SUBMISSION TO THE SENATE SELECT COMMITTEE ON AUSTRALIA AS A TECHNOLOGY AND FINANCIAL CENTRE

Australian Davos Connection Limited
ABN 65 085 852 848
adcforum@adcforum.org
www.adcforum.org

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1. Introduction

This submission is made by ADC Forum, Australian Davos Connection Limited, an independent, not–for–profit, organisation founded in 1996 by the Australian members and participants of the World Economic Forum (WEF). For over two decades, ADC Forum has brought together the nation's foremost decision makers and thought leaders across all sectors to focus on the issues that are critical to future prosperity.

ADC Forum recognises both the potential and issues related to Australia's growth as a technology and financial centre. It has a history of addressing these issues in events such as the annual Australian Leadership Retreat and the ADC Global Blockchain Summit, held in Adelaide in 2019, which brought together world leading entrepreneurs, financiers, regulators, researchers and innovators with Australian business leaders to focus on strategies and practical applications for business growth. This led to adoption of the Adelaide Principles, a set of principles designed to guide the implementation and regulation of blockchain, distributed ledger technologies and digital assets.[1]

ADC Forum believes that the issues being considered by the Senate Committee are critical for the future prosperity of Australia. The potential is enormous, but so are the risks. In this submission, ADC Forum has drawn on its faculty of leading international experts to provide input on the key issues being considered by the Senate Committee and to propose policy pathways for dealing with these issues.

Consistent with its commitment to promoting the public good and Australia's prosperity and global contribution, ADC Forum is offering to work with the Government in developing policy and regulatory frameworks to address the issues being considered by the Committee.

Australia is at an inflection point, where it can become a world leader in this field whilst avoiding being swamped by potentially uncontrollable forces and ADC Forum stands ready to draw on its exceptional pool of expertise to help ensure our nation to set the right directions.

[1] Adelaide Principles - https://www.adcblockchain.org/adelaide-principles

2. ADC Forum’s Policy Capacity

ADC Forum is an internationally connected community, enabling a strategic architecture for business to intersect with governments and academia across the world. ADC Forum brings a unique perspective, reflecting the changing nature of Australia and the world. ADC Forum is able to draw on a network of leaders and the best thinkers across the globe to provide unique insights and challenge conventional wisdom. It takes a cross–sectoral approach to developing capacity for business, government, universities and broader civil society to jointly contribute to a resilient global system. Individual relationships and active engagement with partners are central to ADC Forum’s success and its capacity to provide unparalleled access to global influencers.

ADC is unique in combining a strong policy capability with credibility in the business sector, the capacity to incubate ideas and opportunities and the delivery of outcomes within the framework of an integrated strategy. Hence, ADC is more than a think tank, and integral to its strength is its openness to collaborate with other institutions and organisations, reflected in a range of national and international agreements and working arrangements.

ADC Forum has a strong track record of contributing to national policy development, publishing major reports on key areas of Australia’s development, which have influenced state and national policies. As an organisation working in the public interest, ADC Forum is able to contribute to the areas being considered by the Senate Committee.

Consistent with its tradition of bringing together leading thinkers and practitioners from around the world, to focus on issues critical to our future, ADC Forum has established an international experts group of thought leaders, policy experts and industry leaders to provide expertise in realising the potential of these sectors, as shown below:

ADC Forum Digital Technology and Fintech Council

1. Loretta Joseph, Chair, ADC Cyber Security Council
2. Steven Roux , CEO, Dragon Tree Capital
3. Michael Bacina, Partner, Piper Alderman
4. Lord Anthony St John, Member House of Lords, Chair House of Lords, Fintech and AI Committees
5. Lord Megndad Desai, Member House of Lords, Chair OMFIF
6. Dr Jane Thomason, Author, Industry Associate, University College London Centre for Blockchain
7. Greg Medcraft, Directorate Head, Division of Financial Enterprise, OECD
8. Liming Zhu, Research Director, CSIRO, Data 61

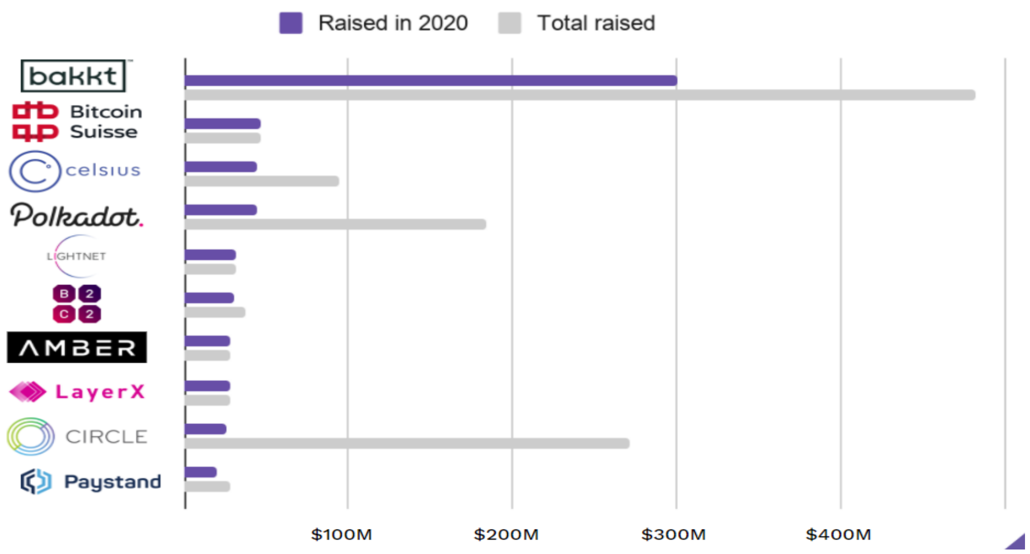
This Council is available to work with the Government in addressing the issues being considered by the Senate Committee.

3. Background

The Senate Committee is interested in assessing options for the development of a comprehensive regulatory framework for cryptocurrency and digital assets and what type of policy provision and legal certainty is needed to drive private investment into Australian digital assets, rather than the investment occurring offshore.

Crypto market capitalization topped $1 trillion at the beginning of 2021, and there has been an upswing in cryptocurrency interest from mainstream finance. The U.S. The Office of the Comptroller of the Currency approves national banks to custody crypto assets as a 'normal activity.' The EU Commission published a proposal for the regulation of crypto assets, called 'Markets in Crypto-Assets Regulation' (MiCA). Once adopted and in force, the MiCA will regulate directly applicable law in all EU Member States. Central Bank Digital Currencies continue to be actively pursued by multiple jurisdictions with China leading the charge. Mauritius has a comprehensive custody regulatory framework.

The rise of stable coins, decentralised exchanges, automated market making (AMM), and greater sophistication means the asset class continues to strengthen. Institutional adoption of digital assets will continue to rise with Reuters reporting the S&P Dow Jones would be launching a crypto index in response to institutional demand for this asset class. The global enterprise blockchain market size is expected to expand from USD 3.0 billion in 2020 to USD 39.7 billion by 2025, at an effective Compound Annual Growth Rate (CAGR) of 67.3% during 2020–2025. DeFi total value locked is likely to be $100bn in 2021as users realise that returns can be 'amplified' with varying degrees of risk and return as they 'put their crypto to work'. The blockchain and crypto space has attracted investment internationally, especially   financial services providers (trading, lending, earning yields, brokerage, market-marking), blockchain powered payment networks and blockchain ecosystem. Crypto exchange Bakkt raised $300 million in March 2021 and has recently announced that it is going public with a merger with a SPAC(Special Purpose Acquisition Company) Victory Park Capital, valuing the firm at $2.1 billion.



Source: Novum Insights 2021

4. Definitions

Before a regulatory regime can be established, it is important to understand what is being regulated and what regulatory rules apply. Anything can be tokenized and be represented digitally on distributed ledger technology. Some tokens already fall under well-developed legal frameworks, however, subjecting all tokens to financial regulation may not be appropriate because the mere act of tokenization does not change the essence or inherent characteristics of the underlying asset. Existing taxonomies and classification systems typically suffer from being either too broad or too narrow.

A clear gap has been any kind of globally accepted token asset classification system. An example of an industry led token classification comes from the [Global Blockchain Convergence] (GBC), an informal global organization dedicated to creating an environment that facilitates the adoption of blockchain and other complementary technologies. The so-called “sensible token classification system” categorizes different tokens by functionality and/or features. Then it goes back to the often-cited principle of “same asset, same risk, same regulation” or “same activity, same risk, same regulation.” GBC points out that “what has been regulated a particular way for the physical world should be regulated the same basic way for the digital world.”

The sensible token classification system thus introduces five categories of tokens –

1. physical asset tokens,
2. services tokens,
3. intangible asset tokens,
4. native DLT tokens, and
5. Stablecoins.

Physical Asset Tokens

Physical asset tokens are a digital representation of a real-world (tangible) asset created and maintained on a distributed ledger, including blockchain. These assets fall within well-developed regulations, abiding by the principle of “same asset, same risk, same regulations.” The fact that the tokenized versions of physical assets result in greater liquidity should not result in different regulatory treatment. Assets in this category include tokenized gold, tokenized paintings (not digital art, but real-life art), tokenized designer shoes and more.

Services Tokens

Services tokens are a digital representation of services to be provided by person(s)/entities to other person(s)/entities. Assets in this category include music files, purely digital art files, cleaning services tokens, concert tokens and more. As these are “services” tokens, applicable terms and conditions may set the parameters and limitations of the services to be provided. For music or digital art files, the associated copyrights, licenses, intellectual property may fall under the “intangible asset tokens” category discussed next, unless they are transferred with the files.

Intangible Asset Tokens

Intangible asset tokens are any traditional intangible asset tokenized on DLT. These assets also fall within well developed regulations like the two above. Assets in this category include security tokens, real estate ownership tokens, intellectual property, government program tokens and more. As these tokens represent intangible assets, it is important to include terms and conditions, limitations and obligations of different parties in the smart contract.

Native DLT Tokens

Native DLT tokens are native to the distributed ledger technology. One might confuse Intangible Asset Tokens and Native DLT Tokens. The latter cannot exist outside of DLT. These tokens are created by a smart contract and the desired functions and features can be programmed within the token 9eg. Governance, incentivisation) . As these tokens' features and functions can be built with programming, this category of tokens does not have a pre-specified set of features and functions. GBC therefore proposes to regulate entities that provide services around native DLT tokens, not individuals using such tokens and services.

Stablecoins

Stablecoins are tokens designed to maintain stable value against an underlying asset, reference or a basket of assets. Excluding tokens that overlap with the categorizations set out above, there remain tokens designed to be used as a general means of payment and tokens stabilized against fiat currencies.

ASIC and categories

We note that as at 30 June 2021, ASIC launched a consultation into crypto-assets which may be appropriate to be included in ETPs and ETFs.

5. Cryptocurrencies Across Jurisdictions

Using the global expertise of the ADC Digital Technology and Fintech Council we are able to share information from an international survey examining the divergent approaches of different countries [2] regarding treatment of virtual currencies from AML/CFT, taxation and licensing perspectives.

[2] Information collected from public sources on the internet is not necessarily indicative of all actions taken by each country. Source: Bloomberg (https://www.bloomberg.com/news/articles/2018-03-19/is-this-legal-making-sense-of-the-world-s-cryptocurrency-rules)

Table One: Comparative Treatment of Digital Currencies

Country	AML/CFT	Taxation	Consumers: Advice or Warning	Intermediaries: Licensing or Registration	Financial Sector Warning or Bans	Bans on Issuance or Use
Australia	-	Clarified tax treatment	Consumer Warning	Plans on introducing new regulations	-	-
Canada	Amendment to existing regulations	Clarified tax treatment	Consumer Warning	-	-	-
China	-	-	-	-	Ban	-
France	Applying existing regulations	Clarified tax treatment	Consumer Warning	-	-	-
Japan	Plans on introducing new regulations	-	Consumer Warning	Plans on introducing new regulations	-	-
Singapore	Plans on introducing new regulations	Clarified tax treatment	Consumer Warning	-	-	-
South Africa	-	-	-	Plans on introducing new regulations	-	-
UK	Applying existing regulations	Clarified tax treatment	-	-	-	-

6. Use of Regulatory Sandboxes

A review of sandbox frameworks in Abu Dhabi, Australia, Dubai, Singapore and United Kingdom, all of which were dedicated to financial services, showed that common features included the aim to provide for a contained and controlled landscape in which firms conduct pilot of financial services and products involving emerging technology or innovative application of existing technology in a cost-effective and timely manner, before being made available to the whole market. The objectives of the sandboxes vary based on the mandate of the regulator administering it. A common trait of all sandboxes was that they were attempting to strike the balance between promoting innovation, maintaining financial stability and protecting consumers of financial services. This was being done through the lowering of barriers to enable innovative financial services and products to be tested without the full cost of compliance with the licensing and regulatory requirements, and while minimising the time taken for these innovative financial products and services to reach financial markets. Simultaneously adequate safeguards were being set up to mitigate related risks and protect customers. The key finding of this benchmarking exercise is that sandboxes are systematically under the administration of the financial services regulators.

Table Two: Regulatory Sandboxes

General Information		Name of Sandbox	Date launched	Type of Applicant		Benefits		Duration	Safeguards		
IFC	Regulator			Existing Licensees	New Applicants	Relaxed licensing obligations	Relaxed regulatory framework		Limitation on customer base/value	Additional reporting duties	Consumer Protection/ Risk Mediation
Abu Dhabi	Abu Dhabi Global Market	Regulatory Laboratory	2 November 2016	✓	✓	X	✓	2 years	✓	✓	✓
Australia	Australian Securities & Investments Commission	Regulatory Sandbox	December 2016	✓	✓	X	✓	12 months	X	X	✓
Dubai	Dubai Financial Services Authority	Innovation Testing License	06 March 2017	✓	✓	X	✓	6 to 12 months	✓	✓	✓
Singapore	Monetary Authority of Singapore	Regulatory Sandbox	June 2016	✓	✓	X	✓	12 months	✓	✓	✓
United Kingdom	Financial Conduct Authority	Regulatory Sandbox	9 May 2016	✓	✓	✓	✓	3 to 6 months	✓	✓	✓

7. Licensing and Authorization of Digital Asset Exchanges

Digital asset exchanges are internet-based platforms designed to facilitate the trading of digital assets and accordingly they can access customers across the world with a relatively limited physical footprint in any single jurisdiction. Traditional exchanges and trading platforms are subject to laws and regulations (usually in the form of a licensing or authorisation regime) in the jurisdiction(s) in which they operate and/or market and the intermediaries (brokers/trading and clearing participants) who can access the platform also usually need to have some form of license or authorisation. Digital asset exchanges are direct-to-customer platforms and typically operate without the need for intermediaries to place orders on behalf of their users or hold users' assets in custody. As such, a digital asset exchange can function as a broker, custodian and trading venue at the same time.

This section focuses on centralized digital asset exchanges. For completeness, we note that there will be a host of other considerations for decentralized exchanges. For example, where the listing of a token is purely based on user voting, certain tokens which may be characterized as 'securities' (or other regulated products) could be listed and traded on the decentralized exchange, which may then trigger licensing and authorization issues for the exchange. In addition, if there are regulatory developments in the future which result in a listed non-security token becoming a security, there will be further considerations as to how these tokens should be dealt with.

Recent events have shown that regulators are increasingly scrutinising exchanges on two fronts; firstly, they want to ensure that digital asset exchanges are not facilitating trading in regulated financial products (e.g., tokens which have the characteristics of securities) without holding the appropriate license or authorization and, secondly, they want to understand how exchanges market their services to potential customers and whether such marketing activity itself constitutes some form of regulated financial activity for which a license or authentication and authorisation is required. Other features, such as the provision of leverage, may also trigger regulatory scrutiny.

These issues are exacerbated by the absence of any internationally harmonized view of token characterization (as noted above), meaning that a token which is not classified as a 'security' (or other regulated product) in one jurisdiction might be classified as a 'security' (or other regulated product) in another jurisdiction. Additional features and services, such as leverage, derivatives, futures etc., are also subject to jurisdictional differences.

One approach, which currently seems to be the most widely adopted approach in the market, is that the website for the exchange is accessible globally, but certain jurisdictions and categories of customer are 'switched off' pursuant to the exchange's terms and conditions and its client onboarding procedures.

Under the terms and conditions of the exchange, customers from certain prescribed jurisdictions are expressly prohibited from using the services of the exchange. For example, Binance being warned by the Japanese Financial Services Authority against doing business in Japan without a license, the U.S. SEC taking action against Bitfunder for facilitating the trading of security tokens without holding the appropriate licenses.

The same 'switching off' approach could be taken with respect to specific digital assets. For example, a digital asset which is not classified as a 'security' in Switzerland but would be classified as a 'security' in Hong Kong could be made available for trading for Swiss persons but 'switched off' for Hong Kong persons. This approach would reduce the risk of the exchange facilitating trading of 'securities' without a license in a particular jurisdiction but, as a commercial matter, may result in limiting the range of digital assets that are available to trade in some jurisdictions.

This approach allows the flexibility to 'switch off' an entire jurisdiction, where it is clear that this is required by applicable laws and regulations, and to fine tune the exchange's offering in other jurisdictions by only 'switching off' the ability to trade specific tokens.

Marketing of exchange services should be in compliance with applicable laws and regulations of the target jurisdiction (e.g. marketing activities should not be conducted in 'switched off' jurisdictions). Where marketing is conducted through a website, measures as those discussed below should be adopted. In conjunction with these 'switching off' safeguards, it also would be prudent for exchanges to limit active/concerted marketing campaigns to permitted jurisdictions (i.e., jurisdictions which have not been 'switched off') and in which there are not a significant number of tokens on the exchange which are 'switched off'.

In addition, exchanges also may need to implement further measures including, but not limited to, the following:

- include a generic catch-all clause in the terms and conditions of the exchange stating that services will not be provided to persons where the use of such services would be contrary to applicable laws and regulations;
- notify customers about tokens which are 'switched off' in the relevant jurisdictions;
- implement systems and controls so that such persons cannot actually trade the 'switched off' digital assets, including geo-blocking and IP address checks;
- to avoid inadvertently triggering any marketing restrictions, the website and marketing materials of the exchange should list the jurisdictions which are not 'switched off' (i.e. are 'switched on').

The 'switching off' approach for jurisdictions is only a partial solution, given the pervasive use of Virtual Private Networks in the industry. The above outlined approach therefore needs to be coupled with necessary sanctions screening using a reliable provider for sanctioned persons and entities.

Another approach is to only permit the trading of tokens in certain jurisdictions as prescribed by the exchanges and block all other jurisdictions (i.e. the 'switching on' approach). Customers will therefore be unable to access the exchange's website or trade tokens in jurisdictions which have not been 'switched on'. The advantage of the 'switching on' approach is that operational risk of providing services in a jurisdiction where such services are prohibited should be lower. This also provides a more comprehensive mechanism for dealing with legal and regulatory risk. From an efficiency standpoint, it also narrows the jurisdictions that need to be monitored on an ongoing basis.

Irrespective of whether a 'switching on' or 'switching off' approach is adopted, the key will for exchanges will be to carry on thorough jurisdictional analysis and have effective customer screening and robust controls.

One further consideration is that exchanges should have appropriate procedures in place to react to abrupt changes to regulations or regulatory expectations in a particular jurisdiction. For example, if a regulatory change in a certain jurisdiction results in the trading of digital assets becoming unlawful or a certain token is recharacterized as a security, exchanges will need to immediately 'switch off' the relevant jurisdiction or the trading of the relevant token.

To address this, exchanges should consider implementing the following best practices:

- monitor regulatory developments in jurisdictions where the exchange's tokens are traded and on an ongoing basis. If there is a potentially adverse change, the exchange should assess whether this merits 'switching off' the jurisdiction as a whole or certain tokens from being traded in the jurisdiction. Where there is some ambiguity, the exchange may wish to obtain an updated legal opinion from the issuer or from the exchange's own legal counsel to confirm the legal and regulatory status of the relevant tokens;
- require issuers to disclose to the exchange, among other things, (i) any material issues with the status or condition of the project, financial condition, management team of the issuer; and (ii) any other material changes to information submitted in the original listing application by the issuer, pursuant to the continuing obligations requirements under the listing rules;
- prohibit users in affected jurisdictions from 'buying' the relevant tokens but (subject to the bullet point below) permitting them to sell such tokens; and
- engage in discussions with the local regulator to resolve how the affected token holders can exit their positions (e.g. whether it is permissible for the token holders to make a final trade within a prescribed timeframe). Otherwise, such token holders may have to hold on to tokens which they cannot dispose of, which may therefore be valueless. In any event, this risk should be clearly identified to exchange users.

8. Cryptocurrencies: an Asset-Class for Expert/Retail Investors

Cryptocurrencies are unregulated and their prices are extremely volatile in their exchange rates to fiat monies, and tend to be of a high-risk nature. Consequently, we propose that Cryptocurrencies may not be suitable for retail investors but may constitute an asset-class appropriate for investment by Expert Investors. Such a recognition may encourage the setting up of Cryptocurrency Expert Funds in Australia to invest into baskets of Cryptocurrencies. Retail investors must be informed of the risks these new assets involve. Digital assets are a new asset class of which cryptocurrencies are just a subset. They are highly speculative, volatile and risky. We cannot stop the population using technology and nor should this be the regulatory goal. Regulators can caveat "buyer beware" rules. Regulatory frameworks must be sensible and not stifle innovation.

Income Tax treatment of Cryptocurrencies

Relating to taxation, we advocate for a concerted approach to be adopted between the regulators APRA and ASIC, the ATO and Treasury may be adopted in devising the tax treatment to be applied to profits generated from Cryptocurrencies.

One such approach which may be considered is to subject all persons accepting Cryptocurrencies as remuneration or revenue to normal taxation, subject to any applicable deductions, under the prevailing legislations with regards to income derived in or from Australia.

Consequently, businesses opting to accept Cryptocurrencies as payment for goods and services may be required to either record the sale based on the market value of the relevant goods or services in the local currency, (AUD) or the Cryptocurrency rate at the time of transaction.

Any person trading in Cryptocurrencies in the ordinary course of business may be taxed on profits made from the trading. Profits generated from mining and trading Cryptocurrencies for fiat money may also be taxed. However, a person buying Cryptocurrencies for long-term investment and thereafter realising a capital gain from the disposal of such investments, may not be taxed, given the absence of capital gains tax.

Custody

In recent years, fintech has been growing exponentially in complexity. One missing component to date has been the availability of appropriate custody services for the safekeeping of digital assets. While the regulators do issue custodian licences, the existing regulatory framework applicable to these licences, unless appropriate updates are made, is not directly applicable to the safekeeping of digital assets. In the eventuality the regulators may wish to license entities providing custody services for digital assets, an important aspect to be considered is the cyber resilience of these service providers, i.e., their ability to limit the impact of security incidents.

A major challenge remains the lack of independent third-party digital asset custodians. In traditional financial services, these service providers fulfil three key functions, namely validation, security and trust. In the absence of digital asset custodians, first-party custodianship remains the main form of safeguarding clients' assets. This is a fundamental security concern given that loss of the private key relating to the assets equates to losing the ownership rights to the digital asset. A few businesses providing digital asset custodian services are now emerging.

Emergence of Digital Asset Collateral Lending

The recent times have also seen the rise of a lending industry whereby digital assets such as Cryptocurrencies are being used as collaterals to provide borrowers with loans in fiat currencies. One of the leading service providers in this space operates a platform to which prospective buyers and borrowers gain access through the payment of access tokens. The platform then links borrowers and lenders whereby the terms of the loans are agreed directly by these two parties. This service provider also offers the option for the lender and the borrower to keep custody and ensure the safekeeping of the digital asset, used as collateral, during the period of the loan.

9. Cybersecurity

As fintech continues to grow in sophistication, threats posed by cyber-attacks are likely to escalate. Such attacks have the potential to cause significant disruption, thereby threatening investor confidence as well as the integrity and stability of the financial services sector, with serious adverse reputational implications for Australia.

It is thus vital for service providers in the fintech space to have effective cyber security programmes to defend themselves against cyber security events[3] to ensure the availability and functionality of their electronic systems and to protect those systems and any sensitive data stored on those systems from unauthorized access, use, or tampering. The requirements for such cyber security programmes must therefore be imposed on these service providers, including those ensuing the custody of digital assets, be it through tailored licensing conditions at a first stage, and thereafter as a statutory obligation, should Australia enact a legislative framework specific to fintech activities.

Fintech service providers may consequently be required, while applying for a licence from ASIC or the APRA, as may be applicable, to have a cyber security policy, approved and to be annually reviewed by its board of directors, covering the:

- identification of internal and external cyber risks by, at a minimum, ascertaining the information stored on its systems, the sensitivity of such information, and how and by whom such information may be accessed;
- protection of its electronic systems, and the information stored thereon, from unauthorized access, use, or other malicious acts through the use of defensive infrastructure and the implementation of policies and procedures;
- detection of systems intrusions, data breaches, unauthorized access to systems or information, malware and other cyber security events;
- response to detected cyber security events to mitigate any effects thereof; and
- recovery from cyber security events to restore normal operations and services.

The applicant may also be required to have dedicated in-house cyber security personnel adequate to manage its cyber security risks.

10. Decentralised Finance (DeFi)

DeFi enables cryptocurrency users around the globe to make use of traditional financial services such as borrowing, lending, trading, and investing in a decentralized and transparent manner. In 2020 people can borrow, lend, trade, invest, exchange, hedge, and store cryptographic assets on DeFi Apps on the Ethereum network. DeFi refers to the opening of the traditional, closed, financial system, to one that is decentralised, modular, interoperable and programmable. All you need is an internet connection and a cryptocurrency wallet.

CoinTelegraph describes the crypto hedge fund industry as the future of finance. PWC's Crypto Hedge Fund Report, estimated that crypto hedge funds assets under management have globally increased to over US$2 billion in 2019 from US$1 billion the previous year and that funds generally saw a 4X increase in 2019. They report that most investors (90%) are family offices (48%) or high-net worth individuals (42%). The leading traded assets are Bitcoin (97%) followed by Ethereum (67%), XRP (38%), Litecoin (38%), Bitcoin Cash (31%) and EOS (25%). Some crypto hedge funds are also involved in cryptocurrency staking (42%), lending (38%) and borrowing (27%). PWC also reported that crypto hedge funds using an independent custodian increased in 2019 from 52% to 81% and

[3] A "cyber security event" means any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt, or misuse an entity's electronic systems or information stored on such systems.

that the percentage of crypto hedge funds using third-party research increased from 7% to 38% in 2019.

Cryptocurrency custody solutions are important for safeguarding cryptocurrency assets. Private keys are a complex combination of alphanumerics and are hard to remember and can be stolen or hacked. Online wallets are a potential solution but they have also proven susceptible to hacks. Cryptocurrency custody solutions provide storage and security services for cryptocurrencies and are mainly aimed at institutional investors, such as hedge funds. Crypto custodians securely store crypto assets for investors who want to minimize the potential loss of funds due to a lack of technical expertise or are required to use a qualified custodian by law. Custodians are directly tied to commercial and investment banks, as their success hinges on the growth of the bank to secure more assets under management. As the bank brings in assets, the custodian secures those assets and charges a small fee. Today, four large custodians (BNY Mellon, State Street, JPMorgan, Citi) provide the majority of custody services globally with nearly $120 trillion in assets under custody. Professional investors need compliant cold storage and insurance from brand-name companies with a strong reputation.

Now groups with consistent returns like Icoinic Capital (regulated by the Amsterdam Stock Exchange) are beginning to amass significant assets under management. This fund is registered with the Dutch financial authority, has a Dutch bank account, and is fully audited on a quarterly basis. Iconic operates out of the Amsterdam Stock Exchange, the oldest exchange in the world. Their returns have been solid and growing, 11%+ in 2018, 25%+ in 2019, and 125%+ in 2018 (as of late October). Iconic Capital is fully compliant with best practices from traditional finance and reports on an annual basis to the Dutch Central Bank.

Coinbase, Kraken, Gemini, Bitfinex, Bitstamp and Binance are continuing their rapid expansion through acquisitions and product releases, and decentralised exchanges like Uniswap and dYdX are booming. Uniswap is a fully decentralized protocol for automated liquidity provision on Ethereum. A simple formalized equation drives unstoppable liquidity for thousands of users and hundreds of applications. Uniswap enables developers, liquidity providers and traders to participate in a financial marketplace that is open. Coindesk reported that Uniswap made $7,000,000 in August alone. Coindesk reported that the RenVM DeFi network's token surged by more than 100% over a single week in August. The total value locked in RenVM jumped to more than $174 million on Monday, August 17th, from approximately $59.9 million a week earlier.

Another significant DeFi offering is the ability to earn interest on crypto asset holdings through algorithmic, autonomous interest rate protocols such as Compound. With the backing of traditional investors such as Bain Capital, Compound wants to generate value from the idle cryptocurrencies in wallets and exchanges. The Compound protocol currently has over a billion dollars in assets earning interest of up to 2% across 9 markets. Aave, Finnish for 'ghost' and a metaphor for the transparency of its infrastructure, is another decentralised money market that offers both stable and variable interest rates on a variety of cryptocurrencies. Aave also offers zero collateral flash loans, an innovation unique to crypto finance. In short, users must repay their loan before the next block is mined or else the entire transaction is cancelled.

Platforms such as Nexus Mutual provide even greater assurance against smart contract failure through the development of decentralised insurance protocols. Nexus Mutual has a membership process in which users are subject to KYC/AML checks and a 0.002 ETH joining fee. Members are then able to receive quotes and gain cover on smart contracts, with the Dai or Ether used to purchase cover converted into NXM (Nexus Mutual Tokens), which users receive a 10% return on should they not make a claim. Etherisc is another decentralised insurance platform that operates under an insurance-as-a-service model, which allows users to generate their own insurance products. The user base has already generated a basic suite of insurance products from flight delay and disaster insurance to collateral protection for crypto-backed loans.

The blockchain and crypto industries still face many challenges due to regulatory questions. Completely decentralized applications raise flags with regulators over risks of fraudulent transactions and money laundering. There is also unease regarding all the responsibility put upon developers in the decentralized application field. Regulatory guidance will gradually gain greater clarity as regulators catch up.

11. Debanking

Debanking has been raised as a significant obstacle to the further domestic development of the FinTech sector. Without banking facilities the industry cannot flourish. Banks have argued that there are AML/CTF risks associated with banking the blockchain industry . Whilst these risks remain, they can be mitigated . Deep forensics on the blockchain by companies like Chain Analysis show less than 1% of all crypto transactions are used for ML/TF purposes. As the blockchain is an immutable, distributed , secure and transparent ledger all transactions can be traced and tracked unlike cash. In our submission, the economic and business risks of not banking this emerging sector far outweigh any AML/CTF risks presented.

12. Action required to realise Australia's potential

Whilst mitigating the AML/CTF risks Australia and its business community must harness the opportunities this sector creates.

Data 61 has done extensive research on the positive economic and social impact the sector will have on the Australian and global economy. The industry is large and growing rapidly, with Kraken valued at $10bUSD and Coinbase $85-100bUSD, there is opportunity Australian Crypto exchange market. There is considerable growth, economic opportunity and employment creation opportunities in digital assets. There is also the potential to attract overseas investment from a crypto friendly regulatory environment. One of the biggest firms that offers analysis on the cryptocurrencies, including DeFi, is Chainanalysis which has just completed its second $100 million fund raise in four months. This latest funding doubles the value of Chainanalysis to almost $2 billion.

Our nation can realise its potential to become a leading player in the areas of digital technology by drawing on international experience and expertise, as well as the capability of world recognised experts in Australia. In this context, the following are important:

1. The smaller Commonwealth nation states have led the way when it comes to comprehensive regulatory frameworks and laws. Bermuda, Mauritius and Singapore (to a lesser extent) are examples of these nations. Australian should draw on this experience.

2. Whilst in broader terms Digital Assets are a new asset class, with applications that are emerging in real time. Crypto assets are more akin to commodities than securities and should be classified as such. Crypto assets are NOT legal tender. The proposed Token Classification Framework will provide a basis for Australia to understand the different applications of tokens and consider an appropriate regulatory framework accordingly. ADC Forum team members contributed to this framework.

3. In relation to what type of policy provision and legal certainty is needed to drive private investment into Australian digital assets rather than the investment occurring offshore, regulatory clarity is needed to provide entrepreneurs building these businesses legal certainty. The jurisdiction must remain competitive but secure against risks these new assets pose.

4. Global lessons are that digital assets do not fit existing regulatory frameworks and Australia should not try to retrofit into an existing regulatory framework. Australia should approach regulatory design from first principles with an underlying emphasis on consumer protection and risk management moving forward.

5. Consumer and investor protections must be balanced with encouraging innovation.

6. A “Buyer beware” caveat is useful only when the securities regulator has defined crypto assets as commodities.

7. Digital assets, in some respects, mirror characteristics of commodities.

8. In some instances, securities regulation should prevail and it is important to understand the rights attached to the underlying asset.

9. If investment is purely speculative with the intention of monies contributed being used by a person to make a profit or monetary gain, then the regulatory framework should reflect this, and securities tokens are reflective of the underlying asset and should be fully captured in the Corporations Act with compliance requirements tailored to Digital Assets and the current commercial landscape (i.e. mandating insurance if such insurance is not available stifles innovation).

10. In instances where money is not being invested for investors and there is no intent of financial gain from monies invested, which would remove those instances from falling under the Corporations Act.

11. If these assets are a derivative of a Bond, security or debenture, no new specific legislation is required and these assets fall under exciting regulation, however the practical issue of compliance with the existing regime needs to be considered carefully as there have been no examples in Australia of any crypto-bond, securities or debentures being issued to date.

12. In the absence of an ability to make legislative amendments, if compliance requirements with the Corporations Act render innovative blockchain token products impossible, it may be required that a stand-alone Act or Rules under the various regulators be created.

13. The Way Forward to Realising the Potential

Australia has the opportunity to learn from international experience to develop a comprehensive regulatory framework for cryptocurrency and digital assets; it does not have to reinvent the wheel. ADC Forum Team members have deep experience in working with multiple jurisdictions to develop such frameworks.

ADC Forum has the capacity and remit to play a leading role in working with the Government in releasing the enormous potential of this sector, whilst mitigating against the significant risks inherent in an emerging field. ADC Forum is uniquely placed to contribute to realising this national potential, as a not-for-profit, working in the national interest, drawing on the exceptional Australian and international expertise of the ADC Forum Digital Technology and Fintech Council (see page 2). ADC Forum would be pleased to engage with the Government to develop an agreement to undertake the necessary work, so that Australia can be at the forefront of fields which will dominate global financial dynamics.