

Article Information

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Blockchain Bites: US Federal Reserve releases paper on tokenisation, Kraken hunted by Australian Regulator, TRM Labs: Australia home to >400 DCE's but regulatory clarity needed, FTX to liquidate crypto holdings

Michael Bacina, Steven Pettigrove, Jake Huang, Luke Higgins, Luke Misthos and Kelly Kim of the Piper Alderman Blockchain Group bring you the latest legal, regulatory and project updates in Blockchain and Digital Law.

US Federal Reserve releases paper on tokenisation

The US Federal Reserve, the central banking system of the USA, has released [a paper](#) on “tokenization” (technically spelled tokenisation in Australia) considering the benefits and risks of tokenization.

First up, tokenization is defined as:

the process of linking reference assets to crypto tokens via design features that link the token’s price to the value of the token’s reference asset

And the Fed highlights 5 key design features:

1. a blockchain;
2. a reference asset;
3. a mechanism to assess the value of the reference asset;
4. a means to store and/or provide custody for the reference asset; and
5. a mechanism to facilitate redemptions of the token and/or the reference asset.

The market for tokenized assets is estimated by the Fed to be only USD\$2.15M as of May 2023 with approximately \$700M of that locked in DeFi protocols. Gold is highlighted as the largest tokenized asset, accounting for nearly half the estimated market, and real estate as a very challenging asset to tokenize, due to all the legal requirements around the transfer of ownership.

The Fed highlights the benefits of tokenization as including:

- granting investors access to markets that might be inaccessible;
- programmability of crypto tokens and smart contracts to access additional features not currently available;
- facilitating the lending against new collateral types in cheaper ways;
- faster settlement in tokenized assets than in real-world counterparts;
- improved liquidity, in the same way that ETFs have improved liquidity of the assets in those ETFs.

Financial stability implications are an area of concern in the paper, with a clear concern being a linking of volatile crypto prices and the traditional financial markets in the longer term. The concerns of crypto and traditional price linking is again compared to ETFs where academic literature has found a strong correlation between liquidity, price discovery and volatility of ETFs and the underlying assets. Other stability concerns raised include automatic margin sales by smart contracts or inaccessibility of markets if there is a run on a weekend.

The fact that the US Federal Reserve, one of the most watched central banks in the world, is building its institutional knowledge around tokenisation and crypto-assets, is a positive step and signal to the increasing growth and spread of blockchain technology.

By Michael Bacina

Kraken hunted by Australian Regulator

The Australian Securities and Investments Commission (**ASIC**) announced today that it has commenced legal proceedings against the Australian arm of global crypto exchange, Kraken.

In a [press release](#), ASIC asserted that a margin trading product offered by Kraken (through a registered digital asset exchange entity, Bit Trade Pty Ltd) was a 'credit facility' and that publication of a Target Market Determination (**TMD**) for retail users was required. A TMD is part of Design and Distribution Obligations (**DDO**) which require businesses offering retail financial products to assess the needs of users, and to distribute those products in a targeted manner.

ASIC has sought an injunction to prevent the product from being offered. No court date has yet been set.

Kraken's product

According to [ASIC's Court filing](#), the margin trading product is a credit facility as it provides customers credit to buy and sell certain crypto assets on the Kraken exchange. Kraken calls the product Margin Extension.

To obtain a margin extension, a customer must have a minimum balance of certain crypto assets in their account to be used as collateral. Customers can receive an extension of margin of up to 5 times the value of their collateral. Kraken charges an opening and rollover fee for the extension of margin.

If a customer's collateral level falls below a required minimum, Kraken may sell the customer's crypto assets and apply the proceeds to repay the margin extension such that the customer's collateral reaches the minimum requirement.

DDO obligations

ASIC claims Kraken's Margin Extension product satisfies the expanded financial product definition in the *Australian Securities and Investment Commission Act 2001* (Cth), to which DDO apply when the product is issued to retail clients.

Accordingly, it says that Kraken was required to issue a TMD on and from 5 October 2021 which corresponds with start of ASIC's DDO powers. The Managing Director of Kraken Australia, Mr Jonathon Miller said to the [Australian Financial Review](#):

We have been attempting to constructively engage with ASIC on this matter for some time to ensure our product offering, as an AUSTRAC registered Digital Currency Exchange, remains compliant...[w]e are both surprised and disappointed to have received today's enforcement action. We believe this product is offered in compliance with Australian law, and will continue our efforts to receive clarity on this matter.

This is a similar theme which emerged from other ASIC crypto-related prosecutions, which appears counter to the policy objective of managing risk in crypto-assets. ASIC is [seeking](#) declarations, pecuniary penalties and an injunction prohibiting Bit Trade from continuing to distribute the product.

This latest enforcement action by ASIC follows a [series of regulatory enforcement actions in relation to crypto-asset related offerings](#). ASIC's has [identified both DDO and crypto-assets as top enforcement priorities in its corporate plan](#), with a particular focus on products which ASIC says mimic traditional financial products. The latest action suggests that ASIC will test the limits of its DDO powers in relation to crypto-based products. ASIC has been [making increasing use of its DDO powers as an enforcement tool](#), especially in relation to funds and derivative products.

Unfortunately there is presently no guidance published by ASIC setting out how a TMD would be prepared or published for any crypto-product, or a margin product similar to the Margin Extension product.

By Michael Bacina, Steven Pettigrove and Jake Huang

TRM Labs on regulation and crime: Australia home to >400 DCE's but regulatory clarity needed

In a TRM Labs webinar today with TRM Policy Lead Angela Ang, Steve Vallas, Ari Redford and Joni Pirovich, Brad Brown of AUSTRAC confirmed that Australia is home to 400 registered digital currency exchanges ranging from multi-national exchange operators right down to sole operators.

Angela Ang noted that ASIC had highlighted the popularity of crypto-assets with Australians, but Steve Vallas shared some insights that the local Australian market is:

Dominated by a narrative of scams, at the expense of the international opportunity...when I ran the Digital Asset Conference, we brought businesses that are international... to show how they can work.

And

geography used to matter a lot more now, but it's just data packets, historically [Australia's] weakness has been our geographical location.

Joni Pirovich said:

There's still a significant education gap which is still to be bridged.

Brad Brown said:

[AUSTRAC] collect a lot of information with annual reports... we are seeing at the medium business a lot of outsourcing of AML obligations, which is not necessarily a bad thing... we have been trying to bring [the larger entities] into the tent... with AUSTRAC's fintel alliance.

Angela Ang said:

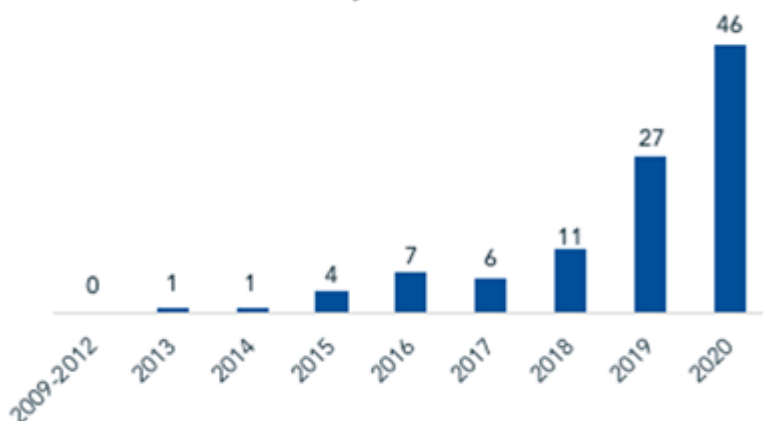
From my time at MAS, the crypto companies and regulators started speaking different languages and it takes time... for a conversation to happen.

On the topic of financial crime Mr Brown said:

There is plenty of crime that relates to the use or misuse of cryptocurrency or criminals who seek to use crypto via layering or placement, across multiple different crime types, cryptocurrencies are just another medium of use that can be laundered or moved internationally.

TRM Labs has analyzed the reported Australian [criminal cases](#) which referred to crypto-assets, identifying an increase in criminal use of crypto-assets being prosecuted.

Australian Cryptocurrency Cases, by Year



Source: Aaron Lane and Lisanne Adam, 'Crime and Cryptocurrency in Australian Courts' (2022) 48(3) Monash University Law Review (advance).

TRM identified that the use of crypto was considered an aggravating factor by courts in sentencing, showing that criminals using crypto is a more sophisticated action by criminals and hence requiring a greater punishment. Importantly TRM also found that offenders were caught with 'traditional policing methods' and not necessarily from blockchain analytics, but that in a couple of causes there was undercover work to break into darknet markets.

Mr Vallas made a valid point on the power of Government in signalling a welcoming approach to innovation:

Overseas jurisdictions are putting forward a supportive narrative, Singapore in particular has a pathway ... for people to succeed... in Dubai there are signals with VARA ... Australia is lacking signalling from Government and businesses at a minimum are looking at other jurisdictions... I speak to a lot of lawyers who say businesses are asking 'what is a welcoming jurisdiction' and that's not Australia.

Ms Ang observed:

The industry wants clarity on what is expected by regulators ... [in jurisdictions] where they can get that the industry is willing to put in the work and engage. We need proportionality as well, [when] we apply the Financial Stability Board's same risk same regulation framework it has to be done in a thoughtful way, [because] how this looks in practice can be very different, while the law can be technology neutral, it is important that the actual application has to be mindful because of these differences.

In closing Mr Brown said:

AUSTRAC will keep investing in preparing reports so there is more information available to the public.

As Australia likely moves towards a regulatory framework under the existing Australian Financial Services Licence regime, it will be essential to have a thoughtful application of nuanced requirements to this new technology if the blockchain innovation happening around the world is to find a home in Australia.

By Michael Bacina

Grand Sale, Grand Sale! FTX to liquidate crypto holdings

FTX, the [bankrupt cryptocurrency exchange](#), has received US Court approval to invest and sell down its crypto asset holdings. The "coin monetization" strategy is intended to minimize risks related to price volatility, maximize sales value and increase cash distributions to creditors.

At a hearing on 13 September in the Bankruptcy Court in Delaware, Judge John Dorsey [approved FTX's proposal allowing the company's bankruptcy advisors to sell up to \\$100 million in cryptocurrency per week](#) (which can be increased to up to \$200 million per week, subject to conditions) and enter into hedging and staking agreements that will allow FTX to minimize price volatility and earn passive income on some of the crypto assets like bitcoin and ether.

The Judge dismissed concerns raised about the monetization plan including:

- claims raised by two FTX customers who said the sales could cause crypto prices to crash and that FTX may not own all of the crypto assets that it holds;
- claims previously raised by the Ad Hoc Committee of FTX's non-US customers in an [adversary proceeding](#) that the crypto assets are customer property, not property of FTX's estate; and
- similar claims raised by some customers of FTX in a US [class action](#).

Ultimately, FTX's Official Committee of Unsecured Creditors, the Ad Hoc Committee and the class action plaintiffs all supported the plan despite some reservations.

The bankruptcy advisors to FTX noted the plan will increase the "overall net benefit of the estate" and enable the dollarisation of claims in order to maximise distributions.

Further, FTX said that the parties advancing the trust claims have not provided any evidence to demonstrate their property interest in specific crypto assets held by FTX:

so absent a very specific assertion by customers, there is no way for us to trace individual cryptocurrency to individual customers. It's all part of one pool.

FTX emphasized that it is the claimant's burden to:

show an interest in property or to specify with particularity what property of ours is theirs actually...we don't see an allegation of specificity that we can respond to...

The Ad Hoc Committee's noted:

we don't necessarily agree with everything the debtor said about the traceability of property interest.

However, the Committee nevertheless supported the motion, due to the need to dollarize the assets and liquidate them in a

market favourable way over an appropriate period, with the assistance and expertise of experts in the area.

In court filings, FTX said it was aware that its attempt to liquidate coins could move the crypto market. To mitigate this risk, the exchange has hired the [US crypto firm Galaxy](#) as an investment advisor to manage the risk of “information leakage” potentially triggering short-selling activities and causing abrupt crypto price declines. But keeping FTX’s current crypto portfolio also carries risks, potentially locking FTX into holding certain assets as their prices drop.

FTX said in a [document](#) filed ahead of the hearing that its estate has recovered US\$3.4 billion in so-called “Category A” crypto assets so far, including US\$1.16 billion worth of Solana, US\$560 million in bitcoin, and US\$192 million in ether. Category A assets are tokens with a market capitalization of at least US\$15 million and an average daily trading volume of at least US\$1 million during the past 30 days. The exchange’s top holdings of Category A assets are shown in the table at the beginning of this article.

Last month, FTX filed a [draft plan of reorganization](#) with the intention of seeking agreement on the plan by Q2 2024. The parties indicated at last week’s hearing that they will strive to speed up that process. FTX Customers must file their claims in the Chapter 11 bankruptcy by [29 September 2023](#).

By Jake Huang and Steven Pettigrove