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BLOG

Turf War Over Digital Assets Regulation Highlighted by *SEC v. Wahi* Suit

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The sustained and increasing interest in trading digital assets has driven the U.S. Securities and Exchange Commission (SEC or "Commission"), led by its Chairperson (and former MIT blockchain professor) Gary Gensler, to take an aggressive approach to regulation of the asset class. While the SEC and other regulators have offered guidance and engaged in some investigative and enforcement activity, the regulation of digital assets, which have a broad spectrum of properties and characteristics, has created considerable legal and regulatory uncertainty in the space.

One critical unresolved regulatory issue is determining when a digital asset is a "security," which triggers a host of regulatory and compliance obligations for entities and individuals involved in the purchase or sale of the instrument. Other federal regulators, such as the Commodity Futures Trading Commission (CFTC), are seeking to increase their jurisdictional oversight. While legislation percolating through Congress seeks to address these types of issues, including the bipartisan Lummis-Gillibrand Responsible Financial Innovation Act (the "Lummis-Gillibrand Act"), the SEC continues to signal its view that most digital assets are "securities," and therefore, that it possesses far-reaching jurisdiction over digital assets.

It is in this context that the Commission recently filed *S.E.C. v. Wahi, et. al*. (2022), an insider trading case brought in federal court in the state of Washington against a former Coinbase manager and others. The crux of the action is whether the former manager unlawfully provided the others advance notice of which digital assets were to be listed on the Coinbase platform before the listing was announced publicly. The action is significant because it is predicated on the theory that the subject digital assets are in fact securities and because the Complaint contains a reasonably thorough analysis of why the SEC believes that they are.

Regulating Cryptocurrencies Prior to *Wahi*

The SEC previously provided guidance regarding digital assets in various speeches,[1] reports,[2] and no-action letters.[3] But this guidance has not conclusively resolved the threshold issue of which assets are securities and has been characterized as sowing further confusion by many industry participants and even, on occasion, an SEC commissioner.[4]

In the *Wahi* complaint, the SEC analyzed the securities law issue as it typically has,[5] by applying the reasoning set forth in a 1946 Supreme Court, *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946), concerning tracts of land in a Florida orange grove. The Howey test asks whether there was an investment of money in a common enterprise with the expectation of a profit to be derived from the efforts of third parties. In 2019, the SEC released a whitepaper laying a framework for applying *Howey* to digital assets.[6] In that document, the SEC expressed that "the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others."[7]

Attention to *Wahi*

In *Wahi*, the SEC continues its trend of focusing on the *Howey* test, but notably conducts an independent analysis of nine different digital assets. In this regard, *Wahi* represents rare insight into the SEC's approach. The Commission focused most of its position on the assertion that investors relied upon the efforts of managers and company executives to increase their value. For example, RLY, a token and security according to the SEC, was created by Rally Network, Inc. ("Rally"). For example, the SEC pointed to Rally's promotion of RLY's availability on secondary markets, use of transaction revenue from RLY tokens to "cover the operation costs plus the hiring and onboarding of new team members and experts," and how the company's leaders were actively engaged in building the token's worth through holding 30% of outstanding token amounts.[8] The Commission further pointed out similar facts in the management and distribution of the other eight digital assets.

The action has sparked controversy, including within the regulatory community. For example, the SEC's main regulatory "competitor" in this space, the CFTC, expressed concern in a statement on *SEC v. Wahi*, characterizing the action as a "striking example of regulation by enforcement." In this vein, many commentators argue that the Commission failed to give the market adequate notice of the action, lacks jurisdiction, may stifle an innovative market, or be unable to consistently apply its rules and regulations to digital assets. Commissioner Gensler has shown indifference to those types of comments by stating that he "just call[s] it 'enforcement.'"

Impact of Lummis-Gillibrand

The timing of the SEC's Complaint is particularly controversial because Congress is presently considering several legislative proposals that would divest the Commission of jurisdiction over certain types of digital assets. For example, the Lummis-Gillibrand Act seeks to distinguish between digital assets as securities versus commodities granting more jurisdiction to the CFTC. Although passage of that bill in its present form is perhaps unlikely, it illustrates that elected representatives are beginning to deeply consider the regulatory "turf war" and related uncertainty in the marketplace.

Conclusion

The *Wahi* complaint, while providing insight into the SEC's application of the *Howey* test to particular digital assets, has been criticized as "regulation by enforcement." Legislatures and regulatory agencies continue to struggle with fundamental issues regarding digital assets regulation, and the market seeks regulatory clarity. Market participants should assume that, unless it is divested of jurisdiction, the SEC will continue to escalate its enforcement activity in this space, taking a broad view of what constitutes a "security" under U.S. law.

Winston & Strawn is closely monitoring these developments. We will provide our clients and friends of the firm with more information on this topic as it becomes available.

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[1] Penn Law Capital Markets Association Annual Conference (https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422).

[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (https://www.sec.gov/litigation/investreport/34-81207.pdf) (dated July 25, 2017).

[3] *See* Re: Pocketful of Quarters, Inc., Securities and Commission Exchange (dated July 25, 2019) (https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1); *also see*, Incoming Letter re: Pocketful of Quarters, Inc., Pocketful of Quarters, Inc. (dated July 25, 2019) (https://www.sec.gov/divisions/corpfin/cf-noaction/2019/pocketful-of-quarters-inc-072519-2a1-incoming.pdf).

[4] Commissioner Hester M. Peirce, *On the Spot: Remarks at "Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem: Necessary Regulation or Crippling Future Innovation?"*, June 14, 2022 (https://www.sec.gov/news/speech/peirce-remarks-regulatory-transparency-project-conference).

[5] *In re: Blockchain Credit Partners d/b/a DeFi Money Market*, Securities and Exchange Commission File No. 3-20453 (Aug. 6, 2021) (showing the SEC's application of the *Reeves* test, which is another way in which an asset could be classified as a security); see also, *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

[6] SEC "Framework for "Investment Contract" Analysis of Digital Assets, https://www.sec.gov/files/dlt-framework.pdf, 2019.

[7] *Id*.

[8] *Wahi* at 28-32.

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