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A Decade in Review: SEC Cryptocurrency Enforcement – Where We Have Been and Where We Are Going after FTX

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Ten years ago, the Securities and Exchange Commission released an alert warning individual investors that "the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi or other schemes." On the same day, the Commission filed claims against Trendon T. Shavers, the founder and operator of "Bitcoin Savings and Trust," for defrauding investors in a Ponzi scheme involving 700,000 Bitcoin (BTC). Almost a decade later, on December 13, 2022, the SEC alleged that Samuel Bankman-Fried had orchestrated a years-long scheme to defraud equity investors in FTX Trading Ltd., as he raised more than $1.8 billion.

These two frauds bookend the explosive growth of the digital asset industry, with several bull markets and crypto winters in between. The 700,000 BTC in the Shavers case were worth more than $60 million at the time but would have a market price of more than $18 billion today.

The collapse of FTX was a watershed moment for the crypto industry, and its consequences have rippled through the crypto enforcement landscape. The SEC already had taken an enforcement-first approach to crypto, focusing on settled enforcement actions, some litigation, and limited rulemaking or formal guidance. As

we discuss below, we expect that the fallout of FTX will be a continued, and possibly even stronger, enforcement-first approach by the SEC, with less interest in the traditional regulatory approach of coupling industry growth with investor protection.

Early Years

In 2017, the SEC issued a report of investigation concerning a blockchain project called The DAO. In the report, the SEC expressed the view that offers and sales of digital assets by "virtual" organizations are within the scope of federal securities laws. Following the DAO Report, much of the SEC's initial enforcement focus centered on initial coin offerings, or ICOs, a then-popular form of digital crowdfunding. Individuals contributed either digital assets (typically Bitcoin or Ethereum) or fiat currency in exchange for digital tokens. The SEC often alleged that the sale of a digital asset was accompanied by an explicit or implicit expectation of profit as the value of the asset would increase. The SEC asserted that this met the definition of an "investment contract," which is a type of security under federal law that the Supreme Court interpreted in a 1946 case, *SEC v. W.J. Howey Co.* In another decision, *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Supreme Court explained when a note is a security. The SEC has cited *Reves* in asserting that some digital assets are securities, although less frequently than it has relied on *Howey*. Since then, SEC leadership has frequently expressed the view that nearly all digital assets are securities and that their sales must be registered under the federal securities laws or fall within an exemption from registration.

Of the 127 enforcement actions the SEC brought between 2013 and 2022 involving cryptocurrencies, seventy were related to ICOs. The SEC started with several smaller actions that resulted in settlements and then moved on to larger sales, some of which were litigated. A primary example and a significant success for the SEC is *SEC v. Telegram Group Inc.* In October 2019, the SEC filed a complaint seeking a preliminary injunction against Telegram to prevent the company from distributing 2.9 billion Gram tokens to a group of 171 buyers. The SEC alleged that these buyers had agreed to resell the tokens into the secondary market, effectively acting as underwriters in an unregistered offering of securities. A federal district court granted the preliminary injunction and, in one of the SEC's largest ICO settlements, Telegram agreed to return more than $1.2 billion to investors and to pay a civil penalty of $18.5 million.

In another litigated action that remains pending as of the writing of this article, the SEC alleged that Ripple Labs, Inc. and two of its executives raised over $1.3 billion through an unregistered and ongoing securities offering of its XRP token. The SEC's case against Ripple Labs has raised questions about (i) whether the SEC's approach to

crypto enforcement has provided fair notice to the industry of what conduct is acceptable and what is not; and (ii) when a digital asset is a security—a question that is the crux of the SEC's enforcement authority. Over the course of the litigation, Ripple has asserted a fair notice defense based, in part, on the settlement agreement Ripple entered into with the DOJ and FinCEN in May 2015, which referred to XRP as a "convertible virtual currency," as well as a 2019 meeting with the SEC in which a digital asset platform requested guidance on its consideration of listing XRP and was not told at the time that the SEC considered XRP to be a security. How the court rules on the merits of these arguments remains to be seen.

The SEC also brought several fraud cases against token issuers, including a case against the three individuals who claimed to have created a way to use a credit card to spend crypto in retail stores. The fraud received significant public attention, including because celebrities endorsed the project, and the three founders also were charged criminally.

The SEC then began to branch out from ICOs by bringing small cases against intermediaries who arranged for secondary trading of tokens after they were sold in ICOs. In September 2018, the SEC settled with a self-described "ICO Superstore" for acting as an unregistered broker-dealer. Two months later, the SEC settled with an individual for operating an unregistered national securities exchange.

Recent Expansion

In recent years there has been an increased enforcement focus on other economic activity within the crypto industry. The SEC's shift was in many ways highlighted in a May 2022 press release announcing that it was doubling the headcount of the newly renamed "Crypto Assets and Cyber Unit" within the Enforcement Division. The SEC said that the expanded unit would investigate ICOs, exchanges, crypto lending and staking products, decentralized finance (DeFi) platforms, non-fungible tokens (NFTs), and stablecoins. In the last year, the SEC has followed through on its promise to scrutinize the industry more broadly.

Lending and Staking

The SEC has pursued multiple actions involving lending and staking products. In February 2022, the SEC settled claims against BlockFi Lending LLC for not registering its retail crypto lending product, BlockFi Interest Accounts (BIAs) and for making materially false and misleading statements on its website concerning collateral practices and the risks associated with lending activity. BlockFi provided digital asset borrowing and lending services to users financed, in part, through its BIAs. BIA

customers lent crypto assets to BlockFi in exchange for a monthly interest payment. To settle the action, BlockFi agreed to pay a $100 million fine, split equally between the SEC and thirty-two states in a parallel action; to cease offering BIAs within the United States; and to submit a Form S-1 for a new investment product, BlockFi Yield. BlockFi later filed for bankruptcy, reportedly largely because of its dealings with FTX.

Nearly a year later, the SEC announced a settlement with crypto exchange Kraken for not registering its crypto asset staking-as-a-service program. Under the program, which had been operational since 2019 and which the SEC did not allege to be fraudulent, customers transferred crypto assets to Kraken, which pooled the assets and staked them in exchange for annual investment returns. Kraken agreed to cease its staking program and pay a $30 million penalty.

Insider Trading

In the last year, the SEC also brought its first insider trading case involving digital assets when it filed claims against a former exchange product manager, Ishan Wahi. The SEC's complaint alleged that Wahi, who coordinated public listing announcements for the exchange, tipped the timing and content of upcoming listing announcements to his brother and his friend, who were also named as defendants. The SEC alleged that the brother and friend used this information to purchase at least twenty-five tokens, nine of which the SEC explicitly alleged were securities, ahead of the listing announcements becoming public, and then sold the assets shortly after the announcements for a profit. The SEC first settled with the brother and later settled with Wahi. As discussed below, the DOJ brought a parallel criminal action against the same defendants.

Market Manipulation

The SEC has brought several recent actions alleging market manipulation involving digital assets. In September 2022, the SEC filed claims against The Hydrogen Technology Company and two individuals for the unregistered offer and sale of its digital asset (Hydro) and for an alleged scheme to manipulate the trading volume and price of Hydro. The SEC alleged that Hydrogen hired a marketing firm to use a bot to create the appearance of robust market activity for Hydro, then sold Hydro into that artificially inflated market for a profit on Hydrogen's behalf. The SEC claimed that this activity resulted in more than $2 million in profits.

In January 2023, the SEC alleged that Avraham Eisenberg manipulated the price of perpetual futures for the digital asset MNGO and drained the available assets from the Mango Markets platform. Mango Markets is a decentralized trading platform that uses MNGO as the "governance token" for the platform. The SEC analyzed the

functions of the token, the voting patterns and behavior, and the scope of the governance power to conclude that a DeFi governance token was a security. As discussed below, the DOJ and CFTC brought parallel criminal and civil charges.

Exchanges and Broker-Dealers

Recent enforcement activity has reflected a continued and increased focus on exchanges and broker-dealers. In August 2021, the SEC announced a settlement with Poloniex LLC for allegedly operating an unregistered digital asset securities exchange. To settle the allegations, Poloniex agreed to pay nearly $10.4 million in disgorgement and penalties.

In April 2023, the SEC filed a complaint against Bittrex, Inc. for operating an unregistered national securities exchange, broker, and clearing agent. The complaint alleges that, since at least 2014, Bittrex has held itself out as a platform facilitating purchases and sales of crypto that were securities and that, between 2017 and 2022, Bittrex earned at least $1.3 billion in revenue from transaction fees from investors.

In the Bittrex and Wahi cases, which were litigated actions, the SEC named several of the assets that it believed were securities. The token issuers were not named as defendants and therefore not present as parties to mount a defense. We expect the SEC to continue this practice of naming specific alleged securities without adding their issuers as parties to the litigation. Although this provides some information to the defendants and the market, it has significant consequences for the issuers without affording them an avenue to challenge the SEC's allegations.

Other Regulators and Law Enforcement Agencies

The SEC's enforcement focus has been paralleled by increased enforcement activity by the DOJ, CFTC, and state authorities. The current lack of a single statutory regime regulating digital assets has led to sometimes disjointed enforcement approaches. For instance, in the case of Mango Markets noted above, the DOJ also brought charges against Eisenberg for his alleged market manipulation. However, rather than alleging securities fraud as the SEC did, the DOJ aligned its charges with the CFTC's parallel civil action and alleged *commodities* fraud and manipulation.

The DOJ's approach in the Wahi insider trading matter also diverged from the SEC's claims. The DOJ charged the Wahi brothers and the friend with wire fraud conspiracy and wire fraud but did not allege securities fraud. The DOJ did not allege that any of the tokens at issue were securities and, while it identified certain tokens at issue, its list only included two of the tokens named by the SEC.

At the state level, crypto enforcement has been similarly active with state regulators announcing 112 enforcement actions in 2022. The New York Attorney General's office has brought a number of recent actions against the crypto industry. On March 9, 2023, the NYAG filed a lawsuit against KuCoin—a crypto trading platform—for failure to register as a securities and commodities broker-dealer and for falsely representing itself as an exchange. Most notably, the NYAG in its complaint took the unprecedented position that ETH—which the CFTC has taken the position is a commodity—is a security under both federal and New York state law.

The SEC's Enforcement-First Approach

Looking back, the SEC's approach to crypto can be characterized as "enforcement first." The relative lack of guidance or rulemaking has been the subject of much criticism, including from within the SEC. While there have been some rule proposals that touch on the crypto industry, since issuing the DAO Report in 2017, the SEC has not proposed any crypto-focused rules and has provided little Commission-level guidance. Some have argued that an enforcement-first approach is particularly unhelpful for blockchain technology because it may have the potential to render obsolete the historic structure underlying at least some aspects of existing securities regulation.

SEC enforcement actions have limited value as a form of guidance. The cases are fact-specific, which do not articulate broad principles that can be applied directly to other contexts. There have been a few litigated actions resulting in decisions by Article III judges. Even with the recent bout of contested actions, by the time cases result in judicial decisions their facts often are several years behind the current status of the industry. SEC enforcement actions also do not involve the process that supports rulemaking—issuing a proposal for public comment, assembling a public record of varied opinions on that proposal, and then issuing a rule that must be supported by a cost-benefit analysis. Moreover, some have argued legislation would be the best way to make the policy decisions inherent in regulating a new type of commercial activity. As a result, the industry argues that the SEC's approach deprives industry actors of fair notice, precludes meaningful debate, and picks winners (projects that do not draw SEC scrutiny) and losers (projects that are subject to enforcement actions).

FTX and the Future

FTX was one of the world's largest centralized cryptocurrency exchanges before it unraveled in November 2022, eventually filing for bankruptcy and placing into jeopardy the investments of hundreds of thousands of customers. Precipitating the

collapse was a leak of financial documents from FTX's affiliated trading arm, Alameda Research, revealing that the majority of the trading firm's holdings were FTX's own token, FTT. The price of FTT crashed within days, and FTX, its U.S. affiliate FTX.us, and Alameda all filed for bankruptcy.

After the collapse, FTX founder and crypto celebrity Sam Bankman-Fried was arrested in the Bahamas following notice from U.S. officials that they had filed criminal charges and would seek extradition. The next day, the U.S. Attorney's Office for the Southern District of New York unsealed an indictment against Bankman-Fried with a variety of charges, including conspiracy to commit wire fraud, conspiracy to commit securities fraud, and conspiracy to commit commodities fraud. The SEC and CFTC filed their own fraud complaints.

The collapse of FTX and subsequent regulatory actions capped off a string of bankruptcies and alleged fraud cases. Significantly, in FTX, the alleged fraud had nothing to do with innovative technology. The scale and impact of FTX's collapse put increased pressure on regulators to show they were an active "cop on the beat."

It is worth noting that, so far, the SEC has experienced success in much of its litigation. In 2020, the SEC won a motion for summary judgment against Kik Interactive, Inc. after alleging that sales of Kin tokens were unregistered sales of investment contracts. As noted above, the SEC obtained a preliminary injunction and favorable settlement in *Telegram*. Another example is *SEC v. LBRY, Inc.*, in which the SEC alleged that LBRY conducted an unregistered offering of securities for the sale of its LBC token. In November 2022, the U.S. District Court for the District of New Hampshire granted the SEC's motion for summary judgment, holding that the initial sales of LBC had violated federal securities laws under the *Howey* analysis and rejecting LBRY's fair notice defense based on the fact that its sales were not conducted through an ICO.

Takeaways

The SEC's enforcement-first approach is poised to continue in the wake of FTX. Although it is possible that a comprehensive regulatory regime may gain some traction, it does not seem to be a current priority for the SEC. This leaves those within the industry in something of a bind—even those who would like to register and offer products and services within the U.S. are finding that path difficult, if not impossible, to navigate.

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