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The Crypto Crackdown

Recent turmoil and contagion in the cryptocurrency sector have reinforced the focus on cryptocurrencies under the existing securities laws by the Securities and Exchange Commission (SEC). By analyzing recent enforcement actions against token issuers and staking platforms, this opinion piece seeks to provide a view of how the SEC is influencing the crypto market landscape and activities in the United States.

SEC & the Howey Test

The SEC oversees the regulation of traditional securities, such as equities and debt instruments and investment contracts. The SEC's regulatory stance is that federal securities laws require all offers and sales of securities, including most digital assets, to be registered under its provisions or to qualify for an exemption. In 1946, the U.S. Supreme Court in SEC v. W.J. Howey determined whether a transaction qualified as an investment contract and, therefore, a security. The determination that came to be known as the Howey Test involves the four prongs listed below.

(1) It involves "an investment of money"

An investment of money does not necessarily need to be in the form of cash. Such investment can be in the form of a "product or service" or "exchange of other values." First, according to the SEC, investors only need to invest property with economic value, including currency, tangible goods, or labor, to meet the monetary investment criterion.[1] Second, even if a token is issued without any direct monetary exchange, the issuance of such tokens may still be deemed to meet the monetary investment criterion by the SEC and thus constitute the issuance of securities, as long as the issuing company benefits from the exchange.[2]

(2) There is an expectation of profits from the investment

The SEC defines profit as capital appreciation resulting from the initial investment or capital development or income generated from using the purchaser's funds (price increases resulting from external market forces, such as inflation, are typically not considered profit).[3,4] The motive of the investor must also be considered.[5] If a token were purchased solely for consumption or utility, then profit would not be expected. However, utility function and expectation of profit may not be mutually exclusive. An investor who purchases a token that can be consumed can still expect profit if it can be sold for a profit.

(3) The investment is in a "common enterprise"

Common Enterprise: "The fortunes of the investors and defendant also are tied together in this common enterprise."[6]

In deciding the common enterprise criterion, the court established two standards: "horizontal commonality" and "vertical commonality." "Horizontal commonality" refers to pooling the assets of multiple investors together, with all investors sharing the profits and risks of the enterprise.[7] In contrast, "vertical commonality" can be divided into "strict vertical commonality" and "broad vertical commonality."[8] The former refers to the correlation between investors' wealth and the initiator's wealth, while the latter requires that investors' wealth be related to the initiator's professional ability; that is, investors rely on the initiator's professional ability to obtain returns. The SEC believes that in the issue of digital assets, the financial values of digital asset buyers are usually interrelated and dependent on the initiator's efforts; thereby, primary investment in digital assets may meet the common enterprise requirement.[9]

(4) Any profit comes from "the efforts of a third party or promoter"

Combined with the second prong, the expectation of profit must be derived from the effort of a third party or promoter. This prong is satisfied when "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[10] The SEC considers the "economic reality" of the situation when deciding whether this prong is satisfied: "An investment scheme involves a combination of both pre-and post-purchase managerial activities, both of which should be considered in determining whether Howey's test is satisfied."[11]

Notable SEC Enforcement Actions

The SEC's crackdown on cryptocurrencies has resulted in several enforcement actions against companies in the industry. These actions have targeted initial coin offerings (ICOs) failing to register with the SEC and staking service providers.

SEC v. LBRY, Inc.

On March 29, 2021, the SEC filed an enforcement action against LBRY, alleging violations of Section 5 of the Securities Act. According to the SEC, LBRY had offered LBC tokens as an investment contract, meaning the tokens had to be sold in compliance with registration requirements or exemptions. In November 2022, the court ruled in favor of the SEC's motion for summary judgment.

This is consistent with SEC Chairman Gary Gensler's view that most digital asset tokens are securities.[12] The court also stated that whether an ICO took place is only one factor in determining whether a token constitutes a security. Additionally, the court endorsed the SEC's argument that LBRY's decision to own a significant amount of LBC was sufficient to satisfy an expectation of profits based on the efforts of others.[13] This decision could challenge token issuers and render two of Howey's prongs duplicative. It remains to be seen how this decision will impact the industry. However, it is an important data point for industry participants seeking clarity on the intersection of digital assets and U.S. securities laws.

The Kraken Settlement

In a recent settlement with the SEC, Kraken, a top three cryptocurrency exchange by trading volume, agreed to pay $30 million to resolve allegations that it violated agency rules by offering a "staking" service—providing investors with financial incentives for depositing or "pooling" their assets. To settle the SEC's charges, Kraken ceased its U.S. staking services without admitting wrongdoing. Kraken's terms of service and staking pool construct granted the company validator status—an operator in charge of offering stakeholders fluctuating yields consistent with their contributions of computational resources, which could have created a variable profit share for Kraken.

In the post-settlement press release, SEC Chair Gary Gensler stated, "staking-as-a-service (StaaS) providers must register and provide full, fair, and truthful disclosure and investor protection."[14] The enforcement action against Kraken presents potential legal risks for all StaaS providers. Although

StaaS providers should be mindful of such risks, the settlement does not set a legal precedent for future judicial actions.[15] A StaaS provider's service and business model may differ substantively from Kraken's, and any potential enforcement outcome could vary.

Conclusion

While the enforcement cases above target piecemeal regulation and cases are selected for their perceived chances of success, the sentiment expressed by the SEC Chair suggests that this may be the first step toward more extensive regulations on crypto service providers and platforms. Further updates are to come, but in the immediate future, there may be more enforcement actions as regulation of cryptocurrency and platforms continue to take shape. More capitalized and mature parties may want to consider whether to register their native digital assets, file for exemptions, or lead regulatory efforts. In comparison, early-stage organizations may look for exit opportunities as sellers to larger acquirers. Additionally, although the SEC may continue to take enforcement actions against centralized "common enterprises," it is still being determined how the tightening of regulations affects truly decentralized finance.

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[1] See *SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, 2017.

[2] *In re Tomahawk Exploration LLC*, Securities Act Rel. 10530 (August 14, 2018)

[3] *Sec. & Exch. Comm'n v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020)

[4] *When it comes to analyzing utility tokens, the SEC staff's "Framework for 'investment contract' analysis of Digital assets" may be the emperor without clothes (or, sometimes, an orange is just an orange) (part IV)*. Winston & Strawn. (n.d.). Retrieved March 23, 2023, from https://www.winston.com/en/crypto-law-corner/when-it-comes-to-analyzing-utility-tokens-the-sec-staffs-framework-for-investment-contract-analysis-of-digital-assets-may-be-the-emperor-without-clothes-part-iv.html

[5] *United Hous. Found. v Forman*, 421 U.S. 837, 854-55 (1975)

[6] *SEC v. Kraken*

[7] *Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994)

[8] Ibid.

[9] See *Framework for "Investment Contract" Analysis of Digital Assets*, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn10

[10] *Securities & Exchange Commission v. Glenn W. Turner Enterprises Inc*, 474 F.2d 476, 482 (9th Cir. 1973)

[11] *S.E.C. v. Mutual Benefits Corp*., 408 F.3d 737, 743 (11th Cir. 2005)

[12] https://cryptoslate.com/sec-chair-gensler-confirms-everything-other-than-bitcoin-is-a-security-implications-and-analysis/

[13] https://www.ropesgray.com/en/newsroom/alerts/2022/december/sec-lbry-examining-the-implications-of-the-secs-latest-victory-for-crypto-and-digital-asset-markets

[14] https://www.sec.gov/news/press-release/2023-25

[15] https://www.paulhastings.com/insights/client-alerts/kraken-consents-to-sec-injunction-and-ceases-marketing-its-staking-as-a#_edn32

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