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https://treasury.gov.au/consultation/c2023-427004

Queensland University of Technology

HopgoodGanim LAWYERS

ZEROCAP

30 November 2023

Mr David Menz, CFA
Director, Crypto Policy Unit

Department of Treasury
Langton Crescent
Parkes ACT 2600

By email: crypto@treasury.gov.au

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Dear Mr Menz

Regulating Digital Asset Platforms Proposal Paper [October 2023]

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

1. Introduction

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

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

1.3 Tim Edwards was assisted by Luke Dawson (Special Counsel), Tom Mirolo-Lynam (Solicitor), Jonah Farry (Law Clerk) and James Lindsay (Law Clerk).

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

1.5 Zerocap is a digital asset focused capital markets firm which primarily provides liquidity, structured products and on-chain custody to institutional clients and investors. Zerocap is a loud advocate for Australia's digital asset industry and a long-standing client of HopgoodGanim Lawyers.

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

2. Question Set 1

Prior consultation submissions have suggested the Corporations Act should be amended to include a specific 'safe harbour' from the regulatory remit of the financial services laws for networks and tokens that are used for a non-financial purpose by individuals and businesses.

What are the benefits and risks that would be associated with this? What would be the practical outcome of a safe harbour?

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

1.8 This appears motivated by a desire to create a balance between the ability to innovate and consumer protection goals.

1.9 We are supportive of that approach. There is obvious and resounding merit in Australia being perceived to have an economy and regulatory environment which favours, and helps to foster, safe and responsible technological innovation. This was a key point in many submissions made in response to the Senate Select Committee on Australia as a Technology and Financial Centre in 2021,[1] and must remain a priority going forward.

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

Unclear language

1.11 In short, we caution against use of the term 'safe harbour' in this context.

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

1.13 Subdivision C (of Division 3 of Part 5.7B), namely ss 588GA to 588GAAC of the *Corporations Act*, contains various provisions intended to negate directors' liability for insolvent trading in

[1] Select Committee on Australia as a Technology and Financial Centre – Final Report (October 2021).

circumstances where certain strict conditions are satisfied in a restructuring context (**Safe Harbour Provisions**).[2]

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

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

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

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

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

1.19 This may sound like a pedantic point, but if the goal is to encourage innovation, then persons subject to the statute ought to be encouraged to feel like certain acts are permitted, rather than simply 'excused' from illegality if certain criteria can be satisfied. The difference there may be substantial and create different legal outcomes, whether intended or not. Further, innovators ought to be free from the risk that comes with having an onus of proof.

1.20 A forthcoming article with the *International Journal of Semiotics of Law*,[3] directly addresses linguistic issues of regulation and directly draws upon the Australian Treasury's Token Mapping exercise as a case study. In this, the conclusion drawn is that the language used by regulators of blockchain and digital assets is not aligned with that used by those communities they seek to engage with. This has potential issues with misunderstanding, misalignment, and arbitrage. Regardless there can be positives to using neologisms and specific language distinct from the community because this can carry a unique regulatory purpose and be distinguishable from other regimes both domestic and international. However, if this is not done carefully, confusion and regulatory overlap can be created[4] —such as that caused by the language of 'safe harbour' as demonstrated in this submission.

[2] The term was also used, in neighbouring (and now mostly or entirely defunct) provisions, to create an immunity from action or liability in certain circumstances related to the effects of the COVID-19 pandemic.

[3] See Olivia Sewell, Lachlan Robb, John Flood, 'Asset, Token, Or Coin? A Semiotic Analysis Of Blockchain Language', (2023) *International Journal of Semiotics and Law*, (Forthcoming).

[4] which has no simple fix except to avoid creating the overlap in the first place. See also related government work by Dr Robb into risks and nature of regulatory overlap. See, Lachlan Robb, Trent Candy, Felicity Deane, 'Regulatory overlap: A systematic quantitative literature review' (2022) *Regulation and Governance* 17 (4).

International perspectives

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

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

1.23 We recommend that similar protections be implemented in the proposed new legislation, being a positive permission for DAPs who are not providing or facilitating any financialised function, and, whilst this is discussed in more detail with respect to Question Set 16 below in this submission, a temporary permissive carveout or right for entrants who are in the process of taking appropriate steps to comply with then-new regulation.

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

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

1.26 This would also be consistent with our understanding of the 'FinTech Regulatory Sandbox Framework' provided by the Monetary Authority of Singapore, which provides qualified applicants financial support for up to 50% of eligible expenses and appropriate bespoke regulatory privileges (such as the relaxing of certain regulatory requirements) where they can demonstrate that the proposed technology to be used is not yet applied in the financial services sector in Singapore. Arguably, this approach is more of a 'first mover' exception than a 'low value' exception, but it achieves a similar result for small-scale innovators looking to scale a project.

3. Question Set 2:

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

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

3.1 The proposed low value exemption (**Proposed LV Exemption**) is also clearly intended to strike a balance between facilitating innovation and protecting consumers from harm. We

[5] See the general recommendation made as *Recommendation 1 (Common Standards of Regulatory Outcomes*).

[6] Commissioner Hester Peirce, 'Token Safe Harbour Proposal 2.0' (Public Statement, U.S Securities and Exchange Commission, 15 April 2021); Monetary Authority of Singapore (2022); Proposal for EU Regulation on Markets in Crypto-assets, and amending Directive (EU) (2021); Digital Law Association(2021).

make the following key comments as to its proposed scope and the potential difficulties, or even impossibilities, which might arise if it is to be applied and enforced as proposed.

Interaction with the non-cash payments regulatory regime

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

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

3.4 In short, there are some instances in which a digital asset platform (**DAP**) provider will be providing both a platform, and something which is clearly or arguably (depending on the particular workings) an NCP facility as well.

3.5 If that is true, then unless the provider's activities activity both the discussed low value exemption and the equivalent applying to NCP facilities, then it may be that the NCP regulations apply as well.

3.6 This may be an intended outcome which serves its intended function in many cases. However, there will be cases where the unclear way in which the NCP facility regime applies to digital assets and DAPs effectively infects the ability for the Proposed LV Exemption to work as well. There may be little benefit (and little innovation permitted) where the NCP facility regime imposes, or could arguably impose, a requirement to obtain an AFSL on an entity otherwise satisfying the requirements of the Proposed LV Exemption.

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

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

Limited scope by virtue of the low cap

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

3.10 It is this 'large throughput or volume' application, reminiscent of the majority of cases which enliven the NCP LV Exemption, which informs our abovementioned concerns. We expect it is likely most providers to take advantage of the proposed exemption will use their platforms in this way; making it critical there is harmony and clarity as to the function of this new proposed regime, and the existing NCP regime.

3.11 As to other, simpler potential applications of the Proposed LV Exemption, we do not understand why many providers would test their technology using a small number of real-value

tokens in a public system which exposes them to the application of regulation, rather than internally or virtually such that the regulation could not apply regardless. That is partly why we believe the most common and relevant application of the Proposed LV Exemption would be to high volume or throughput transactions (which, again, are the sort most likely to fall within the existing NCP regime).

Difficult or impossible application

3.12 It is also critical that mechanisms are included which clearly set out how this exemption will be tested and applied in light of the sheer volatility of many digital assets or tokens.

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

3.14 Indeed, it is not inconceivable that some tokens might, even if only for short periods of time, fluctuate from $1.00 each in value to $20.00 each in value. That could create scenarios where a provider very easily qualifying for the Proposed LV Exemption ceases to overnight; or ceases to for a few minutes a day on odd days; and so on.

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

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

Practical difficulty in enforcement by providers

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

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

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

4. Question Set 4

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

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

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

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

4.3 The NTA requirement differs for non-custodial providers at 0.5% of the value of the facility. We see no issue with that and make no further submissions about it. The focus of our concerns is the $5 million NTA proposed with respect to custodians.

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

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

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

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

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

Quantum – the costs of external administration

4.6 The fees of insolvency practitioners are rarely insignificant. Often in a liquidation scenario, the liquidator's fees can be the difference between creditors receiving cents in the dollar or creditors receiving nothing.

4.7 Further, in our experience, the best insolvency practitioners tend to require the proffering of either an indemnity from a solvent entity, or the presence of significant funds in a bank account of the relevant company, in order to agree to take on the appointment. These are all points in

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

favour of the imposition of an NTA geared towards insolvency practitioner fees and disbursements.

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

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

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

4.11 Even the external administration of the Australian FTX entity was obviously far cheaper than that of the US entity (and no doubt those intimately involved with that administration will proffer data in that regard).

The additional costs arising from the relevance of digital assets

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

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

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

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

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

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

[8] If requested, we can privately provide further deidentified costing data as to the costs we have seen incurred in liquidations of particular sizes, and with particular complexities.

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

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

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

(g) how the Court can freeze or make orders to recover cryptocurrency;

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

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

4.15 In addition to these things, there is the likely added liquidator costs associated with:

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

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

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

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

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

4.18 For context, in the Example Appointment, which we expect is nearing its conclusion:

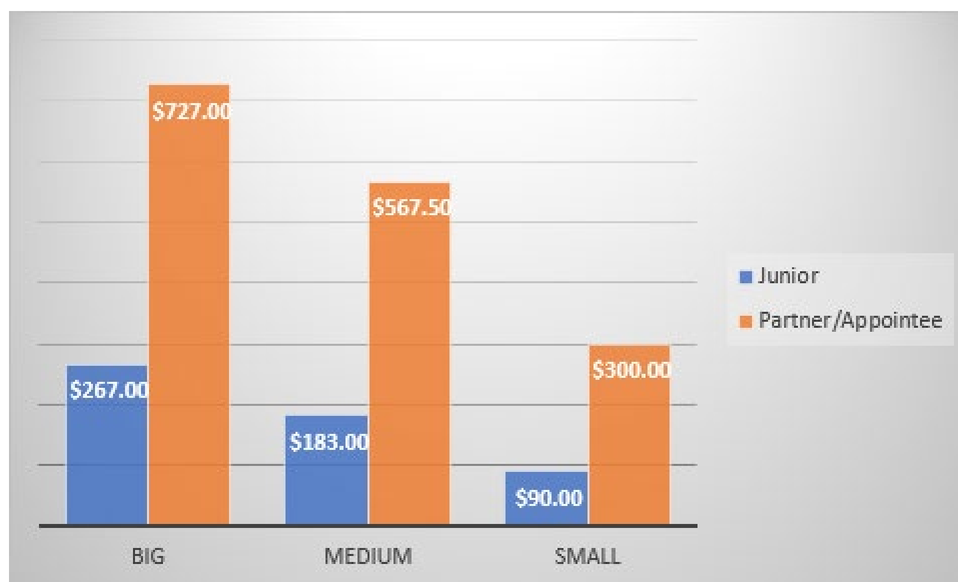
(a) the fees of the Receivers and Managers, being Partners or former Partners of a 'Big 4' accounting firm, total about $1.5 million (AUD); and

(b) of that sum, about $1.2 million (AUD) is legal fees or disbursements.

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

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

an average cost per hour of insolvency practitioner, sorted by firm size and level of seniority (junior or senior):



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

Our definition of 'orderly winding up'

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

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

4.24 An 'orderly winding up' is, in our view, a winding up where there are sufficient funds to persuade a competent and experienced insolvency practitioner to take on an appointment, and to fund initial recovery efforts for the benefit of creditors – and not more than that. Otherwise, funds are to be kept by participants, on ice and to their detriment, to fund liquidations that in the normal course should be brought to an end sooner rather than later

(for better or worse), with the only beneficiaries to be insolvency practitioners and advisers themselves.

4.25 We do not, as solicitors practising in the insolvency space, say that lightly.

Conclusions as to appropriate custodial NTA amounts

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

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

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

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

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

4.31 This would enable responsible industry participants to survive, whilst stakeholders can retain confidence that they can be wound up in an orderly manner should the need arise.

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

Tangibility – eligible assets

4.33 As a separate issue, the term 'tangible' is outdated in this context. It need not be changed if the meaning can be specified, but this fact should be considered by drafters.

4.34 The jurisprudential reason behind excluding intangible assets from proscribed liquid reserves is that, traditionally, these have been difficult to value, and difficult to find liquidity when looking at traditional intangible assets such as intellectual property, software, contracts, domains and websites, and human capital. However, in the digital asset context we will need certainty as to whether digital assets are 'tangible' – or otherwise sufficient based on other terminology - for the purposes of the NTA requirements.

4.35 If digital assets are able to be held for the purposes of NTA, this will need to be clearly set out and we would encourage the overt selection of digital assets that are not directly tied to the operations of the DAP or derive their value from such operations (i.e. algorithmic stablecoins

that are reliant on a native platform token) so as to not be effected by the volatility associated with winding up nor to have the NTA assets locked alongside the other property of the entity.

4.36 One recommendation is to permit true, fiat-backed stablecoins to be used to satisfy NTA requirements. That would require guidance to be issued by Government or a regulator as to which such stablecoins are viewed to be satisfactory; but would enable, in our experience, far more industry participants to satisfy these requirements (thus encouraging competition and innovation).

De-banking

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

4.38 If Government intends to force DAPs to hold monies in bank accounts, then something needs to be done to permit those providers to hold bank accounts. We hope that further regulation reduces the anxiety of banks and alleviates this problem, but there is no guarantee of that at the moment and this should be regarded as a very serious concern for drafters.

FTX

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

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

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

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

4.40 Much of the related unlawful conduct was no doubt prohibited by existing legislation, which was not complied with, and which was not able to be enforced, before it was too late. NTA requirements would not have prevented the above. They should not be over-used now in the hope of preventing such a scenario occurring again. There is absolutely a place for them, provided that they are:

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

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

5. Question Set 7

Do you agree with the proposal to adopt the 'minimum standards for asset holders' for digital asset facilities? Do you agree with the proposal to tailor the minimum standards to permit 'bailment' arrangements and require currency to be held in limited types of

cash equivalents? What parts (if any) of the minimum standards require further tailoring?

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

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

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

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

5.4 We agree with that approach. We do not understand why DAP providers should be prohibited from running Lend to Exchange Models where it is made painfully clear to consumers that this is what they are agreeing to, and how that will affect them in an insolvency scenario.

5.5 That would entail greater clarity than most of the industry provides at the moment. It is our experience that most retail users and some institutional users of DAPs believe they own digital assets held on the exchange when, in fact, all they own is a contractual entitlement (under a Lend to Exchange Model) to require payment or the provision of certain assets, leaving them as unsecured creditors.

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

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

5.8 One reason for which Lend to Exchange Models should be permitted is that, in our experience, DAPs employing them have reduced controls and thus costs, and a greater freedom to invest and earn. This in turn means they can offer more lucrative rates or returns to users and that, in turn, means that customers can choose to take greater risk for greater reward. Consumer protection controls should prevent customers from unknowingly taking said risk, but otherwise, should permit them to take reasonable risks, facing providers who otherwise comply with the

requirements of the legislation anyway (i.e., who have complied with the requirements to be licensed as, and maintain licensing as, a DAP).

5.9 Another reason for this view is that, if it is true that Lend to Exchange Models can be and are more attractive to many customers (and that is our view), then prohibiting it in Australia, where it is permitted in many other jurisdictions, will merely drive customers offshore, so to speak. That creates a number of serious enforcement burdens and obviously harms Australia's digital asset industry. It should be avoided.

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

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

(a) fiduciary duties are an inherent aspect of trust relationships. Trustee obligations are equitable in nature, and attributable to the trust property despite being personal obligations to the beneficiaries;

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

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

(d) moreover, it will allow creditors to draw on the vast and well-established body of case law on trusts when the subject matter of their claim concerns digital assets held on trust.

5.12 The discouragement of a Lend to Exchange Model (including by the imposition of strict controls as recommended above) will exclude many industry players, but that would seem to be a necessary consequence of the pursuit of the goals of the Proposal Paper.

International Perspectives

5.13 As noted above, the IOSCO recommends that "Regulators should require a CASP to place Client Assets in trust, or to otherwise segregate them from the CASP's proprietary assets"[9] (but does not, in our view, propose that Lend to Exchange Models be banned).

5.14 There is a significant body of case law acknowledging the capacity of digital assets to be held in trust, subject. As you are no doubt aware, notable cases include:

Case	Jurisdiction	Summary
Ruscoe v Cryptopia (in liq) [2020] NZHC 728	New Zealand	The New Zealand High Court considered for the first time whether cryptocurrencies can be considered 'property' at common law, and to what extent an account holder's interest in cryptocurrencies are protected from claims made by the creditors of a CASP in liquidation. The Court concluded that Cryptopia fulfilled the role of a trustee in relation to the accountholders and the

[9] Insert.

		digital assets were deemed to be held in multiple trusts. Further stating that Cryptopia's principal role was to hold each group of digital assets as trustee for the accountholders, to follow their instructions, and to let accountholders increase or reduce their beneficial interests in said trusts. Predicated on the fact that Cryptopia itself did not engage in trading cryptocurrencies, thereby limiting its function to holding assets on trust in the eyes of the Court.
B2C2 Pty Ltd v Quoine Pty Ltd [2019] SGHC(I) 3	Singapore	B2C2 Pty Ltd was the Singapore International Commercial Court's first cryptocurrency judgement, which applies the law of mistake in circumstances where legally binding contracts were performed by an automated contracting system without human intervention. The Court was also tasked with considering whether cryptocurrencies constituted property capable of being held on trust, and what the appropriate remedies were for breach of contract or trust in the circumstances. B2C2 had entered into a membership contract with Quoine under which B2C@ could make trades of cryptocurrencies with other parties on Quoines automated trading platform. The platorm malfunctioned executing a trade at 250 times market value in B2C2's favour. Quoine reversed the trade despite its contract stating that trades were "irreversible". The Court found that "*cryptocurrencies are not legal tender in the sense of being a regulated currency issued by a government byt do have the fundamental characteristic of intangible property as being an identifiable thing of value.*" Further stating that cryptocurrencies are "*definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability.*"[1] Ultimately the Court held that Quoine was in breach of contract for the reversal, and in breach of trust
ByBit Fintech Limited v Ho Kau Xin & Ors [2023] SGHC 199	Singapore	The Court, in citing a Monetary Authority of Singapore Consultation Paper, not too dissimilar from that which these submissions are made in response to, held that "it is possible in practice to identify and segregate such digital assets". And that "it should be legally possible to hold [crypto assets] on trust".
Re Gatecoin Limited [2023] HKFI 91	Hong Kong	The Court held that cryptocurrency could be regarded as 'property', citing the reasoning of the Court in the *Ruscoe v Cryptopia* case with affirmation, and are thereby able to be held on trust for beneficiaries for the purpose of administrating an insolvent estate.
Zi Wang v Graham Darby [2021] EWHC 3054 (Comm)	England	In this matter, there was an exchange of cryptocurrencies between the Claimant and the Defendant which were to be returned at the end of a defined period.

[1] The Court affirming the satisfaction of the elements set out in *Bank v Ainsworth* [1965] 1 AC 1175 at 1248.

		The Defendant sought to make use of the transferred assets during the period of possession, by way of sale or otherwise, and the Claimant disputed this. The Court ultimately held that while there could exist circumstances where cryptocurrencies were held on trust, the facts of this case did not provide for such a judgement to be made, and that there was a degree of commerciality in the arrangement sufficient enough to preclude any trust. Summary judgement was granted in favour of the defendant, and the injunction request made by the Claimant was denied.

6. Question Set 11

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

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

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

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

6.3 However, we are also aware of a growing number of clients, particularly in the wake of ASIC enforcement litigation commenced against BlockEarner last year, who do not meet this threshold. These actors engage with staking by only providing technological infrastructure for customers to stake their assets. In this scenario, the platform does not pool any assets, and does little more than take technical steps the customer could conceivably take themselves to enable them to engage with the relevant network and stake their assets. The role is more akin to custody than it is to the encouragement or further facilitation of staking.

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

6.5 Overregulation in this space risk driving investment into riskier offshore systems that are unlicensed. Regulatory uncertainty in staking creates a material impact on revenue for compliant platform providers. This situation means that there is a significant amount of digital assets held on custody that cannot then be staked. The customers using these platforms typically invest and believe in the asset, and that if they are going to hold it, they may as well

generate a yield—something which staking provides. If a platform is unable to offer staking, then those same customers are likely to take funds out of custody providers and find offshore providers that can enable both custody and staking in a single service.

6.6 This offshore shift is not seen as a move to more positively regulated spaces, but rather to the 'alegal' areas that are yet to regulate these actions. This means that there is a higher risk to Australians that use these services as they are more likely to be pooling assets and be unlicenced. Assuming that there is a goal of consumer protection, then overregulation of staking can be seen as a failure if it drives this use to higher risk offshore platforms.

7. Question Set 15

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

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

7.2 The key regulatory difficulty we have seen face participants in the industry pertains to the oft-discussed issue of token-mapping. The existing credit regulations do not neatly, and with certainty, apply to digital assets involved in arrangements that are reminiscent of traditional margin lending or debenture arrangements.

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

7.4 To that end, we would support:

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

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

7.5 If such changes are perceived as too drastic, this need might instead be able to be met by something less than legislation, such as a guidance note issued by a regulator (even one pertaining to a very small number of digital assets or related activities, to allow more specific analogies to be drawn by lawyers and regulators). This may strike a fair balance between information, regulatory certainty, and the difficulties faced by the concreteness of legislative statements and definitions in emerging technologies.

7.6 In the absence of such steps to clarify how existing regulation works, we would instead have to recommend that the proposed new legislation is expanded to treat lending arrangements

as 'financialised functions', so that there is at least certainty as to what is regulated and what is not in this field.

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

8. Question Set 16

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

8.1 The term 'transitory period' is, in our experience, something different to a grandfathering period. We take the term to mean that, at the end of such a period, new regulations will be in force and expected to be complied with. If that understanding is wrong, the below concerns may be moot.

8.2 Otherwise, our key concern as to the proposed transitory period of 12 months is that it may leave many industry participants, who have done the right thing and applied for appropriate licensing as soon as is practicable (and no doubt after taking comprehensive legal advice), still unable to comply with the laws. It is an issue of practical compliance.

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

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

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

8.6 The recommended solution would be to:

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

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

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

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

8.8 Conversely, by having a short (1 year as proposed) adoption time but which has a provision for clemency with those waiting in the queue, this is likely to strike a positive cord between the two extremes.

9. Next steps

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

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

Yours faithfully,

Tim Edwards
Partner and Head of Digital Assets,
HopgoodGanim Lawyers

Dr Lachlan Robb
Lecturer, Queensland University of Technology

Luke Dawson
Special Counsel, HopgoodGanim Lawyers

Ryan McCall
CEO, Zerocap