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Are Crypto Currencies Securities?

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With the newest wave of SEC enforcement proceedings, it is important for platforms to know where cryptocurrency and digital asset regulation stands. If a digital asset is deemed a security, it is subject to federal rules and regulations, and potentially state rules and regulations. Issues arise under the Securities Act of 1933, which regulates the offer and sale of securities, and protects investors by requiring disclosure of material information

related to the public offering of securities. Section 5 of the Securities Act states that there must be full and fair disclosure through registration with the SEC, providing information necessary to enable prospective investors to make informed decisions. This section – particularly §§ 5(a) & (c) – is the most commonly litigated provision of the act. Broad language allows the SEC to take jurisdiction over issues of emerging assets, such as cryptocurrencies and other digital assets.

The Exchange Act of 1934 is the primary source of marketplace regulation, authorizing the SEC to identify and penalize improper securities transactions, including sales on the open market. It is usually enforced in tandem with the Securities Act and regulates the trading of securities on securities exchanges. Under the Exchange Act, an "exchange" is any organization, association, or group of persons, whether incorporated or unincorporated, that constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood. An exchange is found when an organization, association, or group of people: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

Cases involving alleged violations of these acts apply the 75-year-old *Howey* test to determine whether an asset falls within their scope. Under *Howey*, an investment contract exists when there is: the (1) investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others. This test is flexible and applies to any contract, scheme, or transaction, regardless of whether it has any characteristics of traditional securities.

An additional analysis, albeit less-frequently applied, is the *Reves* test, used to determine whether a note is a security. Unlike *Howey,* where clear prongs must be met for an investment contract to be present, Reves applies a balancing test. *Reves* factors include the motivations of the buyer and seller, the plan of distribution, the reasonable expectations of the investing public and risk-mitigation considerations. (7) The SEC has applied this test several times in cease-and-desist orders. (8) They have also cited it in several statements to support securities laws' broad application.

Through the *Howey* and *Reves* Lenses, the SEC Views Some Digital Assets as Securities.

The SEC has attempted to clarify its application of existing law to digital assets. In 2017, it published a report on Decentralized Autonomous Organizations.(9) In the DAO report, the SEC emphasized the breadth of securities laws' application and provided found In the DAO report, the SEC emphasized the breadth of securities laws' application and provided foundational principles guiding their application to digital assets. This came through a three-pronged *Howey* test with several cites to *Reves* for additional support. The DAO report remains the SEC's default framework for regulating digital assets as securities.

In 2019, the SEC's Hub for Strategic Innovation and Financial Technology published a "DAF" – Digital Assets Framework. Like the DAO report, the DAF is not a law or regulation. It simply provides a guide to applying *Howey* and *Reves* to digital currencies. The DAF goes into slightly more detail than the DAO report, listing factors applicable to the expectation of profit derived from the effort of others, which is the most contested prong of the *Howey* test under these circumstances. The DAF also emphasizes that the SEC remains adamant that no single attribute is determinative. Rather, there must be a totality-of-the-circumstances / economic-realities analysis. The DAF builds on the DAO report, and, interestingly, points that out under some circumstances the *Howey* elements may be rendered ineffective.

Applying *Howey,* Some Courts Have Deemed Digital Assets to be Securities.

– Ripple

In *Ripple,* the SEC brought an action against Ripple Labs and its senior leaders for conducting unregistered offers and sales of crypto-asset securities in connection with its issuance of the XRP token, in alleged violation of § 5(a) and (c) of the Securities Act. (11) Ripple argued that their digital currency, XRP, is not a security and therefore not subject to securities laws and registration requirements. The court agreed with respect to several forms of sales.

Judge Torres, of the Southern District of New York, analyzed three types of XRP sales under *Howey*: institutional sales, programmatic sales, and other distributions to employees. He determined that there was (1) an investment of money by institutional investors in exchange for XRP, and (2) horizontal commonality between Ripple and the institutional investors based on a pooling of investors' funds tied to the success of a common enterprise, and that (3) Ripple's communications, marketing campaign and nature of the sales would have led a reasonable institutional buyer to expect a profit based on Ripple's efforts. Therefore, institutional sales met the *Howey* test and were investment contracts.

The most noteworthy aspect of *Ripple* is that programmatic sales did not meet the third prong of the *Howey* test. Even if investors had expectations of profits, the court said, they did not expect those profits to come from Ripple's efforts, because they were blind bid/ask transactions and buyers could not know if their money went to Ripple or any other XRP buyer. This ruling benefits retail investors because they feel this will spur regulatory clarity. Conversely, the SEC expressed it's discontent with thtis aspect of the ruling.

The "other distributions under written contracts" sales did not meet the first *Howey* prong and were not considered investment contracts. The consideration given in exchange for XRP was something other than money, and the SEC could not show that Ripple was able to fund its project by virtue of these transfers. Thus, the first *Howey* prong-investment of money-was not satisfied, a rare occurence in the case law.

- Terraform

Just two weeks after the Ripple case was decided another judge of Southern District of New York, Judge Rakoff, decided *Terraform,* holding that digital assets may be securities, drawing key distinctions that the SEC will almost certainly use in future enforcement actions. The court denied Singapore-based Terraform's motion to dismiss, rejecting it's jurisdictional and major-question-doctrine defenses, and granting summary judgement on the SEC's claim that Terraform offered and sold unregistered securities (12)

The court held that digital currencies LUNA, MI, and UST, the products at issue, were securities by virtue of their being inestment contracts. (13). MIR and LUNA were such because Terraform promised profits on purchase of those tokens from its continued efforts, including facilitating a secondary market and continuing to develop the underlying technology. And UST was deemed and investment contract despite being a stablecoin that does not increase in value, because a key side benefit was that purchasers were to receive returns from Anchor Protocols, a pool of funds that would generate interest; that is, the UST would profit by earning interest on the float. (14)

Terraform expressly rejects *Ripple's* distinction between secondary markets and direct sales, saying Howey makes no such distinction. Judge Rakoff reasoned that the market source has no bearing on the expectation of profits derived from others.

– Binance, Coinbase, Kraken

The SEC is becoming more aggressive. In 2023, they commenced enforcement proceedings against the three largest cryptocurrency platforms – Coinbase, Binance, and Kraken. The charges against all three platforms are similar – viz., that the companies operate as unregistered securities exchanges, brokers, dealers, and clearing agencies in violation of the Exchange Act.

Binance settled the *criminal* charges against it, agreeing to pay $4.3 billion to resolve disputes with the Department of Justice, Commodity Futures Trading Commission, and Financial Crimes Enforcement Network. Binance's CEO agreed to pay $150 million and step down from his position at Binance. However, the SEC is pursuing the *civil* matter against Binance, an Asia-based company, because it actively solicited United States-based customers, ignored the SEC's registration requirements, and concealed the presence of American customers on its platform. (15)

Coinbase also settled its case with the New York Department of Financial Services. Coinbase is defending the new federal claims by saying the SEC does not have authority to regulate its assets because they are not investment contracts under *Howey* – specifically under the "expectation of profits" prong.(16) (A hearing was held on January 17th on Coinbase's motion for judgement on the pleadings, but a decision has not yet been issued.)

Kraken, founded in 2011, is another key player in the digital asset exchange market. It settled a dispute last year with the SEC for $30 million, but in a new lawsuit the SEC asserts that Kraken was required to register with the SEC because the assets available through its platform are securities. (17) Kraken has disputed the claims and intends on filing defenses.

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Hundreds of people phoned in to listen to Coinbase's and the SEC's oral arguments last month, showing the cryptocurrency and digital asset landscape is at a pivotal point. Whether crypto-currencies and other digital assets are deemed securities will continue to be heavily litigated, and the law will continue to evolve. Stay tuned

Notes

1 Eva Su, Digital Assets and SEC Regulation, CONGRESSIONAL RESEARCH SERVICE (June 23, 2021) https://sgp.fas.org/crs/misc/R46208.pdf.
2 id.
3 id.
4 id. at § 78c(a)(1).
5 S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298–99, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946).
6 id.
7 Reves v. Ernst & Young, 494 U.S. 56, 67, 110 S. Ct. 945, 952, 108 L. Ed. 2d 47 (1990).
8 Cease and Desist Order, S.E.C., DMM (2021); Cease and Desist Order, S.E.C., against Blockfi, LLC. (2022).
9 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207, 2017 WL 7184670 (July 25, 2017).
10 See DAF.
11 SEC v. Ripple Labs, Inc., et al. (20-cv-10832-AT-SN (S.D.N.Y. 2020)).
12 SEC v. Terraform Labs Pte. Ltd., No. 23-CV-1346 (JSR), 2023 WL 4858299, at *9 (S.D.N.Y. July 31, 2023); West Virginia v. EPA, 142 S. Ct. 2587, 2607–2608 (2022). The major-question doctrine refers to statutory interpretation where regulatory authority is questionable. Courts will look to the context and overall history of a statute and its overall place in the statutory scheme. The Supreme Court has rejected claims of statutory authority where the claim has vast economic significance and Congress has not clearly empowered the agency with authority over the issue.
13 id.
14 id. at *12.
15 SEC v. Binance Holdings, Ltd., 1:23-cv-01599 (D.D.C. 2023).
16 SEC v. Coinbase, Inc & Coinbase Global, Inc., 1:23-cv-04738, (S.D.N.Y. 2023).
17 Complaint, SEC v. Payward Ventures, Inc., 3:23-cv-06003, (N.D. Ca. 2023).