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SEC Faces Stricter Review of Its Effort to Regulate Crypto

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I. Intro

In the latter half of 2023, a number of important federal court decisions came down that pushed back at the SEC's efforts to constrain the crypto industry. These decisions reflect a maturation of the analysis of when a digital asset or its sale triggers federal securities laws. The decisions also reflect courts' readiness to challenge the SEC's own determination of the scope of its authority in the crypto space. The SEC, however, appears undeterred and has continued an aggressive approach, charting new territory in enforcement actions involving nonfungible tokens (NFTs) and exchanges, and expeditiously moving forward to appeal unfavorable precedent.

II. Investment Contract Cases

Over the summer, two important decisions were rendered by courts in the Southern District of New York (SDNY), which closely analyzed when the sale of digital assets constitute "investment contracts," a type of securities under federal securities law. Two other cases addressing the same issue will be fully briefed by year's end.

A. *Background:* Howey

No statute defines cryptocurrency as a security. Instead, the SEC and courts use the "*Howey* Test," derived from the Supreme Court case, *SEC v. WJ Howey Co.*, 328 U.S. 293 (1946). *Howey* addressed whether certain real estate contracts for land on orange groves, which came with related service and harvest agreements, constituted "investment contracts," were a type of security under federal securities law. The Supreme Court held that they were and, in so doing, articulated the following factors needed for an investment contract (described as a "contract, transaction, or scheme") to exist: (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits based on the efforts of others. Under *Howey*, if these criteria are met, there is an investment contract, and attendant sales must be registered according to federal securities laws.

B. Prior Case Law

The SEC had been overwhelmingly successful using the *Howey* test to argue that token sales triggered federal securities laws. Most early cases involved an ICO (initial coin offering), where a blockchain entity had sold new tokens to fund its overall blockchain project. The SEC easily persuaded the court that the ICO constituted an unregistered securities offering under *Howey* because there was an (1) an investment of money (the purchase of the new token), (2) in a common enterprise (the blockchain project/ecosystem), and (3) an expectation of profits by the buyer based solely on the efforts of others (the issuer nearly always made promises of an increased value in the coin and/or the success of the overall project). The SEC also successfully made its *Howey* argument in fraud contexts, where bad actors were sued for making false promises to investors to lure them into investing in fraudulent schemes.

C. Ripple

On July 13, 2023, an SDNY court issued its highly anticipated summary judgment decision in the SEC's action against Ripple Labs, Inc. ("Ripple"), *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, 2023 WL 4507900 (S.D.N.Y. July 13, 2023), rendering the first major ruling in which a U.S. federal judge found that certain digital assets sales fall outside the ambit of U.S. securities law.

In December 2020, the SEC sued Ripple and two of its senior executives, alleging that they engaged in an illegal securities offering by offering and selling XRP—the native token of the Ripple network. The case was not an ICO case, nor did the SEC allege fraud. Also setting it apart from earlier cases, the defendants were extremely well-resourced and had publicly stated they would never settle.

In its analysis, the court stressed (unlike many previous courts) that the question it had to answer was not whether *XRP* was an investment contract, but whether the *sale* of XRP constituted an investment contract. With that, the court applied the *Howey* test to three categories of XRP transactions: (1) institutional sales of XRP to sophisticated parties, pursuant to written contracts; (2) programmatic sales consisting of "blind" bid/ask transactions, like those on exchanges; and (3) distributions to employees and developers as compensation.

The court found that the first category of sales—the institutional sales—were indeed investment contracts. As to the first prong of the *Howey* Test, there was an investment of money. As to the second, the court found evidence of a common enterprise, emphasizing that the proceeds of the sales were used to finance the overall Ripple operation, such that the fortunes of the investor were tied to other investors. As to the third, the court found that the record showed that buyers had an expectation of profit based on how the networks succeeded.

But, in a surprise to many, the court then found that the other transactions were not investment contracts. As for the exchange trades, the court emphasized that buyers and sellers do not know each other, and because the XRP buyers in a blind trade could not have known whether their payments were going to Ripple, the sale did not meet the *Howey* Test's third prong. The court also found that Ripple's use of XRP to pay employees and developers was not an investment contract because, under the first *Howey* Test prong, there was no investment of money. The court then determined that whether the individual defendants aided and abetted securities law violations as to Ripple's institutional XRP sales was a question of fact to be determined at trial.

The SEC swiftly moved for an interlocutory appeal of the decision in an effort to immediately challenge the court's ruling. But, on October 3, 2023, the court denied the request, meaning that the SEC would have to wait to appeal until after the 2024 trial on the claims against the individual defendants. However, on October 19, 2023, the SEC announced it was dropping all remaining claims—meaning that the individuals walk away from the approximately $1.3 billion in claims sought by the SEC. The move also meant that the SEC would no longer have to wait to appeal the sorely unfavorable summary judgment ruling.

D. Terraform Labs

While the crypto community was still reveling in the Ripple decision, another SDNY court—just weeks after Ripple—came out another way. In *SEC v. Terraform Labs. Pte. Ltd.*, No. 23-cv-1346, 2023 WL 4858299 (S.D.N.Y. July 31, 2023), the SEC alleged that crypto issuer Terraform's sales of various tokens, including its algorithmic stablecoin, TerraUSD (UST), constituted the unregistered sale of investment contracts. However, unlike in the Ripple case, the SEC also alleged that Terraform was engaged in a massive fraud, with explicit promises of profit and lies made to purchasers. Also unlike Ripple (which had remained a viable, ongoing business since its inception), Terraform's collapse and the depegging of UST (i.e., the token fell vastly below a 1 USD value) had a crippling effect on the overall crypto market, wiping out nearly $45 million in market capitalization in one week.

On July 31, 2023, the court denied defendants' motion to dismiss the complaint. As in Ripple, the court declined to frame the issue simply as whether Terraform's tokens or "crypto-assets" were investment contracts, and instead zoomed out to assess the entirety of the parties' economic arrangement to determine if it met the *Howey* factors, noting further that "[a] product that at one time is not a security may, as circumstances change, become an investment contract that is subject to SEC regulation." Accepting the SEC's allegations as true (as required in such motions), the court found all three *Howey* factors fulfilled. The purchase of the tokens constituted an investment of money. The court found that the overall Terraform ecosystem constituted a common enterprise. Finally, the court found that because defendants had made statements about how the increase in value of the ecosystem would increase the value of the coins or increase token holders' chances of profiting off of the ecosystem there was a reasonable expectation of "profit"—even for the purchase of the stablecoin, which, by definition, was designed to keep one stable price. Guiding the court's decision was the SEC's allegation that Terraform's tokens were never "standalone tokens" but were products that conferred rights to purchase another security (i.e., other Terraform tokens) and participate in the overall Terraform ecosystem.

Notably, the court then went out of its way to explicitly reject the *Ripple* court's approach to distinguishing tokens based on their manner of sale, instead stating that whether investors purchased crypto assets directly from the defendants or through a secondary market such as an exchange was irrelevant to the analysis of whether they constitute investment contracts. The court instead asserted that the analysis should primarily turn on whether defendants' actions and statements could reasonably be interpreted as "evincing a promise of profits based on their effort."

E. Coinbase

In June 2023, the SEC filed a complaint—not against another token issuer—but against Coinbase, a crypto asset trading platform. The SEC alleged that Coinbase operated as an unregistered securities exchange, broker, and clearing agency. The SEC further alleged that Coinbase engaged in the unregistered offer and sale of securities through its "staking-as-a-service" program, which allows "customers to receive rewards paid out by proof-of-stake protocols for contributing to the validation of transactions on those blockchains." Critically, the SEC claimed that twelve tokens listed for trading on Coinbase were securities.

Coinbase responded by filing a motion for judgment on the pleadings. In its papers, Coinbase argued that recent SEC crypto cases, including *Terraform*, did not support the SEC's position that Coinbase traded securities. According to Coinbase, the SEC had failed to allege, per *Terraform*, that the "contracting parties" on Coinbase's exchange "agreed" or "schemed" that the buyer's payment would be invested in the seller's "profit-seeking endeavor." Coinbase also noted that *Terraform* concerned an action against an issuer—*not* a secondary market exchange.

Coinbase also gave a full-throated version of the "major questions doctrine" argument, which was supported by a subsequently filed amicus brief submitted by U.S. Senator Cynthia Lummis. The doctrine is founded on the principal that only Congress, and not unelected agency heads, may decide how to regulate a significant portion of the American economy. According to Coinbase, the doctrine squarely applies to the digital asset industry as it is purportedly worth $1 trillion. While the major questions doctrine had come up in other crypto cases, Coinbase's argument on the topic has been the most developed.

The SEC opposed the motion in October, further relying on its previous crypto cases—including *Terraform*—for support. The parties' briefing will be complete by November 2023.

F. Binance

In June, alongside the Coinbase action, the SEC also filed a complaint against Binance (a Cayman Islands-based crypto asset trading platform), its founder, Changpeng Zhao, and U.S.-based affiliates, BAM Trading and BAM Management (collectively the Binance defendants). Also central to the complaint is Binance.US, a crypto asset trading platform operated by Binance and BAM Trading.

The SEC's allegations concerning the Binance defendants go far beyond the allegations against Coinbase. Not only did the SEC assert that certain Binance defendants and entities operated as unregistered exchanges, broker-dealers, and/or clearing houses but *also* that BAM Trading and BAM Management misled Binance.US customers and investors regarding "the existence and adequacy of market surveillance and controls to detect and prevent manipulative trading on the Binance.US platform's crypto asset trading volumes." In a related press release, SEC Chair Gary Gensler said that Zhao and the Binance entities "engaged in an extensive web of deception" and "misled investors about their risk controls and corrupted trading volumes while actively concealing who was operating the platform, the manipulative trading of its affiliated market maker, and even where and with whom investor funds and crypto assets were custodied."

Later in June, as the SEC case was moving forward, the Binance defendants agreed to, among other things, repatriate any assets held for the benefit of BAM's U.S. customers back to the U.S. SEC Enforcement Director Gurbir Grewal stated that this measure would ensure that U.S. customers would be able to withdraw their assets from the platform while the SEC works to resolve "the alleged underlying misconduct and hold Zhao and the Binance entities accountable for their alleged securities law violations."

On September 21, the Binance defendants moved to dismiss the SEC's complaint. The parties' briefing is scheduled to be complete by December 12.

III. Spot ETF Application Decision

The SEC has also recently received judicial pushback for its continuous denial of applications for bitcoin spot exchange traded funds (ETFs). In August 2023, the U.S. Circuit Court of Appeals for the D.C. Circuit (D.C. Circuit) held that the SEC's inconsistent approach to different types of ETFs was an impermissible use of the Commission's regulatory power, thus paving the way for the first regulated spot bitcoin ETF.

For the past six years, the SEC has received numerous requests for approval to list bitcoin investment products on national exchanges. To obtain approval, the listing must meet the requirements of Exchange Act Section 6(b)(5), which requires that the rules of a national securities exchange be "designed to prevent fraudulent and manipulative acts and practices" and "protect investors and the public interest."

In 2022, the SEC approved two requests to list bitcoin futures ETFs. A bitcoin futures ETF, like a future for any other commodity, is a contract to buy or sell an underlying asset (in this case, bitcoin) at some future point. Yet despite the SEC's approval of the two bitcoin *futures* ETFs, the SEC has continuously rejected listing proposals for bitcoin *spot* ETFs, which references the *immediate* ownership of the actual underlying asset (here, bitcoin). In every instance, the SEC decided that the proposals did not meet the Exchange Act's anti-fraud and investor protection standards.

In July 2022, the SEC rejected NYSE Arca's listing proposal to the SEC for Grayscale Bitcoin Trust's bitcoin spot ETF, stating that Grayscale was not "designed to prevent fraudulent and manipulative acts and practices."

Grayscale appealed the SEC's decision to the D.C. Circuit, arguing that the surveillance sharing agreement with the CME that led to the SEC approving the two futures ETFs should also apply to its spot ETF. In August 2023, the court agreed, vacating the SEC's order and holding that "Grayscale advanced substantial evidence that its proposed bitcoin ETP was similar to the Teucrium and Valkyrie bitcoin futures

[ETPs] and therefore should have received the same regulatory treatment." The court also held that the SEC had been arbitrary and capricious in denying the proposal because the SEC's explanation for inconsistent treatment of similar products was inadequate; the SEC "never explained why Grayscale owning bitcoins rather than bitcoin futures affects the CME's ability to detect fraud."

The SEC had until October 13 to appeal the court ruling but opted not to do so. On October 19, Grayscale filed a form S-3 with the SEC to register its $18 billion bitcoin trust as a product under the Securities Act of 1933, a step toward converting the trust to an ETF. It would be the first spot bitcoin ETF in the U.S. In the meantime, the SEC postponed its decision on applications for six other bitcoin spot ETFs from WisdomTree, Invesco Galaxy, VanEck, Bitwise, Valkyrie, and Wise Origin Bitcoin Trust.

IV. New NFT Cases

The SEC recently brought its first two enforcement actions targeting the sale of non-fungible tokens (NFTs). In August and September respectively, the SEC charged Impact Theory, LLC and Stoner Cats 2 LLC with conducting unregistered offerings of "crypto asset securities" in the form of NFTs. The SEC's decision to classify these NFTs as investment contracts, and therefore securities, marks the first time that the SEC has pursued an enforcement action involving the unregistered sale of NFTs.

According to the SEC, Impact Theory, a media and entertainment company, raised almost $30 million worth of ether from selling NFTs to hundreds of investors. Prior to the "offering," the company stated that it would deliver "tremendous value" to purchasers, and that it would use the offering proceeds for "development," "bringing on more team," and "creating more projects." Stoner Cats 2 raised approximately $8 million from selling 10,302 NFTs in order to fund the production of an animated web series. The company promised those who purchased NFTs exclusive access to the web series, an online community, and unspecified future content.

The SEC asserts that these facts demonstrate that the "investors," or purchasers, of the NFTs had a reasonable expectation of future profit based on the companies' managerial and entrepreneurial efforts. As such, the companies violated Sections 5(a) and 5(c) of the Securities Act by offering and selling unregistered securities. Moving forward, sellers will have to tread carefully in making statements regarding potential profit for those who purchase NFTs.

V. Conclusion

While the SEC shows no signs of slowing down crypto enforcement actions, recent court decisions show that the agency will not proceed unchecked. Anticipated court decisions in the coming months will shape the crypto enforcement landscape and provide clearer parameters for when the SEC can—and cannot—regulate in the U.S. crypto market.

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