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The SEC's Materially False Statements on Crypto

By **Jeffrey Alberts**

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Since Gary Gensler became Chair of the U.S. Securities and Exchange Commission in 2021, he has consistently dismissed suggestions that it is unclear how the U.S. Supreme Court's decision *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) applies to cryptocurrency tokens. Instead, he has asserted that it is clear under *Howey*, an 80-year-old decision concerning orange groves, that most cryptocurrency tokens are securities.

He also has made a series of public statements in which he criticized cryptocurrency executives who claim that cryptocurrency tokens cannot be securities, including by implying that their assertions about a lack of clarity concerning the application of securities laws to crypto tokens were made in bad faith.

On July 13, 2023, however, a federal judge in the Southern District of New York ruled that the analytical approach to cryptocurrency tokens advanced by Chair Gensler and the SEC staff was incorrect. Not only is it not *clear* that most cryptocurrency tokens are securities, the court concluded that *no cryptocurrency tokens are securities*.

This ruling radically undermines the SEC's legal position concerning how securities laws apply to cryptocurrency tokens and destroys the credibility of Gensler's vociferous assertions that it is clear how securities laws apply to cryptocurrency tokens.

Oranges Aren't Securities

The SEC has long asserted that a digital asset can be a security, because it can be an "investment contract," which is one of the enumerated categories identified in the definitions of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934.

The SEC staff laid out this position in some detail in the "Framework for 'Investment Contract' Analysis of Digital Assets" posted on the SEC's website.

What always seemed counter-intuitive about the SEC's position is that it applied the term "investment contract" not only not only to agreements to sell digital assets, but to the digital assets themselves. This struck many as inconsistent with the Supreme Court's definition of "investment contract."

In *Howey*, the Court held that "an investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." 328 U.S. at 298-299. *Howey* involved agreements entered into between

profit-seeking investors and two entities under common control and management that sold the investors orange groves and the service of cultivating and servicing the orange groves.

Through their agreements with these entities, the investors were investing in a common enterprise through which they expected to profit solely from the efforts of their contractual counterparties who would service the orange groves, by watering the orange trees, harvesting the oranges and selling the oranges, among other things.

In *Howey* the Supreme Court did not rule that the oranges (or the orange groves) were investment contracts. An orange is not a "contract, transaction or scheme." So, while an orange can be the subject of an investment contract, it cannot itself be an investment contract. Oranges aren't securities.

This ruling radically undermines the SEC's legal position concerning how securities laws apply to cryptocurrency tokens and destroys the credibility of Gensler's vociferous assertions that it is clear how securities laws apply to cryptocurrency tokens.

Gensler Says Most Crypto Tokens Are Securities, 'Not Goldfish'

Despite the fact that a digital asset, like an orange, is not a contract, transaction or scheme, SEC Chair Gensler has repeatedly and emphatically told the public that most digital assets are securities.

For example, on Sept. 8, 2022, Gensler made a statement to the Practicing Law Institute: "Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities." He also mocked people "in the crypto industry [who] have called for greater 'guidance' with respect to crypto," saying the SEC's explanatory messages to the industry were clear and "[n]ot liking the message isn't the same thing as not receiving it."

On April 18, 2023, Chair Gensler told the U.S. House of Representatives Committee on Financial Services, "As I've said numerous times, the vast majority of crypto tokens are securities." He then noted that this had serious implications for intermediaries that transact in crypto tokens, because "[g]iven that most crypto tokens are securities, it follows that many crypto intermediaries are transacting in securities and have to register with the SEC."

Gensler also poked fun at people who had suggested that it was unclear whether intermediaries such as decentralized finance ("DeFi") platforms were subject to securities regulations simply because they were intermediaries in transactions involving tokens, quipping, "It's the law; it's not a choice. Calling yourself a DeFi platform, for instance, is not an excuse to defy the securities laws."

Gensler then posted a video on May 3, 2023, in which he continued to suggest that crypto entrepreneurs were acting in bad faith when they suggested that it was not clear whether crypto tokens can be securities under *Howey*. This video is less than 4 minutes long and encapsulates Gensler's smug dismissal of the argument that crypto tokens—like oranges—are not securities: "Crypto markets suffer from a lack of regulatory compliance. It's not a lack of regulatory clarity."

To underscore his view of the absurdity of suggesting that there was a lack of clarity in the law, he compared crypto companies who argued that crypto tokens are not securities to dog owners who try to avoid leash laws by calling their dogs goldfish: "if there is law against walking your dog without a leash, you cannot avoid it just by calling your dog a goldfish." "Many crypto platforms are just pretending that these investment contracts that they offer are more like goldfish"

As an example of how crypto platforms are just pretending not to know the law under which the SEC argues that tokens often are securities, Gensler used the same video to discuss a pending case, in which the SEC had alleged that "an executive knew the law so well that he actually advised issuers to scrub specific language from their web pages in an effort to pretend their tokens weren't investment contracts. You could say, in other words, they tried to say their dogs were goldfish."

Gensler False Claims That 'Goldfish' Are Securities

At the time that the SEC published Gensler's video criticizing crypto executives for making "an effort to pretend their tokens weren't investment contracts," the SEC's case against Ripple Labs, Inc., the developer and seller of the crypto token "XRP" was pending in the Southern District of New York before U.S. District Court Judge Analisa Torres. The SEC had alleged that XRP was an investment contract.

In her decision on the parties' cross-motions for summary judgment, Judge Torres ruled that XRP was not an investment contract, because "XRP, as a digital token, is not in and of itself a 'contract, transaction[,] or scheme." The obvious implication of this ruling is that the statements by Gensler and SEC staff that tokens can be (and usually are) investment contracts were false.

Of course, this does not imply that contracts involving crypto tokens cannot be securities. As Torres points out, even "ordinary assets—like gold, silver, and sugar—may be sold as investment contracts, depending on the circumstances of those sales." Judge Torres ruled that some of the sales of XRP, including sales of XRP to institutional buyers pursuant to contracts, were made through investment contracts.

She ruled that other sales of XRP, including sales that Ripple made over public exchanges, which did not involve contracts and were "blind bid/ask transactions" did not involve investment contracts. These buyers "could not reasonably expect" that "Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP," for several reasons, including that the buyers did not even know to whom they were paying their money when they bought the XRP on a public exchange.

It is possible that the SEC will appeal this decision. The SEC has an incentive to fight for the principle that once a token is sold pursuant to an agreement that meets the standard of an investment contract, the token itself becomes a security, making every subsequent transaction involving the token a securities transaction.

Without this assumption, it will have to actually prove—as it would for assets like oranges or sugar—that subsequent transactions were made pursuant to investment contracts. This legal burden is a regulatory inconvenience that the SEC likely will fight to avoid, as it will make it much more difficult to regulate crypto intermediaries who often do not even enter into contracts with users.

Regardless of whether the SEC ultimately prevails on appeal, after the *Ripple* decision, the SEC will not be able to credibly claim that the law was clear concerning whether digital assets can be securities. It is one thing to suggest crypto executives are "pretending" that digital assets are not securities and their arguments are intellectually equivalent to calling a dog a goldfish; it would be quite another for a regulatory agency to suggest these things of a federal judge. This ruling likely will cause the SEC to take industry input into how securities law applies to blockchain technology more seriously, and that's a good thing.

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