BETTER MARKETS

SEC REPORT

JANUARY 25, 2023

THE SEC'S EXCELLENT RECORD ON CRYPTO: REGULATION & ENFORCEMENT

INTRODUCTION

The Securities and Exchange Commission (SEC) has a very broad mission to protect investors and markets, and it does that primarily through regulation and enforcement. It is a very big job. The SEC oversees a $100 trillion capital market, representing 38 percent of the capital markets worldwide. It oversees the initial offering of securities, secondary trading in the markets, and all the market participants who make it work, including broker-dealers, advisers, and exchanges. That specifically includes 24 national securities exchanges, 99 alternative trading systems, ten registered credit rating agencies, seven registered clearing agencies, five self-regulatory organizations, 29,000 issuers, 15,000 registered investment advisers, and 16,000 investment companies.

Although the scope and breadth of the SEC's responsibilities have increased dramatically over the years, the agency's funding has not kept pace, and, as a result, the staffing levels today are at or below 2016 levels. The SEC's budget is insufficient given its enormous responsibilities and when compared to the wealth and resources of the financial services industry it oversees. Absent a dramatic increase in funding, the SEC must continue to be strategic and judicious in the use of its limited resources.

These facts are the context within which to understand and evaluate the SEC's actions and its track record regarding the crypto industry. Within that context, the SEC's track record has been remarkably good. According to a January 18, 2023, report from Cornerstone Research, the SEC "continues to make cryptocurrency-related enforcement a top priority . . . bringing 30 enforcement cases against digital-asset market participants in 2022, up 50% from the 20 actions brought in 2021 and the highest number since 2013." And, according to one expert, "since its first crypto-related enforcement action in 2013 through 2022, the SEC has brought 127 cases . . . against digital-asset firms and people. And as far as I can tell, has experienced not a single loss."

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However, it is important to remember that, no matter how big and frequent the headlines, the crypto industry is a relatively small part of the vast markets and innumerable market participants and activities that the SEC oversees and regulates. Nonetheless, given the grievous damage to investors and the dangers to the markets, the SEC has allocated significant time, attention, and resources to policing crypto while it fulfills its many other statutory mandates.

Put differently, the time, attention, and resources devoted to crypto are time, attention, and resources that are not devoted to any of the SEC's many other responsibilities. For example, the SEC filed 760 enforcement cases in fiscal year 2022, including the 30 crypto cases.[1] Should the SEC have brought fewer non-crypto cases[2] to enable it to bring additional crypto cases? Such difficult decisions are compounded by the crypto industry's spare-no-expense, scorched earth litigation strategy against the SEC, which often forces the SEC to devote materially more time, attention, and resources than it does in other types of cases.

[1] *See* Appendix 1 for a summary of the SEC's key crypto cases.

[2] For example, the SEC brought numerous enforcement actions for insider trading and market manipulation, for securities offerings and foreign corrupt practices act violations, and against broker-dealers, investment advisers/investment companies, and issuers.

There are also some who have complained that the SEC has not moved fast enough and filed cases more quickly. Those people do not understand the SEC's investigation process, which typically takes two or more years to complete. Yes, investors can be seriously harmed in the meantime, but the SEC can only act quickly if there is overwhelming, virtually undisputed evidence that would readily convince a court to act expeditiously on a minimal record. Those cases are very uncommon. Most often, the SEC can only bring charges once its investigation has uncovered ample admissible facts and evidence to prove a violation of the law; it then must provide the subject of those potential charges due process to respond, which itself is often lengthy; it then has to present the case to the five SEC Commissioners who have to be convinced to vote to approve the case; only then, can the SEC bring a case. Given Chair Gensler has been at the SEC for less than two years, crypto cases are complex and difficult, the SEC lacks staff, resources, and expertise, and the crypto industry is fighting every investigation as hard as possible, the SEC has brought crypto cases remarkably fast.

That's why the SEC has simultaneously pursued a multi-track strategy to try to get the crypto industry to comply with the laws like every other law-abiding firm and industry in the U.S.:

1. It has publicly urged the industry to come in and work with the agency to come into compliance.

2. It has selectively brought enforcement actions against people, products, services, and firms for breaking the law to maximize the impact and deterrent effect (while increasing staff focused on—and with expertise in—crypto).

3. It has used its regulatory authority to deny crypto firms' requests to unlawfully engage in certain types of activities.

These efforts have been made inordinately more difficult due to two circumstances. First, the crypto industry has knowingly and intentionally chosen not to comply with the law while attempting to buy special interest legislation that would provide for minimal, inadequate regulation. Second, the crypto industry's political allies have been putting enormous pressure on the SEC to not enforce the law against the industry.

These circumstances are crucially important. Every other law-abiding business in the U.S. respects the rule of law and (more often than not) follows the rules. Of course, some push the rules, some bend the rules, and some even break the rules, but it is almost always within an overall intent to comply with the law. That is not true with the crypto industry, which has knowingly chosen as a business strategy and practice to not comply with the law. Put differently, it is a lawless industry by choice. And, as mentioned above, if the SEC attempts to enforce the law against it, the industry uses its vast resources to fight the SEC, forcing it to be even more careful in deciding what cases to bring or not bring against the industry. The best recent illustration of this is Ripple Labs Inc., which the SEC sued in December 2020,[3] and which has spent $100 million in lawyer fees in this one case in just two years.

[3] This crypto case illustrates that the SEC's actions regarding the crypto industry have been nonpartisan, which should surprise no one because the SEC's mission to protect investors and markets is nonpartisan. This high-profile lawsuit against Ripple Labs Inc. was filed in December 2020 by Trump's SEC. The activities under Chair Gensler are consistent with and an extension of the actions under the Trump administration and by Trump's SEC Chair.

The crypto industry also uses its war chest to buy influence. It has spent more than $100 million in campaign contributions and on lobbying in an attempt to buy special interest legislation that would help establish crypto as a legitimate financial product and market sector while at the same time ensuring the industry would be subject to minimal, light touch regulation. Fortunately, the rush to establish a new regulatory framework for crypto has lost some of its momentum considering the recent chaos in the crypto markets, including notably the collapse of FTX and arrest of its former CEO Sam Bankman-Fried, but that legislative push will undoubtedly soon resume in earnest. However, while it has not achieved it's legislative goal, it has numerous very powerful and vocal political allies who are attempting to pressure the SEC to go easy on the industry. So far, that hasn't worked, but it is an ever-present reality that the SEC has to deal with.

Importantly, the problem is not, as the industry has claimed, that complying with the law and, for example, registering with the SEC "is not possible." It is entirely possible but complying with the law would require crypto to follow the customer/investor protection and financial stability rules like every other legitimate business. In summary, depending on whether it was registering securities for sale to investors or registering as an exchange, broker-dealer, custodian, or clearing house, that would require crypto to, for example:

(a) ensure disclosures and representations were fully accurate and materially complete (i.e., truthful transparency and antifraud);

(b) establish systems and controls to protect customer assets, prevent internal theft (like commingling or embezzlement) and external hacks, etc.;

(c) eliminate conflicts of interests or mitigate them while fully disclosing them;

(d) maintain accurate books and records;

(e) implement robust and effective management, risk, legal, and compliance programs;

(f) submit to routine examinations and supervision by the SEC and SROs like FINRA; and

(g) institute margin, liquidity, capital, and related protections to fulfill their obligations and prevent contagion in the event of severe volatility, significant losses, and crashes as we've been seeing for almost a year now.[4]

Complying with those rules is entirely possible but that would interfere with crypto's profit-maximizing predatory business model and almost certainly reveal the Ponzi scheme that is at the core of the industry, as JP Morgan Chase's CEO Jamie Dimon has highlighted and recently reiterated.

Enforcing these longstanding laws and rules—designed to ensure investors receive important information, are not defrauded, and are otherwise protected—is not "regulation by enforcement" as the SEC's critics endlessly and reflexively claim. The laws and rules applicable to securities and related securities activities have been clear, black letter law and rules for many decades. Those rules and laws have been consistently applied over those decades to financial products of all types regardless of claims that they are somehow unique or imbued with a distinguishing type of innovation. New laws and new regulations are not needed; what is needed is for a knowingly lawless industry to comply like other

[4] *See* Appendix 2 for a more detailed listing of some of the key rules and laws that are applicable to all other businesses in the securities industry and would be applicable to crypto if it complied with the law.

law-abiding businesses. Until then, the industry's own conduct is forcing the SEC to bring enforcement actions to protect investors, markets and financial stability.

Notwithstanding the SEC's impressive track record in the face of these challenges, attacks on the SEC regarding its regulation and enforcement of the crypto industry are increasing. These attacks are mostly fact-free and come from the crypto industry and its allies. That isn't to say the SEC is perfect or not subject to legitimate criticism. In fact, we have criticized the agency for failing to go after the crypto exchanges more aggressively. But the SEC has done a remarkably good job under extremely difficult circumstances. The facts, detailed here, demonstrate as much.

REGULATION

Given the lure of crypto is based on nothing of underlying value and that its widespread appeal stems from the so-far empty promise of financial innovation coupled with the promise of future profits, the SEC has carefully and deliberately tailored its regulatory approach to crypto. It has done this in three primary ways: (1) assertion of its authority over those digital assets that are securities, (2) scrutiny of exchange-traded products based on cryptocurrency, and (3) development of guidance for regulated entities and investors on the risks of the cryptocurrency markets.[5]

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Assertion of Authority to Regulate Crypto Securities

The SEC has found little merit in the industry's claims that most of the crypto products and activities are not securities. Chairman Gensler has repeatedly stated that the vast majority of crypto tokens are securities and that securities in any form, no matter how novel on their face, should be subject to the same robust regulation under the securities laws to protect investors and the integrity and stability of our markets.[6] He has emphasized that for now, at least, cryptocurrencies are used primarily for speculative investment purposes; that the asset class is akin to the "wild west" and "rife" with fraud; and that investor protection has to be paramount. Because the SEC already has the legal tools it needs to police many if not most cryptocurrencies operating in the securities sphere, the SEC has no compelling reason to engage in additional rulemaking at this time.

All of which means that the SEC expects those offering crypto securities, and the platforms trading them, to comply with the registration, disclosure, and anti-fraud provisions of the securities laws.[7]

[5] In addition, of course, the SEC has been protecting investors by carefully reviewing any companies with crypto-related business models that seek to go public. That process is a bed-rock function that clearly falls within the regulatory purview of the SEC—there is no question that securities are involved. And while the process may be lengthy, as reported in some cases, the SEC is duty-bound to ensure that those companies disclose all material information that investors will need before deciding whether to place their money at risk in a sector fraught with potentially ruinous volatility, risk, and in many cases, lawlessness. *See also*, Appendix 2.

[6] The Chair of the Commodities Futures Trading Commission (CFTC), which regulates the minority of crypto that are not securities as commodities, has made similar statements, including that one of the CFTC "greatest accomplishments" was its crypto enforcement cases and that it is "one of the toughest cops on the beat." Unfortunately, the CFTC is a very small agency that has been chronically underfunded and understaffed for years, bringing a total of just 82 enforcement cases in 2021 compared to the SEC's 760 cases. It does not have a robust investor protection mandate, history, capacity, or culture, and its markets are almost exclusively large institutional traders, not retail investors. It is also viewed as decidedly crypto-friendly, raising questions about the sustainability of its already minimal enforcement program.

[7] *See, e.g.*, Appendix 2.

The SEC has acted accordingly, bringing dozens of crypto-related cases, as discussed herein. Those actions are largely predicated on the claim that crypto offerings are unregistered securities in the form of investment contracts, defined under longstanding Supreme Court precedent (a case called *Howey*) as instruments through which a person invests money in a common enterprise with the expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Moving forward, the SEC should be more aggressive in bringing enforcement actions against companies acting as unregistered exchanges that offer trading in cryptocurrency investments. And it should continue to resist attempts to weaken the SEC's authority over crypto investments in the form of proposed legislation that would give another, less capable regulator primary regulatory jurisdiction over this market.

Rejecting Exchange-Traded Products Based on Cryptocurrency

Throughout 2022, the SEC received several proposed rule changes from exchanges seeking to list shares of trusts or ETFs providing exposure to Bitcoin prices. The proposals included shares of at least the following products: the Grayscale Bitcoin Trust, the NYDIG Bitcoin ETF, the First Trust SkyBridge Bitcoin ETF, the Bitwise Bitcoin ETP, the Global X Bitcoin Trust, the ARK 21Shares Bitcoin ETF, the Wise Origin Bitcoin Trust, the WisdomTree Bitcoin Trust, and the One River Carbon Neutral Bitcoin Trust.

The SEC uniformly denied proposals for trust shares based on the Bitcoin spot price on grounds that each exchange had failed to show that it could prevent fraud and market manipulation, especially through market surveillance-sharing agreements. But the SEC did approve listing of products based on Bitcoin futures. As far as we are aware, the SEC has rejected the listing of every Bitcoin spot-based exchange-traded product since the start of Chair Gensler's term.

Guidance on Cryptocurrency and Compliance

The SEC has also issued important new guidance related to cryptocurrency and digital assets. We highlight three such items here:

Staff Accounting Bulletin No. 121. In April 2022, the SEC's Division of Corporation Finance and Office of the Chief Accountant issued new guidance directed at cryptocurrency trading platforms holding assets for their users. This guidance specifically identified and examined the "unique risks and uncertainties" of safeguarding cryptocurrency assets, "including technological, legal, and regulatory risks and uncertainties." It further provides several hypothetical scenarios and compliance considerations for each type of these risks.

Sample Letter to Companies Regarding Recent Developments in Crypto Asset Markets. Late in 2022, the SEC's Division of Corporate Finance released guidance on disclosures related to the recent chaos in the cryptocurrency and digital asset markets. The guidance identifies several categories of potentially material impacts to public companies' finances, including "risks related to a company's liquidity and ability to obtain financing; and risks related to legal proceedings, investigations, or regulatory impacts in the crypto asset markets." The guidance provides a sample list of issues that public companies should consider when drafting, revising, or updating disclosures.

Investor Bulletin: Crypto Asset Interest-Bearing Accounts. In February 2022, the SEC's Office of Investor Education and Advocacy and its Division of Enforcement's Retail Strategy Task Force issued guidance

meant to educate investors on the risks of interest-bearing accounts for cryptocurrency deposits (like that offered by BlockFi, discussed below). The guidance explains the lack of regulatory protections these accounts provide compared to more traditional deposits at banks or credit unions. The guidance also warns investors about the inherent risks associated with cryptocurrency investment activities that fund the interest payments for such accounts.

ENFORCEMENT

As happened in the prior administration under Chair Clayton, the SEC has continued to crack down on cryptocurrency offerings and exchanges that have flouted the securities laws. As Chair Gensler has explained in his public remarks, "the vast majority" of cryptocurrency tokens likely fall under the jurisdiction of the securities laws as "investment contracts"; these tokens, then, are a type of security that generally must be registered with the Commission prior to their marketing or sale. The Chair in fact publicly offered the Commission's assistance in registering digital tokens. And as securities, they are subject to the full range of requirements and prohibitions under the securities laws, including the provisions outlawing fraud and market manipulation.

The cryptocurrency industry widely considers even the most basic regulation as anathema, painting it as overly burdensome.

Yet the cryptocurrency industry widely considers even the most basic regulation as anathema, painting it as overly burdensome, and only a handful of firms are believed to have taken the Chair up on his offer. That has left large numbers of digital token operations—perhaps thousands—in open defiance of federal law. As a result, the Enforcement Division has ramped up the fight to force the industry into compliance, punish those who have failed to comply, and where possible recover ill-gotten gains for the benefit of injured investors through the disgorgement remedy.

The Enforcement staff has had some notable successes during the past year. Perhaps its biggest win yet came against a digital asset company called LBRY, against which the agency secured a judgment in federal court for selling unregistered securities. LBRY created a blockchain-based system to compile and share videos and other digital content. After some venture capital investment, LBRY began funding its new system by offering a digital token called LBC tied to its blockchain. Crucially, LBRY did so by touting the prospects of LBC price appreciation as its video content ecosystem grew, much like one would when promoting the IPO of a traditional media company. In fact, LBRY often described its token in terms taken directly from the equities world, including LBC's "market capitalization," a "private placement" of LBC, factors for "investment decisions" in LBC, and LBC's "long-term value proposition." The district court thus found LBC's status as a security so clear that it saw no need for a trial and handed the SEC a quick victory.

Of course, one court victory will not induce industry-wide compliance, particularly for an industry that has knowingly chosen to break the law. The industry's conduct in another SEC lawsuit against a cryptocurrency outfit called Ripple Labs proves the point. As far back as 2013, Ripple offered a digital token, XRP, to fund and promote the use of its blockchain technology, allegedly marketing XRP as a liquid investment opportunity. Ripple raised billions of dollars this way despite warnings from a large law firm that XRP might be an unregistered security. The SEC sued in December of 2020; discovery in

the case concluded and both sides moved for summary judgment. Several industry entities have filed their own briefs against the SEC, evidencing the industry's collective if not highly coordinated efforts to fight the SEC. While it will likely be appealed by whoever wins in the district court, once the case is finally resolved, it promises to serve as an important precedent on the application of the *Howey* test to cryptocurrency offerings, at least in cases involving investments with similar features.

Not all problems in this space arise from the sale of digital tokens, and the SEC has had a busy year prosecuting actions against other cryptocurrency-related violations. On Valentine's Day, for instance, the Commission gave the investing public the gift of the BlockFi settlement. BlockFi offered accounts in which investors lent it cryptocurrency assets in exchange for variable interest payments; it funded these interest payments by lending the cryptocurrency to third parties and other activities. The company attracted nearly 400,000 U.S. investors to these accounts, which, of course, were not registered with the SEC as securities. When the Commission came calling, BlockFi agreed not only to pay a $50 million penalty for its violations but also to cease offering its non-compliant products. Going forward, the company committed to registering with the Commission and redesigning its products.

In early 2023, the Commission followed up with a civil suit against two entities, Genesis and Gemini, offering a "Gemini Earn" account also similar to the BlockFi program. Gemini, through its crypto trading platform, brought in investors willing to deposit their digital assets into the Earn accounts; Genesis then lent out those assets to crypto hedge funds or others, in exchange for generous interest rates paid to the Earn account. With the crypto market collapse last year, Genesis froze customer withdrawals, and the SEC soon sued. Unlike BlockFi, however, this case appears headed towards expensive and prolonged litigation as the founders of Gemini, the Winklevoss twins, have pledged to fight the SEC. Even more recently, the SEC has struck a multi-million dollar settlement with yet a third platform, Nexo, offering interest-bearing crypto accounts similar to those offered by BlockFi, Genesis, and Gemini.

A number of the past year's notable cryptocurrency-related SEC enforcement and regulatory actions are summarized in Appendix 1 below.

APPENDIX 1

Notable Enforcement Actions Brought, Prosecuted, or Concluded by the SEC During 2022 or 2023 Against Cryptocurrency Offerings as Unregistered Securities

SEC v. Ripple Labs Inc., No. 1:20-cv-10832 (S.D.N.Y.). This is a civil enforcement action alleging that the defendants sold digital assets (known as "XRP") that were unregistered securities under the *Howey* investment contract test, and seeking an injunction, disgorgement, and civil monetary penalties. The parties have briefed cross-motions for summary judgment.

SEC v. LBRY, Inc., No. 1:21-cv-00260 (D.N.H.). Similar to Ripple, the SEC sued LBRY on the theory that the latter's digital tokens were unregistered securities, specifically "investment contracts." LBRY denied the allegations and asserted a due process defense. On November 7th, the district court granted summary judgment to the SEC and denied summary judgment to LBRY. LBRY has since moved to limit the SEC's remedies and has asserted that it will dissolve as an entity.

SEC v. Chicago Crypto Capital LLC, No. 1:22-cv-4975 (N.D. Ill.). In September, the SEC sued Chicago Crypto Capital, its founder, and two of its salespeople for the unregistered offering and sale of cryptocurrency asset securities on behalf of an online exchange, as well as for fraudulent statements in the sale of those securities. These defendants, according to the SEC, managed to raise $1.5 million through such activities; they did so partly through cold calls, social media, and targeting of unsophisticated investors. As of mid-December, the court has entered default judgments against the company and two individual defendants; a third individual defendant settled the claims for roughly $240,000 in combined disgorgement and civil penalties.

SEC v. Block Bits Capital, LLC, Nos. 3:22-cv-2563, -2565 (N.D. Cal.). Block Bits, a related corporate entity, and its two founders raised nearly $1 million by offering unregistered investments in a proprietary, automated operation to trade cryptocurrencies across multiple platforms with some assets held in risk-free "cold storage" mechanisms. The SEC sued the corporate entities and the founders, alleging that the investments were not registered as securities and that the offering was false. In reality, the SEC alleged, the firm had no automated trading or cold storage mechanisms at all. The Department of Justice brought a separate criminal action for wire fraud against the founders, and the civil case against the corporate entities and one founder has been stayed during the pendency of the criminal case. The second founder settled with the SEC for disgorgement of $75,000 plus prejudgment interest.

SEC v. MCC International Corp., No. 2:22-cv-14129 (S.D. Fla.). In the Spring of 2022, the SEC filed a civil suit alleging that MCC and its founders raised over $8 million of investments in a cryptocurrency mining and trading operation with guaranteed daily returns and an initial coin offering. The SEC alleged that the entire operation was fabricated and nothing more than an ongoing fraud, and it secured a temporary restraining order, preliminary injunction, and asset freeze against MCC once the founders fled to Brazil upon learning of the SEC's investigation. In September, the SEC moved to hold the founders in contempt for violating the asset freeze. One founder defendant has appealed the preliminary injunction.

SEC v. Dragonchain, Inc., No. 2:22-cv-1145 (W.D. Wash.). This civil suit alleges that Dragonchain offered and sold cryptocurrency assets that were unregistered securities under *Howey*. In total, Dragonchain raised over $16 million over five years. The defendants had yet to respond to the SEC's complaint as of mid-December.

SEC v. Genesis Global Capital, LLC, No. 1:23-cv-00287 (S.D.N.Y.). The SEC filed this civil suit not in 2022 but in early 2023. Gemini, a trust company founded by the Winklevoss twins, provides retail investors with an app-based ability to trade and store cryptocurrencies. In 2021, Gemini partnered with Genesis to offer the "Gemini Earn" program, in which Gemini's retail investors would lend their crypto assets to Genesis in return for interest payments; Genesis pooled these assets and re-lent them to institutional investors at a profit over the interest payments. Gemini, meanwhile, earned an agent fee for each customer that entered the program. The SEC alleges that the Gemini Earn program constituted an unregistered offer and sale of securities. The case has yet to proceed beyond the initial complaint.

BlockFi Lending LLC, Securities Act Release No. 11029, Investment Company Act Release No. 34503 (Feb. 14, 2022). BlockFi offered accounts in which investors lent it cryptocurrency assets in exchange for variable interest payments; BlockFi funded these interest payments by lending the cryptocurrency to third parties and other activities. The company attracted nearly 400,000 U.S. investors to these accounts. The SEC alleged that the BlockFi accounts were unregistered securities under the *Howey* test for investment contracts, operated as an unregistered investment company, and made false or misleading statements regarding its collateral practices. In a settlement with the agency, BlockFi agreed to stop offering its accounts unless or until they were registered as securities, bring itself into compliance with the Investment Company Act, and pay a $50 million civil penalty. BlockFi will also pay another $50 million in penalties through a separate settlement with a group of state governments.

Sparkster Ltd., Securities Act Release No. 11102 (Sept. 19, 2022). Software development company Sparkster and its CEO raised $30 million in a four-month offering of its digital tokens. Like many other digital token creators, Sparkster promoted its tokens as likely to increase in value and as tied to the long-term growth of the Sparkster software ecosystem. The company and CEO settled claims by the SEC that its tokens constituted unregistered securities, agreeing to destroy any tokens it still possessed, ask for removal of its token from trading platforms, disgorge the $30 million raised (plus $4 million in interest), and pay an additional half-million civil penalty. The SEC also filed a separate complaint in federal court against an influencer surreptitiously compensated to promote the Sparkster tokens; that case has yet to reach resolution.

Kim Kardashian, Securities Act Release No. 11116 (Oct. 3, 2022). The SEC reached a settlement with Kim Kardashian over her promotion of cryptocurrency tokens via Instagram. The agency alleged that the tokens were securities (as investment contracts under *Howey*) and that Kardashian did not disclose $250,000 in compensation for her promotion of these tokens, thereby violating anti-touting rules. Under the settlement, Kardashian agreed to forego any potential cryptocurrency promotion, to disgorge the full amount of her compensation plus interest, and to pay a $1 million civil penalty.

American CryptoFed DAO LLC, Securities Act Release No. 11134 (Nov. 18, 2022). In late 2021, the SEC initiated administrative proceedings against American CryptoFed (ACF) for material misstatements in the registration statements for two digital tokens registered as equity securities. Rather than correct the misstatements, ACF subsequently applied to withdraw its application in mid-2022. The SEC denied that application, issued a subpoena to ACF, and, in late 2022, began stop-order proceedings to suspend the effectiveness of the registration.

Nexo Capital, Inc., Securities Act Release No. 11149 (Jan. 19, 2023). Cayman Islands-based Nexo offered an "Earn Interest Product" in which investors deposited crypto assets in return for interest payments; it then re-deployed these crypto assets in a variety of investments. Nexo began offering this product to U.S.-based investors by 2020 but voluntarily ceased transactions with U.S. customers after the SEC announced its settlement with BlockFi. In January 2023, Nexo consented to an administrative order

under which it will pay $22.5 million in penalties to the SEC and $22.5 million to state regulators; Nexo will also terminate all Earn Interest Product accounts for U.S. customers by April 2023.

Other Securities Law Violations Related to Cryptocurrency

SEC v. Wahi, No. 2:22-cv-01009 (W.D. Wash.). The SEC sued a Coinbase employee and two of his close associates for trading on inside information about which crypto assets would be listed by Coinbase. The SEC alleges that the coins at issue are securities. The defendants have yet to respond to the complaint, and motions to dismiss are expected in early 2023.

SEC v. Okhotnikov, No. 1:22-cv-3978 (N.D. Ill.). The SEC charged several defendants in connection with an alleged pyramid scheme implemented through cryptocurrency blockchains (e.g., Ethereum). Some defendants have already settled; the remaining defendant moved to dismiss the complaint in late November.

SEC v. Bankman-Fried, No. 1:22-cv-10501 (S.D.N.Y.). After the collapse and bankruptcy of cryptocurrency exchange FTX, the SEC filed a civil suit against FTX's CEO and founder, Sam Bankman-Fried. The agency alleged that Bankman-Fried defrauded investors in FTX, including U.S. investors, through lies about FTX's risk management practices, its relationship to Bankman-Fried's hedge fund (Alameda Research), and other aspects of FTX's governance and operations. On the same day that the SEC filed its civil suit, the U.S. Department of Justice unsealed an indictment against Bankman-Fried for wire fraud, conspiracy to defraud the United States, conspiracy to commit money laundering, and other charges.

SEC v. Da Silva, No. 1:22-cv-10534 (S.D.N.Y.). The SEC filed a civil suit against four individuals allegedly behind "an international pyramid scheme case involving a fake crypto asset trading and mining company." Three of the defendants are U.S. citizens who acted as promoters; according to the complaint, these three specifically targeted retail investors in Spanish-speaking communities and promised large, guaranteed returns. As of mid-December, the defendants have not responded to the complaint.

SEC v. Eisenberg, No. 1:23-cv-503 (S.D.N.Y.). In January 2023, the SEC sued Avraham Eisenberg for his role in draining over $100 million Mango Markets, a cryptocurrency trading platform affiliated with the MNGO token. According to the SEC, Eisenberg used multiple accounts on the Mango platform to bid up the price of MNGO by more than 2,000% and MNGO futures by more than 1,300% in a very short period. He then exploited a weakness in the MNGO protocols to take an automatic loan of $116 million of non-MNGO assets from the platform. The MNGO prices crashed back to earth, and Avraham absconded with his assets. Eisenberg has already been charged with criminal commodities fraud and manipulation. Nonetheless, the SEC's suit maintains that the MNGO tokens were investment contracts under *Howey* and therefore securities; the agency alleges that Eisenberg committed fraud and market manipulation with respect to these securities.

ParagonCoin, Ltd., Exchange Act Release No. 94216 (Feb. 10, 2022). ParagonCoin previously registered its digital tokens, intended to add blockchain technology to the cannabis industry after a settlement with the SEC in 2018. By early 2019, however, ParagonCoin had ceased filing periodic reports, reported an annual loss over $10 million, and had no public trading or quotes for its tokens. This year, the SEC initiated proceedings to revoke the registration of ParagonCoin's securities.

Exchange-Traded Products Based on Cryptocurrency

Grayscale Investments LLC v. SEC, No. 22-1142 (D.C. Cir.). The SEC denied a NASDAQ subsidiary's attempt to offer an exchange-traded product centered around a Bitcoin trust sponsored by Grayscale; the agency focused on lack of protections against fraud and manipulation for the Bitcoin spot market. Grayscale petitioned the D.C. Circuit to overturn that decision, arguing in part that the SEC has arbitrarily distinguished between approved products for Bitcoin futures and the denied proposals for Bitcoin spot market products. The case is currently in the middle of merits briefing.

APPENDIX 2

Long-Standing, Well-Established Securities Laws and SEC Jurisdiction

What is a "security"

Definition of "security"

- any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit fora security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. (Section 2a1 of the Securities Act of 1933 / Section 3(a)(10) of the Exchange Act).

The *Howey* Test

- An "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others (*SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946))
  - "[F]orm [is] disregarded for substance and the emphasis [is] on economic reality." 328 U.S. at 298
  - This test "embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 299.
- Per *Tcherepnin v. Knight*, 389 U.S. 332 (1967), "[e]ven a casual reading of [Section] 3(a)(10) of the 1934 Act reveals that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term."

How Securities Issuers Comply with Securities Laws

Initial Offer and Sale of Securities – Securities Act of 1933

- Any person, company or entity of any type that seeks to raise capital by issuing securities (investment contracts) to the public must register with the SEC (Section 5 of the Securities Act) unless an exemption exists.

Exemptions include:

- private offerings to a limited number of persons or institutions;
- offerings of limited size;

- intrastate offerings; and
- securities of municipal, state, and federal governments.

Unless exempted, all securities issuers must file a **registration statement** with the SEC and a provide a **prospectus** to investors prior to the offer or sale of securities.

- Registration Statement (Form S-1) shall include (Section 5 of the Securities Act)
  - a description of the company's properties and business;
  - a description of the security to be offered for sale;
  - information about the management of the company; and
  - financial statements certified by independent accountants.

- Prospectus (Section 10 of the Securities Act) shall contain information necessary to enable prospective purchasers to make an informed investment decision, including information related to:
  - business operations;
  - financial condition;
  - results of operations;
  - risk factors; and
  - management.

Requirements applicable to a securities issuer once the securities are publicly traded – Securities Exchange Act of 1934

- File periodic (Form 8-K), quarterly, (Form 10-Q) and annual reports (Form 10-K), subject to Reg S-K; S-X;
- Comply with internal accounting controls and audit of financial statements;
- Corporate governance controls (such as executive clawbacks policies);
- Subject to proxy provisions;
- Insider trading restrictions; and
- Foreign Corrupt Practices Act recordkeeping.

Issuer Liability

- Full and fair disclosure of all material information—"if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the shareholder (*TSC Industries v. Northway*, 426 U.S. 438, 449 (1976)), then it is material information and must be disclosed fully, accurately and timely.

- Section 10b of the Exchange Act / Rule 10b-5—antifraud provision—prohibits fraud in connection with offer or sale of security.
- Section 11 of the Securities Act – Signers of the registration statement, directors, accountants, and underwriters are liable to purchasers of that security for any "untrue statement of a material fact or omitted to state a material fact therein or necessary to make the statements therein not misleading".
- Section 12(a)(1) of the Securities Act – purchaser may rescind or recover damages against any person who offers or sells any security in violation of Section 5.
- Section 12(a)(2) of the Securities Act – purchaser may rescind or recover damages against any person who offers or sells any security by means of prospectus or oral communication that includes a materially false or misleading statement if seller fails to use reasonable care.
- Section 17(a) of the Securities Act – remedy for the SEC and/or DOJ for redressing any fraudulent or deceptive conduct in offer or sale of securities.
- Section 24 of the Securities Act – criminal penalties for willful violation of any provision of Securities Act.

Broker-Dealers Compliance with Securities Laws

Registration – Exchange Act Sec. 15(b)

A registered broker-dealer must:

- File Form BD, which includes disclosure of broker-dealer principals, controlling persons, and employees;
- Become a member of a self-regulatory organization (Section 15(b)(8)/Rule 15b9-1);
- Become a member of the Securities Investor Protection Corporation and pay annual fee;
- Comply with applicable state requirements; and
- Associated persons (employees) must also be registered (Form U-4) and meet qualification requirements (such as Series 7 exam).

Various Rules and Duties Owed by Broker-dealers

- Customer Protection Rule – Rule 15c3-3
  - Broker-dealers are required to (1) obtain and maintain possession or control of all securities and excess margin securities for its customers; and (2) keep customers' cash separate from their own.
- "Chinese Wall" – Rule 14e-3
  - Broker-dealer policies and procedures designed to segment the flow and prevent the misuse of material nonpublic information.
- Submission to SEC and SRO examinations
- Duty of Fair Dealing
  - Broker-dealers owe their customers a duty of fair dealing, including:
    - execute orders promptly;

    - disclose material information;
    - charge reasonable prices; and
    - disclose conflicts of interest.
- Duty of Best Execution
  - A broker-dealer must seek to obtain the most favorable terms available under the circumstances for its customer orders.
- Suitability
  - A broker-dealer must have an "adequate and reasonable basis" for a recommendation of a particular investment strategy or security (NASD Rule 2310).
- Net Capital Rule – Rule 15c3-1
  - Requires broker-dealers to maintain net capitals in excess of certain thresholds, subject to haircuts depending on riskiness of assets.
- Customer Confirmation Rule – Rule 10b-10
  - A broker-dealer must provide certain transaction data to their customers.
- Disclosure of Credit Terms – Rule 10b-16
  - A broker-dealer must give customers purchasing securities on credit certain information related to the credit terms and status of their accounts.
- Short Sale Restrictions
  - A broker-dealer must take certain actions when offering short sales to customers such as location requirements and close-out requirements (to avoid naked short selling).
- Consumer Financial Information – Regulation S-P
  - A broker-dealer must provide customers with initial, annual, and revised notices regarding broker-dealer's privacy policies and practices.
- Maintain anti-money laundering program
- Comply with OFAC sanctions restrictions
- Trading during an Offering – Reg M
  - A broker-dealer faces certain restrictions with initial offering of securities.
- Restrictions on Insider Trading
- Restrictions on private securities transactions – NASD Rule 3040

Antifraud obligations

Broker-dealers are subject to **antifraud provisions** of the Exchange Act which prohibits misstatements or misleading omissions of material facts and fraudulent or manipulative acts or practices in the purchase or sale of securities:

- Section 9(a) – prohibits manipulative practices
- Sec. 10(b) – prohibits use of manipulative or deceptive device
- Section 15(c)(1) and 15(c)(2) – applies to over-the-counter (OTC) markets

Regulation ATS

An alternative to registration as a national securities exchange, Regulation ATS governs broker-dealers operating an automated trading platform that collects and executes orders in securities electronically.

- Must be a registered broker-dealer.
- Must file Form ATS and quarterly Form ATS-R.
- Fair Access Rule; and
- Reg SCI.

Exchanges Compliance with Securities Laws – Securities Exchange Act of 1934

Registration – Section 5 & Section 6

Section 5 makes it unlawful for any broker, dealer, or exchange to operate an unregistered exchange to effect any transaction in a security.

Section 6 – National Securities Exchanges must be registered with the SEC, including the following requirements—

- Ability to enforce compliance with the rules of the exchange by its members (Section 6(b)(1));
- Any registered broker dealer may become a member of the exchange (Section 6(b)(2));
- Fair representation of its members in selection of its directors and administration of affairs (Section 6(b)(3));
- Equitable allocation of dues and fees (Section 6(b)(4));
- Rules in place to prevent fraudulent and manipulative acts or practices, protect investors and the public interest; and do not permit unfair discrimination between customers, issuers, brokers, or dealers (Section 6(b)(5));
- Members shall be appropriately disciplined for violations of the Act or rules of the exchange (Section 6(b)(6));
- And deny membership to any person not registered as a broker-dealer.

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