4 December 2023

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**Regulating Digital Asset Platforms**

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on the Regulating Digital Asset Platforms Consultation Paper.

Overall, and subject to the reservations noted below, AFMA is broadly supportive of the proposed framework.

AFMA, like Treasury, seeks to find a balance between ensuring the existing investor protections and comprehensive regulatory platform that surrounds financial products is not undermined, while allowing space for future innovation and evolution within the sector. We fully support the principle of similar risk, similar regulatory response.

Much of the success or otherwise of the proposed framework will depend on the implementation details. We caution against a piecemeal approach. Risk analysis and regulatory response for digital assets must be structured and done in advance.

The risks associated with investment in financial and non-financial products are well-known, the regulatory structures should not slowly be rebuilt for digital assets as issues arise.

*Digital custody focus supported*

With this in mind, we support the initial focus on digital custody activities using "asset holding as the regulatory anchor point" per the Consultation Paper, as this is aligned with a key potential source of incremental risks to end-clients.

Targeting digital custody activity is broadly consistent with the approaches taken in key Asia Pacific markets, for example Hong Kong and Singapore. Consistency with peer

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jurisdictions is important to ensure a level playing field, interoperability and ensuring Australian investors are effectively served.

We note however that the industry is rapidly evolving and retaining regulatory flexibility is important, particularly in relation to the regulatory perimeter of digital asset custody, for example, in relation to the sub-activities captured and the digital assets in scope.

*Focus on tokenized non-financial products and new activities supported*

AFMA strongly supports the reliance on the existing regulatory framework for financial products. The proposed focus on non-financial products and new activities is supported as both appropriate from a consideration of potential risks, and in terms of providing a proving ground for potential later financial product applications.

We expect that the proposed regulatory approach, if completed in its detail with appropriately balanced regulations, may meaningfully contribute to a future pathway for digital assets that are financial products.

*Technological neutrality*

AFMA sees no new risks in blockchain technology, only familiar risks expressed in new ways. As such the existing regulatory framework for financial products might be used as a guide to the type of regulatory requirements that could be appropriate for the digital asset framework.

There is little doubt that the regulatory requirements around existing financial services could benefit from streamlining and rationalisation. In its ongoing review the Australian Law Reform Commission (ALRC) has found many illogical and unclear structures, and we are aware from experience that there are many rules that are unnecessary, non-optimal or out of date. We suggest that where the current regulatory requirements for financial products are not copied across for digital assets due to being excessive, that these existing regulations be included in a rationalisation program.

Such an approach would support regulatory neutrality between technology types and would be a necessary and critical part of a successful enablement of more technology types within the regulatory framework.

There are risks that if a risk-based balance is not maintained between the regulation of traditional finance and digital asset regulation, there is the potential that business could be driven to use blockchain technology not for inherent technical advantages but to take advantage of regulatory differences.

*Conclusion*

Our responses to the questions are attached for Treasury's consideration.

For more information or if you have questions in relation to this letter, please contact me on 02 9776 7993 or at djeffree@afma.com.au.

Yours sincerely

Damian Jeffree

**Senior Director of Policy**

# Appendix A: Responses to Consultation Questions

## Questions (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?*

The division between financial products and non-financial products is a critical one for the proposed digital asset platform regulatory framework.

AFMA supports the relatively well understood test of whether something is a financial product as appropriate for determining whether financial services law applies.

We query the analysis in Info Box 2 around the relative risks of financial investments and non-financial investments. The risks of non-financial investments include capital loss, a similar maximum downside as for most financial investments. Further, risk management structures around financial investments typically make the risks being taken on much clearer and lower than many non-financial investments. We caution against reliance on the view that non-financial investments are inherently lower risk.

Where digital assets can be constructed that provide similar financial exposures but legally remain outside the regulatory perimeter of financial products there will be the attendant risks to investors. A lightweight regulatory framework is unlikely to mitigate or manage these risks optimally.

As a general principle we suggest that independent risk assessments be undertaken to ensure that the risk landscape of each type of non-financial product activity is fully understood, and its risks managed to a similar outcome as those of existing financial products.

## Questions (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?*

No response.

### Questions (Set 3)

*What would be the impact on existing brokers in the market? Does the proposed create additional risk or opportunities for regulatory arbitrage? How could these be mitigated?*

The risk of regulatory arbitrage and thereby impact on existing brokers would largely go to the extent that firms were able to find products that were not financial products that were still able to provide similar exposures for investors. We would suggest that this risk would need to be carefully monitored.

### Questions (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?*

We would recommend an independent risk assessment for the specific activities performed by the platform provider be done to ensure capital requirements are appropriate.

While we support the objectives to ensure orderly winding up of operations, the rationale and basis behind the Net Tangible Assets (NTA) requirements should be provided to bring transparency and clarity to the market.

In addition, the NTA obligations could provide additional barriers to innovation and competition for custodial service providers, limiting the provision of custodial service to a small set of providers. If NTA requirements are seen as a barrier to innovation in the digital asset sector, it might risk reducing the attractiveness of Australia in the APAC region.

We consider the tailoring NTA, based on the activities performed by the platform provider, to be the most efficient approach.

### Questions (Set 5)

*Should a form of the financial advice framework be expanded to digital assets that are not financial products? Is this appropriate? If so, please outline a suggested framework.*

As Treasury is aware, the financial advice framework is being redeveloped at present. We would suggest this work needs to be completed before any extension of the framework could be considered to digital assets that are not financial products.

### Questions (Set 6)

*Automated systems are common in token marketplaces. Does this approach to pre-agreed and disclosed rules make it possible for the rules to be encoded in software so automated systems can be compliant?*

*Should there be an ability for discretionary facilities dealing in digital assets to be licensed (using the managed investment scheme framework or similar)?*

Automated systems and smart contracts can also be implemented on traditional electronic marketplaces, with rules encoded in software. This is an important but limited element of compliance.

Discretionary accounts have additional risks. We suggest the approach should be consistent with that in stockbroking.

### Questions (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)?*

A risk assessment for typical arrangements of the types suggested might assist with these questions.

### Questions (Set 8)

*Do you agree with proposed additional standards for token holders? What should be included or removed?*

While the proposed additional standards appear to be sensible requirements, determining whether there are additional requirements that would be appropriate to be included in regulations requires a risk assessment and consideration of the typical related obligations placed on firms performing similar functions for financial products. These might include the information security requirements of the NIST or ISO standards or similar as required by ASIC's operational resilience market integrity rules.

### Questions (Set 9)

*This proposal places the burden on all platform providers (rather than just those facilitating trading) to be the primary enforcement mechanism against market misconduct.*

*Do you agree with this approach? Should failing to make reasonable efforts to identify, prevent, and disrupt market misconduct be an offence?*

*Should market misconduct in respect of digital assets that are not financial products be an offence?*

The proposed approach is consistent with the approach to market supervision in major markets including the US and was formerly the approach in Australia until the Market Integrity Rules moved to ASIC in 2011.

The benefits of having the platform provider being the primary enforcement mechanism include:

- A scaled approach to unwanted behaviour. While some offences should be covered by regulation, many can be more efficiently and effectively dealt with via market self-management.
- Responsiveness of market rules to innovation and market need is much higher when managed by industry.

We query the analysis provided in Info Box 13. As noted above, non-financial products can create the risk of the loss of capital for retail investors, a substantial risk. Further, non-financial products can create important externalities for society. We note that the potential for increased onshore trading of commodities facilitated by streamlined regulatory structures (blockchain or traditional) could entail significant positive externalities, and these externalities could potentially over time become systemically important.

For more fundamental market offences, such as market manipulation, in financial markets there are offences in legislation, and we view this as appropriate. Similar offences should similarly apply to digital asset activities.

## Questions (Set 10)

*The requirements for a token trading system could include rules that currently apply to 'crossing systems'1 in Australia and rules that apply to non-discretionary trading venues in other jurisdictions.*

*Do you agree with suggested requirements outlined above? What additional requirements should also be considered?*

*Are there any requirements listed above or that you are aware of that would need different settings due to the unique structure of token marketplaces?*

We agree there are significant parallels with crossing systems and merit in aligning the requirements. Current crossing system rules sit in the context of a public market to which the trades must be reported. Consideration might be given to the additional regulatory protections that this wider regulatory context provides.

[1] Like crossing systems, token trading occurs 'off-book' from the perspective of a network observer. See Market Integrity Rules 2017 for the rules that apply to crossing systems.

### Questions (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?*

AFMA holds some specific concerns around staking. We have seen some examples of token staking that are high risk, of dynamic and potentially unknowable complexity, and that are not suitable for retail investors.

We suggest that a complete risk assessment is done with a comparison to the protections provided under the financial services law.

The proposed approach is very high level, may not cover all risks, and those that is does cover may not be covered in sufficient detail to support comparable outcomes to those currently achieved in traditional finance.

### Questions (Set 12)

*How can the proposed approach be improved?*

*Do you agree with the stated policy goals and do you think this approach will satisfy them?*

AFMA supports global consistency and uniformity to avoid a fractured framework.

### Questions (Set 13)

*Is requiring digital asset facilities to be the intermediary for non-financial fundraising appropriate? If so, does the proposed approach strike the right balance between the rigorous processes for financial crowdsource funding and the status quo of having no formal regime?*

*What requirements would you suggest be added or removed from the proposed approach? Can you provide an alternate set of requirements that would be more appropriate?*

No response.

### Questions (Set 14)

*Do you agree with this proposed approach? Are there alternate approaches that should be considered which would enable a non-financial business to continue operating while using a regulated custodian?*

The proposed approach is supported.

As industry evolves, the opportunity to further develop the regulatory framework for digital assets may present itself, or drivers might arise to introduce broader scope regimes consistent with other jurisdictions.

We note that traditional finance companies are now more actively exploring tokenization of financial products and there is an emerging trend in the market to put these financial products on more open and interoperable networks alongside non-financial products. Over time, investors may wish to interoperate between financial and non-financial products on these networks. The ability to serve these customers may be supported by bringing new activities into the regulatory perimeter.

### Questions (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?*

Where activities produce outcomes that are similar to those of financial products these outcomes should be similarly regulated.

### Questions (Set 16)

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

No response.