DLK ADVISORY

CRYPTO PRODUCTS AND FINANCIAL SERVICES LAW

In a landmark decision on the application of the financial services law to crypto-backed products, the Federal Court has found that a fintech company had provided unlicenced financial services and operated an unregistered managed investment scheme in the offering of a specific product. This decision provides more clarity as to when crypto-backed products are considered to be financial products which require licencing under the law and provide appropriate protections for consumers.

As background, the case concerned a fintech company registered with AUSTRAC which operated a digital currency exchange that allowed users to exchange Australian dollars into various cryptocurrencies including USD Coin, Bitcoin, and Ethereum. It also offered various products to its customers, one of which was the “Earner Product” which essentially allowed its customers to lend their crypto-assets back to the company and receive a fixed rate of return over the term of the loan. According to the facts in the Federal Court Judgment, this fintech company does not hold or have the benefit of an Australian Financial Services Licence (AFSL) and has never done so.

The Federal Court found that ASIC succeeded in establishing contraventions of ss 601ED and 911A of the Corporations Act 2001 in relation to the Earner Product, as the Court found that the product is a managed investment scheme (and was not registered and had more than 20 members). As a result, ASIC has stated that it will now seek orders from the Court imposing pecuniary penalties on the company involved.

In addition to this decision, ASIC continues to initiate investigations and other enforcement action against various companies to protect consumers from harms caused by crypto-asset offerings. According to various ASIC media releases, it currently has two civil penalty proceedings in relation to companies providing unlicensed financial services, and one case against a company for allegedly failing to comply with design and distribution obligations for a margin product offering.

Despite its success with the Federal Court decision, ASIC remains concerned that consumers do not fully appreciate the risk associated with products involving crypto-assets. It reminds consumers that many crypto-assets and other digital assets continue to be largely unregulated as they are not commonly considered to be financial products and when a product fails, consumers are most likely to lose all their money.

On top of the unregulated nature of a large proportion of crypto-assets, there is also the chance of consumers being caught up in crypto scams, with the three main types of scams being investing in a fake crypto exchange, website or app, fake crypto products or jobs trading in crypto, and using crypto to pay scammers. In the case of fake crypto exchanges, ASIC notes that the webpage or platform may mimic a real online exchange or wallet and either steal the legitimate logins of consumers already invested in crypto or use those webpages to entice consumers to invest money in fake crypto which appear to go up in value.

Crypto ponzi schemes and Initial Coin Offering “rug pull” scams are also increasingly common. As with normal ponzi schemes, the initial investor is promised large returns by investing in a particular crypto asset and is then encouraged to recruit family members and friends to the scheme. The promoter uses money from other investors to pay the “earnings” of the initial investor, and the scheme eventually collapses, leaving everyone out of pocket. Similarly, the “rug pull” scam involves hyping an initial coin offering, usually through social media. When the amount invested reaches a certain level, the scammer cashes out their coins and disappears. With the liquidity gone, the value of the coins plummets and becomes worthless.

These are just a few of the increasingly sophisticated scams in the crypto assets space, with the ACCC estimating that more $3bn were lost to financial scams in the last financial year. Consumers who fall prey to these scams are warned that transactions are not easy to recover, and in many cases, money is quickly sent overseas with limited oversight by either the banks or the authorities.

CONTACT

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