Article Information

Authors: Michael Bacina, Steven Pettigrove, Tim Masters, Jake Huang, Luke Higgins, Luke Misthos, Kelly Kim,
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Blockchain Bites: SEC obtains judgment in crypto insider dealing case, HK issues new bank guidance on tokenised assets, CFTC Chair calls on Congress to enact crypto legislation, ASIC secures travel ban on Blockchain Global director, UK consults on OECD standards on crypto tax reporting

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

SEC obtains judgment in crypto insider dealing case

The US Securities and Exchange Commission (SEC) has obtained default judgment against Sameer Ramani in connection with its investigation and prosecution of the first US insider trading case relating to dealings in cryptocurrencies. The scheme in question occurred over 2021 and 2022 when Ishan Wahi, a former product manager at Coinbase, tipped his brother Nikhil Wahi and friend Sameer Ramani regarding the 'timing and content of upcoming listings' on the exchange. The confidential information obtained during the course of Wahi's employment was used to trade in cryptocurrencies yielding substantial profits for the defendants.

In the recent judgment, the Court ruled that the trading of certain crypto assets via a secondary market such as Coinbase constituted securities transactions. In particular, it focused on whether the tokens traded were investment contracts under US law. The Court stepped through the 'three-prong' Howey test, analysing whether the instruments involved:

> (1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others

Investment of money

The Court had no difficulty in concluding that Ramani had made an investment of money in personally paying for the tokens that he acquired.

Common enterprise

The requirement of a common enterprise was held to be satisfied, with the Court affirming:

> facts alleged are sufficient to show both horizontal and vertical commonality in the token trading enterprise.

Horizontal commonality refers to an enterprise common to a group of investors. This was held to be established as 'every token-holder's financial fortunes were intertwined with the continued success of the entire token trading enterprise.'

While it is not necessary to establish both, the Court nevertheless found that vertical commonality was also present, which involves an enterprise common to the investor and seller, promoter or some other third party. In making this finding, the court relied on factual allegations that the token holders and issuers shared a risk of loss.

Expectation of profits produced by efforts of others

This involved an objective inquiry into whether purchasers were led to expect financial returns by efforts other than their own. It was alleged that 9 token issuers identified in Ramani's trades 'broadly and repeatedly disseminated claims that each token would appreciate in value' as part of their promotion, promising to 'create, develop, and maintain an ecosystem' that would foster demand and price increase.

The Court also acknowledged that these promotional statements applied equally to indirect investors, who purchased their tokens via secondary markets. It cited the finding in *SEC v Terraform Labs* that public representations to persuade both direct and indirect purchasers 'would presumably have reached' those who purchase their tokens via secondary markets.

While acknowledging that the assessment of whether instruments purchased over a secondary resale market involved an investment contract requires consideration of the 'economic reality of each transaction' and 'what investment package was actually offered', the Court did not consider each transaction and token in isolation.

The Court finally concluded:

> Thus, under *Howey,* all of the crypto assets that Ramani purchased and traded were investment contracts.
>
> The Court's analysis remains the same even to the extent Ramani traded tokens on the secondary market.

There are concerns that the Court's blanket finding may have bearing on the SEC's separate enforcement action against Coinbase, which alleges that Coinbase facilitated unregistered securities transactions. However, neither Coinbase nor the token issuers were a party to the present action and none of the allegations brought by the SEC in relation to the tokens in which Ramani traded were properly tested. The outcome of the Coinbase case is hotly anticipated, following the hearing in January, where Justice Failla reserved judgment on summary judgement motions brought by the SEC and Coinbase.

Ramani now faces a civil penalty of over USD$1.6M and disgorgement of the identified proceeds UDS$817,602.

Separately, the SEC's civil claims against the Wahi brothers were settled in May 2023, with the brothers pleading guilty to wire fraud conspiracy in a separate criminal proceedings brought by the Department of Justice, with Ishan facing a sentence of 24 months in prison and Nikhil 10 months.

In dealing with this novel case, the SEC warned:

> While the technologies at issue in this case may be new, the conduct is not…the federal securities laws do not exempt crypto asset securities from the prohibition against insider trading, nor does the SEC.

These proceedings highlight the need for cryptocurrency exchanges and businesses, in particular, to implement a token dealing policy to mitigate the risks of employees and contractors dealing in tokens based on inside information, manage potential conflicts and avoid reputational harm. While the SEC's allegations of insider dealing on the basis that the relevant crypto-assets were said to be securities were not properly tested in this case, fraud offences and a range of other laws may also be invoked where an employee uses inside information for the purpose of seeking a profit.

Written by Kelly Kim and Steven Pettigrove

HK issues new bank guidance on tokenised assets

The Hong Kong Monetary Authority (**HKMA**), the city's de-facto central bank, has issued new guidance to banks involved in digital asset-related activities, such as selling and distributing tokenised products.

The guidance comprises two circulars, they are:

- Provision of Custodial Services for Digital Assets (**Custody Circular**) which provides guidance for banks (i.e. authorised institutions, or AIs) that are interested in holding digital assets for clients.
- Sale and Distribution of Tokenised Products (**Tokenised Products Circular**) outlines standards for banks to sell

and distribute tokenised products that are digital representations of real-word assets.

The guidance continues Hong Kong's efforts to regain Asia's crypto crown. It follows several other initiatives intended to foster the development and regulation of digital assets. Some of them include:

- in February 2024, the HKMA consulted on new regulations on the prudential treatment of cryptoassets exposure;
- in December 2023, the HKMA consulted on aregulatory regime governing stablecoin issuers in Hong Kong;
- in December 2023, the Securities and Futures Commission (**SFC**) and the HKMA jointly issued guidance on distribution of virtual asset investment products; and
- in November 2023, the SFC and the HKMA jointly published two circulars for tokenised securities-related activities and on tokenisation of SFC-authorised investment products. Notably, these circulars established a "see-through" principle for tokenised investment products, while setting out considerations surrounding issuance, disclosure, distribution, risk management and competence.

Custody Circular

The Custody Circular applies to custodial activities relating to digital assets by banks and their subsidiaries.

The scope of the circular includes digital assets, tokenised securities, and other tokenised assets, but does not include digital assets belonging to the bank, or limited purpose digital tokens (e.g., loyalty points, in-game assets).

Banks must satisfy the following requirements, among many others, in relation to their digital asset custodial services:

- *Governance and risk management*: before launching digital asset custodial services, banks are expected to undertake a comprehensive risk assessment and to implement appropriate policies and procedures to mitigate identified risks. Banks should also have adequate resources and staff competence.
- *Segregation of client digital assets*: Client digital assets should be held in separate client accounts (including wallet addresses) that are segregated from the bank's own assets.
- *Safeguarding of client digital assets*: Banks should implement adequate systems and controls and adopt industry best practices (e.g., using hardware security modules, key sharding, backup arrangements, etc.) to ensure that client digital assets are properly accounted for and safeguarded. Specifically, banks should hold 98% of client digital assets in cold storage and maintain an appropriate compensation arrangement to cover potential loss of 50% of the client digital assets in cold storage and 100% of the client digital assets in hot and other storages.
- *Delegation and outsourcing*: Banks may only delegate or outsource their custody function to another bank or a SFC-licensed virtual asset trading platform.

Banks that are already providing digital asset custodial activities have a 6-month transition period to comply with the new standards.

Tokenised Products Circular

The Tokenised Products Circular applies to banks that sell and distribute "tokenised products", meaning digital representations of real-world assets, such as tokenised structured investment products that are unregulated under the Securities and Futures Ordinance (**SFO**) and tokenised spot precious metals. However, the Tokenised Products Circular does not apply to tokenised securities, which are already governed by other SFC and HKMA guidance.

The HKMA adopts a see-through approach to the underlying product and apply the same regulatory requirements and consumer protection measures to the tokenised form of that product.

However, the HKMA recognises that tokenised products come with additional risks, including how the products are structured and arranged in the tokenisation process. Therefore, the HKMA expects banks to implement additional procedures:

- *Due diligence*: Banks should conduct adequate due diligence and fully understand the tokenised products (particularly around the technology aspects), conduct diligence on the issuers and service providers of the tokenised products, and be satisfied with the IT and cybersecurity practices in connection with the tokenised products.
- Banks may also issue their own tokenised products, and if so, will need to consider how outsourcing and custodial arrangements are implemented.
- *Product and risk disclosure*: Banks are expected to act in the best interests of their customers and make adequate disclosure of the relevant material information about a tokenised product. In particular, they should adequately disclose risks, including in respect of the distributed ledger technology network utilised, cybersecurity, limitation on transfers, and settlement finality.

- *Risk management*: Banks must implement proper policies, procedures, systems, and controls to identify and mitigate the risks arising from tokenised product-related activities (e.g., including frameworks for complaint-handling, compliance, internal audit, and business contingency planning).

Written by Jake Huang and Steven Pettigrove

CFTC Chair calls on Congress to enact crypto legislation

In a recent appearance before the House Agriculture Committee, US Commodity Futures Trading Commission (CFTC) Chair Rostin Behnam emphasised the pressing need for legislative action to address regulatory gaps in the digital asset markets.

"Fill the gap in crypto regulation," Behnam urged, underlining the need for proactive measures to mitigate potential risks in the burgeoning crypto market. He cautioned against dismissing cryptocurrencies as a passing trend, asserting that such a notion is erroneous. This notion, of course, is not unfamiliar to crypto enthusiasts, who have heard countless times of the impending death of cryptocurrencies. This has even become an inside joke for blockchain veterans, with the creation of the popular and ironic "Bitcoin Obituaries" website being one such example.

Central to Behnam's plea is the recognition of bitcoin as a commodity, a stance he reiterated during the committee hearing. Referring to bitcoin (BTC) and ether (ETH) as the two predominant tokens in the digital asset market, Behnam noted their significant share in the overall cryptocurrency market capitalisation.

Behnam's remarks were prompted by questions regarding the Financial Innovation and Technology Act for the 21st Century (FIT Act), a legislative proposal that has garnered traction, but failed to progress to a floor vote. The discussion at the hearing revolved around broader concerns regarding the CFTC's jurisdiction and budgetary requirements for the forthcoming fiscal year.

Expressing confidence in the CFTC's ability to establish a regulatory framework within a year of congressional approval of the FIT Act, Behnam underscored the agency's preparedness to adapt to evolving market dynamics.

The classification of cryptocurrencies as commodities faced scrutiny from lawmakers, with Rep. John Duarte seeking clarification on the matter. Behnam noted:

> If [BTC] is not a security, then it's a commodity

Behnam's advocacy for regulatory clarity echoes broader industry sentiments regarding the necessity for a coherent regulatory framework. It is also in stark contrast with the SEC's regulation by enforcement approach, which asserts that existing regulations are clear. Notwithstanding this divergence, both the CFTC and the SEC have taken a large number of enforcement actions in digital asset markets, a point which Behnam emphasised during the hearing noting that these cases assumed nearly half of the CFTC's docket in 2023.

In conclusion, Behnam's plea for congressional action reflects a growing recognition that cryptocurrencies are here to stay and the attendant need for regulatory clarity. As the industry continues to mature, concerted efforts towards establishing a robust regulatory framework are imperative to facilitate responsible innovation and safeguard investors.

Written by Luke Higgins and Steven Pettigrove

ASIC secures travel ban on Blockchain Global director

The Australian Securities and Investments Commission (**ASIC**) has secured a travel ban in the Federal Court of Australia against former Blockchain Global director Liang (or Allan) Guo following an ex parte application made in the Federal Court of Australia.

Mr Guo, along with Messrs Samuel Xue Lee and Zijang (Ryan) Xu ran the ACX Exchange, with Mr Guo being the only one remaining in Australia.

The ACX Exchange has been embroiled in legal woes since its collapse in December 2019, when the exchange stopped responding to user's withdrawal requests and stopped updating token prices.

Following its suspension from Blockchain Australia, customers secured a freezing order against the assets of the exchange in September 2021. Mr Guo will now be temporarily banned from leaving Australia for a period of 6 months pursuant to an interim order handed down by the Court while ASIC pursue an investigation into possible breaches of directors' duties and fraud over the collapse of the exchange.

Under the Corporations Act, where ASIC is in the process of carrying out an investigation in relation to a person, it can apply to the Court to make orders:

1. requiring that person to deliver up to the Court a copy of his or her passport and such other documents the Court thinks fit; and
2. prohibiting that person from leaving this jurisdiction without consent of the court.

While the Court acknowledges there is no information suggesting an intent by Mr Guo to leave Australia, the nature of ASIC's investigation and the potential for criminal prosecution nonetheless constitutes a flight risk, in the Court's eyes.

The critical point the Court must consider when exercising this power is whether the restraint of a person is necessary or desirable for the purpose of protecting the interests of aggrieved persons. In this instance, the Court found that Mr Guo's right to travel internationally may be outweighed by the public interest in ASIC being able to pursue its investigation.

The Court eventually made the interim orders on the basis that ASIC's investigation is in its early stages and ASIC has not had the opportunity to speak with Mr Guo. Further, Mr Guo is considered by ASIC a "central player" in its investigation and it will be necessary for ASIC to interview and examine Mr Guo, seeing as he is the only person of interest who remains in Australia.

Mr Guo has not yet had the opportunity to respond to ASIC's application or the allegations raised in the claim, and the matter is next due before the court on 12 March 2024.

Written by Steven Pettigrove and Luke Misthos

UK consults on OECD standards on crypto tax reporting

On Wednesday, the UK government opened a consultation over its plans to adopt the Organization for Economic Co-operation and Development (**OECD**)'s Crypto asset Reporting Framework (**CARF**) and proposed amendments to the existing Common Reporting Standard (**CRS2.0**). The CARF was developed to address the rapid development and growth of the Crypto-Asset market and owing to concerns over the erosion of global tax transparency. The UK Treasury has projection that implementing the framework could result in tax revenues of £35M (~USD$45M) between 2026 and 2027 and £95M (~USD$121M) between 2027 and 2028.

OECD is a leading intergovernmental forum with over 38 member countries, that develops global standards for sustainable economic growth. The updated CARF is

> designed to ensure the collection and automatic exchange of information on transactions in Relevant Crypto-Assets.

The framework consists of three parts:

1. Rules that can be transposed into domestic law in different jurisdictions to collect information from relevant Reporting Crypto-Asset Service Providers;
2. a multilateral competent authority agreement on automatic exchange of information pursuant to the framework and related agreements; and
3. an electronic format to be used by Competent Authorities for the purposes of exchanging CARF information and by Reporting Crypto-Asset Service Providers to report to tax authorities.

Under the framework, businesses providing exchange services in Relevant Crypto-Assets are considered Reporting Crypto-Asset Service Providers. The package has been agreed at an international level but includes 'optional elements, and the practical implementation is not prescribed in detail'. The UK consultation thus addresses the details and invites comments on the proposed implementation in four parts:

1. CARF – the UK government's approach to the optional elements;
2. CRS – 2 potential amendments, including new types of assets and provisions around operational improvement;

3. Domestic Reporting Rules – seeking views on requiring UK reporting entities to include UK residents' information; and
4. Summary of consultation questions

The amendments to the CRS2.0 framework would see the addition of a number of new financial assets, products and intermediaries, which offer alternatives to traditional financial products.

In late 2023, the Australian Government in a joint statement, also affirmed their intent to

> work towards swiftly transposing the CARF into domestic law…to commence by 2027, subject to national legislative procedures.

Submissions are open until 29 May 2024 and the UK government is seeking views from diverse industry participants from stakeholders, Crypto Asset Service Providers, financial institutions to professional advisory firms. The rules are scheduled to come into effect by 2026 and 2027 at the earliest for crypto asset exchanges.

Written by Kelly Kim and Steven Pettigrove