Digital Digest – Volume 1

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DLA PIPER

Welcome and introduction

As the commercial and financial sector aims to deal with the increasing volume of law, regulation and market practice impacting the digital and crypto space, the team at DLA Piper have put together a "Digital Digest" to bring together key themes to be considered when doing business in the digital and crypto space in or from the UK. The UK is a world centre for digital activity and innovation and many participants are either based in the UK or look to the UK as a guide for how to address legal and regulatory issues impacting the sector. It is therefore essential to remain aware of relevant developments.

This Digest will be published every two months to pick up relevant themes that have developed in the intervening period. Whilst many of the issues will relate to law and regulation in the UK there will also be commentary on relevant themes that are occurring outside the UK in other key markets but which are likely to impact the thinking of businesses that may be based in the UK on how they approach particular activities.

In this edition, we highlight a number of regulatory milestones constituting big steps in presenting the vision in respect of future legal and regulatory policy frameworks. This includes the HM Treasury Consultation in relation to proposals for the UK's Financial Services regime for cryptoassets. This is likely to shape the future of digital business in the UK and in several jurisdictions that reflect the UK regulatory environment. The three phase approach will see some changes in the near term with further development over the coming months and years. The proposed changes will extend the scope of financial promotions to cover crypto related business but we note that crypto registered firms will be able to communicate their own financial promotions relating to cryptoassets.

In the EU, a key step occurred on 16 May 2023, with the final adoption by the Council on the text of the landmark EU Markets in Crypto-Assets Regulation (MiCA) and the Transfer of Funds Regulation (TFR). This will provide the framework for a comprehensive approach to cryptoasset regulation across the EU and will likely impact many businesses aiming to move to a digital basis for future activity.

In Dubai we were pleased to have worked as legal advisors to the Dubai Virtual Assets Regulatory Authority (VARA) in establishing the Emirate's virtual asset specific regulatory framework. The forward looking regulatory approach should help to encourage participants to the region.

We also comment in this Digest on jurisprudential analysis of digital assets and highlight in particular the UKJT published legal statement on the effectiveness of issuance and transfer of digital assets under English Law.

The English courts have been busy with developments in legal thinking applying to the digital asset sector. Recognition of digital assets as property under English law has been a key development in English jurisprudence, as a number of legal principles rest on the legal nature of the asset, and will be a key determinative factor in how the assets are dealt with from an English law perspective. Several key recent cases, building upon this principle, are mentioned in this Digest and we will follow developments in these and subsequent cases as they shape the future treatment of digital asset rights by the courts over the months and years to come.

We hope you find this Digest useful and welcome your comments and feedback.

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1. New regulatory framework for cryptoassets

1.1. Prudential treatment of crypto-asset exposures

The Basel Committee on Banking Supervisions (BCBS) has finalised in December 2022 its standard on the prudential treatment of cryptoasset exposures. These standards provide a harmonised international regulatory and supervisory approach to banks' crypto-assets exposures and aim to balance responsible private sector innovation with sound bank risk management and financial stability.

The BCBS standard divides crypto-assets into two groups: Group 1 (low risk) includes tokenised traditional assets and stablecoins meeting specific criteria, whereas Group 2 (higher risk) includes all crypto-assets that do not meet the classification conditions. Group 2 cryptoassets are subject to more stringent prudential requirements.

The European Union and other Basel jurisdictions will need to transpose the Basel standard into their legislation by the 1 January 2025 deadline. In the European Union, where the banking regulatory framework is already under review, the European Parliament, in a report in February 2023 on the adoption of the third Capital Requirement Regulation (CRR III), called on the Commission to adopt a proposal by 31 December 2024 to transpose the BCBS standards. Until the legislative proposal is adopted, institutions' exposure to cryptoassets would be required to apply prudent own funds requirements, including a risk weight of 1 250% to their exposures to crypto-assets in the calculation of their own funds requirements.

1.2. Landmark MiCA Regulation

Following the adoption by the EU Parliament of the text of the landmark EU Markets in Crypto-Assets Regulation (MiCA) in April 2023, the Council further formally adopted MiCA on 16 May 2023, which marks the final step in the much-debated legislative process.

MiCA sets out a comprehensive and harmonised framework for the regulation of cryptoasset markets across the EU. It will regulate cryptoasset issuers as well as Cryptoasset Service Providers (CASPs), including custodians, exchanges and other intermediaries. MiCA will apply to a wide range of currently unregulated cryptoassets, including utility tokens, payment tokens and stablecoins. However, importantly, MiCA will not apply to Non-Fungible Tokens (NFTs) and to tokenized securities.

MiCA forms part of the European Commission's broader digital finance package, which also includes the Digital Operational Resilience Act (DORA) and the Distributed Ledger Technology (DLT) pilot regime.

The text of MiCA shall now still be published in the *Official Journal of the European Union*. MiCA should then start to apply after a transitional period of 18 months, i.e. around end 2024/early 2025. The rules applicable to stablecoins will however start to apply after a period of 12 months, therefore becoming effective around summer 2024.

1.3. Revised Regulation on Transfers of Funds

Together with MiCA, the Council also adopted on 16 May 2023 the proposal for a regulation on information accompanying transfers of funds and certain cryptoassets that recasts Regulation 2015/847 of 20 May 2015 on information accompanying transfers of funds (the Transfer of Funds Regulation or TFR).

This regulation was proposed by the European Commission in summer 2021 as part of the AML Package, a package of legislative proposals aimed at strengthening the EU's anti-money laundering and countering terrorism financing (AML/CFT) rules. The package also includes a proposal for AML Regulation and a proposal to create a new EU AML authority.

Giving effect to the Financial Action Taskforce (FATF)'s recommendations on virtual assets, the revised TFR will extend the obligation of payment service providers to accompany transfers of funds with information on the payer and payee to crypto assets.

The TFR shall also apply towards the end 2024/beginning of 2025, to coincide with the entry into force of MiCA.

1.4. NFT platforms, DAOs and DeFi arrangements to become EU AML obliged entities

As non-fungible tokens (NFTs) are excluded from the scope of MiCA, NFT platforms will not fall under the European definition of crypto-assets service providers (CASP), Consequently, NFT platforms would not become obliged entities under the future EU AML Regulation.

To close this gap, the European Parliament suggested in an amended draft version of the new AML Regulation made available online in March 2023, the inclusion of NFT platforms and persons providing services for the sale and purchase of NFTs as a separate category of AML obliged entities. This would mean that NFT platforms and those providing NFT-related services would become subject to the whole set of EU AML legislations.

The same would also go with Decentralised Autonomous Organisations (DAO) and other Decentralised Finance (DeFi) arrangements, to the extent they perform or provide for or on behalf of another person crypto-asset services.

1.5 AI – AI regulation

In early May the European Parliament's committees approved the negotiating position for further development of the Artificial Intelligence (AI) Act. The regulation will now head to the trilogues stage for the Parliament, Council and Commission to agree on a common text.

The core element of the AI Act is to develop a mechanism to provide regulatory controls and information requirements on development and deployment of AI depending on the perceived risks presented by the AI. Some activities will be prohibited whilst others, depending on a sliding scale classification will be subject to varying levels of control.

In the EU AI Act, deployers play a critical role in ensuring that fundamental rights are protected, complementing the obligations of the provider. Deployers are better placed to identify risks not foreseen in development due to their being closer to the use case and having greater knowledge of the context of use including vulnerabilities of the people or groups of people likely to be affected.

The AI Act will also call for identification of specific low-risk, high-risk or fully prohibited use cases. Low-risk cases under the classification system would be required to comply with basic transparency and reporting requirements, whilst those that fall into high-risk contexts will have to comply with stricter requirements. Use cases considered to pose an unacceptable risk will be banned in the EU.

The prohibited use list may include 'real-time' remote biometric identification systems in publicly accessible spaces; social scoring; or facial recognition databases.

In relation to "foundation models" including large language models such as ChatGPT, it is viewed that the complexity, potential impact and lack of control over the model's development, should result in the models being subject to additional requirements on design, testing, environmental impact, and disclosure necessary for providers to comply with the AI Act.

With the current high level of interest and investment in AI systems there will be intense negotiation to come on this topic.

2. HM Treasury consults on proposals for the UK's financial services regime for cryptoassets

On 1 February 2023, HM Treasury published a consultation setting out proposals for the UK's financial services regime for cryptoassets. The consultation was open for responses until 30 April 2023.

The UK plans to bring cryptoassets into scope of the Financial Services and Markets Act 2000 (FSMA), via the Financial Services and Markets Bill, rather than introducing a bespoke crypto regime (so different to the EU approach under MiCA). This means that, broadly speaking, regulatory requirements for financial services (including under the FCA Handbook) will apply to cryptoasset firms in the UK, to the extent they undertake relevant activities (such as broking, advising or safeguarding assets), subject to any targeted amendments that may be introduced to account for particular features of the crypto markets.

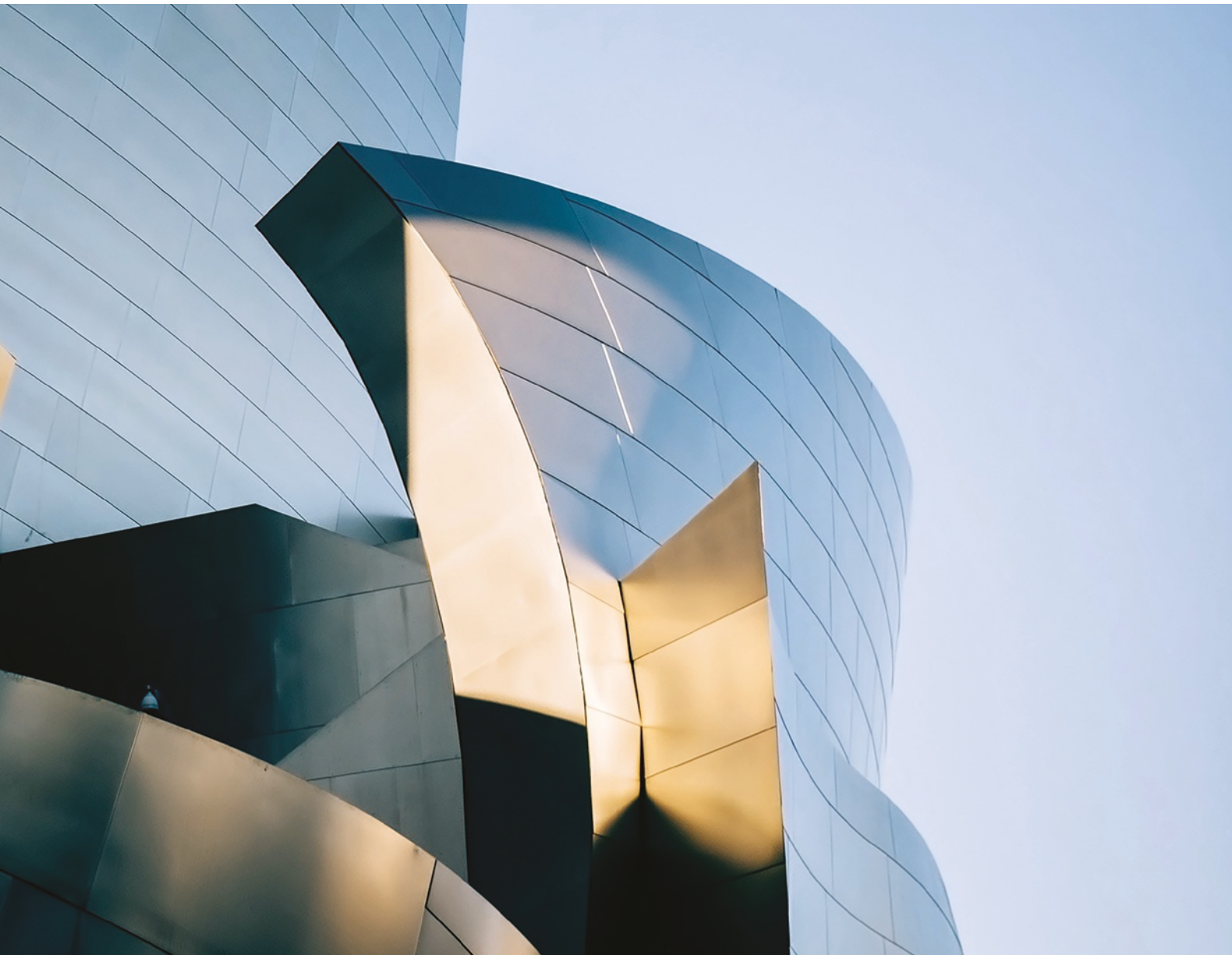
The UK intends to adopt a phased approach to regulation of cryptoassets, with the first stage covering fiat-backed stablecoins used for payment, and stage 2 covering other cryptoassets.

3. FCA registered cryptoasset firms may communicate their own financial promotions relating to cryptoassets

Cryptoassets will soon be brought into scope of the UK financial promotions regime. This broadly means that financial promotions relating to cryptoassets must be either communicated or approved by an authorised firm, unless an exclusion applies (for example the financial promotion is only made to investment professionals).

On 1 February 2023, HM Treasury published a policy statement setting out the Government's intention to introduce a bespoke exemption in the Financial Promotion Order for cryptoasset businesses registered with the Financial Conduct Authority (FCA) under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs) for anti-money laundering purposes (but not otherwise 'authorised' under FSMA).

This exemption will enable FCA-registered cryptoasset businesses to communicate their own cryptoasset financial promotions to UK consumers.



4. Dubai introduces world's first virtual assets specific regulatory regime

In February 2023, the Dubai Virtual Assets Regulatory Authority (VARA) published the Virtual Assets and Related Activities Regulations 2023 regulating virtual assets and associated service providers.

DLA Piper has worked with the Dubai Virtual Assets Regulatory Authority (VARA), as its exclusive global legal advisor, on the creation of the Emirate's virtual asset specific regulatory framework. More information on DLA Piper's involvement can be found here.

5. UK jurisdiction taskforce legal statement on digital securities

In February 2023, the UKJT published its Legal Statement on the issuance and transfer of digital securities under English private law, a copy of which can be accessed here.

This statement follows on from the UKJT's landmark Legal Statement on Cryptoassets and Smart Contracts, in which the UKJT concluded that (i) cryptoassets can, depending upon the asset in question, constitute property (a conclusion subsequently confirmed by the English courts), and (ii) smart contracts are capable of being enforceable agreements under English law.

In response to a public consultation, the UKJT's latest statement focuses on the aspects of digital securities that are potentially novel and distinctive and discusses how well general legal principles apply.

6. High Court discharges interim proprietary injunction against cryptocurrency exchange

In *Piroozzadeh v Persons Unknown and Others* [2023] EWHC 1024 (Ch), the High Court set aside an interim injunction that was previously granted against a cryptocurrency exchange on a without notice basis. That injunction required the exchange to preserve certain cryptocurrency that the claimant, the alleged victim of a fraud, claimed to be able to trace to the exchange. The Court held that the approach the claimant took with respect to the exchange was not appropriate in the circumstances.

Where a victim of a cryptocurrency fraud seeks an injunction to preserve crypto assets that were the subject of a fraud, the victim's legal advisers should consider – in a similar vein to a fraud occurring in respect of bank accounts – whether it would be sufficient to obtain an injunction against the fraudster and/or the owner of the cryptocurrency account in question, and merely serve that injunction on the exchange as a third party, rather than naming the cryptocurrency exchange as a respondent in the proceedings.

If the claimant does seek an injunction against an exchange itself, the court papers should distinguish the position of the cryptocurrency exchange itself from the position of other potential defendants (i.e., the alleged fraudsters and/or account holders). The claimant should also give proper consideration to the manner in which currency is held on the exchange – here, in arguing for a constructive trust on the part of the exchange, the claimant had failed to explain that the Claimant's cryptocurrency had been swept from the user's account into an unsegregated pool of assets, with the user granted credit in the amount of the value swept; this gave rise to a *bona fide* purchaser defence for the exchange which was not properly explained to the Court despite the Claimant's duty of full and frank disclosure. If an injunction is obtained against a cryptocurrency exchange itself without valid grounds (for example, if the claimant has not complied with its duty of full and frank disclosure, or there are no identifiable assets at the time the application is made which the exchange could be required to preserve), and is thereafter discharged, the claimant may be left with a significant adverse costs order with respect to the costs of the exchange, as was the case here.

7. *Tulip Trading Ltd v Van Der Laan and ors* [2023] EWCA Civ 83 – the latest from the Court of Appeal on developer's fiduciary duties

In *Tulip Trading*, the Court of Appeal unanimously overturned the High Court's first instance decision and determined that there is a serious issue to be tried on the question of whether developers owe fiduciary duties to Bitcoin owners.

The Court of Appeal did not specifically consider whether the defendants owed tortious duties to Tulip. However, it was considered that if a fiduciary duty appeal succeeded, then it would follow that the appeal regarding tortious duty should also be allowed.

However, Court of Appeal acknowledged that, for the case to succeed at trial, there would need to be a significant development of the common law on fiduciary duties. From a legal standpoint, while the established categories in which fiduciary relationships arise are not closed, it is exceptional for fiduciary duties to arise outside of them.

Our analysis of the High Court's first instance decision in *Tulip Trading* can be found here. Our analysis of the judgment of the Court of Appeal can be found here. In a further recent interesting development, a group of 10 of the developers alleged in their defence filed on 26 April that *Tulip Trading's* case is fraudulent and an abuse of the court's process, on the basis that Tulip Trading does not own and has never owned the digital assets that are the subject matter of the claim.

8. High Court permits service of legal proceedings exclusively by NFT

Although the courts of England and Wales have previously allowed service of proceedings by NFT (see *D'Aloia v. Person Unknown & Ors* [2022] EWHC 1723 (Ch)), the High Court in *Osbourne v. Persons unknown and others* [2023] EWHC 340 (KB), for the first time, determined that NFTs can be deployed exclusively as service on an unknown person.

In *Osbourne*, the Claimant commenced proceedings in connection with the hacking of two NFTs from her digital wallet in January 2022. The Claimant's forensic investigator traced the assets to wallets operated by OpenSea, an NFT marketplace, and further, identified that one of the stolen NFTs was transferred to a wallet believed to be linked to a South African individual.

The Claimant had previously obtained an injunction, preventing the stolen NFTs from being bought and sold. However, this judgment determined that the Claimant could use an NFT as an alternative, and exclusive, method of service to put anonymous defendants on notice of her claim. In addition, permission was given for the claim also to be served on the South African individual via email and NFT, on the basis that there was no other method of service available to the Claimant.

9. UK High Court grants the first Bankers Trust Order against overseas cryptocurrency exchanges using new 'gateway' for service out of the jurisdiction

In *LMN v Bitflyer Holdings Inc. and others* [2022] EWHC 2954 (Comm), Mr Justice Butcher recently handed down judgment in the first successful Bankers Trust application against overseas cryptocurrency exchanges based on the new gateway for service out of the jurisdiction under CPR Practice Direction 6B §3.1(25) (known as the 'disclosure gateway').

LMN sought disclosure of customer and transactional information from several overseas cryptocurrency exchanges, to trace stolen cryptocurrency which had, according to LMN's expert, passed through those exchanges. Whilst certain of the exchanges were prepared to provide information to LMN, there was disagreement over the scope of information sought, as well as certain confidentiality restrictions which LMN sought to impose. The claim therefore proceeded to a hearing, at which the order made by Mr Justice Butcher was substantially narrower than that sought by LMN.

Consistently with previous English cases, Mr Justice Butcher agreed that "[t]*here is a good arguable case that cryptocurrencies are a form of property*", and that they are recoverable and traceable in equity. He considered arguments that the transfer of Bitcoin on the Bitcoin blockchain may create a new asset in the hands of the acquirer but held that that there is a good arguable case that the transfers can be the subject of tracing, on the basis that there is a relevant substitution.

10. Exchange adjudged to hold stolen assets on constructive trust for victim of cryptocurrency crime

In *Jones v Persons Unknown* [2022] EWHC 2543 (Comm), the Claimant was the victim of a fraud perpetrated by cyber criminals located overseas. The Claimant owned around 90 Bitcoin, which were invested into a fraudulent crypto investment vehicle. Through the instruction of an expert, the Claimant traced the stolen cryptocurrency to a wallet on a popular centralised exchange, and thereafter commenced proceedings against the (unknown) fraudsters for deceit/unjust enrichment, as well as against the exchange as constructive trustee for the return of his Bitcoin. The Claimant had already obtained a worldwide freezing injunction and proprietary injunction against the Defendants.

In circumstances where the Defendants did not engage in the substantive litigation, the Claimant applied for summary judgment and a delivery up order against the exchange. During the summary judgment hearing, the judge noted that despite the freezing order, the quantity of Bitcoin in the custodial wallet had decreased.

The High Court was satisfied that the test for summary judgment had been met, and further that the exchange was a constructive trustee of the Claimant's Bitcoin, in circumstances where it controlled the wallet holding the stolen Bitcoin and there was no evidence that the exchange had "*any proprietary interest in respect of the claimant's Bitcoin, which would override the claimant's beneficial interest in that Bitcoin*", a potentially significant decision for exchanges in terms of their potential liability to claims by users. Following the dicta in *AA v. Persons Unknown* [2019] EWHC 3556 (Comm), the High Court also agreed that, under English law, Bitcoin could be treated as legal property.

The High Court concluded that the Claimant was entitled to order for delivery up and extended the freezing injunctions to prevent the onward disposal of the Bitcoin. The Court also allowed alternative service on the Defendants by email and by NFT air drop.

News & events

- DLA Piper advises Galaxy Digital on a strategic alliance with DWS for the development of crypto exchange-traded products: *Follow this link for further details.*
- DLA Piper advises Dubai's Virtual Assets Regulatory Authority on world's first virtual assets specific regulatory framework: *Follow this link for further details.*
- Global digital forum – Together with GBBC Digital Finance, we will host leading representatives from government, regulatory bodies and international business at our London office and virtually, to discuss the implications of operating in the new digital environment. *Follow this link for further details.*

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