Article Information

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Blockchain Bites: Hong Kong consults on details of crypto licensing regime, SBF faces new charges, SEC joins hunt for Do Kwon, Incredulous Illinois Bill shows imprecise laws impossible for compliance

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

Hong Kong consults on details of crypto licensing regime

This week, Hong Kong's Securities and Futures Commission (the SFC) launched a consultation on their proposed regulatory requirements for operators of virtual asset trading platforms (i.e. crypto exchanges).

Under a new licensing regime to take effect on 1 June 2023, all centralised virtual asset trading platforms carrying on business in Hong Kong or actively marketing to Hong Kong investors will need to be licensed by the SFC.

In 2019, the SFC introduced a limited regulatory framework for centralised virtual asset trading platforms which offer services in at least one security token. The new licensing regime will modify these requirements and apply them to all virtual asset trading platforms.

The requirements will cover key areas such as:

- safe custody of assets;
- know-your-client checks;
- conflicts of interest;
- criteria for admission of virtual assets to trading;
- cybersecurity, accounting and auditing;
- risk management;
- anti-money laundering/counter-financing of terrorism; and
- prevention of market misconduct.

As part of the consultation, the SFC is seeking views particularly on whether to allow licensed platform operators to serve retail investors. The SFC have indicated that they propose to permit retail investors to access virtual assets subject to additional investor protection measures such as knowledge quizzes, suitability tests and exposure limits.

> *"As has been our philosophy since 2018, our proposed requirements for virtual asset trading platforms include robust measures to protect investors, following the 'same business, same risks, same rules' principle,"*

said Ms Julia Leung, the SFC's Chief Executive Officer, who also added:

> *In light of the recent turmoil and the collapse of some leading crypto trading platforms around the world,*

> *there is clear consensus among regulators globally for regulation in the virtual asset space to ensure investors are adequately protected and key risks are effectively managed.*

SFC said operators of virtual asset trading platforms which plan to apply for a licence, including existing platforms, should begin to review and revise their systems and controls to prepare for the new regime. Those which do not plan to apply for a licence should start preparing for an orderly closure of their business in Hong Kong.

This consultation is the latest step taken by Hong Kong in an effort to reclaim its status as Asia's top virtual asset hub. It follows the Hong Kong Monetary Authority's confirmation in January that it will establish a mandatory licensing regime for stablecoin activities by 2024.

SBF faces new charges

FTX founder, Sam Bankman-Fried (commonly known as **SBF**), faces new charges, including conspiracy to commit bank fraud and operating an unlicensed money transmitting business, under a superseding indictment unsealed on Thursday.

SBF, previously arrested and on bail, now faces a total of 12 charges brought by the Department of Justice following the collapse of FTX. These charges also include conspiracy to make unlawful political contributions and defrauding the US Federal Election Commission.

The indictment contains several new allegations including that SBF, in a bid to open a US bank account:

> *falsely represented to a financial institution that the account would be used for trading and market making, even though BANKMAN-FRIED knew that the account would be used to receive and transmit customer funds in the operation of a cryptocurrency exchange*

US prosecutors say SBF later omitted material facts in a manner that made the above representation misleading. It appears the account was intended to be used to accept and send wire transfers for FTX's international exchange (FTX.com) despite that business not being a registered money transmitter or money service business in the United States.

Prosecutors allege that SBF set up a fake company called North Dimension ("which had no employees or business operations") to obscure the relationship between FTX and Alameda Research (**Alameda**, the trading firm owned by SBF), and to overcome the bank's reluctance to open an account. It is alleged that SBF created a website for the fake company, paid for with his own credit card.

Meanwhile, it is alleged that FTX also used bank accounts in the name of Alameda to receive customer funds intended for FTX and process customer withdrawals.

The US is seeking forfeiture orders against SBF in relation to hundreds of millions of dollars' worth of assets, which in many cases have already been seized by the government. They include more than 55 million shares in the trading app, Robinhood Markets, currently valued at $550 million. The Government also seeks the seizure of over US$150 million in cash held at Silvergate Bank and Farmington State Bank in the name of FTX Digital Markets (**FTX DM**).

The superseding indictment reveals additional details of the alleged fraud perpetrated by SBF and his co-conspirators including the diversion of customer deposits to support trading by Alameda, fund investments, loans to executives and political donations. SBF is set to face trial in October and is currently living at his parents' house on a $250 million bail. The FTX group is currently subject to US chapter 11 bankruptcy, with FTX Australia and the Bahamian entity, FTX DM, in separate insolvency proceedings.

SEC joins hunt for Do Kwon

The US Securities and Exchange Commission has charged Terraform Labs (**Terra**) and its CEO and co-founder, Do Kwon, with 'orchestrating a multi-billion dollar crypto asset securities fraud involving an algorithmic stablecoin and other crypto asset securities'.

In a press release, the SEC alleges Terra and Mr Kwon marketed crypto asset securities to investors seeking to earn a profit and repeatedly claimed the tokens would increase in value. The 55-page complaint paints the entire Terra ecosystem as an elaborate fraud orchestrated by Terra and several collaborators.

Chair of the SEC, Gary Gensler, summarised the charges in the complaint:

> *We allege that Terraform and Do Kwon failed to provide the public with full, fair, and truthful disclosure as required for a host of crypto asset securities…We also allege that they committed fraud by repeating false and misleading statements*

The SEC complaint revealed that, in May 2021, Terra engaged in undisclosed discussions with a third party which intervened by purchasing significant quantities of UST, the native stablecoin of the Terra blockchain, during a minor de-pegging event, with a view to re-establishing its 1:1 peg to the dollar. These discussions were not made public, and UST was branded as "automatically self-healing" creating the perception that the so-called stablecoin's peg had been restored without human intervention. These claims sought to re-assure confidence in the algorithm which purportedly underpinned the un-backed stablecoin's value.

The SEC alleges that Terra's misrepresentations go deeper, specifically that Do Kwon misrepresented the extent and duration of Terra's relationship with the Chai payments platform, an e-commerce system in South Korea. According to the complaint, Do Kwon created a fake server to simulate transactions to deceive investors in the Terra ecosystem.

In a final blow, the SEC alleges that Mr Kwon and his associates transferred over 10,000 bitcoin from Terraform and the Luna Foundation Guard (which was established to defend UST's peg) to an unhosted wallet, $100 million of which has been converted into fiat through a Swiss bank account. This apparent gross self-dealing stands in contrast to the losses suffered by UST holders recorded in the complaint.

The charges against Mr Kwon and Terraform involve securities fraud, conducting an unregistered securities offering and further securities violations.

The action against Terra is the latest in several high profile crypto-related regulatory actions initiated by the SEC this year, including actions involving Gemini, Kraken and Paxos. It seems unlikely that Terraform and Kwon will defend the action with Kwon reportedly on the run in Serbia. The securities law issues raised by the SEC's claim are therefore likely to go untested in the Courts.

Incredulous Illinois Bill shows imprecise laws impossible for compliance

As regulatory pressures grow on crypto-asset businesses in the US, the great state of Illinois has put forward a draft law which presents a teachable moment in the difficulties of drafting laws which seek to regulate technology, or which create obligations which are impossible at a technological level for blockchain businesses to meet.

Illinois Senate Bill SB1887 starts from a sensible policy perspective, seeking to protect consumers, but in attempting to do so it will likely have the effect of driving blockchain and crypto-businesses (and any hosting of miners or validators) from the state. This would protect consumers practically only in that they may be blocked from dealing with any blockchain providers at all, who will be concerned at fines and liability for asset loss which they are unable to prevent. Let's unpack it a bit more:-

The Bill permits a court, after being provided an order from the Attorney General, to order:

> *any appropriate blockchain transaction for digital property or for the execution of a smart contract*

Digital property is defined very broadly as:

> *any form of property recorded on a blockchain, including, without limitation, cryptocurrency, digital tokens, nonfungible tokens, and15tokenized real-world assets.*

The Bill also defines a blockchain operator broadly as:

> *"Blockchain operator" means a person or entity operating a full or partial node, including, without limitation, operating a blockchain mining node, mining pool, validator, validator pool, staking pool, and staking a validator.*

The Bill then requires that:

> *A blockchain network that processes a … transaction originating in this State … shall process a court-ordered blockchain transaction without the need for the private key associated with the digital property or smart contract*

This of course impossible as validators cannot determine if a transaction has originated in Illinois, and the private key relating to a piece of digital property or a smart contract will not be in the possession of a private key. Despite this impossibility, the Bill proposes:

> *a USD$5K-$10K fine per day for any "blockchain operator that has mined, validated or otherwise participated in processing a blockchain transaction…which originated in [Illinois]."*

AND as an added bonus, the "blockchain operator" is also liable to a plaintiff for "*damages suffered due to a violation [of the requirement to change the transaction]*" which would presumably be the value of the loss suffered.

The Bill specifically blocks what would be an obvious defence, saying that the

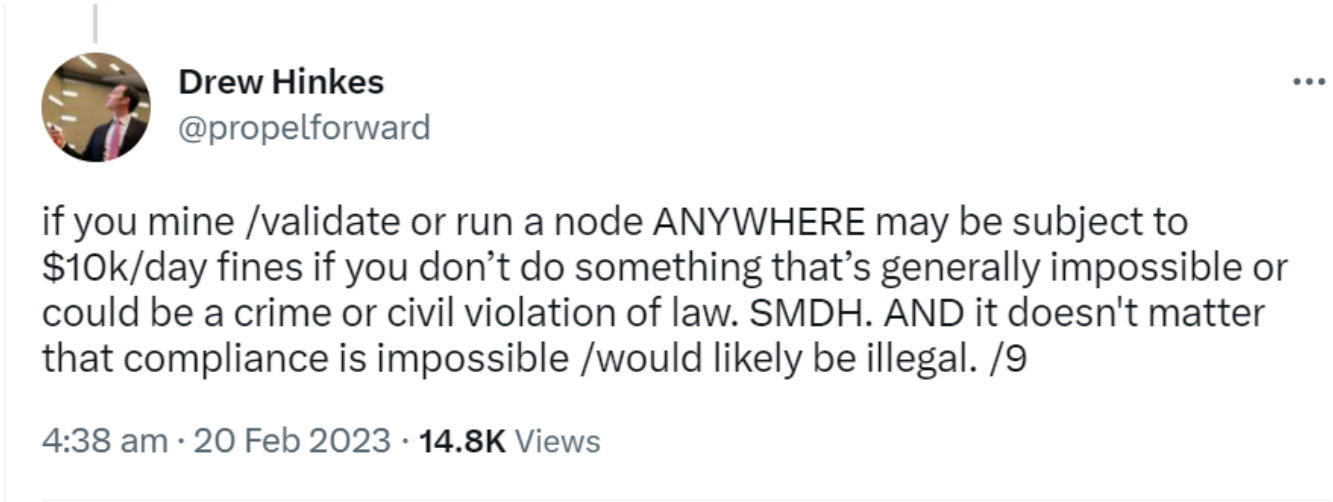
> *"fact that a blockchain network has not adopted reasonable available procedures to comply with [this law]… shall not be a defense…"*

The Bill also seeks to make service on blockchain operators easier, by codifying the ability for a plaintiff to serve court process by "*leaving a copy*" of pleadings with a miner, validator or operator.

This informs an end result that any blockchain provider could be sued by an Illinois resident who has lost (or had stolen) or has disputed possession of a digital asset, and would be fined for not doing something that is impossible. This is because validators and miners do not individually have the power to alter transactions on the blockchain, as the network would reject those changes. If a validator seeks to change transactions in certain blockchains where those changes are rejected by the network could face slashing of their staked assets as well, meaning the operators would be damned if they complied and damned if they don't. It will also encourage actions similar to the *Tulip Trading* case underway in the UK which is similarly seeking to hold developers liable for, and require transactions to be rewritten in the Bitcoin blockchain, in relation to lost/stolen digital assets.

Codification of this kind of liability would create a chill colder than any Illinois winder for any blockchain operators, who would all be potentially liable for failing to seize third party assets, which they are unable to do, and would face criminal or civil liability as a result. Plaintiff class action lawyers would presumably jump on this law and take on speculative matters on the hope that publicly identifiable node operators or pools (such as those operated by VCs or foundations) would settle rather than be sued.

Thanks to Drew Hinkes for his thread on Twitter pointing out, should the Bill become law:



This Bill underscores the importance of regulators being educated to understand how blockchain technology functions, so that incentives created by laws can be aligned to work with the technology, and not run counter to how blockchain systems work. Immutability and finality of transactions is one of the core benefits of blockchain systems, and a law which seeks to

undermine that finality may well amount to a ban of use of the technology, which would ultimately have the opposite effect of consumer protection, as users will be forced to engage with offshore providers who may not meet standards which fit for purpose laws could establish.