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SEC v. Crypto: With the Battle Lines Drawn, Who Has the Advantage?

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For years, the crypto industry has raised serious concerns about the lack of "regulatory clarity" in the cryptocurrency space. The industry has challenged the Securities and Exchange Commission to issue new rules specific to cryptocurrencies and has lobbied Congress to enact legislation to address what many perceive to be regulatory gaps in this area. The SEC's counter has been consistent: the law *is* clear—the legal test outlined in the 1946 Supreme Court case *SEC v. Howey*, the SEC has maintained, provides the necessary clarity on the rules and regulations governing the crypto industry.

The industry finally got the legal decision it had been waiting for last July from a Southern District of New York judge in the SEC's enforcement case against Ripple Labs. The *Ripple* decision was hailed as vindication for the industry's position that the SEC lacks the proper legal authority to regulate crypto. Many saw that decision as the death-knell for the SEC's crypto enforcement program.

In the ensuing months, however, the tides seemed to turn again, this time in the SEC's favor, as two other judges in the Southern District of New York disagreed with and departed from the *Ripple* decision. Now, almost one year later, another judge, this time in the District of Columbia, has endorsed the reasoning in *Ripple* and dealt another serious blow to the SEC.

So where does the crypto industry go from here? The answer, unfortunately, is not so simple.

The Conflicting Legal Precedent

The Securities Act of 1933 defines a "security" to include a wide variety of financial instruments. The statute lists a long series of assets (like stocks, bonds, and notes) that are securities, including an "investment contract." 15 U.S.C. §77b(a)(1). The definition of "investment contract" is at the heart of the crypto industry's dispute with the SEC.

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In a 1946 case involving the sale of interests in orange groves, the Supreme Court interpreted "investment contract" as a transaction involving (1) an investment of money (2) in a common enterprise (3) with profits to come from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). *Howey* has remained the seminal case for interpreting "investment contract" in a variety of contexts.

Litigants in crypto matters have launched different types of attacks on the *Howey* test over the years—ranging from the position that a 75-year-old case involving orange farming has little or no relevance

to an analysis of entirely new financial instruments like cryptocurrencies, to arguments that a close examination of *Howey* and state contract laws reveal additional "ingredients" that must be present for an investment contract to exist. One of the more successful of these challenges to date has been the theory that by its terms an "investment contract" must necessarily involve a *contract* between a buyer and a seller. This was the fundamental legal predicate for the *Ripple* court's decision that galvanized the industry last summer.

In that decision, Judge Analisa Torres found that Ripple's sales of its XRP crypto token to institutional investors, which were governed by explicit contractual arrangements, constituted securities transactions under *Howey*. By contrast, the court held that Ripple's XRP sales to retail investors—which occurred over crypto exchanges through blind bid-ask transactions—were not securities transactions.

The court reasoned that the third *Howey* prong was not met by these types of intermediated transactions, because retail investors buying XRP over an exchange never entered into any type of arrangement with Ripple and thus could not reasonably expect to profit from Ripple's efforts since they "could not have known if their payments of money went to Ripple, or any other seller of XRP." Accordingly, the Court concluded, "the vast majority of individuals who purchased XRP from digital asset exchanges did not invest their money in Ripple at all." *SEC v. Ripple Labs, Inc.*, 682 F. Supp. 3d 308, 328-30 (S.D.N.Y. 2023).

Though the *Ripple* court stated that it was not reaching the question of whether secondary market sales of XRP (as opposed to Ripple's primary offerings) constitute securities transactions, it followed from the court's reasoning that *all transactions* over crypto exchanges—which were, like Ripple's sales to retail investors, blind bid-ask transactions—*could not* be securities transactions. The court's decision, if correct, meant that the SEC had no authority to regulate the massive secondary trading market in cryptocurrencies, including transactions on exchanges like Coinbase and Binance—which the SEC had sued just months earlier for acting as unregistered intermediaries of securities transactions.

Weeks later, however, a second Southern District of New York judge expressly rejected the decision in the *Ripple* case. In *SEC v. Terraform Labs*, Judge Jed Rakoff held: "[T]he Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not.

In doing so, the court rejects the approach recently adopted by another judge of this District in [*SEC v. Ripple*]." Judge Rakoff went on to find: "That a purchaser bought the 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." *SEC v. Terraform Labs Pte. Ltd.*, 684 F. Supp. 3d 170, 197-98 (S.D.N.Y. 2023).

It was these two, wholly divergent rulings that a third Southern District of New York judge had to grapple with earlier this year in *SEC v. Coinbase*. Judge Katherine Polk Failla ultimately sided with Judge Rakoff and the SEC. Rejecting arguments put forth by Coinbase and the numerous *amici* who had filed briefs in the case, Judge Failla held that secondary market transactions in cryptocurrencies could indeed be securities under *Howey*: "The 'crypto' nomenclature may be of recent vintage, but the challenged transactions fall comfortably within the framework that courts have used to identify securities for nearly eighty years."

As Judge Rakoff had done in *Terraform*, Judge Failla went on to expressly hold that "there need not be a formal contract between transacting parties for an investment contract to exist under *Howey*," noting that "courts in this Circuit have consistently declined invitations by defendants in the cryptocurrency industry to insert a 'contractually-grounded' requirement into the *Howey* analysis." *SEC v. Coinbase, Inc.*, __ F. Supp.3d __, 2024 WL 1304037, at **1, 17-25 (S.D.N.Y. Mar. 27, 2024).

With the *Terraform* and *Coinbase* rulings, the euphoria for the industry surrounding the *Ripple* decision was replaced with more uncertainty. But late last month, a decision by a District of Columbia judge in *SEC v. Binance* offered new ammunition for the industry. In a lengthy and thoroughly reasoned opinion, Judge Amy Berman Jackson rejected the SEC's refrain that secondary market crypto transactions fit neatly into the *Howey* rubric.

While the court agreed with the SEC that an investment contract did not require a contractual relation-

ship, it went on to dismiss the SEC's claims relating to secondary transactions in Binance's BNB token. In paring back the SEC's case, the court echoed the industry's complaint that the SEC has taken imprecise and inconsistent positions on what, precisely, *is* the security—the crypto token itself or something else—and whether and how a token can continue to be a security after its initial offering.

The court concluded: "Insisting that an asset that was the subject of an alleged investment contract is itself a 'security' as it moves forward in commerce and is bought and sold by private individuals on any number of exchanges, and is used in any number of ways over an indefinite period of time, marks a departure from the *Howey* framework that leaves the Court, the industry, and future buyers and sellers with no clear differentiating principle between tokens in the marketplace that are securities and tokens that aren't." *SEC v. Binance*, No. 23 Civ. 1599, Docket Entry #248 at 15, 21, 42-43 (D.D.C. June 28, 2024).

While Judge Berman Jackson was explicit that her analysis applied to the specific allegations in the SEC's complaint about the individual token at issue, the *Binance* decision is certain to provide the industry a compelling roadmap to argue that most secondary market transactions fall outside of *Howey*—and thus are beyond the SEC's regulatory reach. (Another important aspect of the decision is its finding that the stablecoin BUSD was not offered and sold as an investment contract.)

One year. Four court opinions. And we are no closer to a clear, comprehensive, consistent roadmap for the crypto industry. As Judge Berman Jackson astutely observed, "the [SEC's] decision to oversee this billion dollar industry through litigation – case by case, coin by coin, court after court … risks inconsistent results that may leave the relevant parties and their potential customers without clear guidance." *Id.* at 21. Indeed, what is most clear after this past year is that the industry is unlikely to get such clear guidance from district courts alone.

The Industry's Response

More and more, faced with what it views to be an existential battle with the SEC, the crypto industry is going on the offensive. The crux of the industry's position is that crypto represents a new and burgeoning financial marketplace and cannot be regulated through a framework that was established decades ago for the traditional financial industry. The idea, then, is that the law must be made to catch up with the technological innovation offered by crypto—or else decades-old statutes and cases will be allowed to stifle new and transformative forms of assets.

At the heart of the industry's efforts to reframe the legal landscape is the insistence that the SEC fundamentally lacks the authority to regulate crypto. The industry's position has been bolstered by the recent evolution of Supreme Court jurisprudence on the "major questions doctrine." That doctrine is rooted in the premise that Congress intends to make major policy decisions itself, and that one branch of government should not arrogate to itself power that properly belongs to another branch. *West Virginia v. EPA*, 597 U.S. 697 (2022); *Biden v. Nebraska*, 600 U.S. __, 143 S. Ct. 2355 (2023). Thus, the industry has asserted, absent a clear mandate from Congress, the SEC's attempt to regulate through enforcement actions constitutes an "extraordinary" exercise of the agency's power in violation of the major questions doctrine.

Thus far, courts have not embraced this argument. The courts in *Terraform*, *Coinbase*, and *Binance* all rejected the doctrine's application to the SEC's crypto enforcement actions. Judge Rakoff, for example, found "no indication that Congress intended to hamstring the SEC's ability to resolve new and difficult questions posed by emerging technologies where these technologies impact markets that on their face appear to resemble securities markets." *Terraform*, 684 F. Supp. 3d at 190.

But these decisions are unlikely to be the final say on this question—or similar challenges under the Constitution's due process clause and the Administrative Procedure Act. For example, Consensys, the software developer behind the Ethereum blockchain, recently sued the SEC in the Northern District of Texas, arguing that the agency's actions in the crypto space constitute "regulatory overreach" brought on by "the ambition of the administrative state to control innovative technologies."

It remains to be seen whether Consensys's lawsuit will survive—particularly now that the SEC has sued Consensys in the Eastern District of New York over its MetaMask software product. But one way or the other, these issues will continue to be battled in the courts for years to come. In fact, the Consensys suit is just one of several lawsuits filed against the

SEC in the Northern District of Texas—as part of the industry's strategic effort to flip the script by initiating affirmative cases in jurisdictions that it hopes will view its position more favorably.

All of this is setting up the ultimate battle ground: the U.S. Supreme Court. There, the industry may find real traction for its argument that a 75-year-old case about oranges should not control the operation of a novel technology that is looking to overhaul the financial system—and a receptive audience for its position on separation of powers and agency overreach.

The road to the Supreme Court, of course, is long and uncertain. So the industry is also devoting significant resources to lobbying for legislative action. In a major victory for the industry, the first crypto-focused legislation was passed by the U.S. Congress in May. This bill—which was ultimately vetoed by President Biden—would have invalidated the SEC's Staff Accounting Bulletin 121 (advising custodians holding cryptocurrencies on behalf of customers to record those assets as liabilities on their own balance sheets). Also in May, the House passed the Financial Innovation and Technology for the 21st Century Act (FIT21), in an impressive 279-136 vote. That bill would amend existing regulatory statutes to clarify the scope of regulatory authority over cryptocurrencies between the SEC and the CFTC. Though the fate of FIT21 through the Senate is far from certain, its bipartisan support in the House including by 71 Democrats—despite warnings by the Biden-appointed SEC Chair that it would put "investors and capital markets at immeasurable risk"—marks a turning point for crypto legislation.

These recent legislative victories have been hard-fought. And their lasting impact is uncertain. Indeed, the outcome of the November elections may totally alter the playing field in the industry's favor. That said, any crypto-focused legislation is unlikely to answer all of today's open questions.

The Path Forward

For now, then, the industry is attempting to come to terms with the current reality—while continuing the fight for its vision of the future. The SEC will surely continue to use its interpretation of *Howey* as the basis for enforcement actions against industry players. While it is possible that a change of presidential administration in 2025 may be a gamechanger, it is equally unknowable whether a new SEC Chair would shift course entirely, including by dropping lawsuits the Commission has already filed.

One path forward is for industry players to go on with business as usual and risk that they will next come into the SEC's sights. Anyone faced with this dilemma and the accompanying threat to their business will need to be prepared to expend the resources to take on a multi-year litigation against the SEC—if that unfortunate day comes. While the SEC is not nearly as well-resourced as the industry, it has thus far been able to hold its own in numerous high-profile litigations—though it remains to be seen whether it can keep up with a growing and increasingly complex litigation docket.

Another option is to go on the offensive, as Consensys and others have done, and sue the SEC in a jurisdiction of their choice. This would put an embattled crypto company in the driver's seat but would come with potentially larger costs in terms of litigation expenses and marketplace risk—as well as the risk that its battle with the SEC may not end on the terms it seeks.

Yet another alternative is to attempt to comply with the securities laws as the SEC sees them. This means closely examining a crypto project or protocol in light of *Howey* and working to minimize regulatory risk while, at the same time, advancing as far as possible the project's technological and financial objectives. While not an easy needle to thread, this may be the most sensible option for smaller developers or those that cannot operate through a prolonged period of regulatory uncertainty.

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