Article Information

Author: Michael Bacina, Steven Pettigrove
Service: Blockchain, FinTech
Sector: Financial Services, IT & Telecommunications

Blockchain Bites: Australia promises to regulate crypto, Timeline of FTX's collapse, JP Morgan completes on-chain pilot of bond transfers, Hong Kong strives to regain Asia's crypto crown

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

Australian government promises to lead the way on crypto custody and licensing

The Australian government has provided its response to the events of the recent week and has promised to make Australia a leader in regulating crypto custody by bringing forward plans to provide crypto custody and centralised exchange licensing. The last media release from the Assistant Treasurer, The Hon Stephen Jones promised that the government would improve the way Australia manages risk around crypto assets and recognised that regulation was struggling to keep up with the pace and adoption of crypto-assets.

Senator Andrew Bragg, writing in an opinion piece in the Australian Financial Review, said:

> FTX did not have an Australian cryptocurrency licence, because no such licensing regime exists. Its Australian licences did not relate to cryptocurrency. And the allegations of fraud are comparable to those in any other industry.

Senator Bragg rightly points out that the best way to protect consumers is to establish regulated markets, being businesses where the risk of undetected wrongdoing can have very significant consequences. This should not be a political or partisan principle, and last year's Senate Select Committee and Final Report was a bipartisan consultation.

A spokesman for Treasurer Jim Chalmers said to the AFR that draft regulation would be introduced into the Australian parliament next year and that:

> We are closely monitoring the fallout from the FTX collapse, including further volatility in crypto asset markets and any spillovers into financial markets more broadly

Leading exchange BTC Markets said:

> The focus for regulators should be on governing human behaviour rather than the underlying technology. Assets such as Bitcoin and Ethereum should not be part of the discussion, instead it's the actions of the management team that resulted in the use of client funds requires scrutiny

A draft bill has been proposed by Senator Bragg and he has taken private submissions and met with industry to gain feedback. That private member's bill represents a good starting point (and will not become law) but a great deal more work is needed, and urgently, to bring together comprehensive and technology-enabling legislation.

Regulation and legislation takes time to develop and ensure fitness for purpose, otherwise unexpected outcomes will occur and businesses will be pushed offshore, creating the very risks which are of concern presently.

Timeline of FTX's collapse

The fall of FTX Trading Pty Ltd, a Bahamas based crypto exchange that was once the third largest in the world, was shocking and has been closely watched and will have a significant impact on the crypto world. Below we chart some key dates in the collapse.

- **2 November – Leaked balance sheet**

CoinDesk reported on a leaked balance sheet from Alameda Research, Sam Bankman-Fried's hedge fund, reporting that much of Alameda's reserves were based on the FTX native token FTT and that Alameda held far more of those tokens than were tradeable on the market. CoinDesk suggested that Alameda's stake would be hard to liquidate at the current market prices.

- **6 November – Binance announces plan to sell its FTT holdings**

The CEO of Binance, Changpeng Zhao (CZ), announced via Twitter his plan to sell Binance's FTT holdings. This resulted in a significant fall in the price of FTT.

- **8 November – Binance announces intention to acquire FTX**

SBF and CZ announced via Twitter that Binance signed a non-binding letter of intent to buy FTX. The deal was subject to due diligence with CZ noting that:

> There is a lot to cover and will take some time. This is a highly dynamic situation, and we are assessing the situation in real time. Binance has the discretion to pull out from the deal at any time. We expect FTT to be highly volatile in the coming days as things develop.

- **9 November – Binance pulls out of deal and regulators investigate FTX, FTX Withdrawals "sluggish"**

After urgent due diligence review, Binance announced that it will proceed with the deal to acquire FTX and that the 'issues are beyond our control or ability to help'. The SEC also announced that they were looking into allegations of mishandled customer funds by FTX US and Alameda Research.

FTX withdrawals are reported to have become "sluggish". Reports come out that "most" of the FTX legal and compliance team have quit. Crypto.com stopping withdrawals of USDC and USDT on the Solana blockchain.

- **10 November – Alameda Research collapses and FTX seeks finance**

In an attempt to save FTX, or at least limit exposure, the sister entity, Alameda Research, began to wind down trading. Then CEO of FTX, Sam Bankman-Fried (SBF), announced the move on Twitter:

> [R]ight now, we're spending the week doing everything we can to raise liquidity. I can't make any promises about that.

FTX needing liquidity, turned to investors, seeking around $9.4 billion to rescue the company from the fall with many users pulling out their holdings.

- **11 November – FTX Trading files for bankruptcy and SBF steps down**

SBF steps down as CEO and to only act to assist in an orderly transition. FTX, along with around 130 other associated entities, filed for Chapter 11 bankruptcy. FTX announced that this movement to start bankruptcy proceedings is:

> to review and monetize assets for the benefit of all global stakeholders.

FTX Australia Pty Ltd an FTX Express Pty Ltd entered external administration in Australia and were carved out of the Chapter 11 announcement (see article below).

- **12 November – Unaccounted for customer funds**

Blockchain analytics firm Elliptic announced that $473 million in assets were:

> moved out of FTX wallets in suspicious circumstances.

FTX US general counsel Ryne Miller, said via Twitter that the company:

> initiated precautionary steps to move all digital assets to cold storage.

- **13 November – Bahamas authorities take action**

The Bahamas Securities Commission announced that they are conducting an investigation not FTX to determine if:

> any criminal misconduct occurred.

- **16 November – SBF gives stunning interviews**

SBF continues to post comments to Twitter and gives an interview over twitter messages to Vox which sets out his intention to try and help, but also appears to implicate his behaviour and decisions.

The Sydney Morning Herald:

> Alameda had accumulated a large "margin position" on FTX, essentially meaning it had borrowed funds from the exchange, Bankman-Fried said. "It was substantially larger than I had thought it was," he said. "And in fact the downside risk was very significant." He said the size of the position was in the billions of dollars, but declined to provide further details.

- **18 November – Bankruptcy Trustee Jay Ray III speaks out**

The Bankruptcy Trustee, Mr Jay Ray III said of his preliminary investigations:

> From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented

This underscores that the collapse was not due to any technological issue with blockchain or cryptocurrency, but appears to be due to the decisions and actions of a small group of people, compounded by the systems and processes at FTX.

What's Next?

At this stage, there is uncertainty around whether there will be further contagion in the industry and what this collapse will mean for the crypto industry and regulation more broadly, with plans for crypto exchange licensing in Australia brought forward in response.

FTX Frozen in Bahamas, FTX Australia in administration

The Bahamian Securities Commission reported on 11 November that they were freezing the assets of FTX Digital Markets after a week which saw the exchange face a liquidity crunch, a potential bail out by Binance and then Justin Sun, and a relentlessly upbeat tweets from SBF apologizing and promising to fix the problem.

FTX Australia, a wholly owned subsidiary of FTX Trading Limited, announced on the same day that it had appointed administrators to take over the company, and that it was co-operating with the regulator ASIC, to secure the best outcome for Australian clients.

The sudden implosion of FTX underscores the need for fit for purpose regulation of centralised exchanges, which should as a matter of good practice be segregating client assets and keeping those assets in safe custody. Rumours have been circulating that FTX Trading / FTX Digital Markets user assets were not properly segregated, and more information as to the goings on inside the exchange may come to light.

The Australian Blockchain industry has been advocating for custody rules for exchanges for over a year, on the basis that such rules would help require the segregation of assets and protect customers in the event of an exchange collapse.

Standards have been proposed by the regulator ASIC for exchange traded products in Report 705, and in the recent CASSPr discussion paper. However, the only exchange traded funds, Cosmos, used synthetic derivatives, not spot holdings, so did not have any compliance obligations around custody.

The only retail crypto funds in Australia which would be required to apply these custody standards, were the subject of stop orders when ASIC recently alleged that the target market determinations accompanying those funds were not compliant, and it is unclear just what changes would have been accepted as compliant by ASIC for those funds to continue to operate. The fund issuer, Holon, published their entire chain of correspondence with the regulator to highlight the strange situation.

In the US, a bill backed by SBF which seeks to increase regulation of exchanges under commodity market monitoring is moving forward, despite opposition and claims it was 'dead'. The fallout from FTX's failure is likely to continue, with BlockFi announcing a pause to withdrawals a few hours ago in light of the situation with FTX.

JP Morgan completes on-chain pilot of government bond transfers

The Monetary Authority of Singapore (**MAS**) has announced the first industry pilot under Project Guardian, an MAS initiative which seeks to explore the economic potential and value-adding use cases of digital assets and asset tokenisation. The pilot, which explores the potential of decentralised finance (**DeFi**) applications in wholesale funding markets, has completed its first live trades.

Under the first industry pilot, JP Morgan, DBS Bank and SBI Digital Asset Holdings conducted foreign exchange and government bond transactions against liquidity pools comprising of tokenised securities bonds from the Singapore Government, Japanese Government as well as the Japanese Yen and the Singapore Dollar.

A successful, cross-currency transaction involving tokenised Yen and Singapore Dollar was conducted and a simulated exercise was also conducted involving the buying and selling of tokenised government bonds.

DeFi enables financial transactions to occur instantly and between two entities, without the need for intermediaries. The pilot transaction proves cross-currency transactions can be traded, cleared and settled instantaneously, freeing up costs owed to financial intermediaries.

Sopnedu Mohanty, Chief FinTech Officer of MAS said:

> The live pilots led by industry participants demonstrate that with the appropriate guardrails in place, digital assets and decentralised finance have the potential to transform capital markets.

Since the announcement of Project Guardian earlier this year, MAS has been working to be seen to be engaged with the financial industry to identify collaboration areas using digital assets in what could be a precursor of financial services businesses acting as a layer between customers and Defi, potentially bringing the benefits of DeFi and the safety of TradFi rails.

Hong Kong strives to regain Asia's crypto crown

At the opening of Hong Kong's flagship Fintech conference last month, the city's officials issued a policy statement on virtual assets, announcing that Hong Kong is "ready to engage" with global virtual asset service providers and invite them to the city.

This policy statement not only demonstrates Hong Kong's confidence in the future of financial innovation brought by virtual assets (**VA**) and Web 3.0, but also shows its determination to stay relevant as an international financial centre:

> As an international financial centre, Hong Kong is open and inclusive towards the global community of innovators engaging in VA businesses… We recognise VA is here to stay, given how it has attracted attention of global investors and is increasingly viewed as a conduit for financial innovations, not to mention the

future opportunities that will be opened up as VA moves into the areas of Web 3.0 and the Metaverse.

Key takeaways from this policy statement include:

- introducing a new licensing regime for Virtual Asset Service Providers (**VASP**), which will align requirements for VA exchanges in terms of AML/CTF and investor protection to those currently applicable to traditional financial institutions;
- announcing a public consultation on how retail investors could have a suitable degree of access to digital assets, while signaling Hong Kong's openess to having Exchange Traded Funds on VA. The Securities and Futures Commission (SFC) soon followed up with a circular;
- signalling openness to property rights for tokenised assets and the legality of smart contracts;
- discussing continous effort to implement a risk-based, proportionate, and agile framework for stablecoins regulation;
- exploring several pilot projects to test the technological benefits brought by VA and their further applications in the financial markets, including NFT issuance for the Hong Kong Fintech Week, green bond tokenisation and e-HKD.

Among other things, this statement represents a significant change of position on retail crypto trading by Hong Kong's authorities: current rules restrict crypto trades to institutional investors with a portfolio of at least HK$8m (US$1m). It also stand in contrast with Singapore's recent efforts to restrict retail crypto trading.

Commentators view this as an effort by Hong Kong to position itself as a much more open jurisdiction for crypto trading as compared to Singapore, which is especially interesting in the context of mainland China's ban on cryptos.

Hong Kong once wore the crypto crown in Asia, being the home of many global exchanges' headquarters or regional offices. However, in recent years Singapore has gradually taken the position away, by actively exploring regulation and welcoming the crypto industry, despite mixed messages at times. According to Chainanlysis, Hong Kong received about US$74bn in terms of the value of crypto assets received last financial year, trailing the $100bn received by Singapore.

It is unclear how the recent collapse of FTX and the turbulence it causes to the crypto market will impact on Hong Kong's position. We will continue to follow up on developments.