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Freeing Cryptoassets from Howey: A Defense of Genuine Token Offering

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FREEING CRYPTOASSETS FROM *HOWEY:* A DEFENSE OF GENUINE TOKEN OFFERINGS

ABSTRACT

The Securities Exchange Commission (SEC) is the most powerful regulator of the U.S. securities market and serves to "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[1] *The agency's task of protecting retail investors and regulating market participants has been, at times, reduced to a binary choice between "Main Street" investors and "Wall Street" insiders.*[2] *Some regulators and legislators rely on this binary to put pressure on cryptoassets, claiming that more regulation leads to more effective investor protections.*[3] *This Note rejects that premise. Genuine tokens offerings (i.e., unregistered security offerings not designed to defraud investors) must be allowed to enter the marketplace, without the red tape, in order for the SEC to properly fulfill its three-part regulatory mission.*

INTRODUCTION

Cryptoassets are caught between definitions and agencies due in part to the SEC's response to emerging technology.[4] The SEC is authorized by Congress to regulate transactions in securities,[5] which are fungible, tradeable financial instruments used to raise capital in a private or public company, either in the form of equity or debt.[6] To determine whether a token is a security, the SEC relies upon *SEC v. W.J. Howey Co.*: a Supreme Court case that defined what an "investment contract" is.[7] Under *Howey*, an instrument

1. SEC, ABOUT, https://www.sec.gov/about.shtml (last updated Nov. 22, 2016).

2. "I should say one more thing about our focus on retail investor protection. I reject the premise that we face a binary choice between protecting Main Street investors and policing Wall Street. To the contrary, I believe the two are complementary." Steven Peikin, Co-Director of Division of Enforcement, SEC, Keynote Speech at Southeastern Securities Conference 2019 (Sept. 6, 2019).

3. Jay Clayton, Chair, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017); Kevin Stankiewicz, *Sen. Elizabeth Warren shoots down a key reason investors buy bitcoin, calls for tighter regulation*, CNBC (July 28, 2021, 11:45 AM), https://www.cnbc.com/2021/07/28/sen-elizabeth-warren-doubts-bitcoin-as-inflation-hedge-wants-tighter-regulation.html. The terms "cryptoasset(s)," "digital asset(s)," "cryptocurrency," "token," and "coin" are used interchangeably in this Note and in the sources cited, unless otherwise specified.

4. "Perhaps no question has generated greater uncertainty than how to determine if a particular token is a security. What to do if a commonly traded asset is, in fact, deemed a security. We simply apply the securities laws. If it is not a security, there is a good chance it is a commodity, which would be subject to the requirements of the Commodity Exchange Act." K. Michael Conaway, Chair, Comm. On Agric., Opening Statement on Cryptocurrencies: Oversight of New Assets in the Digital Age (July 18, 2018).

5. 15 U.S.C. § 78b (2010).

6. Will Kenton, *Security,* INVESTOPEDIA (Mar. 20, 2021), https://www.investopedia.com/terms/s/security.asp.

7. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (2019).

is an "investment contract" when a person invests in a "common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[8] If a token falls under *Howey*'s definition of an investment contract, it must be registered with the SEC pursuant to 15 U.S.C. §§ 77e(a) and (c) prior to sale or delivery.[9] The notable exceptions to this rule are Bitcoin and Ether, which are considered commodities, rather than securities, thus falling under the Commodity Futures Trading Commission's (CFTC) jurisdiction.[10]

The SEC has interpreted *Howey* to mean that almost every cryptoasset offered through an initial coin offering (ICO) is a security and must be registered with the SEC.[11] In 2013, ICOs emerged as a fundraising tool for non-public blockchain-based companies to raise money.[12] Typically, entrepreneurs would offer coins in exchange for existing currencies, like Bitcoin or fiat currencies.[13] These entrepreneurs considered ICOs a preferable alternative to initial public offerings (IPOs) because it circumvented the SEC.[14] The early success of ICOs attracted fraudsters and, thus, the ire of regulators.[15] Then-SEC Chair Jay Clayton testified in a hearing in 2018: "I believe every ICO I've seen is a security."[16] Unfortunately for the cryptoassets market, this statement extends to genuine offerings, which also utilized ICOs to avoid security registration, but not to defraud investors.[17] Rather, genuine offerings rely on ICOs because security registration is (i) "lengthy, complex, and costly," (ii) impairs a token's most marketable feature: its "near instantaneous and seamless settlement of low-cost transactions;" and (iii) unclear given the case-by-case factual determination through which *Howey* is applied.[18] The economic

8. *Howey*, 328 U.S. 293, at 298–99 (1946).

9. 15 U.S.C. §§ 77e(a), (c) (2012) (prohibiting the sale or delivery of a security prior to filing a registration statement).

10. "And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value." William Hinman, Dir. Div. Corp. Fin., SEC, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018).

11. *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the Comm. on Banking, Hous., & Urb. Aff.*, 115th Cong. (2018) [hereinafter *Hearings*] (statement of Jay Clayton, Chairman of the SEC).

12. Usha R. Rodrigues, *Embrace the SEC*, 61 WASH. U. J. L. & POL'Y 133 (2020).

13. *Id.* at 134.

14. *Id.*

15. *Id.* at 135.

16. *Hearings, supra* note 11 (statement of Jay Clayton, Chairman of the SEC).

17. J. Carl Cecere, *Cryptocurrency's Future in the U.S. Is Threatened by SEC Action Against Ripple,* BLOOMBERG LAW (Apr. 19, 2021, 4:00 AM), https://news.bloomberglaw.com/securities-law/cryptocurrencys-future-in-the-u-s-is-threatened-by-sec-action-against-ripple.

18. *Id.*; Matthew Barrack, *Current Regulators Overseeing Cryptocurrencies Are Restricting Access to This Innovative New Technology*, 26 PIABA B. J. 453, 465 (2019).

impossibility is evident by the fact that no token has attempted this path of compliance nor is any forthcoming token expected to do so.[19]

Currently, the SEC does not differentiate these genuine offerings from fraudulent ones.[20] This cast-net fishing enforcement strategy has led to a significant number of enforcement actions against genuine offerings. For example, Ripple Labs, Inc.'s token, XRP (Ripple (XRP)), is not facing allegations that investors were defrauded but was still sanctioned by the SEC.[21] The significant number of SEC enforcement actions against genuine token offerings has led to a debate over whether the SEC's actions constitute an effective ban on emerging cryptoassets.[22] North Carolina Representative Ted Budd, a cryptoasset supporter, asked current SEC Chair Gary Gensler whether the agency intended to follow in China's steps after a 2021 declaration that all cryptoasset transactions are illegal (alleging gambling fraud and money laundering).[23] SEC Chair Gensler responded that he is "technology-neutral" and that it is "up to Congress" to decide whether to ban cryptoassets.[24] Despite the "neutral" stance it claims to take, the SEC's response to cryptoassets does not appear so, given that it (i) enjoined tokens solely for its registration status (even absent investor complaints);[25] (ii) has not adopted a fellow Commissioner's safe harbor proposal for genuine

19. "The bottom line of this is that, as a practical matter, it is completely economically impossible to treat the sale of utility tokens on a blockchain network that is intended to have broad participation as distributions of securities. If the expenses of Securities Act registration don't kill the firm, then the expenses of Securities Exchange Act regulation and the related regulatory burdens will. Indeed, the proof of this statement is in the pudding: no one has attempted this path to 'compliance' and we do not believe anyone will." Steven Lofchie et al., *The Securities Law Treatment of Utility Tokens (Or Why It Is Past Time for the SEC to Engage with the Hard Questions),* FRIED FRANK REGULATORY INTELLIGENCE (Jan. 11, 2022), https://www.findknowdo.com/news/01/13/2022/cabinet-commentary-securities-law-treatment-utility-tokens [hereinafter Lofchie, *The Securities Law Treatment of Utility Tokens*].

20. Rodrigues, *supra* note 12, at 149.

21. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24 at 6–7, SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020), ECF No. 123 (stating that XRP holders sought to intervene under Fed. R. Civ. P. 24 because the SEC's enforcement action harmed their property interests).

22. "Considering the applicability of the existing legal framework to ICOs implies the possibility of extending the federal securities law framework to ICOs. This would occur through the hermeneutic step of including ICOs within the definition of 'security' provided by the Securities Act (and the Securities Exchange Act). Although some construe this extension as a way to frustrate innovation, others argue that it may be a way to create a healthy environment by providing stability and predictability in the market." 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, 208 (2020).

23. Alex J. Rouhandeh, *U.S. Won't Follow China in Banning Crypto, SEC Chief Says*, NEWSWEEK (Oct. 5, 2021, 6:16 PM), https://www.newsweek.com/us-wont-follow-china-banning-crypto-sec-chief-says-1635940; *Notice on Further Preventing and Disposing of the Risk of Hype in Virtual Currency Trading*, THE PEOPLE'S BANK OF CHINA (Sept. 24, 2021, 5:00 PM), http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4348521/index.html.

24. *Id.*

25. SEC, CYBER ENFORCEMENT ACTIONS, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions (last visited Jan. 19, 2022).

offerings;[26] and (iii) has not fostered industry expertise to come to a compromise on a legal solution.[27]

At the forefront of this debate about the SEC's response to the cryptoassets market is Ripple (XRP).[28] Once the world's third most popular cryptoasset, Ripple (XRP) operated in the United States and other jurisdictions, including the United Kingdom, Japan, and Singapore, since 2013.[29] Then, on December 22, 2020, the SEC filed a complaint in the U.S. District Court for the Southern District of New York against Ripple (XRP) and its current and former CEO, Brad Garlinghouse and Chris Larsen, respectively, for an unregistered offering under *Howey*.[30] Unlike similar cases in the past that led to quick settlements,[31] Ripple (XRP) stated that it is unlikely to settle in a joint letter.[32] Instead, Ripple (XRP) filed an intention to present a fair notice defense, saying that the SEC failed to take action for years while it was operating in the United States.[33]

Trust between the SEC and public is crucial to investor protection, yet it appears that this relationship is tenuous "after years of conflicting and confusing guidance on the rules for cryptocurrencies."[34] One of the ways the SEC fulfils its mission to protect investors is through its Alerts and Bulletins, warning investors of potential scams.[35] Yet such investor alerts concerning fraudulent tokens appear to be widely ignored by cryptoasset holders, as scams like Ponzi and pump-and-dump schemes reached a record high in the first quarter of 2021.[36] A survey by the Cato Institute revealed that Americans

26. HESTER M. PEIRCE, COMM'N, SEC, TOKEN SAFE HARBOR PROPOSAL 2.0 (Apr. 13, 2021).

27. "[T]he specific complaint is not that crypto people *disagree* with regulators' decisions, but that the regulators are just not interested in working with them at all." Matt Levine, *Crypto Regulators Aren't Very Sympathetic*, BLOOMBERG (Sept. 22, 2021), https://www.bloomberg.com/news/newsletters/2021-09-22/crypto-regulators-aren-t-very-sympathetic-ktvrpa5i.

28. Roslyn Layton, *The Crypto Uprising The SEC Didn't See Coming,* FORBES (Aug. 30, 2021, 11:24 AM), https://www.forbes.com/sites/roslynlayton/2021/08/30/the-crypto-uprising-the-sec-didnt-see-coming/amp [hereinafter Layton, *The Crypto Uprising*].

29. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 7–8.

30. Cecere, *supra* note 17; SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 *1 (S.D.N.Y. Dec. 22, 2020).

31. SEC v. Telegram Group Inc., No. 1:19-cv-09439-PKC (S.D.N.Y. Mar. 24, 2020).

32. *See* Joint Letter, SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020), ECF No. 45 ("Counsel for the parties have met and conferred and, having previously discussed settlement, do not believe there is a prospect for settlement at this time.").

33. Answer of Defendant Ripple Labs, Inc. to Plaintiff's First Amended Complaint at 97, SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020), ECF No. 51; Roslyn Layton, *The SEC's Fair Notice, Starring William Hinman*, FORBES (July 19, 2021, 1:07 PM), https://www.forbes.com/sites/roslynlayton/2021/07/19/the-secs-fair-notice-farce-starring-william-hinman/?sh=6621b6a82f4f [hereinafter Layton, *The SEC's Fair Notice*].

34. Layton, *The Crypto Uprising*, *supra* note 28.

35. SEC, INVESTOR ALERTS AND BULLETINS, https://www.sec.gov/investor/alerts (last visited Oct. 23, 2021).

36. Emma Fletcher, *Cryptocurrency buzz drives record investment scam losses*, FTC (May 17, 2021), https://www.ftc.gov/news-events/blogs/data-spotlight/2021/05/cryptocurrency-buzz-drives-

are as distrustful of "Wall Street" as they are of Wall Street regulators, like the SEC, finding that 48 percent of Americans have "hardly any confidence" in such regulators.[37] Moreover, in a thread of tweets by the CEO and Co-Founder of Coinbase Brian Armstrong, he criticized the SEC's lack of cooperation with the cryptoassets market, describing the agency's behavior as "sketchy."[38] Thousands of users retweeted and responded to his thread.[39] Furthermore, a recent Forbes article characterized the public backlash to the SEC's lawsuit against Ripple as an "uprising," noting that, although cryptoasset holders are "not particularly pro-Ripple," the case represents the "last straw for crypto enthusiasts" as the public criticized the SEC on Twitter for "regulation by enforcement" and market confusion.[40]

Congress must pass legislation to permit genuine offerings of cryptoassets (i.e., unregistered securities not designed to defraud investors).[41] While there is ample reasoning of why courts should narrow the SEC's application of *Howey,* it is unlikely to occur given the long legislative history of Article III courts[42] deferring to administrative agencies, like the SEC, who have technical expertise in the subject matter that the courts lack.[43] Thus, Congressional intervention is crucial in this matter to avoid the adverse effects of a decision against Ripple (XRP).[44] Effective Congressional action would permit the SEC to retain its authority over truly fraudulent token offerings, while no longer wasting resources against genuine token offerings, like Ripple (XRP) (which is not facing allegations of defrauding investors).[45] The intended result would be an improved relationship between the SEC, market participants, and the cryptoasset holders, leading to more effective regulation and enforcement.

record-investment-scam-losses (finding between October 1, 2019 and March 31, 2020 approximately "twelve times the number of reports and nearly 1,000% more in reported losses").

37. Emily Ekins, *Wall Street vs. The Regulators: Public Attitudes on Banks, Financial Regulation, Consumer Finance, and the Federal Reserve*, CATO INST. (Sept. 19, 2017), https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer.

38. Brian Armstrong (@brian_armstrong), TWITTER (Sept. 7, 2021, 11:06 PM), https://mobile.twitter.com/brian_armstrong/status/1435439291715358721.

39. *Id.*

40. Layton, *The Crypto Uprising*, *supra* note 28.

41. Susan Friedman, *A Real Approach to Cryptocurrency Regulation,* RIPPLE (Nov. 16, 2021), https://ripple.com/insights/a-real-approach-to-cryptocurrency-regulation.

42. U.S. CONST. art. III, § 1 ("Article III courts" include the Supreme Court, Federal Circuit courts, and District courts).

43. Richard G. Himelrick, *Judicial Deference to SEC Precedent+,* 9 PIABA B. J. 61, 62–63 (Winter 2002).

44. David H. Freedman, *Why Ripple's SEC lawsuit could have a lasting impact on crypto*, FORTUNE (July 29, 2021), https://fortune.com/2021/07/29/ripple-xrp-sec-lawsuit-impact-on-crypto-industry; Gurbir Grewal, Dir. Div. Enf't., SEC, Scott Friestad Memorial Keynote Address (Nov. 8, 2021).

45. Cecere, *supra* note 17.

Part I of this Note is an overview of the *Howey* test and its effect on the current SEC cryptoassets regulatory regime. Part II explains Ripple (XRP)'s challenge to the SEC. Part III considers critics and proponents of the SEC's current application of the *Howey* test. Part IV assess the potential impact of the Ripple (XRP) decision on the cryptoassets market and how a Congressional solution could rectify the SEC's current cryptoassets regime.

I. THE HOWEY TEST AND CURRENT SEC REGIME

A. CRYPTOASSETS DEFINED

There are various terms for this instrument, including "digital asset," "digital token," "cryptocurrency," "virtual currency," or "digital coins."[46] These terms all refer to the same idea of an asset that is issued or transferred using distributed ledger or blockchain technology.[47] Blockchain is a digital, peer-to-peer database that records digital transactions in a secure way across a network of computers.[48] The earliest cryptoasset on blockchain was Bitcoin, which was described by a 2008 whitepaper as an electronic payment system where two parties could transact directly without the need of a trusted third party, like a bank.[49] Another key feature of Bitcoin is that there is no central authority to issue coins.[50] Rather, coins are added to circulation through individual "mining" which is incentivized by rewarding the "miner" in Bitcoin, much like a gold miner.[51] The transactions are validated through a "proof of work" model, in which a new block is added by solving an equation which the miners then verify to receive their reward.[52] By comparison, "non-mined" coins or tokens use a "proof-of-stake" model, under which certain holders are tasked with validating a blockchain and then rewarded with the aggregate transaction fees.[53]

One way to distinguish between cryptoassets is to classify them as either transactional, platform, or utility.[54] Transactional cryptoassets, like Bitcoin, were designed to be used as money (i.e., as an exchange for goods and

46. SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 *7 (S.D.N.Y. Dec. 22, 2020).
47. *Id.*
48. *Id.*
49. Satoshi Nakamoto, *Bitcoin: A Peer to Peer Electronic Cash System*, BITCOIN.ORG (Aug. 18, 2008), https://bitcoin.org/bitcoin.pdf.
50. *Id.*
51. *Id.*
52. *Id.*
53. Sean Williams, *The Basics of Mined vs. Non-Mined Cryptocurrency, Explained in Plain English*, MOTLEY FOOL (Mar. 26, 2018), https://www.fool.com/investing/2018/03/26/the-basics-of-mined-vs-non-mined-cryptocurrency-ex.aspx.
54. Street Authority, *3 Types of Cryptocurrencies You Need to Know,* NASDAQ (Jan. 15, 2018, 3:30 AM), https://www.nasdaq.com/articles/3-types-cryptocurrencies-you-need-know-2018-01-15.

services).[55] They are intended to replace government-issued currency.[56] Platform cryptoassets, like Ether, were designed to serve other purposes, like creating markets or launching other cryptoassets.[57] Ethereum is the decentralized platform through which Ether was issued.[58] Lastly, utility cryptoassets, like Ripple (XRP), were designed to transfer fiat money (i.e., money not backed by precious metals, like the U.S. dollar) in a cheaper and faster manner.[59] However, some security practitioners say that Ether is also a utility token, akin to Ripple (XRP).[60] Prior to the SEC enforcement action against Ripple (XRP), it was used by banks and institutions like UBS, Santander, BMO, and American Express.[61] Unlike Bitcoin, Ripple (XRP) is not mined.[62] Rather, it has a "unique system for validating transactions in which participating nodes conduct a poll to verify transactions."[63]

An alternative categorization identifies cryptoassets as either altcoins or tokens.[64] Under this categorization, Bitcoin, as the foremost cryptoasset, sits alone: neither an altcoin nor token.[65] Altcoins, or "alternative to Bitcoin," like Ether or Litecoin, are any cryptoasset launched to improve upon Bitcoin.[66] Tokens are those which were created and distributed through an ICO, like a stock.[67] Thus, Ripple (XRP) is a token under this categorization method.[68] However, this distinction between Ether and Ripple (XRP) is, again, unclear, because Ether was also originally funded through an ICO.[69]

The last fundamental categorization is the distinction between cryptoassets and "real" money.[70] Section 102(23) of the Uniform Law Commission defines virtual currency as a "digital representation of value" that serves as a "medium of exchange, unit of account, or store of value" but is not legal tender.[71] Financial Crimes Enforcement Network (FinCEN) took a similar position in 2013, saying that virtual currencies are a "medium of

55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*
60. Lofchie, *The Securities Law Treatment of Utility Tokens*, *supra* note 19.
61. Street Authority, *supra* note 54.
62. SoFi, *Understanding the Different Types of Cryptocurrency,* SOFI LEARN (Sept. 17, 2021), https://www.sofi.com/learn/content/understanding-the-different-types-of-cryptocurrency.
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. Bernard Marr, *What Is the Difference Between Bitcoin And Ripple?* BERNARD MARR & CO., https://bernardmarr.com/what-is-the-difference-between-bitcoin-and-ripple (last visited Mar. 9, 2022).
69. CRYPTOPEDIA, *Ethereum and the ICO Boom* (Mar. 10, 2022), https://www.gemini.com/cryptopedia/initial-coin-offering-explained-ethereum-ico.
70. Susan Alkadri, *Defining and Regulating Cryptocurrency: Fake Internet Money or Legitimate Medium of Exchange?* 17 DUKE L. & TECH. REV. 71, 76 (2018).
71. UNIF. REGULATION OF VIRTUAL-CURRENCY BUS.'S ACT 10 (UNIF. L. COMM'N 2017).

exchange that operates like a currency in some environments, but does not have all the attributes of real currency [and] does not have legal tender status in any jurisdiction."[72] The IRS followed FinCEN's definition.[73] New York State also explicitly differentiates fiat currencies and virtual currencies.[74] The SEC and the CFTC do not have a definition for cryptoassets but, rather, opt for "broader, more technology-agonistic definitions."[75]

B. THE CRYPTOASSET REGULATORY REGIME

As of today, there is no federal regulatory framework for the cryptoassets market.[76] Critics argue that the result is "regulation by enforcement," a due process challenge against administrative agencies who create a rule via an adjudication, which denies market participants their purported right to advanced notice of prohibited conduct available through notice-comment rulemaking procedures.[77] The SEC Division of Enforcement Director Gurbir Grewal rejects this criticism, saying that this is "not 'regulation by enforcement'" in the cryptoassets market because Article III courts have affirmed the SEC's decisions in the cryptoassets market "time and again."[78]

Under the Administrative Procedure Act, administrative agencies, like the SEC and the CFTC, are empowered by Congress to act with the authority of the Government of the United States within their specified jurisdiction.[79] Agencies are authorized to regulate by rulemaking or adjudication (i.e., enforcement).[80] When agencies regulate by enforcement, it is based on the notion that the agency's rules and regulations are clear enough for market participants to know what is illegal.[81] However, Article III courts defer to administrative agencies, like the SEC, when choosing between promulgating a rule through notice-comment procedures or working on a case-by-case basis through adjudication.[82] Absolute discretion has been restricted a few

72. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF TREASURY, FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (Mar. 18, 2013).

73. INTERNAL REVENUE SERV., NOTICE 2014-21 (2014).

74. N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2 (2020).

75. JOE DEWEY, GLOBAL LEGAL INSIGHTS, BLOCKCHAIN & CRYPTOCURRENCY LAWS AND REGULATIONS 2022 | USA 385 (Joe Dewey ed., 3rd ed. 2021).

76. Douglas S. Eakeley et. al., *Crypto-Enforcement Around the World*, 94 S. CAL. L. REV. POSTSCRIPT 99, 100 (2021).

77. *Id.;* Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement,* 7 YALE J. ON REG. 149, 167 (1990); 5 U.S.C. § 553(b)-(c) (1966) (notice-comment rulemaking procedures, also known as informal rulemaking, require public notice of the rulemaking followed by a period of time to receive comments on the proposal).

78. Grewal, *supra* note 44.

79. 5 U.S.C. § 551(1) (2011).

80. Eakeley, *supra* note 76, at 100.

81. *Id.* at 99.

82. "[T]he choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency." SEC v. Chenery Corp., 332 U.S. 194, 202–03 (1947).

times by the courts when there is "abuse of discretion," identified by three themes:

> [1] a concern about the "functional" appropriateness of agency adjudication when functionally the matter seems better suited for treatment by rulemaking; [2] a concern about the fairness of using an adjudication to establish a new agency policy when adjudicative results normally are applied retroactively; and [3] a concern about the agency acting inconsistently with its own initial decision to use the rulemaking process.[83]

The SEC has jurisdiction to regulate securities under the Securities Act of 1933 and Securities Exchange Act of 1934.[84] The term "security" is defined under the Exchange Act as:

> . . . any note, stock, treasury stock, security future, security based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or . . . investment contract . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[85]

The cryptoassets analysis emerges under the question of when an ownership interest in a legal entity or physical asset constitutes a "stock" or "investment contract."[86] The Supreme Court set the standard test for this question in *Howey*.[87] If a cryptoasset is determined to be a security, the issuer must submit a registration statement with the SEC.[88] As discussed below, the SEC has interpreted *Howey* to extend to almost every cryptoasset on the market.[89]

Typically, cryptoassets that do not fall under the SEC's jurisdiction, like Bitcoin and Ether, fall under the CFTC's jurisdiction.[90] The CFTC has

83. William D. Araiza, *Agency Adjudication, The Importance of Facts, and the Limitations of Labels*, 57 WASH. & LEE L. REV. 351, 355 (2000).

84. Securities Act of 1933, 15 U.S.C. §§ 77a-aa; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-qq.

85. 15 U.S.C. § 78c(a)(10) (2012).

86. Steven Lofchie, *Lofchie's Guide to Broker-Dealer Regulation—What is a Security?—Ownership Interests,* FRIED FRANK REGULATORY INTELLIGENCE (May 14, 2015), https://www.findknowdo.com/us-federal/fried-frank/law-firm-analysis/bd-guide-what-security-ownership-interests [hereinafter Lofchie, *What is a Security?*].

87. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

88. 15 U.S.C. §§ 77e(a), (c) (2012).

89. *Hearings, supra* note 11 (statement of Jay Clayton, Chairman of the SEC, noting, "I believe every ICO I've seen is a security.").

90. Hinman, *supra* note 10 ("And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.").

jurisdiction to regulate the commodities market.[91] The term "commodity" includes a specified list of assets (i.e., wheat and cotton) but also a more open-ended provision, which includes "all services, rights, and interests . . . in which contracts for future delivery are present or in the future dealt in."[92] Bitcoin and Ether are convertible virtual currencies and thus commodities, according to the CFTC.[93] That said, the CFTC does not regulate the cryptoasset itself.[94] The CFTC's oversight of cryptoassets is limited to when a "virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce."[95] As explained by CFTC Commissioner Dawn D. Stump, while commodities, like Bitcoin and Ether, are spoken as falling under CFTC jurisdiction, it is imperative to clarify that the CFTC's authority is restricted specifically to futures contracts and other derivatives products (e.g., swaps) on commodities.[96]

C. HOWEY EXPLAINED

In *Howey,* the Supreme Court set the standard test for determining whether an ownership interest in an asset is an "investment contract" (i.e., a security).[97] In *Howey*, the controversy concerned the sale of real estate contracts in citrus groves which offered buyers the option to lease the land back in exchange for a share of profits from the sales of such fruit.[98] The Supreme Court held that the agreements entered were "investment contract[s]" under Section 3(a)(10) of the Exchange Act.[99] In doing so, the Supreme Court laid out the "*Howey Tes*t," defining an "investment contract" as a scheme involving: (1) the investment of money (2) in a common enterprise (3) with profits to come solely from the efforts of others.[100]

Despite the breadth of the test, there are limitations.[101] For example, the SEC has determined that Bitcoin fails the *Howey* test.[102] The first prong of *Howey* is satisfied because holders may be using Bitcoin as an investment.[103]

91. 7 U.S.C. § 2(a)(1)(A) (2015).
92. 7 U.S.C. § 1a(9) (2010).
93. Press Release 8051-19, U.S. Commodity Futures & Trade Comm'n (Oct. 10, 2019), https://www.cftc.gov/PressRoom/PressReleases/8051-19; *Bitcoin Basics,* U.S. COMMODITY FUTURES & TRADE COMM'N, https://www.cftc.gov/sites/default/files/2019-12/oceo_bitcoinbasics0218.pdf (last visited Nov. 5, 2021).
94. Dawn D. Stump, Comm'r, U.S. Commodity Futures Trading Comm'n, Digital Assets: Clarifying CFTC Regulatory Authority & the Fallacy of the Question, "Is it a Commodity or a Security?" (Aug. 23, 2021).
95. *Bitcoin Basics, supra* note 93.
96. Stump, *supra* note 94.
97. Lofchie, *What is a Security*, *supra* note 86.
98. *Id.*
99. *Id.*
100. *Id.*
101. Barrack, *supra* note 18, at 468.
102. *Id.*
103. *Id.*

However, the "common enterprise" prong fails because the investor assets are not pooled.[104] Additionally, the third prong also fails because the value is based on speculation, not the effort of others, either in a managerial or entrepreneurial sense.[105]

Yet the SEC's reliance on *Howey* actually limits its jurisdiction, given that more than half of the cryptoassets market is outside of its authority.[106] SEC Director of the Division of Corporate Finance William Hinman stated that *Howey* clearly applies when a promoter, intending to raise funds, sells tokens to investors, who expect to earn a return.[107] SEC Director Hinman contended that *Howey* could extend to a secondary sale of a token acquired from an ICO.[108] Yet the sale of a token, which may initially meet the definition of security under *Howey*, may later fail the test if the network becomes sufficiently decentralized.[109] The most famous example of this is the creation of Ether, which has never been subject to SEC sanctions, but was initially a security under *Howey* (offered through an ICO) before becoming sufficiently decentralized and thus, a commodity.[110]

The SEC's application of a decades old case to new, complex technological innovations has long been the subject of criticism.[111] For one, it seems to stretch the limits of the Administrative Procedure Act by assuming that a case from 1946 is appropriate for the cryptoassets market, which just emerged in 2008.[112] As one critic put it: "[T]he SEC offered no clear guidance other than to say that a laundromat token is not a security and then to point to the '*Howey* test.'"[113] Additionally, SEC's strategy protects early tokens, like Ether, and rejects emerging market participants.[114]

104. *Id.*
105. *Id.*
106. Timothy G. Massad, *It's Time to Strengthen the Regulation of Crypto-Assets,* BROOKINGS INST. (Mar. 18, 2019), https://www.brookings.edu/wp-content/uploads/2019/03/Timothy-Massad-Its-Time-to-Strengthen-the-Regulation-of-Crypto-Assets-2.pdf.
107. Hinman, *supra* note 10.
108. *Id.*
109. *Id.*
110. *Id.*
111. Eakeley, *supra* note 76, at 100.
112. *Id.*
113. J. P. Schmidt & Tung Chan, *The Future Infrastructure of Business: A Primer on Blockchain and the Evolving Regulations,* 13 HAW. B.J. 13, 17 (2020).
114. James J. Park & Howard H. Park, *Regulation by Selective Enforcement: The SEC and Initial Coin Offerings*, 61 WASH. U. J.L. & POL'Y 99, 103 (2020).

D. EVOLUTION OF THE SEC'S CRYPTOASSET REGIME

At the beginning of the "Internet Era,"[115] the standard for U.S. regulators was to use a "do no harm" approach to emerging technology.[116] According to the then-CFTC Chair J. Christopher Giancarlo, the "do no harm" approach included "avoid[ing] undue restrictions, support[ing] a predictable, consistent and simple legal environment and respect[ing] the 'bottom-up' nature of the technology and its development in a global marketplace."[117]

The SEC never formally adopted the "do no harm" approach to the cryptoassets market and waited to take a stance.[118] That changed beginning with a 2017 DAO Report in which the SEC stated that many ICOs of new cryptoassets were unregistered securities offerings.[119] According to the CFA Institute Research Foundation, this guidance was the basis of the SEC's subsequent enforcement activity in the ICO market.[120]

The first significant enforcement action occurred in 2017, when the SEC determined that the Munchee ICO to fund the "MUN" coin was an unregistered securities offering.[121] Here, the SEC's conclusion turned on the marketing and selling of MUN tokens as investments.[122] Although the tokens were designed to be used in connection with an app, the SEC found that the issuers did not focus on that element when pitching to the public but rather the investment opportunity.[123] The SEC determined that this created a "reasonable expectation of obtaining a future profit based upon [the developer's] efforts."[124] Therefore, the SEC concluded that MUN tokens were "investment contracts" under *Howey*.[125]

115. Dell'Erba, *supra* note 22, at 177 ("The so-called Internet era started exactly twenty-five years ago as a mass phenomenon, when the European Center for Nuclear Research ("CERN") made the most famous software associated with it (the "world wide web") free, renouncing any rights to the software protocols created by its researcher Tim-Berners Lee.").

116. *Id.* at 192.

117. Christopher J. Giancarlo, Chairman, Comm. Fut. Trading Comm'n, Special Address before the Depository Trust & Clearing Corporation 2016 Blockchain Symposium: Regulators and the Blockchain (Mar. 29, 2016).

118. Dell'Erba, *supra* note 22, at 195.

119. SEC, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(a) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO, at 10 (2017).

120. Matt Hougan & David Lawant, *Cryptoassets: The Guide to Bitcoin, Blockchain, and Cryptocurrency for Investment Professionals*, CFA INST. (Feb. 24, 2021), https://www.cfainstitute.org/en/research/foundation/2021/cryptoassets.

121. IN RE MUNCHEE INC., SECURITIES ACT RELEASE NO. 10445 (Dec. 11, 2017) (Munchee explained on its website that the MUN token would work with the Munchee App to pay users for writing food reviews, sell both advertising to restaurants, and exchange with users for "in-app" purchases.).

122. Stephen P. Wink, et al., *Digital Asset Regulation: Howey Evolves*, LATHAM & WATKINS (Jan. 15, 2020), https://www.lw.com/thoughtLeadership/review-of-securities-commodities-regulation-digital-asset-regulation-howey-evolves.

123. *Id.*

124. *Id.*

125. *Id.*

In another significant action, the SEC enjoined Telegram Group Inc.'s "Gram" token in October 2019, determining that it was an unregistered securities offering.[126] The SEC alleged that Telegram's "Gram Purchase Agreement" is similar to a simple agreement for future tokens.[127] Under the agreement, Telegram would give purchasers the right to apply the investment amount to purchase Grams at a fixed price at the time that Telegram's "TON Network" would be launched.[128] Based on the marketing materials, the SEC concluded it was a security because Gram purchasers expected their profits to be directly derived from Telegram's efforts to build the TON Network.[129]

Another major action was the SEC's enforcement action against Kik Interactive, Inc.'s Kin token.[130] The SEC privately notified Kik of its investigation into its September 2017 ICO.[131] Kik released its response *publicly*, seemingly out of defiance, arguing that the SEC had failed to "develop a regulatory structure that would make sense for [] emerging technologies," and had instead "doubl[ed] down on a deeply flawed regulatory and enforcement approach."[132] Specifically, Kik argued that the SEC had "mapped out a[n] . . . aggressive position . . . that effectively threatens enforcement action against nearly all token offerings," including those that did not fit comfortably within the traditional definition of a "security."[133]

Despite Kik's strong language, the court granted the SEC's motion for summary judgement on September 30, 2020.[134] The factual contention was whether the distribution of Kin, which involved two transactions, (1) a pre-sale of contractual rights and (2) the sale of Kin to the public, were separate or intertwined and sufficiently decentralized.[135] The SEC claimed that the two transactions happened at the same time and were thus intertwined, but Kik responded that they were not, explaining that the sale of tokens only began after the pre-sale.[136] While the court acknowledge that Kik and Telegram were distinguishable on procedural and factual grounds, it ultimately ruled in favor of the SEC on its motion for summary judgement, determining that, despite Kik's claims, Kin was not sufficiently decentralized

126. SEC v. Telegram Group Inc., No. 1:19-cv-09439-PKC at 1 (S.D.N.Y. Mar. 24, 2020).
127. Wink, *supra* note 122 at 9.
128. *Id.*
129. Telegram described the "TON Network" as a new blockchain platform which would be funded by the sale of Grams and would function within Telegram Messenger. *Telegram,* No. 1:19-cv-09439-PKC at 11, 17.
130. SEC v. Kik Interactive, Inc., No. 19-cv-05244 (S.D.N.Y. filed Jun. 4, 2019).
131. Wink, *supra* note 122 at 9.
132. *Id.* at 3–4.
133. *Id.* at 4.
134. Carol R. Goforth, *Regulation of Crypto: Who Is the Securities and Exchange Commission Protecting?*, 58 AM. BUS. L.J. 643, 667 (2021).
135. *Id.* at 666.
136. *Id.* at 667.

and the two transactions of the offering were intertwined and constituted a "single plan of financing with a single purpose."[137]

Despite the series of enforcement actions, the rules determining what coins and tokens fall under SEC jurisdiction remain unclear.[138] The status of Ether was uncertain until the SEC clarified that it was no longer considered a security in several statements.[139] Bitcoin was also deemed to not be a security by then-Chair of the SEC Jay Clayton, somewhat grudgingly.[140] Yet Bitcoin and Ether appeared to be rare exceptions, given Clayton's testimony in a hearing on Virtual Currencies in 2018: "I believe every ICO I've seen is a security."[141]

II. THE SEC'S CASE AGAINST RIPPLE (XRP)

Possibly the strongest challenge to the SEC's cryptoasset regime yet comes from Ripple in defense of the XRP token.[142] The action began on December 22, 2020 when the SEC filed a complaint against Ripple (XRP) and its current and former CEO, Brad Garlinghouse and Chris Larsen, respectively, for an unregistered cryptoasset security offering.[143] The SEC alleged that since 2013, the defendants had sold $1.38 billion worth of XRP without registering the offers or sales, in violation of the Securities Act.[144] Based on its interpretation of Congress's intent, the SEC stated that security registration was necessary because the mandatory disclosures were critical to investors making informed decisions.[145] Thus, the SEC condemned Ripple (XRP)'s unregistered offering as creating an "information vacuum," which harmed investors.[146] While Ripple has disclosed some information, the SEC determined that pertinent information was missing.[147]

137. *Id.* at 667–68.

138. Layton, *The Crypto Uprising*, *supra* note 28.

139. Hinman, *supra* note 10; FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS, *supra* note 7.

140. "[T]here are different types of cryptoassets. . . . Bitcoin . . . has been determined by most people to not be a security." Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin is not a security*, COIN CTR. (Apr. 27, 2018), https://www.coincenter.org/sec-chairman-clayton-bitcoin-is-not-a-security.

141. *Hearings, supra* note 11 (statement of Jay Clayton, Chairman of the SEC).

142. Joint Letter, *supra* note 32.

143. SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 * 1 (S.D.N.Y. Dec. 22, 2020).

144. *Id.*

145. *Id.* at *5.

146. *Id.* at *2, *5.

147. "In fact, throughout the Offering, Ripple held itself out as the primary source of information on XRP. Ripple's website contained select information about how and where to buy XRP, XRP market data, and news and insights related to XRP. In the Markets Reports for the third quarter of 2019, Ripple made clear it would 'take proactive steps' to address the 'spread of misinformation' about Ripple's alleged 'dumping' of XRP and to address the 'fear, uncertainty, and doubt' about investing in XRP spread by others. Ripple thus held itself out as the legitimate source of information essential for investors, inviting them to rely on what Ripple chose to disclose." *Id.* at *36.

The SEC further alleged that Ripple acted in opposition to legal advice, as early as 2012, when the SEC warned Ripple that the offering might be considered an "investment contract" under *Howey* and therefore would be subject to federal securities laws.[148] The SEC inferred that Ripple should have known XRP was a security because, in Ripple's internal communications, they frequently referred to XRP's speculative nature;[149] led investors to expect that Ripple would be key to driving the "success or failure" of XRP;[150] pooled the funds raised in the offering to fund its operations;[151] are the largest single holder;[152] and did not sell XRP in the offering for "use" or as a "currency."[153] Ripple (XRP) is potentially facing a $600 million disgorgement, including prejudgment interest; a ban from participation in any digital asset security offering; and civil money penalties.[154]

Ripple (XRP) rejects the SEC's application of *Howey*.[155] First, Ripple noted that the SEC already recognized XRP as a currency from 2013 to 2020, when it was openly traded on over two hundred exchanges with Bitcoin and Ether (which the SEC publicly deemed as non-securities).[156] At the time, Bitcoin, Ether, and XRP were repeatedly referred to as a new nascent asset class.[157] In 2018, Gensler (now the Chair of the SEC) described XRP as a "*bridge currency*" between two Central Bank Digital Currencies.[158]

148. *Id.* at *6–7.

149. "Defendants understood and acknowledged in non-public communications that the principal reason for anyone to buy XRP was to speculate on it as an investment." *Id.* at *34.

150. "From the outset of the Offering, Defendants publicly promised significant, meaningful entrepreneurial efforts with respect to XRP. . . . During the Offering, not only did Ripple *promise* efforts that could lead to the increase in value of XRP, it actually *made and touted* extensive entrepreneurial and managerial efforts—made with proceeds from the Offering—to the market." *Id.* at *37, *42.

151. "Moreover, Ripple pooled the funds it raised in the Offering and used them to fund its operations, including to finance building out potential 'use' cases for XRP, paying others to assist it in developing a 'use' case, constructing the digital platform it promoted, and compensating executives recruited for these purposes. Ripple did not segregate or separately manage proceeds from different XRP purchasers in the Offering. The nature of XRP itself made it the common thread among Ripple, its management, and all other XRP holders." *Id.* at *45–46.

152. "Currently, Ripple continues to make clear on its website that it holds at least 54 billion XRP, making it by far the largest single holder of the asset." *Id.* at *48.

153. "The first potential use that Defendants touted for XRP—to serve as a 'universal digital asset' and/or for banks to transfer money—never materialized. . . . Ripple has never offered or sold XRP as 'currency,' as that term is used in the federal securities laws. Throughout the Offering, Ripple never restricted offers or sales of XRP solely to purchasers who had a need for alternatives to traditional, fiat currencies, nor did Ripple promote XRP as an instrument for consumers to purchase goods or services." *Id.* at *56, *60.

154. *Id.* at *70.

155. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 6–7.

156. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 97.

157. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 2.

158. *Id.* at 3.

Ripple also pointed out that other United States and foreign regulators have recognized XRP as a non-security.[159] In 2015 and 2020, the Department of Justice and the FinCEN entered into an agreement with Ripple stating XRP would be considered virtual currency and its use would be registered exclusively with FinCEN, not the SEC.[160] In June 2020, CFTC Chair Giancarlo stated that XRP is more like an alternative currency than a security and should have the same legal status as Bitcoin or Ether.[161] Additionally, Japan, Singapore, and the United Kingdom all declared XRP to be a non-security.[162]

Second, Ripple claims that the SEC's action, inaction, and acquiescence over the past eight years demonstrates that XRP is not a security.[163] Per Ripple's timeline,[164] the SEC authorized Ripple's purchase into MoneyGram International as a 9 percent minority holder in order to distribute XRP.[165] In June 2018, SEC Director Hinman publicly stated that when a digital asset becomes decentralized (like Bitcoin and Ether), it is no longer considered an "investment contract" (or "security").[166] Then, in 2019, the SEC met with an exchange to determine the legal status of XRP and did not attempt to dissuade it from listing or trading XRP, as it soon did.[167] That same year, SEC Chair Clayton agreed with SEC Director Hinman's explanation of how a digital asset may evolve past the conditions for an "investment contract."[168] Later, the SEC accepted a firm's Code of Ethics which included a section saying that it would allow investments in Bitcoin, Ether, and XRP because they "are generally accepted to be currencies and not currently subject to regulation by the SEC."[169] In the months leading up to the enforcement action, the SEC continued to tell XRP holders that it had made no determination on the status of XRP as a security.[170]

The SEC was also divided on whether this enforcement action was proper.[171] In December 2020, former SEC Commissioner Joseph Grundfest

159. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 2.
160. *Id.*
161. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 3.
162. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 42.
163. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 12–13.
164. *Id.* at 8–10.
165. *Id.* at 8.
166. *Id.* at 3–4.
167. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 98–99.
168. Defendant's Memorandum of Law in Support of Motion to Intervene Pursuant to Federal Rules of Civil Procedure 24, *supra* note 21, at 4.
169. *Id.*
170. *Id.* at 5.
171. *Id.*

warned the SEC that an enforcement action against XRP would gravely affect individual holders and users and that the SEC risked challenges to its exercise of discretion by filing an enforcement when it had not made a material distinction between Ether and XRP.[172] Additionally, in March 2021, SEC Commissioner Hester Peirce said in an interview that the SEC thinks of *tokens* as securities and would do better to look at the *offering as a whole*.[173]

Third, Ripple contended that XRP holders use the tokens in ways other than as a speculative investment.[174] Some use XRP exclusively in a consumer (non-speculative) capacity[175] as (1) a substitute for fiat currency for everyday purchases at Walmart, Amazon, Target and millions of other businesses;[176] (2) direct payments for over 500 shopping markets, 300 internet service providers, 500 crypto-services, and 30 tourism businesses;[177] (3) collateral to secure loans in fiat currency;[178] and (4) donations to charities and other organizations.[179]

Other developers use XRP operationally within their business model[180] by (1) using the XRP's decentralized exchange for the digitalization of different assets, such as stocks, bonds, and commodities[181] and (2) creating consumer products such as the Xumm Wallet which utilizes the XRP Ledger to store multiple cryptoassets, including Bitcoin, Ether, and XRP.[182]

Further, other XRP holders use XRP in a mixed use capacity as (1) a payment for goods and/or services rendered;[183] (2) "micropayments for providing content on YouTube, Coil and other media outlets;"[184] (3) a means of tokenizing nonfungible tokens;[185] (4) "a bridge currency to transfer one asset from one exchange to another;"[186] (5) a faster and lower-cost method for purchasing and moving other assets such as Bitcoin and Ether[187] and foreign fiat concurrencies (i.e., Pesos, Euros, Yen);[188] (6) as a way of "send[ing] money to friends and family around the world;"[189] (7) "cross-border payments between the United States and Mexico, Europe, the

172. *Id.*
173. *Id.*
174. *Id.* at 6.
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.* at 7.

Philippines, Thailand, and other [countries];"[190] and (8) as a way of purchasing Ripple stock through businesses like Linqto, Inc.[191]

Fourth, Ripple challenges the SEC action for naming only Ripple (XRP) and its current and former CEO when, in effect, it truly penalizes its holders.[192] Ripple claims that the SEC wrongly asserts that XRP holders (1) have no independent options related to the utility of XRP, without Ripple, and (2) lack the ability to develop or grow the XRP ecosystem independent of Ripple's efforts.[193] According to Ripple, the SEC is attempting to force XRP into its analysis of *Howey* by claiming all XRPs are unregistered securities because "XRP investors stand to profit equally if XRP's popularity and price increase,"[194] and, therefore, all XRP holders entered into a common enterprise with Ripple.[195] Ripple takes issue specifically with the quoted language, saying that such an interpretation is "reckless and dangerous" because it "could be applied not only to every cryptocurrency but every commodity [like Bitcoin, Ether, Gold, and Silver]."[196]

III. THE (MIS)APPLICATION OF THE HOWEY TEST

A. CRITICISM OF "REGULATION BY ENFORCEMENT"

Critics of the current SEC approach to the cryptoassets market – calling it "regulation by enforcement" – highlight several issues, including (i) tension with the goals of the Administrative Procedure Act;[197] (ii) dissonance with equivalent foreign regulators;[198] and (iii) tumult with the market participants, which has affected the agency's relationship with cryptoasset holders.[199]

First, there are concerns that the SEC's cryptoasset regime goes against the Administrative Procedure Act.[200] Specifically, the criticism centers around the SEC's broad interpretation of the definition of an "investment contract" from *Howey*, a case which predates the cryptoassets market by several decades, for the bulk of its strategy.[201] Thus, the SEC is inferring that its actions have sufficiently forewarned market participants of the what actions are illegal.[202] Yet, there is empirical evidence that this combination

190. *Id.*
191. *Id.*
192. *Id.* at 8.
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.*
197. Eakeley, *supra* note 76, at 100.6
198. *Id.* at 100–101.
199. Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. CORP. L. 629, 677–78 (2021).
200. Eakeley, *supra* note 76, at 100.
201. *Id.* at 117; SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).
202. Eakeley, *supra* note 76, at 99.

of functional definitions (i.e., the broad interpretation of "security" from *Howey*) and enforcement increases uncertainty, given nearly a hundred cryptoassets issued through an ICO without registration.[203] Additionally, the Administrative Procedure Act requires notice-comment procedures for rulemaking, which critics argue the SEC has sidestepped by issuing rulemaking through enforcement.[204] However, this challenge does not appear likely to succeed, given that the SEC has not lost a single cryptoasset case, either in an Article III or administrative court.[205]

Second, the SEC is out of step with equivalent foreign regulators.[206] Recent data on crypto-enforcement around the world found that the "intensity of [the SEC's] enforcement" stands out on the global stage.[207] Of twenty-three financial markets examined in a 2021 academic study, only fourteen countries commenced enforcement actions or issued official warnings against cryptoassets market.[208] Many countries do not rely on enforcement, as the SEC does, but rather, issue guidance and warning letters.[209] France, for example, is very active, but focuses mainly on issuing warnings and blacklisting certain entities.[210] One reason for the SEC's outsized enforcement activity may be that its financial markets are significantly larger.[211] However, this is not an adequate explanation given that Singapore has a significant share of token ICOs and yet, Singapore's enforcement action are significantly less than the SEC's.[212]

The use of self-regulatory initiatives in the cryptoassets market is another distinction between the SEC and foreign securities regulators.[213] The International Organization of Securities Commissions (IOSCO), an international industry association, recommends self-regulatory organizations (SROs) as a tool for securities regulation.[214] Historically, the SEC has delegated a significant part of its regulatory powers to SROs, which are

203. Guseva, *supra* note 199, at 632; CYBER ENFORCEMENT ACTIONS, *supra* note 25.

204. 5 U.S.C. § 553(b)-(c) (1966); Tessa E. Shurr, *A False Sense of Security: How Congress and the SEC are Dropping the Ball on Cryptocurrency*, 125 DICK. L. REV. 253, 278 (2020).

205. Guseva, *supra* note 199, at 646.

206. Eakeley, *supra* note 76, at 100.

207. *Id.* at 102, 109–113; John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 242 (2007).

208. Eakeley, *supra* note 76, at 108.

209. *See, e.g., SFC Warns of Cryptocurrency Risks*, SEC. & FUTURES COMM'N (H.K.) (Feb. 9, 2018), https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR13; *Swiss Regulator Cracks Down on Fraudulent Crypto Activities*, SWI (Apr. 2, 2020, 3:28 PM), https://www.swissinfo.ch/eng/finma-annual-report_swiss-regulator-cracks-down-on-fraudulent-crypto-activities/45663186 [https://perma.cc/M79V-2DVQ].

210. Eakeley, *supra* note 76, at 113.

211. *Id.* at 103.

212. *Id.* at 103, 118.

213. Dell'Erba, *supra* note 22, at 220.

214. Int'l Org. of Sec. Comm'ns [IOSCO], *Objectives and Principles Of Securities Regulation* 5 (May 2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf.

owned and operated by their members.[215] Examples of SROs include the National Association of Securities Dealers, the New York Stock Exchange, the Chicago Board Options Exchange, and regional stock and option exchanges.[216] After the 2008 financial crisis, SROs were heavily-criticized based on the assumption that they were operating mainly for the benefit of their members.[217] However, in practice, SROs do not opt for systematic deregulation.[218] Rather, their activities are similar to regulators, which include issuing examinations and licenses, promulgating rules that govern their members' practices, and enforcing their rules and the federal laws.[219] Aside from helping administrative agencies fulfil their regulatory work, SROs also cultivate specialized industry representatives that work with regulators to create effective regulatory solutions.[220]

Foreign securities regulators have successfully adopted SROs into their regulatory framework for the cryptoassets market in Switzerland, Hong Kong, the United Kingdom, and Japan.[221] The Swiss Financial Market Supervisory Authority (FINMA) authorized the SRO "Crypto Valley Association" to create independent policies, which is credited with facilitating the emergence of one of the global blockchain hubs.[222] In practice, SROs in foreign jurisdiction demonstrate how important they are for regulators because they facilitate regulatory debate within their industry.[223]

While some private organizations have emerged in the United States, they are not endorsed by administrative agencies.[224] Currently, the Virtual Commodity Association (VCA) is the first SRO to emerge in the cryptoassets market for securities regulation.[225] The VCA was proposed by Cameron and Tyler Winklevoss in 2018 and modeled after the National Futures Association (NFA), an SRO that regulates the futures market and is overseen by the CFTC.[226] However, the VCA is not as impactful as other SROs, like the NFA, because it is not overseen by an administrative agency, nor is membership required by an administrative agency.[227] By not utilizing SROs like foreign securities regulators have, the SEC is not cultivating specialized

215. Dell'Erba, *supra* note 22, at 220.
216. *Id.* at n.270.
217. *Id.* at 219–220.
218. *Id.* at 220.
219. *Id.*
220. *Id.*
221. *Id.* at 220–221.
222. *Id.*
223. *Id.* at 220.
224. Katarina Weessies, *The Virtual Commodity Association And The Uphill Battle For Cryptocurrency Self-Regulation*, DUKE L.'S GLOB. FIN. MKT. CTR. FINREG BLOG (Feb. 20, 2020), https://sites.law.duke.edu/thefinregblog/2020/02/20/the-virtual-commodity-association-and-the-uphill-battle-for-cryptocurrency-self-regulation.
225. Dell'Erba, *supra* note 22, at 221.
226. Weessies, *supra* note 224.
227. *Id.*

industry representatives they can work with to create effective regulatory solutions.[228]

Third, there is anecdotal and empirical evidence that the lack of clarity in the SEC's enforcement strategy strained its relationship with market participants,[229] which has resulted in distrust between cryptoasset holders and the agency.[230] The inconsistency in the three major cases concerning unregistered tokens – *Kik*,[231] *Telegram*,[232] and *Ripple*[233] – *have greatly confused market participants.*[234] *The crux of market participants' complaints is not that they necessarily disagree with the agency's decisions, but that the SEC is not interested in working with them.*[235] *This is leading to a crisis in the agency's relationship with market participants and cryptoasset holders.*[236]

This crisis should not be dismissed, given that the administrative state relies on public acceptance to execute its mission.[237] Administrative changes have been stilted by hostile, politically powerful public interests in the past.[238] One commentator stressed the importance of public support for the administrative state, saying that: "[i]n public affairs, moderation and a firm attachment to the moral consensus of the larger community must be the ultimate guides."[239] In *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*, the National Highway and Traffic Safety Administration attempted to rescind a safety regulation for, among other things, concern it would "poison popular sentiment" toward any of the agency's future safety measures.[240] The importance of this relationship is further highlighted by SEC Chair Gensler's recent (futile) efforts to engage with cryptoasset platform operators and token issuers because, as one commentator put it: "[Gensler] offers [crypto exchanges] no reason to [come in and meet with the SEC]. . . . [H]e needs to offer them some inducement to do so."[241]

228. Dell'Erba, *supra* note 22, at 220.
229. Guseva, *supra* note 199, at 677.
230. Layton, *The Crypto Uprising*, *supra* note 28.
231. SEC v. Kik Interactive, Inc., No. 19-cv-05244 (S.D.N.Y. filed Jun. 4, 2019).
232. SEC v. Telegram Group Inc., No. 1:19-cv-09439-PKC at 1 (S.D.N.Y. Mar. 24, 2020).
233. SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020).
234. Guseva, *supra* note 199, at 633.
235. Levine, *supra* note 27.
236. Layton, *The Crypto Uprising*, *supra* note 28.
237. Milton J. Esman, *Administrative Stability and Change*, 44 AM. POL. SCI. REV. 942, 948 (1950).
238. *Id.*
239. *Id.*
240. Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 39 (1983).
241. Steven Lofchie, *SEC Commissioners Continue Debate on Regulating Crypto*, FRIED FRANK REGULATORY INTELLIGENCE (Dec. 2, 2021), https://www.findknowdo.com/news/12/02/2021/sec-commissioners-continue-debate-regulating-crypto.

B. SUPPORTERS OF AGENCY DISCRETION

Other experts contend that the SEC had to take immediate action against cryptoassets and "could not wait years for cases to wind through the courts."[242] By offering cryptoassets the opportunity to settle the case contingent on their promise to refrain from future violations, the SEC exercised restraint.[243] Additionally, the difficulty in creating a clear test for determining when a token is a security shows that a case-by-case approach is better than a generalized rule.[244]

IV. USING RIPPLE (XRP) TO LIMIT HOWEY

A. WEAKNESSES IN THE SEC'S CASE AGAINST RIPPLE (XRP)

There are strong arguments supporting the argument that Ripple (XRP) is not a security. First, it is contested whether *Kik* and *Telegram* are analogous to Ripple (XRP)'s case.[245] The SEC alleged that Kik's and Telegram's unregistered offering failed *Howey* because of the companies' influence on the value of the tokens.[246] According to the SEC, the same can be found in Ripple (XRP).[247] However, Ripple refutes this, using filings and public statements to demonstrate that it did not directly control, manage, or maintain XRP, at least, to the extent of similar owners of commodities, like Ether.[248] In a 2018 testimony before the U.K. Parliament, Ripple Director Ryan Zagone testified to the difference in XRP, saying:

> XRP is open source and it was not created by our company, so that existed as an open-source technology. We created a company that was interested in modernizing payments and then began using that open-source tech to do so . . . . We didn't create XRP . . . . We do own a significant amount of XRP, it was gifted to us by some of the open-source developers that created it. But there's not a direct connection between Ripple, the company, and XRP.[249]

Empirical evidence suggests that Ripple does not control the value of the tokens was demonstrated when the SEC suit was announced, causing XRP to lose 75 percent of its value within eleven days.[250]

Second, the SEC's silence on Ripple (XRP)'s status for eight years led Ripple and XRP's holders to assume that it was not a security or had been

242. Park, *supra* note 114, at 132.
243. *Id.* at 111.
244. *Id.* at 112.
245. Freedman, *supra* note 44.
246. *Id.*
247. *Id.*
248. *Id.*
249. *Id.*
250. *Id.*

grandfathered in.[251] Revisiting the timeline of the SEC's enforcement regime, its initial guidance on cryptoassets, the 2017 DAO report, was issued four years *after* XRP was introduced.[252] Although the SEC argues that it gave Ripple (XRP) notice in 2012 of the risk that federal securities law could apply, it took no further action until 2020.[253]

Lastly, Ripple (XRP) is accepted as a currency by other jurisdictions and used by banks, companies, and consumer apps as a form of money.[254] Additionally, the U.S. Treasury Department classified Ripple (XRP) as a currency, not a security, in a 2015 settlement.[255]

B. THE LIKELY DECISION AND ITS POTENTIAL ADVERSE EFFECTS

The precedent of Article III court decisions deferring to the SEC indicate that it will be difficult for a judge to rule in favor of Ripple (XRP).[256] That said, Ripple (XRP) filed an intention to present a fair notice defense.[257] Ripple (XRP) states that, under due process, a person of ordinary intelligence must be allowed a reasonable opportunity to know what is prohibited.[258] In this matter concerning XRP, and all other cryptoassets, Ripple claims that the SEC has not provided the cryptoassets market with fair notice given that the SEC failed to act until after Ripple (XRP) was green lit by other actions including (i) the 2015 settlement between Ripple and the DOJ/FinCEN acknowledging XRP as a convertible virtual currency; (ii) then-SEC Director of Enforcement Hinman's 2018 statement that he did not consider Bitcoin or Ether to be securities, without acknowledging XRP; and (iii) the SEC's meeting with Platform A, which made XRP available for buying and selling on its platform.[259] The SEC responded that the three events identified by Ripple (XRP) are "legally inconsequential," stating that the agency is not constitutionally required to provide notice and that no federal court has accepted such a defense.[260] The SEC states that the "only question" applicable to a fair notice defense in this case is whether the term "investment contract" in *Howey* is "unconstitutionally vague" (which no court has ruled

251. *Id.*
252. *Id.*
253. *Id.*
254. *Id.*
255. *Id.*
256. Grewal, *supra* note 44.
257. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 97; Layton, *The SEC's Fair Notice, supra* note 33.
258. Answer Of Defendant Ripple Labs, Inc. To Plaintiff's First Amended Complaint, *supra* note 33, at 97.
259. *Id.* at 97–98.
260. Plaintiff Securities And Exchange Commission's Memorandum Of Law In Support Of Its Motion To Strike Defendant Ripple Labs, Inc.'s Fourth Affirmative Defense at 9, 19, SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020), ECF No. 132.

in over 75 years).[261] The court denied the SEC's motion to strike Ripple (XRP)'s fair notice defense because the SEC had not cited any caselaw where a court struck down such a defense at the pleading stage.[262]

Although Ripple (XRP)'s fair notice defense has been admitted here, there is a long legislative history of Article III courts deferring to administrative agencies, like the SEC, who have technical expertise in the subject matter that the courts lack.[263] The Supreme Court awarded *Chevron* deference to the SEC under the *Mead/Barnhart* factors in a case concerning the SEC's historically broad interpretation of the securities statutes, which usually favors investors.[264] Under *Chevron*, an Article III court will defer to the agency's interpretation of law when the statute is ambiguous and the agency's interpretation is reasonable.[265] To get *Chevron* deference, an agency must satisfy the five *Mead*/*Barnhart* factors: (1) the interstitial nature of the legal question, (2) the related expertise of the agency, (3) the importance of the question to administration of the statute, (4) the complexity of that administration, and (5) the careful consideration the agency has given the question over a long period of time.[266]

Deference also extends to an agency's choice between promulgating a rule through notice-comment procedures or working on a case-by-case basis through adjudication, even in cases where there was no notice to the parties that their actions were illegal.[267] Specifically, courts have upheld agency action that applies a statute directly in an adjudication without a rulemaking.[268] Justice Jackson's balancing test permits retroactivity as balanced against the mischief of producing a result that is contrary to a statutory design or to legal and equitable principles.[269] The rationales for such action include (1) when the agency "could not reasonably foresee" the problem, which must still be resolved, even without a rule; (2) when the agency may not have had enough experience to formulate a rule and wishes to proceed on a case-by-case basis; or (3) when an issue is so specialized or varying that a rule is impossible.[270] Thus, it would be a challenge for a judge to strike down the SEC action here as "regulation by enforcement."[271] It is

261. *Id.* at 9.
262. Order at 9–10, SEC v. Ripple Labs, Inc. et al., No. 20-cv-10832 (S.D.N.Y. Dec. 22, 2020), ECF No. 440.
263. Himelrick, *supra* note 43, at 62–63.
264. *Id.* at 65; United States v. Mead Corp., 533 U.S. 218, 226–27 (2001); Barnhart v. Walton, 535 U.S. 212, 225 (2002) (five factors clarifying *Mead*).
265. Chevron U.S.A, Inc. v. Nat. Res. Def. Council, Inc. 467 U.S. 837, 843–44 (1984).
266. *Barnhart*, 535 U.S. at 225.
267. "[T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency." SEC v. Chenery Corp., 332 U.S. 194, 202–03 (1947).
268. *Id.* at 201.
269. *Id.* at 214.
270. *Id.* at 202–03.
271. Grewal, *supra* note 44.

also unlikely that a settlement will be reached because Ripple (XRP) is unlikely to admit to any wrongdoing, given the strength of its claims and the losses it is facing.[272]

The potential outcome against Ripple (XRP) only highlights the terrible impact of such a decision on the cryptoassets market.[273] The cryptoassets market is massive with the combined market cap of digital currencies currently standing at nearly $2.5 trillion.[274] There will also be ripple effects throughout the financial markets, given the number of financial institutions who utilize XRP.[275] Even if the judge rules in favor of Ripple (XRP), there may be still massive adverse effects if the exemption is only for XRP, rather than for a class of similarly situated tokens, creating "a clash between the old paradigm and the new one."[276]

Additionally, there are concerns about the effect of the decision on the SEC's relationship with cryptoasset holders.[277] The public backlash to the SEC's lawsuit against Ripple has been characterized as an "uprising" and the "last straw" as the public criticizes the SEC's "regulation by enforcement" and resulting market confusion on Twitter.[278] This is highlighted by the record high number of consumer complaints concerning Ponzi and pump-and-dump schemes in the first quarter of 2021, despite the SEC's numerous Alerts and Bulletins, warning cryptoasset holders of potential scams.[279]

C. THE NECESSARY CONGRESSIONAL SOLUTION

Given how unlikely it is for an Article III court to overturn the SEC's decision here, it is up to Congress to reasonably intercede in this matter.[280] In a policy proposal, Ripple expressed support for a return to legislation that promotes an "active dialogue between regulators and market participants," to ensure that the SEC will promulgate "more tailored and effective policy outcomes for the industry and consumers alike."[281] Specifically, Ripple (XRP) endorsed: (1) H.R. 1602 - the Eliminate Barriers to Innovation Act of 2021, which would create a "collaborative working group" of appointees from the SEC, CFTC, FinTech, financial firms, and small businesses; (2) H.R. 4451 - the Securities Clarity Act, which would clarify the SEC's ambiguous interpretation of *Howey* by establishing a new asset type distinguishing digital tokens from securities offerings; (3) H.R. 8373 - the

272. *See* Joint Letter, *supra* note 32.
273. Freedman, *supra* note 44.
274. *Id.*
275. *See* Louis Lehot & Catherine Zhu, *Avoiding Legal Pitfalls to Capitalize on the 2021 Boom in Fintech*, 27 WESTLAW J. BANK & LENDER LIAB. 1 (2021).
276. *Id.*
277. Layton, *The Crypto Uprising*, *supra* note 28.
278. *Id.*
279. Fletcher, *supra* note 36; INVESTOR ALERTS AND BULLETINS, *supra* note 35.
280. Friedman, *supra* note 41.
281. *Id.*

Digital Commodity Exchange Act of 2020, which would allow digital commodity exchanges to choose between federal or state oversight while maintaining the SEC's authority over tokens before they are listed on CFTC-registered exchanges and states' fraud liability authority; and (4) SEC Commissioner Peirce's proposed "safe harbor" which would create an "innovation sandbox" for network and product developers while still enforcing investor protections.[282]

H.R. 4451 and H.R. 8373 were introduced in the House, respectively, on July 16, 2021 and September 24, 2020.[283] As of this Note, no further action has been taken on either.[284] In regard to H.R. 8373, it is imperative to be skeptical of any proposed solutions that rely heavily on diverting regulatory authority from the SEC to the CFTC because, as CFTC Commissioner Stump clarified, the CFTC does not regulate the cryptoasset itself.[285] The CFTC's authority is restricted specifically to futures contracts and other derivatives products (e.g., swaps) on commodities.[286]

H.R. 1602 ("Eliminate Barriers to Innovation Act of 2021") passed the House on April 20, 2021 and was received by the Senate on April 22, 2021, who referred it to the Senate Committee on Banking, Housing, and Urban Affairs.[287] The directive to create a "collaborative working group" appears to have been transplanted into President Biden's recent executive order (EO), which directs various Cabinet members and administrative agencies (including the SEC and CFTC) to coordinate to implement the directive.[288] However, the EO does not include a directive to clarify existing regulation.[289] While it is possible that this EO will lead to a "more digital-friendly regulatory system," it could also swing toward "significant additional regulation."[290] By example, SEC Commissioner Allison Herren Lee's recent comments indicate a push toward more regulation targeting fraud and less

282. *Id.*

283. CONGRESS.GOV, *Actions Overview H.R.4451 — 117th Congress (2021-2022),* https://www.congress.gov/bill/117th-congress/house-bill/4451/actions?r=90&s=1 (last visited Mar. 10, 2022); CONGRESS.GOV, *Actions Overview H.R.8373 — 116th Congress (2019-2020)*, https://www.congress.gov/bill/116th-congress/house-bill/8373/actions?r=5&s=1 (last visited Mar. 10, 2022).

284. *Id.*

285. Stump, *supra* note 94.

286. *Id.*

287. CONGRESS.GOV, *All Actions H.R.1602 — 117th Congress (2021-2022),* https://www.congress.gov/bill/117th-congress/house-bill/1602/all-actions?overview=closed#tabs (last visited Mar. 10, 2022).

288. Proclamation No. 14067, 87 Fed. Reg. 14,143 (Mar. 14, 2022).

289. *Id.*

290. Steven Lofchie, *President Biden Signs Executive Order on Digital Assets*, FRIED FRANK REGULATORY INTELLIGENCE (Mar. 9, 2022), https://www.findknowdo.com/news/03/09/2022/president-biden-signs-executive-order-digital-assets.

interest in establishing a clearer regime when she characterized the cryptoassets market as "largely def[ying] existing laws and regulations."[291]

SEC Commissioner Peirce's proposed "safe harbor" has been called a "middle ground" that would provide investor protections while still facilitating financial innovation.[292] Under the proposal, an emerging token would have a three-year safe harbor from securities regulation requirements, but would still be held accountable for any fraudulent activity.[293] During the safe harbor period, a token would be permitted to become adequately decentralized (as occurred with Ether).[294] In response to concerns regarding transparency, the proposal requires (i) semi-annual updates to the plan of development disclosure and a block explorer and (ii) an exit report, either explaining why the network is decentralized or functional (with guidance), or an announcement that the token will be registered as a security.[295] To fall under the safe harbor exception, emerging cryptoasset creators must file their intention with the SEC and comply with all requirements of the safe harbor, including the disclosure requirements and antifraud regulations.[296]

Fellow SEC Commissioner Caroline Crenshaw criticized safe harbors, including this one, as "[not] in the best interest of investors" when it allows "unlimited capital raising with only limited disclosures, and no registration requirement."[297] Arguably, Commissioner Crenshaw is describing a regulatory sandbox, rather than a safe harbor, as first used by UK's Financial Conduct Authority (FCA).[298] The FCA defines a regulatory sandbox as "a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of engaging in the activity in question."[299] Yet, this safe harbor should be differentiated from a regulatory sandbox, highlighted by Commissioner Peirce's prior comments expressing suspicion of regulatory sandboxes.[300] Even so, regulatory sandboxes are not new tools for financial regulators and have been used to great success as demonstrated by the FCA.[301]

291. Allison Herren Lee, Comm'n, SEC, Remarks at PLI's Corporate Governance – A Master Class 2022 (Mar. 4, 2022).

292. Lofchie, *The Securities Law Treatment of Utility Tokens*, *supra* note 19.

293. TOKEN SAFE HARBOR PROPOSAL 2.0, *supra* note 26.

294. *Id.*

295. *Id.*

296. *Id.*

297. Caroline A. Crenshaw, Comm'n, SEC, Digital Asset Securities – Common Goals and a Bridge to Better Outcomes (Oct. 12, 2021).

298. Dan Quan, *A Few Thoughts on Regulatory Sandboxes*, STANFORD PACS, https://pacscenter.stanford.edu/a-few-thoughts-on-regulatory-sandboxes (last visited Mar. 10, 2022).

299. *Id.*

300. Hester M. Peirce, Comm'n, SEC, Beaches and Bitcoin: Remarks before the Medici Conference (May 2, 2018).

301. Quan, *supra* note 298.

That said, Ripple's list of proposed solutions are not heralded by all.[302] Critical questions remain unanswered in these proposals which rely on using the existing regulatory frameworks.[303] An alternative Congressional solution, drafted by industry experts, would keep the SEC as the main regulator in the cryptoassets market without imposing unnecessary red tape on the offering of emerging tokens.[304] This would be accomplished through a Congressional directive, ordering the SEC to conduct a study into the matter with the goal of moving away from the current one-size-fits-all approach.[305] The proposed solution would only apply to utility tokens, like Ripple (XRP), and would not concern Bitcoin, stablecoins (backed by fiat currencies or a basket of cryptoassets), or non-fungible tokens.[306]

Any of these proposal could be strengthen by endorsing SROs for ICOs in the cryptoassets market.IOSCO recommends SROs as a tool for securities regulation, and foreign securities regulators in Switzerland, Hong Kong, the United Kingdom, and Japan have implemented them with success.[307] Aside from helping administrative agencies fulfil their regulatory work, SROs also cultivate specialized industry representatives that work with regulators to create effective regulatory solutions.[308] For example, the Swiss regulator FINMA authorized the SRO "Crypto Valley Association" to create independent policies, which is credited with facilitating the emergence of one of the global blockchain hubs.[309] And as mentioned earlier, currently, the VCA is the first SRO to emerge in the cryptoassets market for securities regulation in the United States.[310] The SEC could empower the VCA through oversight and mandatory membership and thus cultivate specialized industry representatives they can work with to create effective regulatory solutions.[311]

CONCLUSION

Congressional intervention is crucial in this matter to avoid the adverse effects of a decision against Ripple (XRP). Promulgating exemptions for genuine offerings (i.e., unregistered securities not designed to defraud investors) will result in an improved relationship with market participants that will trickle down toward remedying the lack of trust between the SEC

302. Sebastian Souchet, *Ripple Advocates for Crypto Regulation through Existing Frameworks,* FRIED FRANK REGULATORY INTELLIGENCE (Nov. 17, 2021), https://www.findknowdo.com/news/11/17/2021/ripple-advocates-crypto-regulation-through-existing-frameworks.

303. *Id.*

304. Lofchie, *The Securities Law Treatment of Utility Tokens*, *supra* note 19.

305. *Id.*

306. *Id.*

307. Int'l Org. of Sec. Comm'ns [IOSCO], *Objectives and Principles Of Securities Regulation* 5 (May 2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf; Dell'Erba, *supra* note 22, at 220–221.

308. Dell'Erba, *supra* note 22, at 220.

309. *Id.* at 220–221.

310. *Id.* at 221.

311. *Id.* at 220.

and the cryptoasset holders. The SEC would retain its authority over truly fraudulent token offerings, while no longer wasting resources pursuing offerings against tokens like Ripple (XRP), which have no investor complaints.

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