

Are cryptocurrencies securities? The SEC is answering the question

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When it comes to trendiness in the market, cryptocurrency is all the rage these days.

From celebrity endorsements to Super Bowl ads to NFTs, crypto has become decidedly more mainstream in the last few years. According to Bloomberg and CoinGecko (<https://bloom.bg/3tSOTwV>), the 2021 cryptocurrency market capitalization spiked by approximately \$1.5 trillion, roughly tripling in value from January (\$776.4 billion) to December (\$2.3 trillion). As of March 14, 2022, the cryptocurrency market still sits at a hefty \$1.82 trillion.

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However, this explosive market growth has also come with a ramp-up in regulatory scrutiny by financial authorities, as well as an executive order (“Executive Order on Ensuring Responsible Development of Digital Assets”) signed on March 9 by President Joe Biden calling for federal agencies to more closely examine the risks and benefits of cryptocurrencies.

Part of cryptocurrency’s appeal is that it has, until now, been largely independent of intermediary entities (such as banks and stock exchanges) and has eluded regulation by institutions such as the Securities and Exchange Commission (SEC) and the U.S. Department of the Treasury (USDT). This lack of oversight has allowed cryptocurrency to operate on an almost instantaneous basis among a large cohort of users. However, for these same reasons, crypto has also shown itself to be extremely volatile, susceptible to fraud, and lacking sufficient investor protections.

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first cryptocurrency (Bitcoin) launched in 2009, the question of how exactly to fit the components of this new, decentralized financial ecosystem into traditional categories has been widely debated.

Back in 2017, at the PLI 49th Annual Institute on Securities Regulation, then-SEC Chair Jay Clayton warned cryptocurrency exchanges that many of their products likely qualified as securities and should therefore be registered under federal securities laws. In 2018, Clayton clarified in an interview with CNBC that true cryptocurrencies (i.e., those that simply act as replacements for traditional fiat currency) are commodities rather than securities (“SEC chairman: Cryptocurrencies like bitcoin are not securities” June 6, 2018). This includes cryptocurrencies such as Bitcoin, Ether, and Litecoin.

But since terms like “coin,” “token,” “currency,” and “asset” are regularly used interchangeably to describe the thousands of products in the crypto world, it’s difficult to accurately categorize them based on nomenclature alone. Instead, one must look at function.

When determining whether a digital asset is a security, the SEC considers whether the asset constitutes an “investment contract.” For an asset to be considered an investment contract, it must meet the three criteria of the *Howey* Test which was developed and named after the Supreme Court case *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* Test requires that there must be (1) the investment of money (2) in a common enterprise (3) with a reasonable expectation of profits to be derived from the efforts of others.

Echoing his predecessor’s sentiments, current SEC Chair Gary Gensler reiterated to CNBC in August 2021 that the SEC considers many cryptocurrency coins and tokens to be securities under the *Howey* Test, saying, “If somebody is raising money selling a token and the buyer is anticipating profits based on the efforts of that group to sponsor the seller, that fits into something that’s a security” (“SEC chair Gary Gensler on his vision for cryptocurrency regulation” Aug. 4, 2021).

Earlier this year, Gensler also indicated in a virtual press conference that the SEC will be focusing on crypto exchanges in 2022 (“Crypto Exchanges Will Face More Scrutiny From SEC, Gensler Says” Bloomberg, Jan. 19, 2022).

The SEC has already waged several successful legal battles against crypto creators and platforms on this front. These cases provide a glimpse of what's likely to come.

For example, in June 2019, the SEC filed a complaint in the Southern District of New York against Kik Interactive Inc. which, in 2017, sold one trillion of its digital tokens called "Kin" (*SEC v. Kik Interactive Inc.*, 1:19-cv-05244). Kik claimed that the funds from the offering would help create a "Kin Ecosystem" revolving around — and driving up the value of — its new token. After Kik raised almost \$100 million from investors, the SEC subsequently charged Kik with violating Section 5 of the Securities Act of 1933, alleging that the Kin tokens should have been registered as securities and accompanied by the proper investor disclosures.

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The SEC successfully argued that, under the *Howey* Test, Kik's offering met all three criteria for an investment contract: Money had been invested in a single integrated offering with the expectation by investors that they would see a return generated by Kik's future projects. On Sept. 30, 2020, the court sided with the SEC, granting the commission's motion for summary judgment and requiring Kik to pay a \$5 million penalty.

Beyond cryptocurrency issuers, the SEC has also started focusing its enforcement efforts on other players in the crypto world, including crypto lenders and exchanges. Cryptocurrency lending platform BlockFi Lending LLC recently faced the first crypto lending enforcement action of its kind by the SEC, as well as a civil suit from its own account holders. BlockFi is a platform that offers interest-bearing accounts through which investors can lend their crypto assets to BlockFi in exchange for monthly interest payments. These

interest payments are generated through BlockFi's subsequent lending and investment activities.

In February 2022, an SEC cease-and-desist order alleged that BlockFi had failed to register its interest accounts as securities. The SEC argued that the interest accounts functioned as investment contracts because investors were promised a variable interest rate based on BlockFi's deployment of the crypto assets it was loaned. While BlockFi neither admitted nor denied the findings, the platform agreed to a \$100 million settlement.

Additionally, BlockFi was subsequently hit with a class action lawsuit on March 1 by account holders claiming that they should have been informed that the interest accounts were not registered as securities (*Mangano v. BlockFi*, 2:22-cv-01112). The case is still ongoing.

Perhaps most prominently, the SEC brought a lawsuit against Ripple Labs Inc. and certain of its executives in December 2020, alleging that the defendants raised over \$1.3 billion through an unregistered, ongoing digital asset securities offering (*SEC v. Ripple Labs, Inc.*, 1:20-cv-10832). In that case, the cryptocurrency at issue is XRP, which, according to Forbes, is currently the sixth most valuable cryptocurrency in the world, with a market capitalization of over \$37 billion ("Top 10 Cryptocurrencies in March 2022," March 1, 2022).

The SEC's complaint alleges that the defendants raised funds through the sale of XRP in an unregistered securities offering to investors and by distributing billions of XRP in exchange for non-cash consideration, such as labor and market-making services. The complaint also alleges that the defendants failed to register their offers and sales of XRP or satisfy any exemption from registration, in violation of the registration provisions of the federal securities laws. On March 11, 2022, the individual defendants' respective motions to dismiss were denied.

While the case remains ongoing, it is possible that the outcome could have reverberating effects on the SEC's enforcement activities in this space for years to come.

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