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Blockchain Bites: Regulation by enforcement, Stablecoins lead regulation race, Barclays sees gold in Copper, SEC investigates Coinbase

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

'Regulation by enforcement' by US SEC meet with criticism from crypto industry and other regulators

Late last week the US Securities and Exchange Commission announced insider trading charges against a former Coinbase employee, his brother, and their friend, while the indictment claims that some of the tokens which were part of the alleged scheme were securities under US law, including POWR, issued by Australian based Power Ledger.

The regulatory development of crypto-assets has been ongoing for many years and unfortunately the "regulation by enforcement" approach of the SEC is a distraction and potential impediment to considered and sensible regulation.

The facts surrounding the alleged wrongdoing are relatively straightforward. The SEC alleges that the former employee in question was a part of a group at Coinbase who had prior knowledge of which tokens would be made available for trading on the Coinbase exchange. All Coinbase employees were warned not to trade tokens on the basis of any information gained during their employment. The former employee in question allegedly tipped off his brother and a friend to upcoming token sales, making profits of USD$1.1M by front running listings in over 25 tokens. When called in for a meeting with Coinbase, the former employee bought a one way ticket to India and sought to flee the country, but was stopped at the airport.

On the token classification side, the SEC Complaint opens with the assertion that the insider trading involved "crypto asset securities" and goes on to say:

> *A digital token or crypto asset is a crypto asset security if it meets the definition of a security, which the Securities Act defines to include "investment contract," i.e., if it constitutes an investment of money, in a common enterprise, with a reasonable expectation of profit derived from the efforts of others. … [the defendant] provided material, nonpublic information about, and [the other defendants] traded in, at least nine crypto asset securities that meet this definition.*

The complaint continues [at 90]:

> *… each of the nine crypto asset securities were offered and sold by an issuer to raise money that would be used for the issuer's business. In the offerings, the issuers directly sold crypto asset securities to investors in return for consideration (most commonly Bitcoin, Ether, U.S. dollars, or other fiat currency, or processed through the use of smart contracts). The crypto asset securities then were issued and distributed to the investors' blockchain addresses.*
>
> *As alleged in greater detail below, the issuers and their promoters solicited investors by touting the potential for profits to be earned from investing in these securities based on the efforts of others. These*

> *statements focused on, among other things, the value of the token at issue and the ability for investors to engage in secondary trading of the token, with the success of the investment depending on the efforts of management and others at the company.*
>
> *the issuers and promoters emphasized the ability for investors to resell these tokens in the secondary markets, on platforms such as Coinbase, which was a crucial inducement to investors and essential to the market for these crypto assets securities. Investors were told, explicitly or implicitly, that they could sell their securities in the secondary markets and that the liquidity available in the secondary markets could drive up the value of their crypto asset securities.*

The Complaint cites the key US decision as to whether something is an "investment contract", *SEC v Howey*, only once, and provides no further legal analysis under US law for the assertions put concerning the nine tokens. Instead, reference is made to various marketing from the token issuers referring to the benefits of users buying tokens or sharing in revenues of the project.

Importantly none of the issuers of those tokens have been prosecuted by the SEC, nor has Coinbase, which traded in the tokens. If the assertion as to these token's status is correct, there could be very serious consequences for those who were involved in the projects and for Coinbase and other exchanges which traded in the tokens.

The SEC has previously made vague assertions that parties were dealing in securities when conducting enforcement (such as in the *Ether Delta* and *Tokenlot* cases), and has a string of settled enforcement actions which had never reached a finding of fact or appellate review on the question of token status, so it is unusual to have this level of factual allegation as to the status of tokens in this Complaint.

On one view this approach remains consistent with the SEC as a regulator pressing their point of view as to certain tokens being securities, and taking a form over substance approach. However, an extremely well funded regulator, which has a key position of messaging seen (and followed) not just in the US but around the world, should be expected to consider their allegations actions and messaging in such a rapidly evolving space carefully. Further, the application of securities law is nuanced and complex, and a sweeping assertion that marketing of a token renders it a security under US law is not determinative.

That point was take up by an unusual rebuke from a Commissioner of the Commodities and Futures Trading Commission, who commented that the case is a "striking example of 'regulation by enforcement'" and that:

> *Major questions are best addressed through a transparent process that engages the public to develop appropriate policy with expert input… Regulatory clarity comes from being out in the open, not in the dark.*

Coinbase's Chief Legal Officer, Paul Grewal, issued a strong statement titled: "Coinbase does not list securities. End of story." pointing out:-

> *Seven of the nine assets included in the SEC's charges are listed on Coinbase's platform. None of these assets are securities. Coinbase has a rigorous process to analyze and review each digital asset before making it available on our exchange — a process that the SEC itself has reviewed.*

Mr Grewal summarized the key issue for the US, which also applies to many other jurisdictions:

> *…instead of having a dialogue with us about the seven assets on our platform, the SEC jumped directly to litigation. The SEC's charges put a spotlight on an important problem: the US doesn't have a clear or workable regulatory framework for digital asset securities. And instead of crafting tailored rules in an inclusive and transparent way, the SEC is relying on these types of one-off enforcement actions to try to bring all digital assets into its jurisdiction, even those assets that are not securities.*

A core, and repeated, problem for the entire cryptocurrency and digital currency exchange industry is that existing financial services frameworks were not designed for a decentralised world and are unworkable in many ways for crypto asset issuers, even in the event they want to issue a token which is a security, or in Australia, a financial product.

Coinbase had coincidentally just petitioned the SEC to request clearer rules for crypto asset securities, so as give certainty

for issuers seeking to innovate, and to provide clear boundaries between when a product would be within the regulatory perimeter (or not).

That petition summarised present issues as including:

- An ongoing lack of clear regulation for the subset of crypto-assets which are securities/financial products;
- A plethora of steps and intermediaries which prevent real time settlement of crypto assets which are securities;
- An impossibility for individual investors to trade directly without using a broker; and
- Blockchain technology not being able to be used as a record of transactions under current US rules, even though that is precisely what makes the technology so powerful.

Important other questions are left unanswered by this case, including:

- Will other exchanges delist the tokens in questions (as occurred when the SEC sued Ripple)?
- Are the issuers of the tokens in question, Coinbase or other exchanges which listed the tokens going to intervene in the case to argue the securities point?
- Will the defendants argue that the tokens aren't securities to challenge the SEC's jurisdiction?
- Given this prosecution arose from Coinbase itself referring the matter to the SEC, what incentive does this give to people in the crypto-industry to self report wrongdoing, if the SEC response is to respond in the manner it has?

As Miles Jennings of A16Z noted *"[the] biggest takeaway is that it's remarkable how little new information/guidance can be taken away from the allegations…"*

For Australian projects, many of the same regulatory grey areas as are faced in the US remain the same down under. There are great difficulties in bringing any crypto asset financial products to market, and those grey areas create great risks around token issuances which are not intended to be financial products.

This action by the SEC serves as a reminder of the importance of taking great care when a business considers issuing crypto asset tokens.

Stablecoins lead the regulation race

It is a momentous time for global financial markets. Interest rates continue their ascent followed swiftly by inflation and business costs while the stock and crypto markets, as well as consumer spending, have all dropped.

Despite the crypto industry being hit with a flurry of bad news, namely the Three Arrows liquidation, Terra/Luna meltdown and Celsius bankruptcy filing, stablecoins are emerging from the storm with a range of potential regulatory frameworks.

Following years of lobbying for considered regulation into crypto assets, the UK Treasury has unveiled a proposed digital asset legislation, the Financial Services and Markets Bill. The bill, which aims to retake the UK's status as a global financial leader, includes a regulation piece for stablecoins.

In a speech, the newly appointed UK Finance Minister, Nadhim Zahawi said the bill:

> *reinforces the U.K.'s position as a leading center for technology as we safely adopt crypto assets.*

The bill extends the scope of the *Banking Act 2009* and the *Financial Services (Banking Reform) Act 2013* to include digital settlement assets (**DSAs**) which are "*a digital representation of value or rights*". The bill would authorise the Treasury to regulate DSAs, DSA service providers and DSA insolvency arrangements.

Regulations will be made in consultation with the Bank of England and the Financial Conduct Authority (**FCA**) but won't become law until it passes two more readings in the House of Commons and passes the House of Lords.

Across the Atlantic, the United States are flirting with stablecoin regulation in a different way. Speaking at Consensus 2022, Sen. Pat Toomey, who put forward his own bill on stablecoins this year, told attendees:

> *I'm going to go out on a limb and say we get stablecoins done this year…I know the [Biden] administration is interested in doing something in this space.*

Senior Democratic and Republican officials on the House Financial Services Committee are progressing a draft bill, the

Responsible Financial Innovation Act, that is likely to impose stringent regulation on collateralised stablecoin issuers.

The bill is narrowly focused on establishing a US oversight regime for stablecoins, setting a path for nonbanks to issue them and ban commercial companies from becoming issuers while also implementing new capital and liquidity standards. It does not cover 'algorithmic' stablecoins like Terra so would have little to prevent a repeat of the Luna / Terra situation beyond encouraging better capitalised 'collateralised' stablecoins.

Negotiations over the particulars of the bill, and in particular protections to users of stablecoins, is delaying passage through the committee, and the summer break will further delay debate until September.

The rise of UK, US and EU stablecoin regulatory approaches provides an interesting opportunity to collaborate and compare differences, and the global momentum hasn't escaped the notice of Australia either, with the Governor of the Reserve Bank of Australia, Philip Lowe, identifying stablecoins as "*the one piece of the crypto landscape where I think there is real promise*".

When it comes to regulation, it might just be that stablecoins enjoy the first truly stable and workable set of rules.

Barclays sees potential gold in Copper Series-C

UK-based banking giant Barclays has reportedly invested millions into crypto custody firm Copper during its latest capital raise. Having been in the works since November 2021, the long-standing talks with investors concluded with Barclays taking a stake in Copper, which provides custody, prime broking and settlement services to institutional investors.

The investment comes amid a lash of losses for the crypto industry as billion-dollar firms declare bankruptcy, and stringent regulation as a method of response is becoming a real possibility.

Copper has continued its rise as a serious player in the crypto-industry announcing its Series-C capital raise in November 2021, six months after closing a $50 million Series-B raise.

Being one of the top-four banks in the United Kingdom, Barclays is seemingly circling the crypto space once again, having previously accepted bitcoin as a form of donations to charity in 2015.

While the investment from Barclay's is small relative to their total investments, the continued institutional involvement in crypto-asset providers sends an important message and shows how blockchain and crypto continues to become more mainstream.

Barclays has not always been accepting of crypto, having denied banking services to Binance and Coinbase in the past. The investment could encourage further education and understanding into the space for Barclays and other institutional investment companies.

The fundraising is expected to be finalised within the coming days.

SEC investigating Coinbase for dealing in unregistered securities

Earlier this week, Bloomberg reported that the US Securities and Exchange Commission (the **SEC**) is probing Coinbase – a prominent cryptocurrency exchange – on suspicion that it allowed US consumers to trade unregistered securities.

The investigation follows the SEC's announcement late last week that it was initiating proceedings against a former employee of Coinbase and two associates on insider trading charges relating to nine tokens which are listed on the cryptocurrency exchange. The SEC claims those tokens are securities (i.e. investment contracts) under the *Howey* test. The SEC Chair, Gary Gensler has previously said that he believes Coinbase ought to register as a national securities exchange by virtue of the nature of some of the cryptocurrencies they offer.

In response, Coinbase has been critical of the SEC's investigation, citing the lack of clear rules for defining cryptocurrencies as securities. Coinbase's Chief Legal Officer, Paul Grewal said to Coindesk:

> *We are confident that our rigorous diligence process – a process the SEC has already reviewed – keeps securities off our platform, and we look forward to engaging with the SEC on the matter.*

The latest revelation cast the SEC's decision to prosecute Coinbase's former employee and his associates in a new light. The decision to pursue insider trading charges had been criticized by some as an odd way for the SEC to seek to set precedent on what is or is not a security in circumstances where:

- The SEC could have left it to the US Department of Justice to pursue wire fraud charges (which it has done in parallel with the SEC action) rather than filing a securities fraud complaint which will require it to establish that one or more of the nine tokens in issue are in fact securities;
- The three individuals charged by the SEC present potentially easy targets for the SEC rather than litigating the important question of whether certain tokens may be a security against an issuer or exchange which would have had to satisfy itself that they were not securities before proceeding to issue or list those tokens.

It now appears that the SEC's decision to pursue insider trading charges against the three individuals could be a prelude to a broader battle between the SEC and Coinbase over what constitutes a security under US law.

In Australia, individuals and entities require an Australian Financial Services Licence to issue or deal in financial products, which may include digital assets in some circumstances. Significant civil and criminal penalties may apply for carrying on a financial services business without an AFSL. ASIC has issued guidance in the form of Information Sheet 225 indicating that it expects those involved in issuing or dealing in digital assets to seek legal advice as to whether any token they are dealing in may be a financial product.