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SEC V. THE CRYPTO INDUSTRY — TRACKING THE SEC'S ONGOING LITIGATION AGAINST DIGITAL ASSET EXCHANGES

“This is a question of great economic and political significance.” (Kraken’s motion to dismiss; see page 7.) Whether a digital asset exchange may offer digital assets for secondary trading without those digital assets being registered as securities and operate in the US without being registered with the US Securities and Exchange Commission as a securities exchange, clearing agency, or broker is being litigated in courts across the country, and likely will be litigated for years to come. The US Supreme Court may be the ultimate arbiter if it becomes necessary to resolve circuit court splits on these issues (which seem to be on the horizon). In the meantime, trillions of dollars hang in the balance as exchanges operating in the US face the threat of regulation by enforcement.

By Frederick L. Block, Alyse J. Rivett, Sarah V. Riddell, and Madeleine Ayer *

On January 10, 2024, in a highly anticipated event for the crypto industry, the US Securities and Exchange Commission (“SEC”) approved by a 3-2 vote the first US-listed, exchange-traded product to track spot bitcoin.¹ For the first time in his tenure, SEC Chairman Gary Gensler voted against his Democratic colleagues and sided with the two Republican commissioners to approve 11 applications for spot bitcoin exchange-traded funds, including from well-known financial services

firms.² Chairman Gensler released a post-approval statement, emphasizing that the decision did not signal the Commission’s support of bitcoin or other cryptocurrencies.³ Indeed, Gensler warned investors that, unlike other exchange-traded products, bitcoin was a “speculative, volatile asset” used in part to fund crime.⁴ Gensler conceded, however, that the SEC’s recent loss against Grayscale⁵ in the US Court of Appeals for the District of Columbia left the agency with little choice

¹ Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units, Securities Exchange Act Release No. 34-99306 (Jan. 10, 2024) (“Approval Order”), <https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf>.

² *Id.*

³ Chair Gary Gensler, Statement on the Approval of Spot Bitcoin Exchange-Traded Products (Jan. 10, 2024).

⁴ *Id.*

⁵ *Grayscale Invs., LLC v. SEC*, No. 22-1142 (D.C. Cir. 2023).

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FORTHCOMING

• CRYPTOCURRENCY SECURITIES CLASS ACTION LITIGATION: 2023 YEAR IN REVIEW

but to approve exchange-traded products tracking spot bitcoin.⁶ Accordingly, despite the approval, it appears unlikely from recent events that the SEC will approve other digital asset products any time soon. Indeed, the SEC remains in litigation with some of the largest players in the industry, spanning multiple courts across the United States. The cases address the reach of the SEC’s jurisdiction over crypto assets and which crypto assets are “investment contracts” under securities laws. This current wave of ongoing SEC litigation sets up the likelihood that different courts will reach divergent outcomes, which the US Supreme Court will need to reconcile in coming years.

BACKGROUND ON “INVESTMENT CONTRACTS” AND THE *HOWEY* TEST

Section 5 of the Securities Act of 1933 requires an issuer to register an offer or sale of securities with the SEC unless an exemption from registration is available, such as the exemption for a private placement under Section 4(a)(2) of the Securities Act. Thus, a threshold issue in the SEC’s litigation involving crypto assets is whether an offer or sale of a security has occurred. The term “security” includes an “investment contract,” as well as other instruments such as stocks, bonds, and transferrable shares. The seminal case for determining whether a product is an “investment contract” is *SEC v. W.J. Howey Co.*⁷ In *Howey*, the US Supreme Court set forth the test for determining when an investment contract, and thus a security, exists. The test requires (1) an investment of money (2) in a common enterprise (3) with the expectation of profit (4) that is derived from the effort of others.⁸ The *Howey* case involved the sale of tracts of citrus groves to buyers in Florida who later leased back the land to the company, *Howey*. The company tended to the groves and sold the fruit on behalf of the owners of the citrus groves. Both the buyers of the groves and the company shared in the revenue from the sale of the citrus. In the SEC’s view,

these transactions required registration under the securities laws and the Court held that the leaseback arrangements at issue in the case qualified as investment contracts based on the four-part test. Almost 80 years later, this test is used to determine whether the sale of a digital asset is an investment contract — i.e., whether the sale of digital assets on crypto exchanges is equivalent to the citrus grove arrangement in *Howey*. In the SEC’s view, these transactions require registration under the securities laws.⁹ The industry, however, has vigorously fought back and contested these conclusions in courts, with varying degrees of success.

SELECTED CASES FROM THE SEC’S LITIGATION DOCKET AGAINST THE CRYPTO INDUSTRY

A summary of the key cases recently or currently being litigated by the SEC against the crypto industry follows:

RIPPLE EFFECT

In December 2020, the SEC filed suit against Ripple Labs (“Ripple”), a San Francisco-based cryptocurrency company founded in 2012, along with its two chief executives, Bradley Garlinghouse and Christian Larsen.¹⁰ The SEC alleged that Ripple sold almost 15 billion units of its digital token, XRP, for more than \$1.38 billion without registering its offers and sales with the SEC as securities, as required by federal securities laws.¹¹ The SEC further alleged that Larsen and Garlinghouse aided and abetted Ripple.

⁹ *SEC’s Gensler: The “Runway is Getting Shorter for Non-Compliant Crypto Firms,”* YAHOO (Dec. 7, 2022), <http://yahoo.it/3EJrqo1> (“I feel that we have enough authority, I really do, in this space” to require crypto companies “to come into compliance” with the Commission’s registration requirements).

¹⁰ Complaint, *SEC v. Ripple Labs, Inc., Bradley Garlinghouse, and Christian A. Larsen (collectively d/b/a Ripple)*, No. 1:20-cv-10832 (S.D.N.Y. Dec. 22, 2020), <https://www.sec.gov/files/litigation/complaints/2020/comp-pr2020-338.pdf>.

¹¹ *Id.*

⁶ Chair Gary Gensler, Statement on the Approval of Spot Bitcoin Exchange-Traded Products (Jan. 10, 2024).

⁷ 328 U.S. 293 (1946).

⁸ *Id.* at 299.

Ripple argued that because XRP was a “store of value” and a “medium of exchange,” the token was not a share in Ripple’s profit and therefore not a security that had to be registered with the SEC.¹² Ripple also pointed out that when the Department of Justice (“DOJ”) and the Department of the Treasury’s Financial Crimes Enforcement Network (“FinCEN”) determined that XRP was a virtual currency in 2015, the SEC “said not a word” about whether XRP was a security.¹³

In July 2023, Ripple secured a significant victory in the Southern District of New York when Judge Analisa Torres partially ruled in favor of the company on summary judgment.¹⁴ Applying the *Howey* factors, Judge Torres ruled that XRP constitutes a security when directly sold to institutional investors, like hedge funds, but does *not* constitute a security when sold to the broader general public on secondary digital asset trading platforms or when used as compensation for services.¹⁵ The court’s distinction hinged on the *Howey* factors.¹⁶ Because Ripple pooled the proceeds from the institutional investors, and because each institutional investor’s success was tied to the success of the other investors, the court ruled that money had been invested in a common enterprise.¹⁷ Moreover, the court found that institutional investors had an expectation of profit to be derived from the company’s efforts when Ripple had directly marketed XRP’s investment potential to such investors.¹⁸ With all *Howey* factors satisfied, Judge Torres ruled that the sales of XRP to institutional investors were subject to federal securities laws.¹⁹ XRP sales on secondary trading platforms, however, did not satisfy *Howey* — the buyers did not know where their

payments went and it was unclear whether they had received promotional materials from Ripple, and thus they could not expect a profit to be derived from Ripple’s managerial efforts.²⁰ Similarly, distributing XRP as a form of compensation could not satisfy *Howey* as there had been no investment of money.²¹ Only sales to institutional investors, therefore, constituted unregistered sales of securities.²²

In October 2023, the SEC voluntarily dismissed its claims against Garlinghouse and Larsen.²³ The media reported that “[t]he voluntary dismissal suggests that the SEC may have strategically decided to avoid a prolonged trial in order to reach a final, appealable decision more quickly, thus allowing the agency to challenge aspects of Judge Torres’s summary judgment decision through appeal.”²⁴ The SEC, meanwhile, has characterized the *Ripple* decision in other litigation as an outlier.²⁵ Currently, the issue of what remedies to impose is before Judge Torres. After Judge Torres decides the issue of remedies, the case will be ripe for appeal by the SEC or Ripple.

In contrast to Judge Torres’s ruling that secondary transactions in crypto are not investment contracts and, therefore, *not* unregistered securities, Judge Tana Lin in the Western District of Washington recently concluded the opposite.²⁶ As part of a default judgment order against the remaining defendant in *SEC v. Wahi* for insider trading violations involving a Coinbase employee, Judge Lin concluded that “Under *Howey*, all of the crypto assets that [the defendant] purchased and traded were investment contracts,” and as a result, the

¹² Answer to Complaint, *SEC v. Ripple Labs, Inc., Bradley Garlinghouse, and Christian A. Larsen (collectively d/b/a Ripple)*, No. 1:20-cv-10832 (S.D.N.Y. Jan. 29, 2021).

¹³ *Id.*

¹⁴ Order, *SEC v. Ripple Labs, Inc., Bradley Garlinghouse, and Christian A. Larsen (collectively d/b/a Ripple)*, No. 1:20-cv-10832 (S.D.N.Y. July 7, 2023), <https://www.nysd.uscourts.gov/sites/default/files/2023-07/SEC%20vs%20Ripple%207-13-23.pdf>.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Ripple effects: developments following groundbreaking decision in SEC v. Ripple Labs*, REUTERS, Dec. 5, 2023, <https://www.reuters.com/legal/legalindustry/ripple-effects-developments-following-groundbreaking-decision-sec-v-ripple-labs-2023-12-05/>.

²⁴ *Id.* Indeed, the SEC had earlier sought an interlocutory appeal of the decision, but Judge Torres rejected that attempt. *SEC v. Ripple*, No. 1:20-cv-10832 (S.D.N.Y. Oct. 3, 2023), at Dkt. 917.

²⁵ *Id.*

²⁶ Order, *SEC v. Wahi*, No. 2:22-cv-01009 (W.D. Wash. Mar. 1, 2024).

defendant's illicit trading was in connection with the purchase or sale of a security.²⁷ Because this issue was decided as part of a default judgment order, it is unlikely that Judge Lin's decision (and her conclusions regarding trading of crypto assets on a secondary market) will be appealed to the Ninth Circuit.

COINBASE FILES (ANOTHER) WRIT OF MANDAMUS PETITION AGAINST THE SEC

Fed up with the SEC's inaction in providing any clarity to the crypto industry through the passage of rulemaking, Coinbase has attempted to move things along by filing a petition for a writ of mandamus in the Third Circuit Court of Appeals to compel the SEC to respond to Coinbase's 2022 petition for rulemaking. The petition asks the SEC to adopt rules that govern the regulation of digital assets, including rules that explain which digital assets are securities. The following timeline tracks Coinbase's efforts:

- July 21, 2022: Coinbase files a petition for a rulemaking with the SEC.
- April 24, 2023: Coinbase files a petition for a writ of mandamus in the Third Circuit to compel the SEC to respond to its rulemaking petition.
- June 20, 2023: The Court directs the SEC to report on the status of Coinbase's petition.
- October 11, 2023: The SEC reported that its staff had made a recommendation to the SEC on the petition.
- December 15, 2023: (1) The SEC issued an order denying Coinbase's rulemaking petition (the "Order") and (2) Coinbase petitioned the Third Circuit for a review of the Order.

As reflected above, Coinbase filed a petition for mandamus against the SEC in the summer of 2022.²⁸ In its petition, Coinbase requested that the SEC propose and adopt rules to regulate securities that are offered and traded through "digitally native methods" (i.e., digital asset securities that are available only in tokenized form on a distributed ledger), including potential rules governing when digital assets are securities.²⁹

²⁷ *Id.* at 14.

²⁸ Petition for Rulemaking from Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., to Vanessa Countryman, Secretary, SEC (July 21, 2022).

²⁹ *Id.* at 1.

Coinbase's petition focuses on three areas where it believes SEC rulemaking would be beneficial to the digital asset industry, including (1) how to determine whether a digital asset is a security; (2) existing regulatory requirements that are incompatible with the digital asset securities industry; and (3) existing regulatory requirements that are not necessary or are overly burdensome when applied to digital asset securities.³⁰ Throughout its petition, Coinbase provided explanations as to why rulemaking in these areas would be helpful to the digital asset industry and included related questions for the SEC to consider.

Shortly before Coinbase filed its petition in the Third Circuit, the SEC's Division of Enforcement sent Coinbase a "Wells notice," putting Coinbase on notice that the SEC Staff planned to recommend an enforcement action against Coinbase to the five SEC Commissioners. As noted below, this is precisely what the SEC did just months later.

On December 15, 2023, after the SEC Staff issued a "Wells notice" and after Coinbase petitioned the Third Circuit to issue a writ of mandamus to compel the SEC to respond to its rulemaking petition, the SEC formally denied Coinbase's petition for rulemaking. In its denial of the petition, the SEC stated that Coinbase failed to include the text or substance of a proposed rule as required by the SEC rules of practice and that it was appropriate to deny the petition based on the SEC's discretion to set its priorities of its regulatory agenda.³¹ The SEC's denial of Coinbase's petition was a 3-2 decision split along party lines with all three of the Democratic Commissioners voting in favor of the denial. On the same day as the SEC's denial, Coinbase petitioned the Third Circuit once more, this time seeking

³⁰ *Id.* at 5.

³¹ Letter from Vanessa Countryman, Secretary, SEC, to Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., 2 (Dec. 15, 2023). *See* 17 C.F.R. § 201.192(a) ("Any person desiring the issuance, amendment or repeal of a rule of general application may file a petition therefor with the Secretary. Such petition shall include a statement setting forth the text or the substance of any proposed rule or amendment desired or specifying the rule the repeal of which is desired, and stating the nature of his or her interest and his or her reasons for seeking the issuance, amendment or repeal of the rule. The Secretary shall acknowledge, in writing, receipt of the petition and refer it to the appropriate division or office for consideration and recommendation. Such recommendations shall be transmitted with the petition to the Commission for such action as the Commission deems appropriate. The Secretary shall notify the petitioner of the action taken by the Commission.").

a review of the SEC’s order denying its petition on the grounds that the order violates the Administrative Procedure Act (5 U.S.C. §§ 701 et seq.) (“APA”) because it is arbitrary and capricious, contrary to law, and an abuse of discretion for the SEC to not engage in rulemaking.³² Coinbase asked the court to vacate, enjoin, set aside, and hold unlawful the SEC’s order because the SEC’s “campaign of regulation by enforcement against Coinbase and others” exceeds the SEC’s statutory authority and “flouts the APA.”³³ As of the date this article was written, the Third Circuit had not taken action on Coinbase’s petition.

STABLECOINS ARE SECURITIES

In February 2023, the SEC filed suit in the US District Court for the Southern District of New York against the Singapore-based digital asset exchange Terraform Labs PTE Ltd (“Terraform”) and its founder, Do Kwon.³⁴ Terraform offered TerraUSD (UST) and LUNA, algorithmic stablecoins, which infamously depegged in May 2022, triggering the “crypto winter” (a lengthy period of pricing dips in the crypto market). The SEC alleged that Terraform and Kwon orchestrated a multibillion-dollar securities fraud involving a series of crypto assets.³⁵ The SEC grounded its complaint in allegations of selling unregistered securities, lying to investors about the assets’ stability and profitability, and concealing material information from investors before the system’s collapse, which wiped out \$45 billion in value.³⁶ This case was assigned to Judge Jed S. Rakoff in the US District Court for the Southern District of New York.

Like Ripple, Terraform argued that its assets amounted to a virtual currency, not a security.³⁷ Terraform also accused the SEC of cherry-picking

cryptocurrency winners and losers, pointing to how the SEC omitted Bitcoin from similar attempts to regulate.³⁸

Judge Rakoff, getting his bite at the apple, rejected Terraform’s argument and ruled in favor of the SEC when he denied the defendants’ motion to dismiss in July 2023. Judge Rakoff repudiated Judge Torres’s reasoning in *Ripple* and found that the crypto assets sold by Terraform and Kwon qualified as securities under *Howey*.³⁹ Unlike Judge Torres, Judge Rakoff declined to draw a distinction between digital assets based on the manner in which they were sold (e.g., in secondary sales on an exchange).⁴⁰ Judge Rakoff reasoned that *Howey* “does not differentiate among purchasers, because the manner in which digital assets are purchased would not change a purchaser’s reasonable belief in the promise of future profits.”⁴¹

In December 2023, Judge Rakoff granted summary judgment for the SEC on its claim that Terraform offered and sold unregistered securities.⁴² In January 2024, Judge Rakoff granted Kwon’s motion to postpone the trial, which will concern the SEC’s fraud claims, to ensure Kwon’s timely extradition from Montenegro, where he is currently being held on criminal fraud charges.⁴³ Any appeal in this case will be to the US Court of Appeals for the Second Circuit.

THE SEC CLAIMS THAT COINBASE IS OPERATING AN UNLAWFUL SECURITIES EXCHANGE, CLEARING AGENCY, AND BROKER

In June 2023, months after filing suit against Terraform, the SEC filed suit against Coinbase, the United States’ largest digital asset exchange that was founded in 2012. (As mentioned above, this was after Coinbase had sought relief from the Third Circuit to compel the SEC to act on Coinbase’s 2022 petition for

³² Petition for Review, *Coinbase v. SEC*, No. 23-3202 (3d Cir. Dec. 15, 2023).

³³ *Id.* at 2.

³⁴ Complaint, *SEC v. Terraform Labs PTE Ltd and Do Hyeong Kwon (collectively d/b/a Terraform)*, No. 1:23-cv-01346 (S.D.N.Y. Feb. 16, 2023), <https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-32.pdf>.

³⁵ *Id.*

³⁶ *Id.*

³⁷ Answer to Complaint, *SEC v. Terraform Labs PTE Ltd and Do Hyeong Kwon (collectively d/b/a Terraform)*, No. 1:23-cv-01346 (S.D.N.Y. Aug. 14, 2023).

³⁸ *Id.*

³⁹ Order, *SEC v. Terraform Labs PTE Ltd and Do Hyeong Kwon (collectively d/b/a Terraform)*, No. 1:23-cv-01346 (S.D.N.Y. July 31, 2023).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *US SEC willing to delay Terraform Labs trial for Do Kwon’s extradition*, REUTERS, Jan. 15, 2024, <https://www.reuters.com/legal/us-sec-willing-delay-terraform-labs-trial-do-kwons-extradition-2024-01-15/>.

⁴³ *Id.*

rulemaking.) The litigation was assigned to Judge Katherine Polk Failla in the Southern District of New York. In its complaint, the SEC alleged that Coinbase operated as an unregistered broker, exchange, and clearing agency, and that at least 12 of the more than 240 tokens offered for sale on the platform constituted securities.⁴⁴ The SEC further argued that Coinbase’s “staking-as-a-service” program, which allows users to earn interest on their tokens, is a security in its own right.⁴⁵ In August 2023, Coinbase moved for a judgment on the pleadings, arguing that the SEC’s case lacked merit and should be dismissed as a matter of law.⁴⁶ Coinbase’s main arguments were (1) that the tokens for sale on its platform were not “investment contracts” under *Howey* because there was no contract or agreement between the purchasers and the issuers; rather, the transactions were commodity sales and (2) the SEC’s regulation-by-enforcement approach violates the major-questions doctrine that requires “major questions” to be decided by Congress and not administrative agencies.⁴⁷

On January 17, 2024, Judge Failla held a lengthy hearing to question both sides about their arguments in the case. During the hearing, Judge Failla questioned the SEC’s argument that buying a token amounts to buying into a common enterprise with the expectation of profits.⁴⁸ Coinbase argued that most cryptocurrencies are commodities, not securities, which investors may hope go up in value as collectors of baseball cards or Beanie Babies may hope, but, because digital assets do not carry rights such as dividends, they do not constitute securities.⁴⁹ “It’s the difference between investing in Beanie Baby Inc. and buying Beanie Babies,” Coinbase

argued.⁵⁰ Judge Failla is expected to decide the motion in the coming months.⁵¹ If she allows all or part of the case to proceed, the case could go to trial in 2025.⁵² Any appeal by the SEC or Coinbase will be to the US Court of Appeals for the Second Circuit.

THE SEC CLAIMS THAT BINANCE TOO IS OPERATING AN UNLAWFUL SECURITIES EXCHANGE, CLEARING AGENCY, AND BROKER

In June 2023, the SEC also filed suit against Cayman Islands-based Binance, which operates the largest crypto asset trading platform in the world, its US affiliate, and its founder, Changpeng “CZ” Zhao, alleging a variety of securities violations.⁵³ The SEC alleged the company artificially inflated its trading volumes, diverted customer funds, failed to restrict US customers from its platform, misled investors about its market surveillance controls, and unlawfully facilitated trading of several tokens that were unregistered securities.⁵⁴ On September 21, 2023, Binance moved to dismiss the complaint.⁵⁵ Like Coinbase, Binance argued that individuals invest in all types of assets, like real estate or art, but the presence of an investment alone does not create a security.⁵⁶ Binance further argued that, even if the court determined that the tokens constituted securities, the major-questions doctrine required the suit to be dismissed.⁵⁷ In November 2023, Binance settled with the Department of Justice for more than \$4 billion for a series of financial crimes, including money laundering, which also ousted Zhao from the company.⁵⁸

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ Complaint, *SEC v. Binance Holdings Ltd., BAM Trading Servs. Inc., BAM Mgmt. US Holdings Inc., and Changpeng Zhao (collectively d/b/a Binance)*, No. 1:23-cv-01599 (D.D.C. June 5, 2023), <https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-101.pdf>.

⁵⁴ *Id.*

⁵⁵ Motion to Dismiss, *SEC v. Binance Holdings Ltd., BAM Trading Servs. Inc., BAM Mgmt. US Holdings Inc., and Changpeng Zhao (collectively d/b/a Binance)*, No. 1:23-cv-01599 (D.D.C. Sept. 21, 2023).

⁵⁶ *Id.*

⁵⁷ *Id.*

⁴⁴ Complaint, *SEC v. Coinbase, Inc. and Coinbase Glob., Inc. (collectively d/b/a Coinbase)*, No. 1:23-cv-04738 (S.D.N.Y. June 6, 2023), <https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-102.pdf>.

⁴⁵ *Id.*

⁴⁶ Motion for Judgment on the Pleadings, *SEC v. Coinbase, Inc. and Coinbase Glob., Inc. (collectively d/b/a Coinbase)*, No. 1:23-cv-04738 (S.D.N.Y. Aug. 4, 2023).

⁴⁷ Answer to Complaint, *SEC v. Coinbase, Inc. and Coinbase Glob., Inc. (collectively d/b/a Coinbase)*, No. 1:23-cv-04738 (S.D.N.Y. June 28, 2023).

⁴⁸ *Judge Questions SEC’s Claim to Regulate Coinbase*, WALL ST. J., Jan. 17, 2024, <https://www.wsj.com/finance/regulation/judge-questions-secs-claim-to-regulate-coinbase-ae2f240c>.

⁴⁹ *Id.*

The resolution with DOJ, however, did not resolve the threshold question of whether Binance operates as an unregistered securities exchange. That issue continues to be litigated in the US District Court for the District of Columbia before Judge Amy Berman Jackson. Judge Jackson held a lengthy hearing on January 22, 2024, during which she asked pointed questions to lawyers for the SEC and Binance.⁵⁹ If Judge Jackson allows all or part of the case to continue, the lawsuit (as with the Coinbase case) could be headed for trial in 2025 or later. Any appeal by the SEC or Binance will be to the US Court of Appeals for the District of Columbia.

THE SEC SUES KRAKEN (AGAIN)

As reflected in the SEC's actions against Coinbase and Binance, the SEC has turned from pursuing digital asset issuers for unlawful securities offerings — like Ripple — to aggressively pursuing digital asset platforms through enforcement actions. Similar to Coinbase and Binance, Kraken has found itself in the SEC's crosshairs. Kraken — a global digital asset business founded in 2011 to provide a platform to buy and sell digital assets with the mission of “accelerat[ing] the adoption of cryptocurrency so that everyone can achieve financial freedom and inclusion”⁶⁰ — is not unfamiliar with SEC enforcement actions. In February 2023, Payward Ventures, Inc. and Payward Trading Ltd. (both known as Kraken) agreed to settle (on a no-admit-or-deny basis) SEC charges alleging the failure to register the offer and sale of Kraken's digital asset staking-as-a-service program. Kraken agreed to cease offering the program and pay a \$30 million penalty.⁶¹ Less than a year later, on November 20, 2023, the SEC

filed charges against Kraken for operating as an unregistered securities exchange, broker, dealer, and clearing agency in violation of the Securities Exchange Act of 1934.⁶²

In the SEC's most recent enforcement action against Kraken, the SEC takes issue with Kraken's online trading platform and services that allow customers to open accounts, deposit funds, enter orders, and trade digital assets made available on the platform. The SEC alleged that at least 11 digital assets were securities.⁶³ According to the SEC, Kraken's trading platform and services are available to both retail and institutional customers located in and outside the United States, and the trading platform operates a single set of order books and a matching engine from servers located in the United States.⁶⁴

The SEC alleged that Kraken created risk for investors by not registering with the agency, which entails numerous investor protection requirements.⁶⁵ In support of this position, the SEC further alleged that Kraken's internal controls and recordkeeping were deficient and inadequate, and that Kraken failed to properly record margin transactions, which led to material errors to Kraken's 2020 and 2021 financial statements.⁶⁶ The SEC cited to Kraken's independent auditor's findings that Kraken's commingling of customer crypto assets worth more than \$33 billion with its own assets created a “significant risk of loss” to its

⁵⁸ *Binance, SEC face off over regulator's crypto oversight*, REUTERS, Jan. 22, 2024, <https://www.reuters.com/legal/binance-kicks-off-oral-arguments-push-end-sec-lawsuit-2024-01-22/>.

⁵⁹ *Id.*

⁶⁰ *Kraken continues to fight for its mission and crypto innovation in the United States*, Kraken Blog (Nov. 20, 2023), <https://blog.kraken.com/news/kraken-continues-to-fight-for-its-mission-and-crypto-innovation-in-the-united-states>.

⁶¹ Press Release, SEC, Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges (Feb. 9, 2023), <https://www.sec.gov/news/press-release/2023-25>.

⁶² Complaint, *SEC v. Payward, Inc. and Payward Ventures, Inc. (collectively d/b/a Kraken)*, No. 3:23-cv-06003 (N.D. Cal. Nov. 20, 2023), <https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-237.pdf>.

⁶³ *Id.* ¶¶ 58-59. The SEC alleges that the digital assets with trading symbols ADA, ALGO, ATOM, FIL, FLOW, ICP, MANA, MATIC, NEAR, OMG, and SOL are securities. *Id.* The SEC notes that Kraken also offers digital assets that have been identified as securities in other SEC enforcement actions (including those with trading symbols AXS, CHZ, COTI, DASH, and SAND), but it does not include these digital assets to support its complaint. *Id.*

⁶⁴ *Id.* ¶ 45.

⁶⁵ *Id.* ¶ 1.

⁶⁶ *Id.* ¶ 2.

customers.⁶⁷ In addition, the SEC alleged that Kraken commingled some of its customers' cash with its own and paid operational expenses directly from bank accounts that held customer cash.⁶⁸

Kraken, poised to litigate the issues, filed a motion to dismiss the SEC's complaint. The SEC describes Kraken's crypto assets as forming "the basis of investment contracts covered under U.S. securities laws."⁶⁹ Kraken's Chief Legal Officer, Marco Santori, disagrees and has explained during an interview that there is "no such thing as a broker-dealer for investment contracts or an exchange for investment contracts or [a] clearinghouse for investment contracts [and the complaint is] entirely hollow, made up by the agency" and Kraken "plan[s] to fight the complaint."⁷⁰ Kraken's motion to dismiss hinges on the following arguments: (1) the SEC does not allege that there is a contract between the issuers and Kraken purchasers and therefore there is no "investment contract" under *Howey*, or that transactions on Kraken conveyed post-sale rights or obligations (e.g., the right to receive dividends or voting rights), and the SEC cannot otherwise satisfy the remaining *Howey* elements⁷¹ and (2) the SEC's attempt to expand its authority — which it previously acknowledged that it lacks — presents a major question for Congress to decide.⁷²

The case is assigned to Judge William Orrick in the Northern District of California. A decision on the motion to dismiss, scheduled to be heard on June 12, 2024, is not expected for months, and any eventual appeals by

either the SEC or Kraken will be to the Ninth Circuit of the US Court of Appeals.

TRADE ASSOCIATION SUES THE SEC

In a preemptive measure, the Crypto Freedom Alliance of Texas has paired with LEJILEX, a Texas-based corporation with a digital asset platform, Legit.Exchange, to sue the SEC under a "genuine threat of enforcement." These entities are seeking a court declaration that the sales of digital assets on Legit.Exchange are not sales of securities, Legit.Exchange is not an unregistered securities exchange, and by operating Legit.Exchange, LEJILEX should not be deemed an unregistered broker or unregistered clearing agency.⁷³ The complaint asks that the Court enjoin the SEC from bringing an enforcement action against LEJILEX or similarly situated members of the Crypto Freedom Alliance of Texas.⁷⁴ The complaint was filed in the Northern District of Texas, meaning that any appeals will be heard by the Fifth Circuit Court of Appeals. The SEC is expected to respond to the complaint in the near future.

CONCLUSION

As is evident with the litigation landscape discussed above, the SEC's litigation involving crypto exchanges and assets is currently taking place in courts across the country. At least three or four different courts may reach conclusions in the near future, and, depending on how the courts rule, it may be necessary for the US Supreme Court to resolve any circuit court splits. Because district court rulings and subsequent appeals will take many months or even years, it is unlikely there will be clarity on these issues in 2024. While these cases work their way through the courts, regulators in the United States are expected to continue to aggressively pursue entities and individuals involved in the crypto space. Indeed, in fiscal year 2023, more than 49% of the Commodity Futures Trading Commission's cases involved transactions in digital asset markets, and the SEC has an entire unit dedicated to the enforcement of securities laws in this space. In the meantime, crypto exchanges and other businesses operating in the crypto market would benefit from congressional legislation to clarify the SEC's jurisdictional bounds. ■

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* ¶ 1.

⁷⁰ CNBC Crypto World, *Kraken's chief legal officer addresses recent SEC lawsuit against the crypto exchange*, YOUTUBE (Nov. 20, 2023), <https://www.youtube.com/watch?v=8FGAjVmWEJQ>.

⁷¹ Kraken likens a digital asset to an orange, explaining that neither can be an "investment contract" no matter how it is traded. Motion to Dismiss, *SEC v. Payward, Inc. and Payward Ventures, Inc. (collectively d/b/a Kraken)*, No. 3:23-cv-06003 (N.D. Cal. Feb. 22, 2024) at *23.

⁷² *Id.* at *29 (citing Chair Gensler's remarks before Congress that digital asset exchanges "do not have a regulatory framework" and that only Congress could address this lack of a framework, Kraken invokes the Major Questions Doctrine).

⁷³ *LEJILEX and Crypto Freedom Alliance of Texas v. SEC*, No. 4:24-cv-00168-O (N.D. Tex. Feb. 21, 2024) at *53.

⁷⁴ *Id.*