

# Token Mapping

## Submission to Treasury's Consultation paper

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### Q1) What do you think the role of Government should be in the regulation of the crypto ecosystem?

The role of government can be best described as balancing two conflicting tensions, each with two opposite objectives.

The **first tension** is between the need to allow investors to voluntarily assume risk and its consequences and the need to safeguard consumers from harm. This is consistent with the conclusions of the Wallis Inquiry<sup>1</sup> report that "the purposes of financial regulations are to ensure at least that financial promises are understood and, in their more intense form, that they are met,<sup>2</sup>" To that end, the following objectives should be pursued and balanced:

1. Ensure crypto token investors and ecosystem consumers are free to voluntarily assume risk;
2. Ensure they are safeguarded from fraud and misleading and deceptive conduct;

A consent-based framework should apply where the government does not seek to save crypto investors from bad investments, only from fraud and related activities. Investors should be able to willingly enter into contracts, be they smart contracts or otherwise, and bear their consequences, so long as no deception has been had.

The **second tension** arises between two further objections. The need to safeguard core financial systems and the need to ensure innovation can occur free of

government hindrance and selection bias. To that end, the following objectives should be pursued and balanced:

3. Ensure that crypto tokens and platforms do not pose a systemic risk to the broader financial system
4. Allow for unhindered market-driven innovation in this space, even at the cost of "creative destruction."

On the one hand, the government should ensure that certain crypto tokens and ecosystems, do not pose a systemic risk to the broader financial system. This could involve regulating stablecoins and CBDCs, ensuring that crypto transactions do not facilitate money laundering or terrorist financing, and monitoring other core banking and payment infrastructure that may be affected. On the other hand, cryptocurrencies have the potential to disrupt traditional financial systems and the government must ensure it does not pick winners. We must be ready to embrace a degree of what Joseph Schumpeter<sup>3</sup> referred to as "creative destruction." Supporting innovation in this space by ensuring government regulation does not stifle innovation which would ultimately benefit consumers. This can be achieved by providing clear policy directions to the industry; by not picking technology winners; and by not interfering in free markets (unless where the systemic consequences are catastrophic).

<sup>1</sup> S Wallis et al, Financial System Inquiry, *Discussion Paper*, (Australian Government, 1996)

<sup>2</sup> Ibid, Chapter 4

<sup>3</sup> Schumpeter J, *Capitalism, Socialism and Democracy* (Harper, 1942)

**Q2) What are your views on potential safeguards for consumers and investors?**

The safeguard requirements for consumers and investors have been partially addressed in our response to Q1 when addressing the tension between the need to allow investors to voluntarily assume risk and the need to safeguard consumers from harm.

Our current regulatory systems are fairly effective at doing so. Policymakers must be conscious of the following:

- While the gap between an investor in Telstra and a consumer of Telstra is clear understood and defined, the gap between an investor and consumer of DeFi staking protocol, for instance, is blurrier. As such the consumer/investor distinction is not always suited.
- As an alternative to altering Division 3 of the Corporations Act 2001 or its application to cast a wider net on crypto tokens and digital assets, policymakers may rather expand Division 2 of the ASIC Act 2001 to ensure unfair contract terms, unconscionable conduct and consumer protection available in the ACL in crypto is enforced by ASIC (even in cases where the definition of a financial product may not have been met).
- This alternative approach would allow regulators to address the unique risks associated with crypto assets without altering existing legislation or creating new regulatory frameworks. By enforcing consumer protection and safeguarding against unfair contract terms and unconscionable conduct, policymakers can promote responsible innovation in the crypto ecosystem while maintaining consumer confidence in the market.
- The added benefit of such an approach would be that project proponents will not seek to design platforms that seek to exclude regulatory capture, while regulators will not seek to define

everything in the crypto ecosystem as a financial product even when arguably does not meet the definition of a financial product.

Finally, while we focus of regulators has been investors and consumers, we must not ignore the need to protect software developers and innovators of decentralised systems (including distributed ledger technologies, smart contracts, crypto tokens, and their ecosystems) from regulatory risk and criminal liability for systems which they ultimately they do not control. That said, there may be circumstances where they ought to be held to account through civil liability (such as breach of contract or torts) and/or under consumer law.

**Q3) Scams can be difficult for some consumers to identify.**

There are several reasons why scams are prevalent in the crypto industry. Firstly, the technology behind cryptocurrencies, such as blockchain, can be complex and difficult for the average person to understand. This lack of understanding can make individuals more susceptible to fraudulent schemes that promise easy returns or quick profits.

Secondly, the relative newness of the crypto industry means that there are fewer established regulations and oversight compared to traditional financial markets. This lack of oversight can create an environment where bad actors can operate with less risk of being caught or punished.

Thirdly, the anonymity of transactions in cryptocurrencies can make it easier for criminals to hide their activities and identities, making it more difficult to prosecute them.

Finally, the hype and volatility surrounding cryptocurrencies can attract individuals who are more interested in quick profits than long-term investments. This can create a fertile ground for scams, as individuals may

be more willing to take risks in the hopes of high returns.

In terms of scams, there are two general groups of scams: the first group are scams involving the purported facilitator of a financial product, as is the case in a ponzi scheme, rug pull, or pump-and-dump scheme. The second group are those scams involving third parties imitating legitimate crypto tokens or platforms, or alternatively, those utilising malware and ransomware attacks. For this latter group, consumer education (see below) is the best solution.

**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?**

There are several solutions that could be applied to safeguard consumers who choose to use crypto assets. One solution could include basic disclosure requirements, which allow consumers to reliably compare key security, product and tokenomics features of crypto token systems, ensuring they make more accurate and informed decisions about the risks and benefits of respective crypto tokens and their ecosystems.

Another solution is code auditing, which involves having third-party auditors review the code of crypto products and platforms for security vulnerabilities and other issues that could pose a risk to consumers. This could help identify and address potential security flaws before they are exploited by bad actors. Ultimately, the ideal solution would be the adoption of industry-based standards, certifications and verifications, much like SSL certificates, ISO standards or Kosher, Halal or Vegan certifications have developed across industries to better inform consumers,

But ultimately, consumer education is required to ensure people are familiar with the risks of scams and know how to deal with potential scammers. Ultimately, consumer

education is the role of the investor or consumer rather than the government or the crypto token platform. However, the government through services such as SmartMoney could promote further digital consumer literacy to minimise the impact of scams.

**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?**

The current frameworks by ASIC and ACCC are sufficient to deal with this issue. No bespoke solution is required.

The offshore nature and anonymity of most scammers make successful prosecution all but impossible. An effective policy would be to focus on inoculation through better consumer education, rather than heavy regulation.

**Q4) 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 **crypto token** is a unit of digital information that can be ‘exclusively used or controlled’ by a person*

*A **crypto network** is a distributed computer system capable of hosting crypto tokens. Crypto networks are the platforms on which crypto tokens and ‘smart contracts’ are recorded. Their primary function is to store information and process user instructions..*

**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?**

We propose the following modified definitions.

*A **crypto token** is encrypted digital information denoting scarcity, value or utility and hosted on a crypto network that can be exclusively used or controlled by a person.*

*A **crypto network** is a publicly accessible distributed computer system utilising encryption, and capable of hosting crypto tokens or executing smart contract protocols, applications or tokens.*

The concept could be used to distinguish centralised crypto asset services from public smart contracts, or in the parlance, distinguish CeFi from DeFi.

This could also be used as a test regarding whether or not the investor has day-to-day control over the use of the contribution to generate a return or benefit for the purposes of s763B(b).

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

The **benefits** of adopting the "exclusive use or control" approach in defining crypto tokens and crypto networks include:

- A clear distinction: It could provide a clear distinction between crypto tokens/crypto networks, and avoid regulatory uncertainty.
- Better targetted regulation: It would allow for regulatory focus on those services that ultimately control clients' crypto keys, and allow for unencumbered development of those platforms that maintain exclusive use or control in the hands of the user.
- Investor protection: It could provide better protection for investors by ensuring CeFi platform are encouraged to cede day-to-day control to their users, ensuring the actions that took place in FTX and other exchanges cannot be replicated.
- Flexibility: By focusing on functional characteristics rather than specific technologies, it could provide more

flexibility to adapt to changes in the industry.

**Disadvantages** of adopting this approach could include:

- Complexity: The concept of "exclusive use or control" could be complex and difficult to define in some instances (such as multi-sig wallets) which could create uncertainty.
- Rapidly evolving industry: The crypto industry is rapidly evolving, and new technologies and use cases are emerging all the time. Adopting a specific approach could quickly become outdated.
- Resistance from industry participants: Some industry participants, particularly centralised crypto asset services, may resist the adoption of a specific approach, preferring a more technology-neutral approach that is less prescriptive.
- Novice users mismanaging their keys: As more crypto platforms will be designed to avoid regulatory capture by providing users more control over their crypto assets, there is a risk that novice users will fail to maintain those keys securely and thereby lose their assets.

**Q5) 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?**

The paper cites the reasons against creating an exhaustive taxonomy for crypto asset services and intermediated crypto assets since their functions are as broad as the possible functions of any contractual or social arrangement, and in the case of network tokens and public smart contracts since they include 'computing function'.

We concur with this reasoning and propose no alternative views.

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

- A bespoke taxonomy, although initially intended to provide a clearer regulatory framework for crypto assets, may not necessarily lead to greater legal certainty. In order to achieve this, it would need to be supported by extensive and explicit examples of legislative intent, applying key functional definitions and operative provisions as they would apply to the diverse range of *token systems*.
- Alternatively, a principles-based approach to regulation could be used, which focuses on the overall goals and outcomes of the regulatory framework, rather than attempting to create a comprehensive set of rules. This approach allows for more flexibility and adaptability to the evolving nature of crypto assets and their associated risks but may result in less regulatory clarity.

**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?**

- Individuals and businesses using crypto networks and crypto assets in a non-financial manner should be governed as consumers under Australian Consumer Law.
- Division 2 of the ASIC Act 2001 can be expanded to ensure unfair contract terms, unconscionable conduct and consumer protection available in the ACL in crypto is enforced by ASIC (even in cases where the definition of a financial product may not have been met).

**Q6) 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?**

Wrapped real-world assets should be treated from a regulatory perspective as the underlying asset, and to a large extent, they are already. Currently, there may be instances where they may be classed as derivatives, if they derive their value by reference to real-world assets, therefore specifically included as a financial product. There may be a need to narrow the definition of ‘derivative’ to exclude unwanted regulatory capture.

**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?**

Stablecoins should be required to declare how they are backed and governed, whether backed by full-reserve, over-collateralization, partial-reserve or algorithmic (such as rebase, or seigniorage models). Those stablecoins touting reserves should be subject to a quarterly independent audit of their reserve capacity and disclosure of the assets they are backed by. Those backed algorithmically should have a public-facing smart contract indicating the same.



**Q7) 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?**

Licensed crypto asset service providers should be required to show on-chain proof of reserves.

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

Ultimately, crypto asset exchanges, asset managers and custodians will do this irrespective of regulation to achieve a competitive advantage, as safety and assurance is top of mind for the crypto investor. The market will eventually evolve better practices than can be prescribed by regulation.

**Q8) 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?**

Not necessary, as this is adequately covered by s763A

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

There may be a need to provide further clarity around custodians and stablecoin issuers,

where they would not otherwise be covered by s763A.

**Q9) 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?**

No such restrictions are warranted.

**Q10) 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?**

No. Consumers should be free to freely assume risk and its consequences without the “protection” of government. That said, there may be a need to require some basic disclosure around the asset-backing of stablecoins and the governance frameworks of DAOs to ensure consumers are making informed choices, even where such arrangements may be covered by the financial services framework.

**Q11) 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?**

No specific regulatory frameworks are required for this, so further regulatory guidance, such as Information Sheet 269, released by ASIC, provides helpful guidance.

**Q12) 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?**

There is little government can do to stop the development of smart contracts that fail to comply with existing regulatory frameworks other than by making the alternative less cumbersome. The more complicated the process for regulatory-governed smart contracts, the more likely smart contracts will be designed to evade regulatory capture.

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

As above.

**Q13) 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?**

Conceptually, there is some similarity between the two services. The differences are as follows:

- Smart-contracts provide more transparency and certainty than conventional pawn-broker lending as the policies are hard-wired in code.
- Smart-contract based lending may involve less friction and may be more

accessible to users who cannot access to traditional financial services.

- The assets backing Smart-contract based lending are likely to be more volatile and more prone to the threat of liquidation.
- Smart-contract based involves additional risks, particularly those pertaining to security vulnerabilities, lack of regulatory oversight, and limited legal recourse in case of disputes.

**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?**

There is limited quantifiable data on consumer outcomes in conventional pawn-broker lending compared to analogous services provided through smart contract applications. However, it is worth noting that the regulation and oversight of conventional pawn-brokers is typically more established and may provide greater protections for consumers compared to the emerging smart-contract based lending market. It may be important to closely monitor the development of smart-contract based lending and consider appropriate regulatory measures to protect consumers from potential risks.

**Q14) 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?**

Unlike an order book used by crypto asset exchanges, whereby the investor sets the price they are willing to buy and sell an asset, an AMM declares the estimated price and a consumer may elect to proceed or not with the transaction. Novice investors may be

unfamiliar with the difference. Furthermore, consumers may not be aware of the risks of slippage. Such a risk should be clearly articulated and quantified before any AMM transaction is executed.

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

Further research and analysis are needed to better understand the differences in consumer outcomes between trading on conventional exchanges and AMMs.

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