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# *Legal classification of Crypto-assets*

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## *In brief*

Despite the meteoric growth in cryptocurrencies and tokens or coins (**Crypto-assets**) over the past few years (in publicity as much as value), there remains considerable uncertainty around their legal status and oversight. In our view, we are at a juncture where all parties involved in Crypto-asset transactions - issuers, traders, and the digital exchanges that facilitate transactions - would benefit from greater legal certainty in navigating regulatory obligations (such as registration, consumer rights, licensing, and investor disclosure).

In this LegalTalk Alert we take a deeper look at the current state of legal classification of Crypto-Assets in Australia and discuss some options for what classification might look like in the future.

## *In detail*

### **Why is this relevant?**

Crypto-assets may seem a long way from mainstream adoption and are often dismissed as speculative investments. The reality, however, is that the underlying blockchain technology behind many of these assets is increasingly accepted as a driver of economic change.

Simply bundling all Crypto-assets into a singular bucket of 'cryptocurrencies' would be vastly underestimating the proposed application and uses of Crypto-assets.

Blockchain platforms, and the Crypto-assets generated from them such as tokens or coins, are squarely in the current focus of global financial institutions and governments for a wide range of uses, from global trade through to the everyday household.

From an Australian perspective, many prominent fintech providers, digital banks, and traders are looking to establish Crypto-asset services in Australia. This supply will only increase with the Federal Government's introduction of the Consumer Data Right (to launch initially within open banking on 1 July 2019). Despite these developments, there remains considerable regulatory uncertainty around the legal classification of Crypto-assets and how they will be treated within the Australian corporate regulatory landscape.

## CLASSIFYING CRYPTO-ASSETS

### *Three key questions to classification:*

- *What legal rights are included?*
- *What is its purpose or function?*
- *How was it funded?*

ASIC has released an [updated information sheet 225](#) (Info 225) on the potential corporate regulatory treatment of Crypto-Assets, and the ATO has published [initial guidance](#) on capital gains treatment of cryptocurrency investments. Further, PwC Australia's accounting advisory team recently provided [guidance on accounting considerations under current reporting standards](#). However, much work remains to be done in order to provide clarity on the legal status of these types of assets, particularly when not all Crypto-assets are created equally.

### ***RBA classification - are Crypto-assets currency?***

No.

Regulators globally are a long way yet from classifying any cryptocurrency as 'currency' within their respective countries. Recent media articles touted that Japan, the biggest global market for Crypto-assets, had legislated for cryptocurrencies to be legal tender, however this is not correct. More accurately, Japanese regulation designates cryptocurrencies as acceptable means of payment, but not as legal tender.

Certainly, the Reserve Bank of Australia has made no indication that it intends to consider cryptocurrencies such as Bitcoin as legal tender given, in its view, Crypto-assets are yet to display the formal characteristics of money.

### ***ASIC classification - are Crypto-assets financial products?***

When ASIC made its submission to the Senate enquiry on digital currencies in December 2014, it stated that that digital currencies "do not fit within the legal definitions of 'financial product' in the Corporations Act or the ASIC Act".

Following the increase in initial coin offerings (**ICOs**) and the wide variety of purposes for which coins (or tokens) are used, ASIC revisited its analysis in its updated version of Info 225 issued in May 2018. While Info 225 does not contradict previous guidance that pure digital currencies such as Bitcoin are not financial products, it is now clear that the classification of any particular Crypto-asset as a financial product must be determined on a case-by-case basis.

In Info 225, ASIC advises of three key factors in evaluating a Crypto-asset for status as a financial product:

1. the legal rights attached to the Crypto-asset (for example, does the recipient receive any ownership rights such as voting or distributions);
2. the function or purpose of the Crypto-asset (is its value linked to an off-platform asset, commodity or index); and
3. how the issue of the Crypto-asset was or is funded (are investor funds pooled for a common financial benefit)?

The outcome of the above analysis will help determine whether the Crypto-asset itself could be a security, a derivative, or an interest in a managed investment scheme, all of which are financial products. Further, those who accept use of Crypto-assets for the purchase of goods and services (by direct acceptance or

conversion to fiat prior to payment) are likely to be providing non-cash payment facilities; another form of financial product.

If a Crypto-asset is determined to be a financial product then any person dealing, arranging, making a financial market or providing financial advice in relation to it, must hold an Australian Financial Services Licence (AFSL) unless an exemption is available. Due to this uncertainty, many cryptocurrency service providers, including digital exchanges and investment funds holding Crypto-assets have already applied for AFSLs (or obtained authorisations to act as representatives of existing AFSL holders) to ensure that their operations are appropriately authorised in the event that ASIC finds that an AFSL is necessary.

### ***Looking forward at possible classification***

Current regulatory guidance simply advocates legal analysis of where a Crypto-asset fits within the existing legislative framework. If the existing pace of adoption and development continues, there may shortly come a time when crypto-specific regulations will be needed for the *Corporations Act 2001* (Cth) (**Corporations Act**) and other related legislation. We have considered some possibilities for that framework, and have set out below five possible categories under which the current forms of mainstream Crypto-assets will usually fall.

The challenge for regulators is that Crypto-assets can often be - by design - flexible and adaptive. This makes legal classification difficult, with some assets possibly landing as hybrids across one or more of these categories, or none at all.

Regulators internationally are unequivocal in the need for appropriate oversight of consumer investment in these products. While its execution is at times imperfect, regulators' motive is to facilitate commerce, not to stifle innovation or prevent business development or investment. The level of secondary trading in Crypto-assets, however, and the associated level of risk exposure for retail investors, suggests that the community has made some broad assumptions as to regulatory tolerance (if not endorsement) of Crypto-assets.

#### *Option 1 – Classification by categories*

In our view, it is possible – and desirable - to distinguish some broad key token classes by their function, regardless of their regulatory categorisation:

<b><i>Token Type</i></b>	<b><i>Main function</i></b>	<b><i>Examples</i></b>
<b><i>Utility/Protocol tokens</i></b>	<i>Funding a platform/blockchain for a specific end-use</i>	<i>Golem, Auger, Ripple</i>
<b><i>Security tokens</i></b>	<i>Generates ownership income and/or provides rights in off-platform tradeable assets</i>	<i>Token Estate, BCap, BitCar</i>
<b><i>Platform tokens</i></b>	<i>Used for 'fuelling' a platform on which decentralised projects/services are generated such as apps, smart contracts and ledgers</i>	<i>Ethereum, Cosmos, NEO</i>
<b><i>Asset-backed tokens</i></b>	<i>Stores value that is backed by a real-world asset like gold or oil</i>	<i>Tether, Petro, Royal Mint Gold</i>
<b><i>Cryptocurrencies</i></b>	<i>Used as a general medium of exchange</i>	<i>Bitcoin, Monero, Litecoin, ZCash</i>

Using these categorisations as a starting point, it is possible to envisage a system that, much like the current regulation of financial products, set outs the common characteristics of a particular class of Crypto-asset and attaches defined rules that apply to each or alternatively places them within the existing set of regulations with suitable modifications.

For example, security tokens could either have a modified financial products regime applied to them or be declared securities for certain purposes under the Corporation Act such as disclosure and issuance

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requirements. Equally utility tokens, which provide a form of user benefit, might be better regulated as consumer credit products or alternatively as financial products as non-cash payment facilities. Given the numerous scenarios applicable, appropriate classification should aim to give regulators the flexibility they need to shift with the market, without detracting from improved market clarity on the legal position of, and general requirements for, their activities.

To kick-start this new regulatory system, individual classifications for the existing major Crypto-assets could be available, with a self-nomination option for new ICOs introduced to ease the transition to classification. Participants in each class can then have a clear path to regulation, or at least a pathway towards engaging with regulators in a structured fashion before requirements arise for regulatory enforcement against breaches.

Taxation of assets in these categories would also be of key importance, particularly for start-up entities ill-placed to absorb unintended tax disadvantages and/or unclear tax laws. At the moment, basic taxation principles are applied to the taxation of cryptocurrencies, with limited examples of specifically tailored tax laws. Each case must be considered based on its facts and taxpayers may invest significant energy into validating how their Crypto-assets are taxed. The use of the legal categorisations above could equally provide a framework to help tax regulators and advisers to clarify the treatment of Crypto-assets.

### *Option 2 – General classification as financial products*

Another way to achieve classification might be to categorise all types of Crypto-assets (other than cryptocurrencies) within the Corporations Act definition of ‘financial products’.

The breadth of this approach may inadvertently capture smaller scale providers whom the Corporations Act does not seek to regulate such as small, closed network blockchain-enabled products or services. With this in mind, exemptions might be made for small scale/private enterprises, comparable to the licensing exemptions available to smaller gift card providers.

ASIC has recently highlighted the recommendations by the Council of Financial Regulators (CFS) to update the regulation of stored value facilities, to align regulation with the considerable innovation in that area. The CFS issues paper dated 24 September 2018 (**Issues Paper**) describes rapid technological developments, which are changing the way that the community thinks about and deals with payments, currency, and value transfers. The Issues Paper also considers a multi-tiered approach to regulation, building on, for example, existing exemptions available within the definition of non-cash payment facilities as set out in Corporations Regulation 7.1.07G, and other regulatory exemptions available for low value, limited purpose products and services.

While this is more of a simplistic generalist approach, if done properly then it would not be the case that every token issuer would require full form disclosure documents, financial services licensing, or that all digital exchanges require a traditional financial market licence. However a base starting point would be set, which would provide greater certainty to issuers, consumers/investors, and exchanges.

ASIC’s current insistence on a ‘case by case’ test at any point in time is not overly helpful to those trying to grapple with what Justice Hayne QC has recently described as the “labyrinthine” regulation of financial products and services in this jurisdiction.<sup>1</sup>

### *Option 3 – Classification similar to crowd-sourced funding*

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<sup>1</sup> Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) 1 [290].

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Another possible path forward could follow the recent crowd-sourced funding (CSF) regulation model. The altruistic and community minded concepts driving CSF are particularly well aligned to the themes driving many Crypto-asset generating entities. CSF regulation hinges on the concept of licensed intermediaries acting as regulatory gatekeepers. Those intermediaries are responsible for a level of diligence, disclosure, and deal management, in order to facilitate a fundraising and disclosure regime more appropriate to the types of businesses, markets, and investment volumes involved. Regulators might consider whether this gatekeeper model could be adapted to fit the digital exchange / token issuer relationship in the Crypto-asset world.

### ***Building certainty through classification***

The appeal of anonymised transactions in the blockchain-based investment world has attracted vast amounts of attention from civil libertarians, as well as money launderers, inevitably followed by regulators keen to prevent wrongdoing. Traceless trading and ownership concepts might work well for certain interactions, but there are growing obligations for exchanges, issuers, and traders to demonstrate that parties are both genuine and transacting for legitimate purposes. Total anonymity for investment and payment transactions is increasingly less pragmatic.

We acknowledge that token classification is not static, and new types of Crypto-assets will inevitably arise as innovative blockchain use cases develop. There appears, nonetheless, to be substantial merit in the development of a classification system for Crypto-assets to achieve greater regulatory certainty for a new financial sector, which is growing at a pace never previously seen.

Objective criteria to help establish classification for a new Crypto-asset would be enormously beneficial to companies and developers when planning for ICOs, for service providers when understanding their regulatory obligations across the Crypto-assets that they service, and for investors when considering the risk and return of their investment.

Classification would also help provide certainty within associated regulatory regimes such as consumer laws, the personal properties security law, prudential standards, the consumer data right (i.e. open banking) as well as the impending changes to the financial advice sector. All of these are affected by a decision as to whether a Crypto-asset is or is not a currency, security, financial product, consumer product, or data asset.

### ***The takeaway***

In an emerging industry with a perceived (or, arguably, actual) lack of oversight, regulatory intervention is inevitable. Appropriate classification of Crypto-assets needs to be a fundamental part of that process to provide certainty for issuer, provider and investor. While the options proposed above are far from comprehensive, they provide a starting point for the conversation regarding development of useful classifications. Even if absolute certainty is a way off, there is no shortage of market participants seeking increased clarity.

Stay tuned for our next LegalTalk Alert, which will look at how one might take a security interest in Crypto-assets under the *Personal Properties Security Act 2009* (Cth).

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## ***Let's talk***

For a deeper discussion of how these issues might affect your business, please contact:

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