Contact: Ms Jaime Lumsden (Partner)
Mr Nicholas Pavouris (Associate)
Ms Annabelle Parmegiani (Lawyer)

Tel: (02) 8072 8271

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Committee Secretariat
Senate Standing Committees on Economics
PO Box 6100
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Senate Economics Legislation Committee

We welcome the opportunity to submit a response in relation to the Senate Economics Legislation Committee inquiry in to proposed draft Digital Assets (Market Regulation) Bill 2023 (**DA Bill**).

We strongly support the Government's multi-stage reform agenda for developing appropriate regulatory settings for the crypto sector. We understand that for many in the sector, regulation is anticipated and welcomed, and we stand committed to assisting the sector and the Government in developing a purpose built and fit for purpose crypto regulatory framework. We have provided submissions to the Treasury's proposed token mapping consultation paper in February 2023 and anticipate providing submissions to Treasury's upcoming consultation papers regarding custody and licensing.

We further commend the Senate Committee for their engagement in crypto regulation and their consideration of the DA Bill. Broadly, we believe that Treasury's current consultation process provides the most appropriate forum to receive industry feedback and develop appropriate regulations for the crypto asset opportunity.

The proposed DA Bill serves as an opportunity to discuss what appropriate legislative frameworks are required to:

- provide regulatory certainty to support the continued growth of the industry;
- protect consumers;
- promote competitive offerings;
- facilitate technology development and innovation; and

- help solidify Australia as a competitive market that can grow and attract talent.

We have previously considered some of these matters in our submission in response to the first draft of the Digital Assets (Market Regulation) Bill 2022 circulated by Senator Bragg. We believe that this inquiry is a positive opportunity to discuss elements of the DA Bill which may be adapted by Treasury, the elements of the DA Bill which are not fit for purpose and the key issues that need to be addressed but are absent from the DA Bill.

We welcome any feedback you may have in respect of this submission, and we look forward to the outcome this consultative process.

Yours faithfully

Jaime Lumsden
Partner
Hamilton Locke

Nicholas Pavouris
Associate
Hamilton Locke

Annabelle Parmegiani
Lawyer
Hamilton Locke

Submission Paper

In response to Senator Andrew Bragg's Digital Assets (Market Regulation) Bill 2023

About Hamilton Locke - Funds and Financial Services

Hamilton Locke is Australia's fastest growing law firm, which is focused on transforming the traditional approach to corporate and commercial legal services. Hamilton Locke is a full service offering corporate law firm, which is a part of the HPX Group, that delivers essential corporate services across legal, governance, risk and compliance helping businesses grow and thrive.

The Funds and Financial Services Team at Hamilton Locke (formerly, The Fold Legal) has become one of the go-to firms for cryptocurrency, blockchain, fintech and insurtech businesses seeking regulatory advice. Our Funds and Financial Services team is also one of Australia's largest as a result of the merger between The Fold Legal and Hamilton Locke.

We are known for our technical expertise and industry knowledge, which we use to provide practical solutions for our fintech, cryptocurrency and digital asset clients. Our expertise in financial and credit services is recognised by our ranking in Chambers and Partners Asia-Pacific and FinTech Legal Guides. Reflecting our commitment to client service, we also won Best Law & Related Services Firm (<$30mil) across several specialist categories the past 3 years based on direct feedback from our clients.

Collectively, we have been deeply steeped in the FinTech space since early 2013 and we continue to deepen and strengthen this experience as one of Australia's largest and most diverse financial services practice.

We are technical specialists that have a broad and deep understanding of blockchain technology, cryptocurrencies and digital assets, exchange, Decentralised Autonomous Organisations (**DAO**), alternate platforms and cryptocurrency products and service offerings. Our knowledge of cryptocurrencies and digital assets, combined with our traditional financial services expertise, is market leading. We use our industry knowledge and expertise to deliver practical, compliant, and innovative solutions for our clients. We have worked with cryptocurrency and digital asset exchanges, miners, cryptocurrency and digital asset payment businesses, cryptocurrency and digital asset platforms, DAOs and token issuers to design innovative and compliant offerings.

We are a partner and member of Blockchain Australia, FinTech Australia and InsurTech Australia.

Executive Summary

The regulation of the cryptocurrency and digital assets industry is an important step for both local and global industries. As we have seen with other industries (most notably new energy), uncertainty stifles innovation, and a clear pathway to regulation provides the strongest foundation for true innovation, growth, consumer protection and a competitive market.

We support the Senate Committee's consultation process for the development of regulation for the Australian cryptocurrency and digital assets industry and believe it should continue in conjunction with Treasury and the industry. We believe that this consultation process enables the development of regulation that broadly aligns with the expectations of key stakeholders.

The DA Bill provides an opportunity to address challenges that may arise from draft regulation and highlight issues that should be addressed by Treasury as it undertakes further consultation. There are some broad regulatory requirements in the DA Bill that are generally appropriate for cryptocurrency and digital asset services, however, on the whole the DA Bill is not fit for purpose as it departs considerably from the generally accepted position that both the industry and Treasury has proposed as a path to regulation.

In particular, we believe that the drafting of the DA Bill does not achieve positive regulatory outcomes. We understand that the industry broadly believes that cryptocurrency and digital asset services should not be regulated simply by virtue of their presence or involvement with blockchain. That is, products and services that are not subject to regulation off the blockchain should not be regulated just because they exist on the blockchain, while products and services that are regulated off the blockchain should continue to be regulated consistently on the blockchain. In this way, the DA Bill diverges from the approach taken by Treasury to integrate cryptocurrency and the digital assets industry regulation within existing laws. In particular, the decision to regulate outside the existing financial services regime creates regulatory arbitrage and discourages the digitisation of financial products on the blockchain by creating overlapping and separate licensing regimes.

Further, there are key challenges in the cryptocurrency and digital asset service industry that require regulatory clarity which are not addressed in the DA Bill. Many of these issues were raised during the token mapping consultation process and will continue to be addressed through Treasury's ongoing consultations.

Please note that we have not addressed Part 3 of the DA Bill regarding reporting on central bank digital currencies or Part 4 of the DA Bill regarding the Parliamentary Joint Committee on Corporations and Financial Services.

Submission

Issues and Key Challenges

The DA Bill presents some key challenges that make the bill unsuitable to regulate cryptocurrency and digital assets services. These key issues should be avoided in any future draft regulation. These issues are found both in the overarching regulatory approach to issues contained within specific provisions. We have addressed the broad issues regarding practical implementation of the DA Bill, the DA Bill's capacity to create regulatory arbitrage, the Digital Currency Exchange licence conditions, the scope of custody licences and stablecoin licence conditions in detail below.

Practical Implementation of the DA Bill

The practical implementation of the DA Bill is challenged through the inability to address specific regulations to be contained in delegated legislation, the short transition period and approach to foreign licence recognition.

The DA Bill defers the details of regulatory requirements to delegated legislation. Although it may be appropriate for these specific requirements to be contained in delegated legislation, due to the fact that there is no draft delegated legislation, it is difficult to provide commentary on whether these requirements are appropriate. We would strongly suggest that any proposed draft legislation is accompanied by the draft delegated legislation that contains specific regulatory requirements.

The DA Bill provides a 6-month commencement period. In our view, this transition period is unrealistic and will place a significant burden on industry and a more measured and fulsome approach to any transitional development should be adopted. We strongly recommend that a more appropriate transition timeframe be adopted in any proposed legislative framework concerning cryptocurrency and digital assets. In our view, we consider a transition period between eighteen (18) and twenty-four (24) months would be more appropriate. This is based on our observations during the introduction of the financial services licence regime, credit licensing regime and the onboarding of previously unregulated industries into the licensing regime.

We also recommend that the DA Bill contemplate a safe harbour for existing participants that lodge an application by a particular date, similar to that applied to claims handling and debt management. This safe harbour would enable existing participants to continue operating without significant market disruption until their licence application was approved or rejected.

Further, we recommend that the approach that has been suggested in the DA Bill for foreign provider licence recognition be reconsidered as the current approach may discourage foreign providers from having a local presence in Australia and may provide an easier path to recognition than if a business applied for a licence in Australia. We suspect that this is not the intent and regard should be had to the foreign financial service provider approach adopted by (and which is currently being amended for) the AFSL regime.

Potential for Regulatory Arbitrage

The DA Bill creates the potential for regulatory arbitrage by capturing and regulating existing assets in ways that are not regulated off the blockchain and by failing to properly consider interoperation with the existing financial services regulation and licensing regime.

The definitions adopted by the DA Bill captures assets that are not regulated off-chain. This means that an asset may be subject to regulation by virtue of creating a digital representation on a blockchain. For example, the definition of 'asset-referenced token' includes tokens that maintain a stable value through the reference to the value of a commodity. Due to the broad definition of commodity, the definition of 'asset-referenced token' could capture a token that acts as a digital representation of a high-end handbag. If such a token is captured, then issuers of tokens that act as a digital representation of physical ownership would be subject to regulation by virtue of being on the blockchain. Further, given the regulation proposed under the DA Bill is intending to mimic elements of financial services regulations, there would be regulation of a number of assets with no financial purpose.

The DA Bill has sought to carve out assets that would be regulated as financial products, however, the lack of integration may create difficulty if there are significantly divergent standards applied for financial products. Service providers and product issuers may seek to avoid the more onerous regulation by structuring a product to ensure it does not meet the definition of a financial product, when on balance it has a financial purpose but fails to meet the definition on technical grounds. We have seen this in the market with products like staking and yielding services, which can be offered as managed investment schemes, debentures, derivatives or some other unregulated structure. We believe that the Treasury's current approach to integrate new regulations with the existing law will limit the potential for there to be regulatory arbitrage but will also encourage the digitisation of financial products by removing the current barrier to entry of needing to have a licence in a market where no business wants to be the first to take on the compliance burden. If there is an intention to regulate within the AFS regime and some or all of the regulatory requirements apply on an increasing scale, then it may be appropriate to provide regulatory relief where service providers comply with financial services requirements.

Digital Asset Exchange Licence Requirements

The DA Bill seeks to create a new licensing regime that is distinct from the *Corporations Act 2001* (Cth) (**Corporations Act**). We instead support Treasury's position that the regulatory regime should be included as part of the existing financial services regime, where there is a financial purpose / function for the crypto asset or service.

In our opinion the scope and drafting of regulation for digital asset exchanges contained in Division 2 of the DA Bill is likely to cause adverse regulatory outcomes. The broad definition of 'Digital Asset Exchange' and the proposed licence requirements may create burdensome regulation that does not reflect how other similar markets are regulated. Further, the provisions that seek to protect consumers through market integrity do not reflect the existing market misconduct provisions in existing law, and as such may be ineffective to regulate market misconduct on Digital Asset Exchanges.

The definition of "Digital Asset Exchange" is disconnected from the AML-CTF Act treatment of digital assets, as the exchange of digital assets for other digital assets is not currently regulated under the AML-CTF Act. We think that is important that the AML-CTF Act and any proposed regulation should be consistent with the broader regulatory framework.

The definition of 'Digital Asset Exchange' is also proposed to extend to licensing fiat to regulated assets and the exchange of regulated assets for other regulated assets. This creates a significant disparity in regulation for off-chain equivalents. As an example there is not currently any regulation for spot trades of foreign currency, however the proposal under the DA Bill is to regulate the equivalent transactions that occur on the blockchain. Any other financial product that is also on the blockchain would still be regulated as a financial product.

We believe that the definition of 'Digital Asset Exchange' should account for whether the exchange runs an order book (operates a market), acts as a counterparty to the trade (makes a market) or sources digital assets from other exchanges (a broker) in order to implement effective market conduct regulations. The Digital Asset Exchange Requirements in proposed section 11 of the DA Bill do not reflect the different ways that an exchange may operate. These differing operational models impact the type and kind of regulations required to prevent market misconduct. Regulations that apply to an exchange that operates a market may not be effective for an exchange that makes a market. We recommend that the provisions that outline market integrity rules reflect existing provisions in the Corporations Act that are adapted appropriately for digital asset exchanges.

Digital Asset Custody Services

The proposed regulation of digital asset custody services in proposed division 3 of the DA Bill does not provide enough detail and consideration to the scope and requirements of digital asset custody. Digital asset custody is a significant issue for digital asset service providers. It is also an area of regulation that has significant potential to benefit from alignment with the existing custody regulations that apply to financial services. We note that in light of the Treasury's upcoming consultation paper on digital asset custody, we have provided limited comments for some of the broader issues to be addressed in the consultation paper.

The definition of 'Digital Asset Custody Service' in the DA Bill creates unnecessary regulatory complexity. The definition only applies to services that are prescribed by the rules for the safekeeping, servicing or management of a 'regulated' digital asset. As the draft delegated legislation is not available, it is difficult to ascertain the exact scope and nature of what services will be considered a Digital Asset Custody Service.

In our opinion all digital asset exchanges should be required to obtain a digital asset custody service licence and comply with necessary licence requirements. The use of 'regulated digital asset' means that the digital asset custody service requirements will only apply to digital assets that meet this definition – principally asset-backed tokens, stablecoins, and exchange tokens (we note separately it is unclear what is intended to be caught by exchange tokens). This definition excludes a wide range of digital assets, including non-fungible tokens, utility tokens, and privacy tokens. In our view, if it is important that the custody of digital assets be regulated, then this should be the case for all digital assets, as we see no reason to distinguish between tokens when the risk appears the same.

Additionally, the definition of 'regulated digital asset' specifically carves out digital assets that are also financial products. While we agree interoperability between custody of financial products and digital assets needs to be addressed, we suspect it is inappropriate to opt financial products that are digital assets into the financial services custody requirements, as AFS licensed custodians are unlikely to currently have the means or the appetite to hold digital assets in custody. This would force exchanges (and other platforms) to obtain both a digital asset custody licence and an AFS licence in order to manage custody, as there would be no ability to outsource, and this may not be achievable or desirable. An alternative would be to preference the digital asset custody requirements for digital assets that are financial products, and to potentially include specific custody requirements where digital assets are held that are financial products, and mirror the financial services regime.

While it is our view that digital assets should be regulated through the financial services regime and not a separate digital assets regime, 'digital assets custodial service' could be created as new licence authorisation and interoperability between this authorisation and the existing custodial and depository service authorisation could be managed as we have outlined above.

At a high level, we believe that all digital asset exchanges should have mandatory minimum custody requirements and that the digital asset custody requirements should integrate with existing custody regulations. We suggest that it would be more appropriate to have both standard minimum requirements for all digital asset custody that applied as a result of incidental custody services (excluding digital asset exchanges, which must obtain digital asset custody authorisation) and variable custody requirements that would apply depending on the value of assets under management.

Stablecoin Issue Requirements

The Stablecoin Issue Requirements in proposed section 20 of the DA Bill are not compatible with the proposed definition of 'Stablecoin'. The definition of 'Stablecoin' in the DA Bill captures asset-backed tokens. The requirement for stablecoin issuers to hold the face value of liabilities in either Australian or foreign currencies with an ADI will not be able to met by stablecoin issuers who issue an asset-backed token that meets the DA Bill's definition of 'Stablecoin'. For example, under the DA Bill, those that provide gold backed tokens, would be required to not hold stores of gold, but to hold cash equivalents. We also note that the requirement to have reserves held with an ADI may be inhibited by the experience of debanking in the cryptocurrency and digital asset service industry. Further, the requirement for stablecoin issuers to provide quarterly reports to APRA suggest that the DA Bill seeks to regulate stablecoins as a store of value, which is not necessarily appropriate for tokens that are backed by commodities. We understand that stablecoins can cause systemic risk and should be regulated appropriately. However, we also note that given the tough regulatory landscape for banks in Australia, regulating stablecoins (as defined) as ADIs is likely to negatively impact innovation and limit Australians' access to innovative products such as stablecoins.

Issues Not Addressed in the DA Bill

There are several key issues that are not addressed in the DA Bill. These issues are part of significant concerns that actively impact industry members and should be addressed in future regulation of cryptocurrency and digital asset services.

- Regulation of services like staking / yielding - For example, intermediated staking or yielding (other than where offered on a strictly SaaS basis), needs to be regulated as a specific service, likely within the existing financial services regime, for consistency and predictable consumer protection outcomes;

- How the use of 'person' in the current definitions for financial services will be applied for products that may avoid or circumvent the use of a 'person' to avoid regulation due to this technicality. In many token systems there is no 'person', so crypto assets and services can never meet the definition of a financial product or service;

- How (and if) markets licensing should apply to digitised financial products traded on exchanges. We understand that this is a key bottleneck in the digitisation of financial products, and if this problem remains unresolved, it is unlikely we will see many people putting traditional financial products on the blockchain. The current markets licensing regime applies to a very small number of participants, but it is likely that if crypto assets or services are regulated as financial products, with no adjustments to markets licensing, this will likely result in a hundreds or thousands in the space required to apply for a markets licence. The current markets licensing regime is not geared for a large number participants, from both a licence application perspective and also a regulatory oversight and enforcement perspective; and

- How the regulations will address decentralisation and what it means if DAOs and DEXs avoid regulation due to lack of legal personhood.

We have previously provided commentary on this to Treasury as part of their ongoing consultation.

Concepts and Provisions for Further Consideration

The DA Bill provides some broad concepts that may be considered further in future draft regulation of cryptocurrency and digital asset services. In particular, the general digital asset custody requirements such as capital adequacy and audit broadly align with industry expectations. Similarly, we also support the intention of the digital asset exchange licence requirements to address market misconduct.