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Assessing the Landscape: One Year into the SEC's Litigation Against Major U.S. Digital Asset Exchanges

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The SEC's litigation against the largest digital asset exchanges in America has been unfolding for over a year, beginning with the agency suing various Binance entities[1] in June 2023, followed by actions against Coinbase Inc./Coinbase Global Inc. (collectively "Coinbase"), and Payward, Inc./ Payward Ventures, Inc. (collectively "Kraken") shortly thereafter.

The cases have all advanced through the Motion to Dismiss briefing stage (for *Binance* and *Kraken*) and Motion for Judgment on the Pleadings stage (for *Coinbase*) with rulings in *Coinbase* and *Binance* completed on those issues and expected soon in *Kraken*.

With these cases having been previously discussed in the Polsinelli **Bi-Weekly updates**, the various lawsuits have reached a point in litigation where it is now the opportune moment to assess where those cases stand, anticipate what to expect in the upcoming year, and explore their implications for the digital asset industry through 2024 and into 2025.

BACKGROUND

In June 2023, the SEC brought a lawsuit **against the various Binance entities** and their founder, Changpeng Zhao (together "Binance"). The Binance lawsuit alleges that sales of Binance's own digital assets on its platform (BNB and stablecoin BUSD) along with facilitating the sales of various other cryptocurrencies on the Binance platform, constituted violations of securities laws.[2] Shortly thereafter, the SEC brought a similar **lawsuit against Coinbase**, alleging sales of various cryptocurrencies[3] on its platform were unregistered securities transactions, alleging the Coinbase wallet functioned as an unregistered broker/dealer, and that Coinbase's staking services were also unregistered securities offerings. Finally, the SEC brought a **lawsuit against Kraken**, which had already **settled allegations related to the Kraken staking services**, alleging sales of various cryptocurrencies[4] on its platform were unregistered securities transactions. Other than the *Binance* case related to BNB and BUS, none of the lawsuits named the issuers of the cryptocurrencies as defendants.

At the time of filing of these cases, there was also additional litigation between Binance, Coinbase, and various regulatory bodies. Binance was facing separate lawsuits from the DOJ and CFTC which have **since settled**. Concurrently, Coinbase was involved in a **lawsuit against the SEC** concerning its **request for rulemaking**. This issue was rendered moot when the SEC declined

to issue digital asset-specific rules, leading Coinbase to initiate a **new and still ongoing appeal** of that SEC decision.

COINBASE MOTION FOR JUDGMENT ON THE PLEADINGS RULING

Coinbase was the first of the exchanges to move to dismiss the SEC's lawsuit, taking the unusual procedural posture of **answering the SEC's Complaint** and then **immediately moving for judgment on the pleadings**. This is in contrast to a more standard litigation procedure involving the filing of a motion to dismiss, as both Binance and Kaken did. This strategy allowed Coinbase to supplement the factual record for the court's consideration with the information provided in Coinbase's answer. Coinbase argued that the digital assets sold on its exchange should not be classified as "investment contracts" under the *Howey* test and thus are not securities.[5] Coinbase argued that purchasing the digital assets at issue on a secondary exchange did not give the buyers of those digital assets any contractual rights to the issuer's income, profits, assets of a business, or otherwise impose any obligations for anybody to further develop the applicable digital asset's network. This line of argument has been referred to as the "Investment Contracts Require Contracts" argument.

Coinbase also argued that the "major questions doctrine" justified rejecting the SEC's classification of the digital asset transaction at issue as investment contract transactions. The major questions doctrine holds that significant regulatory decisions should be made by Congress, rather than regulatory agencies, on "major questions" that would significantly affect a substantially sized industry. Coinbase contended that accepting the SEC's legal stance would potentially have a crippling effect on the $3 trillion digital asset industry. Finally, as to the SEC's allegations surrounding Coinbase's digital wallet software and staking functionalities, Coinbase asserted that it did not function as a broker merely by making what it referred to as "passive software" available to customers. Coinbase further argued that the staking-as-a-service functionalities made Coinbase a service provider and not a securities issuer; a point which was emphasized by **various amicus filed in support of Coinbase's argument**. Coinbase also argued that there was no risk of loss with Coinbase guaranteeing to cover any "slashing" or other staking penalties that may be assessed against customer assets.

The **SEC's response** insisted that the "Investment Contracts Require Contracts" argument was not supported by applicable federal precedent, and that investment contracts do not require the buyer of the investment contract to obtain further contractual rights, meaning that to the SEC there is no distinction between primary vs. secondary asset sales in determining if an asset is sold as an investment contract. With regard to the major questions doctrine, the SEC posited that the doctrine is not applicable in the enforcement context, and not otherwise applicable in this particular action.

Oral arguments on the issues **occurred on January 12, 2024**. On March 27, 2024, Judge Failla of the Southern District of New York, **issued her Order**, allowing most of the SEC claims including those related to staking and secondary sales of digital asset claims to move forward. The lone claim dismissed was the claim regarding the Coinbase digital wallet. The court found that the Coinbase digital wallet is merely software, that connects users with third-party decentralized finance platforms, with those third-party platforms actually effectuating the digital asset transactions.

As to the claims allowed to survive, the court found that even if no contractual relationships existed between tokens' issuers and the secondary buyers on Coinbase, transactions for the tokens at issue could plausibly still be considered "investment contracts" under *Howey*. The court reasoned that because "token issuers, developers, and promoters frequently represented that proceeds

from crypto-asset sales would be pooled to further develop the tokens' ecosystems and promised that these improvements would benefit all token holders by increasing the value of the tokens themselves," even downstream purchasers of those sales could still fit in within the *Howey* framework.

The court also held that the risk of loss in the staking program, even if contractually covered by Coinbase, and the consideration in the form of the crypto asset to be staked was sufficiently alleged to survive at this stage in litigation. Finally, the court ruled that the digital asset industry is not of such importance as to invoke the major questions doctrine.

On April 12, 2024, Coinbase filed a **motion to certify an interlocutory appeal** of the court's decision to allow the staking and secondary sales claims to go forward. This request for an appeal remains pending.

BINANCE MOTION TO DISMISS AND RELATED RULING

The Binance entities sued by the SEC took the more standard procedural posture in their attempt to dismiss the SEC's claims, filing **motions to dismiss** in **September of 2023**. Both the U.S. and international groups of defendants argued that the secondary trading of the digital assets at issue do not meet the "investment contract" standard from *Howey* and raised largely similar "Investment Contracts Require Contracts" arguments as Coinbase did. Both groups also argued that the SEC's intrusion into the digital asset industry represents a violation of the major questions doctrine. The U.S. entities argued that the SEC failed to adequately plead its fraud allegations against them. The international defendants argued that they were jurisdictionally immune to most of the SEC's claims and that the applicable statute of limitations foreclosed the SEC from bringing claims regarding the initial sales of the digital asset, BNB.

The **SEC's response** argued, similar to as in *Coinbase*, that securities laws are intentionally flexible, meaning applying a rigid "Investment Contracts Require Contracts" test would be contrary to the spirit of the law and the applicable legal precedent. Interestingly, this response was the first time the SEC shifted its stance on treating Ether as a security, aligning it with Bitcoin and claiming that neither of those digital assets were at issue in this litigation despite being the "largest crypto assets in existence…". The court heard oral arguments on these issues on **January 19, 2024**. While the SEC stated in the *Coinbase* litigation that "the token itself is not the security", during its oral arguments in *Binance*, the SEC also stated, that "the token itself represents the investment contract . . . the token represents the embodiment of an investment contract." *See SEC v. Binance*, Case No. 1:23-cv-01599, Dkt. # 248, Fn. 15 (D.D.C. June 28, 2024) (quoting from oral argument).

On June 28, 2024, Judge Amy Jackson, of the District of Columbia, issued her **Order**, allowing a majority of the SEC's claims to advance to discovery, but dismissing some major portions of the SEC's lawsuit. The nearly 90-page Order brushed off the "Investment Contracts Require Contracts" defense but also was very dismissive of the SEC's "embodiment" theory under which the SEC argued that digital assets can "embody" an investment contract scheme. Judge Jackson did not mince her words, stating "the SEC seemed to speak out of both sides of its mouth" at the hearing on the motions to dismiss and "the agency's decision to oversee this billion dollar industry through litigation –case by case, coin by coin, court after court – is probably not an efficient way to proceed, and it risks inconsistent results that may leave the relevant parties and their potential customers without clear guidance."

Judge Jackson dismissed the SEC's allegations regarding the secondary sales of BNB, being plausibly alleged to be securities transactions, as well as the SEC's claims surrounding the

Binance "Simple Earn" program. She ruled that a consumer's earning of a fixed interest rate for the lending of digital assets was unrelated to Binance's entrepreneurial efforts and thus not an investment contract. She further dismissed the SEC's claims surrounding the BUSD stablecoin, holding that the defining feature of the "stablecoin" was that its value would remain constant such that it would be difficult (if not impossible) to allege how buyers could reasonably expect a profit on it. All the remaining allegations, however, were permitted to advance to the next stage of litigation.

SEC LITIGATION AGAINST KRAKEN AND RELATED MOTION TO DISMISS

In November 2023, the **SEC brought its lawsuit against Kraken**, accusing the second-largest digital asset exchange in the United States of illegally allowing for the secondary trading of "digital asset securities" on its platform. This lawsuit was brought despite **Kraken settling the SEC's allegations** regarding the Kraken staking functionalities earlier in 2023. Jesse Powell, the founder of Kraken, very strongly pointed out that Kraken's cooperation and settlement with the SEC, including paying $30 million USD, appears to have done nothing to protect them from further litigation and insinuating that the SEC is unlikely to ever be satisfied with this industry: "I thought we settled all their concerns for $30 million in Feb. Now they're back for seconds?" He went as far as to encourage others in the space to avoid the U.S. entirely under **its current regulatory regime**.

Kraken **moved to dismiss** the SEC's lawsuit in February of 2024, largely following the argumentative framework in the *Binance* and *Coinbase* cases. All raise similar arguments regarding the token sales at issue not being "investment contracts" using the "Investment Contracts Require Contracts" argument and that the SEC's regulatory overreach is contrary to previous agency positions and violates certain separation of powers principles. In **a separate blog post** explaining the Motion to Dismiss, Kraken stated that the day after Kraken testified to the House Financial Services Committee regarding the need to limit the SEC's authority over the regulation of digital assets, an SEC official called Kraken stating the agency's intent to sue them. Kraken further argued that the unique 9th Circuit Court of Appeals case law (where the *Kraken* case was brought),[6] supported Kraken's arguments regarding the secondary sales not being considered investment contracts.

Another notable aspect of this case is the various *amicus* briefs filed in support of Kraken, including those filed by the **Chamber of Digital Commerce**, the **Blockchain Association/DeFi Education Fund**, Paradigm, and a group of **State Attorney Generals**. All of the *amicus* briefs call into question the **seemingly shifting stance** of the SEC on what is a "**digital asset security**" or an associated "ecosystem" as to turn involvement with a particular blockchain's token enough to satisfy the elements under *Howey*. The **State AG briefing** was especially interesting, claiming the SEC is overstepping into the realm of general consumer protection reserved for the states.

The hearing on Kraken's motion to dismiss occurred on June 20, 2024, with Judge William Orrick, for the Northern District of California, opened the hearing by expressing his intent to adhere to the ruling in the *Coinbase* litigation discussed above, permitting the allegations that the secondary sales of digital assets are investment contracts to proceed. While Judge Orrick heard arguments on the "Investment Contracts Require Contracts" issue, he was firm in stating that he would not be listening to arguments regarding the major question doctrine, appearing to have already decided from the briefing papers that the doctrine was not applicable to this particular case.

As of this publication date, a formal decision has not been issued on Kraken's Motion to Dismiss.

KEY TAKEAWAYS AND WHAT LIES AHEAD

The differing holdings between the *Binance* and *Coinbase* cases regarding secondary sales of digital asset issues potentially create a split of authority on this issue. However, the SEC could argue that these differing outcomes merely reflect variations in facts rather than differing legal standards. The courts in both cases rejected the "Investment Contracts Require Contracts" arguments but arrived at different results in the *Howey* analysis. It is reasonable to expect further splits in authority following the ruling in *Kraken*, as well as from other similar pending cases such as the **declaratory judgment action brought by Consensys**, the SEC's **separate case against Consensys**, and various **other matters** pending on these issues in **courts** across the **country**.

Importantly, all of the courts having considered the applicably of the **major question doctrine** rejected it, largely agreeing that the major questions doctrine only applies if the industry in question resembles, in political and economic significance, those involved in prior Supreme Court cases, such as the tobacco industry in *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000). This is an expected outcome at the district court level, but the major questions doctrine may be a stronger argument at the appellate court level or the Supreme Court if these cases reach that point. In particular, the current Supreme Court has demonstrated its willingness to limit the power of governmental agencies, most recently in the *Loper* case **overturning the agency deference standard stated in *Chevron*** and may be willing to use the major questions doctrine to protect digital assets from agency overreach without express congressional approval.

For the time being, these cases are all scheduled to move through discovery and we can expect intensive litigation over various discovery issues similar to **the fights in the *Ripple* litigation** over communications related to the now infamous **Hinman speech**. Those fights have already begun, with Coinbase recently **requesting documents from SEC Chair Gary Gensler's personal email account**. The arguments may gain an appellate fast track if there is an approved interlocutory appeal of the secondary sales or staking issues while the cases are ongoing. But, more likely, the exchanges will need to wait until discovery is completed and there is a ruling on the merits before a higher court has an opportunity to consider these issues, which could take years. Even if discovery is completed at a breakneck pace in the cases (as the exchange defendants all appear to be pushing for), there will not be a final judgment until late 2025 or early 2026, at the earliest.

Between now and then, there may be a change in presidential administration or law, which could moot the issues or drive the parties to settle. For now, this is "bet is on the company" litigation for at least the U.S. portion of these exchanges. If courts side with the SEC, ruling that secondary sales of a vast majority of digital assets are securities transactions, it is hard to imagine how these key players in the industry can survive in the United States in their current form. The key use case for many digital assets is enabling consumers to self-custody and exchange these assets with minimal reliance on intermediaries. This capability is virtually impossible while complying with the SEC's current interpretation of existing securities laws and regulations. However, if the exchanges win and the courts find that secondary transactions are not investment contracts, while that would be a boon for the exchanges, it would leave a regulatory gap and a potential "**Market for Lemons**" which may be equally harmful.

While the **Financial Innovation and Technology for the 21st Century Act** ("FIT 21") bill sailed through the House of Representatives with a bipartisan vote of 279-136, there is no indication it has anywhere near the support required to pass in the Senate, especially in the current congress which is **on track to be one of the least productive Congresses in United States history**.

Until there is a consensus reached in the courts on the regulatory status of various digital assets or until there are enforceable rules or regulations specific to these relatively nascent technologies and associated products and services, the industry will continue as it has for much of the 2020s in a challenging regulatory environment which stifles innovation and drives projects out of the United States.

Given the evolving and complex nature of digital asset regulations, it is critical that individuals and companies navigating this space retain advisors with specific expertise in the digital asset industry. These professionals possess the nuanced understanding necessary to effectively manage the intricacies of ongoing litigation, regulatory compliance, and strategic planning. As the legal landscape continues to develop, having knowledgeable advisors is crucial for navigating complexities and seizing opportunities within this dynamic sector.

The challenge of building successful and compliant companies and projects is compounded when even the most reputable firms in the industry face intense regulatory scrutiny under questionable legal reasoning. Therefore, it is crucial for digital asset projects in the U.S. to adopt a long-term perspective, recognizing the opportunity to help develop potentially world-changing technologies and foster a dynamic asset class.

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[1] Binance Holdings Limited, BAM Trading Services Inc., and BAM Management US Holdings Inc.

[2] The digital assets named as “crypto asset securities” in *Binance* were: BNB, BUSD, SOL, ADA, MATIC, FIL, ATOM, SAND, MANA, ALGO, AXS, and COTI.

[3] The digital assets named as “crypto asset securities” in *Coinbase* were: SOL, ADA, MATIC, FIL, SAND, AXS, **CHZ**, **FLOW**, **ICP**, **NEAR**, **VGX**, **DASH**, and **NEXO** (coins not named in *Binance* in **bold**).

[4] The digital assets named as “crypto asset securities” in *Kraken* were: ADA, ALGO, ATOM, FIL, FLOW, ICP, MANA, MATIC, NEAR, **OMG**, and SOL (coin not named in *Binance* or *Coinbase* in **bold**).

[5] The *Howey* test is a legal standard established by the U.S. Supreme Court in the seminal case of *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946), which determines whether certain transactions qualify as “investment contract” transactions, subject to securities regulations.

[6] *Hocking v. Dubois*, *885 F.2d 1449 (9th Cir. 1989) (en banc), cert. denied, 58 U.S.L.W. 3657 (U.S. Apr. 17, 1990) (No. 89-1023)*