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Dear Product Regulation team,

Submission to ASIC Consultation Paper 325: Product design and distribution obligations

Thank you for the opportunity to provide a submission to ASIC in relation to Consultation Paper 325: Product design and distribution obligations.

Our submission is set out at **Annexure A**, and responds to Question C3Q3 by:

- providing some examples in the decentralised finance (**DeFi**) sector, particularly the offering by Maker DAO; and
- setting out some additional matters specific to the design and distribution of DeFi products that would benefit from ASIC guidance.

DeFi is lowering the barriers to entry and democratising access to more sophisticated financial products. On the one hand, the innovation is welcome; on the other hand, consumer protections are not being consistently designed into smart contracts nor are appropriate disclosures being made through the interfaces and portals being designed around such DeFi products.

In the absence of smart contract norms or minimum standards around the automatic or manual resolution of disputes or issues arising from consumer participation in DeFi (and especially where DeFi communities have adopted non-traditional governance and remedial responses such as hard forks), we believe ASIC can play a meaningful role in articulating how product design and distribution obligations can be administered in the DeFi sector.

We acknowledge that products in the DeFi sector may not neatly fall within the class of products to which the design and distribution obligations relate. Mills Oakley would be grateful for an opportunity to discuss our submission and to lend assistance as the consultation progresses or with the Innovation Hub or appropriate regulatory policy forum.

If you have any questions or require further information, please do not hesitate to contact Joni Pirovich on +61 3 8568 9629 or jpirovich@millssoakley.com.au.

Yours sincerely

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Annexure A Submission

1 DeFi examples

Decentralised blockchain-based infrastructure, wallets and applications can democratise the offer/funding of financial and payment services by allowing for secure, cost efficient peer to peer transactions. For example, Nexus Mutual (<https://nexusmutual.io/>) is a blockchain-based offering that offers insurance for value tied up in smart contracts, such as peer to peer cryptocurrency lending (e.g. <https://saltlending.com/>). A key example is margin lending type products like Maker DAO's offering of collateralised debt positions, considered in more detail below.

DeFi Pulse (defipulse.io) is a handy resource to check in on from time to time to see and understand more about at least the top 20 DeFi offerings.

An increasing number of DeFi products are becoming available to consumers, which in our traditional financial markets would ordinarily only be available to wholesale and sophisticated investors or available with significant disclosure requirements. One of the key issues in DeFi is striking the right balance between the democratisation of sophisticated financial products and safety net regulation for less sophisticated participants.

The recent bZx attacks are being hotly discussed in the cryptocurrency community and views differ as to whether the attacks were actually unethical or illegal attacks, or opportunism by exploiting smart contract vulnerabilities. For a useful summary, please listen to the podcast released on 25 February 2020, by Laura Shin: <https://unchainedpodcast.com/the-bzx-attacks-unethical-or-illegal-2-experts-weigh-in/>. Note that despite the ongoing discussion about the "attacks", Nexus Mutual has honoured insurance payouts to those that took out insurance in relation to bZx.

Maker DAO, DAI & MKR

Maker is an Ethereum-based decentralised autonomous organisation (**DAO**) with a two token protocol: DAI (the native stablecoin) and MKR (the volatile multi-characteristic token with payment/exchange and voting features). The current combined market capitalisation of DAI and MKR is \$661 million.

Unlike Tether, which is a fiat-collateralised stablecoin (and considered to be centralised), DAI is collateralised using cryptocurrency and algorithms. Maker claims DAI to be the first decentralised stable digital asset and that a stable digital asset is essential for blockchain technology to reach its full potential.

In simple terms, in the Single-collateral Dai (**SAI**) model, Maker allowed users to create collateralised debt positions (**CDPs**) by depositing a single form of collateral (i.e. PETH) in return for DAI. When a user retrieves DAI (say, to trade DAI for other digital assets) an equivalent amount of debt is created and the user cannot access the collateral until the debt is paid. At such time when the user wants to access their collateral they must pay the debt and a Stability Fee. In simple terms, a person can deposit PETH, receive DAI and use DAI to acquire other crypto-assets. If the price of ETH falls to a certain amount below the required collateralisation percentage (which varies depending on the CDP), and the CDP holder does not take appropriate action, the Maker smart contract will automatically liquidate the CDP (i.e. sell the underlying ETH from the ETH pool) and charge a Liquidation Penalty fee. This is much like a margin lending concept.

Until November 2019, the only collateral accepted was Pooled Ether (**PETH**),¹ although Maker has recently released its updated Whitepaper regarding the transition to its Multi-collateral Dai

¹ Maker Foundation, "The Dai Stablecoin System, Whitepaper", (December 2017): 'PETH is obtained by depositing ETH into a smart contract that pools the ETH from all users, and gives them corresponding PETH in return. If there is a sudden market crash in ETH, and a CDP ends up containing more debt than the value of its collateral, the Maker Platform automatically dilutes the PETH to recapitalise the system. This means that the proportional claim of each PETH token goes down relative to the total pooled ETH.'

(MCD) model, which as the name suggests means that multiple types of collateral can be accepted to open a Vault (i.e. the new term for a CDP).

The complete legal structure of, or associated with, Maker DAO, is unknown (which contributes to the difficulty of answering the additional matters for ASIC guidance below). From publicly available information, it appears that:

- The Maker Foundation – Maker Ecosystem Growth Foundation – is a Cayman Islands based non-profit organisation, which will be dissolved once Maker DAO has achieved its decentralisation goals.²
- The Maker Foundation built and launched the Maker Protocol in 2017 in conjunction with a number of outside partners.³
- The Maker team members hold themselves out as being employed by the Maker Foundation and are based in various locations around the world.
- The Maker Foundation controls the Maker Buffer, which represents cryptocurrency held in a multi-signature wallet (a cryptocurrency wallet that requires two or more digital signatures to sign a transaction). Cryptocurrency funds in the Maker Buffer are made up of income from Stability Fees, Liquidation Penalty fees and other income streams. The Maker Buffer is used to cover Protocol debt (which arises when a Vault position must be liquidated through a Collateral Auction, and where the Collateral Auction does not raise enough DAI to cover a Vault's outstanding obligation). If MKR holders vote, then funds from the Maker Buffer can be used to pay for various infrastructure needs and services.
- MKR token holders govern the Maker DAO, are based in various locations around the world, and are not all known parties. A number of wholesale funds hold significant parcels of MKR tokens, and have clear interests in supporting the development and growth of decentralisation, blockchain and cryptocurrency.
- Being Ethereum-based, the level of decentralisation (of nodes) supporting the Maker Protocol is equal to the level of decentralisation of the Ethereum network. Note that from a US perspective, the status of cryptocurrencies as securities could be contingent on how decentralised they are. SEC director of corporate finance, William Hinman, stated:

“If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.”⁴

- The level of decentralisation of the Maker smart contracts is currently less than the Ethereum network. The smart contracts are governed by MKR holders, of which there are fewer MKR token holders than Ethereum nodes at this stage, and not all MKR holders stake MKR in a voting smart contract to have the right to vote on proposals. For this reason, the European Central Bank view Maker DAO as not sufficiently decentralised:

“MKR holders are not protected from the actions of organised minorities of users, who may decide to implement any change to the smart contract governing the stablecoin initiative.”⁵

² Maker DAO Blog, “Introducing the Maker Ecosystem Growth Group”, (11 February 2019), accessed at: <https://blog.makerdao.com/introducing-the-maker-ecosystem-growth-group/>

³ Maker Foundation, “The Maker Protocol: MakerDAO's Multi-Collateral Dai (MCD) System”, (2019), Abstract, accessed at: <https://makerdao.com/en/whitepaper/#abstract>

⁴ William Hinman, “Digital Asset Transactions: When Howey Met Gary (Plastic)”, (14 June 2018), accessed at: <https://www.sec.gov/news/speech/speech-hinman-061418>.

⁵ Dirk Bullmann, Jonas Klemm & Andrea Pinna, European Central Bank, “Occasional Paper Series: In search for stability in crypto-assets: are stablecoins the solution?”, (August 2019), accessed at: <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op230-d57946be3b.en.pdf>.

2 Additional matters for ASIC guidance – specific to DeFi

Based on the Maker DAO example set out above, the following additional matters arise which would benefit from ASIC guidance:

- 2.1 In a DeFi offering, who is the issuer? If a Foundation structure is used initially, perhaps the issuer obligations should be imposed upon the Foundation. If so, what is the legal status of a DAO once the Foundation is wound down and what approach would ASIC take in enforcing product design and distribution obligations at such time that the Foundation is wound down (as Maker DAO and other DAO projects anticipate doing). Could the MKR holders be considered issuers? Who is or are the correct party/ies to be held legally responsible in the event of damage and harm?
- 2.2 In a DeFi offering, who are the distributors? As above, it might make sense that the Foundation is obliged to comply with distributor obligations but the same issues arise when the Foundation is wound down. Could independent developers that submit proposals which are approved by MKR holders be considered distributors?
- 2.3 Should MKR holders, when deciding upon proposals, consider each proposal's description and targeting of a particular target market with regard to ASIC's product design and distribution obligations?
- 2.4 If none of the parties mentioned above are clearly issuers or distributors, DeFi presents a regulatory arbitrage opportunity whereby a regulated entity in Australia is incentivised to transition their product to DeFi (e.g. by submitting a proposal to Maker DAO to build similar or equivalent product albeit denominated in cryptocurrency).
- 2.5 How would ASIC 'temporarily intervene' where the risk of significant consumer detriment arises in the DeFi sector, or in relation to a particular DeFi product?
- 2.6 What is an effective governance process across the lifecycle of a DeFi product?
- 2.7 What is ASIC's jurisdiction to intervene in circumstances like the bZx "attacks" where there is perceived or actual unfairness, detriment or wrongdoing in a very short period of time.