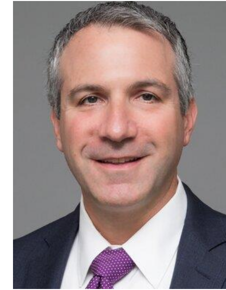
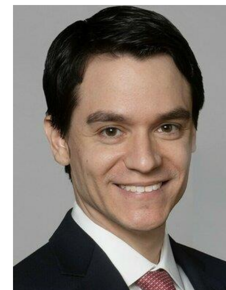
Divergent NY Rulings Compound Crypto Regulation Questions

By **David Axelrod, Celia Cohen and Nathaniel Botwinick** (August 23, 2023)


David Axelrod

Celia Cohen


Nathaniel Botwinick

The lack of clarity in the law regarding whether a particular crypto-asset is or is not a security continues.

The crypto industry had a brief victory in U.S. Securities and Exchange Commission v. Ripple Labs Inc.[1], in which the U.S. District Court for the Southern District of New York held that the crypto-asset at issue was not a security.

But a mere two weeks later in SEC v. Terraform Labs Pte Ltd.,[2] a different judge in the very same courthouse held that the cryptocurrencies at issue may be securities, and noted that it is insignificant whether securities are sold directly to institutional investors or on the secondary market.

Specifically, on July 31, the court in Terraform denied defendants' motion to dismiss the SEC's amended complaint. The defendants argued that the SEC was barred from asserting that the defendants' crypto-assets were securities because (1) the SEC did not have the authority to regulate the crypto-assets in question, and (2) the crypto-assets did not qualify as securities for SEC regulation.

The crypto-assets in question were the Terra cryptocurrency, UST, its companion coin, LUNA, and three other related crypto-assets. UST was supposed to be a stablecoin, a type of crypto-asset with its price algorithmically pegged on a 1:1 ratio with U.S. dollars. At any point, a holder of either UST or LUNA could swap their coins for the other on a 1:1 ratio.

Preliminary Questions Regarding SEC's Ability to Regulate Crypto-Assets

In arguing that the SEC could not regulate the crypto-assets in question, the Terraform defendants relied on: (1) the major questions doctrine; (2) the due process clause; and (3) the Administrative Procedure Act.

U.S. District Judge Jed Rakoff rejected all three of these arguments.

First, under the major questions doctrine, the U.S. Supreme Court has held in Utility Air Regulatory Group v. EPA in 2014 that, in cases where an agency claims "the power to regulate a significant portion of the American economy [that has] ... vast economic and political significance," the agency must point to clear congressional authorization for that power.[3]

Judge Rakoff found that this doctrine did not apply because "the crypto-currency industry — though certainly important — falls far short of being a portion of the American economy bearing vast economic and political significance."[4]

Additionally, Judge Rakoff noted that the SEC was not exercising "vast economic power over

the securities markets," but rather was simply assuring that they provide adequate disclosure to investors.[5]

Second, in rejecting the defendants' argument that the SEC violated their due process rights by bringing this enforcement action without first providing fair notice that their crypto-assets would be treated as securities, Judge Rakoff determined that the SEC has provided sufficient notice through its regulations, written guidance, litigation and other actions, such that a reasonable person operating within the crypto industry would have fair notice that their conduct might prompt an SEC enforcement action.

Similarly, Judge Rakoff found that the APA was also not a bar to the SEC's claims. The defendants argued that the APA required the SEC to announce a new policy on crypto-assets prior to bringing this action. Judge Rakoff held that the SEC was merely enforcing its previously stated views that certain crypto-assets are securities if they meet the Howey test.

The Howey Test

The defendants also alleged in their motion to dismiss that the crypto-assets in question were not securities for SEC regulation.

The Supreme Court, in SEC v. W.J. Howey Co. in 1946, established the standard for determining whether a particular economic arrangement can be classified as an investment contract — in other words, a security, and thus regulated by the SEC.[6]

Under the Howey test, an investment contract under federal securities law is any "contract, transaction, or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of the promoter or a third party."[7]

In Terraform, the court contended with whether each of the defendants' crypto-assets amounted to a transaction or scheme that met the three prongs of the Howey test.

At the outset, Judge Rakoff noted that there is no requirement for a formal contract between parties for Howey to apply — instead, there only needs to be a scheme where one party will make an investment of money in the other party's profit-seeking endeavor.

Furthermore, a product may become a security once circumstances change and thus become subject to SEC regulation. Therefore, Judge Rakoff declined to distinguish between the tokens in this action and their related investment protocols.

Tokens, by themselves, might not qualify as investment contracts, but once they confer the right to purchase another security — as was the case here — or were considered "yield-bearing investments whose value would grow in line with" defendants' business, then they crossed the line into "investment contracts" under Howey.

Additionally, the fact that certain of the coins owned by investors in this case were deposited into an investment pool that advertised profits also qualified these tokens as "investment contracts" under Howey.

Judge Rakoff then proceeded to analyze the five crypto-assets in this case under the three prongs of Howey.

First, Judge Rakoff noted that there was no dispute on Howey's first prong that investors

invested money in exchange for crypto-assets.

For Howey's second prong, Judge Rakoff held that there was a common enterprise given that (1) defendants had marketed one of the crypto-assets as generating returns in return for deposit; (2) defendants used proceeds from the sales of other crypto-assets to develop their blockchain and represented that these improvements would increase the value of the crypto-assets themselves; or (3) the crypto-assets could be exchanged for the other tokens that qualified as investment contracts.

Finally, for Howey's third prong, Judge Rakoff held that the SEC satisfied the standard of whether an objective investor would have perceived the defendants' statements and actions as promising the possibility of returns in exchange for investments. In support of its claims, the SEC relied on the defendants' repeated statements that investors would profit in exchange for their purchases of defendants' crypto-assets.

Distinguishing Ripple

Judge Rakoff's decision in Terraform differed sharply from U.S. District Judge Analisa Torres' recent decision in Ripple written in the same courthouse.[8]

In Ripple, Judge Torres contended with whether XRP, a crypto-asset developed as an alternative to bitcoin and native to Ripple's ledger, was a security.

Ripple sought to create products and services in connection with XRP and offered XRP in three scenarios: (1) sales to institutional investors; (2) programmatic sales on digital asset exchanges; and (3) other distributions, including those to employees of Ripple and to third parties in exchange for developing new applications for XRP and its ledger.

After determining XRP, itself, did not embody the characteristics of an investment contract, Judge Torres continued the analysis in assessing whether the different types of transactions at issue constituted investment contracts under Howey, and therefore securities under the federal securities laws.

Judge Torres drew a line between XRP sold directly to institutional investors, finding those to be securities, with those sold through the secondary market or other distributions, which she held were not securities.

According to Judge Torres, resale purchasers on digital asset exchanges could not have known if their payments went to Ripple as opposed to a third party, and therefore there was no expectation of profit that could be ascribed to the defendant, thus failing Howey's third prong.

Judge Torres held that the other distributions of XRP failed Howey's first prong because there was no showing of an investment of money as part of the transaction or scheme.

Judge Rakoff rejected Ripple's holding regarding secondary sales, and stated that "Howey makes no such distinction between purchasers ... [a]nd it makes good sense it did not. That a purchaser bought coins directly from the defendants or, instead, in a secondary resale transaction has no impact on whether a reasonable individual would objectively view the defendants' actions and statements as evincing a promise of profits based on their efforts."[9]

In Terraform, Judge Rakoff pointed out that the SEC had alleged that, in fact, "the

defendants embarked on a public campaign to encourage both retail and institutional investors to buy their crypto-assets by touting the profitability of the crypto-assets and the managerial and technical skills that would allow the defendants to maximize returns on the investors' coins."[10]

In other words, "secondary-market purchasers had every bit as good a reason to believe that the defendants would take their capital contributions and use it to generate profits on their behalf."[11]

There is no direct parallel between the other distributions in Ripple and the transactions in Terraform, and Judge Rakoff did not address this part of Ripple's holding.

In Ripple, the SEC alleged that these other distributions were akin to an "indirect public offering," because "the parties that received XRP from Ripple ...could transfer their XRP (in exchange for units of another currency, goods, or services) to another holder."[12]

Although Judge Torres rejected this argument because there was no investment of money by the parties who received XRP through these other distributions, it is possible that other courts may find similar actions like these to be indirect offerings.[13]

Conclusion

The decision in Terraform makes it clear that Ripple did not spell the end of SEC enforcement efforts in the crypto arena, and Terraform will spur renewed efforts by the SEC and the private plaintiffs bar to pursue companies engaged in crypto-related investments and offerings.

The SEC in Ripple has requested permission from Judge Torres to seek an interlocutory appeal of her decision. If Judge Torres grants the SEC's request, the U.S. Court of Appeals for the Second Circuit may provide additional clarity and resolve this split within the Southern District of New York.

Even if Judge Torres denies the SEC's request, the SEC could attempt to appeal this issue directly to the Second Circuit, but this would require surmounting a high bar for this type of appeal.

David L. Axelrod and Celia Cohen are partners, and Nathaniel B. Botwinick is an associate, at Ballard Spahr LLP.

Ballard Spahr partners Marjorie J. Peerce and Michael P. Robotti contributed to this article.

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[1] SEC v. Ripple Labs Inc., 2023 U.S. Dist. LEXIS 120486 (S.D.N.Y. July 13, 2023)

[2] SEC v. Terraform Labs Pte. Ltd., 2023 U.S. Dist. LEXIS 132046 (S.D.N.Y. Jul. 31, 2023)

[3] Util. Air Regul. Grp. v. EPA, 573 U.S. 302, 324 (2014)

[4] Terraform at 21-22 (internal citations omitted)

[5] Id. at 22

[6] See SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (Howey)

[7] Id. at 298-99.

[8] See SEC v. Ripple Labs Inc., 2023 U.S. Dist. LEXIS 120486 (S.D.N.Y. July 13, 2023).

[9] Terraform at 45.

[10] Id. (emphasis in original)

[11] Id. at 46.

[12] Ripple at 41 (citations omitted)

[13] See, e.g., SEC v. Telegram Grp., Inc., 448 F.Supp. 3d 352, 380 (S.D.N.Y. 2020) (finding a scheme of a "disguised public distribution" through institutional investors who resold cryptocurrency into the public market).