6 March 2023

Director – Crypto Policy Unit
Financial System Division
The Treasury
Langton Crescent
PARKES   ACT   2600

By email: crypto@treasury.gov.au

Dear Sir/Madam

Token Mapping

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the consultation paper: *Token Mapping*.

AFMA supports better integration of the token-based systems into the financial regulatory framework. Better integration will reduce the risks for investors and, over the longer-term, reduce the risks to system stability.

We support Treasury looking through the technological implementations and some claims about what the technology offers to see what the outcomes, risks, and parties to these arrangements are. We accept that in some circumstances this may require some adjustments to the regulatory drafting to ensure products with similar risks and outcomes are captured.

Please find our responses to some of the questions posed attached below.

Yours sincerely

Damian Jeffree
Senior Director of Policy

General comments:

In AFMA's view the threshold issue is whether or not a token, and/or the arrangements that underpin the dealing of that token, can or should be characterised as a financial product or financial service.

Where this is the case, the focus becomes how the existing regime can be applied or adapted while keeping the regulatory burden and any associated distortions to a minimum.

Q1) What do you think the role of Government should be in the regulation of the crypto ecosystem?

AFMA continues to support the token mapping exercise and the role of government in explicating how tokens fit into the existing regulatory structures and adjusting those structures where necessary to accommodate the new technologies. We also support the continued dialogue and engagement between the public and private sector to ensure the regulatory framework remains fit for purpose.

We support the Government seeing its role as refining existing structures which, as the paper notes, have been drafted from a functional perspective. These existing structures reflect protections built over many decades of experience around the risks for investors.

We also encourage active global coordination between policymakers to ensure regulations that are developed are agile and support the ongoing discussion, led by the G20 in this regard.

Achieving the right balance in regulation that increases clarity and consistency in the treatment of crypto products while managing their risks appropriately will support continued innovation.

Q2) What are your views on potential safeguards for consumers and investors?

We suggest the investor regulatory framework is highly developed and appropriate for tokens that are financial products (or financial product like). Application of this financial product framework will bring welcome symmetries in disclosure, marketing, and distribution requirements for crypto assets. We suggest a consumer regulatory framework is only appropriate for those tokens that are not financial products.

Internationally, we note that some jurisdictions have implemented a customer knowledge assessment such as by the SFC in Hong Kong. The aim is to ensure a sound level of investor expertise and knowledge regarding crypto assets.

AFMA does not support overlapping or duplicative regulatory frameworks and a clear delineation between financial and consumer regulatory structures is a necessary and important output of the token mapping exercise.

Q3) Scams can be difficult for some consumers to identify.
a) Are there solutions (e.g. disclosure, code auditing or other requirements) that could be applied to safeguard consumers that choose to use crypto assets?

AFMA supports efforts to make the Australian economy more resistant to scams. We support an ecosystem approach which recognises the different roles that different sectors must play.

For tokens that are financial products there is a well-developed set of risk disclosures and due diligence that is required and aimed at protecting investors already in place. Financial product designation will bring investor protections around misleading and deceptive conduct, hawking, and design and distribution obligations.

We suggest differences in technological implementation should not move these 'assets' away from the financial products protections. In many such cases regulatory frameworks will not require substantial change just because blockchain is being utilized.

Where implementation differences exist for crypto assets, regulators should aim for outcomes that are consistent with those for financial products. This may mean a more active regulatory approach for some areas that should assist the ecosystem as a whole deliver to investor expectations.

b) What policy or regulatory levers could be used to ensure crypto token exchanges do not offer scam tokens or more broadly, prevent consumers from being exposed to scams involving crypto assets?

AFMA recently supported proposals to require advertisers to confirm advertisements for financial products with the purported licensee in response to the Digital Platforms consultation paper. The consumer regulator suggested these should form part of consumer law, but they could equally be part of other regulatory areas such as financial product law.

AFMA supports enforcement of the existing appropriate rules around exchanges and licencing for relevant activities. This is a well-developed regulatory system that should be applied to crypto exchanges, brokers, and others that support access to crypto products that are or act like financial products. AFMA supports work to ensure the regulatory perimeter captures functionally equivalent products.

Q4) The concept of 'exclusive use or control' of public data is a key distinguishing feature between crypto tokens/crypto networks and other data records.
a) How do you think the concepts could be used in a general definition of crypto token and crypto network for the purposes of future legislation?
b) What are the benefits and disadvantages of adopting this approach to define crypto tokens and crypto networks?

AFMA is advised that the proposed approach could put Australia out of sync with how digital assets are being distinguished in other jurisdictions. Australia should be careful in this emerging area to avoid locking in approaches that might have limited acceptance internationally as this might impede innovation and investment.

Q5) This paper sets out some reasons for why a bespoke 'crypto asset' taxonomy may have minimal regulatory value.
a) What are additional supporting reasons or alternative views on the value of a bespoke taxonomy?
b) What are your views on the creation of a standalone regulatory framework that relies on a bespoke taxonomy?
c) In the absence of a bespoke taxonomy, what are your views on how to provide regulatory certainty to individuals and businesses using crypto networks and crypto assets in a non-financial manner?

AFMA is opposed to a standalone regulatory framework that relies on a bespoke taxonomy. In our view where are financial risks exist, then financial services law should apply. When there are no financial risks then financial services law should not apply. Where a product is a mix of financial and non-financial elements, financial services law should apply to the elements which contain financial risk.

We agree that it is almost impossible to create an enduring but not unwieldy taxonomy for tokens. This is not an unusual set of circumstances and is directly analogous to traditional legal contracts for OTC transactions. OTC contracts are also infinitely flexible and, when implemented in smart contract languages, Turing complete.

We support the introduction of a high-level taxonomy to create a sensible starting point for the integration of token systems into financial (and other) law.

Regulatory certainty for individuals and businesses using crypto networks and crypto assets in a non-financial manner should be based on the functional outcomes. Where the outcomes and risks are not financial these should not be treated as financial transactions.

Q6) Some intermediated crypto assets are 'backed' by existing items, goods, or assets. These crypto assets can be broadly described as 'wrapped' real world assets.

a) **Are reforms necessary to ensure a wrapped real-world asset gets the same regulatory treatment as that of the asset backing it? Why? What reforms are needed?**

b) **Are reforms necessary to ensure issuers of wrapped real-world assets can meet their obligations to redeem the relevant crypto tokens for the underlying good, product, or asset?**

For financial products (and cash in jurisdictions where cash is not a financial product) there are well established protocols for ensuring wrapped real-world assets are treated appropriately. We note that in multiple jurisdictions (e.g. Hong Kong, Scotland) private banks issue bank notes that are redeemable for currency, and serve as what might considered a physical stablecoin equivalent.

There are also financial products that may be a 'wrap' around a physical commodity – for example, gold ETFs. The underlying asset (gold) is not subject to financial regulation while the ETF is a financial product and subject to regulation.

More recently Australian banks have issued tokens redeemable for Australian dollars. The regulatory framework ensures ADIs have sufficient liquidity, reserves, audit quality, systems quality and the many other elements that are necessary to ensure confidence and certainty in redemption. We suggest this existing regulatory system is appropriate for tokens redeemable for financial products, and that it would be difficult to achieve similar outcomes with a reduced set of regulatory requirements.

The issues noted in the consultation paper as contributing to the failure of FTX includes liquidity mismatches, asset rehypothecation, and high leverage. These are all covered by the existing Australian prudential regulatory framework applicable to banks. It follows that if these existing financial product requirements (i.e. licensing, controls, supervision and oversight) were in place the harm and damages could have been prevented.

Q7) It can be difficult to identify the arrangements that constitute an intermediated token system.

a) **Should crypto asset service providers be required to ensure their users are able to access information that allows them to identify arrangements underpinning crypto tokens? How might this be achieved?**

We suggest the due diligence and disclosure requirements already placed on financial services firms are the appropriate framework for ensuring crypto asset service providers identify underlying arrangements and supply this information to investors.

We believe these regulations should be extended to all service providers and not just banks. This aligns with the principle of "same risk, same activity, same regulation".

> **b) What are some other initiatives that crypto asset service providers could take to promote good consumer outcomes?**

The application of the financial services regulation, rather than a consumer regulation framework.

> **Q8) In addition to the functional perimeter, the Corporations Act lists specific products that are financial products. The inclusion of specific financial products is intended to both: (i) provide guidance on the functional perimeter; (ii) add products that do not fall within the general financial functions.**
> **a) Are there any kinds of intermediated crypto assets that ought to be specifically defined as financial products? Why?**
> **b) Are there any kinds of crypto asset services that ought to be specifically defined as financial products? Why?**

Consideration might be given to bringing firms that provide services and on-ramps to crypto products with financial characteristics. We see these firms as providing financial product-like exposure to investors but without many of the protections that would accompany a similar financial product.

> **Q9) Some regulatory frameworks in other jurisdictions have placed restrictions on the issuance of intermediated crypto assets to specific public crypto networks. What (if any) are appropriate measures for assessing the suitability of a specific public crypto network to host wrapped real world assets?**

AFMA supports a principles-based approach to the management of risks around public crypto networks. ASIC Report 705 outlines factors that should be considered before a crypto asset was used as an underlying asset in an ETF and other structures. We suggest these considerations could be applied during the risk assessment of public crypto networks.

> **Q10) Intermediated crypto assets involve crypto tokens linked to intangible property or other arrangements. Should there be limits, restrictions or frictions on the investment by consumers in relation to any arrangements not covered already by the financial services framework? Why?**

Where products create similar risks or exposures as financial products, we believe they should be brought into the scope of regulation. Currently products are available through tokens that produce derivative type exposures but with substantially higher risk, and without the protections of the financial regulatory regime.

Q11) Some jurisdictions have implemented regulatory frameworks that address the marketing and promotion of products within the crypto ecosystem (including network tokens and public smart contracts). Would a similar solution be suitable for Australia? If so, how might this be implemented?

Network tokens and public smart contracts that produce financial product type risks should have the same requirements around marketing and promotion as financial products.

Q12) Smart contracts are commonly developed as 'free open-source software'. They are often published and republished by entities other than their original authors.
a) What are the regulatory and policy levers available to encourage the development of smart contracts that comply with existing regulatory frameworks?
b) What are the regulatory and policy levers available to ensure smart contract applications comply with existing regulatory frameworks?

In AFMA's view a private/public network contains the same level of promises, intermediaries and agents as traditional finance, and as far as possible the existing framework should be applied. In some cases, this will require looking through the implementation technology to the functional outputs, and in others finding where the traditional finance elements are represented in the token arrangements. There is significant benefit in keeping a single system for regulation for financial risk that applies regardless of the technical implementation method.

While there are new types of intermediaries such as non-bank crypto asset service providers, in our view the net functions are the same. For example, the designers and coders of a crypto asset, often self-assembled into groups, typically make representations (which might be considered an implicit promise) about how their product will perform and, bad actors aside, endeavour to implement these outcomes. Firms will then offer pathways onto these assets. These firms are implicitly making promise about the suitability and functionality of the crypto code and infrastructure.

Similarly, the operators of nodes are holding themselves out as good actors, and the system relies on the majority of actors being such to function reliably, the 'consensus' algorithms are a check on the inherent promise. The designers, coders, node operators, and firms offering exchange or access services are acting as a mix of intermediary and agent for the financial product.

'Smart contracts' may be implemented in a number of ways including by the use of a trusted third party, or via the use of public networks. Where a trusted third party is used, typically to run software to automatically make payments between the parties based on agreed data feeds, the arrangement fits reasonably well into existing legal frameworks.

The parties are agreeing to be bound by the output of the code driving payments, and there are separate legal agreements with the third party.

In some cases, the use of public networks can be seen as the contracting parties agreeing to rely on a group of unknown third parties for execution of a contract expressed in code, with the added risks noted in para 111 of the paper. These risks will vary from network to network, and contract to contract.

> **Q13) Some smart contract applications assist users to connect to smart contracts that implement a pawn-broker style of collateralised lending (i.e. only recourse in the event of default is the collateral).**
> **a) What are the key risk differences between smart-contract and conventional pawn-broker lending?**
> **b) Is there quantifiable data on the consumer outcomes in conventional pawn-broker lending compared with user outcomes for analagous services provided through smart contract applications?**

Nil response.

> **Q14) Some smart contract applications assist users to connect to automated market makers (AMM).**
> **a) What are the key differences in risk between using an AMM and using the services of a crypto asset exchange?**
> **b) Is there quantifiable data on consumer outcomes in trading on conventional crypto asset exchanges compared with user outcomes in trading on AMMs?**

AFMA notes that those using automated market makers (AMM) face the same range of risks and challenges as financial markets. These issues include front-running (including through block mechanisms such as Maximal Extractable Value (MEV)), price dislocation, limited market depth/liquidity, and divergent/impermanent loss.