Blockchain Australia

PROMOTING BLOCKCHAIN INNOVATION IN AUSTRALIA

4th March 2021

Submission to the Senate Select Committee on Financial and Regulatory Technology - Questions on Notice

Dear Committee Members,

Thank you for the further opportunity to provide a submission in response to the Select Committee on Financial Technology and Regulatory Technology.

The material presented in this further submission is a snapshot of issues and challenges facing the development of the Australian digital assets and cryptocurrency industry. The list is not exhaustive, nor does it detail the way forward with respect to the matters. Rather, it makes clear that consideration, consultation, guidance and ultimately reform is required to ensure that Australia plays a part in the development of this emerging industry globally.

A whole of Government approach will be necessary to ventilate the matters raised below. Anticipating that change cannot occur until a deeper understanding of the landscape exists across Government departments.This includes consideration of the matters at Ministerial and Cabinet level.

Simply put, a regulatory framework that supports and encourages the development of the industry is required.

The Regulatory Perimeter

Cryptocurrency and digital asset businesses continue to comment to Blockchain Australia that they have no clear guidance or understanding of whether their crypto asset activities are regulated, whether they need to hold an Australian Financial Services Licence and what they need to do to ensure they are compliant.

No specific licensing regime exists for cryptocurrency companies as the assessment of licensing is activity based, but current ASIC guidance in INFO225 merely identifies all the ways possible uses of cryptocurrency could be licensed, without giving guidance to ways in which cryptocurrency can be used in a business without a licence.

No cryptocurrency token or categorisation model exists and as a result no jurisdictional position is taken in Australia to treat like token categories alike, considering key features. There is a clear misalignment between the Australian digital asset space and the definitions used as an example by the United Kingdom’s Financial Conduct Authority (“FCA”).

The FCA clearly sets out categories of tokens which are subject to regulation, being inside the FCA’s jurisdiction, which is referred to as the “regulatory perimeter”. FCA regulated tokens are presently:

1) security tokens, being tokens which carry ownership rights or an entitlement to passive income or revenue sharing; and

2) e-money tokens, which are analogous to a non-cash payment facility in Australia.

The FCA identifies two categories of tokens which are unregulated, which are:

1) exchange tokens, being tokens designed to be used as a peer-to-peer means of exchange but which are not issued by any central authority; and

2) utility tokens, which is a category of tokens not carrying any ownership rights or promises of any kind of profit or return.

The European Union is proceeding with the development of the Market in Crypto Assets regulatory regime. The consultative and fluid nature of this space is such that the FCA made the following comments in relation to their respective approaches :

> *“The UK should aim to be at least as broad in ambition as MiCA – but should also consider whether it can develop a bespoke regime that is more innovation-driven.*
>
> *“A bespoke regime for cryptoassets should adopt a functional and technology-neutral approach, in line with the principles of the current regulatory framework, as well as the concept of “same risk, same regulation”, while being tailored to the risks arising from cryptoasset-related activities. It should also be flexible enough to deal with future challenges – such as how Decentralised Finance (DeFi) should be regulated.”*

The UK Treasury published a consultation paper and called for evidence on the UK's regulatory approach to crypto and stablecoins in January 2021.

The FCA also expressly recognises that Bitcoin and exchange/utility tokens are mainly purchased for speculative purposes and noted that consumer awareness of the risks involved in purchasing unregulated tokens is “high”:

Presently ASIC INFO225 states broadly that:

> *If the value of the crypto-assets acquired is **affected** by the pooling of funds from contributors, or the **use of those funds** under the arrangement, then the ICO is likely to be a managed investment scheme.* (our emphasis)

Given the high degree of similarity in the definition of financial products between the UK and Australia, the guidance is markedly different with Australia essentially signposting that any token which could change in price is likely a financial product, and the UK stating it will not be unless it has clear indicia of a security.

Harmonisation would encourage further UK-Australian trade via the UK-Australia FinTech Bridge as crypto asset related businesses would face reduced regulatory uncertainty in entering either market.

The Managed Investment Scheme Challenge

As noted above ASIC's position seems to be that all token sales are (likely) a managed investment scheme.

> *Example: A token that represents a pre-sale of a service (i.e a token that can be used within a particular token environment) and is treated as an Managed Investment Scheme would not work in Australia because of the prohibitive redemption provisions that apply to shares and managed investment schemes under the Corporations Act; and cannot be traded on crypto exchanges as they would be treated as a financial product and can only be listed on a securities exchanges.*
>
> *A paper based equivalent, where vouchers may be bought for redemption or use as a discount in acquiring goods, attracts no such interpretation despite being almost identical, but far more inefficient.*

In the short term, the provision of clear guidance from Regulators in relation to how they intend to regulate categories of digital assets, including a willingness to engage with industry to provide a position statement regarding the regulation of specific categories digital assets in a balanced way would, we submit, support investment and aid the growth of jobs.

Regulation which seeks to impose blanket licensing or mandatory restrictions without sensible industry engagement and comparison to similar jurisdictions will likely have the opposite effect.

Taxation

Australian Taxation Office (**ATO**) guidance for digital asset transactions using decentralised finance (**DeFi**) applications is largely absent and limited.

Taxpayers are encouraged to lodge early engagement requests at their own expense.

Taxpayers are left to seek private rulings at significant expense in all circumstances involving digital assets with a high likelihood of unfavourable rulings because the ATO is unable to stretch the tax law to accommodate nuances of digital assets.

Applications must be made to the ATO test case litigation funding panel, to recover private binding ruling request costs, at the taxpayer's expense. All digital asset related requests have been denied to date.

Limited public ATO positions indicate that (generally) digital asset transactions trigger taxable event consequences, most of which are anomalous to the intended economic outcomes of the market behaviour. The outcomes create an onerous compliance burden upon taxpayers and have already likely created unintended tax liabilities which taxpayers may not be able to fund.

Examples based on public ATO guidance:

Cryptocurrency to different cryptocurrency transfers create a taxable event

- For example: A transaction from BTC to ETH, which requires the taxpayer to dispose of ETH at year end to pay the CGT on disposal of BTC.

Adding a "software wrapper" to a token can create a taxable event

- For example: ATO provides guidance on its community forum that going from one token to a wrapped token of the same type on the same blockchain (ETH to WETH is an example) is considered a CGT event.

Examples without any ATO guidance but which are likely to trigger taxable events and/or onerous compliance obligations:

Cryptocurrencies that are pegged to fiat currencies are treated as a CGT asset and not like currency or foreign currency, the disposal of such likely creating a taxable event

- For example, a transaction from USDT to TAUD

Contributing cryptocurrency to cryptocurrency savings accounts likely creates a taxable event

- For example: Contributing BTC to a BlockFi account to earn yield (akin to interest) in BTC.

"Staking" involves locking up cryptocurrency to support the blockchain network and receiving rewards. Staking a cryptocurrency likely creates a taxable event.

- For example: The Ethereum network is moving to staking and exchanges are actively considering providing their customers the ability to stake ETH through the exchange to receive ETH rewards. a cryptocurrency to receive

rewards, where the rewards are calculated based on the balance of cryptocurrency staked.

Both activities described immediately above can be likened to depositing money into a bank account to earn interest.

Taxable events should be reviewed in light of the nuances of digital asset transactions because the tax consequences are creating anomalous outcomes to the economic intention of these transactions. The review should be commenced as soon as possible.

Banking Services

Digital currency exchanges and related service providers cannot access reliable banking services. This is a persistent and increasing problem facing both digital asset providers and other businesses involved in the space.

The risk appetite that authorised deposit-taking institutions (**ADIs**) have for providing banking services to digital asset businesses is very low to none in almost all cases. Although ADIs may take the view that an individual business' approach to dealing in digital assets may be low risk, given the broader view of digital assets in the context of regulated banking services, banks are not willing to provide any services due to the perceived risks. This is a "industry-centric" view of risk and runs counter to fair industry practice.

No "right to banking" as a utility exists in Australia and as a result it is possible for financial institutions to unilaterally close bank accounts without warnings, explanations or a right to review, despite a business being operated ethically and legally.

Digital currency exchanges report clients accounts have been closed, clients warned that cryptocurrency is a "scam" and that funds have been returned to clients by the client's own bank without request.

No public guidance or frameworks to guide digital asset exchanges on requirements to establish or maintain banking facilities exist.

The practical effect is that local businesses seek out offshore providers and the rapid development of the global landscape will accelerate this outflow.

*An example: A regime has been implemented in the State of Wyoming in the United States, with regulated entities referred to as Special Purpose Depository Institutions (**SPDIs**). A similar regime could be applied in the Australian context, with SPDIs limited to holding deposits and digital assets, but not lending money or using held assets as collateral for lending activities. That is, a prudentially regulated category of*

ADI or custody provider. The digital assets held by the SPDI could be under a 'bailment' or similar custody arrangement, where legal ownership of the digital assets reside with the customers (given the ownership implications generally associated with holding digital assets). By creating a narrow authorisation (i.e. no fractional reserve banking) without the ability to rehypothecate assets, the risks to customer deposits and assets are significantly reduced.

Today, the digital asset market globally is approximately US$1.5 trillion. Fostering the development of a new breed of ADI or custodian that is completely digital and integrated into the global digital financial ecosystem, will help drive uptake of this technology across the financial services sector.

Insurance

Digital Currency Exchanges struggle or cannot secure insurance coverage across operational requirements.

No industry or limited liability scheme exists to support the sector.

Professional indemnity, Director and Officer insurance is uneconomical and very difficult to secure. We are advised that such products are currently only available via Lloyds of London.

Many businesses elect to self-insure, unnecessarily tying up capital, limiting investment and reinvestment.

Insurers require education and confidence in order to provide the insurance coverage the industry needs.

This problem, articulated in deliberately simple terms is a pervasive issue precluding the development of the sector.

Custodian Services

The industry would greatly benefit from consultation and guidance as to how the regulatory framework for the custody of assets (including financial products and scheme related assets in the context of responsible entities) is to apply where the relevant assets are digital assets.

For example: ASIC's Regulatory Guide 133 sets out the custody requirements associated with holding assets in the context of various schemes (including registered managed investment schemes, managed discretionary accounts and investor directed portfolio services). It does not adequately address how custody providers are to hold digital assets.

The under- development in the space and means that custodians are developing their services elsewhere e.g. Singapore or the US.

Consultation and guidance is required to determine the appropriate regime settings.

Digital Currency Exchange Register

AUSTRAC requires DCE providers to enrol and register with AUSTRAC and comply with related obligations under the AML/CTF Act and associated Rules. They do not currently maintain a public searchable register of DCE providers nor do they provide any form of document that evidences that a DCE is registered with AUSTRAC.

Blockchain Australia has engaged with AUSTRAC with respect to this issue. Both parties being aware of the concerns of the Digital Currency Exchange sector that issues related to the provision of reliable banking services (and ultimately the fear of being debanked) discourages many market participants from wanting to be identified publicly.

In this instance, transparency creates further risks of negative consequences for the industry.

Stored Value Facilities

Digital assets can be used as a method of payment in various ecosystems and networks where platform operators provide a digital asset wallet functionality to support the holding and subsequent transfer of digital assets to third parties as payment for off or on platform goods and services.

Holders of stored value in connection with a Purchased payment facilities (“PPF”) are regulated under the Payment Systems Regulation Act (“PSRA”) and Banking Act as a subset of ADI registered by APRA.

In many cases it may be that the operator is not the practical holder of stored value as it does not have control or ownership of such assets.

In cases where the operator is likely to fall within the definition of holding stored value in connection with a PPF, the outcome is that the operator must become registered as a PPF provider and therefore comply with the prudential framework that applies to ADIs.

The prudential framework is not designed for entities that deal exclusively in digital assets and therefore operators would not be able to practically comply with such a framework in its current form.

Guidance is required from the relevant regulatory authorities.

Designated Remittance Services

Remittance service providers are regulated under the AML/CTF Act.

The broad definition of designated remittance services, as making property or money available to anyone, has the potential to result in a designation that platform providers (including digital asset platform providers) that may effect the transfer of value within a closed loop system, facilitating payments for goods or services, or facilitating the transfer of digital assets are captured.

If the intention is to regulate these services from an AML/CTF perspective to reduce any risks that may exist in the models, it likely needs to be either regulated in a new payments and digital asset specific designated service, or AUSTRAC could publish guidance regarding how it intends to apply such services into the remittance designated service

Guidance is required from the relevant regulatory authorities.

Decentralised Autonomous Organisations (“DAO”) & Smart Contracts

Smart contracts are critical to the development of the cryptocurrency and digital asset ecosystem.

Decentralised Autonomous Organisations can’t launch because DAOs are not properly recognised under Australian law

The enforcement of smart contracts is uncertain under Australian law.

Entrepreneurs are hesitant to submit and work on DAO proposals due to uncertainty surrounding their legal status and the implications of code creation and vulnerability.

Complaints handling

Australian Financial Complaints Authority (“AFCA”) does not have a cryptocurrency team.

Determination of complaints lodged with AFCA are very expensive and time consuming to deal with for Digital Currency Exchanges given the lack of specific expertise and understanding of cryptocurrencies by AFCA.

Funds and fundraising

Early Stage Venture Capital Limited Partnerships cannot invest in digital assets because eligible investments are narrowly defined by the law.

Funds that have elected into the Attribution Managed Investment Trusts regime can't apply the capital account election to any digital assets held by the fund.

Listed Investment companies cannot invest in digital assets because the permitted investments definition isn't broad enough to capture digital assets.

The crowd sourced equity funding regime cannot be accessed because it is limited to offers of ordinary shares and doesn't seem to be able to extend to tokenised securities or other digital assets.

Conclusion

Blockchain Australia is cognizant of the policy challenges that will be faced by the Government in considering, consulting and addressing the foregoing issues.

This does not diminish the need to do so. The urgency for action is being driven by the passing opportunity to play a role, globally in the development of this industry.

Rapid education, upskilling and uptake of technology is critical. We believe this to be readily achievable.

It is a common refrain from the innovation sectors in the economy that investment and jobs will leave Australia for alternative jurisdictions which have clearer guidance. It is of even greater concern that infrastructure investment, being absent domestically, will be compounded by an unattractive inbound investment environment. Resulting in Australia being an overweight importer of key financial service infrastructure.

We welcome further discussions on the establishment of industry led working groups and the rapid development of regulator awareness and education initiatives.

The development of a regulatory framework that supports and creates an environment that drives local investment and encourages inbound investment being the goal.

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Steve Vallas - Chief Executive Officer