Power Ledger

Response to the Treasury's Initial Coin Offerings Issues Paper

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Power Ledger

In Brief

Power Ledger welcomes the opportunity to provide comment on the Treasury's *Initial Coin Offerings (ICOs) Issues Paper*. As an Australian startup that utilises blockchain technology, Power Ledger recognises the risks, but more importantly the significant opportunities that ICOs create for Australia. It is our view that Australia is well placed to harness the benefits that can arise from supporting this type of innovative new funding model, with a large number of already established Australian projects that are scaling to have global reach. We believe this Issues Paper is an important step towards clarifying some questions surrounding the status of ICOs within the current regulatory framework, and look forward to the results of the feedback process.

About Power Ledger

Power Ledger is a Western Australian company, formed in May 2016, that uses blockchain technology to provide an alternate model for the reconciliation and settlement of energy transactions. Our world leading technology platform allows consumers with embedded renewable energy generating technology to sell excess energy to their neighbours. Our ecosystem of applications also extends to offer Virtual Power Plant and distributed market optimisation mechanisms, aimed at empowering consumers and encouraging access to more reliable, renewable energy. The technology and business model were devised to support the transition of mature energy systems into dynamic, consumer-centric and renewable distributed energy markets.

Responses to Key Questions

1.1 What is the clearest way to define ICOs and different categories of tokens?

The common three-class system under which tokens are either a utility, security or currency token is a suitable basis to classify them. Individual offerings will provide particular combinations of rights which may give a token some characteristics of each which makes bright-line classification difficult. However this is not a problem unique to cryptocurrency. In a rapidly evolving environment we think broad purposive categories are more useful than precise definitions.

2.1 What is the effect and importance of secondary trading in the ICO market?

Secondary trading is critical to a strong token market. The ability to conduct near-instant, low-friction trading is a key characteristic of blockchain technology and one which must be available to tokens for the potential of the technology to be fully realised. Where an ICO is not eventually listed on secondary markets to provide this benefit to investors, it's likely that an ICO was actually not the best structure to use for that offering.

2.2 What will be the key drivers of the ICO market going forward?

As cryptocurrency matures as a technology we predict that the key drivers of the ICO market will move away from speculation and technical analysis, towards a more evidence-based analysis of particular projects and fundamental market drivers. Those projects with technology deployed, a proven track record, established market presence, and trusted relationships with token holders will be valued by investors, and vice versa.

In particular, for utility token offerings, the potential of blockchain technology will be demonstrated by those projects which are able to effectively scale up and drive utilisation of their token. Those projects which cannot scale will not be able to take advantage of this significant benefit which blockchain offers over competing technologies. Therefore we predict that scale will be a key driver of the ICO market.

3.1 How can ICOs contribute to innovation that is socially and economically valuable?

ICOs offer startups the opportunity to engage in experimental business models and offer unique value propositions to the market. The process has introduced a new class of investors to the market, allowed many socially valuable projects to be developed, and has created new norms in the relationship between projects and their token holders. This has all occurred in a very short time frame. In an efficient market the greater the number of paths to commercialisation that are available, the greater the number of socially and economically valuable innovations that can be created.

3.2 What do ICOs offer that existing funding mechanisms do not?

ICOs have a number of advantages over other funding mechanisms. ICOs, when structured correctly, are more efficient, transparent and advantageous for both founders and investors. They have the potential to offer founders a ready-made market base and community to drive commercialisation and scale of the underlying technology.

Venture capital (VC) funding is difficult to access and tightly controlled. VC funds can insist on strategies which unduly put their own interests above that of the company and broader economy. It also has an agglomerating effect on investment returns, where the benefits of innovation on a broad scale funnel upwards to a small number of VC firms, often based abroad. ICOs offer the potential to distribute the gains of a successful business through a community of investors.

Crowdfunding, while useful and innovative, is limited in its scope and application and is tied to a legacy concept of share equity. ICOs by contrast almost demand that an innovative approach be taken to a company's structure. ICOs also offer a fundamentally different investment proposition where tokenholders can invest in the potential of a product without necessarily needing (or wanting) to be a shareholder of a company. We think this fundamental change has opened the door to new types of investors.

ICOs are available to companies at a much earlier stage than an IPO typically would be.

Each existing funding mechanism offers particular benefits and drawbacks. Having a wider range of funding options allows companies the option to choose that which is most suitable for them.

3.3 Are there other opportunities for consumers, industry or the economy that ICOs offer?

As described above, ICOs offer opportunities not shared by other investment pathways. What may prove to be the most valuable opportunity is that ICOs and blockchain technology have led to the creation of a new set of expectations and norms in how companies relate to their customers and investors. It has created a culture of extreme accountability and openness where token holders keep a close eye on the performance of their investments. Companies know that due to the nature of blockchain technology, token holders can choose to invest elsewhere with minimal friction (ease), so there is a strong incentive to maintain active and open channels of communication with token holders. This can be favourably contrasted with the relationship which some public companies have with their shareholders. Lessons could be taken from the ICO marketplace and applied to the broader market. The unique characteristics of blockchain technology therefore offers new social and economic benefit opportunities for investors which are a direct consequence of the nature of the technology itself.

3.4 How important are ICOs to Australia's capability to being a global leader in FinTech?

Blockchain technology is one of the largest, fastest growing, and most disruptive aspects of fintech. For Australia to be a global leader it is imperative that Australia establish itself as a jurisdiction with clear and stable regulations, guidance and capability in relation to ICOs.

3.5 Are there other risks associated with ICOs that policymakers and regulators should be aware of?

Fraud and bad actors are unfortunately still an element of the ICO marketplace, and these must be addressed by regulators to protect investors. Consideration should also be given to those cryptocurrencies which are purportedly decentralised but which may be majority

controlled or owned by a small number of individuals. This is a particular concern for proof of stake blockchains.

4.1 Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?

A balanced approach should continue to be taken in relation to the regulation of ICO activity. The referral of misleading and deceptive conduct powers to ASIC is in our view an example of the correct stance to be taken. This allows bad actors to be identified and to clearly fall within the established regulatory framework. There are many aspects of ICOs which do not fit neatly within the established framework, and taking a broad brush regulatory approach is likely to produce adverse consequences for consumers, industry and the economy. There is a danger that by over-regulating at this early stage of the technology that investors will be disadvantaged or that valuable projects are incentivised to consider taking their operations elsewhere. It's important for the market and regulators to take a patient and considered approach to regulation.

4.2 Do current regulatory frameworks enable ICOs and the creation of a legitimate ICO market? If not, why and how could the regulatory framework be changed to support the ICO market?

The greatest issue with the current regulatory framework as applied to ICOs is that it's not completely clear where some utility tokens sit in relation to the definition of financial products, and the factors which will go into a determination that a token either is or is not deemed a financial product. Any prospective ICO issuer is likely to be dissuaded from making an offering in Australia while this regulatory ambiguity exists.

4.3 What, if any, adjustments to the existing regulatory frameworks would better address the risks posed by ICOs?

One beneficial adjustment which would assist potential ICO issuers would be for the regulatory position to be framed in the positive. Currently the general tone of regulatory guidance is focussed on what features a token *cannot* have lest it be deemed a particular class financial product. It would be valuable to have guidance indicating what *can* be done.

4.4 What role could a code of conduct play in building confidence in the ICO industry? Should any such code of conduct be subject to regulator approval?

A code of conduct may be useful but as recent experience in the financial sector has shown, it is unlikely to be sufficient in and of itself. Industries always have difficulty self-regulating, and as there is arguably no blockchain 'industry' (just companies deploying a similar technology in different industries), it will be particularly challenging to achieve widespread consensus and compliance with an industry code of conduct.

4.5 Are there other measures that could be taken to promote a well-functioning ICO market in Australia?

The overriding request from industry in relation to regulation is that greater clarity be provided as to the regulatory approach that will be taken, including both technical and purposive approaches. We echo this request.

It is our view that the current licencing and regulatory costs associated with operating an exchange (as currently defined) in Australia is too high. Security tokens are likely to significantly increase the investment products available and will increase the liquidity and competition available in capital markets. It's important that exchanges be readily set up in Australia to allow the trading of these tokens, and the current licencing costs have a chilling effect on the development of these markets. Regulatory and licensing costs should be reduced to facilitate market growth.

5.1 . Does the current tax treatment pose any impediments for issuers in undertaking capital raising activities through ICOs? If so, how?

We are currently in discussions with the ATO in relation to the tax treatment of ICOs. The exact specifics around the treatment of ICO funding are being discussed in that forum. Generally, though, we think it's important that the tax treatment of ICO proceeds recognises that (1) ICOs do not neatly fit into any existing sources of funding, and their unique characteristics should be considered; and (2) that ICOs are often conducted as a first step by pre-revenue companies which would not be operative if it were not for the ICO. Therefore, to

fairly reflect this reality, funds raised in an ICO should not be considered as revenue incurred at the time of the ICO but should either be categorised as capital, or as deferred revenue.

5.2 Is the tax treatment of tokens appropriate for token holders?

We think that it is important that investors not be subjected to an undue regulatory burden if they choose to invest in ICOs. The current documentary requirements placed on token holders to calculate their tax exposure (which were not clear at the time of the transactions) are very onerous and may disincentivize investment.

5.3 Is there a need for changes to be made to the current tax treatment? If yes, what is the justification for these changes?

In our view, clarity should once again be the key consideration. The ATO should be mindful of the practical effect of the requirements it has passed onto token holders and consider whether this effect marries with the intended operation of the regulations. If not, the reporting process may need to be simplified.

Conclusion

We would like to thank the Australian Government Treasury for the opportunity to provide a response to this Issues Paper, and look forward to the results of the feedback process which will examine the opportunities and risks that ICOs pose to Australia, as well as the impact the surrounding regulatory framework has on both managing the risks and promoting new opportunities.