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Blockchain Bites: HKEX's blockchain-based settlement system, Court blocks SEC appeal against Ripple, Elliptic releases Cross-Chain Crime report, Calls for clarity on staking, Canadians clarify stablecoin compliance, Crypto Council's whitepaper on DeFi regulation

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

HKEX's blockchain-based settlement system goes live

Last week, the Hong Kong Stock Exchange (**HKEX**) announced an exciting initiative to upgrade a key part of its settlement system using blockchain technology. The solution went live on Monday with Citi reported as the first counterparty to settle trades on the platform.

HKEX will use blockchain and smart contracts to upgrade Stock Connect, the landmark mutual market access program linking the Hong Kong and Mainland China equity markets. Stock Connect is the main channel for offshore investors to invest in stocks and ETFs listed on the Shanghai and Shenzhen stock exchanges (called Northbound investments), and vice versa for mainland Chinese investors who wish to invest in stocks listed on HKEX (Southbound investments). Turnover of Northbound investments reached RMB 2.5 trillion (AUD 540 billion) in August 2023 alone.

Stock Connect, especially the Northbound program, is a key part of HKEX's offering, which

> underlines Hong Kong's role as a superconnector facilitating the vital flow of capital between East and West and represents a significant step in HKEX's mission to connect China and the World

HKEX said the new blockchain-based settlement platform, called Synapse, will provide a vital solution to address long-existing problems with post-trade infrastructure for the Northbound Stock Connect.

The source of these problems is that Stock Connect is a T+0 market, but is integrated into the established settlement flow designed for a T+2 market in Hong Kong. Various solutions have been developed by market participants, including asset managers, global custodians, and clearing participants, to improve post-trade efficiencies. However, HKEX said:

> The lack of interoperability amongst these solutions, however, has in turn created additional operating, processing and counterparty risks.

Adopting Distributed Ledger Technology, Synapse provides a standardized and centralized platform that generates a single source of truth for settlement instruction workflow. It simultaneously creates settlement instructions for all parties along the settlement chain, facilitating concurrent processing. It also provides near-instantaneous status updates to HKEX Synapse participants, thereby greatly improving transparency for all market participants via multiple connectivity options.

HKEX's embrace of blockchain follows several other trailblazing blockchain initiatives adopted by Hong Kong in recent months. It also stands in stark contrast with the Australian Stock Exchange (**ASX**)'s botched attempts to replace its existing CHESS settlement system with blockchain technology. The Australian Financial Review reported last year that the ASX was urged to keep faith in blockchain and look at offshore markets for blockchain lessons. Perhaps HKEX's new settlement system will provide just the example for the ASX to follow.

Written by J Huang, S Pettigrove and M Bacina

Ripple riding a wave as Court blocks SEC appeal

Ripple Labs, Inc. (**Ripple**) has secured another victory in its ongoing legal battle against the U.S. Securities and Exchange Commission (**SEC**). In a ruling last week, District Judge Analisa Torres denied the SEC's petition seeking an interlocutory appeal of the judge's ruling that certain programmatic and other sales of XRP did not constitute securities transactions, sending more ripples of excitement through the blockchain ecosystem.

The SEC had sought to overturn Judge Torres' earlier ruling granting summary judgment in the case and a partial victory to Ripple. In July, Judge Torres found that while Ripple's XRP sales directly to institutional investors were unregistered securities transactions, sales of XRP to retail customers through programmatic sales on exchanges were not securities transactions. The judge also held that XRP grants to employees were not securities transactions as they did not involve an investment of money.

The latest legal twist is another blow to SEC's regulation by enforcement strategy against the US crypto industry, following its earlier defeat in the Ripple case and defeats in the Grayscale ETF litigation and Coinbase rule-making petition.

XRP enthusiasts cheered as the news broke, and the XRP token responded with a 5% price rally on the day, demonstrating the market's enthusiasm for the development.

Senior Legal Counsel of ConsenSys, Bill Hughes, tweeted an update following the release of the judgment:

In her brief ruling, Judge Torres pointed out that the SEC had failed to meet its legal burden justifying an interlocutory appeal and to prove that there were controlling questions of law or substantial grounds for differences of opinion.

The Judge also struck back at Judge Rakoff's recent comments in the Terraform Labs case, carefully warning that her judgment in the Ripple case turns on the specific facts of the case and should not be read as a general statement that programmatic or exchange offerings of digital assets cannot amount to a securities transaction depending on the facts.

The SEC may still pursue an appeal of Judge Torres' summary judgment ruling after trial, meaning this legal drama is likely far from over. Her Honour has also set a trial date for April 2024 to address other unresolved issues in the Ripple case.

The SEC's case which has dragged on for nearly three years at this point looks set to continue for several more years at

substantial cost to the parties. Brad Garlinghouse, Ripple's CEO, was recently stated that Ripple alone has spent over US$100 million fighting the SEC case to date. Given the Ripple controversy and lack of uncertainty which continues to hang over the US crypto industry, Congressional action or a consultative rule making process for digital assets looks more and more like a faster, better and more efficient path forward for all concerned.

Written by L Higgins and S Pettigrove

Elliptic releases "The State of Cross-Chain Crime" report

Financial crime compliance company Elliptic has released "The State of Cross-Chain Crime" report (**the Report**) focusing on crypto laundering and exploring the evolution and adaption of crypto-related crimes across the globe.

The Report sheds light on the intricate web of cross-chain crimes, revealing that $7 billion is entwined in crypto laundering activities. Cross-chain bridges and coin swap services are used to obfuscate billions of dollars and some of the most prolific launderers are hackers, dark web markets, online gambling platforms, illicit virtual asset services and coin swap services.

The Report discusses how blockchain technology, renowned for its decentralised and immutable nature, is being exploited by criminals to orchestrate large-scale crypto laundering. Specifically, how the perpetrators, undeterred by the traceability of blockchain, have devised tactics to manoeuvre across chains to launder money and how legacy blockchain analytics solutions do not have the capabilities to trace them.

According to the Report, the following is a list of the origin of Illicit crypto that has been laundered through decentralised exchanges, cross-chain bridges and coin swap services:

1. Thefts ($1.1 billion);
2. Tornado Cash, pre-sanction ($972.7 million);
3. Dark Web Services and Markets ($510.6 million);
4. Suspected North Korean Heists ($351.2 million); and
5. Scams and Ponzi Schemes ($296.4 million).

The vast majority of the funds obtained through theft, Tornado Cash, suspected North Korean Heists and scams and Ponzi schemes use decentralised exchanges to launder money, while dark web services and markets prefer coin swap services.

A lack of robust crypto regulation allows criminals to circumnavigate certain measures designed to prevent hacking success. For example, freezing assets is a tactic employed by exchanges to prevent assets being accessed by hackers. To counteract this, some hackers who steal USDT or USDC typically swap these to decentralised stablecoins to evade this risk.

While action has been taken against Tornado Cash, the other main sources of illegally obtained crypto remain without a united regulatory approach. The preventable loss is underscored by a need for fit-for-purpose cross-border legislation and policy that targets criminals who abuse and/or make available decentralised exchanges and coin swap services to launder ill-got crypto.

The Report ends with an optimistic outlook and discusses how multi-asset screening, cross-asset tracing and cross-chain tracing are measures that are being implemented to counteract the laundering of funds on exchanges and through swapping services.

While the United States contends with the SBF trial, and Hong Kong's Securities and Futures Commission battles its evolving virtual asset marketplace, there is a global threat to Web3 that is underscored by the desperate need for robust legislation that protects consumers and reduces crime.

By T Masters and L Misthos

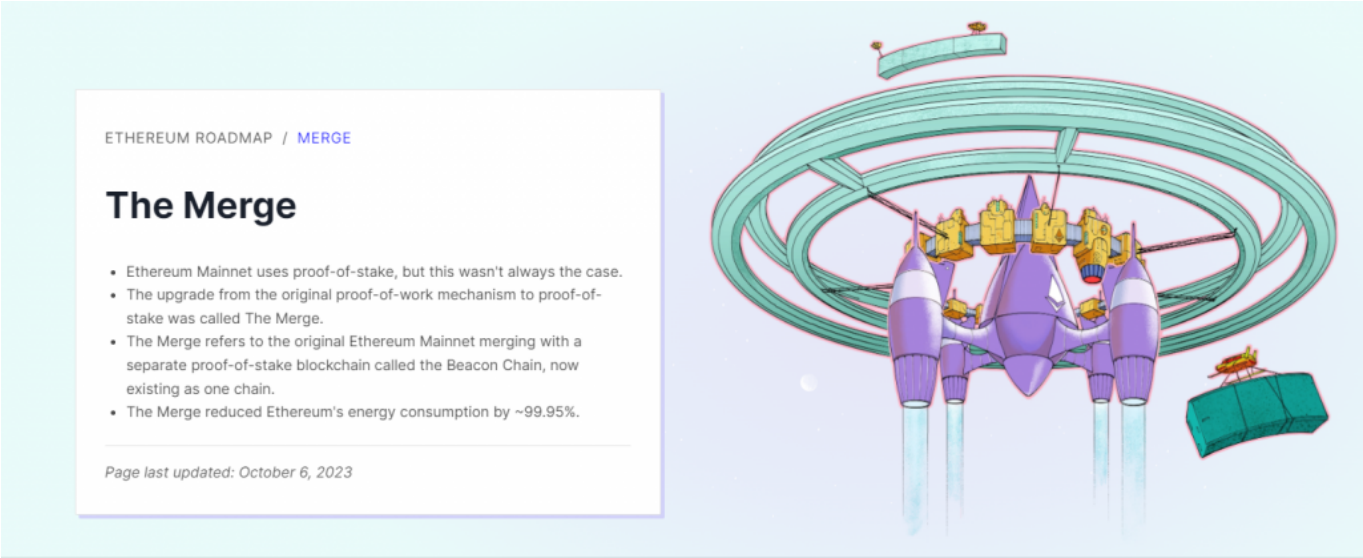
Calls for clarity on staking

In the constantly evolving global blockchain ecosystem, one legal grey area is staking. While some countries (e.g. Hong Kong) aim to blaze the global legislative trail, arguing that specific regulations provide clarity and safety, others (e.g. New Zealand) are wary of premature restrictions that could stifle innovation, particularly given Singapore's decision to ban staking for retail clients and the controversial IRS Revenue Ruling of August this year.

Staking is a process that involves 'locking' up a certain amount of a digital currency in a blockchain network to support its ongoing operations. In return for this commitment, participants or 'stakers' are rewarded with additional cryptocurrency. Staking has gained popularity as a way for cryptocurrency holders to earn passive income while contributing to the maintenance and security of the blockchain network.

Europe has taken significant steps toward comprehensive cryptocurrency regulation with the introduction of the Markets in Crypto Assets law (MiCA). While MiCA covers a wide range of crypto-related activities, staking is conspicuous by its absence. European Central Bank's Christine Lagarde has called for the inclusion of staking in a MiCA sequel, but there is currently no timeline for a MiCA2, leaving uncertainty in the interim.

Staking is a fundamental aspect of the blockchain ecosystem and should not be overlooked, especially following the recent one year anniversary of The Merge, where the Ethereum blockchain (the native blockchain of ETH, the second largest cryptocurrency in terms of market capitalisation) switched from a proof-of-work system to a proof-of-stake system, with a baked in staking return to reward those securing the network. The lack of clarity has forced regulators to consider categorizing staking as either a form of custody (when in the case of Eth it is plainly not custodial in nature), banking or a yield based product, leading to confusion within the industry.



Source: https://ethereum.org/en/roadmap/merge/

Switzerland is a prime example of how an ambiguous regulatory environment can create problems. The Swiss Blockchain Federation recently warned of a shift in practice by financial regulators at Finma, restricting staking to licensed banks. This move has raised concerns about stifling innovation and competitiveness in the country. Regulators argue that in some forms of staking, bankruptcy could jeopardise client assets, necessitating a more stringent, bank-like approach.

Singapore has also taken a restrictive stance, forbidding crypto providers from facilitating staking for retail clients. Even in the European Union, new tax rules like DAC8, designed to cover staking, have been introduced before a clear definition of the practice exists. These regulations would require crypto providers to report staking profits made by their clients, adding to the legal uncertainty surrounding staking.

The Cardano Foundation, a non-profit promoting a major blockchain that relies on staking for transaction validation, shared its concerns about the regulatory landscape with CoinDesk in a recent article on this issue. The Foundation's Chief Executive Frederick Gregaard believes that the situation in Switzerland can be resolved, but it highlights the challenges posed by the lack of clear staking regulations, particularly in the context of The Merge.

While discussions are ongoing in Europe and the UK regarding staking regulations, there is a delicate balance between providing legal clarity and allowing the sector to mature. Rushing into hastily drafting regulations can stifle the growth of an industry that has the potential to revolutionise various sectors of the economy.

These regulatory gaps must also be addressed in Australia. Although it is disappointing that the Board of Taxation's report on crypto-tax was delayed from 30 September 2023 to 29 February 2024, this delay offers an opportunity for a more comprehensive and technologically neutral approach to be adopted.

It is imperative that lawmakers and regulatory bodies take their time to understand the nuances of blockchain technology fully and craft regulations that not only address the specific challenges of the blockchain industry, but also promote innovation and fairness. Australia has a unique opportunity to lead in creating a regulatory framework that fosters innovation, safeguards investors, and promotes a level playing field for all participants.

By M Bacina, S Pettigrove and L Higgins

Canadians clarify crypto stablecoin issuance and conversion compliance

The Canadian Securities Administrators (**CSA**) has shed light on the regulatory framework concerning stablecoin issuance and trading on Canadian crypto exchanges, sparking a myriad of discussions within the blockchain and legal communities.

The CSA unveiled details concerning its interim approach towards the trading of 'value-referenced crypto assets' , notably those often dubbed as 'stablecoins'. Previously the CSA had said that 'value-referenced crypto assets', which are crafted and promoted to sustain a stable over time relative to a reference asset, might be classified as securities and/or derivatives.

Notwithstanding Canadian exchanges racing to register with the CSA, the exchanges are barred from trading crypto assets that are identified as securities and/or derivatives. The CSA has acknowledges that value-referenced crypto assets may hold certain utilities for Canadian clients and that it might permit continued trading of certain 'value-referenced crypto assets' that are referenced to a single fiat currency, subject to terms.

The interim terms and conditions proposed by the CSA were partly informed by feedback from Canadian crypto market participants as well as evolving international standards and regulations and aim to address investor protection concerns presented by value-referenced crypto assets.

Some of these provisions include requiring issuers to maintain an appropriate reserve of assets with a qualified custodian, held for the benefit of the crypto asset holder, and the obligation for the issuer of the value-referenced crypto asset and crypto asset trading platforms that offer them to make certain information related to governance, operations, and reserve of assets publicly available.

Stan Magidson, CSA Chair and Chair and CEO of the Alberta Securities Commission, points out the focus for the CSA is the liquidity reserves of exchanges.

> The transparency of value-referenced crypto assets about the composition and adequacy of their reserves and their governance are critical issues that must be addressed to protect Canadian investors and the integrity of our capital markets.

The CSA is welcoming submissions regarding appropriate long-term regulation.

In Australia, the Federal Government has prepared a strategic plan for a future-ready payments system which could include stablecoin development. The Reserve Bank of Australia has also released a report informed by their findings on pilot tests conducted on stablecoins, which may work to grow stablecoin use in Australia. There is no specific guidance from ASIC as yet in Australia on what they consider stablecoins to be or how they should be issued, but several large Australian banks have already issued their own stablecoins to start experimenting, albeit not at a retail level.

As regulations become clearer, stablecoins appear only likely to grow in importance to the intersection of traditional finance, payments, blockchain and crypto-assets.

By M Bacina and L Misthos

Crypto Council for Innovation calls out case for customised regulation for DeFi

The Crypto Council for Innovation (**CCI**) has released a whitepaper enclosing key elements of an effective Decentralised Finance (**DeFi**) framework. The CCI is a global alliance aimed at spurring the adoption of crypto products and related Web3 projects and have set their sights on tailored DeFi policy.

The whitepaper highlights that the risks posed by DeFi are fundamentally different from those posed by traditional finance, specifically because of there being no central intermediary that controls the activities of a DeFi system and warning that a traditional regulatory approach (such as the "same activity, same risk same regulation" tagline which has been pushed by international bodies) will not work.

The CCI notes that existing "entities-based" regulations were not drafted to address specific DeFi risks, underlining the CCI suggestion that the above tagline to be:

> Same Activity, *Different Risks, Different Regulation* but Same Regulatory Outcome

This would acknowledge the inherent differences in DeFi and traditional finance and encourages policy makers to tailor legislative framework to the technology, but goes directly against the US SEC and IOSCO frameworks which assert that decentralisation is not real and there are individual actors and entities who can be located and regulated.

The CCI whitepaper proposes three policy recommendations designed to help policymakers to draft fit-for-purpose legislation relating to DeFi.

Recommendation 1

Mandatory disclosures by app-operating businesses: A standardised disclosure regime for app-operating businesses that includes information about the underlying De-Fi protocol and, at a minimum, how the protocol works, governance, funds and asset management information.

Disclosure under this recommendation can be broadly classified into four categories:

1. general software disclosures;
2. tokens disclosures;
3. financial disclosures; and
4. automation disclosures.

The intent of this is provide users enough information to quickly understand the risks of interacting with these businesses.

Recommendation 2

Independent certification of public good protocols: The establishment of an Independent Certification Regime Organisation (**ICRO**) to certify DeFi protocols that meet the ICRO's criteria, including security code audits. An ICRO could narrow the scope for businesses in relation to what disclosure obligations they are required to comply with and spur adoption with the introduction of a certification standard.

A self-regulating ICRO would assist to avoid placing excessive compliance burdens on software developers while incentivising them to implement best practices for user adoption. Projects that do not follow the ICRO criteria could be decertified.

Recommendation 3

Regulatory safe harbour program: Providing a clear pathway for projects that have true decentralisation as their objective. A safe harbour regime could allow progressive decentralisation to occur in a controlled manner that protects consumers and would be available to protocol developers that comply with mandatory disclosure requirements imposed by the above-mentioned ICRO, given many protects necessarily are centralised at some point of their development.

Safe-harbor criteria and thresholds are proposed to be established by the ICRO and developers' obligation to adhere to regulatory requirements should decrease as the protocol progressively decentralises.

The whitepaper comes shortly after the International Organization of Securities Commissions (**IOSCO**) consultation report which introduced 9 policy recommendations for DeFi, most of which involve asserting DeFi is not sufficiently different to existing financial services and so should be addressed in broadly the same way, which is apparent from the disclosure in the report that the US SEC had a heavy involvement in preparing the report and in IOSCO's working groups.

While both IOSCO and the CCI acknowledge the importance of the technology element that is pivotal in policy making, the CCI's recommendations are clearly proposed with careful consideration of the unique technological aspects set up a robust framework that focus on innovation and development while IOSCO's recommendations focus on the identification and disclosure of persons involved in DeFi projects.

The CCI draws an important distinction between businesses which operate DeFi protocols, and "public good protocols" which are decentralised and do not fit within traditional regulatory approaches.

While IOSCO holds very significant influence with securities regulators around the world the CCI has made an important contribution in calling out the critical aspects of decentralisation which need to be addressed if fit for purpose regulation is to be achieved.

By M Bacina and L Misthos