Securities Question Stands After Contradicting Crypto Rulings

By **Michael Robotti, Celia Cohen and Nathaniel Botwinick** (January 4, 2024)

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What is a security? That was the question of 2023. The U.S. Securities and Exchange Commision has argued that it's simple: Just apply the three-part Howey test — orange groves or crypto-assets, it's all the same to the SEC.[1]

But if this past year has taught us anything about digital assets, it is that the determination of whether the securities laws apply to digital assets is anything but simple.

The debate about the regulation of crypto-assets came to a head in 2023 when two judges in the U.S. District Court for the Southern District of New York came to opposite conclusions about whether the crypto-assets in their respective cases were securities.[2]

Both judges applied the Howey test to the crypto-assets at issue, but reached two different outcomes.[3] The different outcomes raise the question of whether the regulation of crypto securities should be determined by legislation or on a case-by-case basis through the courts.

From Orange Groves to Cryptocurrency

To understand how courts are looking at the question of whether digital assets are securities, it is necessary to review the U.S. Supreme Court's 1946 decision in SEC v. W. J. Howey Co.

The respondents in Howey were corporations, one of which owned large tracts of citrus groves in Florida, and the other of which was the service provider that cultivated and developed the citrus groves.[4]

Prospective customers were offered both a land sales contract and a service contract, because they were informed that it is not feasible invest in a grove unless service arrangements are made. The Supreme Court held that the transactions qualified as investment contracts, and they thus were securities regulated by the SEC.[5]

The Howey test defines an "investment contract" under federal securities law as 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."[6]

Courts have since applied the Howey test in hundreds of federal cases that found unregistered securities in the investment of a wide range of products, from whiskey,[7] to beavers,[8] to dental devices.[9] Now, the SEC is seeking to apply the Howey test to crypto-assets.[10]

The Ripple Court: This Crypto-Asset Is Not a Security

On July 13, U.S. District Judge Analisa Torres held in SEC v. Ripple Labs Inc. that a certain crypto-asset, XRP, was not a security.[11]

XRP was developed as an alternative to Bitcoin and native to Ripple's ledger, and it was offered in three scenarios: sales to institutional investors; programmatic sales on digital asset exchanges; and other distributions, including those to employees of Ripple and to third parties in exchange for developing new applications for XRP and its ledger.

Judge Torres held that XRP itself did not embody the characteristics of an investment contract, but made different findings with respect to the types of transactions at issue. While she found that the assets XRP sold directly to institutional investors amounted to securities, she distinguished those from the assets sold through the secondary market or other distributions — which she held were not securities.

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

Judge Torres also 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.

The Terraform Court: This Crypto-Asset Is a Security

On July 31, U.S. District Judge Jed Rakoff made waves when he denied the defendants' motion to dismiss the SEC's amended complaint in SEC v. Terraform Labs Pte. Ltd.[12]

The defendants had argued, in part, that the court should dismiss the complaint on the ground that the crypto-assets in the case did not qualify as securities subject to SEC regulation.

The crypto-assets at issue were the Terra USD cryptocurrency, or UST, its companion coin, LUNA, and three other related crypto-assets: wLUNA, MIR and mAssets.

UST was supposed to be a stablecoin, a type of crypto-asset whose price was algorithmically pegged on a 1:1 ratio with U.S. dollars. A holder of either UST or LUNA could swap their coins for the other on a 1:1 ratio.

Judge Rakoff examined whether each of the defendants' crypto-assets amounted to a transaction or scheme under the Howey test, and he held that there only needs to be a scheme where one party will make an investment of money in the other party's profit-seeking endeavor.

In reviewing the five crypto-assets at issue under Howey, Judge Rakoff noted that there was no dispute on Howey's first prong that investors invested money in exchange for crypto-assets.

For the second part of the Howey test, Judge Rakoff determined that there was a common enterprise, given that the defendants had advertised one of the crypto-assets as generating returns in exchange for deposit; the defendants used proceeds from the sales of other

crypto-assets for blockchain development and represented that these improvements would increase the value of the crypto-assets themselves; and the crypto-assets could be exchanged for the other tokens that qualified as investment contracts.

Finally, for Howey's third prong, Judge Rakoff held the SEC had 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 these claims, the SEC relied on defendants' repeated declarations that investors would profit from their purchases of defendants' crypto-assets.

Judge Rakoff rejected Ripple's holding regarding secondary sales and held that whether 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.

The SEC Is Not Backing Down

Following Judge Torres' decision in Ripple on summary judgment, and Judge Rakoff's contradictory decision on the motion to dismiss in Terraform, the SEC moved to file an interlocutory appeal of Judge Torres's decision on two grounds: that the programmatic offers and sales of XRP could not lead investors to reasonably expect profits from the efforts of others; and that Ripple's other distributions of XRP as a "form of payment for services" were legally insufficient to constitute an "investment of money" under Howey.[13]

On Oct. 3, Judge Torres denied the SEC's request for an interlocutory appeal, because it was not a "pure question of law," but rather required a study of "an extensive, heavily disputed factual record and detailed expert reports."

Furthermore, Judge Torres rejected the SEC's argument that the questions presented were "controlling" questions of law, because her decision dealt only with the "unique facts and circumstances of the case" and did not have "precedential value" for other digital-asset cases.

Judge Torres contended, in denying the interlocutory appeal, that there was no substantial grounds for the difference of opinion between her summary judgment order and Judge Rakoff's decision denying the motion to dismiss in Terraform.

In particular, Judge Torres distinguished Terraform on the grounds that Judge Rakoff's decision was at the motion-to-dismiss stage, where all allegations had to be accepted as true; an objective, reasonable programmatic buyer would not have believed that sales of all XRP would be fed back into Ripple and generate additional profits for all XRP holders; and Ripple's promotional materials were only distributed to institutional buyers and not programmatic buyers.

In light of Judge Torres's decision to deny the interlocutory appeal, whether XRP sold in the secondary market is a security will not be at issue until final disposition of the district court case.

In the meantime, while that issue in Ripple is pending resolution, Judge Rakoff had the chance to weigh in on the issue again, when resolving the parties' summary judgment motions in Terraform.

Terraform: The Crypto-Assets are Still Securities

On Dec. 28, Judge Rakoff issued a lengthy opinion granting in part summary judgment to the SEC on its claim that defendants offered and sold unregistered securities, but granting to defendants summary judgment that they did not offer or effect transactions in security-based swaps.[14]

Judge Rakoff found that "no genuine dispute that the elements of the Howey test" were met for Terraform's crypto-assets UST, Luna, wLUNA and MIR.

First, UST was a security because holders could — even though some did not — deposit their tokens in Terraform's promoted Anchor Protocol.[15] The Anchor Protocol was a money market where UST holders could deposit their tokens in a shared pool to earn interest payments, and others could then borrow UST from the pool.[16]

Next, Luna and wLuna were securities, because Terraform had essentially advertised that owning them was the equivalent of owning equity in the company that would lead to profits for investors based on defendants' efforts.[17]

Judge Rakoff also found that MIR was a security because funds from its sales were pooled together for the "Mirror Protocol," and MIR profits were sent back to investors.[18] The Mirror Protocol allowed users to obtain mAssets, which were tokens that would "mirror" the price of a noncrypto-asset.[19]

In contrast, however, Judge Rakoff held that the mAssets themselves were not securities because the holders could not expect to profit from mAssets.

He also held that mAssets did not amount to security-based swaps, because there was no transfer of financial risk as purchasers of mAssets had to deposit additional collateral if the underlying reference security increased in value.[20]

The SEC Holds Firm: No Rulemaking Is Needed

Before Judge Rakoff's summary judgment ruling, on Dec. 15, the SEC denied a petition for rulemaking that requested that the SEC "propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities."

In supporting the commission's decision, Chair Gary Gensler insisted that existing laws and regulations apply to crypto-assets, and there is no need for new rulemaking.

Prior to the SEC's denial of this rulemaking petition, Gensler had stated that the vast majority of crypto-assets are likely to meet the investment-contract test in Howey, making them subject to the securities laws.[21] Indeed, he had previously stated that all crypto-assets other than Bitcoin are securities.[22]

Regardless of the decisions in Ripple and Terraform, it is likely that the SEC will continue to hold to this position. Judge Torres's decision denying the interlocutory appeal in Ripple gave

the SEC something to work with in this regard, when she explained that the decision was unique as to the facts presented and did not have precedential value for other digital-asset cases.

The Question Is Still Open

In the absence of any rulemaking by the SEC, the crypto industry arguably has two different standards — at least for now.

Under Ripple, direct sales to institutional investors may be securities, while secondary sales to other buyers are not securities, at least where the buyers do not know if their payments went to the original seller as opposed to a third party, and thus have no expectation of profit under Howey's third prong.

Additionally, distributions on the blockchain to employees or others for development of the blockchain are not necessarily securities without a showing of an investment of money. Alternatively, under Terraform, both institutional and secondary sales may qualify as securities under Howey.

Accordingly, as we begin 2024, the question of what makes a security is still very much an open question in the crypto industry. The analyses in these cases demonstrate that we may not be able to categorically say that all digital assets are — or are not — securities until and unless the Supreme Court or Congress steps in.

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

[2] Compare SEC v. Ripple Labs Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023) with SEC v. Terraform Labs Pte. Ltd., 2023 WL 4858299 (S.D.N.Y. Jul. 31, 2023) and SEC v. Terraform Labs Pte. Ltd., 2023 WL 8944860 (S.D.N.Y. Dec. 28, 2023).

[3] Last year, a third judge in the Southern District of New classified cryptocurrencies Ether (ETH) and Bitcoin (BTC) as "commodities," while dismissing a proposed class action lawsuit against a decentralized crypto exchange. Risley v. Universal Navigation Inc., 2023 WL 5609200, at *14 (S.D.N.Y. Aug. 29, 2023). This opinion, however, did not involve a discussion of the Howey test. It also differs from the other two opinions because it involves

allegations relating to decentralized exchange contracts, rather than addressing whether the underlying crypto-assets are securities.

[4] Id. at 295.

[5] Id. at 299.
[6] Id.at 298-99.

[7] Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974).

[8] Continental Marketing Corp. v. SEC, 387 F.2d 466 (2d Cir. 1967).

[9] SEC v. Aqua-Sonic Prod. Corp., 687 F.2d 577 (2d Cir. 1982).

[10] The SEC first applied the Howey test for certain crypto-assets in July 2017 when it issued its investigative report concluding that DAO tokens were securities. See SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities, SEC, (July 25, 2017), available at https://www.sec.gov/news/press-release/2017-131.

[11] SEC v. Ripple Labs Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023).

[12] SEC v. Terraform Labs Pte. Ltd., 2023 WL 4858299 (S.D.N.Y. Jul. 31, 2023).

[13] SEC v. Ripple Labs Inc., 2023 WL 6445969 (S.D.N.Y. Oct. 3, 2023).

[14] Terraform, 2023 WL 8944860.

[15] Id. at *13-14.

[16] Id.

[17] Id. at *14.

[18] Id. at *15.

[19] Id. at *3.

[20] Id. at *3 and *17.

[21] See Gary Gensler, "Partners of Honest Business and Prosecutors of Dishonesty": Remarks Before the 2023 Securities Enforcement Forum, SEC (Oct. 25, 2023), available at https://www.sec.gov/news/speech/gensler-remarks-securities-enforcement-forum-102523#_ftnref7.

[22] Ankush Khardori, Can Gary Gensler Survive Crypto Winter? D.C.'s top financial cop on Bankman-Fried blowback, New York Magazine, (Feb. 23, 2023), available at https://nymag.com/intelligencer/2023/02/gary-gensler-on-meeting-with-sbf-and-his-crypto-crackdown.html ("Everything other than [B]itcoin" falls under the SEC's jurisdiction because there are not individuals promoting it and trying to entice investors); see also David Pan, SEC's Gensler Reiterates 'Proof-of-Stake' Crypto Tokens May Be Securities, Bloomberg, (Mar. 15, 2023) (noting that proof-of-stake tokens, such as Ethereum, should be regulated as securities); but see Gary Gensler, Session 6: Smart Contracts and DApps

– Blockchain and Money, MIT Open Courseware, 2018, available at https://ocw.mit.edu/courses/15-s12-blockchain-and-money-fall-2018/resources/session-6-smart-contracts-and-dapps/ (with respect to Ethereum, stating "that I've publicly said I think it had a securities offering, but that was in 2014. And in 2018, the Securities and Exchange Commission has said regardless of why it might have been in '14, it's now sufficiently decentralized that we'll consider it not a security"); see also Risley, 2023 WL 5609200 at *14 (classifying both Bitcoin and Ethereum as commodities).