UNDERSTANDING DIGITAL TOKENS

Legal Landscapes Governing Digital Tokens in Australia

Prepared by the Token Alliance – an industry initiative of the Chamber of Digital Commerce

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CHAMBER OF DIGITAL COMMERCE

The Chamber of Digital Commerce is the world’s largest trade association representing the blockchain industry. Our mission is to promote the acceptance and use of digital assets and blockchain technology. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop a pro-growth legal environment that fosters innovation, jobs, and investment.

TOKEN ALLIANCE

The Token Alliance is an industry-led initiative of the Chamber of Digital Commerce, developed to be a key resource for the emerging industry surrounding the generation and distribution of tokens using blockchain technology. Comprised of more than 400 industry participants, the Alliance includes blockchain and token and legal experts, technologists, economists, former regulators, and practitioners from around the globe. The Token Alliance develops community-driven guidelines for the responsible development of tokens.

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I. INTRODUCTION

The laws and regulations governing the securities and financial sectors in Australia are designed to ensure transparency and allow financial transactions to take place in a regulated and well-informed market. Protection of the consumer and participants in equity style transactions is paramount.

Token Sponsors in Australia operate in an evolving area of the law which currently sits on the periphery of regulations that apply to Australia’s financial markets. To date, regulators have not taken steps to directly regulate the generation of digital tokens or crypto-assets. The current approach is to apply the securities and financial legal framework if the token has the characteristics of a security or financial product. If not, the token will be governed by existing consumer protection and general laws.

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In an attempt to deal with the increasing regulatory uncertainty surrounding digital tokens, the Australian Securities and Investments Commission (“ASIC”), the independent government body responsible for enforcing and regulating company and financial services laws in Australia, has issued a series of regulatory guidelines in the last 12 months setting out the factors in determining whether a token constitutes a security or a financial product. Importantly, if a token constitutes a security or a financial product, then the guidelines suggest that the token would be governed by existing securities legislation. Further, if the event creating, or mechanism to distribute, the tokens constituted a managed investment scheme, it would also be governed by existing securities legislation. In the event of uncertainty, ASIC also operates a service known as the Innovation Hub that allows industry to discuss regulatory issues with specialized personnel at ASIC to obtain clarity on compliance issues.

Unfortunately, apart from ASIC’s regulatory guidelines and access to the Innovation Hub, there is no legal precedent and only limited literature on which a Token Sponsor may rely for clarification as to the applicability of existing law. Each token creation must be judged on its own facts and circumstances as to whether the token will constitute a security or financial product. However, ASIC has acknowledged that “crypto-assets and the use of distributed ledger technology has the potential to make an important contribution to fintech innovation,” so it is hopeful that specific regulation will be introduced in the near future.

II. REGULATION OF DIGITAL TOKENS AND CRYPTO-ASSETS

The capital and financial markets in Australia are governed by various statutes that define and regulate securities, financial products, managed investment schemes, crowdfunding, and non-cash payment facilities. They also address events and circumstances that constitute deceptive and misleading conduct and impose sanctions and penalties for breach.

This report discusses the salient issues that may apply to digital tokens, crypto-assets, and Token Sponsors. Broadly, the relevant considerations relate to whether a digital token or crypto-asset will be classified as a security or financial product or whether the vehicle through which the token is generated constitutes a managed investment scheme.

A. WHAT IS A “SECURITY”? 

“Securities” are defined in the Corporations Act 2001 (Cth) (“Corporations Act”) as including shares or debentures in a company, interests in a managed investment scheme or units of such shares and further includes legal or equitable rights or interests in the foregoing and options.1

“Shares” are generally regarded as an interest that carries rights regarding the ownership of a company, voting rights in the decisions of a body and some entitlement to share in future profits through dividends as well as a claim on the residual assets of a company if wound up.


2 Corporations Act 2001 (Cth) s 92.
ASIC’s approach to digital tokens is that if the purpose of the token is to fund a company, or if the bundle of rights attaching to the token are similar to rights commonly attaching to a share in a company, then it is likely that the token will fall within the definition of a share (security). If so, the Token Sponsor must comply with the requirements of the Corporations Act in relation to the issue of securities, including the preparation of a prospectus, its registration with ASIC, and the necessary disclosures the prospectus must contain.

B. WHAT IS A “FINANCIAL PRODUCT”?

The Corporations Act provides both a general definition of “financial product,” as well as a list of deemed financial products.

1. DEEMED FINANCIAL PRODUCTS

The list of deemed financial products includes securities (see above analysis), as well as derivatives and managed investment schemes. ASIC has identified these deemed financial products as potential categories under which a digital token or crypto-asset may be captured.

a. DERIVATIVES

In broad terms, a derivative involves an arrangement where the quantum of some required future consideration is determined by reference to some underlying asset, which may include a crypto-asset or digital token. Recently, bitcoin futures contracts have become a popular investment and such a product is likely to be classified as a derivative under the Corporations Act.

b. MANAGED INVESTMENT SCHEME

Certain digital tokens or crypto-assets may fall under the umbrella of a Managed Investment Scheme (“MIS”). This is most likely the case when contributions from investors are pooled or used in common enterprise, and participants do not have operational control over the scheme’s management. Whether a digital token or crypto-asset constitutes a MIS will depend on the facts and circumstances, the assessment of which should include an assessment of what rights are attached to the tokens generated by the Token Sponsor. What constitutes a right should be interpreted broadly. These rights are likely to be set out in the Token Sponsor’s white paper.

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4 Corporations Act 2001 (Cth) s 764A(1).
6 Corporations Act 2001 (Cth) s 761D.
7 Corporations Act 2001 (Cth) s 9.
For example, payment for the purchase of a crypto-asset may be described as a receipt for a purchased service. However, if the value of the crypto-asset acquired is affected by the pooling of funds from investors or use of those funds under the arrangement, then the sale of the digital token may constitute a MIS. Use of a managed investment scheme triggers a range of product disclosure, licensing, and potential managed investment schemes registration obligations under the Corporations Act.8

New products may also be deemed to be financial products through regulations.9 However, as of the date of this report, neither digital tokens nor crypto-assets have been designated as financial products. Importantly, ASIC has indicated that it does not consider bitcoin to be a financial product.10

2. THE GENERAL TEST FOR “FINANCIAL PRODUCTS”

“Financial product” is a term first introduced as part of financial services regulation reform in 2001. The term was intended to be sufficiently broad and flexible to allow emerging products to be captured under the regulation.

Importantly, the general test for what constitutes a financial product still applies to digital tokens and crypto-assets. Token Sponsors should consider all of the characteristics of the digital token or crypto-asset to determine whether it is a financial product at time of generation, or whether it may become a financial product after it is generated.

Section 763A(1) of the Corporations Act defines a financial product as a “facility through which, or through the acquisition of which, a person does one or more of the following:

a. **MAKES A FINANCIAL INVESTMENT;**

b. **MANAGES FINANCIAL RISK; OR**

c. **MAKES NON-CASH PAYMENTS.”**

The financial investment limb is likely to be the most relevant for digital tokens and crypto-assets. Under the Corporations Act, a person makes a financial investment if:

a. “THE INVESTOR GIVES MONEY OR MONEY’S WORTH (THE CONTRIBUTION) TO ANOTHER PERSON AND ANY OF THE FOLLOWING APPLY:

i. the other person uses the contribution to generate a financial return, or other benefit, for the investor;

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9 Corporations Act 2001 (Cth) s 764A.
ii. the investor intends that the other person will use the contribution to generate a financial return, or other benefit, for the investor (even if no return or benefit is in fact generated); 

iii. the other person intends that the contribution will be used to generate a financial return, or other benefit, for the investor (even if no return or benefit is in fact generated); and

b. THE INVESTOR HAS NO DAY-TO-DAY CONTROL OVER THE USE OF THE CONTRIBUTION TO GENERATE THE RETURN OR BENEFIT.”

ASIC has also made clear that simply describing a coin or token as a “utility” token or digital currency (in the relevant white paper or elsewhere) will not exclude it from being characterized as a financial product. Instead, the Token Sponsor should assess the digital token or crypto-asset based on all of the rights and features associated with the product and obtain formal legal advice.

C. LICENSING REQUIREMENTS FOR FINANCIAL PRODUCTS

If a digital token or crypto-asset constitutes a financial product, the Token Sponsor may be required to obtain an Australian Financial Services License (“AFSL”).

Under Section 991A of the Corporations Act, “a person who carries on a financial services business… must hold an Australian financial services license covering the provision of the financial services.” As the definition of “financial service” includes the issuing of a financial product, issuers of applicable digital tokens and crypto-assets may fall within this requirement.

The process for applying for an AFSL includes providing substantial material to ASIC, employing or contracting with specialized staff to manage the provision of the relevant financial product and compliance generally, as well as the creation of compliance programs. The timeframe for obtaining an AFSL will vary depending on the circumstances of the application, but will typically require a number of months.

The need for an AFSL may be removed if one of the exemptions in Section 911A(2) of the Corporations Act applies. In particular, a product generator may not require an AFSL if:

a. THE PRODUCT IS OFFERED TO POTENTIAL INVESTORS THROUGH A THIRD PARTY WHO HOLDS AN AFSL WHICH COVERS THE GENERATION OF THAT PARTICULAR PRODUCT; AND

b. THE PRODUCT GENERATOR PROVIDES THE PRODUCT TO INVESTORS BASED ON THE OFFER PROPOSED BY THE THIRD PARTY LICENSEE.

Prohibitions on these kinds of outsourcing arrangements exist in particular circumstances, so Token Sponsors should evaluate the applicability of these exemptions on a case by case basis.

11 Corporations Act 2001 (Cth) s 763B.
12 Ibid.
13 Corporations Act 2001 (Cth) s 766C.
14 Corporations Act 2001 (Cth) s 766A.
D. CROWDFUNDING

Raising funds by generating tokens can sometimes be considered a form of crowdfunding. If so, this activity will be covered by the crowd-sourced funding provisions of the Corporations Act. It should be noted that crowd-sourced funding is regarded as a financial service. Accordingly, and in addition to compliance with the regulatory laws, an AFSL will be required to provide this service.

ASIC has warned Token Sponsors not to use the phrase ‘crowd-sourced funding’ unless the offering is in fact taking place under the crowd-sourced funding regime. In addition, there is a $5 million cap on crowdfunding in Australia, and the regime is currently only open to public unlisted companies. However, amendments are currently being passed through the Parliament to open up the framework to proprietary companies, and there is a chance that these will be passed into law before the end of 2018.

E. NON-CASH PAYMENT FACILITIES

Non-cash payment facilities are arrangements through which a person makes payments, or causes payments to be made, other than by physical delivery of money. A typical example is a credit or debit card. If the token constitutes a non-cash payment facility, it will be governed by and must comply with the Corporations Act.

ASIC is presently of the view that, provided the token is more in the form of a gift card or utility token, it will not constitute a non-cash payment facility.

F. DIGITAL TOKENS THAT ARE NOT FINANCIAL PRODUCTS

Even if digital tokens and crypto-assets (including bitcoin) are not regarded as securities or financial products, they must still comply with consumer law, contract law, and general Australian law.

One of the key laws that applies to all ICOs and crypto-assets (including those that are not financial products) is the general prohibition on parties engaging in misleading and deceptive conduct in the course of trade or commerce. Specifically, Section 18 of the Australian Consumer Law (“ACL”) states that a person must not “in trade or commerce, engage in conduct that is misleading and deceptive or is likely to mislead or deceive.” This prohibition has been extensively tested and developed through the courts and is considered a broad ranging prohibition.

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15 See generally Part 6D.3A of the Corporations Act 2001 (Cth).
17 Corporations Act 2001 (Cth) s 738G.
18 Corporations Act 2001 (Cth) s 738H.
19 Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017.
20 Corporations Act 2001 (Cth) s 763D.
ASIC has provided some guidance on potential conduct by a Token Sponsor that may be misleading or deceptive, including:

c. “the use of social media to generate the appearance of a greater level of public interest in a digital token or crypto-asset;

d. undertaking or arranging for a group to engage in trading strategies to generate the appearance of a greater level of buying and selling activity for a digital token or a crypto-asset;

e. failing to disclose adequate information about the Token Sponsor, the digital token, or the crypto asset, or

f. suggesting that the digital token or crypto-asset is a regulated product or the regulator has approved of the offering if that is not the case.”

A breach of this prohibition can result in serious penalties, including pecuniary penalties, for each instance of misleading and deceptive conduct.

The power to enforce the prohibition on misleading and deceptive conduct in the area of digital tokens and crypto-assets has been specifically delegated to ASIC. ASIC has also provided in depth information on this law in its latest guidance note, so it is likely that this prohibition will be a key focus for the regulator when investigating Token Sponsors.

III. REGULATION OF DIGITAL CURRENCY EXCHANGES

In April 2018, new laws and policy principles were introduced to regulate the operation of Digital Currency Exchanges (“DCEs”) in Australia. DCEs are businesses that exchange digital currency for fiat currency (e.g., Dollars, Euros, RMB) and vice versa. The new laws require an entity to be enrolled and registered with the Australian Transaction Reports and Analysis Centre (“AUSTRAC”) before operating as a DCE. All DCEs must also comply with obligations under the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) (“AML/CTF Act”) including the establishment and continued operation of a compliance program.

For those DCEs intending to offer exchange services for Token Sponsors in relation to digital tokens that are financial products, the DCE may also need a financial markets license or receive an exemption from ASIC in relation to their exchange services.

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22 Ibid.
23 Australian Consumer Law ss 236, 237.
A. REGISTRATION OF DIGITAL CURRENCY EXCHANGES

The AML/CTF Act was amended in April 2018 to require DCEs to enroll and register their business with AUSTRAC before engaging in digital currency exchange services.\(^\text{26}\) The amendments also set out the process for enrollment and registration, the establishment of the Digital Currency Exchange Register, and penalties for breaches of the registration requirements.

A set of policy principles and exemptions also came into effect in and around April 2018 stating that AUSTRAC will exercise leniency in relation to enforcement action until 2 October 2018.\(^\text{27}\) During this time, AUSTRAC may only take enforcement action if a DCE fails to take reasonable steps to comply with the AML/CTF Act. Examples of ‘reasonable steps’ include:

a. complying with any breaches of the AML/CTF Act as soon as practicable;

b. implementing a transition plan outlining actions and timeframes to achieve compliance; and

c. allocating sufficient resources to enable compliance.\(^\text{28}\)

Once the leniency period ends, it is likely that AUSTRAC will be diligent and prompt in pursuing enforcement action. The penalties that apply to breaches of the DCE obligations range from 2 to 7 years imprisonment and pecuniary penalties of $105,000 to $420,000.

B. PROCESS FOR ENROLLMENT AND REGISTRATION

A DCE can enroll and register with AUSTRAC using an online process based on the AUSTRAC business profile form.\(^\text{29}\)

The DCE will need to provide certain information to AUSTRAC, including:

a. national police certificates and checks for certain personnel; and

b. certain information in relation to the business entity.

Foreign companies (whether or not they are registered in Australia) can apply for enrollment and registration. However, AUSTRAC requires the foreign company to provide certain information including any registration details, company history and details regarding any previous legal infringements.


\(^{28}\) Ibid.

C. FINANCIAL MARKET LICENSE

Section 791A of the Corporations Act states that a person must only operate a financial market if:

a. the person has an Australian market license that authorizes the person to operate the market in this jurisdiction; or

b. the market is exempt.

This provision will be relevant to DCEs offering exchange services for digital tokens and crypto-assets constituting financial products. This is because a financial market is defined as “a facility through which:

a. offers to acquire or dispose of financial products are regularly made or accepted; or

b. offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:

i. the making of offers to acquire or dispose of financial products; or

ii. the acceptance of such offers.”

It is also important to note that a financial market may operate simultaneously in Australia and other jurisdictions. As such, DCEs that can be accessed in Australia but have been established outside of Australia may also need to obtain a financial markets license if the DCE offers to acquire or dispose of financial products are regularly made or accepted.

ASIC has also highlighted the financial market regulations and licensing requirements in its latest guidance note. Due to the increased awareness of the financial markets license requirements, a number of DCEs operating in Australia have stopped listing new tokens and some DCEs have removed all tokens other than the mainstream tokens (bitcoin, Ethereum, and Ripple).

Even if a financial markets license is required to operate a DCE, such activity may be exempted by Ministerial power for a particular financial market or a class of financial markets. As of the date of this report, no exemption has been given for a financial market for digital tokens and crypto-assets.

30 Corporations Act 2001 (Cth) s 767A.
32 Corporations Act 2001 (Cth) s 791C.
IV. ASIC’S INNOVATION HUB AND REGULATORY SANDBOX

In an effort to allow regulation to follow rather than restrain innovation and change in the FinTech markets, ASIC has developed programs and tools to assist industry in Australia with navigating the regulatory environment and foster the creation of crypto-asset businesses.

In March 2015, ASIC launched the Innovation Hub, an initiative to help fintech businesses navigate the regulatory system in the financial services sector. The main service provided by the Innovation Hub is direct access to senior staff at ASIC to streamline licensing and offer informal guidance in relation to the regulatory requirements for the business. Since its inception, the Innovation Hub has assisted in the granting of over 36 licenses to FinTech businesses and these businesses received their licenses much faster than those applying through the standard process. Recently, the Innovation Hub has focused on digital tokens and crypto-assets and members of the Innovation Hub are key contributors to the regulatory guidelines that have been issued by ASIC.

As part of the Innovation Hub initiative, ASIC established a licensing relief framework dubbed the ASIC “regulatory sandbox” allowing users to work cooperatively with ASIC on regulatory issues to achieve a solution that suits both the relevant firm and government.

The sandbox comprises the following three relief options:

a. assistance to identify existing statutory exemptions or flexibility;

b. relief for testing certain specified products and services; or

c. for other services, where ASIC grants individual relief.

The sandbox may be used by new-to-market Token Sponsors to liaise with ASIC to determine whether their token would be considered a financial product. However, the sandbox is not available for testing the issuance of financial products (including any digital tokens or crypto-assets considered financial products).

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37 Ibid.
VI. TAXATION

The tax treatment of Token Sponsors remains a pressing issue relative to both the classification of the digital token as either belonging to the capital or revenue account, and the uncertain applicability of the goods and services tax (“GST”).

For digital tokens that are caught by the existing financial product or securities regimes, the tax treatment is relatively settled, with significant bodies of law, including statute, case law, and guidance from the Australian Taxation Office (“ATO”), clarifying the tax treatment of securities and financial products. However, for those tokens that sit outside of the existing regulatory frameworks, the tax treatment is unclear.

If a digital token is not a regulated security or financial product, its sale will likely be treated as revenue of the Token Sponsor and taxed accordingly at the corporate tax rate. There is currently significant discussion in Australia around the granting of deferred taxation liability for Token Sponsors, in recognition of the fact that the funds raised by most Token Sponsors are often allocated to a roadmap stretching years into the future. However, no amendments have yet been suggested to the existing law.

The ATO has repeatedly stated that the tax treatment of Token Sponsors will turn upon the facts and circumstances of the triggering event. Accordingly, many Australian Token Sponsors have taken the path of seeking a private ruling from the ATO to clarify their tax position. While these private rulings will be released by the ATO in redacted form, they may not be relied upon by third parties. In any event, as at the time of writing, no private rulings have been handed down by the ATO in relation to Token Sponsors, despite many currently being underway.

The GST treatment of tokens remains contentious. Prior to 1 July 2017, GST was payable in relation to sales and purchases of “digital currency.” From 1 July 2017, these activities were specifically exempted from the GST regime. While the ATO has expressly recognized that bitcoin, Ethereum, Litecoin, Dash, Monero, Zcash, Ripple, and Ybcoin fall within the definition of “digital currency,” the definition is relatively narrow. Guidance from the ATO released in March 2018 clarifies that Australian Token Sponsors, as well as foreign Token Sponsors selling into the Australian market, may still be required to pay GST on their offerings, particularly where the token provides a right or entitlement to goods or services.

VII. CONCLUSION

Overall, both Australian Token Sponsors and foreign Token Sponsors maintaining a presence within the Australian market are currently operating in an uncertain legal environment. The Australian regulators, like almost all of the regulators in other jurisdictions discussed in this report, have adopted an approach based on functional equivalence. Where a digital token or crypto-asset falls within the existing...
framework, the answer is clear. However, the majority of digital tokens do not easily fit within existing frameworks. The result is less than optimal both for regulators and Token Sponsors on the one hand and the general public on the other. Industry groups, including the Australian Digital Commerce Association, have recognized that clearer guidelines and principles are required. Best practice guidelines are currently being drafted in the expectation that industry will embrace and adhere to these in the hope that they will form the basis for future regulation.

Ultimately, activity from Token Sponsors will continue to grow in Australia as clear economic and technical drivers accelerate market activity. It is hoped that this report encourages regulatory activity to grow as well.

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40 For more information on the Australian Digital Commerce Association, see https://adca.asn.au/.
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