Monochrome

Summary of Senate Select Committee on Australia as a Technology and Financial Centre – Final Report

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Executive Summary

The Final Report, published on 20 October 2021, makes some ground-breaking recommendations with respect to promoting regulatory certainty from key regulators, which will enable digital assets businesses to operate effectively while providing adequate consumer protections. Should Australia adopt these recommendations, including an approach to regulating DAO's similar to the Wyoming model, it would be amongst the most progressive regulatory frameworks in the world.

The committee, in this third phase of its inquiry into Australia as a Technology and Financial Centre, focused on four key areas affecting the competitiveness of Australia's technology, finance and digital asset industries, comprising of:

- the regulation of digital assets, with a focus on cryptocurrency;
- issues relating to 'de-banking' of Australian FinTechs and other companies;
- the policy environment for neobanks in Australia; and
- options to replace the Offshore Banking Unit.

The committee has put forward a series of recommendations to address issues concerning the proper regulation of digital assets in Australia. The primary motivators for said recommendations are to promote innovation and attract investment while providing appropriate safeguards for investors and consumers in the Australian financial marketplace.

Cryptocurrency and digital assets

The report noted that 25 per cent of Australians either currently or have previously held cryptocurrencies, making Australia one of the biggest adopters of cryptocurrencies on a per capita basis.

However, while other jurisdictions have moved forward in attempting to create regulatory frameworks that give market participants certainty and provide consumer protections, Australia has not yet introduced fit-for-purpose regulatory systems for these emerging technology sectors. This is creating uncertainty for stakeholders, including project developers, businesses, investors and consumers.

The committee remarked that two prominent Australian-founded digital currency exchanges have recently been approved for regulatory licenses in Singapore and the UK, highlighting that Australia is missing out by not developing an appropriate national framework.

De-banking

In relation to instances of de-banking in Australia, the committee reported 'extremely concerning' accounts from individuals and businesses that have experienced de-banking

in the remittance, payments and the digital assets sectors. The committee's clear recommendation is that the Australian government develop a clear process for businesses that have been de-banked, including having recourse to a complaints process through AFCA.

Monochrome has been a vocal proponent of the need for a fit-for-purpose regulatory environment since its inception. It is vitally important that (1) consumers be able to access these digital assets in a safe and regulated environment; and (2) businesses operating in the digital assets space benefit from a level playing field with regulatory clarity. Implementation of the committee's recommendations, particularly those that seek to limit de-banking and those that provide more robust consumer protection frameworks around digital currency exchanges, will go some way to realising these benefits. This will ultimately lead to more jobs, more certainty and greater prosperity to the Australian economy and to Australian consumers and businesses alike.

Recommendations

The committee made 12 recommendations in total:

1. The Australian Government establish a market licensing regime for Digital Currency Exchanges (DCE's), including capital adequacy, auditing and responsible person tests.

2. The Australian Government establish a custody or depository regime for digital assets with minimum standards.

3. The Australian Government, through Treasury, conduct a token mapping exercise to determine the best way to characterise the various types of digital asset tokens in Australia.

4. The Australian Government establish a new company structure, being a Decentralised Autonomous Organisation (DAO).

5. The AML/CTF regulations be clarified to ensure they are fit for purpose, do not undermine innovation and give consideration to the driver of the Financial Action Task Force 'travel rule'.

6. The Capital Gains Tax (CGT) regime be amended so that digital asset transactions only create a CGT event when they genuinely result in a clearly definable capital gain or loss.

7. The Australian Government amend relevant legislation so that businesses receive a corporate tax discount of 10 per cent if they source their own renewable energy for digital asset 'mining' and related activities in Australia.

8. The Treasury lead a policy review of the viability of a retail Central Bank Digital Currency (CBDC) in Australia.

9. The Australian Government, through the Council of Financial Regulators, establish a scheme to address the due diligence requirements of banks, to be put in place by June 2022.

10. The Australian Government develop a clear process for businesses that have been de-banked, as to be anchored around the Australian Financial Complaints Authority (AFCA).

11. Common access requirements for the New Payments Platform should be developed by the Reserve Bank of Australia (RBA) in order to reduce the reliance of payments businesses on the major banks for the provision of banking services.

12. The Australian Government establish a Global Markets Incentive to replace the Offshore Banking Unit regime by the end of 2022.

The following provides further detail on each of the Senate Select Committee's recommendations.

Recommendation 1 - Establish a market licensing regime for Digital Currency Exchanges (DCEs)

Establishing a Market Licence regime for digital asset providers, or a subset of these businesses, was raised as an option for regulatory reform.

ASIC's Info Sheet 225 notes that where a digital asset meets the legal definition of a financial product (whether as an interest in a managed investment scheme, security, derivative or non-cash payment facility), then 'any platform that enables consumers to buy (or be issued) or sell these crypto-assets may involve the operation of a financial market'.

There are currently no licensed or exempt platform operators in Australia that enable consumers to buy or sell crypto-assets that are financial products. Platform operators must not allow financial products to be traded on their platform without having the appropriate licence as this may amount to a significant breach of the law.

Applicability of existing Market Licence regime to digital asset businesses

FinTech Australia stated that the Australian Market Licence regime 'is not currently designed for large volumes of applicants', noting that there have only been a small number of licences granted to date and the process for obtaining a Market Licence 'remains relatively bespoke depending on the nature of each business'.

Regulation of DCEs and market licence issues

The committee heard that the current requirement for DCEs to register with the Australian Transaction Reports and Analysis Centre (AUSTRAC) for the purposes of AML/CTF regulation amounts to a very 'light touch' regulatory approach to these businesses, and that enhanced regulation is needed.

FinTech Australia acknowledged that under the current regulatory framework, if cryptocurrencies were to become designated as financial products, a crypto-asset exchange would need to hold a market licence. It recommended that, if this becomes the case, additional guidance and streamlining of the application process from the government and from ASIC will be necessary to help DCEs navigate the process. It cautioned further that a balance will need to be struck to ensure that local DCEs are not forced out of the industry by larger international operators.

The ASX commented that any regulation of crypto exchanges should be designed to ensure the following points are considered:

- Responsible conduct obligations;
- Key person arrangements;
- Proper segregation of participants' assets and private keys from the marketplace's own assets;
- Appropriate record keeping;
- Maintaining policies and procedures to protect a participant's assets from theft or loss;
- Due diligence on partners and participants;
- Sufficiency of resources (including financial, technological, people); and
- Independent assurance.

The committee is of the view that a more thorough regulatory framework will assist the industry to mature. The committee recommends the creation of a new category of market licence that enables DCEs to demonstrate a high level of commitment to consumer protection and operational integrity, without imposing obligations that are so onerous as to drive local operators out of the market.

The key requirements of such DCE Market Licence category should include, at a minimum, requirements relating to capital adequacy, auditing and responsible person tests. These requirements should be scalable with the size of the business, so that newer operators are still able to function in accordance with licence requirements as they scale up their operations.

Recommendation 2 - Australian Government to establish a custody or depository regime for digital assets with minimum standards

The committee noted that Australia has a large and well-established industry for custodial services of traditional assets, with approximately AUD $4 trillion in value held by custodial service providers.

Custodians of funds backed by digital assets manage their digital assets using a combination of a custodian and a sub-custodian. These custodians hold the private keys to the underlying digital assets which are the assets of the fund, as detailed by Piper Alderman.

Can digital assets be appropriately custodied under existing regulations?

Piper Alderman expressed the view that digital assets can be appropriately custodied by a third-party custodian under the current regulatory regime for custodied assets, if they follow the requirements of RG 133:

> For custodians that are familiar with the attributes of, and appropriately aware of how to keep private keys for digital assets safe, there is no legal barrier to those custodians satisfying the organisational structure, staffing capabilities, capacity and resources requirements and the ability for assets to be held on trust as required in the regulations.

In addition, the Australian Custodial Services Association (ACSA) submitted that other relevant considerations should include a broad and consistent baseline level of Know Your Customer (KYC), AML/CTF and regulation within a clear principles-based policy framework.

Options for licensing digital asset custodians

It was noted that some submitters and witnesses advocated for a separate or amended set of standards and licensing requirements for businesses specifically dealing with digital asset custody.

Independent Reserve recommended that the Australian Government define a set of minimum standards for any company offering digital currency custodial services, covering:

- minimum net capital requirements for all custodial service providers;
- IT security arrangements;
- redundancy arrangements (to eliminate key person risk);
- segregation of customer/house assets;
- record keeping/holder entitlement;
- reconciliations/proof of ownership; and
- regular external audit of security procedures.

The ADC Forum pointed to Mauritius as an example of a jurisdiction that has implemented a successful licensing regime for the custody of digital assets. Under this licensing scheme introduced in 2019, parties intending to provide custody services for digital assets in Mauritius are required to obtain a Custodian Services (Digital Asset) Licence from the Mauritius Financial Services Commission, which has a certain requirements that need to be met in order for the licence to be granted.

It was also noted that ASIC's recent Consultation Paper 343 (CP 343) on the use of crypto-assets as underlying assets for exchange-traded products (ETPs) and other investment products included detailed discussion around what appropriate custody requirements could be for crypto-assets underlying an ETP.

Should licensing requirements for custodial providers be a full AFSL?

Independent Reserve recommended an alternate licensing scheme to the requirement to hold an AFSL, whereby businesses that want to provide a custodial service for digital assets and cryptocurrencies 'must be issued an authority/licence to do so prior to offering services to customers', with the following requirements:

- minimum capital requirements (net tangible assets) of at least AUD $5 million;
- audit certificate/external assurance of custodial procedures;
- redundancy procedures;
- segregation of customer and operational funds/assets;
- annual compliance requirements for audit/external assurance; and
- a Responsible Person with adequate experience.

The Digital Law Association advocates for the introduction of a new authorisation class within the AFSL regime to cater for digital assets, noting that such a change would need to deal specifically with issues relating to custody.

Bringing classes of crypto-assets directly into existing Corporations regulation

Mr Kevin Lewis, Special Counsel, Regulatory Policy at the ASX, stated that certain classes of crypto-assets ‘should probably be treated in the same manner, from a regulatory standpoint, as other financial products’, meaning that they would be incorporated into the current regulatory framework for financial products in Chapter 7 of the Corporations Act.

Herbert Smith Freehills (HSF) proposed an amendment to s764A of the Corporations Act to include 'digital asset' as a facility specifically taken to be a financial product for the purpose of Chapter 7.

The committee concluded that the detailed submissions it received will assist the government in developing a bespoke custodial or depository regime for digital assets, which aligns with the general principles for custody of traditional assets while dealing

with the unique features of digital assets. It stressed that this reform should be implemented as soon as possible to help Australia become a global leader in this space.

Recommendation 3 – Classifying digital assets and 'token mapping'

Internationally, the approach to token classification and categorisation of digital assets taken by overseas jurisdictions is inconsistent.

The committee noted the current challenge for policy makers and regulators of developing an adequate understanding and articulation of the different types of digital assets available in the market in order to determine what regulatory requirements should apply to different types of products.

Ripple suggested that Australia adopt a digital asset taxonomy that provides clear distinctions between different types of token, as follows:

- payments or exchange tokens: to describe non-fiat native digital assets that are used as means of exchange and have no rights that may be enforced against any issuer;
- utility tokens: to describe those digital assets that create access rights for availing service or a network, usually offered through a blockchain platform; and
- security tokens: to describe tokens that create rights mirroring those associated with traditional securities like shares, debentures, security-based derivatives, and collective investment schemes.

The Digital Law Association mentioned several factors that will influence how digital assets can be classified, including:

- tokens can change characterisation over time. For example, the analysis of whether a digital asset is offered or sold as a security is not necessarily static.
- the great deal of overlap between classification classes; and
- how a token should be classified and therefore regulated, is also a product of the relationship that token has with other digital assets or its milieu of operation.

In formulating its recommendation, the committee recognised that the current uncertainty around when particular digital assets fall within ASIC's regulatory perimeter needs to be addressed to give investors and market participants the clarity they need to operate efficiently.

In the committee's view, the first step required is to conduct a government-led token mapping exercise to assist in developing an appropriate regulatory model, which takes into account international approaches and lead to a clear typology of digital assets for the purpose of financial regulation in Australia.

Recommendation 4 – A regulatory framework for new types of decentralised organisations

The committee noted that a number of submitters presented evidence on the growing use of 'new forms of governance and community participation' for blockchain projects, which are necessitated by the decentralised nature of these projects.

Mr Scott Chamberlain added that these nascent governance structures have taken many forms, including:

- decentralised autonomous organisations (DAOs): common law partnerships, syndicates or unincorporated associations whose activities and investment decisions are co-ordinated by code or smart contracts.
- legal autonomous organisations (LAOs): traditional legal entities whose internal management is coordinated through code or smart contracts; and
- code coordinated communities (CCCs): coordination via code that includes situations where the parameters of the blockchain protocol itself can be altered by agreement between its users.

Currently, DAOs and other blockchain projects with decentralised governance structures are not readily recognised within existing regulatory categories under Australian law.

The committee noted that multiple submitters argued for the introduction of a DAO legal structure in Australia to be provided in the Corporations Act, which 'must be given legal recognition, the clear ability to hold property and contract, as well as limited liability.'

The Coalition of Automated Legal Applications (COALA) has published a model law for DAOs which can be applied and adapted by different jurisdictions. Proponents of a new DAO legal structure in Australia suggested that the COALA Model Law could be used as a starting point for developing a law in Australia (rather than being adopted directly).

Mr Chamberlain argued that while one possible solution to the issue of how to accommodate decentralised governance structures is enabling DAOs to incorporate, such as in the Wyoming model, in his view a 'better approach is to clarify circumstances in which a CCC or blockchain community are unincorporated joint ventures.

The committee concurred that the Australian government should examine the COALA model and other international examples in developing a DAO company structure that suits Australia's specific corporate frameworks. Ultimately, 'Australia should be at the forefront of this area.'

Recommendation 5 – Clarification of AML/CTF regulations

Presently, certain digital asset businesses are required to register with the Australian

Transaction Reports and Analysis Centre (AUSTRAC) under requirements set out in the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act). The AML/CTF Act applies a risk-based approach to combating financial crime, 'consistent with global best practice', as reflected in the inter-governmental Financial Action Task Force (FATF) standards.

AUSTRAC informed the committee that there are 'more than 455 registered DCE providers in Australia', and that '[s]ince regulations commenced, six businesses have had their registration cancelled and three businesses have been refused registration.'

The Department of Home Affairs and AUSTRAC submitted that DCEs represent the 'on-ramps' and 'off-ramps' to digital currency, and therefore 'have a significant role to play in mitigating financial crime risks'. They further submitted that in June 2019, the FATF set international standards for the AML/CTF regulation of cryptocurrency/digital asset services.

APRA noted that the Council of Financial Regulators (CFR) established a Distributed Ledger Technology (DLT) Working Group in December 2015, to assess regulatory risks, and any emerging financial system risks associated with distributed ledger technologies. This working group is considering developments relating to central bank digital currencies, crypto-assets and decentralised finance.

In conclusion, AUSTRAC's interpretation of the AML/CTF regulations and FATF guidelines need to strike a balance between appropriately managing risks, without implementing the travel rule in a way that undermines the operation of legitimate digital asset businesses. The committee considers that technological solutions to address the driver of the travel rule should be adopted at the earliest opportunity, rather than relying on a punitive approach.

Recommendation 6 – Amendment of the Capital Gains Tax (CGT) regime

The committee noted that several industry bodies recommended a root-and-branch review of Australia's tax laws to ensure that it is fit-for-purpose for the emerging digital asset economy, and that these views emphasise the importance of governments, policymakers and the ATO adopting a proactive approach in this area to ensure that Australia does not get left behind.

FinTech Australia submitted that current CGT arrangements are incompatible with the products and services offered in the digital and crypto-asset industry, particularly for DeFi products. It stated that the central concern is 'a lack of guidance from the ATO about the application of existing principles to new and emerging technologies.

The committee provided the example of a swap event where the application of CGT would not appear to be reasonable to be a token swap where the underlying blockchain that supports the token is being upgraded or replaced; in this scenario, one digital token

is replaced for another at a predetermined rate, and the original token(s) are discarded rather than traded.

FinTech Australia recommended that the government should 'consult with industry to improve the tax regime's application to crypto-assets and DeFi and provide greater tax certainty to the industry'. Further, it recommended that the ATO should 'issue more up-to-date and detailed guidance in respect of crypto-assets beyond general guidance around crypto-crypto-and crypto-fiat disposals'.

The committee concurred that while the ATO has provided general guidance around taxation points for crypto-crypto and crypto-fiat disposals, more specific and detailed guidance is needed.

The recommendation that the CGT regime be amended 'may require the creation of a new CGT asset or event class that enables specific concessions or exemptions to be applied. Treasury and the ATO need to proactively work with industry to develop the relevant changes and provide clarity in this area, including by ensuring that ATO guidance is updated at least every six months to keep pace with new technology developments.'

Recommendation 7 – 10 per cent corporate tax discount for businesses using their own renewable energy for digital asset 'mining' and related activities in Australia

We have been observing the shift to more renewable practices to tackle the issue of energy consumption by the industry. The committee stressed the importance that cryptocurrency mining and related activities taking place in Australia should not undermine Australia's net zero emissions obligations. As such, the committee considers that companies engaging in these activities should be incentivised to source their own renewable energy, via a company tax discount.

Recommendation 8 – Review of the viability of a retail Central Bank Digital Currency (CBDC) in Australia

The committee stated the importance for Australia to continue to 'actively investigate and pilot potential options for a CBDC so that the opportunity is not lost should this become a pressing concern in future.'

The committee notes the work the Reserve Bank of Australia (RBA) is currently undertaking exploring options for a wholesale CBDC, building on the 2019 development of a limited proof-of-concept of a DLT-based interbank payment system using a tokenised form of CBDC backed by exchange settlement account balances held at the RBA. However, the RBA's position is that it does not currently see a public policy case for implementing a retail CBDC in Australia.

The committee stated it considers that the viability of a retail CBDC should continue to be further investigated through a review led by the Treasury, which will help ensure that Australia maximises any potential opportunities in this area. The committee notes that the recent Payments system review undertaken by Mr Scott Farrell recommended that Treasury's payments policy function should be enhanced, including in relation to implementing a strategic plan for the payments ecosystem. Treasury leading a review of the viability of a retail CBDC would be consistent with this approach.

Recommendation 9 - The Australian Government, through the Council of Financial Regulators, establish a scheme to address the due diligence requirements of banks, to be put in place by June 2022

Work by the Australian Competition and Consumer Commission (ACCC) in 2019, through its inquiry into the supply of foreign currency conversion services in Australia, recommended that the government establish a working group to consult on the development of a scheme through which the due diligence requirements of the banks can be addressed. The Council of Financial Regulators (CFR) has now established a cross-agency working group in June 2021 to further examine issues relating to de-banking and potential policy responses. The committee indicated that 'a clearer regulatory framework will provide banks confidence in dealing with crypto businesses.' However, there is no current timeframe on when this working group will finalise any policy recommendations.

The committee is of the view that this work should be progressed and concluded as soon as possible. This work would more easily allow the ACCC to examine whether the denial of banking or payment services raises concerns under the Competition and Consumer Act 2010. A due diligence scheme should be implemented no later than June 2022.

Recommendation 10 - Clear process for businesses that have been de-banked to be anchored around the Australian Financial Complaints Authority (AFCA)

The committee noted its concern that there appears to be a 'disturbing lack of transparency around decisions taken by banks to de-bank businesses', even taking into account an explanation provided by the ABA about the anti-tipping off provisions under the AML/CTF Act preventing them from providing details to potential customers.

The committee recommends that, in order to increase certainty and transparency around de-banking, the Australian Government should develop a clear process for businesses that have been de-banked. This scheme should involve businesses that have been de-banked being able to have recourse to a complaints process through AFCA. It is of the view that in order to provide increased certainty and transparency, a de-banking

process involving the Australian Financial Complaints Authority should be developed and this should include an appeals mechanism.

Recommendation 11 - Common access requirements for the New Payments Platform should be developed by the Reserve Bank of Australia (RBA) in order to reduce the reliance of payments businesses on the major banks for the provision of banking services

The committee also notes the recent review of the payments system undertaken by Mr Scott Farrell which included similar findings in relation to the issue of de-banking.

In particular, the Farrell Review recommended that the RBA should develop common access requirements for payments systems in consultation with the operators of payment systems, and that these common access requirements form part of a new payments licence to facilitate access for licensees to those systems.

The committee noted that consultation is underway on the recommendations of the Farrell Review in order to finalise a government response.

Recommendation 12 - The Australian Government establish a Global Markets Incentive to replace the Offshore Banking Unit regime by the end of 2022

The committee's issues paper for this phase of the inquiry sought options to replace the Offshore Banking Unit (OBU) that would maintain and enhance Australia's global position. The committee noted that it is supportive of the suggestion by the Australian Financial Markets Association to replace the OBU with a Global Markets Incentive.