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Blockchain Bites: What does MiCA mean for crypto intermediaries? SBF files to dismiss charges, IRS sends FTX/Alameda USD$44bn tax bill, SEC ordered to respond to 2022 Coinbase petition, Ex-Coinbase employee sentenced in insider trading case

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Fully licensed: What does MiCA mean for crypto intermediaries?

After multiple delays, the highly-anticipated Markets in Crypto-assets Regulation (**MiCA**) was finally adopted by the European Union on 20 April 2023 making the EU the first major jurisdiction to pass a comprehensive regulatory framework for crypto-assets. MiCA is expected to come into force in 2024, and will apply across the EU. The full text of the final regulation was released last week but has not yet been published in the EU's Official Journal.

We have previously written a series of articles on MiCA covering its application to NFTs and public token offerings, this article will focus on how the new rules affect crypto asset service providers (**CASPs** or crypto intermediaries) in general.

Who are CASPs and what services are licensed?

Under MiCA, a CASP is a legal person or other undertaking whose occupation or business is the provision of one or more crypto-asset services to third parties on a professional basis. CASPs must be authorised and have a registered office in an EU member state where they carry out at least part of their crypto-asset services, subject to exceptions (Art 59). They shall have their place of effective management in the Union and at least one of the directors shall be resident in the Union.

MiCA lists 10 types of crypto-asset services:

1. providing custody and administration of crypto-assets on behalf of clients;
2. operation of a trading platform for crypto-assets;
3. exchange of crypto-assets for funds;
4. exchange of crypto-assets for other crypto-assets;
5. execution of orders for crypto-assets on behalf of clients;
6. placing of crypto-assets;
7. reception and transmission of orders for crypto-assets on behalf of clients;
8. providing advice on crypto-assets;
9. providing portfolio management on crypto-assets;
10. providing transfer services for crypto-assets on behalf of clients;

A CASP providing any of the these services is required to apply for a license with relevant authorisations. This list is broad and covers the main activities typically conducted by centralised crypto-asset exchanges. Significantly, it will establish a licensing regime for intermediaries who provide crypto-asset custody, which is a key risk for consumers, as highlighted by the collapse of FTX last year which apparently engaged in widespread misappropriation of client assets.

What are CASP's licensing obligations?

MiCA imposes a number of general obligations on all CASPs, regardless of the specific crypto-asset services they provide. For example, Article 66 requires CASPs must:

> *act honestly, fairly and professionally in the best interests of clients and prospective clients*

A similar obligation applies to financial services licensees under Australian law.

In addition:

> *Crypto-asset service providers shall provide their clients with fair, clear and not misleading information, in particular in marketing communications, which shall be identified as such.*

CASPs are also required to warn clients of risks associated with purchasing crypto-assets.

General obligations applicable to all CASPs include, among others:

- **Prudential requirements (Art 67).** CASPs must at all times have in place prudential safeguards, including by holding capital sufficient to meet EU capital requirements and/or an appropriate insurance policy;
- **Governance arrangements (Art 68).** Management of CASPs shall be of sufficiently good repute and possess knowledge, experience and skills to perform their duties. Qualifying shareholders are also subject to fit and proper person requirements. CASPs should also adopt policies and procedures that are sufficiently effective to ensure compliance with MiCA;
- **Safekeeping of clients' crypto assets and funds (Art 70).** CASPs shall make adequate arrangements to safeguard the ownership rights of clients, especially in the event of insolvency. CASPs that receive client funds (other than e-money tokens) shall place them with a central bank or a credit institution within the next business day; and
- Other general obligations include having effective policies and procedures on complaint handling, conflicts of interest, outsourcing and orderly wind-down.

In addition, a number of specific obligations may apply to CASPs depending on the specific crypto-asset services they are authorised to provide. For example:

1. CASPs providing custody and administration shall keep a register of positions corresponding to each client's rights to the crypto-assets. They shall have procedures to keep safe the crypto-assets or means of access to the crypto-assets. They shall provide a statement of position to the clients at least once every three months, and segregate client holdings from their own. Crypto-assets in custody are to be insulated from the CASP's own estate in the event of insolvency (Art 75);
2. CASPs operating a trading platform shall implement operating rules that, among other things, define what crypto-assets are admitted to trading. Before admitting a crypto-asset to trading, CASPs shall ensure that the crypto-asset complies with the operating rules of the trading platform and shall assess the suitability of the crypto-asset concerned, including the reliability of the technical solutions used and the potential association to illicit or fraudulent activities. Crypto-assets with in-built anonymisation functions are generally prohibited (Art 76);
3. CASPs exchanging crypto-assets for funds or other crypto-assets shall establish a non-discriminatory commercial policy that indicates the type of clients they agree to transact with and the conditions that shall be met by clients (Art 77);
4. CASPs executing orders for crypto-assets on behalf of clients shall take all necessary steps to obtain the best possible result for their clients, taking into account a range of best execution factors (Art 78);
5. CASPs placing crypto-assets shall communicate key information about the placement to the offeror, and obtain the agreement of the issuers of the crypto-assets. CASPs shall also have adequate procedures in place to avoid conflicts of interest (Art 79);
6. CASPs receiving and transmitting orders on behalf of clients shall implement procedures for prompt and proper transmission of client orders for execution. CASPs shall not receive any benefit for routing client order flow to a particular trading platform or another CASP (Art 80);
7. CASPs providing advice on or portfolio management of crypto-assets shall assess whether the crypto-assets or services are suitable for the clients, considering their knowledge and experience in investing in crypto-assets, their investment objectives including risk tolerance and their financial situation including ability to bear losses. These CASPs should also comply with a number of obligations similar to those applicable to providers of financial advice

(Art 81); and

8. CASPs providing transfer services for crypto-assets on behalf of clients shall conclude an agreement with their clients to specify their duties and their responsibilities (Art 82).

Conclusion

MiCA's approval puts the EU at the front of the race to establish fit for purpose regulations for crypto-assets which support innovation and basic consumer protections. The regulatory certainty offered by MiCA will likely attract more CASPs to the EU, and encourage investors to confidently deal with CASPs by allowing them to distinguish between licensed and rogue providers.

Further, the broad scope of services covered by the regime is likely to encourage the development of a sophisticated crypto-asset ecosystem encompassing exchanges and other verticals such as custody and advice.

We anticipate that other jurisdictions, including Australia, will borrow from elements of the MiCA regime in preparing their own regulations. We will address other aspects of MiCA in further posts in the coming weeks.

SBF files to dismiss charges

Lawyers for Sam Bankman-Fried, founder of the failed cryptocurrency exchange FTX, have filed a number of pre-trial motions seeking to dismiss the charges brought against him by the United States Department of Justice (the DOJ).

Commonly known as SBF, Bankman-Fried was arrested in December 2022 on eight criminal charges initiated by the DOJ. SBF later agreed to be extradited from the Bahamas – where he resided – to the US. The number of charges was subsequently increased to 13, which now include wire, securities and bank fraud charges, conspiracy to operate a unlicensed money transmitting business, money laundering, campaign finance violations and foreign bribery.

All charges are tied to SBF's conduct as the former CEO of FTX, which collapsed dramatically last November and filled for Chapter 11 bankruptcy in the United States along with 101 affiliate companies. The Bahamian and Australian entities of FTX are subject to separate insolvency proceedings.

In March, the US bankruptcy advisors revealed that USD$2.2 billion was paid to SBF through various entities prior to the collapse. This week, the US Internal Revenue Service slapped a USD$44 billion tax bill against the FTX US debtors.

SBF's lawyer characterized the case against him as a "classic rush to judgment" and cited the lack of detailed factual particulars in the original charges. Through his attorneys, SBF is also seeking to compel additional discovery from the Chapter 11 bankruptcy administrators on the basis that they are acting as a de facto member of the "prosecution team". A further pre-trial motion states:

> *The FTX Debtors and their outside counsel continue to make extraordinary efforts to help the prosecution that go far beyond mere cooperation with a criminal investigation.*

Mark Cohen, SBF's lead attorney previously foreshadowed the first motion by telling the court that his client "is not acknowledging he can be tried" on the charges that were added after SBF's extradition from the Bahamas.

In a memorandum of law supporting that motion, SBF's attorneys said he only agreed to the extradition based on a list of charges at that time. The memorandum also notes that the Bahamas government had not consented to extradition on the campaign finance charges. SBF's lawyers say that this violates the rule of specialty at international law by which a person can only be tried of offences to which consent for extradition was given.

SBF's lawyers rely on expert legal evidence regarding the terms of the extradition treaty between the Bahamas and the US which require the Bahamas to "consent" to the charges brought after the extradition. That consent has not been forthcoming to date despite inquiries from the DOJ to the Bahamian authorities.

SBF's lawyers have also raised various technical arguments in pursuit of motions to dismiss the original fraud and other charges for failing to properly state an offence.

SBF is currently set to go to trial from 2 October, 2023.

IRS sends FTX/Alameda group USD$44bn tax bill

The bankrupt cryptocurrency exchange FTX and its affiliates have been hit with 45 claims totaling USD$44 billion by the

United States Department of Treasury and Internal Revenue Service (**IRS**).

On May 10, an alleged tax bill for FTX's sister company, Alameda Research LLC, surfaced online. The bill showed that the IRS had assessed the company for USD$20.4 billion in partnership and payroll taxes, which appears to correspond to one IRS claim found on the website of Kroll's Restructuring Administration practice, the claims agent for the Chapter 11 debtors which comprise some 100 entities in the FTX/Alameda group.

The IRS has also filed claims against sister entities, Alameda Research LLC for USD$7.9 billion, and Alameda Research Holdings for USD$7.5 billion and USD$2.0 billion under the "administrative priority" classification. This classification allows the agency's claims to override those of unsecured creditors during bankruptcy proceedings, thus giving the IRS priority of collection. According to reports, for the U.S. partnership entities, taxes are not paid at the partnership level but are instead passed through to their partners and taxed at the individual level.

The IRS filings also include claims against FTX Trading Limited, the operator of the FTX exchange platform, totaling USD$64million, of which USD$24.8 million is said to have "administrative priority" and a further USD$40 million having priority status.

Although Alameda Research was based in Hong Kong, its founders and key personnel, including Sam Bankman-Fried and Caroline Ellison, are U.S. citizens. The U.S. taxation system is based on citizenship, meaning that Americans are liable for taxes on their global income *regardless* of where they reside or how much time they spend in the U.S. each year. This contrasts with many other countries including Australia where tax liabilities may differ depending on residency status.

In April, US bankruptcy advisors revealed that FTX had recovered USD$7.3 billion in assets and would consider rebooting the exchange as part of a restructuring plan. However, this was before the IRS' immense claims which would impact the recovery for creditors of both Alameda and FTX Trading, given the vast sums owing to it from Alameda. At the time, FTX's liabilities to customers alone nevertheless exceeded recovered assets by over USD$8 billion.

The IRS's substantial claim will came as a significant shock to creditors of the Chapter 11 debtor entities and, given the assertion of priority status in respect of a large amount of those claims, it will no doubt be the subject of further scrutiny by the group's aggrieved creditors and customers.

SEC ordered to respond to 2022 Coinbase petition

An increasingly hostile US approach to crypto has been met recently with industry responses criticising the SEC for failing to provide a pathway to compliance. This included Coinbase responding to a recent *Wells* notice with a 15 minute video explaining their repeated meetings and requests for collaborative exploration of solutions.

Coinbase recently moved more firmly, seeking an order that the SEC respond to a 2022 petition Coinbase filed with the SEC, which petition in turn sought clarity from the SEC regarding their approach to digital assets and the interpretation of securities laws.

The wheels of justice have begun moving in that case, with the SEC being ordered to provide reasons within 10 days as to why it has not responded to the petition.

The petition sought that the SEC:

> *propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities*

The petition also observed:

> *The U.S. does not currently have a functioning market in digital asset securities due to the lack of a clear and workable regulatory regime. Digital assets that trade today overwhelmingly have the characteristics of commodities*

and sought:

> *new rules facilitating the use of digital asset securities would allow for a more efficient and effective allocation of capital in financial markets and create new opportunities for investors.*

Specifically Coinbase sought only rules for digital assets which were securities, namely:

> *a transparent and collaborative process to engage directly with the SEC as a means to initiate a discussion about what the SEC can do within its own authority to provide clarity and certainty regarding the regulatory treatment of digital asset securities.*

It remains to be seen what position the SEC will take concerning this petition, but it certainly throws down a gauntlet to the recent approach of Chair, Mr Gary Gensler, who asserts nearly all digital assets are securities but was unable to explain whether one of the most popular crypto-assets, Eth, was a security or not under US law.

Ex-Coinbase employee sentenced in insider trading case

Ishan Wahi, a former product manager at Coinbase, was sentenced to 2 years in prison this week, following a hearing in the United States District Court for the Southern District of New York. Prosecutors allege that Wahi made up to USD$1.5M in profits by trading on confidential information regarding upcoming Coinbase token listings. Following the 2 years imprisonment, Ishan Wahi faces a further 2 years of supervised release.

In addition to trading on information gleaned from his employer, Wahi allegedly provided tips to his brother Nikhil Wahi and an associate Sameer Ramani, earning profits exceeding USD$1M. The Wahi brothers were arrested in mid 2022 by the US authorities in the course of an apparent attempt to flee to India.

Legal counsel for Wahi submitted:

> *There's no need for this court to impose additional punishment…He has lost his job. He has lost his reputation. He has suffered an enormous amount of negative publicity both here in the United States and in India.*

Nikhil Wahi pled guilty to charges of wire fraud conspiracy in September last year and was sentenced to 10 months in prison. Prosecutors argued that Ishan Wahi was the most culpable in facilitating the insider trading scheme.

> *This was not a one-off mistake – this was over a ten month period…Having access to the kind of information that this defendant had access to was like being able to read the newspaper a day in advance.*

Ishan Wahi's sentencing follows shortly after a jury found a former OpenSea product manager, Nate Chastain, guilty of wire fraud and money laundering in a similar case involving NFT listings on the marketplace's front page in what US prosecutors dubbed the first ever digital assets insider trading case.

These recent high-profile incidents highlight the importance for Web3 companies to implement a token dealing policy for employees and contractors, specific to the relevant business or project. Along with this, regular employee training, particularly for those in high-risk positions including senior management and product managers can help mitigate risks of insider trading which has the potential to cause reputational harm to the business and customer relationships.

It has been reported that the US Securities and Exchange Commission are close to settling separate insider trading charges against Ishan Wahi under US securities law. If those charges are pursued, the SEC will need to establish that one or more of the tokens which Wahi traded in are securities. However, this week's sentencing on charges brought by the US Department of Justice highlights that it is not necessary for the relevant digital asset to be a security (or financial product in the Australian context) in order for regulatory authorities to pursue charges under general fraud and other legislation in relation to trading in digital assets based on inside information.