TradeFlows

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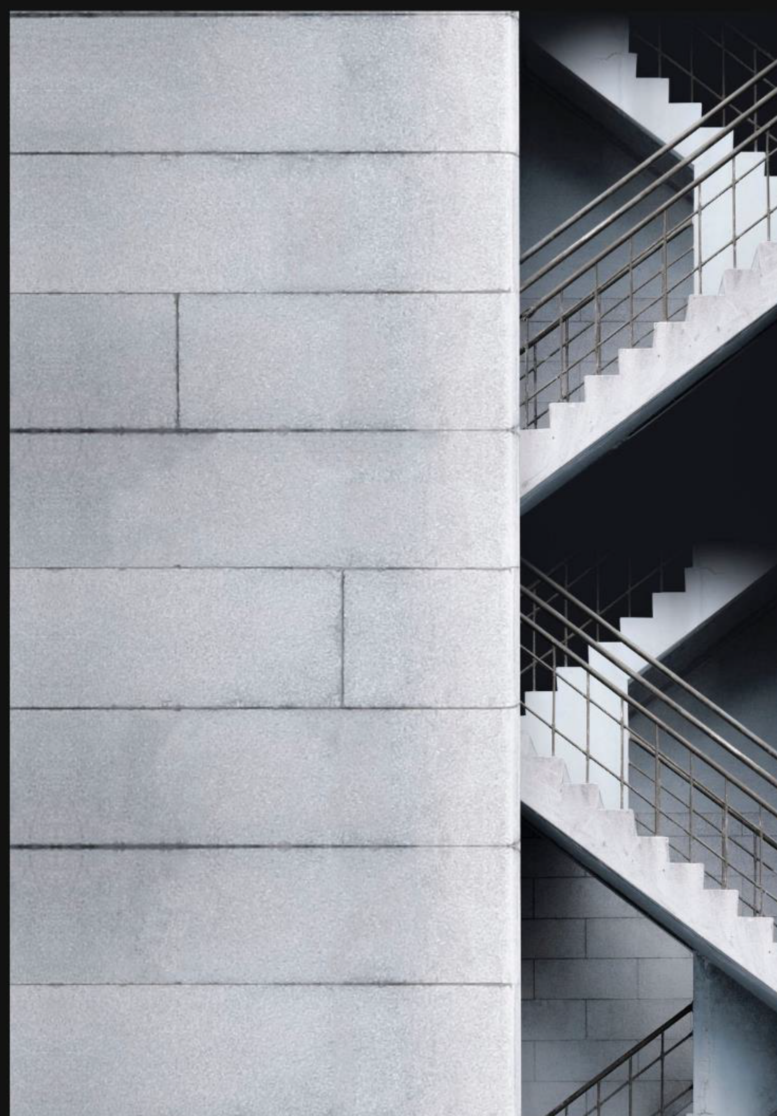
CONSULTATION PAPER RESPONSE

Crypto asset secondary service providers: Licensing and custody requirements consultation



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INTRODUCTION

The Director
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Dear Director,
Crypto asset secondary service providers: Licensing and custody requirements

Thank you for the opportunity to participate in defining the rails for Australia's financial future. We strongly welcome the effort to bring stability and certainty to the way in which consumers engage with web3 infrastructures. We have purposely chosen this formulation instead of using words like 'retail investor' and 'blockchain' that permeate the consultation paper. The reason is that we believe that the consequences of proposals stemming from this consultation would transcend our entire web3 future and not only the way in which the industry / community would engage with crypto assets that might potentially be categorized as financial assets. Please let us be clear, the web3 future is much larger than "crypto investments".

As a way of introduction, TradeFlows is a DAO that is a member of the web3 community, and we are building the future of decentralised commerce. Our first service links eInvoicing with programmable cashflows offering a truly transparent and certain platform for businesses to execute deals. We have expertise in the development of smart contracts within trustless workflows and our core team has deep rooted experience in financial derivatives, investment banking, hedge funds and software development. Our goal is to be the de facto primitive building block for how commerce is done in the web3 community.

Allow us to paint a picture of how different the nature of this consultation paper would read if the current predominant use of crypto assets was driven by token utility rather than consumer speculation. Although we fully understand this is a hypothetical scenario in terms of its historical accuracy, we strongly believe that the future of web3 is utilitarian for society. Therefore, we should consider decisions, rules and frameworks that catalyse this utilitarian web3 future instead of hampering its development.

ROLE OF REGULATORS

Blockchain technology enables regulators to execute their mandate more efficiently, with productive approaches aiming to safeguard economic stability and consumer confidence, while not obstructing innovation. Due to the **unprecedented transparency and integrity** brought by the data generated by the blockchain, **regulators can now gain oversight through real-time data** showing the state of the web3 economy. Furthermore, this oversight also offers deep insight into the way in which the economic actors behave, meaning that **regulators are able to target bad actors at scale and with high degrees of accuracy**.

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As long as the regulators know the identity of the economic agents, we strongly believe that additional regulation on top of the standard consumer non-financial regulation is unnecessary to achieve economic stability as a whole. In addition, risk must be properly defined in order for regulation to achieve its objectives. The risk we believe regulators should focus on is that of systemic institutional risk and that large numbers of retail consumers hold a high weight of a specific crypto asset in their portfolios. We do not believe that the market cap of a specific crypto asset should be the main variable measuring the potential of systemic risk. Rather, **a measure that describes the way in which the crypto asset is being adopted by the wider economy is more important**.

To be clear, we do not believe that licensing is necessary, unless the crypto asset is a financial product or security as defined below. We believe that oversight of crypto assets and wallets that are classified as owned by Australians is enough and anything else has a strong potential to impede innovation.

DEFINITIONS

...the outcome of this consultation paper strongly depends on the definition of these terms

The consultation paper readily uses terms like centralisation, decentralisation, custody and exchange without explicit definition. We contend that the execution of the outcome of this consultation paper strongly depends on the definition of these terms or the use of alternative terms that are more relevant. As with the design of any complex system, the devil is in the detail. We will either define these terms throughout the presentation of our proposal below or offer alternatives.

Furthermore, we would like to contend that crypto assets are financial products or securities if and only if:

- The crypto asset is a token, whether fungible or non-fungible, that is linked to a smart contract or a set of smart contracts where the balance of these smart contracts is not fully controlled by owners of the crypto asset through an on-chain voting mechanism but instead is controlled by another person or distinct group of people to which the crypto asset owner is not part of;
- Or the crypto asset is linked to an off-chain financial product or off-chain security.

On the one hand, the consultation paper loosely defines custody of a crypto asset as an entity having control of private keys while at the same time the consultation paper aims for a technology agnostic approach. All blockchain technology is not dependent on private keys due to recent technological advances, therefore, as stated above, the concept of custody should refer to the technological ability of another person other than the owner of the crypto asset to execute transactions that transfer the asset to a digital location outside of the control of the original owner.

CLASSIFICATIONS

…on-chain processes are transparent, immutable, unambiguously defined and trustless while off-chain processes are not

Regarding the classification of crypto assets, our view is that this is not a constructive exercise during the pursuit of regulating the web3 space apart from the categorisation of the crypto asset either being a financial product / security, as defined above, or not. Part of the reasoning for this view is that we do not believe that additional regulation of activities related to non-financial products / securities is required, therefore the classification is unnecessary but also that **the web3 space is too nascent in terms of utility for anyone to create a classification system that can withstand the rapid advancement of this space**.

Although this consultation paper focuses on centralised businesses acting as “secondary service providers”, all businesses can be configured as combinations of centralised and decentralised workflows therefore, trying to categorise any business as such is both misleading and counterproductive. Furthemore, the concepts of centralisation / decentralisation are ambiguous at best, and we propose that the discriminator should be the concept of on-chain vs off-chain. The reason for the use of on/off-chain vs de/centralisation is that the former is clearly defined while the latter is not. **Additionally, on-chain processes are transparent, immutable, unambiguously defined and trustless while off-chain processes are not**. As clearly stated in the consultation paper, trustless processes do not require the same type of regulation as actions or products that rely on the trust in human action.

Additionally, we would like to point out that the consultation paper references the concept of a centralised crypto exchange and defines them as entities that hold custody of crypto assets and make markets on these crypto assets. **Our view is that this definition is incorrect**. Apart from the use of the word centralised, an exchange of any nature only offers the ability to settle transactions and in some cases offer orderbook functionality. Market makers use exchanges to offer bid and offer spreads, i.e., making markets on selected assets which offers liquidity to the market. We believe that instead of using the term centralised crypto exchanges to describe the umbrella term of exchange / custody / market maker, **a more suitable term would be Off-chain Crypto Markets** where the term “off-chain” is applied if the marketplace has any workflow that executes off-chain. If an Off-chain Crypto Market offers non-self

CLASSIFICATIONS CONTINUED

custodial services, we do believe that regulatory oversight is necessary.

Finally, we feel the need to highlight the importance in understanding that centralised and decentralised notions of a business, as previously mentioned, are ambiguous and multi-faceted concepts that relate to various aspects of a business. This is due to the fact that businesses are aggregations of workflows, either automated on-chain, automated off-chain or executed by humans. Therefore, we strongly believe that any regulatory oversight should not focus on entire businesses but instead on the off-chain workflows within a business when dealing with crypto assets that are financial products / securities or offer custody services.

CLOSING REMARKS

We are eager to see regulation of crypto in Australia, but we believe that careful consideration of our observations should take place. The nature of crypto assets and how we interact with them, along with the nascent nature of these technologies means that the space is changing rapidly. Being cognisant of this changing environment means that rushing into regulation could do more harm than good in the long term and at the very least, be confusing in the short term.

We invite Treasury to continue the conversations with industry and those building real world utility value in the community, like us. This consultation paper is the right type of public discourse required here and we will continue to participate.

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