Law Council
OF AUSTRALIA

Business Law Section

26 May 2023

Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

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

Dear Committee Secretariat,

Senate Economics Legislation Committee Inquiry into the Digital Assets (Market Regulation) Bill 2023

1. The Financial Services Committee and the Digital Commerce Committee of the Business Law Section of the Law Council of Australia (the **Committees**) welcome the opportunity to provide a submission in relation to the *Digital Assets (Market Regulation) Bill 2023* (the **Bill**) and appreciate the opportunity to be involved in the consultation process.

2. The Committees also wish to thank the Committee Secretariat for granting a short extension of time to prepare this submission.

Summary of the Committees' position

3. The Committees endorse a regulatory approach that maintains an appropriate equilibrium between the vast opportunities presented by the digital asset ecosystem on the one hand and the imperative of prudential risk management on the other.

4. The Committees also consider that international practices in regulating the digital asset ecosystem should be considered when developing the Australian framework, allowing for a harmonious convergence of domestic and foreign regulatory frameworks.

5. The problems which the Bill seeks to solve are:

   (a) the present lack of clarity of the regulatory perimeter for digital assets; and

   (b) the lack of regulation of certain activities relating to digital assets that fall outside current licensing obligations.

   Greater clarity is required for businesses to thrive, and consumers to be protected e.g. from scams and bad actors.

Telephone +61 2 6246 3737 • ***Fax*** +61 2 6248 0639 • ***Email*** jessica.morrow@lawcouncil.asn.au
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra • 19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

6. The Committees submit that the evolving digital asset landscape necessitates clear direction and a well-defined regulatory perimeter. The absence of comprehensive regulation can expose investors to risks, undermine market stability, and threaten the overall integrity of the financial system. The Committees consider that effective regulation is essential to protect investors, combat illicit activities, and foster innovation. The Committees would therefore welcome regulatory reform and see merit in aspects of the proposed Bill.

7. At a high level, the Committees recommend the following measures:

   (a) where possible and appropriate, digital asset service providers should be licensed under existing regulatory regimes, and if any new licensing regime is introduced, unnecessary duplication and uncertainty should be avoided;

   (b) digital assets should be categorised (and regulated based on characterisation) in accordance with their functional risks. This is in keeping with technological neutrality;

   (c) any application of existing regulatory regimes should:

      (i) account for the innate dynamism of digital assets and recognise that the addition of rights/features within an asset, for example, may mean that different authorisations/licences are required within short time frames; and

      (ii) when designing and implementing licensing and regulatory engagement processes, recognise that many participants in the digital assets industry may not come from the traditional financial services industry and may therefore be unfamiliar with the existing regime;

   (d) in consultation with relevant stakeholders, including the Australian Securities and Investments Commission and the digital assets industry, the Government should consider introducing licensing 'safe harbour' provisions which digital asset businesses can utilise to assist with transition to any new regime; and

   (e) equivalent foreign regulation should be recognised where appropriate, so that participants in the digital assets industry can operate in the Australian and international markets without the unnecessary imposition of regulatory burdens which are inconsistent with one another.

Classifying digital assets

8. Digital assets occupy a broad and increasing range of use cases. The legal characterisation of digital assets and associated activities will be the determining factor in whether activities are licensed, and the assessment of which licence (and authorisations) are appropriate.

9. The Committees submit that:

   (a) classifying digital assets based on their functional risks for the purpose of regulatory treatment is imperative to ensure compliance, mitigate systemic risks, guide the regulatory framework, and bolster the effectiveness of supervision and oversight functions; and

(b) application of regulation should also have regard to the activities being carried out in respect of a given digital asset.

10. Given the ever-evolving nature of digital assets, the Committees believe that classifying particular digital assets on their substantive and functional qualities will ensure that any proposed regulatory regime remains effective. The Committees note that there are some tokens and smart contracts which do not appear to be financial products upon issue. However, when certain protocols are activated, they effectively assume characteristics of financial products e.g. they may provide a right to receive a dividend subsequent to the time of issue. Conversely, there are digital assets that do not present risks to consumers for which undue regulation is not warranted.

11. The Committees note that other submissions are likely to comment in more detail on the adequacy of the definitions proposed in the Bill and support in-depth industry consultation with technical and legal experts to ensure that appropriate definitions are adopted.

12. As a general principle, the Committees endorse appropriate harmonisation of terminology with applicable international legal frameworks.

Potential uncertainty in application of licensing regimes

13. Australia already has significant complexity in regulation of business activities and financial services. This complexity is compounded in digital asset use cases where the traditional analogue for the use case would not be classified as a financial product but, by virtue of tokenisation and surrounding activities, the use case shares potential characteristics of financial products.

14. The Bill's proposal to provide a licensing framework for certain "regulated digital assets" would address immediate consumer protection policy objectives relating to a significant number of digital asset activities that fall outside the current scope of Chapter 7 of the *Corporations Act 2001* (Cth) (the **Corporations Act**) but are otherwise not subject to licensing requirements. However, the Committees are concerned that it may not completely solve the challenges in characterising edge cases of digital assets on the regulatory perimeter of Chapter 7.

15. An element of the current uncertainty in the regulation of digital assets stems from lack of clarity as to whether particular digital assets / activities fall within the regulatory perimeter of the existing Chapter 7 of the Corporations Act. Under the current Australian financial services licence (**AFSL**) regime, it is sometimes difficult for industry participants and their legal advisers to determine with confidence whether a particular digital asset product or service falls within the scope of Chapter 7 as a regulated financial service or product, or whether the provider of the product or service can rely upon an available exemption.

16. The Committees believe that the same difficulties and uncertainties may arise if "regulated digital assets" are defined as a residual category of digital assets that are not financial products.

17. Digital asset businesses who obtain only the digital asset licence and not the AFSL, or vice versa, will continue to face the risk that they (or their legal advisers) have incorrectly characterised the digital assets they deal in. This is a real risk given that penalties may apply where a person engages in conduct without holding the appropriate licence.

18. To mitigate this risk, entities may feel compelled to obtain both an AFSL and a digital asset licence to ensure they are permitted to deal both with digital assets that are financial products and regulated digital assets that are not. The uncertainty from the financial services regime may be passed down and compel unnecessary regulatory duplication with the digital asset markets licence regime.

19. Therefore the Committees submit that any new licensing regime should take account of this reality and look for ways to minimise regulatory uncertainty.

Synchronisation of licensing regimes

20. The Committees submit that any proposal to introduce a new licensing regime (in addition to the various existing regimes[1]) should have regard to standard principles of law reform, namely:

    (a) proportionality;

    (b) harmonisation;

    (c) technological neutrality;

    (d) efficiency;

    (e) minimising regulatory duplication and compliance/enforcement costs; and

    (f) avoiding the creation of opportunities for regulatory arbitrage.

21. The Committees submit that:

    (a) digital assets and activities which pose the same kinds of risk as financial products and services which are currently regulated under Chapter 7 of the Corporations Act should remain subject to regulation under the existing Chapter 7 regime; and

    (b) to promote synchronisation between licensing of financial products and "regulated digital assets" to the extent possible and appropriate, any new regime should be congruent with existing licensing regimes.

22. By doing so, the Committees believe that the strengths and depth of established frameworks can be used to license and regulate digital assets effectively, thereby promoting market stability, consumer protection, and overall financial integrity. Importantly, where licensing requirements for an entity change between the two regimes due to the innate dynamism of digital assets, appropriate, timely processes to transition between licences should be facilitated by a single regulator.

23. The Committees submit that it will be important for any new licensing regime to provide clarity to market participants and enable fulfilment of regulatory obligations whilst minimising unwarranted legal and operational costs.

[1] In Australia a number of regimes and licenses potentially apply to digital asset businesses including: AFS licensing regime administered by ASIC under the Corporations Act; Digital Currency Exchange registration regime administered by AUSTRAC under the Anti-Money Laundering and Counter-Terrorism Financing Act; Australian Credit licensing regime administered by ASIC under the National Consumer Credit Protection Act 2009; Purchased Payment Facility licensing regime administered by the RBA (through APRA) under the Payment Systems (Regulation) Act 1998.

Safe harbour

24. The Bill sets a transitional period of three months for businesses to comply with licensing requirements. The Committees query whether this is a realistic period for both industry and regulators.

25. The Committees recommend that the Government explores the implementation of a safe harbour framework to assist newly regulated entities with their transition to new licensing requirements.

26. The objectives of such a safe harbour should be to:

    (a) promote consumer protection;

    (b) enable participants in the digital asset ecosystem to explore innovative ideas;

    (c) foster responsible growth and collaboration among stakeholders across the digital asset ecosystem (including regulators); and

    (d) provide a sufficiently flexible and clear framework that facilitates regulatory compliance.

27. The Committees submit that a safe harbour with appropriate compliance eligibility criteria would provide a number of benefits, including:

    (a) fostering innovation;

    (b) nurturing development of the digital asset ecosystem;

    (c) promoting regulatory clarity;

    (d) safeguarding consumer protection; and

    (e) upholding market integrity.

28. The Committees submit that the terms of this safe harbour framework should be developed in consultation with industry professionals, policy makers and legal professionals, all of whom have suitable expertise, to ensure a practical outcome.

Importance of holistic legislative reform

29. Digital asset technology, as part of the foundations of the digital economy, can be expected to intersect with a wide range of existing legislative frameworks – for example financial services (e.g. the current Australian Law Reform Commission inquiry process), web3, digital identity, etc.

30. The Committees submit that the Government should therefore ensure that a coordinated approach to legal reform is adopted across relevant legal frameworks to ensure that policy objectives are not undermined by inconsistencies, undue complexity and regulatory overlap.

Autonomous organisations (AOs) / decentralised autonomous organisations (DAOs)

31. Digital assets, associated activities and their ecosystems range from *centralised* to *decentralised* or *autonomous.* The Bill is targeted at regulation of intermediary or 'centralised' providers of digital asset services.

32. The Committees agree that *centralised* digital asset businesses present a clearly identifiable case for regulation and that regulation should be an immediate priority.

33. However activities of *centralised* digital asset businesses should not be inadvertently conflated with the activities of *decentralised* or *autonomous* platforms. The latter raise different legal issues and consumer risks, and (in the Committees' view) merit further consideration from the perspective of law reform beyond the scope of the Bill.

34. Regulation will need to be clear about the characteristics for centralisation that trigger specific regimes, or conversely what constitutes "decentralised", so as to avoid the risks of harm for which regulation seeks to address.

35. The Committees believe that it is important to consider how laws apply to DAOs or merely AOs in order to promote fair, transparent and orderly markets within digital asset ecosystems and the digital economy.

Other comments

36. The Committees note that a framework for custody and licensing is expected to be released for public comment in mid-2023. The Committees look forward to making a contribution to this future consultation process.

37. If the Senate has any questions or would like to further discuss any matters raised in this submission with the Committee, please do not hesitate to contact Pip Bell, Chair of the Financial Services Committee (pbell@pmclegal-australia.com) or Susannah Wilkinson, Chair of the Digital Commerce Committee (susannah.wilkinson@hsf.com).

Yours faithfully

Philip Argy
Chairman
Business Law Section