

Article Information

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Blockchain Bites: Binance pulls out of FTX acquisition, US Court finds ERC-20 tokens security, first Australian retail crypto fund likely to close, Binance donates \$300,000 to University of WA

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.

Binance pulls out of FTX acquisition, staff leave and websites go dark

Binance has pulled out of a proposed deal to acquire beleaguered crypto exchange FTX, announcing the move yesterday.

FTX has reportedly been scrambling to raise USD\$2 – 3B in the last 48 hours to address a run on the exchange, without success. With news that the entire.legal and compliance team of FTX resigned on Tuesday and the websites of Alameda Research and FTX Ventures have gone down.

This is shaping up as a significant failure which will have far-reaching consequences.

FTX to be acquired by Binance

On 9th November, a deal between FTX and Binance has been announced by Sam Bankman-Fried and Changpeng Zhao, who wrote on Twitter that Binance has signed a non-binding letter of intent to fully acquire FTX.com. CZ, the chief executive of Binance, wrote that the deal will be subject to due diligence stage in the coming days and noted 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.

The deal has also been confirmed by the chief executive and founder of FTX, Sam Bankman-Fried, who <u>wrote</u> that FTX and Binance have reached an agreement on a strategic transaction. SBF <u>commented</u> that one of the main reasons behind the deal is to address a liquidity crunch which arose suddenly and assist in clearing out a backlog of withdrawals. SBF <u>wrote</u> on Twitter that:

This is a user-centric development that benefits the entire industry. CZ has done, and will continue to do, an incredible job of building out the global crypto ecosystem, and creating a freer economic world.

Bankman-Fried has addressed the rumours that FTX and Binance have been in conflict noting that:

Binance has shown time and again that they are committed to a more decentralized global economy while working to improve industry relations with regulators. We are in the best of hands.

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The news has sent shockwaves through the crypto industry and is expected to continue to cause waves while further details emerge of what this bailout deal looks like.

US Court finds ERC-20 tokens sold to the public are an unlawful security

On 7 November, the United States District Court in New Hampshire found that a cryptographic token named LBC was a security under US law after the Securities and Exchange Commission (SEC) brought proceedings against the issuer of the token, LBRY, in May 2021. Barbadoro J gave a summary judgment in favour of the SEC against the issuer. LBRY operates Odysee, a decentralised video-sharing platform, which allows creators to acquire LBC and viewers the opportunity to earn cryptocurrency for watching videos in a "watch to earn" model.

Between 2016 and 2021, LBRY had sold LBC for over USD\$11M in cash and Bitcoin. The SEC alleged that the offer of LBC was an "investment contract" and the offer had occurred without registration and disclosures required under US law. LBRY responded with two defences:

- 1. that LBC tokens were not securities under US law; and
- 2. if the LBC were securities, that the SEC had not given fair notice that the sale of LBC was regulated by securities laws and that the SEC was in violation of LBRY's right to due process.

Barbadoro J ruled against LBRY finding:

No reasonable trier of fact could reject the SEC's contention that LBRY offered LBC as a security, and LBRY does not have a triable defense that it lacked fair notice.

The decision examined the purposes and scope of the 1933 Securities Act and <u>affirmed</u> the decision of *Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)*. The principle established in *Reves* was that when Congress adopted the Securities Act:

"[Congress] enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment".

This principle was used by Barbadoro J to expand the definition of a security so that is able to cover a token and through using the instrument of an investment contract. His Honour adapted the broad definition of this instrument established in $SEC \ v. \ W.J$. Howey Co 328 U.S 293 298-99 (1946) to cover

a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party

Barbadoro J focused on the intention of Congress when adopting the 1933 Securities Act and held that its scope is broad enough to cover a token, <u>noting</u> that:

Consistent with the broad reach of the Securities Act, [t]his definition 'embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits'...The focus of the inquiry is on the objective economic realities of the transaction rather than the form that the transaction takes.

The District Court rejected LBRY's argument that because LBC purchases were made with consumptive intent, the tokens are not a security.

Barbadoro J held that:

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Nothing in the case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract.

This decision to characterise these tokens as a security will have serious flow on effects in the US, where only a very small number of tokens have been offered as securities to date, and the SEC has been active in bringing actions against the sellers of tokens. Many of those actions have resulted in "no admissions" findings and fines, and the ongoing battle between the SEC and Ripple in relation to one such claim continues with summary judgment motions being filed in that case.

Ripple's lawyers are, however, <u>advancing quite different and more comprehensive arguments</u> than LBRY did in this decision, offering the potential of a different outcome which will be closely watched by the industry.

First Australian retail crypto funds likely to close after ASIC "no warning" stop orders

Holon Capital, which was granted an Australian Financial Services Licence in May of this year and launched three crypto focused funds (Bitcoin, Ethereum and Filecoin) in June was recently the subject of a "no-warning" stop order from the Australian Securities and Investments Commission (ASIC) with ASIC using new design and distribution obligation powers granted to it following the Hayne Royal Commission. Further interim stop orders have since been made freezing distribution of those funds indefinitely.

ASIC's objections were raised in relation to the Target Market Determinations (**TMD**) required to be published by Holon as part of offering financial products to retail investors under 944B of the *Corporations Act* which requires that:

A target market determination...must be such that it would be reasonable to conclude that, if the product were to be issued, or sold in a regulated sale... to a retail client in the target market-it would likely be consistent with the likely objectives, financial situation and needs of the retail client.

If a product issuer permits investors who are outside the target market to be issued with their products, then serious consequences can follow.

Typically "no-warning" enforcement is a rarely used tool in a regulator's toolbox, as regulators wish to engage fairly with those they regulate and have obligations to provide procedural fairness in the exercise of their function.

It is more typical to see a "no-warning" stop order where there is a critical time sensitivity or pressing concern over a product. The use of a "no-warning" approach to Holon invites an inference in relation to ASIC's view towards crypto-assets. ASIC has been suggesting for years that crypto-businesses consider obtaining financial services licensing where those products involve financial products.

<u>Holon have published</u> the stop orders and their other correspondence with ASIC, showing that since 10 October 2022, Holon's three retail funds have been barred from dealing with retail investors. ASIC's statement of concerns states, in relation to "medium" and "high" risk investors:

it cannot reasonably be concluded that, if the product were to be issued or sold in a regulated sale to a retail client in the target market, it would likely be consistent with the likely objectives, financial situation and needs of the retail client.

ASIC continues, asserting that the fund is not appropriate for "very high" risk investors either:

There are investors included in the target market for the Fund that may fall within Holon's limited definition of a "Very High" risk and return profile, but because of the significant volatility and deep negative returns in a given year, the Fund would not be suitable for them.

Similar positions are put in relation to Ethereum and Filecoin. Holon's response highlighted the manner in which they had followed TMD guidance and templates for determining a target market for the fund, based on well understood investment principles. Those approaches appear to have been rejected by ASIC with further stop orders being made.

Luke Benhcke of Holon said to the Australian Financial Review:

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ASIC has formulated a carte blanche view on crypto assets and don't seem to be acknowledging standard investment principles for these types of financial products.

This kind of approach is likely to be viewed as "regulation by enforcement" and sends a chilling message to those who have been seeking to offer crypto-asset financial products under licence in Australia.

Of even greater concern, if the CASSPr licensing currently underway with Treasury ultimately results in a markets licence which falls under design & delivery obligations requiring a TMD for the offer of crypto-assets, the approach adopted by ASIC in relation to Holon could lead to a de facto ban over crypto-assets being offered by any Australia CASSPr licence holders.

The perverse outcome, noted by Holon in their submissions, is that with increasing numbers of Australians owning crypto-assets directly, an insured and licensed fund offering would provide additional options for those who do not wish to be exposed to the risk of losing passwords or facing counterparty risk with digital currency exchanges. By shutting these funds, the protections to investors offered by those funds are denied to investors. ASIC's submissions unfortunately do not suggest a path to the funds being offered in a compliant way.

At a minimum, the reputation of Australia as a jurisdiction which is welcoming to crypto-asset businesses, investment and jobs is tarnished by this approach, with more businesses likely to leave our shores for jurisdictions that offer greater certainty and technology enabling regulation.

Binance donates \$300,000 to University of Western Australia

International cryptocurrency exchange, Binance, has donated US \$300,000 in cryptocurrency to the University of Western Australia (**UWA**) to promote blockchain education. The donation was made in BUSD, a 1:1 USD-backed stablecoin, which has been approved and is regulated by the New York State Department of Financial Services.

The donation was made through the Binance Charity, a blockchain-enabled donation platform that uses blockchain technology to support, among other initiatives, the United Nations Sustainable Development Goals.

The donation has been given to assist in funding of the University's existing blockchain work, including to build a master's program and develop a metaverse lab researched and built by students.

Binance and the University of Western Australia believe blockchain will be a growing job sector as <u>calls for regulation are increasing</u>, and the industry enters into a <u>new stage of adoption both internationally</u> and in Australia.

Government-led regulation in Australia will require a range of stakeholders across various industries all with intimate knowledge of the regulations and industry generally. Blockchain courses are increasingly being offered at universities around Australia.

The donation follows a raft of education-based moves in the digital asset industry, from <u>blockchain-based school solutions</u> in <u>India</u>, to a <u>pairing between the Australian National University and Ripple Labs</u> to provide a blockchain law course.

Blockchain fundamentals are becoming increasingly more common in financial services industry, as well as various other business sectors, and it is likely more universities will offer similar courses to UWA in future.

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