CLYDE&CO

Submission
Digital Assets (Market Regulation) Bill 2023

Friday, 19 May 2023

Submissions

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2 Introduction

2.1 Clyde & Co is a leading international firm. With deep experience in financial services regulation, in each of the globe's major international cities, we assist domestic and global blockchain exchanges, DAOs, funds and other CeFi and DeFi businesses with their most sensitive and technically complex mandates.

2.2 Avryl Lattin (Sydney), Liam Hennessy (Brisbane), Thomas Choo (Singapore), Joyce Chan (Hong Kong) are the firm's financial services regulatory Partners who lead the web3 practice within the APAC region. They and their teams have deep experience in financial services regulation, and emerging blockchain technology. Our pre-eminent cyber, privacy and data team advises on those aspects of blockchain technology.

3 Background

3.1 This submission is our third on the *Digital Assets (Market Regulation) Bill 2023* (**Bill**), including Mr. Hennessy's earlier submissions to you.

3.2 There is a threshold point to be made before providing comments on the Bill. Other advanced economies are moving at pace to adopt nuanced regulation which supports blockchain businesses, and protects consumers. Australia risks falling behind if we do not do the same, which is why your Bill is critical. We again

commend you for it, and hope that the benefit of your work can be matched with Treasury's concurrent token-mapping / legislation crafting. Effective bipartisanship is an important part in ensuring Australia's future here.

3.3 As we have done previously, and noting that there is a Senate Inquiry into the Bill, we would be pleased to support policymakers by appearing again as a witness before the Senate to add to our comments below on the Bill.

4 Exchange tokens

4.1 Our financial services regulatory licensing system is built on products as the lynchpin. See s. 763A of the *Corporations Act 2001* (Cth), for financial products, and s. 6 of the *National Consumer Credit Protection* Act (Cth) for credit products. The most important part of the Bill is getting the definition of 'digital asset' right, as everything else flows from there from a licensing perspective.

4.2 The definition of 'regulated digital asset' in the Bill is much improved on its previous drafting. It still needs iteration though, particularly for 'exchange token'. To us, it appears to be a catch all which will create more problems that it will assist. As it is presently drafted, it has the following meaning:

exchange token means a kind of digital asset (other than asset-referenced tokens or electronic money tokens) the main purpose of which is to be used as a means of exchange

4.3 The breadth of the definition of 'exchange token' means it is liable to catch a wide variety of tokens, including NFTs. That definition flows through to the core sections of the Bill including the operation of a digital asset exchange and provision of digital asset custody services. Accordingly, services built on top of NFTs could be caught.

4.4 NFTs have broad use cases including as digital representations of art, collectibles, in-game items, tickets, proof-of-attendance tokens, etc. Many of these use cases bear little resemblance to the features of other more financial-like crypto assets and it is only because of their digital/blockchain form that they come into question. There is no suggestion that the underlying analogue versions of these assets (e.g. a physical piece of art, a physical pokemon/basketball trading card or a concert ticket) are or should be a regulated asset category. Equally, nor is there any suggestion that the marketplaces that sell these underlying types of assets (e.g. eBay, Amazon, etc) are or should be regulated. If the law is to be technologically neutral, NFTs of these types should not be in-scope 'regulated digital assets'.

4.5 Absent this clarity, a marketplace for art-based NFTs, collectible NFTs or gaming NFTs (to name a few NFT use cases), could be required to comply with the same standards expected of persons carrying on a regulated financial business. On the current draft of the Bill, among others this would include minimum capital requirements, segregation of licensee and participant funds and record-keeping and reporting. This seems disproportionate and neither commensurate nor relevant to the functional risk of these asset classes.

4.6 Further, we note that *Markets in Cryptoassets* (**MiCA**) generally refrains from regulating NFTs and for the most part, they are out of scope (we note, however, a potential carve out for NFTs that are part of a "large series or collection" which introduces a level of uncertainty). We believe Australian frameworks should

adopt a similar policy stance regarding NFTs, or at least certain types of NFTs, ideally not leaving any room for uncertainty as to their categorisation.

4.7 A licensing obligation too broad could stifle industry, and overwhelm regulators as we have previously mentioned. We think that this can easily be overcome with some refining of the definition of exchange token e.g. to limit it to particular business structures, perhaps, which we are happy to assist with. A potential nuanced solution would be to provide a statutory safe harbour for digital assets which are 'sufficiently decentralised'. Another potential solution would be to incorporate the substantive application of the particular digital asset as a factor of its categorisation. For example, a digital asset which has the primary purpose of capital appreciation should be carved out from digital assets which have primarily non-financial applications.

5 Utility tokens

5.1 One of the most advantageous things that the Bill can do for the industry is to identify, with clarity, which tokens are not caught under the licensing regime. Other jurisdictions have done this already.

5.2 Tokens which are referrable to art, music, gaming, governance, decisioning rights and so forth need not be licensed. They are not comparable to financial products. They are merely a digital representation of rights, and if they are inadvertently captured under Australia's licensing regime, it will simply not be practically workable.

5.3 Cryptocurrency attracts the most attention in the blockchain space. It is, however, only a small fraction of the potential of the technology. The tokenisation of rights is something we as a firm have experience in, and the speed, efficiency, innovation and cost saving that it represents – together with other applications of blockchain – are unfathomable. If simple tokenisation needs a licence, that will immediately set Australia back compared to our global peers.

5.4 To give a practical example, we are exploring embedding AML / CTF KYC requirements, and retail / wholesale distinctions, into tokens. If / when they are created, they will have no other purpose, but to ensure world-leading compliance with some of our most important regulatory regimes. The manufacturers of those tokens should not need to be licenced, and have the associated compliance cost.

5.5 If the Bill can define, even at a basic level, a utility token which will not attract licensing oversight this will be a major step forward practically and credibility wise for our country. There is scope for the bill to adopt language and definitions from the MiCA regulations in this regard. The definition proposed by MiCA is limited to a type of crypto-assets which is only intended to provide access to a good or a service supplied by the issuer. Regulating what should ordinary be construed as a good or service as a financial product will only lead to problematic categorisation. International alignment will only serve to provide clarity for retail and wholesale consumers.

6 Financial Products

6.1 We note the exclusion of a token that represents a financial product under s. 763A of the *Corporations Act 2001* (Cth) should be covered. Broadly, that is consistent with MiCA, so we understand the rationale. The issue, however, is where a market participant needs to have *both* an AFSL and a digital asset licence to access the Australian market.

6.2 We note that the definition of 'regulated digital asset' specifically excludes a financial product within the meaning of Chapter 7 of the *Corporations Act 2001*. This is a logical approach (see below) which follows the precedent set by MiCA, but clearly further technical detail is required as to how the two regimes would operate in parallel. For example,

(a) What is the hierarchy of application? If something could be a financial product does that mean the provisions of the Corporations Act automatically apply in preference to the provisions of the Bill?

(b) Defining the application of the new regime in this Bill by reference to whether a crypto-asset is a financial product under the existing framework does not address the inherent difficulty and complexity of assessing whether a crypto-asset is a financial product in the first place. The object of providing an "effective regulatory framework" (see section 3 in the Bill) and "regulatory clarity and certainty" (see Explanatory Memorandum) may be at risk in view of this uncertainty.

(c) Are the licences contemplated under this Bill intended to be a type of AFSL or a separate licensing framework? We separately note that AUSTRAC registration requirements will also apply in many cases. Multiple licensing frameworks may lead to duplication, unnecessary compliance costs, confusion and barriers to entry. This in turn may negatively impact global perceptions of Australia as an attractive market for innovative blockchain technology and associated in-bound investment.

6.3 It makes more sense to amend the existing AFSL regime, which ASIC and the industry are familiar with, to include authorisations for regulated digital assets. We will then be building on a foundation which has stood the test of time, is understandable and readily modified.

6.4 In globally explaining our system of licensing to incoming US or European investors, we need to cover separate AUSTRAC and AFSL regimes (sometimes prudential as well). If we add a third licence, that will put us further out of lockstep with other global regulators (many of whom combine responsibility for these obligation e.g. AML).

6.5 It will also reduce the possibility for unintended consequences, noting the frenetic pace of global development, and how broad the AFSL is in nature. We note that major industry participants, evidencing their credibility and seriousness, have supported and sought for the adoption of the modification of the AFSL regime. ASIC already has charge of the Bill, on is drafting (s. 12); it makes sense to have this flow through the AFSL regime.

7 Digital Asset Exchange

7.1 Section 9 proposes that a person that operates, or holds out that they operate a digital asset exchange in Australia must hold a digital asset licence. Clarity is required as to what it means for a person to operate a digital asset exchange. Clarity is also required as to who is not 'operating an exchange'. Developers, node validators and other participants in an ecosystem who are beyond the intended scope should be carved out so as not to stifle the industry.

7.2 In particular, it should not include the operation of a decentralised exchange (a DEX) which operates:

(a) on the basis of user interaction with smart contracts rather than with a centralised exchange (i.e. an intermediary); and

(b) where, generally, no custody of assets occurs (again, unlike a centralised exchange).

7.3 The concept of an intermediary does not apply in many DEX models. DEXs operate by virtue of user interaction with smart contracts and not with a centralised person or intermediary.

7.4 The notion of identifying a person that operates a DEX assumes that such is possible. Simple development and deployment of smart contract code does not necessarily constitute operation of a digital asset exchange. Where a person holds the admin keys to the underlying smart contract code or otherwise has special admin-level privileges, such that the code is capable of being upgraded or augmented by that person (or persons acting on their behalf), the analysis may differ. However, development and deployment of code should not trigger the raft of regulatory requirements contemplated for a digital asset exchange. Code and security audits/inspection rights can be utilised as an additional layer of protection and assurance as necessary.

7.5 Some light touch regulation of persons who run a front-end (i.e. the user entry point) for a DEX may be warranted but if those front-ends are simply built on top of back-end smart-contract code, the ability of persons providing a front-end to alter or control the operation of a DEX is fundamentally limited and the regulatory framework should reflect that.

7.6 Furthermore, even assuming one could identify the relevant person that operates a DEX, many of the Digital Asset Exchange Requirements in section 11 would not translate to a DEX model. For example, the segregation of participant assets from the licensee's assets. Popular DEX models are generally non-custodial and operate on the basis of liquidity-pools. As such, the concept of segregating assets simply does not translate.

7.7 We refer to the approach taken in MiCA where crypto asset services that are provided without an intermediary and in a "fully decentralised manner" fall explicitly outside the MiCA framework. As a minimum position, we'd encourage Australian frameworks to follow suit. If this approach is to be adopted, guidance on what constitutes 'sufficient decentralisation' would be required.

7.8 Otherwise, there needs to be a grace period in connection with the adoption of this licensing regime, and significant investment by policymakers and regulators and in educating the industry and consumers about the new law. In recent years, the approach to Braithwaite's pyramid in terms of the theory of proportionate

regulation engagement has arguably been distorted, with too great a focus on regulation by enforcement.

7.9 We understand why this is the case, given the absence of clear legislation, and it is not specific only to Australia. The US SEC is following this approach. It does, however, need to shift given the complexity, and importance of this sector to businesses and consumers. Australians are early and prolific adopters and innovators of cryptocurrency and digital assets – making good law is one step, but the second is actively approaching the market to assist it.

8 Custody

8.1 Custody is an important piece of the Bill. It is important that minimum capital requirements reflect the global landscape – otherwise participants will simply set up overseas.

8.2 We think that there is a wonderful opportunity here to scale capital requirements in a more nuanced way than currently exist under the AFSL licencing regime. That is, tiers of capital (which should not be simply fiat, or fiat-like) to be held by the licensed entity depending on their size and activities. Noting that many blockchain businesses are in their infancy, this will support their growth, will providing necessary consumer protections.

8.3 We think that the requirement to have the custody service provided in Australia is somewhat limiting given the number of providers, and nature of the industry itself. We suggest broadening this provision to permit foreign custody in specified jurisdiction which are comparable to our own, and in relation to which their legal system can be readily accessed if there is a market failure. A potential nuanced approach could be to implement varying levels of capital requirements, with non-domestic exchanges requiring higher capital requirements. The nature of custody should also be considered (e.g., warm, cold and hot wallets).

8.4 This will then give Australian businesses the ability to access reputable, capable and strong custody providers based in say Singapore or the USA. Consumers and businesses alike will be better for it.

9 Licensing

9.1 ASIC's licensing team is very capable. It is a fact that responsibilities continue to be added to ASIC, and that one consideration needs to be proper resourcing and structuring.

9.2 Much like our Federal and State Court systems consider 'fast track' proceedings to support their stakeholder, there should be a licensing fast-track system which aspiring licence holders can access. They will have to pay more, and potential pre-qualify so as not to disproportionately utilise resources, but this measure will set Australia apart from other jurisdictions for the better.

9.3 ASIC's licensing team should, of course, be additionally resourced to handle the plethora of licensing requests that will come through. This additional resourcing could be funded through levies from the industry, a similar practice to what currently occurs with ASIC industry levies. As we suggested in our previous submission, we think that there should a semi-independent blockchain-specific

body set up to assist ASIC will matters relating to blockchain. Similar to, but different from, the takeovers panel.

9.4 Their role could be the development of secondary rules, delegation of licensing aspects, delegation of enforcement aspects, or whatever else is within Senate or the ASIC Chair's best judgment to delegate to them. In this will, our regulator will hopefully be set up to keep up with the frenetic pace of change, as it is critical that ASIC succeeds in its mission.

10 Transition period

10.1 The Bill provides for a transition period of three months from the date of commencement of the new law (should it be passed). This is significantly less than transition periods in digital asset frameworks of other major markets (e.g. Hong Kong – 12 months under the AMLO licensing regime, Singapore – 6-12 months under the Payment Services Act 2019, and EU – 12-18 months under MiCA)

10.2 Keep in mind that many businesses and operators that may be in-scope of the new law are starting from a place of no regulation. Therefore, much of the infrastructure required to comply with the new law will need to be built from scratch. Implementation takes time. Compliance frameworks will need to be built, technology will need to be sourced, implemented and integrated, staffing and resourcing requirements will need to be addressed and training will need to occur.

10.3 At a minimum, a transition period of six months but ideally no less than 12 months should apply to any new framework for the regulation of digital assets and related services. Providing sufficient time for proper industry implementation would be key to the smooth execution of any new regime.

11 Other matters

11.1 We appreciate that the Bill does not address DeFi, and we understand why that is a task for another day. We do think, however, that it is important to support our economy, blockchain's businesses and consumers over and above the licensing certainty.

11.2 There are 'quick wins' here, based on other countries e.g. tax incentives (like the US has proposed in the Lummis-Gillibrand bill). There is a chance in Australia to take more novel steps, such as establishing a division within ASIC or Ombudsman for blockchain innovation. That role could connect us to our peers globally, commission research, provide reports to the Senate Economics Committee and advance an industry critical for our nation. It will reduce the gap between an innovating market, and following policymakers / regulators.

11.3 Our clients uniformly want regulation. They want to contribute to the development of the blockchain economy in Australia. In our submission, we need to leverage that goodwill and capability to assist policymakers / regulators, and ultimately consumers and the economy.

As a firm, and on behalf of our clients, we thank you for your contribution to the Australian blockchain industry and consumers who rely on them. The Bill is an excellent iteration on

its first embodiment, and with a few minor amendments as suggested above, we think it could form the bedrock of a strong regulatory foundation which will advance Australia globally,

We would be delighted to discuss our submission to you at your best convenience. Avryl Lattin , Liam Hennessy and William Deeb are your key contact points for our firm.

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