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# A Disruptive *Ripple* in the SEC's Regulation of Crypto Assets

## I. INTRODUCTION AND A BRIEF HISTORY OF CRYPTO REGULATION

In May 2022, the total market value of the TerraLuna crypto asset<sup>1</sup> ecosystem fell from an estimated fifty billion dollars to zero dollars in three days.<sup>2</sup> TerraLuna investors had no immediate recourse and government intervention to support the unregulated assets was impossible.<sup>3</sup> A Massachusetts surgeon lost ninety percent of his life savings.<sup>4</sup> A Ukrainian man had thought converting his money into these novel assets was safer than keeping it in a bank in his war-torn country.<sup>5</sup> In the aftermath, Terraform Labs founder Do Kwon addressed his devastated customers on Twitter: “I am heartbroken about the pain my invention has brought on all of you.”<sup>6</sup>

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1. The term “crypto asset” is used to describe the products at issue in this Note. Courts reviewing securities cases against crypto companies vary in their nomenclature, but some use “crypto asset” as a general term, *see, e.g., In re Bibox Grp. Holdings Ltd. Sec. Litig.*, 534 F. Supp. 3d 326, 329 (S.D.N.Y. 2021) (“‘Crypto-assets,’ which are also called ‘cryptocurrency’ or ‘tokens’ . . .”). The SEC often uses “crypto asset” and “crypto asset security” in its complaints against crypto defendants alleging violations of securities law, *see, e.g., Complaint at 1, SEC v. Celsius Network, Ltd.*, No. 1:23-cv-6005 (S.D.N.Y. 2023) (“[Defendants] raised billions of dollars from investors through unregistered and fraudulent offers and sales of crypto asset securities.”).

2. *See* Jiageng Lu, et al., *Anatomy of a Run: The Terra Luna Crash* 1 (Nat’l Bureau of Econ. Rsch., Working Paper No. 31160, 2023), [https://www.nber.org/system/files/working\\_papers/w31160/w31160.pdf](https://www.nber.org/system/files/working_papers/w31160/w31160.pdf) [<https://perma.cc/9G96-PBGJ>] (“Prior to the crash, Terra’s combined market capitalization was \$50 billion, with an average daily trading volume of \$1 billion, making it the third largest ecosystem after Bitcoin and Ethereum. However, within three days of the crash, its value plummeted to zero.”).

3. *See id.* (“[T]he [Terra] crash provides a unique opportunity to enhance our understanding of runs in the absence of regulatory oversight or safety nets such as the Federal Reserve or FDIC deposit insurance . . . . Since Terra operated outside the conventional regulatory framework, such reliance on regulatory intervention was impossible.”).

4. Alexander Osipovich & Caitlin Ostroff, *TerraUSD Crash Led to Vanished Savings, Shattered Dreams*, WALL ST. J. (May 27, 2022, 4:04 PM), <https://www.wsj.com/articles/terrausd-crash-led-to-vanished-savings-shattered-dreams-11653649201> [<https://perma.cc/6CFM-WNMH>].

5. *Id.*

6. Do Kwon (@stablekwon), TWITTER (May 13, 2022, 6:15 PM), <https://twitter.com/stablekwon/status/1525238416991891457> [<https://perma.cc/P3NK-HXXB>].

Do Kwon's characterization of his failed asset as "my invention" is appropriate, considering the crypto industry is still being invented. Crypto assets exist on "blockchains": digital ledgers secured by cryptographic computer code.<sup>7</sup> Blockchain technology has largely been developed in the past two decades.<sup>8</sup> In contrast to fiat currencies like dollars, which are controlled by central governments, crypto assets are, in theory, decentralized, transparent, and beyond the control of any single person or entity.<sup>9</sup>

Certain crypto assets, like Bitcoin, have generated steady interest among investors and financial advisors.<sup>10</sup> Despite its volatile price history,<sup>11</sup> there are growing signs of Bitcoin's acceptance by mainstream financial institutions. For example, federal regulators agree that Bitcoin is a commodity<sup>12</sup> and have approved trading in Bitcoin

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7. See Dylan Yaga, et al., NAT'L INST. OF STDS. & TECH., U.S. DEP'T OF COM., NISTIR No. 8202, BLOCKCHAIN TECH. OVERVIEW ii (2018) <https://nvlpubs.nist.gov/nistpubs/ir/2018/NIST.IR.8202.pdf> [<https://perma.cc/PZN3-NPFN>] ("Blockchains are tamper evident and tamper resistant digital ledgers implemented in a distributed fashion (i.e., without a central repository) and usually without a central authority (i.e., a bank, company, or government). At their basic level, they enable a community of users to record transactions in a shared ledger within that community, such that under normal operation of the blockchain network no transaction can be changed once published.").

8. See Vinay Gupta, *A Brief History of Blockchain*, HARV. BUS. REV. (Feb. 28, 2017), <https://hbr.org/2017/02/a-brief-history-of-blockchain> [<https://perma.cc/6M9F-NGAW>] (describing blockchain-based innovations, including Bitcoin, that were developed in the previous ten years).

9. See, e.g., *In re Bibox Grp. Holdings Ltd. Sec. Litig.*, 534 F. Supp. 3d 326, 330 (S.D.N.Y. 2021) ("The blockchain mechanism allows for the use of crypto-assets as secure stores of value and media of exchange that do not rely on centralized government or private control."). *But see* Alexander Saeedy & Danny Dougherty, *Here's How FTX Executives Secretly Spent \$8 Billion in Customer Money*, WALL ST. J. (Oct. 7, 2023, 5:30 AM), <https://www.wsj.com/finance/regulation/sbf-trial-ftx-customer-money-missing-6ba13914> [<https://perma.cc/5S2P-QBJK>] (reporting that executives at centralized crypto exchange FTX misappropriated customer funds held on the FTX platform to make personal loans, buy luxury real estate, and make political contributions).

10. See Claire Ballentine, *Bitcoin Rebound Fuels Renewed Interest in Crypto Investing*, BLOOMBERG (Oct. 31, 2023, 10:11 AM), <https://www.bloomberg.com/news/articles/2023-10-31/should-i-buy-bitcoin-price-gains-fuel-endorsements-from-financial-planners> [<https://perma.cc/J4NH-NDUQ>] (discussing 2023 Bitcoin price rebound after crypto crisis of 2022 and renewal of some investment advisors' recommendation that clients diversify portfolios by investing in Bitcoin).

11. See John Edwards, *Bitcoin's Price History*, INVESTOPEDIA, <https://www.investopedia.com/articles/forex/121815/bitcoins-price-history.asp> [<https://perma.cc/4ASH-XMYZ>] (last updated Nov. 27, 2023) ("Among asset classes, Bitcoin has had one of the more volatile trading histories.").

12. See *SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 358 (S.D.N.Y. Mar. 24, 2020) ("In the abstract, an investment of money in a cryptocurrency utilized by members of a

futures.<sup>13</sup> In January 2024, crypto advocates celebrated the SEC's decision to approve "spot-Bitcoin" exchange-traded funds that facilitate direct investment in Bitcoin via regulated mainstream financial products and marketplaces.<sup>14</sup>

Bitcoin's relatively stable regulatory status, however, is the exception in crypto, not the rule.<sup>15</sup> Crypto's rapid growth has resulted in a regulatory "wild west."<sup>16</sup> Entrepreneurs have raised money through

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decentralized community connected via blockchain technology, which itself is administered by this community of users rather than by a common enterprise, is not likely to be deemed a security . . . . The SEC, for example, does not contend that Bitcoins transferred on the Bitcoin blockchain are securities."'). *See also* COMMODITIES FUTURES TRADING COMM'N, CFTC/SEC INVESTOR ALERT: FUNDS TRADING IN BITCOIN FUTURES, [https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/fraudadv\\_funds\\_trading\\_in\\_bitcoin\\_futures.html](https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/fraudadv_funds_trading_in_bitcoin_futures.html) [<https://perma.cc/B34T-7BZQ>] (joint agency statement defining Bitcoin as a commodity); Kevin Helms, *SEC and CFTC Caution Investors About Funds Trading in Bitcoin Futures*, BITCOIN.COM (June 12, 2021), <https://news.bitcoin.com/sec-cftc-funds-trading-bitcoin-futures/> (discussing joint CFTC/SEC statement and noting it was released on "Thursday" [i.e., June 10, 2021]).

13. *See* CFTC v. McDonnell, 287 F. Supp. 3d 213, 222 (E.D.N.Y. 2018) ("Legitimization and regulation of virtual currencies has followed from the CFTC's allowance of futures trading on certified exchanges."'). *See also* Nikhilesh De & Danny Nelson, *SEC Approves Bitcoin Futures ETF, Opening Crypto to Wider Investor Base*, COINDESK (Oct. 15, 2021, 8:07 PM), <https://www.coindesk.com/policy/2021/10/15/sec-approves-bitcoin-etf-opening-crypto-to-wider-investor-base/> [<https://perma.cc/8EMD-72ML>] (reporting on SEC approval of Bitcoin futures-based exchange-traded fund).

14. *See* Vicky Ge Huang & Paul Kiernan, *SEC Approves Bitcoin ETFs for Everyday Investors*, WALL ST. J. (Jan. 10, 2024, 5:56 PM), <https://www.wsj.com/finance/regulation/sec-approves-bitcoin-etfs-for-everyday-investors-dc3125ef> [<https://perma.cc/UN6C-W52W>] (reporting on SEC's decision to allow "spot-Bitcoin ETFs" created by mainstream firms like Fidelity and BlackRock to be traded in the U.S., enabling people to invest directly in Bitcoin, an action previously only possible via crypto exchanges like Coinbase or Binance).

15. Like Bitcoin, another popular crypto asset, crypto company Ethereum's Ether token ("ETH"), is generally considered a commodity. The cases discussed in this Note do not concern Ether or Bitcoin, but the regulatory status of those assets is very important to the crypto industry. For more on the recent debate over Ether regulation, see Nikhilesh De, *SEC Chair Gensler Declines to Say if Ether is a Security in Contentious Congressional Hearing*, COINDESK (Apr. 19, 2023, 11:37 AM), <https://www.coindesk.com/policy/2023/04/19/sec-chair-gensler-declines-to-say-if-ether-is-a-security-in-contentious-congressional-hearing/> [<https://perma.cc/C7KD-74LN>] (reporting Gensler's statement that Ether's status as a security versus commodity "depends on the facts and the law"). *Contra* Risley v. Universal Navigation Inc., 2023 U.S. Dist. LEXIS 152946, at \*42 (S.D.N.Y. Aug. 29, 2023) (referring in dicta to Bitcoin and Ether as commodities, not securities); Jesse Hamilton, *U.S. CFTC Chief Behnam Reinforces View of Ether as Commodity*, COINDESK (Mar. 29, 2023, 11:22 AM), <https://www.coindesk.com/policy/2023/03/28/us-cftc-chief-behnam-reinforces-view-of-ether-as-commodity> [<https://perma.cc/8799-G84F>] (reporting CFTC chief's opinion that Ether is a commodity).

16. *See* Elizabeth Napolitano, *SEC Chair Gensler Cites 'Wild West' of Crypto in Case to Increase Agency's Budget*, COINDESK (July 20, 2023, 10:55 AM), <https://www.coindesk.com/policy/2023/07/19/sec-chair-gensler-cites-wild-west-of-crypto->

“initial coin offerings” (ICOs), modeled on initial public offerings of stock.<sup>17</sup> Internet artworks have become crypto assets in the form of non-fungible tokens (“NFTs”).<sup>18</sup> Digital crypto exchanges facilitate billions of dollars in trading each month.<sup>19</sup> Online publications and social media accounts track the latest crypto news.<sup>20</sup> Four crypto companies advertised during the 2022 Super Bowl broadcast, where a thirty second commercial cost \$6.5 million.<sup>21</sup>

As crypto has grown, governments have grappled with how to regulate it. Some jurisdictions have passed new laws. The European Union’s comprehensive Markets in Crypto-Assets (“MiCA”) regulation, which went into effect in June 2023, instituted uniform rules for crypto assets that were not previously covered by existing financial services

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in-case-to-increase-agencys-budget [https://perma.cc/CZ2Y-PY9K] (“‘We’ve seen the Wild West of the crypto markets, rife with noncompliance, where investors have put hard-earned assets at risk in a highly speculative asset class,’ Gensler said in his prepared remarks.”).

17. See Kenyon Briggs, *Taming the Wild West: How the SEC Can Legitimize Initial Coin Offerings (“ICOs”), Protect Consumers from Bad Actors, and Encourage Blockchain Development*, 2 BUS. ENTREPRENEURSHIP & TAX L. REV. 424, 424 (2018) (“An Initial Coin Offering (“ICO”) is the first time a blockchain-based company sells its cryptocurrency to the public. ICOs provide any blockchain entrepreneur the ability to quickly receive funding from anyone in the world.”).

18. See Brian Elzweig & Lawrence J. Trautman, *When Does a Non-Fungible Token (NFT) Become a Security?*, 39 GA ST. U. L. REV. 295, 295 (2023) (“[In addition to digital art,] NFTs may take the form of collectibles, data associated with a physical item, financial instruments, or permanent records associated with a person, such as marriage licenses or property deeds.”). For an application of the *Howey* test for investment contract securities (discussed *infra* Part III) to NFTs, see *Friel v. Dapper Labs*, 657 F. Supp. 3d 422, 450 (S.D.N.Y. 2023) (holding complaint alleging that defendant’s NFTs were unregistered investment contract securities was sufficient to overcome motion to dismiss for failure to state a claim).

19. See Shaun Paul Lee, *Market Share of Centralized Crypto Exchanges, by Trading Volume*, COINGECKO (Jan. 30, 2024), [https://perma.cc/XAB3-35R6] (listing top 10 centralized crypto exchanges, led by Binance with 43.7% market share and \$427.1 billion in spot trading volume in December 2023).

20. For peer-reviewed quantitative research on the role of social media in crypto markets, see Tomaso Aste, *Cryptocurrency Market Structure: Connecting Emotions and Economics*, 1 DIGIT. FIN. 5, 6 (2019) (“[The crypto market is] strongly echoed in social media with great expectations, quick swifts [sic] of sentiment, strong beliefs and harsh disputes.”). Online publications promoting crypto includes websites called Coindesk, CoinTelegraph, Decrypt, The Crypto Times, The Crypto Basic, The Daily Hodl, CryptoGlobe, CryptoNews, BeInCrypto, and The Cryptonomist. Traditional media like Bloomberg, Forbes, and Fortune have also launched crypto verticals.

21. See Anthony Tellez, *Crypto Ads Are a Super Bowl Talker, with Floating QR Codes and Larry David*, NPR (Feb. 14, 2022, 1:42 PM), <https://www.npr.org/2022/02/14/1080237873/superbowl-ads-crypto-bitcoin> [https://perma.cc/6Z7U-FQUF] (discussing Super Bowl ads as evidence of mainstream popularity and adoption of crypto).

legislation.<sup>22</sup> The United States has also taken some steps forward. The Biden administration issued an Executive Order in March 2022 calling for a “whole-of-government” effort to study the risks and opportunities of crypto and other digital assets.<sup>23</sup> In July 2023, the House Financial Services Committee passed two bills proposing regulatory frameworks for crypto,<sup>24</sup> but prospects for enactment are dim.<sup>25</sup> Absent legislative action, the precise legal status of crypto assets is a live dispute between potential regulators and the industry.<sup>26</sup>

The Securities and Exchange Commission (“SEC”) has attempted to fill the regulatory void. The SEC has “broad authority over all aspects of the securities industry.”<sup>27</sup> Its mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate

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22. 2023 O.J. (L 150) 40. *See also Markets in Crypto-Assets Regulation*, EUROPEAN SEC. & MKTS. AUTH., <https://www.esma.europa.eu/esmas-activities/digital-finance-and-innovation/markets-crypto-assets-regulation-mica> [<https://perma.cc/L3FH-FXMH>] (last visited Oct. 7, 2023) (“[MiCA] will support market integrity and financial stability by regulating public offers of crypto-assets and by ensuring consumers are better informed about their associated risks.”). For comparisons between EU and U.S. regulation of crypto prior to MiCA, see generally Philip Maume & Mathias Fromberger, *Regulation of Initial Coin Offerings: Reconciling U.S. and E.U. Securities Laws*, 19 CHI. J. INT’L L. 548 (2019).

23. Exec. Order No. 14067, 87 Fed. Reg. 14143, 14151 (Mar. 14, 2022).

24. Financial Innovation and Technology for the 21st Century Act, H.R. 4763, 118th Cong. (2023); Blockchain Regulatory Certainty Act, H.R. 1747, 118th Cong. (2023).

25. *See* Hannah Lang, *US Crypto Industry Comes to Washington, But Faces Uphill Struggle*, REUTERS (Sept. 27, 2023, 4:43 PM), <https://www.reuters.com/business/finance/us-crypto-industry-comes-washington-faces-uphill-struggle-2023-09-27>

[<https://perma.cc/3VVS-6MFM>] (summarizing crypto regulatory bills passed by House Financial Services Committee in July 2023, highlighting crypto lobby’s efforts to advance bills, but noting opposition from Senate Banking Committee chair Sherrod Brown). *See also* Nikhilesh De & Elizabeth Napolitano, *House Financial Services Committee Votes in Favor of Crypto, Blockchain Bills*, COINDESK (July 26, 2023, 8:35 PM), <https://www.coindesk.com/policy/2023/07/27/house-financial-services-committee-votes-in-favor-of-crypto-blockchain-bills> [<https://perma.cc/4CP8-GSQY>] (discussing perspectives of proponents and opponents of crypto regulatory bills from committee members); Chu Chen, *Digital Commodities Consumer Protection Act of 2022: A Controversial Effort Caught in the Crossfire of the FTX Collapse*, HARV. J. OF L. & TECH. DIG. (Dec. 12, 2022), <https://jolt.law.harvard.edu/digest/digital-commodities-consumer-protection-act-of-2022-a-controversial-effort-caught-in-the-crossfire-of-the-ftx-collapse-1> [<https://perma.cc/WHB6-TYGM>] (discussing bill that FTX founder Sam Bankman-Fried allegedly lobbied for prior to collapse of FTX).

26. *See The Morrison Cohen Cryptocurrency Litigation Tracker*, MORRISON COHEN (Jan. 16, 2024), <https://www.morrisoncohen.com/news-page?itemid=471> [<https://perma.cc/T4YX-KFMR>] (tracking SEC, CFTC, DOJ, state, and private litigation involving crypto defendants).

27. *See The Laws That Govern the Securities Industry*, SEC, <https://www.sec.gov/about/about-securities-laws> [<https://perma.cc/KL9E-CBB2>] (last modified Oct. 1, 2013).

capital formation.”<sup>28</sup> The SEC’s viewpoint on crypto assets has evolved across the past two presidential administrations.<sup>29</sup> At first, the SEC took a “gradual” regulatory approach.<sup>30</sup> The agency first announced its position that many crypto assets are securities in a 2017 non-binding report.<sup>31</sup> In 2019, the agency published a more detailed non-binding guidance document, the “Framework for ‘Investment Contract’ Analysis of Digital Assets.”<sup>32</sup>

The SEC has not, however, produced any formal or informal rules for crypto assets.<sup>33</sup> Instead, the agency has regulated through “selective enforcement.”<sup>34</sup> For instance, beginning in 2017, the SEC targeted initial coin offerings (“ICOs”), a capital-raising scheme favored

28. *Our Goals*, SEC, <https://www.sec.gov/our-goals> [<https://perma.cc/X499-K4ZU>] (last modified Apr. 6, 2023).

29. See Dave Michaels, *Big Battles Loom in SEC’s War on Crypto*, WALL ST. J., (Dec. 28, 2023, 5:30 AM), <https://www.wsj.com/finance/regulation/big-battles-loom-in-secs-war-on-crypto-aeff0d78> [<https://perma.cc/7HQF-MDBU>] (“The SEC in 2024 will mark the seventh year of its campaign to regulate cryptocurrencies through enforcement, with no end in sight.”). For a discussion of the SEC’s efforts to define a regulatory approach to crypto assets in recent years, see Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 463 (2019) (noting the lack of homogeneity among crypto assets and resulting confusion about which assets the SEC will treat as securities).

30. Marco Dell’Erba, *From Inactivity to Full Enforcement: The Implementation of the “Do No Harm” Approach in Initial Coin Offerings*, 26 MICH. TECH. L. REV. 175, 175 (2020).

31. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Release No. 81207, 34 SEC Docket 81207 (July 25, 2017). See also SEC v. Kik Interactive, 492 F. Supp. 3d 169, 176 (S.D.N.Y. 2020) (“In the DAO Report, the SEC described its investigation into a German corporation’s sale of tokens to investors. The SEC determined that the tokens were securities, but no enforcement proceedings were initiated. It ‘advise[d] those who would use . . . distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws.’”) (citations omitted).

32. *Framework for “Investment Contract” Analysis of Digital Assets*, SEC, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [<https://perma.cc/4XJH-XJEC>] (last modified Mar. 8, 2023). See also Bill Hinman & Valerie Szczepanik, *Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets,”* SEC (Apr. 3, 2019), <https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets> [<https://perma.cc/HP9D-DU5Q>] (statement by senior SEC officials explaining the framework).

33. See M. Todd Henderson & Mitchell Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets*, 2019 COLUM. BUS. L. REV. 443, 454 (2019) (noting that SEC had articulated its position on crypto assets through informal guidance, enforcement actions, and public communications, but not formal or informal rulemaking).

34. James J. Park & Howard H. Park, *Regulation by Selective Enforcement: The SEC and Initial Coin Offerings*, 61 WASH. U. J.L. POL’Y 99, 101 (2020).

by crypto entrepreneurs.<sup>35</sup> The SEC has relied on a “functional definition” of security in these enforcement actions,<sup>36</sup> consistently asserting that the disputed crypto assets are “investment contracts,” a type of security listed in the federal securities statutes that the agency enforces.<sup>37</sup> The SEC has also invited crypto entrepreneurs to proactively consult with the agency about how to operate lawfully.<sup>38</sup> But some SEC officials have complained that crypto companies have deliberately refused to follow the law.<sup>39</sup>

For their part, many crypto industry players have objected to SEC jurisdiction, arguing that laws designed for traditional finance are ill-suited to regulate their innovations.<sup>40</sup> Some legal commentators have

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35. See *Investor Bulletin: Initial Coin Offerings*, SEC (July 25, 2017) [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings) [<https://perma.cc/YD56-EQHK>] (“Developers, businesses, and individuals increasingly are using initial coin offerings . . . to raise capital. These activities may provide fair and lawful investment opportunities. However, new technologies and financial products, such as those associated with ICOs, can be used improperly to entice investors with the promise of high returns in a new investment space.”); Press Release, SEC, SEC Halts Fraudulent Scheme Involving Unregistered ICO (Apr. 2, 2018), <https://www.sec.gov/news/press-release/2018-53> [<https://perma.cc/3J86-X72L>] (discussing case against promoters of fraudulent ICO that raised \$32 million from thousands of investors in 2017).

36. See Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. OF CORP. L. 629, 633 (2021) (“Instead of a formal rule, the SEC has opted to use a more flexible modus operandi of enforcement actions relying on a functional definition of securities such as investment contracts.”) (footnote omitted).

37. See *infra* Section II.B for discussion of the governing federal securities statutes. See *infra* Part III for discussion of how courts interpret the meaning of “investment contract” through application of the *Howey* test.

38. See Matt Levine, *Crypto Wants Some SEC Rules*, BLOOMBERG (Sept. 13, 2022, 1:03 PM), <https://www.bloomberg.com/opinion/articles/2022-09-13/crypto-wants-some-sec-rules> [<https://perma.cc/V375-BUAJ>] (describing SEC’s invitation to crypto companies to voluntarily come to the agency to talk about how to comply with securities law).

39. See John McCrack & Hannah Lang, *Crypto Companies Made ‘Calculated’ Decision to Flout Rules, Says SEC Chair*, REUTERS (June 8, 2023, 5:02 PM), <https://www.reuters.com/business/finance/us-sec-chair-says-crypto-companies-made-calculated-decision-flout-rules-2023-06-08> [<https://perma.cc/GN2V-96BX>] (“[Crypto companies] may have made a calculated economic decision to take the risk of enforcement as the cost of doing business [said Gensler.]”); see also Declan Harty, *‘They’re Boiling the Frog’: SEC’s New Crypto Crackdown Roils Industry*, POLITICO (Jan. 18, 2023, 4:30 AM), <https://www.politico.com/news/2023/01/18/sec-crypto-crackdown-gensler-00077866> [<https://perma.cc/JXT7-7KPL>] (“‘There’s so much non-compliance in this field. It’s part of the business model,’ [said Gensler.]”).

40. See Timothy G. Massad & Howell F. Jackson, *How to Improve Regulation of Crypto Today—Without Congressional Action—and Make the Industry Pay for It* 1 (Hutchins Ctr. on Fiscal and Monetary Pol’y at Brookings Inst., Working Paper No. 79, 2022), <https://www.brookings.edu/wp-content/uploads/2022/10/WP79-Massad-Jackson-updated-2.pdf> [<https://perma.cc/39F6-NYYC>] (“Crypto industry spokespeople have long complained



noted the regulatory quandary crypto poses to the SEC: “lax regulation of digital assets may give cover to bad actors, while the good actors are forced to contend with antiquated securities regulations.”<sup>41</sup> Others have criticized how aggressive SEC enforcement might harm American leadership in an emerging economic sector involving financial services and technology.<sup>42</sup>

The fall of “crypto winter” in 2022, however, altered the regulatory landscape.<sup>43</sup> Crypto asset prices collapsed.<sup>44</sup> Several industry titans went bankrupt.<sup>45</sup> The nominal market value of all crypto assets declined from a peak of \$3 trillion in November 2021 to less than \$800 billion at the end of 2022.<sup>46</sup> Spurred into action by American investors’ significant losses, the SEC began a “crypto crackdown” under Chair

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of a lack of regulatory clarity, and have argued that existing securities and derivatives laws do not really fit.”).

41. Henderson & Raskin, *supra* note 33, at 448.

42. See, e.g., Carol R. Goforth, *SEC v. Telegram: A Global Message*, 52 U. MEM. L. REV. 199, 211–12 (2021) (discussing how aggressive SEC regulation has led crypto companies to structure operations to “avoid the U.S. as much as possible,” with the corresponding effect of preventing interested American investors from investing in crypto). But see Guseva, *supra* note 36, at 662–74 (applying game theory ideas and favorably appraising certain early SEC tactics in regulating crypto).

43. See, e.g., Julian Mark & Gerrit De Vynck, ‘Crypto Winter’ Has Come. And It’s Looking More Like an Ice Age, WASH. POST (Dec. 18, 2022, 6:00 AM), <https://www.washingtonpost.com/business/2022/12/18/crypto-winter-ftx-collapse-bitcoin-prices/> [<https://perma.cc/W68M-BTMA>] (describing 2022 crises in crypto industry following 2020–2021 boom).

44. See David Gura, *2022 Was the Year Crypto Came Crashing Down to Earth*, NPR (Dec. 29, 2022, 5:00 AM), <https://www.npr.org/2022/12/29/1145297807/crypto-crash-ftx-cryptocurrency-bitcoin> [<https://perma.cc/S7DK-WT2Q>] (“Like just about everything else in finance, crypto saw its prices tank when the Federal Reserve started to raise interest rates to fight high inflation.”).

45. See Dietrich Knauth, *Crypto Companies Crash into Bankruptcy*, REUTERS (Dec. 1, 2022, 2:30 PM), <https://www.reuters.com/technology/crypto-companies-crash-into-bankruptcy-2022-12-01> [<https://perma.cc/7QYY-NP5K>] (collecting major crypto bankruptcies in 2022: TerraLuna parent Terraform Labs, crypto exchange FTX and its affiliated trading firm Alameda Research, lenders Celsius Network, BlockFi, and Voyager Digital, and hedge fund Three Arrows Capital). For a detailed economic analysis of the 2022 crypto bankruptcies, see Radhika Patel & Jonathan Rose, *A Retrospective on the Crypto Runs of 2022*, CHI. FED. LETTER (May 2023), <https://www.chicagofed.org/publications/chicago-fed-letter/2023/479> [<https://perma.cc/38MJ-E3B7>] (describing collapse of crypto-asset platforms in 2022 following investment losses and widespread customer withdrawals).

46. See Hannah Lang et al., *The Crypto Market Still Bears the Scars of FTX’s Collapse*, REUTERS (Nov. 3, 2023, 12:00 AM), <https://www.reuters.com/technology/crypto-market-still-bears-scars-ftxs-collapse-2023-10-03/> [<https://perma.cc/7LTL-RSUB>] (“After peaking at \$3 trillion in November 2021, the value of the overall crypto market plummeted through 2022, hitting a two-year low of \$796 billion as FTX imploded. It has since clawed back some ground, hovering above \$1 trillion most of this year.”).

Gary Gensler.<sup>47</sup> The agency hired additional staff dedicated to crypto<sup>48</sup> and increased enforcement actions against crypto companies and executives,<sup>49</sup> including new cases in 2023 against Coinbase, Binance, and Kraken, three leading exchanges that survived the crisis.<sup>50</sup>

The SEC's enforcement actions against crypto companies rest on the legal theory that crypto assets are "securities" within the meaning of the governing statutes and case law.<sup>51</sup> But without direction from Congress or appellate courts, the agency's legal argument is fallible—and vulnerable to criticism—as it is litigated case-by-case.<sup>52</sup> Meanwhile, crypto companies have hired lawyers and lobbyists to advance their agenda.<sup>53</sup> Lawsuits against crypto defendants continue to

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47. Declan Harty, *'They're Boiling the Frog': SEC's New Crypto Crackdown Roils Industry*, POLITICO (Jan. 18, 2023, 4:30 AM), <https://www.politico.com/news/2023/01/18/sec-crypto-crackdown-gensler-00077866> [<https://perma.cc/JXT7-7KPL>].

48. Press Release, SEC, SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit (May 3, 2022), <https://www.sec.gov/news/press-release/2022-78> [<https://perma.cc/YZD9-T7VP>] ("Crypto markets have exploded in recent years, with retail investors bearing the brunt of abuses in this space[,] said Gurbir S. Grewal, Director of the SEC's Division of Enforcement.").

49. Press Release, SEC, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), <https://www.sec.gov/news/press-release/2022-206> (stating that SEC filed 760 enforcement actions against crypto companies in fiscal year 2022, a 6.5% increase from previous year). See also MORRISON COHEN, *supra* note 25 (collecting 25 SEC cases and administrative proceedings initiated since the beginning of 2023).

50. See Fatima Hussein & Ken Sweet, *SEC Lawsuits Against Cryptocurrency Companies Raise Questions About Industry's Future*, A.P. (June 11, 2023, 11:00 AM), <https://apnews.com/article/cryptocurrency-sec-treasury-banking-binance-coinbase-53b0aaac91df229f28756e2fb8e7f846> [<https://perma.cc/8R55-C7HK>] (discussing potential implications of SEC litigation against Binance and Coinbase); Jonathan Stempel, *US SEC Sues Kraken Crypto Exchange Over Failure to Register*, REUTERS (Nov. 20, 2023, 7:34 PM), <https://www.reuters.com/business/finance/us-sec-sues-kraken-operating-crypto-trading-platform-without-registering-2023-11-20/> [<https://perma.cc/2TAD-ERMT>] (reporting on suit against Kraken in which the SEC alleged it is an unregistered securities exchange).

51. See Gary Gensler, Chair, SEC, Speech at "SEC Speaks" Event: Kennedy and Crypto (Sept. 8, 2022), <https://www.sec.gov/news/speech/gensler-sec-speaks-090822> [<https://perma.cc/R8J4-5QU4>] ("Nothing about the crypto market is incompatible with the securities laws. Investor protection is just as relevant, regardless of underlying technologies.").

52. See Courtney Degen, *Commissioner Peirce Criticizes SEC's Approach to Crypto, Pace of Rule-making*, PENSIONS & INVS. (Oct. 21, 2023, 1:21 PM), <https://www.pionline.com/regulation/commissioner-peirce-criticizes-secs-approach-crypto-pace-rule-making> [<https://perma.cc/D4K7-XVGN>] (reporting on SEC Commissioner Hester Peirce's criticism of Chair Gensler's current approach to crypto regulation, including her objection to the use of enforcement actions instead of the issuance of clear rules that help crypto companies comply).

53. For discussion of the crypto industry's use of major law firms, see Abigail Adcox, *Crypto Turns to Big Law for Defense Amid SEC Crackdown*, NAT'L L. J. (June 6, 2023, 5:55

be filed<sup>54</sup> and the largely unregulated crypto marketplace puts the investing public at risk.<sup>55</sup>

A recent split in the Southern District of New York threw the problem of crypto's regulatory uncertainty into sharp relief. In *SEC v. Ripple Labs*, Judge Analisa Torres held that XRP, the proprietary token of crypto firm Ripple Labs, was a security when sold directly to large institutional investors but not when sold "programmatically" to individual retail investors in "blind bid/ask transactions" on public digital asset marketplaces.<sup>56</sup>

An important factor was the court's conception of the relative sophistication of the two types of investors, the "reasonable" institutional and programmatic purchasers of XRP.<sup>57</sup> The record showed how Ripple management directly marketed XRP to "sophisticated" "Institutional Buyers," like hedge funds, with whom they entered written sales contracts.<sup>58</sup> This personal contact made it reasonable for

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PM), <https://www.law.com/nationallawjournal/2023/06/06/crypto-turns-to-big-law-for-defense-amid-sec-crackdown> [<https://perma.cc/73F4-FDUW>]. For discussion of the industry's lobbying efforts, see Hannah Lang, *US Crypto Industry Comes to Washington, But Faces Uphill Struggle*, REUTERS (Sept. 27, 2023, 4:43 PM), <https://www.reuters.com/business/finance/us-crypto-industry-comes-washington-faces-uphill-struggle-2023-09-27> [<https://perma.cc/E4FA-3AA3>] ("The [crypto] industry spent nearly \$13 million on federal lobbying in the first half of 2023, putting it on track for another record year after spending \$21.6 million in 2022."). But see Eleanor Mueller, 'A Lot of Nonsense': Crypto Lobby Faces New Capitol Hill Reality, POLITICO (July 24, 2023, 4:30 AM), <https://www.politico.com/news/2023/07/24/house-senate-crypto-crackdown-00107641> [<https://perma.cc/33T5-TSCD>] (noting that 2022 crises had led a critical mass of lawmakers to push back against industry's lobbying agenda).

54. See MORRISON COHEN, *supra* note 26 (tracking SEC, CFTC, DOJ, state, and private individual/class action litigation against crypto defendants).

55. See, e.g., Bo Li & Nobuyasu Sugimoto, *Crypto Contagion Underscores Why Global Regulators Must Act Fast to Stem Risk*, IMF BLOG (Jan. 18, 2023), <https://www.imf.org/en/Blogs/Articles/2023/01/18/crypto-contagion-underscores-why-global-regulators-must-act-fast-to-stem-risk> [<https://perma.cc/T4UA-3GAW>] (discussing how unregulated growth of crypto could pose systemic risks to global financial system).

56. *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, 2023 U.S. Dist. LEXIS 120486, at \*26–33 (S.D.N.Y. July 13, 2023).

57. See *id.* at \*29–30 (explaining objective test based on the court's analysis of an investors' reasonable expectations when buying the asset); *id.* at \*38–39 (contrasting Institutional and Programmatic Buyers on basis of sophistication). Throughout the opinion, the court uses the terms "Institutional Buyer," *id.* at \*25, and "Programmatic Buyer," *id.* at \*35, to describe the two investor classes. Ripple's transactions with Institutional Buyers are referred to as "Institutional Sales," *id.* at \*8; transactions with Programmatic Buyers on digital asset exchanges are called "Programmatic Sales," *id.* at \*35.

58. See *id.* at \*30, \*38 (noting that Ripple marketed XRP to institutional investors by circulating promotional brochures); *id.* at \*8 ("Ripple . . . sold XRP directly to certain

such investors to expect the Ripple management team to deploy their invested capital to increase XRP's value and generate profits.<sup>59</sup> In these "Institutional Sales" transactions, then, XRP took the form of an unregistered security—a violation of securities law.<sup>60</sup>

By contrast, the court said that "Programmatic Buyers" of XRP were "generally less sophisticated."<sup>61</sup> Such investors bought the asset "blind[ly]" on public exchanges.<sup>62</sup> In these anonymous transactions, a Programmatic Buyer could not know whether Ripple or another party was the seller, so he could not reasonably have expected Ripple management to put his specific money to work augmenting the value of XRP and thus creating investment returns.<sup>63</sup> Because XRP did not meet the definition of security when sold in this programmatic fashion, the court said that these retail investors in XRP did not merit the legal protections enjoyed by institutional investors who bought the exact same asset.<sup>64</sup>

The *Ripple Labs* partial summary judgment order ended the SEC's crypto enforcement action winning streak,<sup>65</sup> boosted Ripple's business,<sup>66</sup> and delivered a major public relations victory to the industry at large.<sup>67</sup> But eighteen days later, Southern District of New York Judge

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counterparties (primarily institutional buyers, hedge funds, and ODL customers) pursuant to written contracts (the "Institutional Sales").

59. *Id.* at \*29–30.

60. *See id.* at \*34–35 ("[T]he Court concludes that Ripple's Institutional Sales of XRP constituted the unregistered offer and sale of investment contracts in violation of Section 5 of the Securities Act.").

61. *Id.* at \*39.

62. *See id.* at \*9 ("Ripple's XRP sales on these digital asset exchanges were blind bid/ask transactions: Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it.").

63. *Id.* at \*37.

64. *See id.* (concluding that Ripple's programmatic sales of XRP were not unlawful sales of securities).

65. *See* Thomas Lee Hazen, *Little Ripples or Big Waves? Two Recent Cases on Crypto Currency as a Security*, 27 No. 9 WallStreetLawyer.com: Sec. Elec Age NL 1 (Sept. 2023) ("A number of courts and the SEC have held that when marketed as an investment, crypto currency is a security. As a result, the SEC has aggressively pursued [crypto-related] enforcement actions . . . [and] was having great success in these actions but suffered its first defeat in *SEC v. Ripple Labs, Inc.*") (footnotes omitted).

66. *See* Sage D. Young, *Ripple's XRP Token Surges 96% After Partial Victory in SEC Lawsuit*, COINDESK (July 14, 2023, 10:52 AM), <https://www.coindesk.com/markets/2023/07/13/ripples-xrp-token-surges-28-after-court-rules-xrp-sales-arent-investment-contracts> [<https://perma.cc/M26U-364V>] (reporting increase in XRP price after July 13 decision).

67. *See, e.g.,* Allison Morrow, *Crypto Scores a Key Legal Victory in Long-running Regulatory Feud*, CNN (July 14, 2023, 2:14 PM), <https://www.cnn.com>

Jed Rakoff, a renowned securities law expert,<sup>68</sup> explicitly rejected his colleague's reasoning in *Ripple Labs* in another crypto asset case, *SEC v. Terraform Labs*.<sup>69</sup>

There, the SEC had sued Singapore-based crypto company Terraform Labs and its founder, CEO, and majority shareholder Do Kwon, alleging various violations of securities laws, including securities fraud and failure to register its assets as securities.<sup>70</sup> Judge Rakoff reviewed a scenario similar to the facts of *Ripple Labs*: a company's sales of crypto assets, both directly to large institutional investors and via online crypto exchanges to retail investors.<sup>71</sup> In contrast to *Ripple Labs*, however, Rakoff held that the crypto assets in question were securities, regardless of the sales channel or the investor's identity and sophistication.<sup>72</sup> Rakoff said *Ripple Labs* had incorrectly applied<sup>73</sup> the test from landmark Supreme Court case *SEC v. W.J. Howey Co.*, which analyzes whether an economic transaction qualifies as an "investment contract" security regulated by federal securities laws.<sup>74</sup>

This Note explains why the principle of *Terraform Labs*—if a crypto asset passes the *Howey* test, the securities laws cover all investors in the asset, without regard to sophistication—follows precedent and effectuates the laws' purpose of investor protection. By contrast, *Ripple Labs*'s grant of less protection to everyday investors

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/2023/07/14/business/crypto-sec-ripple-xrp/index.html [https://perma.cc/ZJE6-P3TH]  
 ("Despite the nuance of Torres' ruling, crypto investors are cheering it as a long overdue win.").

68. See Todd Baker, *Crypto Got Rakoff'd*, FIN. TIMES (Aug. 3, 2023), <https://www.ft.com/content/5e5a3c4a-7508-4db8-ab23-1ff17c87c880> [https://perma.cc/X7VT-DSG9] ("[Judge] Rakoff is without doubt the most respected judge in the country when it comes to complex securities matters.").

69. See *SEC v. Terraform Labs Pte. Ltd.*, No. 23-CV-1346, 2023 WL 4858299, at \*15 (S.D.N.Y. July 31, 2023) ("[T]he Court rejects the approach recently adopted by another judge of this District in a similar case, [*Ripple Labs*].").

70. See *id.* at \*1 (summarizing SEC allegation that Terraform Labs "orchestrated a multi-billion dollar fraud"); see also *id.* at \*1–4 (establishing plaintiff-favorable standard of review for a defendant's 12(b)(6) motion and reviewing the SEC amended complaint's factual allegations).

71. See *id.* at \*2 (sales to institutional investors); *id.* at \*3 (direct sales on crypto-asset marketplaces).

72. *Id.* at \*14 ("[T]he SEC's assertion that the crypto-assets at issue here are securities under *Howey* survives the defendant's motion to dismiss."); see *id.* at \*15 (discussing applicability of holding that crypto-assets are securities, regardless of purchaser's identity or the sales channel).

73. *Id.* at \*15 ("*Howey* makes no such distinction between purchasers [as the *Ripple Labs* decision does], and it makes good sense that it did not.").

74. *SEC v. W.J. Howey, Co.*, 328 U.S. 293 (1946), discussed *infra* Part III.

than to hedge funds and high-net-worth individuals is inconsistent with both the original purpose of the securities laws and seven decades of jurisprudence interpreting the meaning of “investment contract” securities.

Discussion proceeds in four parts. Part II introduces the history, regulatory scheme, contents, and operations of the foundational New Deal-era securities laws that the SEC invokes in current crypto asset enforcement actions.<sup>75</sup> Part III discusses the *Howey* test and its progeny of cases that gave courts the flexibility to regulate novel investment vehicles.<sup>76</sup> Part IV looks at crypto: the SEC’s crypto litigation alleging the existence of an investment contract, how courts have applied *Howey* to crypto assets, and the divergent reasoning of *Ripple Labs* and *Terraform Labs*.<sup>77</sup> Part V concludes with a recommendation for Second Circuit review of the *Ripple-Terraform* split to help resolve the pressing question of the regulatory status of crypto assets.<sup>78</sup>

## II. THE FOUNDATIONAL SECURITIES LAWS

This section provides background on the foundational securities laws: the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act,” and together, “the Acts”). Section II.A discusses the Acts’ historical context and disclosure-based regulatory philosophy. Section II.B provides an overview of how the Acts operate, focusing on provisions related to disclosure, SEC enforcement, and private rights of action.

### A. *Historical Context for Disclosure-Based Securities Regulation*

In the wake of the 1929 stock market collapse and in the early throes of the Great Depression, the federal government began work on the first national securities laws.<sup>79</sup> Although many economic problems helped precipitate the 1929 crisis, “the role of fraudulently floated

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75. See *infra* Part II.

76. See *infra* Part III.

77. See *infra* Part IV.

78. See *infra* Part V.

79. See 3 HAROLD S. BLOOMENTHAL & SAMUEL WOOLF, SECURITIES AND FEDERAL CORPORATE LAW, § 1.1 (2nd. ed 2023) (providing context on economic and financial market crisis that prompted the first federal securities laws).

securities . . . should not be underestimated.”<sup>80</sup> The public learned about securities market corruption from the hearings associated with the Senate Banking Committee’s 1933 investigation into the causes of the stock market collapse.<sup>81</sup> The proceedings would come to be known as the Pecora hearings, after Ferdinand Pecora, the Banking Committee’s dogged chief counsel.<sup>82</sup> Pecora wielded internal records from banks and securities firms to aggressively question industry witnesses.<sup>83</sup> Their testimony included shocking stories of fraud and self-dealing on Wall Street.<sup>84</sup> The revelations of the Pecora hearings informed the Banking Committee’s drafting process and ultimately the final versions of the first federal securities statutes.<sup>85</sup> Moreover, the hearings had a profound effect on public perceptions of the financial industry,<sup>86</sup> “indict[ing] a system as a whole that had failed miserably in imposing those essential fiduciary standards that govern persons whose function it was to handle other people’s money.”<sup>87</sup> The revelations of the industry’s endemic fraud contributed to a “diminution of the faith the country placed in its

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80. 1 THOMAS L. HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION*, § 1:16 (8th ed. 2023).

81. See Alan Brinkley, *When Washington Took on Wall Street*, VANITY FAIR (May 17, 2010), <https://www.vanityfair.com/news/2010/06/pecora-201006> [<https://perma.cc/5VKF-GTFL>] (discussing Pecora hearings).

82. See *id.* (explaining that the investigation came to be known by Pecora’s name).

83. See *id.* (“Pecora’s staff burrowed into the vast archives of the major banks and collected a staggering amount of information on almost every aspect of American finance, much of it never before seen outside the closed doors of the banking world.”).

84. See Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 325 (2011) (“[One session during the Pecora hearings] revealed a degree of executive compensation previously unknown to the American public, illusory stock transactions seemingly used to avoid income taxes on [National City Bank CEO Charles] Mitchell’s million dollar salary, and [the bank’s] securities arm selling securities to investors that the company itself was dumping.”).

85. See Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 509–10 (2003) (noting that Pecora remained chief counsel to the Senate Banking Committee through the drafting and enactment of the 1933 Securities Act and 1934 Exchange Act).

86. See Michael Perino, *The Financial Crisis Inquiry Commission and the Politics of Governmental Investigations*, 80 UMKC L. REV. 1063, 1064 (2012) (“The sensational headlines [about the Pecora hearings] galvanized public opinion for reform and created the climate in which Congress was able to re-shape and, in some instances create, much of the modern structure of federal financial regulation.”).

87. James M. Landis, *Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

financial institutions, which were already being severely questioned in the wake of the stock market collapse.”<sup>88</sup>

The narrative connection between the market crash and subsequent economic suffering,<sup>89</sup> combined with the public outcry in response to the Pecora hearings, prompted a wide demand for federal control of the securities industry.<sup>90</sup> Heeding this demand might have led to federalization of the merit-based regulatory scheme reflected in the “blue sky”<sup>91</sup> securities laws that nearly all states had enacted by 1933.<sup>92</sup> State blue sky securities laws had two requirements of prospective securities offerings: full disclosure of all relevant facts about the security and submission to merit-based scrutiny by state governments.<sup>93</sup> In short, state agencies would analyze securities in advance to determine suitability for public sale.<sup>94</sup> But state blue sky laws were ineffective at preventing the rampant abuses that preceded the 1929 crash.<sup>95</sup> Today, some critics assessing blue sky laws argue that merit regulation hampers

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88. Elisabeth Keller, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 338 (1988) (footnote omitted).

89. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 410 (1990) (“While [stock market] speculation had long been criticized on moral grounds as profligate gambling, it began to be seen as a direct cause of terrible and tangible suffering [during the Great Depression.]”).

90. See Landis, *supra* note 87, at 30 (discussing mounting criticism of securities industry abuses that led to “wide demand” for federal control).

91. 1 HAZEN, *supra* note 80, § 1:15 (“There are a number of explanations for the derivation of the “blue sky” appellation, the most common of which was because of the [1911] Kansas statute’s purpose to protect the Kansas farmers against the [East coast] industrialists selling them a piece of the blue sky.”) (footnote omitted).

92. Susan G. Flanagan, *The Common Enterprise Element of the Howey Test*, 18 PAC. L. J. 1141, 1143 (1987) (“By 1933, blue sky laws existed in forty-seven of the forty-eight states.”) (footnotes omitted).

93. 1 HAZEN, *supra* note 80, § 1:15 (“[S]tate blue sky laws not only focused on providing investors with full disclosure of relevant facts, but also required that all securities registered thereunder ‘qualify’ on a merit basis, evaluating the substantive terms of the securities to be offered.”).

94. See *id.* (“In order to rule on the merits of such investments, the state securities commissioner or administrator typically was given the power to determine whether the securities were suitable for sale.”).

95. See *id.* (“Notwithstanding the broad regulatory potential of the merit approach, the blue sky laws proved to be relatively ineffective in stamping out securities frauds, especially on a national level.”). See also Flanagan, *supra* note 92, at 1144 (“As a direct result of [widespread securities industry] abuses and the ineffective enforcement of the blue sky laws, half of the \$50 billion of new securities sold in the decade following World War I proved to be worthless.”).



entrepreneurship, reduces competitiveness, and disrupts the smooth functioning of markets.<sup>96</sup>

For the new federal legislation, however, President Roosevelt and Congress eschewed merit regulation for a regime based on disclosure.<sup>97</sup> In the Securities Act and the Exchange Act, Congress required companies offering securities, at risk of liability, to share information with investors and the government, both when issuing new securities<sup>98</sup> and on an ongoing basis.<sup>99</sup> Federal agencies would not evaluate investments in advance, as under state merit regulation, but would instead require that securities offerors provide the public with “full, fair, and truthful disclosure.”<sup>100</sup>

The disclosure scheme balances the interests of sellers and buyers of securities. Full disclosure demands honesty from companies, obviates the need for costly and slow government merit analysis, and gives investors “sufficient opportunity to evaluate the merits of an investment and fend for themselves.”<sup>101</sup> This approach does not purport to remove risk from investing but rather “eliminate serious abuses” typical of the earlier unregulated marketplace.<sup>102</sup> In a speech marking the passage of the Securities Act, President Roosevelt declared, “[t]hose who seek to draw upon other people’s money must be wholly candid

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96. See generally Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 104 (1987) (arguing that merit regulation unduly burdens free markets). Cf. Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH. L. REV. 647 (2010) (considering whether merit regulation should be revisited at the federal level).

97. See 1 HAZEN, *supra* note 80, § 1:16 (“[The Securities Act] contained many of the features of state blue sky laws, except that it did not (and, as amended, still does not) establish a system of merit regulation. Instead, under the guidance of a federal agency, the Act focuses on disclosure.”).

98. See Securities Act of 1933, 15 U.S.C. § 77f-h (mandating disclosure to SEC via registration statements); 15 U.S.C. § 77j (mandating disclosure to investors in prospectuses); 15 U.S.C. § 77l (creating civil liability for violations of the Securities Act).

99. See Securities Exchange Act of 1934, 15 U.S.C. § 78m (requiring periodic reporting and disclosures companies whose securities trade on public markets, who possess more than ten million dollars in assets, and whose securities owned by more than 500 parties); see also *Securities Exchange Act of 1934*, LEGAL INFO. INST., [https://www.law.cornell.edu/wex/securities\\_exchange\\_act\\_of\\_1934](https://www.law.cornell.edu/wex/securities_exchange_act_of_1934) [<https://perma.cc/CZZ5-D4FD>] (last visited Jan. 2, 2023) (providing an overview of the Securities Exchange Act).

100. See Securities Act of 1933, 15 U.S.C. § 77 (“An Act. To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.”).

101. 1 HAZEN, *supra* note 80, § 1:17.

102. *United Hous. Found., Inc v. Forman*, 421 U.S. 837, 849 (1975).

regarding the facts on which the investor's judgment is asked.”<sup>103</sup> The market would retain the principle of “caveat emptor,” buyer beware—however, a new instruction, “caveat vendor,” or seller beware, would help level the playing field.<sup>104</sup>

The Acts also were designed to help American business flourish by “promot[ing] efficiency, competition, and capital formation.”<sup>105</sup> Regarding the Securities Act, President Roosevelt wrote to Congress, “[t]he purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.”<sup>106</sup> That purpose has arguably been fulfilled; the Acts have been lauded as among the most effective and balanced federal economic regulations.<sup>107</sup> Today, SEC Chair Gary Gensler credits the Acts with laying the foundation for American financial markets to become the “envy of the world.”<sup>108</sup>

#### B. *How the Acts Protect Investors*

The Securities Act and Exchange Act are comprehensive pieces of legislation that Congress passed in response to a national economic

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103. President Franklin D. Roosevelt, Statement on Signing the Securities Bill (May 27, 1933).

104. See Franklin D. Roosevelt, *Message to Congress on Federal Supervision of Investment Securities*, AM. PRESIDENCY PROJECT, <https://www.presidency.ucsb.edu/documents/message-congress-federal-supervision-investment-securities> [<https://perma.cc/C8SC-HD2X>] (“This proposal [of the 1933 Securities Act] adds to the ancient rule of caveat emptor the further doctrine, ‘Let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”).

105. See Securities Exchange Act of 1933, 15 U.S.C. § 77b (“Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this subchapter the [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”).

106. Franklin D. Roosevelt, *Message to Congress on Federal Supervision of Investment Securities*, *supra* note 104.

107. See Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEG. STUD. 1, 31 (2001) (“The Securities Act accordingly provides a useful cautionary tale about the efficacy of economic regulation. The [A]ct is generally regarded as one of the greatest success stories of the New Deal. Unlike many regulatory statutes, it has been largely untouched by claims that it raises entry barriers or enforces cartel agreements among members of the regulated industry.”); see also 1 HAZEN, *supra* note 80, § 1:17 (citing Mahoney article and discussing topic further).

108. Gary Gensler, Chair, SEC, SEC Annual Conference on Financial Market Regulation: A Century with a Gold Standard (May 6, 2022), <https://www.sec.gov/news/speech/gensler-acfmr-20220506> [<https://perma.cc/5K7N-J76L>].

crisis—and a crisis of investor confidence in securities markets.<sup>109</sup> For the purposes of this Note, three areas of the statutory scheme—mandatory disclosure, SEC enforcement, and private rights of action—demonstrate how the laws implemented Congress’s mandate to protecting investors.<sup>110</sup>

First, the Acts emphasize upfront and ongoing disclosure of detailed information to the public and to the SEC. The Securities Act governs disclosure prior to the public issuance of new securities.<sup>111</sup> The Exchange Act expanded upfront disclosure requirements and added periodic reporting requirements for securities traded on secondary markets.<sup>112</sup> In these periodic reports, sellers must include information for current and prospective investors about relevant business activities, such as management changes and insider transactions in securities (for example, when an executive sells stock).<sup>113</sup> The Acts also provide for certain exemptions from disclosure requirements for small private securities sales, intrastate offerings, and sales of government bonds.<sup>114</sup> But when there is doubt, courts usually construe these exemptions strictly to “promote full disclosure for the protection of the investing public.”<sup>115</sup>

Second, the Exchange Act created the SEC and empowered it with broad authority to administer and enforce the securities laws.<sup>116</sup> The Exchange Act gave the SEC jurisdiction over securities

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109. *See supra* Section II.A.

110. *See* Henderson & Raskin, *supra* note 33, at 447 (noting that mandatory disclosure, the policing of fraud, and limitations on insider trading are “pillars of modern securities law” designed to make markets fair for all investors).

111. *See The Laws That Govern the Securities Industry, supra* note 27 (providing overview of the Act’s pre-issuance disclosure requirements); *see also* Securities Act of 1933, 15 U.S.C. § 77f-h (requiring securities registration statements be provided to the SEC); 15 U.S.C. § 77j (requiring investment prospectuses be provided to individual investors).

112. 1 HAZEN, *supra* note 80, § 1:18 (“The Exchange Act expanded securities registration and ongoing reporting requirements, requiring ‘full disclosure of the company’s business, financial position, and management as well as numerous periodic reporting requirements.’”).

113. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (governing disclosure of insider securities transactions).

114. *See, e.g.,* Securities Act of 1933, 15 U.S.C. § 77c(a) (exempting intrastate securities offerings).

115. SEC v. Cavanaugh, 445 F. 3d 105, 115 (2d Cir. 2006).

116. Securities Exchange Act of 1934, 15 U.S.C. § 78d (creating the SEC); *see also* 1 HAZEN, *supra* note 80, § 1:29 (noting that Congress granted SEC the responsibility to administer the securities laws via rulemaking, adjudication, investigation, and enforcement).

marketplaces, like stock exchanges;<sup>117</sup> Congress recognized that giving the agency authority over the marketplaces where investors traded securities was essential to the effectiveness of the disclosure-based scheme.<sup>118</sup> The Exchange Act also empowered the SEC to punish perpetrators of securities fraud, including individuals, like investors or corporate executives, as well as organizational entities.<sup>119</sup>

Finally, the Acts created private rights of action to enable individual investors to seek damages. The Securities Act included express private rights of action related to issuers who sell securities without filing registration documents, or make material misstatements or omissions in those disclosures.<sup>120</sup> The Exchange Act added an express private right of action for stock price manipulation<sup>121</sup> and imposed penalties for insider trading.<sup>122</sup> Subsequent Supreme Court cases<sup>123</sup> have recognized implied private rights of action in the Exchange Act and SEC regulations passed pursuant to the statute—the most important being an imposition of liability for material misstatements or omissions made in connection with the purchase or sale of any security, whether or not that security is traded publicly.<sup>124</sup>

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117. *See* 15 U.S.C. § 78e (prohibiting securities transactions on unregistered exchanges without an exemption); 15 U.S.C. § 78f (defining national securities exchanges).

118. *See id.* 15 U.S.C. § 78b (“[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are effected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . .”).

119. *See id.* § 78j (prohibiting fraud and manipulation); 15 U.S.C. § 78u-2 (giving the SEC the power to assess civil penalties in administrative proceedings).

120. *See* Securities Act of 1933 § 771(a)(1) (imposing strict liability for offer or sale of securities issued in violation of registration requirements); § 77k (liability for material misstatements or omissions in registration statements); § 771(a)(2) (imposing liability for material misstatements or omissions in the offer or sale of securities by a prospectus or related oral communication); § 77o (creating “control person liability” right of action against people who have control over primary violators of disclosure requirements, similar to vicarious liability).

121. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78i(f).

122. *See id.* 15 U.S.C. § 78p(b) (imposing strict liability for short-swing trading by insiders when the issuer has equity securities registered pursuant to the statute).

123. *See, e.g.,* *Goldman Sachs Grp., Inc. v. Ark. Tch. Ret. Sys.*, 141 S.Ct. 1951, 1958 (2021) (citing *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 267 (2014)) (“We have inferred from [§ 78j(b) and Rule 10b-5] an implied private cause of action permitting the recovery of damages for securities fraud.”).

124. *See* 15 U.S.C. § 78j(b) (forbidding manipulation and deception in securities markets); 17 C.F.R. § 240.10b-5 (SEC rule enacted pursuant to Exchange Act that empowers the agency to target securities fraud).

### III. THE PROBLEM OF DEFINING “SECURITY” AND *HOWEY*’S FLEXIBLE SOLUTION

Of course, the Acts only protect investors when a “security” is involved. The Acts recognize familiar types of securities, like stocks, bonds, and certificates of deposit.<sup>125</sup> Beyond such common investment vehicles, however, “security” is defined broadly, in keeping with Congress’s intent.<sup>126</sup> This broad construal reflects the amorphousness of a “security” as an object of regulation; securities are created on paper rather than being produced like a physical good, can be issued in unlimited quantities, and have no intrinsic value because they represent only rights in something else, like a share of a company’s potential cash flow.<sup>127</sup>

Congress recognized that this fluid concept of “security” called for a fluid statutory definition.<sup>128</sup> A primary tool to facilitate this flexible regulatory approach is the inclusion of the catch-all term “investment contract” in the Acts’ lists of regulated securities.<sup>129</sup> The judicial analysis of whether an investment contract exists focuses on function rather than form, looking “not so much at what is actually being offered as how it is being offered and what is being promised.”<sup>130</sup> As such, the term has helped the SEC and private investors police the market’s gray areas, performing “yeoman work in bringing within the scope of securities regulation many investment schemes that are blatant attempts to avoid compliance with the securities laws.”<sup>131</sup> As the Acts

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125. See Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (listing security types regulated by the statute); Securities Exchange Act of 1934 § 78c(a)(10) (same).

126. See *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (“Congress did not therefore attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of ‘security’ sufficiently broad to encompass virtually any instrument that might be sold as an investment.”) (footnote omitted).

127. 1 HAZEN, *supra* note 80, § 1:48.

128. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847–48 (1975) (discussing Congress’s intent in enacting foundational securities laws).

129. See Miriam R. Albert, *The Howey Test Turns 64: Are the Courts Grading this Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1, 8 (2011) (“The Supreme Court’s definition of investment contract in *Howey* is flexible, consistent with the congressional approach to defining the broader concept of what constitutes a security.”).

130. 1 HAZEN, *supra* note 80, § 1:50.

131. 3 BLOOMENTHAL AND WOOLF, *supra* note 79, § 2.2.

did not spell out the meaning of “investment contract,” that job has fallen to the federal courts.<sup>132</sup>

The current “investment contract” test was defined in 1946 by the Supreme Court in *SEC v. W.J. Howey Co.*<sup>133</sup> To this day, the *Howey* test grants the SEC considerable flexibility to regulate securities in the interest of the investing public.<sup>134</sup>

*Howey* involved an investment scheme in a Florida orange grove.<sup>135</sup> The Howey Company sold slices of land paired with service contracts whereby the fruit was cultivated and sold by farmers affiliated with the company.<sup>136</sup> This was a package deal: one could not buy pieces of land without accepting the service contract.<sup>137</sup> In return, investors could get a share of the operation’s profits.<sup>138</sup> Howey’s marketing materials suggested that substantial profits were possible based on the operation’s strong recent performance.<sup>139</sup> Salespeople targeted guests of a nearby resort hotel, so many investors were not Florida residents but visitors from “distant localities.”<sup>140</sup> Moreover, investors were “predominantly business and professional people” with “no desire to occupy the land or to develop it themselves,” but were “attracted solely by the prospects of a return on their investment.”<sup>141</sup>

In determining whether this arrangement was a regulable “investment contract,” the Court considered the circumstances of the company, investors, transactions, and the parties’ ongoing relationships. The Court announced a test that says an investment contract exists where there is a “contract, transaction or scheme whereby a person

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132. See *Forman*, 421 U.S. at 848 (“The task has fallen to [the SEC] . . . and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.”).

133. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

134. See *infra* Part IV.

135. *Howey*, 328 U.S. at 299–300.

136. *Id.* at 295–96.

137. See *id.* (“Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made.”).

138. See *id.* at 296 (“The [Howey] company is accountable only for an allocation of the net profits based upon a check made at the time of picking.”).

139. See *id.* (“It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period.”).

140. *Id.* at 299.

141. *Id.* at 296, 300.

invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”<sup>142</sup>

Under its new test, the Court said the orange grove scheme qualified as an investment contract.<sup>143</sup> The buyers’ circumstances and expectations were germane. The fact that the typical investor lived far away and lacked the skills, experience, and equipment to grow and sell oranges made it unreasonable to consider the transaction a standard sale of land, with or without the services contract.<sup>144</sup> The Court concluded that “all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.”<sup>145</sup> The *Howey* Company’s offering was therefore an investment contract that violated the Securities Act’s prohibition on the offer and/or sale of unregistered securities in interstate commerce.<sup>146</sup>

The *Howey* Court consciously connected its test to the securities laws’ purpose of compelling “full and fair disclosure.”<sup>147</sup> Quoting House Reports from the time of the Securities Act’s passage, the Court announced that the new test respected the statutory purpose of regulating “the many types of instruments that in our commercial world fall within the ordinary concept of a security.”<sup>148</sup> *Howey* enacted a “flexible rather than a static principle” that could adapt “to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”<sup>149</sup> In other words, *Howey*

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142. *Id.* at 298–99.

143. *Id.* at 299.

144. *See id.* at 300 (“A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments . . . . The resulting transfer of rights in land is therefore incidental.”).

145. *Id.* at 300.

146. *Id.* *See also* Securities Act of 1933, 15 U.S.C. 77e (prohibiting the use of interstate channels like the mail to offer to sell or sell unregistered securities, the section of the statute the Court considers in *Howey*).

147. *See* Securities Act of 1933, 15 U.S.C. §§ 77a–aa (“To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.”).

148. *Howey*, 328 U.S. at 299 (quoting H. REP. NO. 85, 73rd Cong., 1st Sess., at 11) (internal quotations omitted).

149. *Id.*

sought to future-proof its test to cover investment vehicles not yet in existence.<sup>150</sup>

Two overarching principles have guided *Howey* and its progeny. First, emphasis is placed on a putative investment contract's "substance over [its] form"<sup>151</sup> and close analysis of "the economic reality" underlying the transaction.<sup>152</sup> In essence, the circumstances of the sale and the parties' expectations are more important than the transaction's technical form.<sup>153</sup>

Second, courts applying *Howey* have construed "investment contract" liberally to effectuate the remedial purpose of the securities laws.<sup>154</sup> Given the need to correct for the fraud of the pre-1929 securities market, "Congress defined the term 'security' broadly, and the Supreme Court in turn has construed the definition liberally."<sup>155</sup>

In addition to those two guiding principles, subsequent cases have helped clarify the meaning of the *Howey* test's four elements: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others.<sup>156</sup> Judicial expansion of these four elements beyond their literal linguistic

150. See 1 HAZEN, *supra* note 80, § 1:49 (collecting examples of unusual economic transactions that have been ruled investment contracts under *Howey*, such as self-improvement courses, animal breeding programs, and cemetery lots).

151. See *Howey*, 328 U.S. at 298 (discussing earlier state courts' interpretation of blue sky securities laws that "disregarded" form for substance, jurisprudence that informed the Court's consideration of "investment contract" in *Howey*); see also *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("[I]n searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance . . .").

152. *Howey*, 328 U.S. at 298. See also *United. Hous. Found. v. Forman*, 421 U.S. 837, 849 (1975) ("Congress intended the application of [the securities laws] to turn on the economic realities underlying a transaction, and not on the name appended thereto."); *Glen-Arden Commodities, Inc. v. Constantino*, 493 F.2d 1027, 1034 (2d Cir. 1974) (affirming *Howey*'s mandate to look at transaction in the light of economic reality and the totality of circumstances).

153. See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982) ("Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.").

154. See, e.g., *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 480–81 (9th Cir. 1973) ("The [1933 and 1934] Acts [as remedial legislation,] were designed to protect the American public from the speculative or fraudulent schemes of promoters.").

155. *Id.* at 481. See also *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963) ("It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail [in the securities industry].").

156. *Howey*, 328 U.S. at 299–300.



meanings demonstrates *Howey*'s utility in permitting regulation of unusual transactions as "investment contracts."

First, with regard to the "investment of money" element, courts have said that cash is not the only form of consideration that can create an investment contract.<sup>157</sup> Investors may satisfy this element with goods, services, or another exchange of value.<sup>158</sup> The key factor is "whether the purchaser was required to give up something of value in exchange for the promised consideration."<sup>159</sup> For example, in *SEC v. Addison*, a valid investment contract was found in an arrangement wherein mining workers exchanged labor for a promised share of company profits.<sup>160</sup> Non-cash property can also suffice as an investment of money, including payment in Bitcoin.<sup>161</sup>

The common enterprise element focuses on "the extent to which the investor's interest rises and falls with others involved in the enterprise."<sup>162</sup> A common enterprise can be achieved through horizontal commonality or strict vertical commonality.<sup>163</sup> Horizontal commonality is established when investors' assets are pooled and the fortunes of each investor are tied both to the fortunes of the others and to the success of the overall enterprise.<sup>164</sup> Strict vertical commonality "requires that the fortunes of investors be tied to the fortunes of the promoter," wherein

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157. See, e.g., *Uselton v. Com. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of *Howey*'s reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract.") (citation omitted).

158. See *id.* at 574–76 (holding that employees' voluntary participation in company stock ownership plan satisfied investment of money element because employees contributed their legal right to a portion of their wages to acquire stock through the plan).

159. 1 HAZEN, *supra* note 80, § 1:51.

160. See *SEC v. Addison*, 194 F.Supp. 709, 722 (N.D. Tex. 1961) (stating the performance of labor can form the basis for a sale of securities because it offers value in consideration of the security).

161. See, e.g., *SEC v. Shavers*, 2013 WL 4028182, at \*2 (E.D. Tex. Aug. 6, 2013) (holding that Bitcoin payments can satisfy the investment of money element because Bitcoin can be used as currency in limited cases or exchanged for conventional currencies).

162. 1 HAZEN, *supra* note 80, § 1:52.

163. Federal courts are divided on whether to also accept broad vertical commonality in securities cases interpreting *Howey*. Second Circuit courts have accepted horizontal commonality, have not explicitly rejected strict vertical commonality, but have rejected broad vertical commonality. See 1 HAZEN, *supra* note 80, § 1:52 (discussing Second Circuit "common enterprise" jurisprudence).

164. See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994) (explaining horizontal commonality); see also *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) ("[H]orizontal commonality . . . involves the pooling of assets from multiple investors so that all share in the profits and risks of the enterprise.").

the success of the promoter and the investor are directly intertwined<sup>165</sup> and the promoter's prospects for financial gain are tied to the investment in essentially the same way as the investor's.<sup>166</sup>

The "expectation of profits" element is satisfied when investors are motivated by the prospects of a return on their investment.<sup>167</sup> "Profit" means an income or return, such as "dividends, other periodic payments, or the increased value of the investment."<sup>168</sup> Profits usually take the form of "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds."<sup>169</sup>

Courts apply an objective standard when evaluating whether investors had a reasonable expectation of profits,<sup>170</sup> examining what the seller's conduct would have led a reasonable buyer to anticipate.<sup>171</sup> The inquiry focuses objectively on the promises and offers made to prospective investors; it is not a search for the precise motivations of the investor plaintiff in the case at bar.<sup>172</sup> For instance, a seller's efforts to promote the investment opportunity via sales and marketing materials

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165. *Revak*, 18 F.3d at 88 (citing *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978)).

166. 1 HAZEN, *supra* note 80, § 1:52.

167. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 296, 301 (1946). *See also* *SEC v. Hui Feng*, 935 F.3d 721, 730–31 (9th Cir. 2019) (finding existence of requisite expectation of profit even when investment intent was secondary to a motive unrelated to profit).

168. *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

169. *United. Hous. Found. v. Forman*, 421 U.S. 837, 852 (1975).

170. *See, e.g., SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 584 (2d Cir. 1982) ("[I]n determining whether [an] offering is an investment contract courts are to examine the offering from an objective perspective . . .").

171. *See Audet v. Fraser*, 605 F. Supp. 3d 372, 398 n.7 (D. Conn. 2022) ("'[T]he subjective intent of the purchasers may have some bearing on the issue of whether they entered into investment contracts,' even if the ultimate inquiry must focus 'on what the purchasers were offered or promised.'" (citing *Warfield v. Alaniz*, 569 F.3d 1015, 1021 (9th Cir. 2009))).

172. *See Warfield*, 569 F.3d at 1021 ("Under *Howey*, courts conduct an objective inquiry into the character of the instrument or transaction offered based on what the purchasers were 'led to expect.'"). Courts may consider an investor's subjective intent as probative in determining what a reasonable, objective investor would have anticipated based on the circumstances of the investment. *See, e.g., SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 374 (S.D.N.Y. 2020) ("The subjective intent of the Initial Purchasers does not necessarily establish the objective intent of a reasonable purchaser . . . [but], may be properly considered in the Court's evaluation of the motivations of the hypothetical reasonable purchaser."). Multiple motives for an investment, such as tax benefits as well as profits, do not necessarily defeat the expectation of profits element. *See Aqua-Sonic*, 687 F.2d at 583–84 (holding that expectation of profit element was met even though investment was promoted primarily for its potential tax benefits).

can generate reasonable expectations of profits by this objective standard.<sup>173</sup>

Finally, the fourth element of *Howey* states that the expectation of profits must stem “solely from the efforts of a promoter or a third party.”<sup>174</sup> Subsequent decisions have relaxed this standard, clarifying that “solely” is not a literal limitation.<sup>175</sup> Rather, an investor’s reasonable expectation of profits must “derive[] from the entrepreneurial or managerial efforts of others.”<sup>176</sup> The appropriate inquiry is whether the efforts made by the promoter or third party are the “undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”<sup>177</sup> Moreover, the efforts of promoters both before and after the investment of money are relevant to the analysis.<sup>178</sup> However, no investment contract will be found if the investors’ own efforts are the most significant ones in determining the success of the enterprise.<sup>179</sup>

The *Howey* test, in sum, provides the SEC and private plaintiffs with considerable flexibility to litigate alleged violations of securities laws, especially where the putative investment contract is novel and not already subject to specific regulations. Unsurprisingly, then, *Howey* has been a potent tool for the SEC and private investors to vindicate their rights in lawsuits against crypto companies.

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173. See, e.g., *Edwards*, 540 U.S. at 392 (describing marketing materials and website language that defendant used to promote payphone business to prospective investors).

174. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299–300 (1946).

175. See, e.g., *United States v. Leonard*, 529 F.3d 83, 88 (2d Cir. 2008) (quoting *Aqua-Sonic*, 687 F.2d at 582) (“[T]he word ‘solely’ should not be construed as a literal limitation; rather, we ‘consider whether, under all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter’s contribution in a meaningful way.’”).

176. *United Hous. Found. v. Forman*, 421 U.S. 837, 852 (1975).

177. *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 483 (9th Cir. 1973).

178. See, e.g., *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743–44 (11th Cir. 2005) (“[I]nvestment schemes may often involve a combination of both pre- and post-purchase managerial activities, both of which should be taken into consideration in determining whether *Howey*’s test is satisfied.”).

179. See 1 HAZEN, *supra* note 80, § 1:54 n.3 (collecting cases in which an enterprise relied primarily on an investors’ own efforts and therefore defeated the “efforts of others” element of *Howey*).

## IV. ARE CRYPTO ASSETS SECURITIES?

A. *Applying Howey to Crypto Before the Ripple-Terraform Split*

Since the fall of crypto winter in 2022, the SEC has stepped up enforcement actions against crypto companies and executives.<sup>180</sup> The litigation sometimes goes no further than a civil penalty assessed in an administrative proceeding.<sup>181</sup> Or the parties settle after the SEC defeats a defendant's 12(b)(6) motion to dismiss,<sup>182</sup> prevails on summary judgment,<sup>183</sup> or is granted a preliminary injunction.<sup>184</sup> All this means that there have been no trials in SEC cases that have applied *Howey* to crypto assets, much less appellate review of lower courts' conclusions.<sup>185</sup>

A brief review of recent cases considering whether crypto assets are investment contract securities will contextualize the implications of the *Ripple-Terraform* split. Opinions from private civil and SEC-initiated cases are both relevant, as district courts draw from both types of cases when applying securities law to crypto assets.

The "investment of money" element has not been a barrier in the application of *Howey* to crypto assets. Courts have held prospective investors satisfied this factor when making an investment of fiat currency, or other qualifying crypto assets, in return for the crypto assets that allegedly violated securities laws.<sup>186</sup>

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180. For a discussion of the 2022 crypto crises, see *supra* Part I.

181. See, e.g., Impact Theory, LLC, Exchange Act Release No. 11226, 2023 WL 5530012 (Aug. 28, 2023) (settling with NFT company for allegedly offering and selling NFTs that qualified as investment contract securities).

182. See, e.g., SEC v. NAC Found., LLC, 512 F. Supp. 3d 988, 997 (N.D. Cal. 2021) ("The SEC adequately has pled the defendants' sale of an unregistered security."); Friel v. Dapper Labs, Inc., 657 F. Supp. 3d 422, 425–26 (S.D.N.Y. 2023) (holding private plaintiff's complaint sufficient to overcome 12(b)(6) motion to dismiss).

183. See, e.g., SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169, 169–70 (S.D.N.Y. 2020) (granting SEC's motion for summary judgment and holding that Kin crypto tokens were unregistered investment contract securities).

184. See, e.g., SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352, 358–59 (S.D.N.Y. 2020) (granting preliminary injunction based on successful SEC allegation that crypto tokens at issue were investment contract securities).

185. For a discussion of the SEC's motion for an interlocutory appeal for Second Circuit review in *Ripple Labs*, which was denied by Judge Torres on October 3, 2023, see *infra* note 241.

186. See *Telegram*, 448 F. Supp. 3d at 358 (noting that investors invested \$1.7 billion in exchange for promised delivery of 2.9 billion Gram tokens upon launch of Telegram's blockchain project). See also *Audet v. Fraser*, 605 F. Supp. 3d 372, 395 n.6 (D. Conn. 2022)

For the second *Howey* element requiring a “common enterprise,” *SEC v. Telegram* involved a complex, two-step public offering, in which a tech company raised billions to fund operations and the launch of a new blockchain by selling “Gram” crypto tokens to 175 large individual and institutional investors.<sup>187</sup> The record revealed a plan for the 175 “initial purchasers” to be able to resell their Grams on public markets at a profit once Telegram launched its blockchain.<sup>188</sup> The court said that the common enterprise requirement was satisfied because the 175 initial purchasers had established horizontal commonality, as there “was a pooling of assets and that the fortunes of investors were tied to the success of the enterprise as well as to the fortunes of other investors both before and after launch.”<sup>189</sup> The court also found strict vertical commonality because the success of Telegram’s overall business and the profitability of the 175 initial purchasers Gram tokens turned on the success or failure of Telegram’s blockchain project.<sup>190</sup>

For the third and fourth elements of *Howey*, courts have also found that crypto asset investors had a reasonable expectation of profits based on the entrepreneurial and managerial efforts of the crypto defendants. In *SEC v. Kik Interactive*, the popular messenger app Kik raised nearly \$100 million by selling “Kin” crypto tokens, claiming that the money would fund operations and the development of a blockchain project.<sup>191</sup> The court found that Kik’s representations to the investing public via company statements, media appearances, and events consistently promised to use investors’ money in ways that would make Kin tokens more valuable.<sup>192</sup> Investors may have had a role in generating interest in Kin, but the success or failure of the enterprise, and thus Kin’s value, depended almost exclusively on the company’s

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(holding that customers’ payment for company’s Paycoin crypto token using same company’s Hashpoint cryptocurrency was an exchange of value sufficient to satisfy the investment of money element of *Howey*).

187. *Telegram*, 448 F. Supp. 3d at 355.

188. *Id.*

189. *Id.* See also *Balestra v. ATBCOIN*, 380 F. Supp. 3d 340, 354 (S.D.N.Y. 2019) (“[T]he value of [the digital asset] was dictated by the success of the . . . enterprise as a whole, thereby establishing horizontal commonality.”).

190. *Telegram*, 448 F. Supp. 3d at 356.

191. *SEC v. Kik Interactive, Inc.*, 492 F. Supp. 3d 169, 176 (S.D.N.Y. 2020).

192. See *id.* at 174 (“Kik’s CEO explained how people could make money from early purchases of Kin. For example, at an event five days before the beginning of the public sale of Kin, he said, ‘if you set some aside for yourself at the beginning, you could make a lot of money.’”).

own efforts.<sup>193</sup> The court also rejected Kik’s argument that buyers primarily bought Kin to use or consume, rather than out of a desire to profit.<sup>194</sup> The court observed that Kin could not be put to consumptive use at the time the tokens were sold and any such use “would materialize only if the enterprise advertised by Kik turned out to be successful.”<sup>195</sup> The court was thus satisfied that a reasonable investor would have bought Kin with an expectation to profit from Kik’s entrepreneurial and managerial efforts.<sup>196</sup>

As of July 2023, then, courts had established precedent that sales of crypto assets to institutional and individual investors could constitute unlawful distributions of investment contract securities. Then *Ripple Labs* upended this status quo.

*B. The Ripple-Terraform Split*

*SEC v. Ripple Labs* brought an end to the SEC’s success in using *Howey* to argue that crypto assets are investment contract securities.<sup>197</sup> The opinion extended the protections of securities laws to large institutional investors who bought XRP tokens directly from Ripple but declined to protect average investors who purchased the same asset on public digital asset exchanges.<sup>198</sup> Why?

As a preliminary matter, *Ripple Labs*’s application of *Howey* to the Programmatic Sales of XRP did not analyze all four elements of the test. The court only considered the third and fourth elements, reasonable expectations of profits based on the entrepreneurial and managerial efforts of others, in holding that the sales to retail investors on public exchanges were not unlawful sales of investment contract securities.<sup>199</sup>

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193. *See id.* at 180 (“The demand for Kin, and thus the value of the investment, would not grow on its own. Growth would rely heavily on Kik’s entrepreneurial and managerial efforts.”).

194. *Id.*

195. *Id.*

196. *Id.* at 179. *See also* *Balestra v. ATBCOIN, LLC*, 380 F. Supp. 3d 340, 354–357 (S.D.N.Y. 2019) (applying *Howey* reasonable expectations of profits element to crypto asset).

197. *See supra* Part I for discussion of SEC crypto regulatory strategy and Section IV.A for discussion of successful SEC actions against crypto defendants prior to *Ripple Labs*.

198. *SEC v. Ripple Labs, Inc.*, No. 20 Civ. 10832, 2023 U.S. Dist. LEXIS 120486, at \*26–33 (S.D.N.Y. July 13, 2023).

199. *Id.* at \*39 n. 17 (explaining that because the expectation of profits prong was not satisfied, the court did not reach an analysis of other *Howey* prongs with regard to programmatic XRP sales).

Because Ripple's programmatic sales of XRP did not create in retail investors a reasonable expectation of profits from the efforts of others, it failed the *Howey* test; there was no need to consider other *Howey* elements before denying the SEC's summary judgment motion as to the programmatic sales.<sup>200</sup>

A place to start is the SEC arguments rejected by the court. The SEC alleged that Ripple aimed XRP at crypto asset investors with the understanding that people were speculating on XRP as an investment contract security.<sup>201</sup> But the court said that evidence of speculative motive on the part of the buyer or seller does not prove the existence of an investment contract security.<sup>202</sup> Even if some programmatic buyers hoped to profit on XRP, it was unreasonable to accept that they "derive[d] that expectation from Ripple's efforts" and not other factors, such as "general cryptocurrency market trends."<sup>203</sup>

The court instead focused on the "blind" nature of the programmatic sales of XRP.<sup>204</sup> The anonymity of these transactions meant retail investors on digital asset exchanges "could not reasonably expect" that their money would go toward improving the value of XRP, as they "could not have known if their payments of money went to Ripple, or any other seller of XRP."<sup>205</sup>

Moreover, Ripple's programmatic sales represented less than one percent of global XRP sales volume, so the "vast majority of individuals" buying XRP on public exchanges "did not invest their money in Ripple at all."<sup>206</sup> The court also reminded the SEC that even if some Programmatic Buyers might have bought XRP with the expectation of profits to be derived from management's efforts, the correct "inquiry is an objective one, focusing on the promises and offers made to investors; it is not a search for the precise motivation of each

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200. *Id.* See also *id.* at \*39 (summarizing court's holding as to the programmatic sales).

201. *Id.* at \*35.

202. *Id.* at \*35–37.

203. *Id.* at \*37.

204. See *id.* at \*35–36 (emphasizing that Programmatic Sales were blind bid/ask transactions); see also *id.* at \*37 ("Here, the record establishes that with respect to Programmatic Sales, Ripple did not make any promises or offers because Ripple did not know who was buying the XRP, and the purchasers did know who was selling it. In fact, many Programmatic Buyers were entirely unaware of Ripple's existence.") (citations to record omitted).

205. *Id.* at \*35–36.

206. *Id.* at \*36.

individual participant.”<sup>207</sup> The court reasoned that Ripple did not make any promises or offers to retail investors who bought XRP from the company on secondary exchanges because neither party knew who the other was.<sup>208</sup> In fact, “many Programmatic Buyers were entirely unaware of Ripple’s existence.”<sup>209</sup>

The absence of specific written contracts between Ripple and Programmatic Buyers also distinguished these sales from the company’s direct sales to Institutional Buyers which the court held to be unlawful securities offerings.<sup>210</sup> In addition to the written contracts, Ripple circulated official promotional materials to Institutional Buyers—but there was “no evidence that these documents were distributed more broadly to the general public, such as XRP purchasers on digital asset exchanges.”<sup>211</sup> Nor did the record contain any evidence that Programmatic Buyers understood that any statements made by Ripple executives that they may have seen were official representations about the company’s efforts to make XRP a success.<sup>212</sup>

Finally, the court distinguished Programmatic Buyers from Institutional Buyers on the basis of their relative sophistication as investors.<sup>213</sup> A full examination of the parties’ expectations and understandings led the court to conclude that a reasonable Institutional Buyer “would have been aware of Ripple’s marketing campaign and public statements connecting XRP’s price to its own efforts.”<sup>214</sup> But there was no evidence that a reasonable Programmatic Buyer, “who was generally less sophisticated as an investor,” had formed similar expectations and understandings, or had the capacity to “parse through the multiple [Ripple] documents and statements,” such as company executives’ social media announcements and quotes in news articles.<sup>215</sup> Weighing the “economic reality and totality of circumstances,” the court concluded that Ripple’s programmatic sales of XRP “did not constitute the offer and sale of investment contracts.”<sup>216</sup>

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207. *Id.* at \*37 (cleaned up) (citation omitted).

208. *Id.*

209. *Id.* at \*37–38.

210. *Id.* at \*38.

211. *Id.*

212. *Id.* at \*37–38.

213. *See id.* at \*38–39 (comparing sophistication of two types of investors).

214. *Id.*

215. *Id.* at \*39.

216. *Id.*



In the immediate aftermath of *Ripple Labs*, the crypto industry rejoiced.<sup>217</sup> But some legal observers were puzzled. Securities law scholar Ilya Belyin said that the opinion was “bonkers,” stating that its “logic deprives ordinary investors of the protection of securities laws . . . because of [their] asserted inability to understand how Ripple contributed to the appreciation of the XRP token.”<sup>218</sup> To Belyin, this implied that the court believed that “unsophisticated [retail] investors weren’t clever enough to understand [Ripple’s public communications] and instead must have tied their expectations that the tokens would appreciate to factors unrelated to Ripple’s efforts.”<sup>219</sup> Another commentator in the financial press noted another potential implication of *Ripple Labs* for the SEC’s crypto enforcement strategy: “apparently [the SEC] can’t simply claim ‘Howey’ to win.”<sup>220</sup>

Then, on July 31, 2023, Judge Rakoff issued the *SEC v. Terraform Labs* order denying the defendant’s 12(b)(6) motion to dismiss.<sup>221</sup> The case involved similar facts to *Ripple Labs*: the sale of crypto tokens to two audiences through separate channels: direct sales to large institutional investors and anonymous sales to retail investors on public exchanges.<sup>222</sup> For Rakoff, what warranted dispute was *Ripple Labs*’s conclusion that since Programmatic Buyers did not know the identity of the party that sold them XRP, “[w]hatever expectation of profit they had could not, according to that court, be ascribed to [Ripple’s] efforts.”<sup>223</sup>

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217. See *supra* notes 66–68 and accompanying text.

218. Ilya Belyin, *Ripping the Ripple Opinion*, COLUM. L. SCH. BLUE SKY BLOG ON CORPS. & CAP. MKTS. (July 18, 2023), <https://clsbluesky.law.columbia.edu/2023/07/18/ripping-the-ripple-opinion> [<https://perma.cc/RWW2-23AC>].

219. *Id.*

220. Todd Phillips, *The SEC Needs to Get Philosophical*, FIN. TIMES (July 19, 2023), <https://www.ft.com/content/df615515-39c8-430b-ac37-00aa16dece6a> [<https://perma.cc/N65V-LVLN>]; see also Kadhim Shubber, *Ripple Coin: Sometimes a Security, Sometimes Not*, FIN. TIMES (July 13, 2023), <https://www.ft.com/content/cdc20435-ff3e-4148-96b7-81f70211cc2d> [<https://perma.cc/MP7Y-2GK7>] (discussing the “rather curious” opinion).

221. *SEC v. Terraform Labs Pte. Ltd.*, No. 23-CV-1346, 2023 WL 4858299, at \*1 (S.D.N.Y. July 31, 2023) (“[T]he Court concludes that because . . . the defendants used false and materially misleading statements to entice U.S. investors purchase and hold on to defendant’s products, and because those products were unregistered investment-contract securities . . . the motion to dismiss must be denied.”). The court also rejected the defendants’ motion to dismiss for lack of personal jurisdiction, *id.* at \*5–7.

222. See *id.* at \*1–4 (discussing facts of case and nature of defendant’s business and distribution of assets).

223. *Id.* at \*15.

Judge Rakoff's rejection of *Ripple Labs*'s disparate treatment of institutional and retail investors is the critical holding of *Terraform Labs* and sets up the central legal problem of this jurisdictional split. Rakoff observed that "*Howey* makes no such distinction between purchasers. And it makes good sense that it did not."<sup>224</sup> Whether one negotiates directly with Ripple executives to buy XRP pursuant to written sales contracts or purchases the same asset from Ripple on public exchanges "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."<sup>225</sup>

Applying the *Howey* expectation of profits element to the SEC's factual allegations against Terraform Labs, Rakoff observed that "defendants embarked on a public campaign to encourage *both* retail and institutional investors to buy their crypto-assets by touting [their] profitability . . . and the managerial and technical skills that would allow the defendants to maximize returns on the investor's coins."<sup>226</sup> The company said that proceeds from all token sales, "no matter where they were purchased," would support the company's efforts and "would generate additional profits for *all* crypto-asset holders."<sup>227</sup> Summarizing his decision not to follow *Ripple Labs*, Rakoff wrote, "[s]imply put, secondary-market purchasers had every bit as good a reason to believe that defendants would take their capital contributions and use it to generate profits on their behalf."<sup>228</sup> There was no need to distinguish between institutional and retail investors based on sophistication or any other dimension.<sup>229</sup> Because the defendants' conduct generated a reasonable expectation of profits based on efforts to increase the value of their crypto tokens, that element of *Howey* was satisfied, no matter whether the investor was institutional or retail, or whether the sales were made directly or on a "secondary market" (e.g., a digital asset exchange like Coinbase or Binance).<sup>230</sup>

*Ripple Labs* and *Terraform Labs* have therefore split the Southern District of New York's *Howey* jurisprudence as applied to

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224. *Id.*

225. *Id.*

226. *Id.* (cleaned up).

227. *Id.*

228. *Id.*

229. *See id.* (explaining why the distinction between purchasers made in *Ripple Labs* was an incorrect application of *Howey*).

230. *Id.*

crypto assets. The cases may also affect broader SEC policy choices. First, *Ripple Labs* poked a hole in the efficacy of the SEC's regulation by selective enforcement approach, in which the agency sues specific crypto actors instead of proposing generally applicable rules.<sup>231</sup> Second, *Ripple Labs* raised questions about the agency's litigation chops in crypto actions.<sup>232</sup> Third, the high-profile split may create a "legal quagmire" that will slow SEC efforts to police crypto.<sup>233</sup>

The *Ripple Labs* opinion may also change dynamics in the crypto market, emboldening industry players to resist compliance with securities laws, fight the SEC, and lobby Congress for favorable legislation.<sup>234</sup> In the meantime, the investing public has no clarity about whether securities laws will protect investments in crypto assets. Crypto investors could suffer further losses without the backing of the remedies provided by securities law. Overall, the uncertainty created by the *Ripple-Terraform* split curtails the power of the SEC to fulfill its purpose of protecting investors.<sup>235</sup>

## V. RECOMMENDATION AND CONCLUSION

*Terraform Labs'* holding—crypto assets are *Howey* investment contract securities, no matter the identity of the parties or the method of sale—follows settled precedent and effectuates the securities laws' purpose of protecting investors. Judge Rakoff properly applied *Howey's* flexible principle to the economic reality of the Terra crypto asset

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231. See Henderson & Raskin, *supra* note 33, at 445, 450 (noting that the shortage of intelligent SEC rules and regulations for crypto leaves issuers of digital assets and investors without a clear and predictable framework). See also *supra* notes 34–40 and accompanying text for discussion of the SEC's regulation of crypto by selective enforcement.

232. See Phillips, *supra* note 220 (raising doubts about the SEC's crypto litigation strategy).

233. See Joe Miller & Stefania Palma, *How the US Justice Department Became Top Cop in the Crypto 'Wild West'*, FIN. TIMES (Dec. 30, 2023), <https://www.ft.com/content/a304af1a-bfcf-4a79-ac4c-6aace52eb51f> [<https://perma.cc/NY6J-RCCE>] (discussing the "legal quagmire" the SEC faces as a result of the inconsistent decisions in *Ripple Labs* and *Terraform Labs* and describing cases as two of the agency's "flagship enforcement actions").

234. See *supra* notes 53–55 and accompanying text for discussion of the crypto industry's litigation and lobbying efforts.

235. See *supra* Part II for a discussion of securities laws and the SEC's mission to protect investors.

transaction, emphasizing “substance over form,”<sup>236</sup> and the parties’ “full set of contracts, expectations, and understandings.”<sup>237</sup> Furthermore, Rakoff gave his approach extra weight in the most recent substantive decision in the case: the resolution of the parties’ cross summary judgment motions. On December 28, 2023, Rakoff granted summary judgment to the SEC on its claim that Terraform Labs’ four crypto assets were investment contract securities under the *Howey* test.<sup>238</sup> By finding no genuine dispute of material fact after reviewing the undisputed evidence,<sup>239</sup> Rakoff’s reasoning in applying *Howey* to crypto assets gains precedential value.

In contrast, *Ripple Labs* strayed from *Howey* by creating a differentiated taxonomy of protection based on a judicial assessment of investor sophistication.<sup>240</sup> In extending protection to hedge funds and high-net-worth individuals but denying it to everyday investors, *Ripple Labs* did a disservice to the purpose of the securities laws—to make securities markets safe and fair for ordinary investors by mandating disclosure and imposing liability for non-compliance.

In the 1930s, Congress enacted the foundational securities laws in response to a stock market crisis that shook everyday investors’ faith in securities markets.<sup>241</sup> The collapse in crypto asset values in 2022, while on a much smaller scale, erased hundreds of billions of dollars of wealth and devastated many lives. If other courts follow the *Ripple Labs* application of *Howey*, the SEC will have less power to vindicate the interests of small investors, while institutional investors with the money and power to gain direct access to crypto executives will enjoy a greater degree of safety. This would be an unjust outcome contrary to the spirit of the securities laws and seven decades of jurisprudence since *Howey*.

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236. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (“[I]n searching for the meaning and scope of the word ‘security’ in the Act, form should be disregarded for substance . . .”).

237. SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352, 379 (S.D.N.Y. 2020).

238. SEC v. Terraform Labs Pte. Ltd., No. 23-CV-1346, 2023 WL 8944860, at \*13–15 (S.D.N.Y. Dec. 28, 2023) (granting summary judgment to SEC because defendants’ UST, LUNA, wLUNA, and MIR crypto assets all satisfied the *Howey* test for investment contract securities).

239. See *id.* at \*1–5 (outlining factual background of case to set up summary judgment decisions).

240. See SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2023 U.S. Dist. LEXIS 120486, at \*38–39 (S.D.N.Y. July 13, 2023) (comparing investor types through lens of sophistication).

241. See *supra* Section II.A for historical context on the passage of the original securities laws.

The Second Circuit will not yet have the opportunity to resolve the issues raised by *Ripple Labs*, as Judge Torres denied the SEC's request for interlocutory appeal on October 3, 2023.<sup>242</sup> However, if another crypto asset case comes before the Second Circuit, the appellate court should resist the upside-down reasoning of *Ripple Labs* and follow *Terraform Labs*'s proper application of *Howey*.

Given the significant losses suffered by crypto investors in the United States, courts should not allow crypto companies to skirt securities laws. Through proper application of *Howey*, no crypto actor will be able to escape "economic reality."<sup>243</sup>

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242. SEC v. Ripple Labs, No. 20 Civ. 10832, 2023 U.S. Dist. LEXIS 178300, at \*1 (S.D.N.Y. Oct. 3, 2023). The order denying the SEC's motion for interlocutory appeal emphasized the extensive review of the facts on summary judgment, *id.* at \*11, and the inefficiency of appellate interlocutory review, *id.* at \*21. Judge Torres stated that *Terraform Labs* "did not engage" with the "reasoning" of *Ripple Labs*, nor was it "required to" at the more plaintiff-friendly motion to dismiss stage, compared to the more demanding summary judgment standard that the judge applied in her July opinion, *id.* at \*17. Finally, because *Ripple Labs* only made claims about whether the specific sales constituted sales of securities, the holding was limited to these facts and did not have precedential value for a large number of cases, *id.* at \*12–13. See also Scott Mascianica et al., *The Latest from the World of Ripple and Its (Ripple) Effects*, HOLLAND & KNIGHT: SECOND OPS. BLOG (Nov. 2, 2023) <https://www.hklaw.com/en/insights/publications/2023/11/the-latest-from-the-world-of-ripple-and-its-ripple-effects> [<https://perma.cc/AWJ8-ALCJ>] (summarizing denial of SEC's motion for interlocutory appeal).

243. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (placing emphasis of *Howey* investment contract inquiry on the "economic reality" surrounding the transaction).

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