

Crypto Policy Unit

Financial System Division

Treasury

Langton Cres Parkes ACT 2600

Australia

By email: crypto@treasury.gov.au

Submission to Treasury: Australian Government's Token Mapping Consultation Paper of February 2023

Thank you for the opportunity to respond to Treasury's Token Mapping Consultation Paper, February 2023 (**Consultation Paper**).

LegalVision is a tech-driven commercial law firm that operates primarily online. The majority of our clients are start-ups and small to medium businesses, some of which are blockchain-enabled or crypto-related companies that are keen to see a considered and balanced regulatory regime deployed in Australia. As a major disruptor in the legal industry, we work with startup NFT projects including marketplaces, crypto softwares-as-a-service, crypto gaming, social philanthropy and digital currency exchanges. We support reforms that give clarity to industry participants to develop products, provide both consumer and investor protection and allow Australia to develop into an internationally recognised crypto hub.

In responding to the Consultation Paper, LegalVision, seeks to ensure that any changes proposed by government support the following objectives:

- Encourages innovation and ongoing investment into blockchain and other emerging technologies
- Facilitates the adoption and use of blockchain
- Provide appropriate investor protection
- Deals with both institutional and retail investors

Our responses to the specific questions in the Consultation Paper follow in Annexure A. We would welcome the opportunity to meet with Treasury to discuss any matters in our submission or the broader cryptocurrency evolution.

Annexure A – Responses to Specific Questions

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

Answer

We believe that the Government should play the following active roles in the crypto ecosystem:

- develop a regulatory framework for the crypto ecosystem that:
 - is clear and easily understood by industry participants, legal professionals and other professional advisors;
 - encourages investment into, and therefore the ongoing development and innovation of, crypto and blockchain businesses and technologies;
 - is conducive to making Australia a desirable jurisdiction for crypto business to be based and to operate;
 - sufficiently protects consumer rights; and
 - sufficiently protects investor rights;
- enforcement of the relevant regulatory framework;
- engage with other governments and their respective agencies in the prevention of crime (for e.g. money laundering and terrorism financing) and the development of a global set of rules for engagement in the crypto ecosystem; and
- continued consultation with industry stakeholders to ensure that the regulatory framework is up-to-date and enforcement efforts are in the public interests.

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

Answer

Consumer and investor protection is critical to the mainstream adoption of crypto products which have inherent risk. Safeguards can be developed in response to identifying where risk exists in consumer and investor interactions with the crypto ecosystem.

1. **Markets:** Crypto products are risky because of the volatility of crypto markets. For example, market manipulation by 'whales'.
2. **Intermediaries:** Consumers and investors are placed at risk because of misleading and deceptive marketing and advertising that may be perpetrated by intermediaries.
3. **Technology:** Software code may be written to execute actions which may harm consumers and investors. For example, consider rug pulls. Design of a crypto product can also carry a degree of risk. For example, consider algorithmic stablecoins and the Terra LUNA crash of 2022.
4. **Custody:** Consumers and investors who provide their crypto assets to intermediaries to deal with such assets on behalf of consumers and investors are at risk because of a lack of custody and security requirements imposed on such custodians.

In this process, we note the need to recognise that decentralised protocols would be difficult and may be impossible to regulate and on the other hand, arguably should not be regulated. Further, certain Australian laws already apply to and regulate certain crypto products.

We consider the following to be potential safeguards:

- **Legislation:** Further legislation is required where the current legal framework is not able to provide consumer and investor protections. This process can have regard to similar jurisdictions where licensing and custody regimes have been introduced in Hong Kong and Singapore for virtual asset service providers.
- **Enforcement and Guidance:** The appointment of an independent government body to oversee any regulatory reform and provide guidance is a form of safeguarding for consumers and investors.
- **Security:** Security standards and requirements would mitigate certain risks described above. For example, regular code auditing may be mandated or certain security requirements to be implemented for any custodial arrangement of crypto assets.
- **Education:** Education provided to consumers and investors will mitigate some of the risks described above.

Question 3: Scams can be difficult for some consumers to identify.

- Are there solutions (e.g. disclosure, code auditing or other requirements) 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?

Answer

Given the complexity of scams and the variability in sophistication between consumers, it will be impossible to completely prevent scams, whether in relation to crypto assets or any other product or service.

In our view, the following steps could be taken to at least reduce the frequency and/or quantum of scams:

- **Disclosure:** Regulation to require local exchanges to disclose their token listing processes, custody/storage arrangements and other key terms that govern transactions on that exchange.
- **Compliance Checks:** Routine compliance checks on local exchanges will also serve to boost consumer confidence in the crypto industry as a whole.

In implementing any of the above, we note that such policies should take into account compliance costs, so as to “price out” start ups or smaller industry participants.

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?

Answer

For the purpose of having a general definition of ‘crypto token’ and ‘crypto network’, the

concept of ‘exclusive use or control’ would be counterproductive.

Firstly, crypto tokens/crypto networks may, by their function or token system, not have exclusive use or control. For example, crypto asset providers may mint multiple crypto tokens, each with a non-exclusive right to use an artwork. These crypto tokens/crypto networks would easily circumvent a definition that employed that concept. There are also mechanisms which can be coded into a smart contract which defies the concept of exclusivity.

Secondly, the Consultation Paper itself states that the function (not exclusive use or control) of a product is the key link to Australia’s existing financial services regulatory framework. As such, any definition employing the concept of exclusive use or control will not be useful as it will require either an entirely bespoke regulation to sit aside Australia’s existing financial services regulatory framework or a significant overhaul of Australia’s existing financial services regulatory framework.

To the extent a general definition does not have to include any legal concepts such as “control”, we consider this type of definition to be one which can then be readily used across a range of legislation without changing the definition for each legislation.

Question 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?

Answer

There are many crypto assets that would currently not fall under the definitions of ‘financial product’ in the *Corporations Act 2001* (Cth) (**Corporations Act**), even when their function dictates that they should. Further, given the possible functions of crypto assets are effectively as broad as the possible functions of any contractual or social arrangement, for many crypto providers, it is unclear as to whether particular crypto assets are ‘financial products’. A bespoke crypto asset taxonomy will add value to regulations over the crypto ecosystem.

Preferably, it would be desirable, both for consumers as well as crypto asset service providers, to list out what types of crypto assets (based on their taxonomy) should belong in section 764A of the *Corporations Act*, or at least a regulation passed under section 764A(1)(m). Such a list, while based on taxonomy, does not need to be exhaustive. It can, much like the broader existing financial services regulatory framework, be based on the ‘function’ of the crypto asset.

The addition of the following into the list of ‘financial products’ will add greater certainty to industry participants and customers:

- crypto assets whose function involves the right, control, interest or ownership (in

- whole or in part) over a ‘financial product’; and
- intermediated crypto assets whose function involves the right, control, interest or ownership (in whole or in part) over a ‘financial product’.

For intermediated crypto assets, the same treatment should be applied regardless of whether there is one degree of intermediation or multiple degrees of intermediation. Similar, no differentiation should be applied whether the intermediation relies on intermediaries, agents, smart contracts, the function of the crypto asset or other crypto assets.

A standalone regulatory framework (one that does not tie in to the existing financial services regulatory framework) will not be helpful. It will add to the complexity of the entire regulatory framework and cause further uncertainty to crypto providers and consumers.

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.

- 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?**
- 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?**

Answer

Question 6(a)

Reading the question in full, a distinction should be drawn between crypto assets that are ‘backed’ by existing goods or assets such as gold or bullion for the purpose of providing price stability, and crypto assets that are redeemable for the underlying good, product or asset (which are more likely to be non-fungible but can also be fungible). Regulatory reform will depend on the many examples of ‘wrapped’ real world assets.

Take NFTs for example which can be backed by fine art paintings, artefacts, medical records or an intellectual property licence. If a motor vehicle is tokenised, it is presumable that the NFT itself would not be required to be registered or insured under statute as that motor vehicle would be in Australia. However, to comply with relevant state motor vehicle registration laws, despite having tokenised the motor vehicle, ownership should be “perfected” by way of formal registration with the relevant authorities. For such crypto assets, a full disclosure of the nature of the asset should be drawn to the attention of any purchaser or holder of the wrapped real world asset by the intermediary because of the potential impact to the purchaser. For example, purchasing a token backed by real property should be accompanied by a disclosure stating that “perfection” of title is subject to the relevant registrations with authorities, such as registering a mortgage or title. These will have financial consequences if not initially conveyed to the purchaser by the intermediary.

On the other hand, a wrapped real world asset such as a cryptocurrency or token that is backed by gold or bullion should be subject to the same regulatory treatment because of the creation of a secondary commodity market by the issuer of the token. These wrapped real world assets are more likely to be fungible. Without regulatory or government

checks, the creation of such markets can lead to significant financial crises and place consumers and investors at significant risk.

Question 6(b)

For the former category, reforms may not be necessary as existing law applies. For example, any contractual promise for a token to be 'redeemable' for a real world asset should be fulfilled by the issuer of the 'wrapped' real world asset.

For the latter category, reforms may be necessary to ensure that the issuers of such wrapped real world assets are able to provide, access or liquidate the backed assets when necessary.

Question 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?

Answer

Question 7(a)

If an industry participant has the financial and operational means to assist users with accessing that type of information and educating the user, then such a requirement will have benefit to the consumer. However, this may not be possible in practice due to financial and time constraints for industry participants, as such it may not be conducive to innovation and growth. The types of arrangements can also be separated into arrangements or information which are publicly available on public blockchain networks, and arrangements which may be classified as private and have commercially confidential characteristics.

Although a point can be made that financial institutions do not necessarily need to prove or provide to customers how their funds are managed or protected subject to disclosure obligations, and therefore, crypto asset service providers should not, when an intermediated token system interacts with a public token system, the key difference is that a public token system cannot be held to account the same way a financial institution can. Sanctions can be made on certain public token systems (such as TornadoCash) but sanctions will be a reactive measure.

Based on existing regulatory frameworks which require certain service providers to give users' access at a similar and conceptual level, take for example the Consumer Data Right regime or privacy laws regime, empowering users with a right to access information is a feasible and reasonable requirement to impose, provided it is balanced and well considered.

Question 7(b)

Crypto asset service providers can make the process for consumers to access such information seamless and educational. By providing information to consumers for where consumers can access other third party sources to verify those arrangements, crypto asset service providers can mitigate a degree of risk and build trust in the industry.

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.

- (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?

Answer See our response to Question 5 above.

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?

Answer We do not think that the Government should assess and presumably only allow certain public crypto networks to host wrapped real world assets for the following reasons:

- It will be contrary to public policy - only allowing certain public crypto networks to host wrapped real world assets. This might also have an unintended consequence of “pricing out” many smaller industry participants if the assessment criteria can only be met with significant costs.
- The other proposed regulatory changes in this response to this Consultation Paper and the existing laws are sufficient. For example, certain jurisdictions are recognising NFTs that represent title/interest over real property. Instead of assessing and attempting to regulate the public crypto network, it will be preferable (especially from the consumer’s right to seek remedies from Australian courts) to simply subject the NFT themselves to Australian property law (see, for example, our responses to Question 12 and 13).

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?

Answer There should not be a monetary limit on the types of investments consumers make in relation to any arrangements not covered by the financial services framework. A monetary limit will restrict the types of products and markets which can be established and dealt with in Australia. Existing laws will apply to these types of arrangements.

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?

Answer

Further consultations and investigations will need to be carried out on this, particularly an observation of how the relevant frameworks deployed by other jurisdictions has impacted those jurisdictions.

It should also be noted that the Corporations Act also imposes disclosure requirements for financial products when offered/issued to retail clients. Further, consumer laws (e.g. concerning misleading and deceptive conduct) already apply to all marketing and promotion of crypto assets.

Any additional regulation concerning marketing and promotion should take into account compliance costs, so as to “price out” start ups or smaller industry participants.

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.

- (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?

Answer

Australian regulatory frameworks around contract law, which already cover smart contracts, are sufficient. Like traditional contracting, there are public policy reasons for not creating any further regulatory frameworks to govern private contracting. It is also worth noting that the open-source software community is ‘self-regulating’ in that developers and contributors will make and are incentivised to make improvements on existing open-source software.

However, it may be worth creating a set of minimum standards (more so from a security perspective) which smart contracts need to meet for use by intermediaries. A government body or tool which provide ‘certified’ certain open-source software to provide guidance for industry participants in consumers would be welcomed.

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).

- (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?

Answer

For the purposes of this question, we have assumed “conventional pawn-broker lending” is not limited to pawn-brokers who accept smaller household items as security for a small loan, and that it includes larger limited-recourse loan providers such as line-of-credit

lenders.

Most smart contract lending currently has a limited recourse only against various cryptocurrencies (i.e. a type of personal property). However, given the flexibility of smart contracts, it is reasonable to assume that it may accept crypto assets linking to other personal properties or even real properties.

The main difference between smart contracts and conventional pawn-broker lending is that in the latter, securities are usually registered (in the Personal Property Securities Register for personal property and in the Certificate of Title for real property). Such registrations, by operation of legislation, would rank ahead of any other unsecured interests. Smart contracts would usually not involve making such registrations over the collateral, unless specifically designed to.

But because smart contracts are self-executing, this creates a situation whereby if a collateral has a prior registration, the self-execution of the smart contract will be in breach of existing legislation and jeopardise the position of secured creditors. This will also have implications in bankruptcy or insolvency proceedings, where distributions are made to the line of creditors based on their ranking (and where secured creditors generally rank ahead of all unsecured creditors).

Our proposal is that the Government should consider enacting legislation making smart contracts subject to existing laws concerning registered security over personal properties and real properties. This should apply for all smart contracts that deal with any title or interest over personal property or real property, not only to those that deal with collateralised lending.

We do not possess any quantifiable data on the consumer outcomes in conventional pawn-broker lending compared with user outcomes for analogous services provided through smart contract applications.

Question 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?**

Answer

There are certainly more risks which are more prevalent in AMMs than in crypto asset exchanges, such as front running, oracle pricing errors and mercenary capital/black swan events. However, from a consumer protection perspective, the main risk is that there is no intermediary (i.e. crypto asset exchange provider) to regulate or to be accountable.

It will be difficult, if even possible, to prevent the risks associated with AMMs. This is especially given the case that transactions are international and often anonymous. Education to consumers may mitigate some of the risks described above.

We do not possess any quantifiable data on consumer outcomes in trading on

 conventional crypto asset exchanges compared with user outcomes in trading on AMMs.

Yours sincerely,

LegalVision ILP Pty Ltd