## Article Information

Authors: Michael Bacina, Steven Pettigrove, Jake Huang, Luke Higgins, Luke Misthos, Kelly Kim, Dorothy Sam
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# Blockchain Bites: JPEX in hot soup as Hong Kong SFC vows to ladle out justice, EU may say au revoir to major stablecoins under MiCA, Decentralised Governance and DAOs: Machiavelli as a solution? Celsius customer clawbacks coming as creditors confirm Reorg Plan

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

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***JPEX in hot soup as Hong Kong SFC vows to ladle out justice***

In response to the rapidly shifting terrain of 'virtual asset trading platforms' (**VATPs**), Hong Kong's Securities and Futures Commission (SFC) announced it is taking action to fortify investor protection and enhance information sharing within the ever-evolving 'virtual asset' marketplace.

The timing of this announcement couldn't be more fitting, following the tumultuous JPEX crypto exchange scandal that has sent shockwaves through Hong Kong's financial circles. The SFC's intention is clear: to help the public discern the legitimate from the unregulated VATPs that might be prowling in Hong Kong's bustling crypto jungle to prevent similar events in future.

To address the concerns raised by the JPEX incident, the SFC suggests the implementation of a series of pivotal measures:

1. **Published VATP Lists**: The SFC wants to "ensure that information is disseminated in a clear, transparent and timely manner." The SFC intends to publish lists of licensed VATPs, VATPs mandated to close down within a specified period, VATPs deemed licensed as of June 1, 2024, and a list of VATP applicants.
2. **Enhancing the Spotlight on Suspicious VATPs**: To assist the public in discerning the reputable from the rogue in Hong Kong's VA landscape, the SFC will elevate and prominently display a dedicated list of 'suspicious' VATPs on its website (no word yet on the SFC's definition of 'suspicious').
3. **A Campaign for Public Vigilance**: The SFC, in partnership with the Investor and Financial Education Council (**IFEC**), is launching a public campaign aimed at elevating awareness about fraud prevention. This campaign will utilise various channels, including mass media, social media platforms, and educational seminars.
4. **Sharpened Intelligence Gathering and Enforcement**: The SFC states that is committed to strengthening its intelligence gathering process related to VA-related businesses and encourages the public to report any suspicious activities through the SFC's Online Complaint Form, providing vital intelligence.

The decision to publish the lists of VATPs was in direct response to public demand, according to Julia Leung Fung-yee, the CEO of the SFC. She emphasised, however, that an application for licensing doesn't necessarily translate to full compliance with the SFC's rules and regulations.

Until now, the cryptocurrency trading landscape in Hong Kong had been relatively exclusive, with just two platforms, OSL Digital Securities Limited and Hash Blockchain Limited, securing licenses to serve retail customers following the SFC's new virtual asset rules implemented on 1 June 2023.

The financial fracas of the JPEX incident, which has sent shockwaves through Hong Kong, is believed to be the city's largest-ever financial fraud, affecting over 2,300 victims and an estimated HK$1.43 billion.

The JPEX saga unfolded after the Dubai-based crypto exchange was accused of running without a license in Hong Kong, where it had garnered a substantial customer base. The SFC also alleged out that certain online influencers and over-the-counter virtual asset money changers had disseminated false information, by claiming that JPEX had applied for a VATP license.

In the ensuing panic, investors rushed to withdraw their assets, only to find that they could withdraw a maximum of 1,000 USDT, the dollar-pegged stablecoin issued by Tether. The withdrawal, however, came with an unexpected sting — an administrative fee of 980 USDT. The exchange eventually suspended withdrawals, citing "unfair treatment by relevant institutions in Hong Kong."

The Hong Kong police have since taken action, arresting 11 individuals linked to the JPEX scandal, including social media influencer Joseph Lam Chok. These suspects are facing charges of fraud and operating an unlicensed virtual asset exchange.

With measures ranging from public awareness campaigns to enhanced information dissemination, the SFC's proactive stance signifies a commitment to learning from past mistakes and steering Hong Kong's constantly evolving blockchain industry towards a bright, more secure future. The SFC's actions continue to set the benchmark for other jurisdictions seeking to keep up, offering hope that the lessons of today will shape a more resilient and global crypto ecosystem.

Australia could learn from Hong Kong, right now there is no way for users to check with AUSTRAC whether a digital currency exchange is registered with AUSTRACT, and such a move would help provide at least some indication of standards being met. Once licensing is in place for Australian digital currency exchanges (Australia doesn't use VASP language unlikely much of the rest of the world), then free searches for licence holders will likely be available if the AFSL regime is used (which appears likely).

*By M Bacina, S Pettigrove, and L Higgins*

**EU may say au revoir to major stablecoins under MiCA**

As the application of the European Union's (**EU**) Markets in Crypto-asset Regulation (**MiCA**) draws near, speculation is growing as to how its stablecoin framework will apply to foreign and decentralised issuers.

Adopted by the bloc on 20 April 2023, MiCA is the world's first leading regulatory framework designed to regulate digital assets across the EU. The provisions for stablecoins in MiCA will apply from 30 June 2024, six months ahead of other rules on licensing for crypto wallet provides and exchanges.

As we previously advised, MiCA sets governance and reserve requirements for two types of stablecoins:

1. crypto-assets that purport to maintain a stable value by referencing the value of one official currency (known as an **Electronic Money Token** or **EMT**); and
2. crypto-assets that purport to maintain a stable value by referencing another value or right or a combination thereof, including one or more official currencies (known as an **Asset-referenced Token** or **ART**).

MiCA's application to NFTs is cocooned in nuance and complexity and its application to stablecoin issuers has caused similar confusion for stablecoin issuers that are preparing to abide by compliance obligations.

Marina Parthuist, head of legal at Binance France, expressed skepticism regarding Binance's ability to comply with MiCA. Speaking to an online public hearing hosted by the European Banking Authority, Ms Parthuist seemed pessimistic about MiCA's application to Binance's stablecoin offerings:

> *This [MiCA] could have a significant impact on the market in Europe compared to the rest of the world.*

and that Binance is:

> *heading to a delisting of all stablecoins in Europe on June 30.*

The striking comments made by Ms Parthuist was quickly doused by Binance CEO Changpeng Zhao who, on X, announced Ms Parthuist's response was taken out of context and that Binance has partners launching in Europe.

MiCA also requires issuers of stablecoins to be EU-based undertakings, a significant compliance hurdle that will affect entities with favourable offshore governance models and/or decentralised entities.

While MiCA does not apply to Australian issuers or entities (insofar as they operate outside of the EU), there is a lesson to be learn with respect to unclear or unnecessarily complex hurdles that impact adoption. This is especially pertinent due to Australia's recent uptick in innovation and development relating to stablecoins by private banks, such as ANZ's exploration of tokenised asset use cases and government departments such as the RBA testing an Australian CBDC.

*By M Bacina and L Misthos*

**Decentralised Governance and DAOs: Machiavelli as a solution?**

In a paper released this week, Miles Jennings of A16Z Crypto, offers a fresh perspective on how to tackle the challenges emerging in decentralised governance models within the web3 landscape using Machiavellian principles.

Most web3 decentralised governance models are currently administered by decentralised autonomous organisations (**DAOs**). These DAOs draw from both direct and indirect democracy, as well as concepts from corporate governance.

Jennings says:

> *the majority of DAOs have failed to overcome the complexities and socio-political realities involved in decentralized governance, and their legitimacy and utility has suffered as a result.*

As a new and upcoming organisational structure which operates outside existing legislative frameworks in many countries, DAOs face a range of governance issues. In Jennings' paper, five key issues are explored.

1. *Lack of Coordination*. Decentralisation, a defining feature of DAOs, means that decisions are collectively made by members. Without proper leadership or plans put in place, coordinating and developing web3 projects can be difficult.
2. *Interest Misalignment*. DAOs mostly rely on token-based voting, which can lead to power imbalances and conflicts of interests. Aligning the interests of DAO members and token holders is a challenge.
3. *Lack of Accountability*. DAOs currently lack governance mechanisms to hold token holders accountable for poor decisions. Assigning responsibility can be hard without clear leadership, particularly given judging who made bad contributions is subjective.
4. *Vulnerability to attack*. Token-based voting systems can be vulnerable to manipulations like vote buying. Token holders may be motivated to manipulate the system by separating their economic interest from governing power.
5. *Low participation*. Direct democratic models often suffer from low voter turnout. This can open the door to more manipulation by specific groups who hold more power.

Some solutions have been introduced by DAOs and their communities to address these issues. These include:

1. ***Implementing representative democracy mechanisms*** through token holders electing delegates to vote on their behalf in the DAO;
2. ***Creating subDAOS*** to help finish dedicated tasks and coordinate openly with other subDAOs; and
3. ***Adopting non-token-based governance*** such as proof of personhood and proof of participation to address token voting issues.

There are also ways to ***increase accountability*** through paying DAO contributors more competitively to get the right people on board, setting clear performance criteria for token holders to evaluate performance, and introducing forking, a way where DAOs can let better decision makers 'fork' worse decision makers.

According to Jennings, Machiavelli's principles help explain and address web3's decentralised governance problems.

- ***Principle 1***: Acknowledging that true democracy is often unattainable due to voter ignorance and limited engagement. This can be seen in low voting participation rates in web3.
- ***Principle 2:*** Recognising the natural tendency for organisations, including web3 DAOs, ending up as autocratic structures. Initial founders of the DAO's protocol are likely to become the ones with power.

- ***Principle 3:*** Understanding that unchecked leaders can exploit their power and resist accountability from token holders.
- ***Principle 4:*** Emphasising the importance of opposition within DAOs to foster healthy competition by addressing the inequalities in token holding between competing parties.
- ***Principle 5:*** Underscoring the need for new leaders to rise into the leadership class. This involves addressing issues with DAO community members attaining true power due to the high costs involved in attaining tokens.

Jennings introduces four Machiavelli-inspired guidelines targeting these issues:

1. Embracing governance minimisation;
2. Creating a balanced leadership group 'that is subject to perpetual opposition';
3. Providing ways for regular changes to leadership; and
4. increasing 'the overall accountability of the leadership class'.

Jennings plans to expand on his proposals for implementing these principles in a future paper. The guidelines suggest that DAO governance will continue to evolve and a principles based framework for addressing current problems. As Jennings reflects, there is a fine balance between keeping the key objective of decentralisation and implementing too many changes that may undermine it. It will be interesting to see how DAOs continue to navigate this balance, especially as a number of jurisdictions around the world consider endorsing the DAO structure as a new form of legal vehicle.

*By M Bacina, S Pettigrove, D Sam and T Masters*

**Celsius customer clawbacks coming as creditors confirm Reorg Plan**

Fourteen months after Celsius Network filed for Chapter 11 bankruptcy protection in the US, creditors this week approved a Reorganisation Plan (**Plan**) with more than 98% of retail creditors voting in favour, which could see a recovery rate of between 67 and 85 cents on the dollar.

The US Bankruptcy Court for the Southern District of New York will hold a confirmation hearing for final approval on 2 October. If approved, the reorganisation will impact about 600,000 customer accounts that held assets valued at US$4.2 billion.

The Plan contemplates that the Celsius bankruptcy estate will have the right to claw back, or offset customer withdrawals and other transactions in the months leading to Celsius' bankruptcy. The US bankruptcy code allows clawback of transactions that took place up to three months before Celsius filed for Chapter 11 bankruptcy protection on 13 July 2022.

In summary, the Plan says that:

1. Customers who made net withdrawals of less than US$100k in the 90 days prior to bankruptcy and agree to the Plan will not face clawback claims;
2. In contrast, customers who had net withdrawals of between US$100k to US$250k can settle claims for 27.5% of their funds;
3. The bankruptcy estate may pursue those who withdrew over US$250k.

The clawback provisions could impact customers who withdrew significant funds shortly before Celsius went down unless they can rely on one of the various clawback defences under the US bankruptcy code. There are certain defences under US bankruptcy laws which may be available to these creditors, depending on their individual circumstances.

Stablecoin issuer Tether recovered US$840 million from Celsius by selling collateral, and Voyager Digital (another bankrupt crypto firm) withdrew at least US$7.7 million from Celsius in the 90 days before it went bankrupt. It remains to be seen whether they will be able to rely on defences typically available to financial intermediaries under US bankruptcy legislation.

If approved by the Court, the Plan will also see the sale of Celsius assets to crypto consortium Fahrenheit Holdings, which won a bid to acquire the Celsius assets in May 2023.

Celsius halted withdrawals in July 2022 and filed for bankruptcy as crypto winter set in (following the collapses of Luna/Terra and Three Arrows, and followed by FTX). The Celsius bankruptcy has dealt with a number of complex and novel legal issues relating to creditor claims and crypto-assets. For example, in January this year, the US bankruptcy court found that certain assets held by Celsius were property of the company, not customers themselves, under applicable terms and conditions.

Celsius also agreed to a US$4.7 billion suspended settlement with the Federal Trade Commission, however, it has said this settlement will not affect any reorganisation plans as it will not be paid until customer assets are returned.

Due to the notorious complexity of the US Chapter 11 bankruptcy process, customers and other creditors who recovered over US$100k before Celsius filed for bankruptcy will need to consider their options if the Plan obtains Court approval on 2 October, and instructing legal counsel to explore potential defences to clawback claims.

*Written by J Huang and S Pettigrove*