Creating Exceptional Outcomes

Regulating Digital Asset Platforms Proposal Paper

Submission by:
/ Queensland University of Technology;
/ HopgoodGanim Lawyers; and
/ Zerocap.

Prepared for:
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Regulating Digital Asset Platforms Proposal Paper - October 2023

HopgoodGanim Lawyers, Queensland University of Technology Law School, and Zerocap appreciate the opportunity to make a submission in relation to the Regulating Digital Asset Platforms Proposal Paper as released to the public on 16 October 2023 (**Proposal Paper**).

1. Introduction

1.1 HopgoodGanim Lawyers is a leading Australian independent legal and advisory firm operating nationally and internationally to deliver exceptional outcomes to clients across a broad range of industry.

1.2 Tim Edwards is a Partner of HopgoodGanim Lawyers, the Head of its cross-discipline Digital Assets practice group, and an Accredited Specialist in Commercial Litigation (Qld) with a particular focus on complex insolvency disputes.

1.3 Tim Edwards was assisted in preparing these submissions in response to the Proposal Paper by Luke Dawson (Special Counsel), Tom Mirolo-Lynam (Solicitor), Jonah Farry (Law Clerk) and James Lindsay (Law Clerk).

1.4 Dr Lachlan Robb is an academic in the Queensland University of Technology School of Law, focusing on the socio-legal dimensions of emerging technology. Lachlan's PhD was an investigation into blockchain start-ups and how the technology potentially disrupts legal and normative orders, and he currently studies the wider responses to emerging technologies as seen by both regulators and the legal profession. Dr Lachlan Robb is a consultant to HopgoodGanim Lawyers for the purposes of this submission.

1.5 Zerocap is a digital asset focused capital markets firm which primarily provides liquidity, structured products and on-chain custody to institutional clients and investors. Ryan McCall, Founder and CEO of Zerocap, has assisted with the preparation of these submissions to address the Proposal Paper from an industry participant's perspective. Zerocap is a loud advocate for Australia's digital asset industry and a long-standing client of HopgoodGanim Lawyers.

1.6 We are pleased to see the progress that is being made by the Australian Government towards the regulation of distributed ledger technology and its use cases, and this latest step in refining and advancing the regulatory regime is encouraging. We do, however, wish to make a number of comments in response to specific consultation questions raised in the Proposal Paper, based on our expertise and experience.

2. Question Set 1

> *Prior consultation submissions have suggested the Corporations Act should be amended to include a specific 'safe harbour' from the regulatory remit of the financial services laws for networks and tokens that are used for a non-financial purpose by individuals and businesses.*
>
> *What are the benefits and risks that would be associated with this? What would be the practical outcome of a safe harbour?*

2.1 The Proposal Paper suggests that a measure be inserted into the *Corporations Act 2001* (Cth) (**Corporations Act**) to afford some sort of regulatory protection for those involved with networks or tokens used for non-financial purposes. The operative term used is 'safe harbour'.

2.2 This appears motivated by a desire to create a balance between promoting innovation and protecting consumers.

2.3 We are supportive of that approach. There is obvious and resounding merit in Australia being perceived to have an economy and regulatory environment which favours, and helps to foster, responsible technological innovation. This was a key point in many submissions made in response to

the Senate Select Committee on Australia as a Technology and Financial Centre in 2021,[1] and must remain a priority going forward.

2.4 Our comments on this question are informed by our experience as and with Australian legal practitioners in the insolvency space; and for the most part, go to the particular terminology used and its potential consequences if enacted into law.

Unclear language

2.5 In short, we caution against use of the term 'safe harbour' in the context of the Proposal Paper's intentions.

2.6 The Corporations Act already uses the term 'safe harbour' elsewhere; and the distinct meaning attributed to the term in those other contexts could cause any new amendments to that same piece of legislation to become confused or subject to radical interpretation.

2.7 Subdivision C (of Division 3 of Part 5.7B), namely sections 588GA to 588GAAC of the Corporations Act, contains various provisions intended to negate directors' liability for insolvent trading in circumstances where certain strict conditions are satisfied in a restructuring context (**Safe Harbour Provisions**).[2]

2.8 The term 'safe harbour' is not used in the operative wording of these provisions – only in the headings. However, those headings have given colloquial meaning and the Australian insolvency industry typically refers to the protections created by these provisions as the 'safe harbour' provisions – or the 'safe harbour defences'.

2.9 The term 'defence' is important. In practice, these provisions are treated as defences to personal liability. That is also how they have been applied in cases. Earlier provisions in the Corporations Act proscribe that certain circumstances bring about a breach of the prohibition of insolvent trading. The Safe Harbour Provisions, which come later in the Corporations Act, provide that the breach is taken to have never occurred when certain criteria are met. The onus to establish the application of the Safe Harbour Provisions lies on the person seeking to rely on them. That is why they are treated as defences. This is a different functionality to a carve-out from liability, or by greater contrast, a positive permission.

2.10 A 'positive permission' is what is, in our view, usually afforded by a 'sandbox', a grandfathering mechanism, or another permissive statutory provision. It is different to providing what is, effectively, a defence.

2.11 Granted, the end effect of a defence and a positive carveout, at law, should technically be the same – that is, no liability or risk of prosecution arises. However, there are important procedural, methodological, and even sentimental differences between a defence and a positive carveout.

2.12 The former does not encourage innovation. In our view, and with respect, a defence creates a greater risk of not only aggressive statutory interpretation by regulators seeking to achieve different or more aggressive policy outcomes to those which appear to underpin the Proposal Paper, but also that poorly advised or misinformed industry participants fail to satisfy their onus to raise a defence for technical legal reasons.

2.13 This may sound like a pedantic point, but if the goal is to encourage innovation, then persons subject to the relevant statute ought to be encouraged to feel like certain acts are permitted, rather than simply 'excused' from illegality if certain criteria can be satisfied, subject to their own onus. The difference

[1] Select Committee on Australia as a Technology and Financial Centre – Final Report (October 2021).
[2] The term was also used, in neighbouring (and now mostly or entirely defunct) provisions, to create an immunity from action or liability in certain circumstances related to the effects of the COVID-19 pandemic.

there may be substantial and create different legal outcomes, whether intended or not. Further, we believe that genuine innovators ought to be free from the risk that comes with having an onus of proof.

2.14 A forthcoming article with the *International Journal of Semiotics of Law*,[3] directly addresses the linguistic issues of regulation and directly draws upon the Australian Treasury's Token Mapping exercise as a case study. In this article, the conclusion drawn is that the language used by regulators of blockchain technology and digital assets is not aligned with that used by those communities they seek to engage with. This has potential to create issues related to misunderstanding, misalignment, and arbitrage.

2.15 Regardless, there can be positives to using neologisms and specific language distinct from the community because this can carry out a unique regulatory purpose and be distinguishable from other regimes, both domestic and international. However, if this is not done carefully, confusion and regulatory overlap can be created[4] —such as that caused by the language of 'safe harbour', as demonstrated in this submission.

International perspectives

2.16 The sentiment of a safe harbour, as we perceive it (being a desire to create a haven and positive permission which encourages innovation) is consistent with a general recommendation made in the IOSCO Paper dated 16 November 2023.[5] It recommends the creation of a safe harbour, in the ordinary sense of the word, embedded within existing regulation.

2.17 Ultimately, that sentiment is, in our view, admirable. We strongly support its implementation in law. However, care should be taken to ensure that words are not used which are already attributed other meaning by the Corporations Act, and that any resulting mechanism is implemented through a positive permission in statute which does not place the onus of proving compliance, at first instance, on the industry participant rather than a regulator seeking to show non-compliance.

2.18 A proposed alternate descriptor is something to the effect of 'Permitted Conduct'. In our view, this better serves the ordinary meaning of the term 'safe harbour', which we consider to be 'a place free from danger or risk of harm'.

2.19 This would also be consistent with our understanding of the 'FinTech Regulatory Sandbox Framework' provided by the Monetary Authority of Singapore (**MAS**), which provides qualified applicants financial support for up to 50% of eligible expenses and appropriate bespoke regulatory privileges (such as the relaxing of certain regulatory requirements) where they can demonstrate that the proposed technology to be used is not yet applied in the financial services sector in Singapore.

2.20 Similarly, in the US, senators have recently proposed time-limited exemptions for new tokens so that issuers are given clarity as to how regulations will apply to them. Frameworks in Singapore, the UK, Canada, and which are proposed in the EU, contain similar positive permission provisions.[6]

2.21 We recommend that similar protections be implemented into any proposed legislation, being a positive permission for digital asset platforms (**DAPs**) who are not providing or facilitating any financialised function, and a temporary permissive carveout or right for entrants who are in the process of taking

[3] Olivia Sewell, Lachlan Robb, John Flood, 'Asset, Token, Or Coin? A Semiotic Analysis Of Blockchain Language', (2023) *International Journal of Semiotics and Law*, (Forthcoming).
[4] which has no simple fix except to avoid creating the overlap in the first place. See also related government work by Dr Robb into the risks and nature of regulatory overlap: Lachlan Robb, Trent Candy, Felicity Deane, 'Regulatory overlap: A systematic quantitative literature review' (2022) *Regulation and Governance* 17 (4).
[5] See the general recommendation made as *Recommendation 1 (Common Standards of Regulatory Outcomes*).
[6] Commissioner Hester Peirce, 'Token Safe Harbour Proposal 2.0' (Public Statement, U.S Securities and Exchange Commission, 15 April 2021); Monetary Authority of Singapore (2022); Proposal for EU Regulation on Markets in Crypto-assets, and amending Directive (EU) (2021); Digital Law Association (2021).

appropriate steps to comply with then-new regulation (an idea we discuss in more detail with respect to Question Set 16 below).

3. Question Set 2:

Does this proposed exemption appropriately balance the potential consumer harms, while allowing for innovation? Are the proposed thresholds appropriate?

How should the threshold be monitored and implemented in the context of digital assets with high volatility or where illiquid markets may make it difficult to price tokens?

3.1 The proposed low value exemption (**Proposed LV Exemption**) is also clearly intended to strike a balance between facilitating innovation and protecting consumers from harm. We make the following key comments as to its proposed scope and the potential difficulties, or even impossibilities, which might arise if it is to be applied and enforced as proposed.

Interaction with the non-cash payments regulatory regime

3.2 It is our understanding that the intent is for the existing financial services regulation, which regulates financial products and services, to apply in addition to any proposed new regulation where the relevant tokens or platform entitlements provided are financial products or services themselves.

3.3 We understand and agree with that approach. However, we urge Treasury to have careful regard for how this exemption is intended to interact with both the non-cash payments (**NCP**) facility regulations already contained in the Corporations Act and the low-value exemption contained in those regulations (**NCP LV Exemption**).

3.4 In short, there are some instances in which a DAP provider will be providing both a DAP and something which is clearly or arguably (depending on the particular workings) an NCP facility as well. If that is true, then unless the provider's activities enliven the application of both the Proposed LV Exemption and the NCP LV Exemption, then it may be that the NCP regulations apply in any event (potentially making the Proposed LV Exemption ineffective in that instance, even if it is uncontroversially enlivened).

3.5 This may be an intended outcome which serves its intended function in many cases. However, there will be cases where the unclear way in which the NCP facility regime applies to digital assets and DAPs effectively infects the ability for the Proposed LV Exemption to work as well. In other words, the intended purpose of the Proposed LV Exemption may not be achieved where the NCP facility regime imposes, or could arguably impose, a requirement to obtain an Australian financial services licence (**AFSL**) on an entity otherwise neatly satisfying the requirements of the Proposed LV Exemption.

3.6 One way around this would be to amend the existing NCP regime such that it does not apply to DAPs which meet the NCP LV Exemption and otherwise comply with these new proposed laws—or at least so that the way it interacts with any new legislation is clear and specified. The primary problem is a lack of clarity, rather than a fundamental disconnect between existing and proposed legislation.

3.7 We are concerned that without this clarification the proposed exemption will not create the benefit that it is intended to—which (subject to our comments below) has a purpose and function we agree with.

Limited scope by virtue of the low cap

3.8 The '$1,500' entitlement cap for any single customer of a DAP is, in our view, very low. In our experience, it will rarely apply or be applied except where DAPs provide and intend for small account or wallet balances to frequently be deleted, replaced or recycled (permitting a large net throughput or volume of transactions but never a large balance at any single time).

3.9 It is this 'large throughput or volume' application, reminiscent of the majority of cases which enliven the NCP LV Exemption, which informs our abovementioned concerns. We expect it is likely that most

providers taking advantage of the Proposed LV Exemption will use their platforms in this way; making it critical there is harmony and clarity as to the function of this new proposed regime and the existing NCP regime.

3.10 As to other, simpler potential applications of the Proposed LV Exemption, we do not understand why many providers would test their technology using a small number of real-value tokens in a public system —which exposes them to the application of regulation—rather than internally or virtually such that the proposed regulation will not apply regardless. That is partly why we believe the most common and relevant application of the Proposed LV Exemption would be to high volume or throughput transactions (which, again, are the sort most likely to fall within the existing NCP regime, whether that is intended to be the case or not).

Difficult or impossible application

3.11 There certainly may be DAP platforms or scenarios which involve no financialised function and where the Proposed LV Exemption perfectly serves its intended purpose (for example, platforms facilitating blockchain-based ticketing systems where no token is or can be exposed to volatile price movement).

3.12 However, given the proven propensity for digital assets, tokens or related entitlements to have volatile values, it will still be critical that mechanisms are included within any proposed legislation which clearly set out how the Proposed LV Exemption will be tested and applied to DAPs exposed to said volatility.

3.13 In short, if it remains possible (as we expect it to) for tokens used on DAPs to fluctuate in value quickly, then monitoring and testing (let alone enforcing) the eligibility for the Proposed LV Exemption will become impractical for regulators, if not impossible.

3.14 Indeed, it is not inconceivable that some tokens might, even if only for short periods of time, fluctuate from $1.00 each in value to $20.00 each in value (or even are extremely difficult to value with reference to fiat currency altogether, such as certain NFTs). That could create scenarios where a DAP provider very easily qualifying for the Proposed LV Exemption ceases to overnight; or ceases to for a few minutes on one day or a few days; and so on.

3.15 We propose any new regulation provide for an averaging mechanism to be applied to test eligibility for the Proposed LV Exemption. For example, it could be legislated that the Proposed LV Exemption only activates where the total value of users is on average, across a period of say 5 business days, less than $1,500.00.

3.16 Importantly, we would be remiss not to note that the same concerns and recommendations must apply equally to the NCP LV Exemption.

Practical difficulty in enforcement by providers

3.17 We also take this opportunity to note a practical matter that industry participants will no doubt seek guidance on—whether from regulators if possible, or if not, their legal advisers.

3.18 From the perspective of a law firm who often sees and advises those operating or exposed to DAPs in a payments context, the practical problem for clients (beyond interpreting and understanding the meaning of the Proposed LV Exemption) would not necessarily be measuring customer account or wallet balances (which could be done automatically and using alerts), but determining what to actually *do* with customers who approach the limit.

3.19 Stopping customers from transacting works, but not if the problem is that assets already bought or held are increasing in price. The only way to keep a customer under the minimum value limit in that scenario would be to force them to sell their digital assets on certain terms. That would raise its own consumer protection concerns; and seems impractical and altogether undesirable. We suggest that thought be given to this issue by Treasury.

4. Question Set 4

Are the financial requirements suitable for the purpose of addressing the cost of orderly winding up? Should NTA be tailored based on the activities performed by the platform provider?

Does the distinction between total NTA needed for custodian and non custodian make sense in the digital asset context?

4.1 We note for completeness that the term '**NTA'** refers to 'net tangible assets'—a very relevant concept where digital assets themselves are of course intangible (even if some are linked to or backed by tangible assets). It is a familiar concept to those exposed to the financial services industry and does, certainly, have a place in this area of regulation.

The $5 million NTA for custodians

4.2 The NTAs proposed by the Consultation Paper in respect of DAP providers that perform custody functions appear to be drawn from the margin lending requirements in the Corporations Act. We say that as we have observed that they have a 'flat' or fixed amount ($5 million as well) as opposed to a proportionate or formulaic calculation.

4.3 Commentary in the Proposal Paper makes it clear that this Question Set and the proposals underpinning it are intended to create a mechanism which ensures that DAP providers on the precipice of, or subject to, insolvency events retain enough liquid assets to cover the professional costs associated with an orderly winding up (being, namely, the professional fees and disbursements of an **insolvency practitioner**[7]); as distinct from creating a reserve to pay customers or platform users directly. This is important and informs our submissions below.

4.4 Based on our experience with complex insolvency matters, including a number of (in our view) highly relevant matters which involve not merely cryptocurrency but the need for insolvency practitioners to identify, trace in equity, sue for or otherwise recover, store, deal with or sell large amounts of cryptocurrency or other digital assets (and incur the costs of doing those things), our key comments on the proposal are that:

(a) it is crucial that NTA requirements be imposed for this purpose;

(b) it is, however, critical that great care is given to how these NTA requirements are defined, calculated, assessed and imposed; and

(c) if such care is not taken, these NTA requirements may, on their own, stifle innovation and completely cripple the digital asset industry.

Quantum – the costs of external administration

4.5 The fees of insolvency practitioners are rarely insignificant. Often in a liquidation scenario, the liquidator's fees are a key if not the key factor influencing whether unsecured creditors receiving cents in the dollar or nothing.

4.6 Further, in our experience, the best insolvency practitioners tend to require the proffering of either an indemnity from a solvent entity, or the presence of significant funds in a bank account of the relevant company, before they agree to take on an appointment. These are all points in favour of the imposition of an NTA geared towards covering insolvency practitioner fees and disbursements.

4.7 We must, however, firmly disagree with the imposition of a 'flat' NTA for custodial entities in the order of $5 million. The imposition of a flat rate for all DAP providers has no regard for the size or complexity of the relevant entity, or its financial position; and thus, little regard for the likely actual cost of an 'orderly winding up' in context. This proportionality based approach would certainly be, in our

[7] Being an Administrator, Receiver, Manager, and/or Liquidator.

view, more consistent with the 'same activity, same risk, same outcome' approach adopted in the Proposal Paper than the application of a fixed NTA requirement of $5 million.

4.8 It is clear that in massive liquidations—such as that of the foreign FTX entities—insolvency practitioner fees could well exceed $5 million. For example, we understand from reported media that the legal fees incurred by the lawyers acting for FTX's liquidators in the USA have exceeded US$100 million.

4.9 However, if one is to examine the average size and complexity of the operations of the Australian entities operating in this industry, and the average size of relevant liquidations in Australia generally (as we have done in preparing this submission), it is quite clear that very few liquidations are likely to be anywhere near as expensive or as disastrous for consumers as that of FTX.[8]

4.10 Even the external administration of the Australian FTX entity was far cheaper than that of the US entity (and we expect those intimately involved with that administration can proffer data in that regard).

The additional costs arising from the relevance of digital assets

4.11 We have acted for insolvency practitioners tasked with navigating scenarios heavily involving digital assets. One such appointment, of note, was acting for Receivers and Managers appointed at the behest of the Australian Securities and Investments Commission (**ASIC**) to identify, trace, recover, take custody of, and realise part of some $40 million (at that time) worth of cryptocurrency (the **Example Appointment**).

4.12 It is clear to us from that experience (and others) that external administrations involving cryptocurrency, at least for now, can commonly cost more than external administrations which do not. There is a greater need to take legal advice where the legal status or position of cryptocurrency is presently unclear.

4.13 For example, we have had to advise appointees as to whether customers of an exchange are the true 'owners' of cryptocurrency, and that is a relatively novel issue. By way of example only, there are also the commonly asked, and sometimes expensive, legal questions of:

(a) whether particular tokens are financial products or particular activities are financial services for the purposes of the Corporations Act (and, if so, what liability may ensue for the company or its directors);

(b) whether particular providers are in fact operating managed investment schemes (and if they have done so unlicensed, what the consequences of that are);

(c) when in fact a particular entity was 'insolvent' at law in circumstances where many of its assets were volatile in value, such that its financial position may have rapidly fluctuated;

(d) similarly, whether a transaction was uncommercial and constituted an unfair preference, or was otherwise voidable, where one or more of the assets transacted with or against was again highly volatile (thereby changing the value of the transaction rapidly);

(e) whether one or more trust relationships exist or not, and if so, what are their terms;

(f) how a smart contract operates or functions in a legal context, and its status at law as a binding agreement or otherwise;

(g) how a court can freeze or make orders to recover cryptocurrency;

(h) how a Decentralised Autonomous Organisation (**DAO**), or alleged DAO, can or should be treated under Australia law in the insolvency context; and

[8] If requested, we can privately provide further deidentified costing data as to the costs we have seen incurred in liquidations of particular sizes, and with particular complexities, whether involving digital assets and corresponding issues or not.

(i) how equitable tracing principles apply to transfers of cryptocurrency through mixed funds or wallets.

4.14 In addition to these things, there is the likely added insolvency practitioner costs associated with:

(a) paying forensic experts to trace cryptocurrency (and many reputable experts of this kind work within large accounting firms and are not cheap);

(b) paying a custodian to take safe custody of cryptocurrency (with large firms often approaching the likes of Zerocap to assist with that for a fee); and

(c) the added cost and difficulty of insurance coverage for the cryptocurrency (which can attract a significant premium given the risk and unknown novelties involved).

4.15 These factors can all increase the costs of a winding up. However, they will not always increase costs substantially. It is rare that all of the above issues will arise in any one appointment. It is far more likely that one or two of them will arise in the majority of appointments. Further, the reason these issues arise and are novel is that they are new; the longer they persist, the less novel or difficult (and thus expensive) they will be.

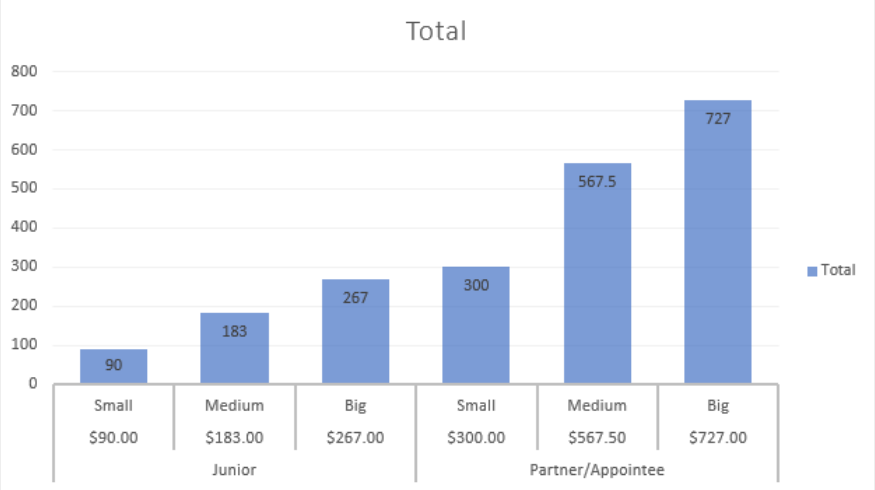
4.16 As it is, our advices on these matters cost less than they did 12 months ago because we have precedent to draw on, we have more experience (as will our competitors), and the state of the law is altogether becoming clearer. New regulation will only improve this position.

4.17 For context, in the Example Appointment, which we expect is nearing its conclusion, the total fees and disbursements (including legal fees and disbursements) incurred by the Receivers and Managers (who are Partners or former Partners of a 'Big 4' accounting firm) are less than $3 million (AUD).

4.18 The Example Appointment was, in our experience, an unusually complex job—hampered not only by uncommon complexity (much of which had nothing to do with the involvement of cryptocurrency but rather the conduct of the parties and stakeholders), but some novelty which we expect will now have dissipated. Still, even that appointment has so far resulted in a total spend of well less than $5 million.

4.19 Australian insolvency practitioners typically range in cost depending on firm size and billing practitioner's seniority. Nonetheless, for reference we set out the below table which sets out an

average cost per hour of insolvency practitioners we commonly engage with, sorted by firm size and level of seniority (junior or Partner/Appointee level):



4.20 At the above hourly rates, and in our experience, it is a large and complex appointment indeed that requires the incurring of liquidation fees and disbursements approaching $5 million.

Our definition of 'orderly winding up'

4.21 Further, during the Example Appointment, as with any long-running external administration (which was rightly permitted to be long-running), recoveries were made which assisted the funding of the administration. It is, in our view, over-conservative to classify the proposed NTAs as an amount required to fund an entire liquidation or receivership. That would, with respect, be luxurious and very conservative.

4.22 Instead, the function of such NTAs should be to provide the amount needed to secure and support the appointment of a competent insolvency practitioner and fund initial recovery efforts. Should those efforts then not be able to fund the continued administration, and funding not be able to be obtained in any other way, the administration should be brought to an end where possible regardless, as is normal and responsible practice in the insolvency industry.

4.23 To summarise, an 'orderly winding up' is, in our view, a winding up where there are sufficient funds to persuade a competent and experienced insolvency practitioner to take on an appointment, and to fund initial recovery efforts for the benefit of creditors—and not more than that. This perspective also appears to be shared by the ASIC, which described an orderly winding up (in the context of 'responsible entities' for managed investment schemes under the existing financial services regime) as "*having sufficient capital or liquidity to meet the costs of administrators and other professional service providers required to wind down or transition assets*".[9] Otherwise, funds are to be kept by participants, on ice and to their clear detriment, in order to fund liquidations that in the normal course should be

[9] RG 166, 'Responsible entities: Financial requirements' (2011) at [16].

brought to an end sooner rather than later (for better or worse), with the only beneficiaries to be insolvency practitioners and advisers themselves.

4.24 The authors of this submission who are themselves solicitors practising in the insolvency space do not say that lightly.

Conclusions as to appropriate custodial NTA amounts

4.25 In summary, the amount of $5 million will be unreasonably large and over-cautious for many businesses responsibly operating in the industry, and its imposition could well devastate the industry.

4.26 It is possible to run and complete, let alone responsibly commence and progress to the point of recoveries likely being made, an external administration in Australia for much less than that, despite many of the (in our view, reducing) complexities arising from the involvement of digital assets.

4.27 Granted, some firms ought to, given their size and complexity of their operations, be forced to hold at least $5 million in NTA. Some should be forced to hold much more. But they are likely to be few in number and not to comprise the majority of relevant insolvencies.

4.28 Overall, our recommendation is that a mechanism should be legislated to calculate the NTA requirement for custodial providers which is a percentage of their assets under management.

4.29 The precise figure of that percentage should (if it is intended to cover the initial costs of an external administration and to be calculated conservatively, favouring the protection of consumers), in our view, be in the order of 1.0% to 2.5% of the assets in user accounts, under management or on trust.

4.30 This would enable responsible industry participants to survive and innovate responsible, but also encourage stakeholders to have confidence that such participants can be wound up in an orderly manner, should the need unfortunately arise.

4.31 Two further issues with the proposal pertain to whether certain digital assets can be included within NTA reserves, and if not, how entities struggling to obtain and retain bank accounts (noting the ‘de-banking; phenomenon of which are presume Treasury is aware) can possibly comply.

Tangibility – eligible assets

4.32 As a separate issue, the term ‘tangible’ is outdated in this context. It need not be changed if the meaning can be specified, but we suggest this fact be considered by Treasury.

4.33 The jurisprudential reasoning behind excluding intangible assets from proscribed liquid reserves is that, traditionally, assets such as intellectual property, software, contracts, domains and websites have been considered difficult to value or dispose of relatively quickly. However, in the digital asset context, it would be helpful to have certainty as to whether digital assets are ‘tangible’ for these exact purposes—or otherwise sufficient based on other terminology—for the purposes of the NTA requirements.

4.34 If digital assets are in fact able to be held for the purposes of satisfying a NTA requirement, this will need to be clearly specified and we would encourage the overt selection of digital assets that are not directly tied to the operations of the DAP or otherwise derive their value from such operations (i.e. algorithmic stablecoins that are reliant on a native platform token) so that they are neither affected by the volatility associated with a winding up, nor commingled with the other property held by DAP provider (which might place them at risk of being ‘locked’ away from insolvency practitioners in the same way that other property might be, particularly where a trust relationship is imposed).

4.35 One recommendation is to permit true, fiat-backed stablecoins to be used in order to satisfy NTA requirements. That would require guidance to be issued by Government or a regulator as to which such stablecoins are viewed to be satisfactory. Be that as it may, we consider that this would enable

far more industry participants to satisfy the proposed NTA requirements in a manner which still meets the intended underlying purpose (thus encouraging competition and innovation).

De-banking

4.36 Should this recommendation not be followed, it seems likely providers will be forced to keep fiat in an Australian bank account. There is an obvious and dire problem with that at the time of writing, being that Australia's major banks are presently extremely reluctant to permit businesses with a connection to cryptocurrency or other digital assets, even conservative and responsible businesses they otherwise support or seek to invest in themselves, to hold and maintain bank accounts.

4.37 In short, if Government intends to force DAPs to hold monies in Australian bank accounts, then something needs to be done to enable or assist those providers to actually maintain Australian bank accounts. We hope that further regulation reduces the anxiety of banks and alleviates this problem, but there is no guarantee of that at the moment and this should be regarded as a very serious concern by Treasury.

FTX

4.38 We caution against over-critical approaches to this issue as there may be a push to 'fix' this area simply because of the public consumption of the FTX issues. The obvious policy goal is to prevent what is referred to as the 'FTX event'. However, the injustice in that event was, on our assessment, primarily caused by:

(a) *first*, a dire lack of corporate control, governance and integrity (and we note the various public comparisons between this event and the Enron insolvencies);

(b) *second*, the fact that many users were deemed unsecured creditors; and

(c) *third*, the first factor leading to a perceived lack of funds to pay unsecured creditors.

4.39 Much of the related unlawful conduct was no doubt prohibited by existing regulation, which was not complied with, and which was not able to be enforced before it was too late. In our opinion, NTA requirements would not have prevented most let alone all of above consequences. Thus, NTAs should not be overused now in the hope of preventing such a scenario from occurring again. In our view, there is absolutely a place for NTAs, provided that they are:

(a) made relative to the size and complexity of the provider; and

(b) either permitted to include fiat-backed stablecoins, or accompanied by some measure to discourage de-banking, thus enabling actual compliance.

The 0.5% non-custodial NTA

4.40 Whilst the point is not a focus of this submission, the NTA requirement for non-custodial providers (being 0.5% of the value of the DAP) is, in our view, potentially onerous. This is for the reasons outlined above with respect to the true likely cost and meaning of an orderly winding up in a digital asset context.

4.41 This NTA would likely be relevant where a DAP provider is already contracting with a custodian (itself satisfying the relevant NTA) and already paying that custodian a fee which is likely calculated with reference to the amount of assets under management. These factors, taken together, could mean that a 0.5% NTA is uncommercial for a small to medium sized enterprise to maintain – even where, again, they are entirely outsourcing the custody function.

5. Question Set 7

Do you agree with the proposal to adopt the 'minimum standards for asset holders' for digital asset facilities? Do you agree with the proposal to tailor the minimum standards to permit 'bailment' arrangements and require currency to be held in limited types of cash equivalents? What parts (if any) of the minimum standards require further tailoring?

The 'minimum standards for asset holders' would require tokens to be held on trust. Does this break any important security mechanisms or businesses models for existing token holders? What would be held on trust (e.g. the facility, the platform entitlements, the accounts, a physical record of 'private keys', or something else)?

5.1 At present, many DAPs providers impose terms and conditions which, in our view, provide that they do not hold assets on trust for customers, but rather, are loaned those digital assets (or an amount akin to the initial price, or the value of those digital assets) by the customer, who is an unsecured creditor owed those assets (or that amount). The former can be conveniently referred to as **Trust Model**. The latter can be conveniently referred to as a **Lend to Exchange Model**.

5.2 It is our understanding that the Proposal Paper seeks to impose a regime whereby DAP providers are no longer permitted to utilise a Lend to Exchange Model and must only use a Trust Model. If that understanding is wrong, the true position should be made clearer in any draft legislation.

5.3 If our understanding is right, it will mean that any proposed legislation is inconsistent with what is, in our view, suggested by the most recent IOSCO Paper.[10] That said, we must note that the IOSCO Paper generally favours and strongly recommends the Trust Model—and only goes so far as to arguably permit the Lend to Exchange Model where particular criteria are met, including extremely clear terms and disclosure.

5.4 We agree with that approach. We do not understand why DAP providers should be prohibited from operating Lend to Exchange Models where it is made painfully clear to consumers that they are agreeing to be bound by that type of model, as well as how that will affect them in an insolvency scenario.

5.5 That would entail greater clarity than most DAP providers at the moment. It is our experience that most retail users and some institutional users of DAPs believe they own digital assets held on the exchange when, in fact, all they own is a contractual entitlement (under a Lend to Exchange Model) to request payment or the provision of certain assets. Ultimately, in an insolvency context, these persons are left as unsecured creditors.

5.6 This means that it would be fitting, in our view, for any exchange running a Lend to Exchange Model to be expressly required by any new legislation to make extremely clear disclosure to its customers which explains the nature of their relationship with the exchange, explains that customers will be mere unsecured creditors as well as the implications of that, and forces customers to positively confirm they understand that. These things cannot and should not be hidden in lengthy terms or 'small print'.

5.7 It may be that the contrary would, even at the time of writing, offend provisions of the Australian Consumer Law regardless—but the issue is important enough that obvious regulatory guidance should be imposed if Lend to Exchange Models are to be permitted, albeit under strict controls.

5.8 One reason for which Lend to Exchange Models should be permitted in this fashion, is that in our experience:

(a) DAP providers employing such models have reduced controls and thus incur lower costs;

[10] Being OICV-IOSCO, 'Policy Recommendations for Crypto and Digital Asset Markets Final Report' The Board of the International Organization of Securities Commissions (16 November 2023) Recommendation 13 '*Segregation and Handling of Client Monies and Assets*'.

(b) these providers also enjoy a greater freedom to invest and thus earn revenue using or in connection with platform assets;

(c) the combination of lower costs and higher revenue means such providers can sometimes offer significantly more lucrative rates or better returns to users; and

(d) taken together, these features means that customers can choose to take greater risk for greater reward.

5.9 In our view, consumer protection controls should prevent customers from unknowingly taking any risk, but should otherwise permit them to take reasonable risks of which they are clearly made aware, facing providers who otherwise comply with the requirements of the legislation anyway (i.e. who have complied with licensing and related requirements).

5.10 Another reason for this view is that, if it is true that Lend to Exchange Models can be and are more attractive to many customers (and that is our view), then prohibiting them in Australia, where they are permitted in many other jurisdictions, will almost certainly just drive customers offshore. That creates several serious enforcement burdens and obviously harms Australia's digital asset industry. It should be avoided.

5.11 All of that said, we do hold the view that favour should be given to Trust Models. They should be encouraged. They are far safer for consumers and can still be employed in ways which encourage innovation. Our view is merely that Lend to Exchange Models should not be stamped our entirely.

5.12 We say that Trust Models are safer because, in short:

(a) fiduciary duties are an inherent aspect of trust relationships. The obligations of trustees are equitable in nature and attributable to the trust property;

(b) therefore, beneficiaries have rights of a proprietary nature constituting an equitable estate in the trust property;

(c) this means, relevantly, that in an insolvency scenario, whether assets are held on trust for customers will generally determine whether those assets should be made available to the general body of creditors; and

(d) moreover, these models would allow user creditors to draw on the vast and well-established authority on trusts when the subject matter of their claim concerns digital assets held on trust.

5.13 The strict regulation (but certainly not altogether prohibition) of Lend to Exchange Models (namely by the imposition of strict controls as recommended above) will exclude many industry players, but that would seem to be a necessary consequence of pursuing the goals the Proposal Paper seeks to achieve.

International Perspectives

5.14 As noted above, the IOSCO recommends that "*[r]egulators should require a CASP* [crypto-asset service provider] *to place Client Assets in trust, or to otherwise segregate them from the CASP's proprietary assets*"[11] (but does not, in our view, propose that Lend to Exchange Models be banned).

5.15 We note for completeness that there is a significant and developing body of authority acknowledging that digital assets can be held on trust. We applaud what seems to be a default (and in our view,

[11] IOSCO. (2023). *CR01/2023 Policy Recommendations for Crypto and Digital Asset Markets*. Consultation Report.

correct) recognition in the Proposal Paper that digital assets are property under Australian law which are capable of being held on trust.

5.16 As Treasury is no doubt aware, this issue has been traversed by the following authorities:

Case	Jurisdiction	Summary
Ruscoe v Cryptopia (in liq) [2020] 2 NZLR 809	New Zealand	The New Zealand High Court considered for the first time whether cryptocurrencies can be considered 'property' at common law, and to what extent an account holder's interest in cryptocurrencies are protected from claims made by the creditors of an exchange in liquidation. The court concluded that Cryptopia fulfilled the role of a trustee in relation to the account holders and the digital assets were deemed to be held in multiple trusts. It also held that Cryptopia's principal role was to hold each group of digital assets as trustee for the accountholders, to follow their instructions, and to let accountholders increase or reduce their beneficial interests in said trusts. This reasoning was predicated on the fact that Cryptopia itself did not engage in trading cryptocurrencies, thereby limiting its function to holding assets on trust in the eyes of the court.
B2C2 Ltd v Quoine Pte Ltd [2019] SGHC(I) 3	Singapore	This was the Singapore International Commercial Court's first cryptocurrency-related judgement, which applied the law of contractual mistake in circumstances where legally binding contracts were performed by an automated contracting system without human intervention. The Court also considered whether cryptocurrencies constituted property capable of being held on trust and what the appropriate remedies were for breach of contract or trust in the circumstances. B2C2 had entered into a membership contract with Quoine under which B2C2 could make trades of cryptocurrencies with other parties on Quoine's automated trading platform. The platform malfunctioned, executing a trade at 250 times market value in B2C2's favour. Quoine reversed the trade despite its contract stating that trades were "*irreversible*". The Court found that "*cryptocurrencies are not legal tender in the sense of being a regulated currency issued by a government but do have the fundamental characteristic of intangible property as being an identifiable thing of value."* It went on to hold that cryptocurrencies are "*definable, identifiable by third parties, capable in its*

Case	Jurisdiction	Summary
		nature of assumption by third parties, and have some degree of permanence or stability." Ultimately, the Court held that Quoine was in breach of contract for the reversal and in breach of trust.
ByBit Fintech Limited v Ho Kai Xin & Ors [2023] SGHC 199	Singapore	The Singapore International Commercial Court, in citing a MAS Consultation Paper (not too dissimilar from that which these submissions are made in response to) held that "*it is possible in practice to identify and segregate such digital assets*"; and that "*it should be legally possible to hold* [crypto assets] *on trust*".
Re Gatecoin Limited [2023] HKCFI 91	Hong Kong	The Court of First Instance held that cryptocurrency could be regarded as property (citing the reasoning of the High Court of New Zealand in *Ruscoe v Cryptopia*), and is thereby able to be held on trust for beneficiaries for the purpose of administrating an insolvent estate.
Zi Wang v Graham Darby [2021] EWHC 3054 (Comm)	England	The High Court of Justice considered an exchange of cryptocurrencies between the claimant and the defendant which were to be returned at the end of a defined period. The defendant sought to make use of the transferred assets during the period of possession, by way of sale or otherwise, and the claimant disputed this. The Court ultimately held that while there could exist circumstances where cryptocurrencies were held on trust, the facts of this case did not provide for such a judgment to be made.

5.17 As to what facet of a digital asset ought to be held on trust, it is our view that there are genuinely a number of workable ways in which the relevant trust property could be defined. However, in our view, the simplest and most protective means would be to specify that the trust property comprises all of:

(a) any digital asset or token attributable to the user by, or in, an account balance or any other form of platform entitlement granted to the user;

(b) the private key of the wallet in which any such digital asset or token resides; and

(c) the right or rights attributable to the holder of any such private key.

5.18 The rights attributable to the holder of such a private key were well described by Professor Kelvin Low,[12] who was cited in the decision of the High Court of Singapore in *ByBit Fintech Limited v Ho Kai Xin & Ors* [2023] SGHC 199 at [36],[13] to the effect that such a right is '*properly conceptualised as a*

[12] Kelvin FK Low, "Trusts of Cryptoassets" (2021) 34(4) Trust Law International 191.
[13] in turn citing *Miller v Race* (1758) 1 Burr 452 at 457.

narrow right to have the unspent transaction output of a crypto asset locked to a holder's public address on a blockchain'.

5.19 In our view, the above would adequately protects consumers whilst working well within the technological infrastructure that is or ought to be adopted by DAP providers adopting a Trust Model.

6. Question Set 11

What are the risks of the proposed approach [regarding staking]*? Do you agree with the suggested requirements outlined above? What additional requirements should also be considered?*

Does the proposed approach for token staking systems achieve the intended regulatory outcomes? How can the requirements ensure Australian businesses are contributing positively to these public networks?

6.1 We generally agree with the definition of, and technical observations made as to, staking contained in the Proposal Paper. We describe staking to be the act of validating transactions while posting collateral that acts as an insurance against fraudulent validation, which in turn provides security to the network. The key aspect we wish to comment on is that DAP providers can be involved in the staking process to varying extents, and care should be taken to ensure any regulation considers this and does not impose harsh obligations on providers who are only involved in the staking in a connective or ancillary way.

6.2 Some platforms provide staking services by enabling customers to contribute assets, which are then pooled on or by the DAP and effectively managed by the DAP provider so that they may be staked. In this scenario, the DAP is actively managing pooled assets and we agree this should be treated as a financialised function, as proposed.

6.3 However, we are also aware of a growing number of industry participants, particularly in the wake of the ASIC's enforcement litigation commenced against BlockEarner last year, who no longer offer this sort of pooling or management function. These actors instead engage with staking by only providing technological infrastructure for customers to stake their assets, such that their DAP does not pool any assets and does little more than take technical steps the customer could conceivably take themselves with the proper expertise and hardware to enable them to engage with the relevant network and stake their digital assets. The role is more akin to custody than it is to the encouragement or further facilitation of staking.

6.4 We do not believe that scenario should attract any greater regulatory burden than any standard digital asset custody arrangement. The DAP does no more than take custody of digital assets, already stored or recorded on the blockchain, and enables them to be used for a particular function on said blockchain.

6.5 Again, overregulation in this space risks driving investment into riskier offshore systems that remain unlicensed. Regulatory uncertainty in staking creates a material impact on revenue for compliant DAP providers. This situation means that there is a significant amount of digital assets held on custody that cannot then be staked. The customers using these DAPs typically invest and believe in the digital asset and that if they are going to hold it, they may as well generate a yield—something which staking provides. If a DAP is unable to offer staking, then those same customers are likely to take funds out of custody providers and find offshore providers that can enable both custody and staking in a single service.

6.6 This offshore shift is not seen as a move to more positively regulated spaces, but rather to the 'alegal' areas that are yet to clearly or restrictively regulate these actions. This means that there is a higher risk to Australians who use these services as they are more likely to be pooling assets and be

unlicenced. Assuming that there is a goal of consumer protection, then overregulation of staking can be seen as a failure if it drives this use to higher risk offshore DAPs.

7. Question Set 15

Should these activities or other activities be added to the four financialised functions that apply to transactions involving digital assets that are not financial products? Why? What are the added risks and benefits?

7.1 The Proposal Paper correctly identifies that both margin lending-like arrangements and debenture-like arrangements may already be regulated under the *National Consumer Credit Protection Act 2009* (Cth) and under the financial services regime in the Corporations Act (respectively).

7.2 The key regulatory difficulty we have seen face participants in the industry pertains to the oft-discussed issue of token-mapping. The existing credit regulations neither neatly, nor with any certainty, apply to many kinds of digital asset involved in arrangements that are reminiscent of traditional margin lending or debenture arrangements.

7.3 We urge Treasury to continue, or at least legislate or publish the results of, some form of token-mapping process to assist this. The result could take a number of forms. It could be the amendment of statutory definitions so that there is greater certainty (even if not absolute certainty) as to which digital assets will fit into the existing credit regulation regime.

7.4 To that end, we would support:

(a) the amendment of the definition of ‘money’ as it pertains to debentures to include fiat-backed stablecoins, provided enough guidance was given as to what stablecoins are considered to meet that description by Government or regulators (to provide clarity); and

(b) the amendment of the definition of ‘marketable security’ to include digital assets which are not financial products (this being our understanding of the intent of the provision, and a necessary change to provide clarity).

7.5 If such changes are perceived as too drastic, this need might instead be able to be met by something less than legislation, such as a guidance note issued by a regulator (even one pertaining to a very small number of digital assets or related activities, to allow more specific analogies to be drawn by lawyers and regulators even if it does not give them definitive answers). This may strike a fair balance

between information, regulatory certainty, and the difficulties faced by the concreteness of legislative statements and definitions in emerging technologies.

7.6 In the absence of such steps to clarify how existing regulation works, we would instead recommend that the proposed new legislation is expanded to treat lending arrangements as 'financialised functions', so that there is at least certainty as to what is regulated and what is not, in this context.

7.7 The prohibition on debenture-like arrangements that utilise stablecoins in particular would appear to be a fairly drastic measure given that other regulatory protections are available (including those identified in the Proposal Paper).

8. Question Set 16

Is this transitionary period appropriate? What should be considered in determining an appropriate transitionary period?

8.1 We interpret the term 'transitionary period' to mean something other than a grandfathering period. We take the term to mean that, at the end of such a period, new regulations will be in force and are expected to be complied with. If that understanding is wrong, the below concerns may be moot.

8.2 If not moot, our key concern as to the proposed transitionary period of 12 months is that it may leave many industry participants, who have done the right thing and applied for appropriate licensing as soon as is practicable (and no doubt after taking comprehensive legal advice), still unable to comply with the laws. It is an issue of practical compliance.

8.3 In our experience, a 'traditional' financial services provider can expect the processing timeframes for the ASIC to grant an AFSL to range anywhere from six months to two years, depending on a variety of factors. The Proposal Paper, if its recommendations are enacted into law, would draw many currently unlicenced service providers out of the woodwork and into the regulatory ambit of the financial services regime. This would almost certainly drive a sharp uptick in AFSL applications.

8.4 We appreciate that regulators are not always the most well-heeled statutory bodies and query whether this uptick in AFSL applications would be met with a commensurate increase in resourcing. If that were to be so, our concerns may very well be unfounded. However, if current circumstances persist, we would be particularly concerned about many industry actors being caught afoul of law after the transitionary period, despite their best efforts to comply in their newly regulated domain.

8.5 This may also have other undesirable flow-on affects in the authorised representative market. A lack of supply or indeed increased delays could see an update in 'AFSL-for-hire' type arrangements which would undoubtedly see the market move in the opposite direction to that which Treasury must intend.

8.6 The recommended solution would be to:

(a) extend the period to 18 or even 24 months; or

(b) alternatively, to keep the proposed 12-month timeframe to encourage quicker adoption, but to adopt the approach taken in other jurisdictions such as Singapore, whereby having an application for a license under consideration provides temporary permission and protection until that licence application is decided.

8.7 We note that an analogy may be drawn to the roll out of the General Data Protection Regulation (**GDPR**) within Europe. The GDPR was adopted in April 2016 and became enforceable in May 2018. Anecdotally, professional services and data protection officers were rarely consulted until the start of

2018 and the long implementation time caused discrepancies between the efficacious early adopters and the resistant laggards.

8.8 The second option mentioned above (in paragraph 8.6(b), being provision for clemency for those waiting for regulatory approval or licencing, is likely to strike a positive chord between the two extremes. This is our preferred recommendation.

9. Next steps

9.1 We welcome clear regulation that provides all interested Australians with clarity and certainty as to the treatment of digital assets going forward. We would be happy to discuss further and contribute to the discussion, including by providing assistance with drafting.

9.2 If we can be of any further assistance, please do not hesitate to contact the writers to discuss the matters further.

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