Australian Government - Crypto asset secondary service providers : Licensing and custody requirements

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May 2022

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Introduction and Summary

Blockchain Assets Pty Ltd is the trustee and manager (the Manager) of the Blockchain Early Opportunities Fund. This submission draws on the experience the Manager has researching and investing in blockchain technology for more than 6 years.

We have over the years watched the development of regulations across the world as they have evolved. Back in 2016 there was very little interest shown by regulators and this matched their level of knowledge. Today the global regulatory environment is a mixed bag, there are some examples of outright failure (the New York Bitlicense being one such example) and some of success (the Wyoming crypto bank and regulatory laws being a good example).

We are active in trying to help the regulatory environment for the crypto industry and have previously have made the following public submissions :

1. The Australian Treasury on the proposed Ban on Cash which came out of the October 2017 Black Economy Task Force Report (see here);

2. The 2018 Treasury Review into Initial Coin Offerings (see here);

3. The 2019 Australian Human Rights Commission report on technology (see here); and

4. The 2021 Australian Securities and Investment Commission Discussion Paper 343 on Regulation of Crypto Assets (see here).

Our feedback is that the proposed approach would not significantly improve protection for retail investors or achieve other regulatory objectives. In this paper we are calling for changes in the regulatory methodologies that are as transformative as the technology they are seeking to regulate.

Being technology agnostic is an admirable goal, however, a cut-reduce-rebrand -paste of existing regulatory methodologies will not serve Australia well in the long term. An example we would urge the Government to not follow is that of the creation of the Australian Charities and Not-for-profits Commission (ACNC) in 2012. As the Founder and Chair of a micro scale charity (The Mandalay Projects) I can attest to the increased cost and bureaucracy of the ACNC and I can see no benefit at all, the ACNC seems to have become another big government department that shuffles paper around but has not improved or added value to the industry they are meant to regulate.

Australia has the opportunity to lead the world with a new approach to regulation and this is the time to take that leadership position.

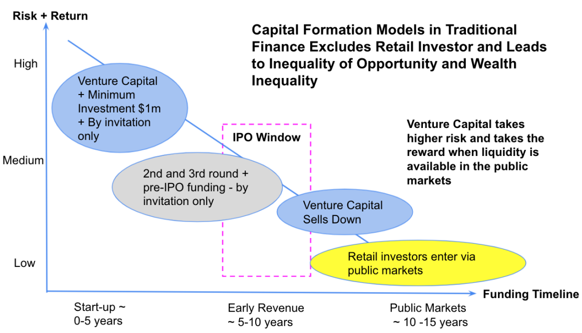
In setting out our feedback we have not followed the approach of answering the specific questions asked, we leave this for others to do, our approach is to set out some different ways of thinking about regulation as this is what we feel is needed. We certainly do not have all the solutions, but we have two suggestions for how the approach to regulation could be improved.

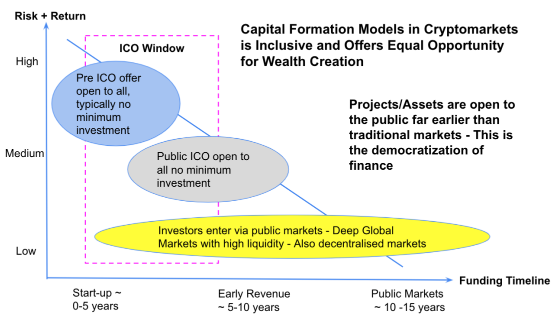
The Objectives of Financial Regulation

As we have set out in prior submissions, we feel that financial regulations should have three objectives :

1. encouraging financial inclusion;
2. reducing wealth inequality; and
3. providing consumer protection.

Blockchain technology has enabled greater financial inclusion (often referred to as the [democratisation of finance]) and [reduced wealth inequality]. These are two of the most significant social benefits of the technology (see our submission to ASIC [here]).





The so-called 'sophisticated investor' designation in the *Corporations Act 2001* has had the effect of creating two classes of investors. Wealthy investors have access to sophisticated and tailored financial advice and a wide range of investments. Poor investors have, at best, access to 'robo' advisors and low risk low return investments (the bottom right in the illustrations above).

This discrimination based on wealth is no longer appropriate in Australia. The notion that wealthy people are somehow more financially sophisticated than poor people should be abandoned entirely. Our current regulations seek to provide consumer *protection by exclusion*. We believe this concept should be turned on its head, the financial markets should be open to everyone and the protection measures should be an overlay of that principle. So *inclusion with protection*.

Our Suggestions

Create an open source but curated Wiki for crypto scams

ASIC and Consumer Protection agencies at State and Federal level should initiate an open source wiki site and work with volunteers from industry to bring the site to a global level list of potential crypto scams.

(it is noted that ASIC does employ some pre-emptive strategies (see OneCoin notice here)….the suggestion is to greatly enhance this strategy and indeed make it one of the foundational pillars of crypto regulation).

Justification/Background

Regulatory agencies the world over have a prosecutory approach to regulation. They act only once a law has been breached, this is a foundation stone of anglo saxon legal systems, it is not possible to prosecute a crime until a crime has been committed. In the case of financial fraud, the deterrent effect of ex-post prosecution is limited, particularly in the case of scams with global reach where the scammer is most likely in an undisclosed location outside Australia. As far as the victims are concerned, an ex-post prosecution is too little too late to offer them any form of protection or justice.

Regulators need to be able to act earlier, at least as an early warning system, for potential scams and fraudulent projects. Broad statements do not achieve anything, we need a way to specifically call out potential scams before they cause too much damage.

There is a difference between a scam, a bad business model and incompetence. Like any other markets all three exist in the crypto world. However the word scam gets used a lot to describe projects that were honest and well intentioned but badly put together and have failed. There are a lot of bad projects out there that fall into this category, however, we feel it is important to use the word scam only in the context of criminally fraudulent or deceptive conduct.

True crypto scams like OneCoin and Bitconnect are egregious and there are many of these. It is shameful if even one Australian falls victim to these scams, which sadly they have. The proposed regulations will not at all stop this type of scam and others like it. For those who know crypto the red flags are easy to spot and a quick google search of the project name will lead to copious amounts of data setting out why the community views this or that project as a scam.

ASIC and other government agencies should tap into the collective knowledge of the crypto industry and in partnership to develop a traffic light style list of possible scam projects . This could be done by way of a crypto wiki scam site where members of the public can post scams that are reviewed and ranked by approved oracles. This is something the Australian Govt could fund/launch for the global crypto ecosystem. But also I feel the industry should be a part of this, in a self-regulatory partnership. Blockchain Assets Pty Ltd would be happy to be a part of a team putting together such a wiki if there is government support.

One thing the crypto community is very good at is open decentralised projects that farm the collective 'hive mind' of the internet. A global wiki scam site, kick started by ASIC, would be picked up by responsible players in the global marketplace and could become an important part of the consumer protection tool box for all global regulators.

Expand the Coverage of Financial Advice and Education

1. *Create a decentralised reputation system for financial educationalists*
2. *Encourage regulated financial planners to set-up financial training and literacy education business separate from their regulated advisory businesses*
3. *Encourage independent financial and crypto educationalists to engage with the financial planning industry*

Justification/Background

Our investor protection laws have financial discrimination at their core. The so-called 'sophisticated Investor' classification has led to retail investors being excluded from investment opportunities. There are whole sectors of the financial industry that cater just for sophisticated investors. This has led to wealth inequality and financial exclusion.

As we have set out in previous submissions, this technology removes the barriers (to entry) to early stage investment for retail investors. The democratisation of finance and the potential reduction of wealth inequality are two of the most encouraging social reforming aspects of this technology. Australia is one of the most socially forward countries [1] in the world and there is an opportunity to build on this with this technology.

[1] https://www.globalcitizen.org/en/content/social-progress-index-2020/?template=next

With the technical barriers removed there is really now a moral question around, **to what extent should regulations exclude retail investors from the very same opportunities that have previously only been open to the wealthy and well connected?** Or perhaps the better question is how can regulators fulfil their consumer protection mandate without denying retail investors the opportunity for wealth betterment and reduced wealth inequality for society as a whole?

If financial discrimination is to be removed from the regulatory landscape, the level of financial education and advice needs to increase in both depth and breadth.

An analysis of the February 2019 Royal Commission report into Misconduct in the Banking, Superannuation and Financial Services Industry and how it could relate to cryptoasset secondary service providers is highly relevant. One of the behavioural outcomes of this report is a financial advisory industry which leans away from the provision of advice to retail level clients, clients who need it the most. *According the Advisor Ratings 2022 Financial Advice Landscape Report*, only 10.1% of the adult population are serviced by regulated financial advisors. According to the report 'There is a growing gulf between Australians who say they need the services of an advisor and those with the capacity to pay'...we expect the problem to get worse before it gets better. Sadly, most Ausreaians who have stated they want advice cannot afford to pay for it…'. This dearth of regulated financial advice is exacerbated when it comes to cryptoassets. Most if not all regulated financial advisors are not able to advise on cryptoassets.

In the absence of regulated financial advisors servicing the retail sector a huge opportunity has opened up for influencers and crypto specific educational service providers. We now have ASIC warning finfluencers to get a licence or be fined. This is a heavy handed and unhelpful approach. At every turn retail clients are being denied advice and being excluded from the financial system, this is a systemic issue that blunt enforcement by exclusion does not solve.

Educational services are of course different from advice and perhaps this is where ASIC and influencers can work closer together to be clear about where education stops and advice starts. I believe there will be some solutions to be found by looking at the early stage examples of projects such as ReputationDAO, which provides verifiable, decentralised and programmable reputation services for DeFi. Instead of a world where people are licensed by a centralised party we now have technology which enables reputations to be built and rated in a decentralised manner.

We are fortunate to have no shortage of people building businesses and reputations around the provision of financial and cryptoasset education. Instead of threatening such people with fines we should be bringing them into the solution in a way that is seamless and helpful to all concerned.

Another plank to the financial education/advice puzzle are regulated Financial Advisors. They should be encouraged to develop educational services as a separate part of their business. As experts they are perfectly placed to play a role here. Their advice licences and insurance policies are often quite restrictive and often they will feel that these restrictions will exclude their participation in the education space. If encouraged to build financial educational businesses alongside but separate from their financial advisory businesses I am sure this will result in a net increase in financial literacy.

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