/investors in Australia (which would be aligned with the current approach under s 911A and 911D of the Corporations Act). There are little additional regulatory levers that can be pulled to protect consumers accessing to protect consumers from offshore risks. The crypto market is designed to be global and accessible anywhere as well as decentralised. We believe that better consumer outcomes will be achieved if the Government develops regulations that foster the Australian crypto industry and prevent providers from moving offshore. This may require Treasury to take a big picture perspective when developing regulations, as any regulations that provide air-tight consumer protection will not be effective if they cannot be enforced. One option may be to create a "passport" or "equivalency relief" regime which allows offshore providers who already have equivalent licences in other recognised jurisdictions to be easily recognised under relief in order to reduce the incentives for providers to wholly operate offshore.

Even for providers who do operate onshore, there are also issues around the use of poorly disclosed offshore contracting entities for the provision of some services (often to avoid higher levels of regulation, such as for crypto futures) and / or the location of the entity which has custody of the assets. Consideration should be given to a requirement to onshore crypto assets to improve the ability to recover in the event of insolvency (in addition to specific custody rules for the holding of crypto assets in custody generally) and clear disclosure mandated for contracting arrangements so consumers know which entity they are dealing with and what regulatory protections are available.

Question 3 – Are there solutions that could be applied to safeguard consumers that choose to use crypto assets? 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?

Appropriate custody requirements and minimum token listing requirements for exchanges alongside increased education as well as fostering a strong Australian crypto market will assist in improving consumer outcomes when interacting with crypto. The global nature of crypto assets means that offshore based scams are impossible to prevent and, as such, there will always be an element of risk for Australian consumers which sits outside of the regulatory purview. As noted above, increasing consumer education and creating a strong domestic crypto market will increase positive consumer outcomes. As Treasury will note from its work across other industries, there is no amount of regulation that will eliminate fraud and scams and this is why education is so important. We note that many exchanges in Australia have strong anti-fraud and scam processes in place to educate and identify potential fraud and risk.

We believe that the key regulatory safeguard for consumers will be in the design of the custody requirements. Although we do not think that the current custody provisions in the financial services regime are appropriate to apply to crypto given the nature of how these assets exist and are used, we think that developing a fit-for-purpose custody regime will offer the most safety for consumers. We believe that the crypto custody provisions should focus on decreasing the ability for scammers to access digital assets, increasing the ability for a regulator to pursue the theft of digital assets stolen by a project (i.e. rugging), impose minimum standards for storage of private keys, and provide regulation for outsourcing custody obligations.

As previously noted, there is a certain amount of scam behaviour which exists outside of this jurisdiction that cannot be prevented by regulations. It would not be possible for any regulator to assess all tokens produced globally and available for purchase and update a list in a timely manner to offer any real protection to consumers. Whilst exchanges may list tokens on their platform, they are not the product issuer and provided that they satisfy their internal criteria for listing such tokens, the consumer has to accept some level of risk. The nascent nature of the crypto market means that the area between poor investment into an unsuccessful project and intentional scam can often be quite grey. One option is minimum listing criteria that regulated exchanges must follow when listing a token, however the difficulty with this approach is that it may simply lead to consumers using offshore exchanges. We recommend caution in attempting to regulate to eliminate scams as this may simply result in an over-regulated environment which stifles innovation and forces providers and consumers into jurisdictions they consider more friendly or accessible.

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

We are of the view that the concept of exclusive use or control appears to be a feature of crypto tokens and networks but it is not the defining feature and there are a number of the elements that would need to be captured in defining crypto tokens and networks.

We think that for the purposes of developing a general definition of crypto token and crypto network (which we assume would be developed using a principles-based approach in the same way the Corporations Act currently defines financial services and products), there needs to be a list of

factors/elements that make up a crypto token or network. We think that whilst 'exclusive use or control' may form one part of that definition, it should not be the sole factor. There are problems with using a term like 'exclusive use or control' and this includes being able to accurately define the terms 'exclusive' and 'control' with reference to crypto and ensuring that these definitions will capture the relevant tokens. Consideration should be given to the cryptographic nature of crypto tokens and crypto networks as a defining or relevant feature.

We think that whilst it is important for there to be an overarching general definition of crypto tokens and networks, there may need to be considerable granular taxonomy developed. How much of this is required is impossible to determine in the absence of specific proposed regulation, as in our view, the taxonomy and definitions necessary, flow from the outcome that is desired. That is, one must create as much taxonomy as is required to achieve the outcome that is required. For example, it may be possible to use high-level taxonomies to capture assets and services, but a more granular taxonomy may subsequently be required to manage exclusions.

Question 5 – This paper sets out some reasons for why a bespoke 'crypto asset' taxonomy may have minimal regulatory value. What are additional supporting reasons or alternative views on the value of a bespoke taxonomy? What are your views on the creation of a standalone regulatory framework that relies on a bespoke taxonomy? 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 support the approach by Treasury to apply a principles-based approach to regulating and mapping tokens.

In terms of the creation of a standalone regulatory regime, we consider the following to be the appropriate basis for regulation:

Existing Financial Products

Some crypto products are quite clearly financial products and should continue to benefit from the protections afforded by the financial services regime. For example, if a share or a debenture were placed onto the blockchain or involved the use of crypto tokens, it should not cease to be protected under the financial services regime.

We note that currently there are few instances of existing AFS licensees placing traditional financial instruments on the blockchain. There are a number of barriers to them doing so, one of which is that no crypto exchanges currently hold an AFS licence, meaning that any tokenisation of financial products has limited trading opportunities. This is one reason we consider that regulation of financial function crypto assets and services should be regulated under the existing financial services regime – this barrier will continue if a standalone crypto regime is created (and may increase, as traditional AFS licensee may now need the additional crypto licence).

Another barrier to the tokenisation of traditional financial products is the markets licensing regime. Some consideration needs to be given to its suitability in blockchain use cases to ensure it is fit for purpose before increasing the regulation of crypto assets and services under the financial services regime.

New Financial Products

Some crypto assets and services look like financial services and have financial services functions, but:

- are not regulated due to technicalities e.g. the fact that the definitions for things like managed investment schemes and facilities to make a financial investment hinge on the existence and involvement of a "person". In many token systems there is no "person", so these crypto assets and services can never meet the definition; or
- some crypto assets or services can be structured to avoid or limit regulation, even though the

function is the same, for example, staking and yielding services offered through intermediaries can be structured as a managed investment scheme, a debenture, possibly a derivative, and other unregulated structures.

Accordingly, the financial services regime should be adjusted to clearly capture crypto assets and services which are not captured due to a technicality, or to provide consistency in the treatment of crypto assets and services which provide opportunities for providers to make structural decisions to minimise their regulatory obligations.

This should include amending the “facility” definitions for a facility to make a financial investment, a facility to manage a financial risk, and a facility for making non-cash payments, to ensure they are fit for purpose in capturing innovative crypto assets and services which nonetheless have a financial function.

It may also include revising any specific product definitions that similarly depend on the involvement of a “person”, and the introduction of new categories of financial services/products specific to crypto assets or services that are intended to be captured. For example, intermediated staking or yielding (other than where offered on a strictly SaaS basis), needs to be regulated under a new category to ensure consistency. Other crypto assets and services that have a financial function include trading crypto on margin (not currently regulated as a financial service), collateralised lending (may be regulated as consumer credit, but not if the lending is done via a decentralised protocol), and liquidity pools (not currently regulated, as doesn’t meet the definition of a managed investment scheme as no “person” is involved).

The regulation could use high-level descriptions, like “intermediated crypto asset”, in which case exclusions will be required to carve out anything that is unintentionally caught, or it could involve defining specific new financial products e.g. a definition of a “crypto yielding platform”. The latter approach involves more granularity but also less flexibility in terms of future-proofing. A high-level taxonomy is more likely to capture future crypto assets and services which have not yet been conceived without the need for legislative intervention, and for this reason, given the fast evolution of crypto assets and services, a high-level taxonomy should be preferred. Granular definitions should only be developed where strictly required.

We do not think it is appropriate for “crypto tokens” broadly to be specified as a financial product, as we think it is inappropriate for all tokens to be regulated in this way. We also do not think it is appropriate for currency or store of value type tokens, such as BTC and ETH, to be regulated as financial products, although note our later comments about banking business and stored value in respect of currency backed stablecoins.

We do not think over the counter (OTC) spot trades of crypto tokens should be regulated as a financial service, consistent with the fact spot trades of foreign currency are not regulated as a financial service. Of course, if a token is independently a financial product, then an OTC trade will amount to “dealing” in that product, and appropriate licence authorisations will be required.

Non-Financial Products

Certain crypto assets do sit completely outside the financial services regime and we do not necessarily believe that bespoke regulation is necessary for such products at this stage (these include, as an example, genuine NFTs, royalty use cases, and tokens used in ticketing). There are numerous other regimes including general consumer protection laws that already regulate these products and should continue to do so, and where more purpose-built regulation exists for a use case (e.g. ticketing) that should also continue to apply. This is because we take the view that the function should be regulated not the tool to access it. Similar to the idea that a financial product should not cease to be regulated just because it is on the blockchain, something that is not ordinarily regulated should not become regulated just because it is on the blockchain.

Custody

It may be appropriate for custody obligations to sit outside of the financial services regime, as this is an example of regulation that needs to apply to the tool and not the use case, as the same protections should be afforded for any crypto asset that is held in custody, irrespective of its status as a financial product. That is, it isn't necessarily desirable to opt an entity into the financial services regime for custody if it isn't otherwise regulated by the financial services laws.

However, some consideration needs to be given to which entities are likely to be the ones holding assets in custody. If the majority of assets to be protected (whether financial products or not) are held inside cryptocurrency exchanges or other crypto asset platforms, imposing the custody requirement inside the financial services regime may not result in the imposition of financial services obligations on entities that are otherwise disconnected from the financial services regime i.e. if all the entities providing custody are already likely to need an AFS licence for other reasons, it may be appropriate to put the custody obligation inside the financial services regime. Alternatively, if using a properly AFS licensed custodian was a complete exemption from needing a licence with a custody authorisation, it may be acceptable to put the custody regime into the financial services regime. Consider the use case of collateralised lending where the lender promises to hold the collateral in cold storage. If collateralised lending is not a financial product (and lending generally isn't, except for margin loans), then placing the custody regime inside the financial services regime would opt the lender into the AFS licensing regime for an incidental function. If, however, the lender were completely exempt provided they used an appropriately licensed custodian, then it would make sense to place the custody regime inside the financial services regime. We note this is different to the current regime for financial products, where outsourcing custody still requires the person to hold an AFS licence to cover "incidental" custody services with a reduced net tangible asset requirement.

If the custody obligation is placed inside the financial services regime, the definitions used will need to be broad enough to provide custodial protections to any crypto token that requires it, irrespective of whether it is a financial product. This is unlike the current custody regime, which only applies to the holding of financial products in custody.

We do not believe that the current custody obligations for financial services are necessarily appropriate in their current form due to the fundamental differences in the underlying technology of the blockchain. Consideration needs to be given to what a custodial regulatory regime for crypto assets and services should look like so that it is both appropriate and manages the relevant risks. This will require the participation of industry to identify and explain the technical differences which affect the custodial risks.

Markets licensing

Lastly, we consider that the current markets licensing rules should not be assumed to be fit for purpose for the crypto industry. We note that as soon as any crypto assets or services are classified as financial products, there is a risk that the markets licensing rules will apply. These rules need to be reviewed, again with technical industry participants, to identify where rules are impractical or unnecessary or where new rules may be needed. If the markets licensing cannot be reviewed concurrently with the creation of licensing for crypto assets and services, then there needs to be a transition period. We think this is quite important because the current markets licensing regime applies to a very small number of participants, but it is likely that if crypto assets or services are regulated as financial products, with no adjustments to markets licensing, this will likely result in a hundreds or thousands in the space required to apply for a markets licence. The current markets licensing regime is not geared for a large number participants, from both a licence application perspective and also a regulatory oversight and enforcement perspective.

Question 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.

Question 6(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?

Our view is that no reforms are needed, because based on our consideration of the various types of tokens that might arguably be wrapped real-world assets, consumers:

- already have the protections of the underlying asset (because they own it);
- only have a right to exchange the token for the underlying asset, so do not have the protections of the underlying asset (and should not, because such protections do not flow through to the holders of other such instruments that are not on the blockchain) and the consumer may also have access to financial services regulatory protection (where the token is a regulated derivative); or
- should not have the protections of the underlying asset (because of the limited nature of the right of the consumer to that asset).

To reach this conclusion, we have considered what types of token may constitute wrapped real-world assets and have come up with the following possible categories.

Category 1

Tokens that denote ownership of the underlying asset i.e. the token is the “record” or “proof” of ownership. Examples include Gold and Silver Standard and other similar bullion-backed tokens where the bullion is “on bailment” with the token issuer. It could also include financial products, such as interests in a managed investment scheme or securities, where the token forms part of the registry function.

In this case, the token holder is considered to have legal ownership of the underlying asset and, as such, they would get the same regulatory treatment (as the case may be, depending on the nature of the underlying asset). This category presumably also includes NFTs which give the token holder intellectual property rights in certain forms of art or other intangible property.

For this category of wrapped real-world assets, we are of the view that existing protections afforded to customers are already sufficient because the customers that own these tokens are the legal owner of the assets and therefore have the protection that is afforded to them already under law.

Category 2

Tokens that are derivatives that give token holders rights to exchange the token for an asset. In this case, the token holder does not own the underlying asset, in the same way the owner of a share option does not own the underlying asset, and owners of share options do not have the same protections as owners of shares. Rather, derivatives are regulated already under the Corporations Act, and holders of derivatives get protections under that regime. Currently that regime divides derivatives into whether they can be settled by delivery of tangible property or not, with derivatives that can be settled by delivery of tangible property currently unregulated, while those that cannot are regulated as a financial product.

We believe that for these wrapped real-world assets, the protections (where they apply) currently afforded in relation to derivatives is appropriate and no reforms are required. Any protections extended in relation to the underlying assets should not extend to token holders of the derivative token, because other holders of derivatives do not have the protections of underlying assets.

Category 3

Tokens that represent a fractionalised interest in an underlying asset or group of assets. Unless there is some mechanism for the token holders to exercise day-to-day control over the token, this structure is generally likely to still mean the token is an interest in a managed investment scheme, even though

not set up with the traditional unit trust / registry structure as mentioned in Category 1. This type of scheme would be more akin to horse syndicates, where a group of people have joint ownership of an asset without a unit trust structure. It is, however, still legally a managed investment scheme. We have put this in a separate category because, to the less informed observer, the underlying or wrapped real-world asset might appear to be the fractionalised asset (although it is, in fact, the interest in the scheme). We have used this category (as distinct from Category 1) so we can address both whether the token holder should have the protections afforded to either the managed investment scheme created by the fractionalisation (even without formal structures) or the underlying fractionalised asset.

In respect of the interests in managed investment schemes created by the fractionalisation, this underlying asset is dealt with in Category 1 and the situation remains the same – as the legal owner of an interest in a scheme (even though there is no formal trust structure / registry), the token holder has the usual protections afforded under the Corporations Act.

In relation to the underlying fractionalised asset, if there is no “holding on trust” of the underlying asset (as is often the case where a scheme is created by joint ownership without a unit trust structure), the token holder has joint legal ownership of the underlying assets and has the same protections as a legal owner of those underlying assets. Therefore, the token holder already has the same protections in relation to both categories of asset that exist in a Category 3 structure.

The underlying assets may also be managed by a third party (e.g. the syndicate manager is an example of this in the horse racing syndicate) and this person will need to hold an AFS licence as they will be providing financial services in respect of an interest in a managed investment scheme. This provides the consumer with adequate protection in relation to the asset the manager is managing. We therefore believe that no further reforms are required.

Further, it is also possible that this Category 3 may include token holders of fractionalised assets where the token holders do have day to day control of the assets (which could be facilitated by governance mechanisms on the blockchain). In this case, then the token is not likely to be a managed investment scheme, however if this occurred, the token holders would still be joint legal owners of the real-world asset and will have the same protections as any other owner of that real-world asset (in the absence of the token). For example, if it was real property, all the token holders would be listed as joint tenants or tenants-in-common (as applicable) on the property title. We believe that in this case, token holders already have the same protections as owners of the real-world assets (because they are owners of the real-world assets) and no changes are required.

Category 4

Tokens that are “nominally” backed. These are tokens where the token issuer makes certain promises to do or not do certain things, but none of those promises relate to transferring ownership of the underlying asset to the consumer. An example is the Carbon Token which is nominally backed by Australian Carbon Credit Units (ACCU). These tokens are “nominally” backed because the Registry for ACCUs does not presently allow retail investors to legally own an ACCU. The token is essentially an artificial way to drive demand in a closed market. Token holders do not have legal or beneficial ownership of the ACCU and have no right to swap their token for an ACCU, so it does not fall into any of the above categories.

In this case, we do not think that reforms to extend to consumers the protections available in relation to the underlying asset are appropriate. This is because the consumer does not own the asset and is never intended to own the asset.

Category 5

We note there is arguably a fifth category, being stablecoins backed by currency e.g. USDC, where the consumer deposits a US dollar, receives a minted USDC, and the US dollar is represented as being held in reserve to be redeemed on demand. The structure of a stablecoin can be regarded as a promise to return what was deposited or as a promise to honour a certain price for the token, but in this context it is immaterial as the underlying asset is “money” which generally has no regulatory

protections and we do not support a different regulatory treatment applying solely by virtue of the fact that the blockchain is used. Therefore, it is not relevant to consider this class of wrapped real-world asset in this question. We note, however, that stablecoin activity bears some resemblances to banking business, though that is outside the scope of this consultation. We are aware that APRA is already considering the implications of stablecoins in a banking and stored value context.

Question 6(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?

We have again considered this question in relation to the above categories.

Category 1

As noted above, these are typically bailment (tangible assets) and / or proof of ownership (intangible assets) tokens.

In a historical bailment arrangement, a person owns the goods, and bails them to a second person. It is always known by both parties that the goods physically existed and that the owner originally had possession and ownership. In a token arrangement, the token holder usually simultaneously buys and bails the underlying asset to the token issuer (on token issue) or buys the token from another token holder, in both cases without ever seeing the underlying assets or any proof of the existence of the underlying assets. Because of this, there should be regulation to ensure issuers can meet their obligations to deliver the underlying assets and that there is appropriate custody of goods.

In the intangible assets example (e.g. share registers, unit trust registers), there are no physical goods to be delivered and many of these arrangements will generally be adequately managed under financial services regulation.

Category 2

Derivatives that are regulated under the Corporations Act require the issuer to hold an AFSL and are subject to general obligations such as honesty, efficiency and fairness. Failing to ensure the issuer could meet their obligations under a token derivative would be a breach of these general obligations. We believe that there should be no change to these requirements as they apply equally across tokenised derivatives and non-tokenised derivatives.

For derivatives that are not regulated as financial products, there is currently no regulation (apart from general contract law) to ensure that derivatives issuers deliver the physical goods (as these are excluded from the Corporations Act) e.g. put and call options over assets like residential dwellings. If this were to be changed because of the use of the blockchain, in our view it should be changed for such unregulated derivatives which are not on the blockchain, as there should be consistent treatment irrespective of the medium used.

Category 3

Where these tokens are structured as unit trusts with beneficial ownership of underlying assets, there are already custody requirements for the holding of the real-world assets and Category 1 applies.

Where they are managed investment schemes without the unit trust structure, and token holders do not have day to day control of the real-world assets, then the custody requirements in the Corporations Act will still apply to the person who has day to day control.

If the token holders do have day to day control over the real-world assets, it doesn't seem necessary for there to be regulation of the token issuer to meet their obligations to deliver, as it seems the token has been set up from the start to give the token holders, and not the token issuers, control, so there is nothing to deliver.

Therefore, in all cases in Category 3, we do not consider reform is required.

Category 4

In this category there is no underlying asset to be delivered to the consumer but promises of some kind are still being made. However, we believe that the existing misleading or deceptive conduct laws are sufficient to cover the conduct in this case and no reforms are required.

Category 5

It is our view that regulation is needed to ensure that issuers of stablecoins backed by currency meet their obligations to hold and return currency upon request. This is demonstrated by continuing issues around Tether's holdings and whether it has sufficient available reserves.

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

Question 7(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?

We are of the view that increasing disclosure obligations in many cases does not have the effect of clarifying for consumers the risks associated and this has been widely observed in the financial services sector to date. We are of the view that what is most appropriate is for customers to understand practically the process of what is occurring, and this should be taken into account when determining what, where, and how as it relates to disclosures.

An excellent example of the fraught issue around disclosure is intermediated staking and yielding services. It is commonplace for these services to be disclosed in terms that obfuscate the legal and contractual nature of the arrangement that is being entered into, but also for such disclosures to be buried in hard to find locations and / or in complex terms and conditions (and, as mentioned earlier, it can be difficult to identify exactly who the counterparty is and where they are located).

Effective disclosure would involve transparently disclosing such matters to consumers in a way that is meaningful to them. As an example, consumers would obtain more benefit from knowing that the yielding platform they are using involves the consumer lending money to a provider and it may be lost due to credit risk, rather than being told they are investing in a debenture. We think that disclosure on a less technical basis and more of a general risk basis is more meaningful and appropriate for consumers. For example, it is appropriate for consumers to know whether a crypto product or service is provided in Australia or offshore and whether an entity (if any) is providing the service. It may also be appropriate for disclosures to allow the use of videos and to consider mandating disclosures via easy-to-understand FAQs or "Key Facts", the latter of which reflects the current disclosure requirements of AFS licensees for some products.

Question 7(b) - What are some other initiatives that crypto asset service providers could take to promote good consumer outcomes?

We think that where products are captured under the financial services regime, the design and distribution obligations (DDO) should apply and the use of selling to a specified target market would assist in promoting good consumer outcomes. While we anticipate most tokens are not (at the current date) financial products, and therefore there is unlikely to be DDO on many tokens, many crypto asset service providers are creating intermediated services or products which are (or should be) regulated financial services or products and it is appropriate for DDO to apply at this level.

We note that current marketing guidelines related to misleading and deceptive conduct already apply to all products and will continue to apply, which is a significant protection for consumers.

Question 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.**

Are there any kinds of intermediated crypto assets that ought to be specifically defined as financial products? Why? Are there any kinds of crypto asset services that ought to be specifically defined as financial products? Why?

Where crypto assets / services are clearly a financial product, they should continue to be regulated as such. It may be appropriate to define certain crypto assets and services as financial products where:

- **Intention** – The asset or service is currently excluded from the definition of a financial product but there are reasons to want to regulate that product or service e.g. because the product or service has the same financial product purpose / function / intended outcome for the consumer. For example, this might include buying / selling crypto on margin. Margin lending is a financial product, but because it is defined by reference to financial products, and cryptocurrency is not generally a financial product, trading crypto on margin is unregulated, even though it carries more or less the same risks as trading shares on margin. This may also possibly include some assets or services which are functionally identical to currently defined financial products but which are excluded on a technicality e.g. the definition of a facility for making an investment requires that there is a “person” to whom money (or money’s worth) is provided. In decentralised crypto assets / services, there often is no “person” and so they avoid regulation. Some consideration needs to be given generally to how to regulate and enforce against decentralised services / products, and whether a ‘responsible person’ should and can be designated and / or what responsibility should be attributed to the developer who wrote the code (if any);
- **Uncertainty** – There is uncertainty about whether a particular asset or service is caught, or there is scope for service providers to decide how regulated an offering will be, based on structuring decisions, even though the intended outcome for consumers is functionally identical. For example, there are a variety of yielding products on the market, some of which may be structured as managed investment schemes or debentures (subject to different regulatory regimes for retail clients) or as an entirely unregulated product. Other examples might include liquidity pools / market making using the lending / borrowing of crypto assets. Where this type of uncertainty occurs, defining a new financial product will create certainty and regulatory consistency;
- **Efficiency** – Where regulating the intermediary service is the most efficient way to regulate the sector and provide certainty and protection to consumers, for example, a number of tokens are decentralised or issued by issuers offshore and it is difficult to impose requirements upon them, so regulating exchanges by which those services are provided may be the most efficient way to provide regulatory certainty. As we have outlined above, regulators should be mindful that because of the nature of the assets, consumers will continue to be able to access services from offshore exchanges that do not have a local presence or need a local licence – which is an approach that has been seen in other financial services. The alternative is to find some way to determine a responsible person for regulated services / exchanges who can be held to account under a regulated model.

Further, we believe that if a product does not already fit within the existing financial services regime, or one of the use cases above, then there is no need to regulate such a product under this regime (including for the kinds of products we have outlined above (such as genuine NFTs)).

Question 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 think that it is appropriate to restrict the networks in which tokens must be built in for sale in Australia. The network is chosen for a myriad of reasons and is one of the factors that drives innovation. We think that if there are very legitimate reasons for a public network to be prohibited, that network should be prohibited directly by legislative instrument as opposed to prescribing the approved networks.

Question 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?

As we have outlined in previous answers, some assets should be added as financial services. We believe that products that exist outside of the financial services framework do not require separate bespoke requirements that are not already included in other regulation.

Question 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?

We think that there is scope for additional regulation for marketing and promotional material for crypto ecosystems. We note that there are already protections for misleading and deceptive conduct in marketing materials. We note that adding crypto regulation to the Corporations Act will likely mean that some form of the existing marketing regulation will apply to crypto products including the general advertising warning. We would also expect that regulation will allow ASIC to exercise its powers under the ASIC Act in relation to stop orders, enforceable undertakings, public warning notices, infringement notices, publishing corrections and adverse publicity amongst others to manage any associated risks. We are of the view that that there does not need to be any additional marketing or promotional material regulation.

Question 12 - Smart contracts are commonly developed as 'free open-source software'. They are often published and republished by entities other than their original authors. What are the regulatory and policy levers available to encourage the development of smart contracts that comply with existing regulatory frameworks? What are the regulatory and policy levers available to ensure smart contract applications comply with existing regulatory frameworks?

We are of the view that it is quite difficult to regulate free open-source software. There is no obligation on these creators to comply with any specific regulation and it would be impossible for a creator offshore (without specific engagement) to know what the intended use of their smart contract will be. Where a smart contract amounts to a financial product, then the obligation to ensure that the smart contract meets any policy objectives should sit with the developer of the specific regulated product, where it is created in Australia, under the DDO obligations.

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

We think that one of the key differences between pawn-brokers and collateralised lending is in the value proposition of the collateral. Typically, with pawn-broking the asset is a second hand good with a fairly predictable and stable value – this is the hallmark of what makes it a valuable proposition for

the pawn-broker. For non-recourse collateralised lending, there is typically only an ability to accept prominent mainstream tokens such as Bitcoin, Ethereum, Litecoin and USDC.

While we agree that many of these assets are highly volatile and their value fluctuates, they are best compared with securities lending rather than a pawn-broking arrangement. To make that comparison closer, if a specific crypto token were regulated as a security in Australia, then any collateralised lending offered using that token would be regulated in Australia in the same way as traditional securities lending. We believe that they both contain the same risk profile. Securities lending is regulated as a non-standard margin loan under the Corporations Act when it is provided to retail clients.

Margin calls are often a feature of smart contract collateralised lending. For example, businesses that are enabling consumers to use BTC or ETH as collateral to obtain a home loan, or a loan of funds that can be used for a home deposit (where the BTC or ETH cannot), will often require additional collateral to be provided if the value of the collateral already provided falls too far. This is not a feature of pawn-broker lending, but is a common feature in margin loans.

Some businesses that offer collateralised lending are making contractual promises to hold the collateral in cold wallets and will not trade them or rehypothecate them, while others make no such promises and may choose to trade collateral on their account. This is also different to pawn-broking and highlights the different risks of theft and loss that relates to crypto tokens as collateral.

Lastly, the amounts of money being lent via collateralised lending are significantly larger than the amounts lent via pawn-brokers. Anecdotally, the target market for pawn-brokers is low-income earners and those on government benefits. Collateralised crypto lending has now started to move into the home loan space overseas and can involve loans that run into the millions. The amounts at risk (and therefore the value of collateral) is much higher than is the case in pawn-broking.

Question 14 - Some smart contract applications assist users to connect to automated market makers (AMM). What are the key differences in risk between using an AMM and using the services of a crypto asset exchange? Is there quantifiable data on consumer outcomes in trading on conventional crypto asset exchanges compared with user outcomes in trading on AMMs?

We have no comments at this time.