HOLLEY NETHERCOTE
LAWYERS

Our Ref PD:CB12348

28 June 2021

Email: fintech.sen@aph.gov.au

Dear Committee,

RE: SUBMISSON TO THIRD ISSUES PAPER (THE PAPER)

> *Hamish: "Hey Andy…[Let's] send [a crypto]…to the moon."*
>
> *Andy: "Isn't that illegal?"*
>
> *Hamish: "It's slippery territory. I don't think it's illegal, I think it's sub legal, which is just below the surface of legal. You shouldn't do it, but, you know, it's still floating in the seas of legality.*[1]

While the above was said in jest, it highlights the ambiguity when applying cyptocurrency and digital asset (collectively, **virtual assets**) business activities to Australia's existing regulatory framework. This submission makes five recommendations to address that ambiguity and stimulate virtual asset innovation in Australia.

This submission responds specifically to the following statement in the Paper:

> *…the committee will be assessing options for the development of a comprehensive regulatory framework for cryptocurrency and digital assets.*

SUMMARY

Thank you for the opportunity to present a submission. Our submission draws on our expertise in financial services regulation and includes surveyed data from most of Australia's largest digital currency exchanges[2] and five key recommendations. It proposes that the government:

In the short term:	**Then:**
1. Assemble the Right People. Establish a well-constructed task force, focusing on the virtual assets sector, comprised of appropriate public and private sector	**5. Establish a comprehensive legal framework:** Jurisdictions

[1] The above quote comes from media personalities 'Hamish and Andy' in the context of whether they could drive up the price of a virtual asset by popularising it through their podcast, after discussing the GameStop Corp saga. Hamish & Andy podcast, episode 132, 2021.

[2] Survey respondents include BTC Markets, Independent Reserve, Kraken, Luno, Coinjar, Cointree, Mine Digital and a number of other anonymous digital currency exchanges. There is no independently verifiable data on the largest DCEs in Australia but our understanding is that the respondents represent the vast majority of the largest exchanges in Australia.

representatives, to work with government and industry to shape a bespoke regulatory framework after careful consideration.	globally are rolling out a "second wave" of legislative frameworks for the virtual assets sector. In our view, it is too early to say whether any are successful. Whilst anecdotally, Canada, the UK and the European Union appear to be working towards comprehensive frameworks, there is still an opportunity for Australia to be a global leader and develop a framework that is truly bespoke to the virtual asset community – striking the balance between innovation and consumer protection.
2. Give Regulatory Relief and Clarity. Work work with ASIC to issue relief and no-action positions to address certain existing onerous applications of financial services laws on the virtual assets sector relating mostly to Australian Markets Licence and Australian Financial Services Licence obligations. ASIC should clarify which activities are captured by the relief and which are not, by using practical examples and adopting industry language.	
3. Regulate poor conduct and set a higher bar. Apply laws relating to market misconduct[3] and general obligations[4] to key players in the virtual assets primary and secondary markets.	
4. Establish common languages. The global virtual asset ecosystem requires global coordination. Improve and widen multi-jurisdiction free trade Agreements[5], support the standardisation of rules relating to how exchanges communicate transaction data[6], and support the standardisation of protocols relating to smart contracts.[7]	

Our submission does not focus on widening the ambit of Anti-money laundering and counter-terrorism financing (**AML/CTF**) laws. We agree that those laws need reform, and expect to see the responses to the current Financial Action Task Force (**FATF**) consultation paper in the near future.[8] FATF's focus is on minimising money laundering (**ML**) and terrorism financing (**TF**) at an international level. It has been the global leader, in our view, in facilitating discussion about how to define cryptocurrencies and digital assets (it calls them virtual assets[9] and we have adopted that definition in this submission). Our submission also does not focus on taxation issues associated with virtual assets (of which there are many). We undertand that Joni Pirovich of Mills Oakley is coordinating submission on these topics in response to the Paper, and we endorse her views.

[3] Eg. rules prohibiting insider trading and market manipulation. Those rules currently don't apply unless the asset in question is a financial product – see Division 2 and 4 of the Corporations Act 2001.
[4] General obligations are imposed on licensees and trustees in various legislative frameworks. For example, see section 912A(1)(a),(aa),d)(e)(f)(g)
[5] See, for example, https://www.dfat.gov.au/trade/agreements/negotiations/aukfta/australia-uk-fta-negotiations-agreement-principle#digital
[6] Intervasp.org is a leader in this regard.
[7] Legalschema.org is the leader in this regard.
[8] https://www.fatf-gafi.org/publications/fatfrecommendations/documents/public-consultation-guidance-vasp.html
[9] FATF says "A virtual asset is a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes. Virtual assets do not include digital representations of fiat currencies, securities and other financial assets that are already covered elsewhere in the FATF Recommendations.: https://www.fatf-gafi.org/glossary/u-z/

WHY ARE WE MAKING A SUBMISSION?

Holley Nethercote Lawyers represents a large number of businesses in the virtual assets sectors. Our lawyers are experts in financial services regulation and licensing:

1. We prepared the draft legal framework for virtual asset service providers for a Free Economic Zone in an Asian country (not yet in law).
2. Paul Derham chairs Blockchain Australia's Financial Crime Committee and Code Conduct Committee and oversaw the drafting of the Australian Digital Currency Code of Conduct (the **Code**), which sets standards for Digital Currency Exchanges (**DCEs**) in Australia to adopt and represents the first layer of "further regulation" that has been considered for the DCE sector in Australia to date. The Code builds trust with banks, consumers and government by raising standards beyond what the law currently requires. It has subsequently been used internationally by governments and one global consulting firm as a model for regulating virtual assets overseas.[10]
3. We were heavily involved in the government working groups that lead to the current DCE registration regime.
4. Our founding partner Grant Holley recently annotated CCH's Chapter 7 (the licensing chapter) Corporations Law resource.
5. Our partner Mark Sneddon was Crown Counsel (Advising) to the Victorian Attorney-General and continues to participate in various thinktanks, legislative lobby groups and law reform councils including acting as Chair of the Digital Commerce Committee of the Business Law Section of the Law Council of Australia. He has prepared draft bills for State and Federal Parliaments.
6. Our Head of Licensing Frank Varga held senior management roles at ASIC for over 30 years, including overseeing the Licensing team for the final 15 years of his time there.

WE NEED TO ACT *NOW*

According to the 2020 Corruptions Perceptions Index[11], Australia ranked at number 11, ahead of Canada (ranked 12), the United Kingdom (ranked 14) and the United States (ranked 26).

With a Corruptions Perception Index score of 77/100 and rank of 11/180, Australia continues to be one of the top scoring 'trustworthy' countries in the Asia Pacific region.[12]

In the U.S. News & World Report's 2021[13] rankings, Australia ranked second in the 'Agility' category, which measures a country's adaptability to 'respond to obstacles'. To be agile, 'a country needs to be efficient in its actions, adopt and accept modern solutions and progress to meet changing solutions.'[14]

Considering our envied position on the global stage based on these measures, now is the time to act and take a leadership role in regulating virtual assets to support our existing

[10] We have been told this anecdotally by members of IDAXA.
[11] https://www.transparency.org/en/cpi/2020/index/aus
[12] https://www.transparency.org/en/news/cpi-2020-asia-pacific
[13] https://www.usnews.com/news/best-countries/agility-rankings
[14] https://www.usnews.com/news/best-countries/agility-rankings

industry and to encourage innovation and investment. The time is over for a 'wait-and-see approach'.[15]

WHERE WE'VE BEEN

There are consistent themes from the submissions received by the Committee to date regarding a lack of clarity and uncertainty surrounding regulation of virtual assets. There is also a concern for potential overregulation and that "kneejerk reactions"[16] to regulation will stifle innovation and push companies offshore. Overregulation in some sectors of Australia has seen a mass exodus of the regulated population.[17] Regulation, whilst important, imposes costs on a regulated population. In the case of DCEs and virtual asset service providers (**VASPs**[18]), disproportionate increases in costs will result in higher transaction fees. Due to the global nature of virtual assets and the ease with which markets can be arbitraged, the DCE and VASPs will choose to move out of Australia if the regulatory burden is too great. This happened according to some commentators, with the introduction of the New York BitLicense in 2015.[19]

However, a lack of regulation can discourage domestic and international investment, make important service provider relationships more difficult, decrease consumer confidence and disadvantage industry participants with a more conservative legal risk appetite. There is a consensus that regulation is required, but that any proposed regulatory framework for DCEs needs to be fit for purpose, "well designed and proportionate."[20]

The flow-on effect of a fit-for-purpose regulatory framework is that it helps build trust with banks. After many years of: involvement in government working groups; helping establish the Australian Remittance and Currency Providers Association for the purpose of raising standards and addressing de-banking; representing clients to Australian banks; and consideration of overseas caselaw, our view is that the Government cannot force the banks to bank a particular sector. Rather, the legislative framework for that sector should set a minimum legal standard that is conducive to the banks wanting to bank regulated entities in the sector.[21]

WHAT APPROACH SHOULD WE TAKE?

Before finalising our views, we surveyed nine DCEs who we believe represent the vast majority (90+%) of secondary market trading in virtual assets in Australia. As a result of

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[15] Both Treasury and ASIC adopted this approach according to *Committee Hansard* dated 4 March 2015 and 7 April 2015.
[16] mHITs Limited, *Submission 48*, p 14.
[17] See, for example, the drop in licensed adviser numbers. According to the AFR, "The supply of registered financial advisers is on track to be 50 per cent lower than before the Hayne royal commission in 2018, while the costs of quality advice for regular consumers have skyrocketed.": https://www.afr.com/companies/financial-services/financial-adviser-workforce-set-to-halve-by-2023-20210409-p57hsg
[18] We expect that the definition of a DCE may change, or that there may be new designated services under AML/CTF laws that capture the wider definition of a VASP. Where the context allows in this submission, a reference to a DCE includes a reference to a VASP.
[19] https://www.bizjournals.com/newyork/news/2015/08/12/the-great-bitcoin-exodus-has-totally-changed-new.html
[20] Dr Rhys Bollen, *Submission 46*, p 37.
[21] The Commonwealth Secretariat prepared an excellent summary of the issues relating to the traditional payments sector here: https://thecommonwealth.org/sites/default/files/inline/DisconnectingfromGlobalFinance2016.pdf

that data, our work with international and domestic bodies and our clients, we make five recommendations.

First, we will set out the survey response data. Then, we set out our five recommendations.

HOLLEY NETHERCOTE DCE SURVEY RESULTS	DISAGREE = 1 (RED) AGREE = 10 (GREEN)	AVERAGE
1. DCEs should be exempt from needing an Australian Markets Licence (like the ASX). (s791A)	1 3 5 8 8 10 10 10 10	7.22
2. General conduct obligations should apply to DCEs. (s912A)	1 5 5 7 8 8 10 10 10	7.11
3. DCEs should be subject to conduct rules relating to market misconduct, as set out in Divisions 2 and 3, Part 7.10.	1 5 5 7 7 7 9 10 10	6.78
4. DCEs should have financial adequacy obligations that are risk based. So, holding custody of assets will trigger an asset requirement.	1 3 3 5 7 8 10 10 10	6.33
5. DCEs should be subject to client money obligations where they hold client money. (s981A)	1 2 3 7 7 7 8 10 10	6.11
6. DCEs should be subject to a licensing framework like an Australian Financial Services Licence framework.	1 1 1 6 7 8 10 10 10	6.00
7. DCEs should be subject to compensation obligations like PI insurance or alternative methods to the extent PI is not available. (s912B)	1 3 3 5 7 7 8 10 10	6.00
8. Mandatory breach reporting obligations should apply to DCEs. (s912D)	1 2 3 7 7 7 9 9 9	6.00
9. DCEs should be subject to design and distribution laws. (s994AA)	1 1 1 5 5 5 5 5 10	4.22
10. DCEs should report transaction data to a trade repository to assist with tax reporting, market manipulation, insider trading, etc. (s901E)	1 1 1 1 3 5 5 6 9	3.56

RECOMMENDATION 1: ASSEMBLE THE RIGHT PEOPLE.

Establish a well-constructed taskforce, focusing on the virtual assets sector, comprised of appropriate public and private representatives, to work with government and industry to shape a truly bespoke regulatory framework after careful consideration.

The Government's response to the Senate Economics References Committee Report in 2015[22] agreed with Recommendation 3:

> *"The committee recommends that the Australian Goveernment Consider establishing a Digital Economy Taskforce to gather further information on the uses, opportunities and risks associated with digtal currencies. This will enable regulators…to monitor and determine if and when it may be appropriate to regulate certain digital currency businesses. In the meantime, the committee supports ADCA's* [Blockhain Australia was previously called ADCA] *continued development of a self-regulation model* [the Code] *in consultation with government agencies."*

The government appointed the FinTech Advisory Group to progress that work. In our view, the remit of the group was too wide and didn't include the CEO of ADCA which represented many of Australia's DCEs and other blockchain-powered businesses. In our view, a new group should be established. It should include representatives:

1. from Government
2. from Blockchain Australia
3. from the International Digital Asset Exchange Association (**IDAXA**)
4. from ASIC, AUSTRAC, APRA, ACCC, Reserve Bank of Australia
5. from the Attorney General's Department and Treasury
6. from law firms which represent DCEs and are familiar with virtual asset regulation and financial services regulation.

The task force should establish a set of principles to informthe legislative framework. In a submission to the Canadian Securities Administrator and the Investment Industry Regulatory Organisation of Canada, the Chamber of Digital Commerce Canada outlined eight 'core recommendations' for establishing a digital assets regulatory framework. We think the eight core recommendations are an excellent list. In summary, these recommendations are:

1. Recognise that not all digital assets/platforms should fall within the reach of securities, commodities, or derivatives regulatory frameworks.
2. Provide frequent, timely and transparent guidance on digital assets and whether such assets are securities or derivatives.
3. Co-ordinate efforts with policy makers and regulators.
4. Take a principles based, technology neutral approach to regulation and policy to foster innovation.
5. Establish industry collaboration for effective and appropriate regulatory and policy regimes.
6. Establish a taskforce to study and review digital asset trading platforms.
7. Educate investors and consumers on digital asset trading platforms.
8. Research the global blockchain ecosystem.

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22 https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Digital_currency/Report

We endorse these key principles and believe their inclusion would greatly benefit our local policy development process.

The taskforce could also communicate with overseas regulatory bodies that have already completed a similar process of public consultation in their respective jurisdictions. For example, the UK recently announced a targeted taskforce to investigate a potential UK central bank digital currency.

With a more specialised taskforce, direct effort could be diverted to addressing the following recommendations in this Paper.

RECOMMENDATION 2: GIVE REGULATORY RELIEF AND CLARITY.

> *In the short term, work with ASIC to issue relief and no-action positions to address certain existing onerous applications of financial services laws to the virtual assets sector relating mostly to Australian Markets Licence and Australian Fainancial Services Licence obligations. ASIC should clarify which activities are captured by the relief and which are not using practical examples and adopting industry language.*

Relief from existing laws is overwhelmingly supported by the surveyed DCEs as set out on page 5 of this submission.

An Australian financial services licence is required if a person carries on a financial services business in Australia.[23] An Australian Markets Licence is required if a person operates a financial market in Australia.[24] The licenses are required if the financial services (for example, advising, dealing and making a market) or the facility through which offers are made or accepted, are in relation to a financial product. Because of the breadth and depth of virtual assets and the speed of innovation, there is no clarity in Australia about whether or not most virtual assets are financial products.[25]

ASIC has released information sheet 225[26] which we are instructed by DCEs is inadequate. Whenever listing a new virtual asset, DCEs must decide whether to seek legal advice on that virtual asset, or whether to "risk it and list it" because of a perception that "if everyone else in Australia is listing it, it must not be a financial product." In this environment, the participants with a more conservative appetite to legal risk are at a disadvantage.

ASIC has power to grant relief in some situations, and it can take no action in others. It can also provide further clarity on whether certain virtual assets are financial products. ASIC should include a frequently updated list of Top 10 virtual assets that it believes are not financial products, and Top 10 virtual assets that it believes are financial products (and if so, what type).

[23] Section 911A, Corporations Act 2001.
[24] Section 791A, Corporations Act 2001.
[25] ASIC's submission to the Senate Inquiry into Digital Currency in December 2014 differentiated between digital currencies which in its view were not financial products, and digital tokens which often were.
[26] https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-assets/

After forming this view, ASIC should provide a transition period of no-action towards DCEs, enabling them to comply with ASIC's guidance.[27]

RECOMMENDATION 3: REGULATE POOR CONDUCT AND SET A HIGHER BAR.

> *Apply laws relating to market misconduct[28] and general obligations[29] to established DCEs in the cryptocurrency and digital assets primary and secondary markets.*

The quote from Hamish and Andy at the beginning of this submission is partly correct: market manipulation laws don't apply where the trading does not relate to a financial product, and many virtual assets are treated as if they are not financial products.[30]

Given the nascent status of many virtual assets, DCEs are required to engage liquidity providers with large stores of the new virtual asset before listing it, so as to maintain a stable market when the virtual asset is listed. Internationally, our view is that insider trading connected with this practice is rampant. In Australia, insider trading prohibitions are tied to inside information which relates to financial products.[31] So, they are unlikely to apply to many of the domestic coin listings.

Further, licensees in multiple categories in Australia[32] are required to comply with general obligations, such as the obligation to provide financial services "efficiently, honestly and fairly". Imposing these obligations on established DCEs would mean ASIC has jurisdiction over contraventions of the general conduct obligations. See footnote 4 above for the specific general obligations that we think should apply to DCEs.

These recommendations could be achieved by the Government declaring that virtual assets are financial products.[33] There are existing mechanisms to exempt or provide relief from certain requirements in the current regulatory framework, so that only relevant parts of the general obligations and market misconduct provisions apply to DCEs.[34]

Regulating poor conduct and setting a higher bar in terms of general obligations is overwhelmingly supported by the surveyed DCEs as set out on page 5 of this submission.

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[27] We recognise the irony of this suggestion given that our firm is often approached by DCEs to provide legal advice on whether a particular virtual asset is a financial product. Implementation of the suggestion would mean legal advice is not required.
[28] Eg. rules prohibiting insider trading and market manipulation. Those rules currently don't apply unless the asset in question is a financial product – see Division 2 and 4 of the Corporations Act 2001.
[29] General obligations are imposed on licensees and trustees in various legislative frameworks. For example, see section 912A(1)(a),(aa),d)(e)(f)(g).
[30] S1041A *Corporations Act 2001.*
[31] S1042A.
[32] Australian Financial Services Licensee, Australian Credit Licensees, Authorised Deposit-taking Institution licensees, and trustees of Responsible Entities are all required to comply with broad general obligations. Section 912A of the Corporations Act 2001 lists those obligations for Australian Financial services licensees.
[33] S764A(1)(m).
[34] See, for example S765A(1)(z) *Corporations Act 2001.*

RECOMMENDATION 4: ESTABLISH COMMON LANGUAGES.

> *The global virtual asset ecosystem requires global coordination. Improve and widen multi-jurisdiction free trade Agreements[35], support the standardisation of rules relating to how exchanges communicate transaction data[36], and support the standardisation of protocols relating to smart contracts.[37]*

Improve and widen multi-jurisdiction free trade agreements and passporting and common or mutually recognised regulatory frameworks

The government's recent agreement with the UK[38] is an excellent example of the possibilities that free trade agreements can facilitate cross-border corporation not only in traditional markets but specifically in relation to virtual asset innovation.

There are also lessons to be learned from the Asia Region Funds Passport initiative, which is a multilateral framework to facilitate the cross-border marketing of managed funds across participating economies in the Asia region.[39] The notion of passporting between jurisdictions with similar levels of regulation and security should be fully explored.

More recently, the European Union's digital finance strategy includes considering regulation on Markets in Crypto-Assets (**MICA**).[40] Consultations for MICA commenced in 2018 to help regulate 'out of scope crypto asset providers' in the EU, and 'provide a single licencing regime to all member states by 2024.[41] MICA will apply to providers of virtual assets or services that do not currently fall under an existing EU regulation. It's been called the a "patchwork" quilt of existing EU regulations specifically to address the risks of virtual assets. One of its purposes is to ensure the EU financial sector remains competitive and innovative, without compromising consumer protection.[42] By way of example, Article 5 would require issuers to be incorporated as a legal entity and publish a 'whitepaper', which must be 'fair, clear and not misleading'.[43]

Anecdotal feedback from DCEs is that the MICA initiative is promising.

Establish a Smart Contract Common Language

This month, the UK launched a new Legal Scheme initiative, which provides a common language for sharing of legal documents as data. As the UK has identified, the need for a common language has become 'pressing', given the universal trend towards the digitisation of the contracting process. This scheme proposes standardisation of, amongst other things, the protocols underlying smart contracts.

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[35] See, for example, https://www.dfat.gov.au/trade/agreements/negotiations/aukfta/australia-uk-fta-negotiations-agreement-principle#digital
[36] Intervasp.org is a leader in this regard.
[37] Legalschema.org is the leader in this regard.
[38] See, for example, https://www.dfat.gov.au/trade/agreements/negotiations/aukfta/australia-uk-fta-negotiations-agreement-principle#digital
[39] https://fundspassport.apec.org/membership-of-the-arfp/australia/
[40] https://eur-lex.europa.eu/legal-content/EN/HIS/?uri=COM:2020:593:FIN
[41] https://www.sygna.io/blog/what-is-mica-markets-in-crypto-assets-eu-regulation-guide/
[42] https://www.sygna.io/blog/what-is-mica-markets-in-crypto-assets-eu-regulation-guide/
[43] https://uploads-ssl.webflow.com/5df7642ffbd9264804671001/5f7b3b3116ebd4add01abd32_XReg%20EU%20MiCA%20explained%20-issue%201-1.1a%20-FINAL.pdf

The burgeoning distributed finance (**Defi**) industry includes virtual-asset versions of all forms of financial markets: transferring, investing and raising. Much of the Defi movement is made possible by the application of smart contract protocols. By working internationally with a common language protocol, Australia would be facilitating innovation and growth locally, making it easier for overseas entities that meet those standards, to establish in Australia.

Establish common language to address the problems presented by the FATF's Travel Rule

The taskforce should be part of the consultation process and collaboration with international bodies, to ensure DCEs are able to comply with the FATF's proposed Travel Rule.[44] This would also involve developing a common message schema between DCEs.

IDAXA and other international bodies have prepared an interVASP Messaging Standard called IVMS 101[45] which attempts to bring the same "language" to multiple jurisdictions as they grapple with implementing the Travel Rule. The Government should support this initiative and work towards common languages for the reasons described above.

RECOMMENDATION 5: ESTABLISH A COMPREHENSIVE LEGAL FRAMEWORK.

> *Jurisdictions globally are rolling out a "second wave" of legislative frameworks. In our view, it is too early to say whether any are successful. Whilst anecdotally, Canada and the European Union appear to be working towards comprehensive frameworks, there is still an opportunity for Australia to be a global leader and develop a framework that is truly bespoke to the virtual asset community – striking the balance between innovation and consumer protection.*

In addition to the comments set out above, we think that there should be a "light" licensing framework that applies to DCEs and it should be risk-based. We understand this is a longer term proposition.

For example, if a DCE holds custody of customers' virtual assets, there is a risk that the DCE is subject to fraud, a cyber attack or otherwise loses access to its virtual assets or becomes insolvent – resulting in a loss on a massive scale. For example, in 2020, ACX, a virtual asset exchange that at the time was registered with AUSTRAC as a DCE, froze its accounts and investors lost approximately $10m.[46] In 2019, Canadian exchange Quadriga CX claimed that C$180m was lost due to the alleged death of its founder.[47] In 2014, Mt Gox unexpectedly shut down losing nearly US400m of funds.[48] How big does an Australia-based failure need to be, before the Government regulates custody?

Blockchain Australia will shortly release the next version of its voluntary Code which says at paragraph 4.2.4:

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[44] The Travel Rule is a short-hand reference to the FATF's Recommendation 16 which recommends that VASPs obtain, hold and transmit required originator and beneficiary information, immediately and securely, when conducting virtual asset transfers. VASPs find applying this rule very difficult. Australia has not yet mandated it's application into law.
[45] Intervasp.org is a leader in this regard.
[46] https://www.afr.com/companies/financial-services/collapse-of-crypto-platform-a-cautionary-tale-20210228-p576hn
[47] https://www.bbc.com/news/world-us-canada-47203706
[48] https://www.bbc.co.uk/news/technology-40561420

Where a Blockchain Australia Certified Digital Currency Business provides a service of storing, holding, owning or controlling Digital Currency on behalf of a customer, it will:

(a) Hold Digital Currency of the same type and amount as that which is owed or obligated to the customer, and provide evidence of this upon request by the customer;
(b) Not lend, trade, encumber or otherwise use the Digital Currency except in accordance with the express directions of the customer;
(c) Hold in Cash or Cash Equivalent, an amount equal to or greater than the AUD equivalent value of all hot wallet balances; and
(d) Publish prominently on its website (for example, in its terms and conditions):
1. *the capacity (e.g. as principal or agent) in which it holds Digital Currencies; and*
2. *whether third party custodians are relied upon.*

We think this is a good start – it imposes a liquid cash obligation on an exchange that matches the AUD value of the exchanges custody balances 1:1 so far as virtual assets are held in a hot-wallet. Currently, it is only a voluntary obligation.

For lower risk DCEs, i.e. non-custodial exchanges and smaller DCEs and start-ups, the government should issue relief like the current Enhanced Regulatory Sandbox relief[49] to complement the other no-action relief as mentioned above.

The objective is to provide an appropriate level of regulation to protect consumers, reduce systemic risk and encourage trust with stakeholders (particularly banks) without hindering innovation. This is the sentiment we continue to hear in the industry, and is consistent with the Senate Committee's agenda, noting that the Committee's first issues paper identified that 'Australia's regulation of the financial services industry fails to strike such a balance.'[50]

The survey we conducted, the results of which are set out on page 5 of this submission, steps through high level elements of Australia's financial services and markets licence regimes, with DCE feedback on its views. We recommend the committee consider this feedback and report it to Government.

NEXT STEPS

We welcome any questions and the opportunity to discuss our submission with the Committee.

Yours sincerely,

Paul Derham, Mark Sneddon, Clarisse Berenger and Sarah Archer
Holley Nethercote Lawyers
https://www.hnlaw.com.au/industry/digital-currency/

[49] https://www.legislation.gov.au/Details/F2020L00632 and https://www.legislation.gov.au/Details/F2021C00351
[50] First Issues paper, p 33.