

February 2019

## Response to Australian Treasury Issues Paper

### Introduction

The Australian government has recently released an [issues paper](#) identifying advancements in financial technology - or “FinTech” as potentially transformative for the Australian economy. It lists the opportunities and risks posed by Initial Coin Offerings (ICOs) in Australia and asks for industry feedback on whether the regulatory framework is well placed to allow those opportunities to be harnessed and how Australia can position itself to capitalise on new opportunities. Independent Reserve has led unified responses from industry leaders and significant stakeholders for submission to this issues paper.

### Summary

The keys to a successful ICO market include consumer protection, licenced secondary market providers and defined standards for issuers. It is also necessary to cater for secondary trading in the ICO market to ensure investors have a secure mechanism to exit their investments.

Independent Reserve recommends that tokens should be classified relative to their function rather than a blanket classification of ‘Financial Products’. Since ICOs can offer fast and efficient ways to raise capital that are not catered for in traditional equity markets, relevant legislation changes would make Australia an even more attractive environment for innovative homegrown talent to source funding and grow operations locally. While ICOs carry the risk of attracting unscrupulous operators, risk can be mitigated if existing regulation incorporates licensing for secondary market operators, minimum listing requirements (tailored for each token classification) and defined disclosure requirements for ICOs. Robust regulation will support ICO markets, particularly in allowing them to access basic services such as banking, insurance, payment platforms etc as well as allowing for streamlined tax reporting.

### Responses and recommendations

#### Definitions and Token Categories

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

When seeking to classify tokens for the purposes of capturing the token in current or future Australian Legislation, it is important to consider the impact this may have on the wider adoption of blockchain and token technologies in business. For example, adopting a blanket approach where all tokens are classified as “financial products” could have unintended negative consequences. A blanket classification could include private blockchains used by business for their own purpose, or between suppliers and consumers for a series of transactions. Requiring licencing for this type of activity would be expensive, inhibit innovation and

dampen the adoption of new technologies and not necessarily target the current legislative blind spot where the tradeable tokens currently operate. 'Pure' cryptocurrencies (e.g. Bitcoin, Litecoin, zcash) clearly have no rights, assets or other values attached to them other than the value the market assigns them, it does not make sense to classify these types of tokens as a financial product.

From the two examples given above, we do not support a blanket classification of all tokens and coins being "Financial products".

For a number of reasons, Independent Reserve believes the clearest way to define tokens is by their function. This type of classification is similar to how financial products are classified in current legislation. Amendments to sections 763B, C and D of the Corporations Act could be made to include tokens. There are a number of papers already published regarding potential functional classifications, including this paper by PwC: <https://www.pwc.com.au/legal/assets/legaltalk-alert-legal-classification-of-crypto-assets-16-october-2018.pdf>

In a broad sense, Independent Reserve agrees with the classification types proposed in the PwC paper, namely;

- Utility tokens
- Security tokens
- Platform tokens
- Asset-backed tokens
- Currency tokens

## Drivers of the ICO Market

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

The ability to trade tokens in the secondary market is of critical importance to the viability of many ICO fundraising activities. In order to attract a broad-range of investors, it is necessary for those investors to know that there will be a stable and secure mechanism to exit their investments in an orderly fashion should they choose to do so. Being able to trade your investment if it no longer meets your expectations or requirements is an important consumer and investor protection mechanism.

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

Robust legislation that gives consumers and investors confidence that ICO issuers have gone through a thorough due-diligence process and that ICO issuers need to stand behind claims made in any ICO offer documentation. One major difference between an ICO and the traditional equity-raising is an ICO can be used to fund a single product line, expansion, service, etc; whereas traditional equity listings list entire companies. This is a significant difference as the continuous disclosure environment and regulatory overhead for ICO issuers can be materially reduced. If the token being issued is a utility token, most of the content of a traditional PDS would not be required for inclusion.

The keys to a successful and robust ICO market are:

- Consumer protection
- Flexibility for issuers
- Lowering barriers for issuers
- Consumer confidence

- Regulator endorsement of the industry
- Robust and licensed secondary market providers (exchanges)
- Reasonable disclosure requirements for ICO issuers based on the classification of the token

## Opportunities and Risks

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

If ICOs operate under a robust regulatory framework with support from licensed secondary market operators, ICOs allow innovative companies in Australia to source their funding in Australia and continue to grow their operations in Australia. This has the benefit of fostering a start-up friendly environment in Australia, making it an attractive place to operate a business for our talented young entrepreneurs and also an attractive market for overseas funds seeking access to start-ups that are run in a robust and reliable manner.

A thriving ICO market in Australia will encourage talent to stay in Australia and will bring additional investment dollars into the country to support Australian innovation and entrepreneurs.

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

ICOs can potentially offer a faster, more efficient and cost-effective way of raising capital that are not currently catered for in the venture-capital or equity raising spaces. Traditional capital raising activities are extremely capital intensive (equity-raising) with a complex and costly listing regime that brings an administrative overhead to comply with continuous disclosure, listing rules and compliance. This puts an equity listing out of reach for a large number of start-up businesses.

Angel investing and venture capital funding can also be difficult due to the limited number of options in Australia and the requirements around making offers only to institutional-level and sophisticated investors.

ICOs allow the entrepreneurs to connect with their community, including retail investors, SMSF holders, small to medium sized enterprises as well as the institutions and sophisticated investors. The administrative burden, if the legislation is constructed correctly, can be significantly reduced from the equity capital raising model. This allows a faster pathway to funding, greater participation in the start-up industry and allowing the entrepreneurs to quickly raise funds and continue to build their businesses and products.

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

There is a unique opportunity available for Australia to become a world leader in the ICO space; to become the ICO and cryptocurrency capital of the developed economies. According to ICO Data (<https://www.icodata.io/stats/2018>), there was \$USD7.5bn raised from ICOs in the last calendar year ending December 2018. If Australia can show leadership and legislate this industry to become an attractive jurisdiction for companies to raise capital, there is a huge opportunity for the Australian economy as well as all of the related services that potential ICO fundraisers would require: Legal advice, marketing, audit, banking, processing staff, professional services, exchanges, market-makers, escrow, custody etc.

Local retail and institutional investors would get a chance to see a large range of innovations from around the world and be able to participate in the fundraising activities; and the broader economy and related industries would see a large inflow of capital and related services.

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

As the ICO market grows in size and significance we will see companies choosing to domicile in the jurisdiction with the best regulatory framework that provides certainty and protection to their investors. If Australia is slow to move, the opportunity will migrate offshore to more ICO-friendly jurisdictions and the country will struggle to capitalise on a booming industry.

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

Yes, there are associated risks. The biggest risk is that by attracting ICO activity to Australia, it also attracts unscrupulous operators.

For Australia to reap the benefits of the ICO industry, it is important to have a regulatory regime that serves as a barrier to unscrupulous operators. There have been unfortunate incidents of ICO issuers seeking to raise funds in order to personally benefit and not to provide any service or product (commonly known as "Exit scams"). Any legislation contemplated by regulators should have in-built consumer and investor protections and minimum disclosure requirements for any ICO seeking listing in Australia.

For capital raising activities, vital protection mechanisms are adequately handled through the current Product Disclosure Statement requirements. Amending the legislation to allow a truncated version of a PDF for ICO issuers would be a positive step forward (short-form PDS are already available for certain capital raising activities).

## **Regulatory Frameworks in Australia**

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

Yes, any security or security-like tokens need to be brought inside the regulatory landscape ASAP; and the other classifications of tokens need to be defined so the industry has certainty of what regulations are applicable for each ICO.

### 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?

No, there is insufficient regulatory support for the ICO market in Australia. As a provider of exchange services, we are continually struggling to access the most basic services that enable us to provide our services: Banking, Insurance, payment platforms etc. We are often told that without any licensing regime or regulation over the markets we provide, the service providers are unable to get risk sign off on the exchange being a customer. We have been operating for more than five years and have an unblemished customer and asset security record, yet we face these issues. Any firm seeking to raise funds via ICO will face these same issues. Having a regulatory and licensing regime in place will provide the related service providers the comfort they need to provide the necessary services to the ICO and cryptocurrency industry operators.

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

- Licensing for secondary market operators
- Minimum listing requirements (tailored for each token classification)
- Disclosure requirements for ICOs

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?

We support having an industry code of conduct. Our view is that a code of conduct should always assume that all signatories are operating within the regulatory framework. The role of the code of conduct would require signatories to do more than the letter of the law and to act in the best interest of the industry and its participants. This should increase the level of security for customers and issuers in addition to allowing providers (such as exchanges) to take actions against individuals and businesses that do not abide by the code.

Our view is that the code should be owned by the industry and not the regulatory body. The Australian Digital Commerce Association (ADCA) is well placed to be the owner of an industry wide code of conduct.

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

In the primary and secondary markets, mandate the use of properly designated and reconciled Trust accounts to ensure the appropriate separation of customer and operational funds.

Mandate the use of licensed and approved secondary market providers to give investors assurance that their investments are able to be traded and priced in an efficient and transparent manner.

## **Tax Treatment of ICOs**

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

Yes. The uncertainty around the classifications of each token prevents issuers from including simple tax information in any offer document. A clear, concise classification with related tax treatment would assist greatly in allowing potential investors in ICOs to make an informed decision.

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

Without an agreed classification of tokens, it is difficult to answer this question.

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?

Assuming that the recommendation for an appropriate classification is implemented (see response to 1.1), then the expanded classification of the asset classes should capture the existing tax treatment. There is no compelling argument at this point to provide special tax treatment to an ICO transaction as opposed to a traditional capital raising and debt/equity issuance.



### **About Independent Reserve**

*Established in 2013, Independent Reserve is an Australian institutional grade cryptocurrency exchange with an orderbook enabling Australian and NZ clients to securely trade, invest and hold digital currencies. Independent Exchange's mission is to provide a pro-regulation platform with the highest security to access cryptocurrencies.*

<https://www.independentreserve.com>