19 July 2021

Senator Andrew Bragg
Chairman, Select Committee on Australia as a Technology and Financial Centre
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senator Bragg

Response to the Third Issues Paper of the Select Committee on Australia as a Technology and Financial Centre

We write to provide a submission to the Senate Select Committee on Australia as a Technology and Financial Centre ('Committee') following the tabling of the Committee's Second Interim Report and the publication of the Third Issues Paper. Note that we make this submission in our personal capacities, building on the previous submission and appearance of Darcy Allen, Chris Berg and Aaron Lane.

INTRODUCTION

We are a team of academic social scientists—economists, political scientists, lawyers, 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 welcome the extension of this inquiry, and in particular its additional emphasis on regulatory barriers as they pertain to: "the regulation of cryptocurrencies and digital assets" and "issues relating to 'debanking' of Australian FinTechs". Our focus is on the regulation of Australia's digital economy, including recommendations for reform for cryptocurrency, digital assets and new blockchain-based organisational forms.

The recommendations in this submission emerge from the combination of (1) our academic research on the frontiers of blockchain and the digital economy; and (2) discussions with entrepreneurs and businesses in Australia and internationally. Australia's current regulatory stance presents an imminent risk to innovation, particularly with mobile capital and labour and a global competition to design digital infrastructure. If these barriers are overcome, however, we are also presented with an enormous opportunity to attract capital and investment to these shores.

The authors are all affiliated with the RMIT Blockchain Innovation Hub (RMIT BIH). The RMIT BIH was established in 2017 as the world's first research centre on the social science of blockchain technology. The RMIT BIH brings together academic researchers in the fields of economics, communications, finance, history, law, sociology, and political economy. The directors of the RMIT BIH have made a significant contribution to the Australian Government's National Blockchain Roadmap.[1] This award-winning research centre is at the forefront of bridging academic research with the design of digital economy business models, and the implications that has for institutions, including established regulatory frameworks.

The joint focus of our research programs is primarily in blockchain technology, including its applications in cryptocurrencies and other digital assets. Blockchain technology, however, must also be understood as the foundation of a much broader technology stack including artificial intelligence and the internet of things. As such, while our submission focuses on the regulatory tensions presented by blockchain, it is important to recognise that ameliorating these challenges powers-up a much broader tech stack, contributing to the development of Australia as a financial and technology centre.

This submission consists of two parts. In Part 1, we outline the fundamental problem of regulating the transition to a digital economy. This difficulty stems from the nature of blockchain and cryptocurrencies as institutional technologies. When we discuss regulatory reform for a digital economy, what exactly is it that we're trying to support, and to regulate? The transition to a digital economy will require deep institutional shifts in business models. Those business models are grounded in unfamiliar digitally-native property rights and contracting relationships. Regulatory reform must be made within this context: the development of new concepts of organisational forms, rather than direct transaction of existing rules.

In Part 2, we turn to specific recommendations for the Committee. This is of course not an all-encompassing list of reforms to transition to a digital economy. Many of our recommendations stem from direct discussions with entrepreneurs and innovators in Australia regarding the challenges that they face. Our recommendations are as follows:

1. Reform the treatment of Capital Gains Tax for cryptocurrency
2. Update ATO guidance on Bitcoin in respect of the definition of foreign currency
3. Treat fiat-backed stablecoins as fiat currency for the purposes of taxation
4. Adopt a wallet-centric approach to taxation and wallet whitelisting
5. Create a new legal structure for Decentralised Autonomous Organisations
6. Regulation of algorithmic (c.f. managed) investment schemes
7. Enable employee share schemes to be paid in tokens
8. Regulatory certainty for cryptocurrency and digital asset exchanges

[1] <https://www.industry.gov.au/sites/default/files/2020-02/national-blockchain-roadmap.pdf>.

9. Financial advisors to give consumers advice about investing in digital assets
10. Public Register for AUSTRAC

PART 1: Understanding Regulation for a Digital Economy

Australia is slowly transitioning from an industrial economy to a digital economy. Traditional sectors, such as agriculture and education, are integrating digital technologies into their operations in efforts to improve productivity. More deeply, entrepreneurs are developing new business models that are natively digital, built using technologies such as blockchains, smart contracts and machine learning. This technology stack presents an unprecedented opportunity to build a modern digital Australian economy. While the adoption of digital technologies increased throughout the recent COVID-19 pandemic, there is still much work to be done. Some Australian businesses are digitising their operations to lower their production costs and remain competitive, but we need new frontier business models that are digital at their core.

Our regulatory frameworks inhibit the transition to a digital economy. In the early stages of an economy's digital transformation—with small and easily conceivable advances in digitisation—an ad hoc reform approach might be effective. It was conceivable that regulators could scramble to ameliorate the "pacing problem" through foresight and good intentions, applying existing principles to new problems as they arise.[2] But in 2021, with the dramatic and ceaseless build-out of digital capabilities, this policy approach is insufficient because a digital economy isn't simply an industrial economy on the internet. The digital economy that is now possible is not only digital, it also relies deeply on automation and decentralisation. The business models of such a digital economy cannot easily be squeezed into existing regulatory frameworks because those frameworks have emerged to control an economy of analogue markets and hierarchies.

The essential problem that we face is to create a regulatory framework that enables both decentralised and centralised infrastructure, and the complex networks of trust that these systems produce.

1.1 What is a digital economy?

An economy is a complex evolutionary system. Individuals and groups are constantly exchanging and coordinating through a web of institutions and organisations. Through time, entrepreneurs pursue new business models, constrained by the competitive forces of the market. As some business models expand and others contract, new patterns of specialisation and trade emerge organically. While this evolutionary process is continuous and unending, many scholars have sought to define different epochs or types of economic systems: agricultural, industrial, and digital. While the boundaries between these different economic systems are blurry—defined, for instance, on the shifting factors or production, types of economic activities, and the organisational structure of the economy—the focus of this submission is the transition from an industrial to a digital economy.

[2] On the 'pacing problem' see Marchant, G. E., Allenby, B. R., & Herkert, J. R. (Eds.). (2011). *The growing gap between emerging technologies and legal-ethical oversight: the pacing problem* (Vol. 7). Springer Science & Business Media.

The focus on the digital economy has been compounded by the rapid pace of advance in a suite of digital technologies, not least including the internet, communications networks, blockchains, artificial intelligence, digital payments, smart contracts and the internet of things. The conventional approach to new technologies is to ask how they will be integrated into our industrial systems to power more efficient production. From this perspective it is unsurprising that the Australian government currently has a Digital Technology Taskforce to "ensure that Australia is a leading digital economy by 2030".[3] Much of the focus to date has been on how digital technologies can be leveraged to improve productivity in key Australian industries.

The industrial and the digital economies are integrated; digital technologies can and are being leveraged in existing industrial contexts. But such adoption of digital technologies is only a transition-point towards a more natively-digital economic infrastructure. A digital economy is not simply an industrial economy on the internet. Rather, a digital economy is defined by a deep shift in the architecture of the underlying infrastructure. That infrastructure enables voluntary coordination and exchange not only digitally, but in a decentralised way. A truly digital economy, rather than a digital industrial economy, comprises multi-sided platforms, decentralised community governance, automated decision making, and privately governed property rights and contracts. That infrastructure implies that a digital economy isn't simply a manifestation of existing industries on the internet; it consists of business models operating within, and shaping, digital institutional infrastructure.

How does a digital economy look and feel different to an analogue industrial economy? The business models that are profitable and robust sit at different layers and levels of the economy. Payments and cross-subsidies of platform business models often run in counterintuitive directions. Property rights, including data, push towards the edges and are created and enforced through networks. Competition for labour and services and infrastructure becomes more global. Decisions and management are often made collectively rather than through hierarchy. The liability for decisions is often murky or entirely opaque, making an unclear path for dispute resolution and enforcement.

A decentralised digital economy might appear radical and distant. Partly, this is because the architecture that we have described is unfamiliar in a world of centralised hierarchies and industrial production. But a truly digital economy is now in sight, enabled through rapid competition and advance in frontier technologies: distributed ledgers, smart contracts, machine learning, decentralised identity, zero knowledge proofs. Ultimately these are technologies of freedom, for expanding our economic, political and social liberties.[4]

For Australian regulators, the challenge the digital economy presents is both an opportunity and a threat. The opportunity is a more efficient and seamless economy and governance system. For Australia, a

[3] <https://www.pmc.gov.au/domestic-policy/digital-technology-taskforce>.
[4] Allen, D.W.E., Berg, C., and Davidson, S. (2020). *The New Technologies of Freedom.* American Institute for Economic Research.

digital economy means deeper and more liquid decentralised financial markets, trusted granulated tracking and finance of agricultural produce, seamless cross-border education credentialing, and regulatory integration and hard-coding of rules into platforms. The threat is a failure to capture these tangible benefits for Australians, expanding the divide between analogue regulatory frameworks and the frontiers of digital technological development. Many digital economy opportunities are either directly prohibited or face uncertainty in relation to existing static regulatory frameworks. To be entirely clear: if the Australian government fails to enable and adapt to these digital business models, these platforms will still be built—they will simply be built in other jurisdictions, or remain in murky dark parts of the economy, leaving consumers susceptible to fraud.

We have demonstrated here the clear need for governments to craft a regulatory framework that embraces and facilitates the digital economy. But the regulatory challenges for the digital economy are particularly unique, a problem we turn to below.

1.2 Regulating a digital economy is hard

Effectively regulating a digital economy is a fundamentally different task to that of an industrial economy. Transitioning to a digital economy is not simply placing our existing industries on the internet. It is a much deeper process of enabling and facilitating new business models and organisational structures, such as automation and decentralisation. The business models of a digital economy look and feel different. They have complex incentives and governance structures. Many of those structures do not fit easily (or even conceivably) within our taxation, corporate governance and competition policy frameworks. Many new business models, augmented by digital infrastructure, displace the underlying regulatory objectives or realistic enforceability.[5] Regulating a digital economy is hard.

Australia's existing regulatory environment is both a strength and a weakness in the development of the digital economy. On one hand, our regulatory frameworks provide a stable environment within which to invest and develop new business models. Such a stable system of rules is necessary for entrepreneurs to plan and make business decisions. On the other hand, the accumulation of many static and backward-looking regulations can have deleterious effects on the development of new technologies and business models. Many of those rules, as we will see below, have co-evolved with Australia's existing set of governance and technological capabilities.

Regulating innovation is difficult. One fundamental choice when dealing with new technologies is the speed and scope of regulatory intervention. When regulators apply their heavy hand too early, innovation can be stifled. Those regulatory changes might, and often do, fail to foresee the opportunity and direction of particular technological advances. As with entrepreneurs, regulators simply cannot foresee the path of a new technology. Regulating too early brings a threat of both regulatory capture

[5] See, e.g., <https://www.pc.gov.au/news-media/speeches/regulating-digital-economy/regulating-digital-economy.pdf>.

(where incumbent industries control regulation in their own interests) and technological lock-in, where prominent companies early in the phase place a strong sway over the formation of regulatory frameworks. But a lack of regulation also has costs. Regulatory frameworks can provide assurance to innovators of the legal status of particular frameworks, help to coordinate competitors around common standards, and enable them access to other regulated industries.

The approach to regulating the digital economy in Australia today has proceeded in two main phases.

The first phase was predominately self-regulation. Where companies do not fit easily within existing regulatory frameworks, they have often sought to develop their own systems to support their customers (e.g., consumer safety, privacy). This private governance is bound by competitive pressure and customer exit. Even in the absence of regulatory obligations, private platforms have developed their own attempts at KYC and other due diligence mechanisms – either in the anticipation of future regulation, the prospect of private litigation, or to avoid reputational damage through negative press.

The second phase was regulators issuing regulatory guidance. Individual regulators have issued guidance based on the existing regulatory frameworks relevant to their own domains (e.g., the Australian Taxation Office issuing guidance on the tax treatment of cryptocurrencies; the Australian Securities and Investments Commission issuing guidance on the application of corporate finance regulation). This approach has costs and benefits. One cost is regulatory uncertainty. Regulatory guidance is just that – guidance. It does not reflect a binding legal position and the regulator may revised its position without the scrutiny of the legislative process. One benefit is that this approach allowed the digital economy to continue evolving and not be boxed-in with special rules. Another main benefit of this approach is the ability to discover the costs of the existing regulatory frameworks. In relation to the blockchain economy, more than five years have passed since the first regulatory guidance on blockchain technology and cryptocurrencies was issued. Over this time it has been discovered that many blockchain and cryptocurrency applications and organisations are likely to be treated as managed investment schemes under Australia law (although this has not been judicially considered). However, in many instances this regulatory treatment will be a category error as many blockchain and cryptocurrency applications and organisations do not have a central manager. Similarly, other business models (e.g., cryptocurrency exchanges, decentralised autonomous organisations; VC funds) do not have traditional parallels. At a time when other jurisdictions are providing legal clarity and attracting talent and investment through "cryptofriendly" regulation, the regulatory guidance approach is no longer optimal for Australia to be a financial and technology centre. [6]

[6] For an explanation of "cryptofriendliness" see e.g., Novak, M. (2020). Crypto-friendliness: understanding blockchain public policy, *Journal of Entrepreneurship and Public Policy*, vol. 9, no. 2, pp. 165-184.

PART 2: Recommendations for Reform

2.1 Principles

The recommendations that follow in this part of the submission can be seen through three broad unifying principles through which the transition to the digital economy, and establishing Australia as a financial and technology centre, can be achieved:

1. **Regulatory certainty is required but there is a balance to be struck between certainty, flexibility, and commercial reality.** There should be a principles-based regulatory approach that focuses on identifying specific regulatory objectives and legislating the "minimum viable regulation" in order to achieve those objectives – including regulation through voluntary codes or practice where it is appropriate. The duplication of reporting and compliance to multiple regulatory agencies should be avoided.
2. **Innovations in the digital economy should accommodated**. New products or services, new methods of production, new sources of supply, new markets, and new organisational forms are integral part of a dynamic economy.[7] These innovations are the fundamental source of economic growth and prosperity. New technologies – and the applications and organisational architectures they enable – should neither be advantaged nor disadvantaged.
3. **Review and amendment mechanisms should be implemented**. Regular and systematic reviews into the regulation of the digital economy will be required to feed information into the legislative and regulatory process in a purposeful way and to overcome the regulatory "pacing problem". This Committee, along with other Federal government initiatives such as the Digital Economy Taskforce and the National Blockchain Roadmap, are all examples of current mechanisms that are well-placed to fulfil this task into the future.

2.2 Outline of this section

- Recommendations 1-4 propose changes to support tax consistency and compliance.
- Recommendations 5-9 propose changes to modernise corporate law.
- Recommendation 10 proposes a change to bolster the AML/CTF regime.

2.3 Recommendations

[7] Schumpeter, J. 1934. *The Theory of Economic Development*. Harvard Economic Studies.

Recommendation 1 – Reform the treatment of Capital Gains Tax for cryptocurrency

Background

The ATO have advised that "a capital gains tax (CGT) event occurs when you dispose of your cryptocurrency."[8] Operating in what is treated as a barter economy, where transactions can occur multiple levels beyond fiat currency, means the compliance burden for taxpayers is increasingly complex and uncertain. Taxpayers' compliance becomes increasingly abstract and therefore increases the risk of inadvertent non-compliance.

Proposal

We propose new mechanisms to better craft the CGT provisions to cater for the growing crypto-economy and the growing complexity of this ecosystem. This recommendation should be read in conjunction with the other taxation recommendations in this submission.

We recommend the introduction of a new CGT asset/event class that enables specific concessions or exemptions to be applied and confirm the timing and approach to taxable events.

This could for example ensure that for certain crypto-assets, taxable events would occur only when:

- Cryptocurrency is exchanged with fiat currency (most commonly the Australian dollar);
- Cryptocurrency is used in the acquisition or disposal of a non-fungible token (such as a piece of digital art). Depending on the CGT classification of the respective token (e.g. personal use asset, collectable), these transactions may yield the normal concessional treatments.
- Cryptocurrency is used in the acquisition or disposal of non-tokenised/tangible goods or services. Depending on the CGT classification of the respective token (e.g. personal use asset, collectable), these transactions may yield the normal concessional treatments.[9]
- Include a set of special rules comparable to collectables or personal use assets, such as thresholds for transactions to be taxable[10] and rules around losses (for example, quarantine losses).

This approach will require legislative reform but will simplify the capital gains tax regime, reducing regulatory burdens and encouraging compliance.

[8] <https://www.ato.gov.au/general/gen/tax-treatment-of-crypto-currencies-in-australia---specifically-bitcoin/>
[9] As outlined in the submission to the Senate Committee on Australia as a Technology and Financial Centre by Chris Berg, Darcy Allen and Aaron Lane, answers to questions on notice from a public hearing held 11 February 2021, Sydney (received by the Senate Committee on 22 February 2021), at 4.
[10] A comparable approach is being applied in the United Kingdom, allowing for an annual exempt amount. See, e.g., <https://www.gov.uk/capital-gains-tax/allowances>.

Recommendation 2 – Update ATO guidance on Bitcoin in respect of the definition of foreign currency

Background

The global reach of blockchain technology not only creates issues for double taxation, tax evasion and avoidance, but raises concerns over a standard unit of account to calculate income tax liabilities (and income) when dealing with transactions occurring in a foreign currency.[11] The same problems arise for crypto-based transactions. Although *Seribu and Commissioner of Taxation* [2020][12] found that bitcoin was not a foreign currency for the purposes of ITAA97, this was on the basis that no other foreign state recognised it as legal tender. In 2021, this situation has shifted with El Salvador confirming, and Paraguay announcing, bitcoin's official status as legal tender. It is not unreasonable to expect further sovereign states to follow suit over time. As such, the validity of current ATO guidance is now under scrutiny.[13]

Proposal

We recommend that the ATO update guidance to reflect the changing global position of Bitcoin and consider that Bitcoin may now meet the definition of a financial currency and therefore may be captured within the foreign exchange regime. The updated guidance should still treat Bitcoin and other similar cryptocurrencies consistently as Bitcoin can be easily converted to another cryptocurrency using decentralised or centralised exchanges and several other cryptocurrencies use similar underlying blockchain mechanisms (e.g., Bitcoin Cash, Dogecoin). This could be achieved by the ATO updating their existing guidance or through legislative reform. Alternatively, legal clarity on the interpretation could be achieved through the ATO's Test Case Litigation Program.[14]

[11] Stephen Barkoczy, *Foundations of Taxation Law*, (Oxford, 11th ed, 2019), 1046, 'Barkoczy'.
[12] *Seribu Pty Ltd and Commissioner of Taxation* [2020] AATA 1840, [30], 'Seribu'.
[13] Tax Determination *TD 2014/25 Income tax: is bitcoin a 'foreign currency' for the purposes of Division 775 of the Income Tax Assessment Act 1997*, [33].
[14] <https://www.ato.gov.au/tax-professionals/tp/test-case-litigation-program/>.

Recommendation 3 – Treat fiat-backed stablecoins as fiat currency for the purposes of taxation

Background

Price volatility is a well-known issue that has hampered the wide scale adoption of cryptocurrencies. Stablecoins are the solution to that problem – a cryptocurrency that seeks to maintain its value relative to another (comparatively stable) asset. There are different methods to achieving price stability using traditional reserves (fiat currency, derivatives, commodities), digital reserves (cryptocurrencies, or digital assets), or algorithms and smart contracts to control the supply of the stablecoin.[15] Business is now being done in stablecoins – including for internal transactions inside a corporate group, between cryptocurrency exchanges, as payment for services, and for blockchain foundation grants. This technology allows cheaper, quicker and more secure transactions. Stablecoins (and other cryptocurrencies more broadly) could be considered a "non-cash payment facility" requiring licensing and product disclosures.[16] For tax purposes, it is not consistent to treat US dollars in an online bank account (for which there are well-established tax rules), for example, and US-backed stablecoin in an online cryptocurrency exchange wallet differently when these are functionally the same transaction.[17]

Proposal

Stablecoins that are backed by fiat-currency should be treated as that currency for the purposes of taxation. For example, USDC is a leading US-dollar backed stablecoin. If a business receives USDC as payment, then they are taken to have received US dollars. This proposal will require legislative reform.

[15] For further see, e.g., Moin, A., Sirer, E., and Kevin Sekniqi. 2019. 'A Classification Framework for Stablecoin Designs'. ArXiv:1910.10098 [Cs, q-Fin], September. <http://arxiv.org/abs/1910.10098>.
[16] See section 736D *Corporations Act* 2011 (Cth).
[17] See Divisions 775, 960 *Income Tax Assessment Act* 1997 (Cth).

Recommendation 4 – Adopt a wallet-centric approach to taxation and wallet whitelisting

Background

In May 2021, the ATO announced that "Cryptocurrency [is] under the microscope this tax time."[18] Inadvertent non-compliance is an issue when tax rules require an excessive amount of record keeping (see Recommendation 1 above). Obligations are often imposed on intermediaries, such as the digital exchanges. For example, these exchanges are required to be registered with AUSTRAC and compliant with anti-money laundering and counter-terrorism financing requirements.[19] Whereas peer-to-peer transactions (i.e. non-custodial wallet to non-custodial wallet) will generally escape such requirements, there is therefore a heightened risk of money laundering and terrorism financing vulnerabilities.[20] Cryptocurrency wallets represent a core infrastructure of the digital economy and a natural point of asset and income flow. Therefore, wallets represent a key point in the blockchain architecture to capture the tax burden for crypto-economic activities.

Proposal

The Federal government should introduce a set of standards, or whitelist, for wallets to signify compliance quality (such as public accessibility, integration with ATO API, taxpayer identity, and key storage requirements). This would enable greater ability for streamlining taxation points and compliance burdens. Further, whitelisting wallets opens opportunities in time to enact automated tax collection, such as final taxing of crypto-activities and wallet-centric simplified taxation regimes. This proposal will require consultation to develop standards with industry stakeholders – but could be managed through existing Digital Taskforce or National Blockchain Roadmap processes.

[18] <https://www.ato.gov.au/Media-centre/Media-releases/Cryptocurrency-under-the-microscope-this-tax-time/>.
[19] Part 6A of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).
[20] The Financial Action Task Force (FATF), 'Public consultation on FATF draft guidance on a risk-based approach to virtual assets and virtual asset service providers,' (2021, March), available from: https://www.fatf-gafi.org/publications/fatfrecommendations/documents/public-consultation-guidance-vasp.html, p.14.

Recommendation 5 – Create a new legal structure for Decentralised Autonomous Organisations

Background

Blockchain is best understood as a governance technology – providing the digital infrastructure for new ways of governing economic exchange.[21] Decentralised Autonomous Organisations (DAOs) are a new category of organisation that operates on decentralised blockchain infrastructure, whose operations are pre-determined in open source code and enforced through smart contracts. One useful analogy is that DAOs are the joint stock companies of the blockchain economy. These new organisational structures already exist with millions of dollars' worth of crypto-assets under "management". Currently under Australian law, a DAO could be held to be a partnership or an unincorporated association meaning that the ability to hold assets and contract in its own name is now clear. Further, liability of members is not clear. Accordingly, it has been proposed that a DAO is given separate legal identity and DAO token holders are given limited liability.[22] This regulatory innovation will drive economic activity in this space and be a magnet for Australian innovation and location decisions for DAOs – creating local employment (and taxation) activities.

In April 2021, the US State of Wyoming became the first state to allow new and existing LLC entities to operate as DAOs – with legislation sponsored by Wyoming's Select Committee on Blockchain, Financial Technology and Digital Innovation Technology.[23] A challenge for Australia is that the *Corporations Act* 2001 (Cth) does not have a type of entity that is directly comparable to an LLC.

Proposal

A new category of company should be created under the Corporations Act – a Limited Liability DAO (LLD). This would require legislative changes. However, existing mechanisms such as changing a type of company[24] or replaceable rules[25] could be adapted for the LLD. It is recommended that the legislative changes are based on the "DAO Model Law" developed by COALA as a starting point and adapted as necessary for the existing Australian corporate frameworks.[26]

[21] See e.g., Davidson, S., de Filippi, P., and Potts, J. 2018. 'Blockchains and the economic institutions of capitalism', *Journal of Institutional Economics,* vol. 14, no. 4, pp. 639-658.
[22] For discussion see e.g., Sims, A. 2019. 'Blockchain and Decentralised Autonomous Organisations (DAOs): The Evolution of Companies?', *New Zealand Universities Law Review*, vol. 28, pp. 423-458.
[23] <https://www.wyoleg.gov/2021/Introduced/SF0038.pdf>.
[24] See section 163 *Corporations Act* 2001 (Cth).
[25] See section 141 *Corporations Act* 2001 (Cth).
[26] <https://coala.global/reports/#1623963887316-6ce8de52-e0a0>.

Recommendation 6 – Regulation of algorithmic (c.f. managed) investment schemes

Background

A managed investment scheme (MIS) is an investment structure where a "responsible entity" manages investments for unit holders. In summary, the *Corporations Act* 2001 (Cth) provides that a MIS will exist where (i) members contribute money or money's worth as consideration to acquire rights to benefits produced by the scheme; (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the members; and (iii) the members do not have day-to-day control over the operation of the scheme.[27] Generally, a MIS is required to be registered with ASIC if it has more than 20 members.[28] A registered entity is required to be a public company and hold an Australian Financial Services License.[29]

There is a significant risk facing blockchain companies in Australia that the MIS regime will be inappropriately applied, particularly as it pertains to decentralised finance ('defi') products.[30] There is approximately US$41.5 billion worth of tokens in the defi ecosystem.[31] Inappropriate and high cost regulation threatens the viability of the defi industry in Australia and will send entrepreneurs and job-makers overseas.

For example, popular defi applications include a class of automated market makers (AMMs) that allow users to make token-to-token exchanges outside 'traditional' centralised exchanges like Binance or Coinbase. Investors pool tokens in these automated exchanges, earning profit through fees. The pool automatically prices exchanges in a way that rebalances the pool, guaranteeing that each asset is always available.

It is likely an AMM would be considered a MIS within the legal definition outlined above. However, there are several regulatory problems in applying the MIS regulatory framework to defi products like AMMs:

- These schemes have no *manager* – that is, there is no responsible entity on whom the obligations of a financial services licence could be meaningfully imposed or exercised. The scheme – and thus the return on the investment – is determined entirely algorithmically.

[27] Section 9 *Corporations Act* 2001 (Cth). We note that a "time-sharing scheme" is also a MIS but this is not relevant to our submission.
[28] Section 601 ED *Corporations Act* 2001 (Cth).
[29] Section 601FA *Corporations Act* 2001 (Cth).
[30] These products are distinct from Initial Coin Offerings, which ASIC considers should usually be regulated within the MIS framework. We strongly support the committee's recommendation that the Treasury release its final report into the regulation of ICOs as soon as possible.
[31] See: https://defipulse.com (19 February 2021).

- Automated market makers like this have no responsible agent. Amendments to the protocol (for example, varying the fee for investors) are entirely controlled by the voting behavior of governance token holders (typically investors).

Applying the rules governing managed investment schemes to these autonomous and algorithmic financial products is a category error. In any case, treating a defi product as an MIS would not achieve the government's policy goals. Defi products are censorship resistant and fully digital. Australian investors can interact with defi products developed around the world at almost zero cost. Regulatory avoidance is trivially easy because these products can be freely "forked" (that is, their code copied, modified, and re-deployed permissionlessly). Applying the MIS framework to Australia-built defi products means that Australian companies are highly reluctant to innovate in this frontier fintech field.

Proposal

The Corporations Act should be amended to exempt "autonomous financial products" from the existing definition of a MIS. To qualify as an autonomous financial product, the product needs to be:

- Fully algorithmically deterministic (that is, all investment decisions are made by an algorithm rather than a responsible human entity);
- Governance decisions are sufficiently decentralised and made solely by those who have invested; and
- Fully open source, with its code published on a recognised platform (such as GitHub), allowing investors to scrutinise the code themselves.

This change would be straightforward and is consistent with the existing legislative approach of the Act.[32] While legislative change is preferred to provide certainty, we note that this approach could also be achieved through regulation as section 9 of the Act provides a mechanism for the Regulations to declare that a scheme is not a MIS.

[32] There are already 13 specific exemptions to the definition of a MIS in the Corporations Act.

Recommendation 7 – Enable employee share schemes to be paid in tokens

Background

Employee share schemes, where employees are partially compensated for work in the form of equity, are a powerful and important mechanism used by start-up firms to align incentives of employees with the firm. They enable start-ups to employ cost-effective remuneration mechanisms as they do not require the outlay of money. Firms that offer employee share schemes have on average higher retention, higher productivity and higher value adding growth.[33] They are extremely common in technology start-ups and are characteristic of some of the most innovative industries in the world.

In Australia, employee share schemes enjoy special treatment to ensure that they are not prohibitive to offer employees (for example, by excluding them from the disclosure and licensing obligations that would otherwise accrue to a public offering of shares) and to prevent unreasonable taxation burdens being placed on employees.[34] For example, employees who are offered discounted share options in qualifying start-ups are able to defer the payment of tax on the discounts, to ensure that employees do not face immediate tax bills without access to funds.[35]

Proposal

The employee share scheme should be extended to tokenised ownership models. In the blockchain industry it is common to provide employees and external contractors tokens in the form of options, locked up (unable to be sold), or vested over time through a smart contract. While some token models can be seen as analogous to shares, as this submission has suggested, digital tokens can be variously seen as everything from foreign currencies to community or club membership voting rights. We welcome the government's intentions to simplify and expand the employee share scheme regime. Employee token schemes should be aligned with the employee share scheme regime, and token share schemes should be eligible to benefit from those future reforms.

[33] Hendrickson, L., et al. 2017. *The Performance and Characteristics of Australian firms with Employee Share Schemes*, Department of Industry, Innovation and Science.
[34] Division 83A ITAA97.
[35] For example, see section 83A-33 ITAA97 for requirements to apply the start-up concession. See also alternative requirements to satisfy in order to defer the taxing point: section 83A-105 ITAA97.

Recommendation 8 – Regulatory certainty for cryptocurrency and digital asset exchanges

Background

Cryptocurrency and digital asset exchanges are a key interface between the blockchain and crypto-economy and the traditional financial sector. Exchanges are currently operating in a regulatory grey zone which is leading to several issues. On the exchange side, these include de-banking, difficulty accessing insurance coverage, and regulatory uncertainty that corporate regulators could take enforcement action – all of which have a chilling effect on the industry. On the consumer side, there are risks including those involving custody management, cyber security, adequate capital and liquidity, financial literacy and dispute resolution. It should be noted that Australian exchanges will be subject to the general protections such as those under the Australian Consumer Law.[36]

There is no single exchange business model. Broadly speaking, cryptocurrency exchanges fall into two categories with different risk profiles – custodial (where the exchange or third party provider as ultimate control over the digital assets) and non-custodial (where individuals have direct control over their own assets). Further some exchanges offer access to other services such as Non-Fungible Tokens (NTFs). This is inherently in-flux, making it imperative that any regulatory changes are carefully introduced following a principles-based approach. For Australia to create and maintain its reputation as a financial and technology centre it should avoid onerous licensing conditions on exchanges that stifles competition and innovation (e.g. US state of New York).

Proposal

In the first instance, there should be a "Safe Harbour" for Australian cryptocurrency and digital asset exchanges, and associated developers. This would come with the condition that exchanges are acting in good faith and cooperate with reasonable requests for information from corporate regulators. This could be achieved through legislative reform with a three year sunset provision. The purpose of the safe harbour is the first step on the roadmap to developing an enforceable industry code of practice. It is recommended that the industry code of practice is developed with stakeholders and managed through existing Digital Taskforce or National Blockchain Roadmap processes.

[36] Schedule 2, *Competition and Consumer Act* 2010 (Cth).

Recommendation 9 – Financial advisors to give consumers advice about investing in digital assets

Background

An AFS licence holder authorises the holder and its representatives to provide "financial services" including providing financial product advice to clients.[37] At present, cryptocurrencies and other digital assets fall outside of the definition of "financial products".[38] This is a barrier to AFS licence holders and representatives providing consumers with general or personalised financial advice on these investments under this licensing regime (including insurance implications). This does not mean that Australian retail investors are not making investments into cryptocurrencies and other digital assets – just that these investments are occurring without the full benefits of financial advice.

There are calls for improved blockchain literacy, which we see directly linking with the ability of, and need for, professionals to provide appropriate advice in respect of crypto-related activities.[39] Further, there is a need for consistency for future offerings. In the near future it is likely that retail investors will have access to cryptocurrency-based exchange traded funds and other derivative markets. It would be inconsistent if AFS licence holders and representatives could provide advice on these indirect investments but could not provide advice on direct investments. Financial advisors will still have general fiduciary and statutory duties to clients (including competence) in providing advice about investing in digital assets.

It is acknowledged that the financial advice industry has been subject to significant regulatory changes over the last decade – from the "Future of Financial Advice" reforms in 2012 through to the Federal government's response to the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Proposal

Licenced financial advisors should be able to give consumers advice about investing in digital assets. This will require legislative change. It is also recommended that professional bodies (including the Financial Adviser Standards and Ethics Authority) incorporate knowledge of cryptocurrencies and other digital assets into professional standards and professional development materials.

[37] See Part 7.6 *Corporations Act* 2001 (Cth).
[38] See Part 7.1 *Corporations Act* 2001 (Cth).
[39] See for example, Jana Schmitz and Guilia Leoni, 'Accounting and Auditing at the Time of Blockchain Technology: A Research Agenda,' (2019) 89(2), *Australian Accounting Review*, 331-342.

Recommendation 10 – Public Register for AUSTRAC

Background

In 2016, the *Anti-Money Laundering and Counter-Terrorism Financing Act* 2006 (Cth) was amended to require Australian "digital currency exchange providers" (including cryptocurrency exchanges) to comply with Anti-Money Laundering and Counter-Terrorism Financing laws and register with the regulator AUSTRAC.

AUSTRAC explains that "[AUSTRAC] can refuse an application, and can also suspend, cancel or refuse to renew a registration if we think a business or organisation poses an unacceptable risk of money laundering, terrorism financing, or other serious crime. We can also impose conditions on registration if we identify an unacceptable risk in a business or organisation, or its operation."[40] At the end of 2020, AUSTRAC had revoked the registration of six cryptocurrency exchanges and refused to register a further three exchanges.[41]

AUSTRAC currently makes available on its website a list of those companies that have had their registrations cancelled or refused. However, AUSTRAC does not publish the register of those companies that are currently registered and the conditions of such registration (if applicable). According to recent reports, the Australian Competition and Consumers Commission (ACCC) had $26 million in losses reported to it for cryptocurrency scams between January and May 2021.[42] Given this context, Australian consumers (and their advisors) should be able to quickly undertake due diligence to see if a cryptocurrency exchange is genuine and lawfully operating in Australia.

Proposal

AUSTRAC should publish the full register of registered cryptocurrency exchanges. This register could be integrated with ASIC's systems and its approved information brokers.

[40] Ibid.
[41] <https://www.austrac.gov.au/digital-currency-exchange-provider-registration-actions>.
[42] <https://www.smh.com.au/money/investing/crypto-scam-losses-rocket-to-record-high-20210625-p584du.html>

Further information

We appreciate the opportunity to provide the Committee with this written submission responding to the Third Issues Paper. We would be happy to appear in a hearing if Committee members would like us to elaborate on any aspect of this submission, or have any questions.

Yours faithfully

Dr Darcy W.E. Allen
Associate Professor Chris Berg
Professor Sinclair Davidson
Dr Aaron M. Lane
Dr Trent MacDonald
Dr Elizabeth Morton
Distinguished Professor Jason Potts