

RMIT Blockchain Innovation Hub Researchers
Submission on Digital Assets (Market Regulation) Bill 2023

19 May 2022

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
By email: economics.sen@aph.gov.au

Dear Secretary

Digital Assets (Market Regulation) Bill 2023

We write to provide a submission on the above Bill currently before the Senate Economics Legislation Committee. We do so in our personal capacities.

We are a team of academic social scientists — economists, lawyers, and accountants — researching and contributing to the design of the decentralised digital economy. We also have experience and expertise in the design of regulation and its implications, such as the effect of regulation on innovation and entrepreneurial discovery.

We are all members of the RMIT Blockchain Innovation Hub (RMIT BIH). The RMIT BIH was established in 2017 at RMIT University as the world's first research centre on the social science of blockchain technology. The BIH brings together academic researchers in the fields of economics, taxation, communications, finance, history, law, sociology, and political economy. Since then, this award-winning, world-leading research centre has been at the forefront of bridging academic research with the design of digital economy business models, and the implications that has for institutions, including regulatory frameworks. In addition to research, industry collaboration and global engagement, the RMIT BIH has developed a suite of educational offerings from short courses, undergraduate majors and masters degrees, to higher degrees by research. RMIT BIH members were part of the Australian Government's National Blockchain Roadmap Steering Committee and RMIT BIH members have appeared before the Australian Senate's Select Committee on Australia as a Technology and Financial Centre along with other consultation processes. RMIT BIH members are regularly published in leading academic journals, present at international academic and industry conferences and are sought-after industry collaborators.

We note that the text of our submission draws on RMIT research and incorporates material from our previous submissions to the Senate and responses to Treasury consultation processes.

Yours faithfully

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Dr Elizabeth Morton
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1. The Regulatory Challenge

The *Digital Assets (Market Regulation) Bill 2023* (The Bill) seeks to address important policy issues that Australia must face in its transition from an industrial economy to a digital economy. The emerging technology stack (including blockchains, smart contracts, and artificial intelligence) presents an unprecedented opportunity to build a modern digital Australian economy — providing consumer and societal benefits including employment opportunities. The role of Parliament is to craft a regulatory framework that embraces and facilitates the digital economy.

A digital economy is not simply an industrial economy on the internet. A digital economy is defined by a deep shift in the architecture of the underlying institutional and organisational infrastructure. As seminal research from the RMIT Blockchain Innovation Hub shows, blockchain technology is fundamentally an institutional technology that introduces new possibilities for economic coordination and governance.¹ A fully realised digital economy (c.f. a digital industrial economy) comprises multi-sided platforms, decentralised networks, community governance, automated decision-making, and privately governed property rights and contracts. These characteristics of a digital economy unlock new possibilities for governing mutually beneficial economic exchange.

A digital economy looks and feels different to an industrial economy. The business models that are profitable and robust sit at different layers and levels of the economy. Payments and cross-subsidies run in sometimes opposite and counterintuitive directions. Property rights, including data, push towards the edges and are created and enforced through networks. The workforce, and the infrastructure it is coordinated through, become increasingly global. Decisions and management are often made more fluidly and collectively rather than through the hierarchies of firms or governments.

The fundamentally different decentralised architecture of a digital economy implies a corresponding shift in the role of government. A digital economy requires a different approach to achieving an effective regulatory framework. This is because the digital economy cannot easily be squeezed into existing taxation and regulatory frameworks. As the Treasury's first consultation paper in 2021 correctly identified, “the principles for regulating crypto assets are not identical to those behind financial product regulation and should not be treated as such.”² Accordingly, where possible, and particularly where there are significant potential unintended consequences of regulatory action (e.g., in decentralised networks), governments should adopt an approach of permissionless innovation³ guided by the objective of becoming a crypto-friendly jurisdiction.⁴

¹ Davidson, S., De Filippi, P. and Potts, J., 2018. Blockchains and the economic institutions of capitalism. *Journal of Institutional Economics*, 14(4), pp.639-658; Berg, C., Davidson, S. and Potts, J., 2019. *Understanding the blockchain economy: An introduction to institutional cryptoeconomics*. Edward Elgar Publishing.

² Treasury. 2021. Crypto asset secondary service providers: Licensing and custody requirements (Consultation Paper). Australian Government, p. 12.

³ Thierer, A., 2016. *Permissionless innovation: The continuing case for comprehensive technological freedom*. Mercatus Center at George Mason University.

⁴ Novak, M. and Pochesneva, A., 2019. Toward a Crypto-friendly Index for the APEC Region. *Journal of the British Blockchain Association* vol. 2 no. 1, pp.39-45.

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2. Australia's Approach to Crypto Asset Regulation

The initial approach that Australia took to the regulation of crypto assets was to apply legacy corporate law frameworks. Arguably, this was a sensible approach in the 2014-2018 period when blockchain technology and crypto assets were in a period of rapid discovery. As the industry has matured, the context is different. It is now estimated that over 1 million Australians own at least one cryptocurrency.⁵ Today the global market cap for cryptocurrencies exceeds US\$1 trillion.⁶ Although AUSTRAC does not publish a register, it is believed that over 400 separate digital currency exchanges are registered to operate in Australia. In this context, there is a significant public policy challenge in addressing legitimate customer protection issues with centralised digital currency exchanges and other crypto asset service providers, in providing regulatory certainty to the crypto and broader blockchain industry, and in seeking not to stifle continued innovation and adoption – or drive people and businesses offshore.

The Bill represents the first attempt at regulatory certainty for crypto assets in Australia, following a previous Senate inquiry, Federal government responses, and Treasury consultations. The global regulatory environment is rapidly shifting:

- In March 2022, the Government of Dubai (United Arab Emirates) established a Virtual Assets Regulatory Authority – with a licensing regime now in place following the release of the Virtual Assets and Related Activities Regulations 2023.
- In December 2022, the Legislative Council of Hong Kong SAR passed legislation establishing a new licensing regime for virtual asset service providers, commencing from June 2023.
- In February 2023, HM Treasury in the United Kingdom released a consultation paper on its proposed phased approach for regulating cryptoassets. The first tranche of legislation is currently before the UK Parliament.
- In April 2023, the European Parliament approved the Markets in Crypto-Assets Regulation (“MiCA”) which will regulate crypto asset issuers and service providers. The MiCA regime is expected to be operational from 2024.

A key consumer and investment risk in the Australian crypto ecosystem is regulatory uncertainty. Regulatory certainty is required to provide predictability and stability for entrepreneurs, investors, and consumers in this emerging industry. Australia's current regulatory grey zone is leading to several issues on the exchange side (including de-banking, difficulty accessing insurance coverage, and the risk of 'regulation through enforcement') and on the consumer side (including risks around custody management, cyber security, adequate capital and liquidity, and dispute resolution). To be entirely clear: if Australia fails to adapt to and enable digital business models, these platforms will still be built—they will simply be built in other jurisdictions, or remain in dark parts of the economy, leaving consumers and investors exposed.

⁵ Roy Morgan, 'Over 1 million Australians now own Cryptocurrencies such as Bitcoin, Ethereum, Ripple, Cardano, Dogecoin and Shiba Inu' (Article no. 8929), 12 April 2022.

⁶ See: <<https://coinmarketcap.com/>>.

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3. Our Key Recommendation

We consider that the Bill is an encouraging step forward in embracing and facilitating the digital economy.

Our key recommendation is that Parliament should maintain a clear distinction between centralised crypto asset businesses and decentralised platforms and protocols. That is, there is a clear case for appropriate regulation of centralised crypto asset businesses, to provide regulatory certainty for businesses and guard against clear agency and information costs for consumers. However, there is little utility, if any, in regulating decentralised platforms and protocols but this would impose significant regulatory costs. Maintaining a clear distinction between centralised businesses and decentralised platforms and protocols is necessary to build a competitive regulatory advantage in the context of mobile capital and labour flows.

4. Provisions of the Digital Assets (Market Regulation Bill) 2023

3.1 Part 1 – Definitions

Digital Asset

The Bill's definition of "digital asset" ("a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology")⁷ is the same as MiCA's definition of "crypto-asset".⁸ The definition is similar to the UK definition.⁹ However, integral to the Bill's definition of "digital asset" is the subsequent definition of "distributed ledger technology". In this regard, the Bill's definition of a distributed ledger technology ("a kind of technology that supports the distributed recording of encrypted data") appears to depart from MiCA's four-part definition:

- (1) 'distributed ledger technology' or 'DLT' means a technology that enables the operation and use of distributed ledgers;
- (2) 'distributed ledger' means an information repository that keeps records of transactions and that is shared across, and synchronised between, a set of DLT network nodes using a consensus mechanism;
- (3) 'consensus mechanism' means the rules and procedures by which an agreement is reached, among DLT network nodes, that a transaction is validated;

⁷ *Digital Assets (Market Regulation) Bill 2023*, cl 5(1).

⁸ European Parliament legislative resolution of 20 April 2023 on the proposal for a regulation of the European Parliament and of the Council on Markets in Crypto-assets and amending Directive (EU) 2019/1937 (MiCA).

⁹ Article 3.

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- (4) ‘DLT network node’ means a device or process that is part of a network and that holds a complete or partial replica of records of all transactions on a distributed ledger.¹⁰

As such, we recommend that the entire definition should be adopted to promote consistency and interoperability amongst global regulatory frameworks.

Through an exhaustive definition of “regulated digital asset” the Bill appears to exclude Non-Fungible Tokens, governance tokens, and utility tokens. This approach is sensible as a broader definition of regulated digital assets would significantly raise the regulatory costs for all blockchain-enabled projects without clear regulatory benefits.

Finally, the Bill removes financial products from the purview of the Digital Assets regime, which is necessary to avoid regulatory duplication.

Stablecoin

The Bill defines “stablecoin” as a regulated digital asset (i.e., not a financial product) that is either:

- (a) an asset-referenced token (a kind of digital asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender (whether Australian or otherwise), one or several commodities or one or several digital assets, or a combination of such assets).
- (b) an electronic money token (a kind of digital asset the main purpose of which is to be used as a means of exchange and that purports to maintain a stable value by referring to the value of a fiat currency that is legal tender (whether Australian or otherwise)).

There are shortcomings in the definition of “asset-referenced token” (notwithstanding that the definition is borrowed from MiCA). Specifically, we are concerned that this definition may unintentionally include:

- Wrapped assets – a tokenised version of an asset that can be used on another blockchain. There are currently hundreds of wrapped assets on a range of different blockchain ecosystems. For example, “Wrapped Bitcoin” is an asset backed by Bitcoin and issued on another blockchain network, such as Ethereum. Wrapped assets are important for interoperability between blockchains (including “bridges”), decentralised applications, and liquidity in decentralised finance (DeFi) ecosystems. Wrapped assets would fall within the Bill’s definition of stablecoins because the wrapped asset is designed to maintain a stable value with reference to the underlying asset (in the case of Wrapped Bitcoin it is intended to be stable to the price of Bitcoin).

¹⁰ Regulation (EU) 2022/858, article 2.

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- Derivative DeFi assets – an umbrella term for financial instruments such as futures, options, perpetual swaps, synthetic assets, and the like which exist in DeFi ecosystems. Although these instruments may appear to resemble traditional securities, DeFi protocols leverage blockchain-enabled smart contracts removing the need for centralised intermediaries to settle transactions. Derivative assets may fall within the Bill’s definition of stablecoins – if not regulated as financial products under the *Corporations Act* – because the value of the derivative asset is generally intended to track the underlying asset (e.g., the price of gold).
- Liquidity pool (LP) tokens – a token that represents a share of digital assets in a liquidity pool on DeFi decentralised exchanges (which facilitates token trading without intermediaries). When a liquidity provider provides one or more digital assets into a liquidity pool, in return they generally receive an LP token to represent their share of the pool. These LP tokens are typically redeemable for the underlying assets, but can also be traded on secondary markets, with the value of the LP token representing the value of the underlying assets in the pool (and any fees or rights accrued). LP tokens are important in cryptoeconomic systems to ensure sufficient liquidity in markets, enabling trading without substantial price impacts. LP tokens may fall within the Bill’s definition of stablecoins because the value of the LP token is necessarily linked to the value of the assets in the liquidity pool.
- Cryptocurrency Collateralised Stablecoins – a type of stablecoin that is designed to maintain a stable value by using other cryptocurrencies as collateral. Typically, these stablecoins are over-collateralised to guard against price volatility (the specific collateral ratio differs between platforms). The stablecoins that are used in DeFi protocols and other decentralised applications are not trivial. For example, DAI (a Cryptocurrency Collateralised Stablecoin on the Ethereum network, soft-pegged to the US dollar) currently has a market cap of more than \$7.2 billion. Cryptocurrency Collateralised Stablecoins may fall within the definition of stablecoins because the value of the asset is linked to the collateral.

There is also a shortcoming in the definition of “electronic money token”. Specifically, we are concerned that the definition captures both fiat-backed stablecoins (i.e., backed or collateralised with fiat currency reserves held with the issuer or custodian) and algorithmic stablecoins (i.e., not backed by centralised reserves but decentralised mechanisms such as smart contracts and algorithms that dynamically regulate token supply). The clear assumption in the licensing provisions of the Bill¹¹ is that stablecoins are fiat-backed.

¹¹ *Digital Assets (Market Regulation) Bill 2023*, cl 20.

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Overall, these shortcomings can be addressed by explicitly providing that the Bill regulates *centralised* rather than *decentralised* applications. This is sensible as the justification for regulating decentralised protocols is weak as decentralised operations are carried out without a central authority, operate on transparent open source blockchains, and require self-custody of crypto assets. Further, enforcement against decentralised protocols is difficult and costly. Accordingly, we strongly recommend that the Committee make appropriate amendments to confine the Bill's purview to *centralised* activity.

3.2 Part 2 – Licensing

Part 2 of the Bill imposes licensing requirements for operating a digital asset exchange, operating a digital asset custody service, and issuing stablecoins. We are broadly supportive of these provisions as these areas are the highest priorities to achieve regulatory certainty for industry and consumer protection. It is sensible that entities can apply for more than one type of licence, that foreign licences may be recognised to functionally achieve regulatory equivalence without duplication, and that a register of licences will be made public for greater transparency.

To improve regulatory clarity, we recommend that there is a single regulator for the Digital Assets Licensing Regime. In this regard, clause 12 provides ASIC with the function of supervising digital asset exchanges but there are no similar provisions for digital asset custody or stablecoins. Further, we recommend that clause 23 be amended to provide that ASIC *must* grant a licence if (*and must not grant a licence unless*) the application is made in accordance with the Bill and the Rules – consistent with the provisions for granting an Australian Financial Services Licence.¹²

3.3 Part 3 - Central Bank Digital Currencies (CBDCs)

The immediate role for the Parliament is to provide a clear regulatory pathway for crypto asset businesses to promote regulatory certainty and guard against the key risks of centralised crypto asset services. Part 2 of the Bill achieves these objectives. Part 3 of the Bill has a much different regulatory intention, targeted at monitoring expenditure and holdings of foreign CBDCs in Australia.

The Bill requires ADIs to report information about holdings and use of foreign CBDCs to ASIC and the Reserve Bank. This provision should be framed with the possibility that there are several CBDCs globally, each providing the same services as 'traditional' digital currencies do today. The (non-security) risks CBDCs present are technical risks, and therefore prudential (rather than in ASIC's domain of financial markets and consumer protection). Accordingly, we suggest that the appropriate regulatory authority to monitor CBDC holdings should be APRA rather than ASIC.

¹² See e.g., *Corporations Act 2001* (Cth), s 913B.

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3.4 Parts 4-7 – Other Provisions

In terms of the machinery aspects of the Bill, other than our previous comments on clarifying the responsibilities of ASIC and APRA, we recommend that the transition period should be amended to 12 months.

5. Additional Issues

We note that the Bill does not provide any clarity over tax implications.

Treasury reports that there is an expectation that over 1 million taxpayers will lodge a 2022 tax return that includes crypto activities.¹³ With this in mind, we urge that priority be given to considerations of The Board of Taxation Review of the tax treatment of digital assets and transactions in Australia. The Board of Taxation is due to report back to the Government by September 2023.¹⁴ This follows *Treasury Laws Amendment (2022 Measures No. 4) Bill 2022* amending the definition of foreign currency to specifically exclude digital assets, except if Government-issued. This amendment offers clarity as to whether the foreign currency regime applies, ensuring the status quo is maintained pursuant to the Australian Taxation Office position outlined in Tax Determination TD 2014/25.¹⁵ This followed developments internationally, particularly the Republic of El Salvador, which have recognised Bitcoin as legal tender in 2021.¹⁶ However, this amendment offers only narrow clarity, not attending to the breadth of issues arising for taxpayers participating in the crypto economy. Tax practitioners and taxpayers are facing substantial challenges in this space.¹⁷

6. Further Information

We are available to provide further information on the Bill or similar legislation either at a hearing of the Committee or by request in writing.

¹³ Treasury, Token Mapping (Consultation Paper) February 2023 (p. 3).

¹⁴ The Board of Taxation, Review of the Tax Treatment of Digital Assets and Transactions in Australia, <<https://taxboard.gov.au/review/digital-assets-transactions-aus>>.

¹⁵ Australian Taxation Office, Income tax: is bitcoin a 'foreign currency' for the purposes of Division 775 of the Income Tax Assessment Act 1997? 17 December 2014 (TD 2014/25).

¹⁶ See Treasury Laws Amendment (2022 Measures No. 4) Bill 2022 Explanatory Memorandum, 45.

¹⁷ See Morton, E., Devos, K., Vesty, G., Nguyen, L. 2023. 'The crypto-economy and tax practitioner competencies: an Australian exploratory study' (Working Paper). Paper available on request.