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"Unclear at Best": *SEC* v. *Payward, Inc. et al.* and the Ongoing Struggle to Understand Secondary Crypto Transactions

Key Takeaways

- **A Northern District of California court denied the defendants' pre-discovery motion to dismiss the SEC's complaint against Payward, Inc. and an affiliate, operators of the Kraken crypto trading platform, accusing the defendants of violating the Exchange Act by operating an unregistered securities exchange, broker-dealer, and clearing agency. As a result, the SEC's claims against the defendants will move forward to the discovery phase of the litigation.**
- **Following Ninth Circuit precedent, the district court applied the *Howey* test to determine whether secondary sales of various crypto assets on the Kraken trading platform qualified as "investment contract" transactions subject to SEC regulations.**
- **However, the court rebuked the SEC for repeatedly attempting to characterize these crypto assets as "securities" in and of themselves, instead focusing its *Howey* analysis on a transaction-by-transaction inquiry into whether each alleged transaction involving such assets qualified as a "securities" transaction.**
- **This clear reframing by the court of the SEC's position places an extremely high burden of proof on the agency to withstand summary judgment in favor of the defendants and prevail at trial on its claims because, unlike pre-crypto-era *Howey* cases that address only one transaction or a series of very similar transactions, the SEC's claims against Kraken involve millions of transactions, each with divergent circumstances between various market users with disparate expectations and motivations for trading, as well as fundamentally heterogeneous access to, and awareness of, information about the assets being traded.**

Background

On August 23, 2024, U.S. District Judge William H. Orrick of the Northern District of California issued an order denying the defendants' motion to dismiss in *SEC* v*. Payward, Inc. and Payward Ventures, Inc.* ("**Order**").[1] In *Payward*, the Securities and Exchange Commission ("**SEC**") filed a complaint alleging that an online crypto asset trading marketplace (the "**Kraken Market**") operated by Payward, Inc. and Payward Ventures, Inc. (together, "**Kraken**") was an unregistered securities exchange, broker-dealer, and clearing agency, all in violation of the

[1] Order denying the motion to dismiss, *SEC* v*. Payward Inc.*, *et al.*, No. 23 Civ. 06003 (WHO), ECF No. 90 (N.D. Cal. Aug. 23, 2024).

Securities Exchange Act of 1934, as amended (the "**Exchange Act**").[2] Similar to the SEC's enforcement actions against crypto asset trading platforms Binance, Coinbase, and Bittrex, the SEC's claims against Kraken turn on whether at least some of the crypto assets (sometimes referred to as "tokens") available on the Kraken Market (the "**Identified Assets**")[3] are themselves "securities" or, alternatively, whether secondary transactions involving the Identified Assets by users of the Kraken Market are securities transactions — a logical and legal prerequisite for subjecting a variety of Kraken's activities to SEC regulation.

In allowing the *Payward* case to move forward to the discovery phase, the court concluded that the SEC's Complaint plausibly alleged that at least some of the transactions on the Kraken Market constituted "investment contracts" under *Howey*,[4] making them a type of securities transaction subject to the federal securities laws. However, by reframing the SEC's allegations to try to side-step fundamental flaws in the SEC's legal theories, the *Payward* decision only adds to the confusion around secondary transactions involving crypto assets, chalking up what the court saw as the SEC's mistaken understanding of *Howey* case law to a "semantics error."[5]

Now, with three very different applications of *Howey* to secondary transactions in crypto assets in major enforcement actions by the SEC,[6] market participants' repeated calls for "greater clarity" as to the application of the federal securities law to crypto asset activity may finally be acknowledged by the SEC and heeded by Congress through new legislation.

Varying Approaches to Secondary Transactions in Crypto Assets

As discussed in our recent client alert, *SEC* v. *Binance: The Dis-Embodiment of Howey?*, the federal district court judges overseeing the *SEC* v. *Binance et al.* and *SEC* v. *Coinbase et al*. litigations took very different approaches when applying the *Howey* test to secondary transactions of crypto assets (the SEC's case against Bittrex was settled[7] without litigation). In the *Binance* case,[8] U.S. District Judge Amy Berman Jackson of the District of Columbia held that *Howey* is inherently a facts-and-circumstances specific test that applies to each offering of alleged securities separately and requires an examination of the entirety of the circumstances surrounding each offering.

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[2] This case is separate from a prior SEC action against Kraken for alleged violations of Sections 5(a) and 5(c) of the Securities Act of 1933, as amended (the "**Securities Act**"), as a result of Kraken's alleged failure to register the offer and sale of its staking-as-a-service program with the SEC as an offering of securities. Kraken reached a settlement with the SEC in that case pursuant to which it agreed to cease offering or selling securities through staking services in the United States and to pay an aggregate of $30 million in disgorgement, prejudgment interest, and civil penalties. *See* Final Consent Judgment, *SEC* v. *Payward Ventures, Inc. and Payward Trading, Ltd.*, No. 23 Civ. 00588 (JSC), ECF No. 8 (N.D. Cal. Feb. 13, 2023).

[3] The SEC's complaint provides factual allegations in respect of the following 11 Identified Assets: ADA, ALGO, ATOM, FIL, FLOW, ICP, MANA, MATIC, NEAR, OMG, and SOL. *See* Compl., *SEC* v. *Payward Inc.*, *et al.*, No. 23 Civ. 06003 (WHO), ECF No. 1 (N.D. Cal. Nov. 20, 2023) ("**Complaint**"). In the Order, Judge Orrick focuses only on those factual allegations regarding ALGO and SOL in determining that the SEC has plausibly claimed that at least some crypto assets traded on the Kraken Market as "investment contract" securities.

[4] An "investment contract" is one of the items in the list of financial products and economic arrangements included in the definition of the term "security" in the Exchange Act. The current understanding of the term "investment contract" was set forth by the Supreme Court in *SEC* v. *W.J. Howey Co.,* 328 U.S. 293 (1946) ("***Howey***"). For a transaction or scheme to be an "investment contract" — and thus, a security — it must have four elements: (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) from the efforts of others. *See Howey,* 328 U.S. 293, 298–99. The question of whether all four of these elements are present in a purported investment scheme is known as the "*Howey* test."

[5] Order at 15.

[6] In the Order and in early-stage decisions in cases brought by the SEC against Coinbase and Binance, two other crypto asset marketplace operators, discussed further below.

[7] Final Consent Judgment, *SEC* v. *Bittrex Global, et al*., No. 23 Civ. 00580 (RSM), ECF No. 53-2 (W.D. Wash. Aug. 10, 2023).

[8] Order on the motion to dismiss, *SEC* v. *Binance Holdings Ltd.*, *et al.*, No. 23 Civ. 1599 (ABJ), ECF No. 248 (D.D.C. June 28, 2024) ("***Binance* Order**").

Specifically, when analyzing the SEC's claims that Binance had violated the federal securities laws in facilitating secondary sales of BNB tokens on the Binance trading platform, Judge Jackson noted that the SEC's *Binance* complaint pleaded very little concerning how BNB was actually promoted and sold in the secondary market after its initial distribution, and thus had failed to adequately allege that when traded between users of the Kraken Market, BNB tokens were offered or sold as "investment contracts" under *Howey* as required for the securities laws to apply.

In contrast, in the *Coinbase* case,[9] U.S. District Judge Katherine Polk Failla of the Southern District of New York declined to draw a distinction between direct purchases of crypto assets from the alleged "issuers" of the assets and the trading of the assets between third parties on the secondary market, and considered them together because, as argued by the SEC, profits from both the primary and secondary sales would be fed into the continued development of the relevant asset's purported "ecosystem." Accepting the SEC's novel "ecosystem" approach, Judge Failla concluded that when a customer purchases a token on Coinbase's platform, she is not just purchasing a token (which, according to Judge Failla, has no "inherent value"); rather, she is buying into the token's digital ecosystem.[10]

Reframing the Kraken *Case*

After quickly rejecting the argument that a formal contract or post-sale obligations are required for an investment contract transaction to be present, the Order calls out what Judge Orrick sees as the SEC's mistaken references to crypto assets as "crypto asset securities," characterizing this phraseology as "unclear at best," while acknowledging that the SEC's "inconsistent manner" of discussing the assets traded on the Kraken Market "confuse[d] its case."[11] Indeed, Judge Orrick notes in a footnote that to the extent the SEC's Complaint refers to crypto assets themselves as securities, "I do not credit its allegations," reflecting his implicit acknowledgement that such allegations are legally deficient under *Howey* case law and cannot sustain the SEC's claims against Kraken. Nevertheless, the court describes the SEC's approach as a "semantics error," reasoning that despite the many references to the Identified Assets themselves as being "securities," what the SEC really intended to say was that the Identified Assets traded on the Kraken Market merely "*form the basis* of investment contracts."[12]

To be sure, if the SEC had framed its allegations in the Complaint in the manner suggested by Judge Orrick, that would have aligned the SEC's claims with the existing *Howey* jurisprudence in which a wide variety of assets that are not themselves securities (which we refer to as "**non-security assets**") have been sold in investment contract transactions — *i.e.*, transactions in which these assets function merely as the "objects" of those schemes.[13] A review

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[9] Order on the motion for judgment on the pleadings, *SEC* v. *Coinbase, Inc*., *et al.*, No. 23 Civ. 04738, ECF No. 105 (S.D.N.Y. Mar. 27, 2024) ("***Coinbase* Order**").

[10] *Coinbase* Order at 58–59 (contrasting the supposed "inherent value" of real property with crypto assets which, in the court's view, have no inherent value without a related "ecosystem," a flawed theory beyond the scope of this memorandum).

[11] Order at 15. In fact, Judge Orrick states definitively in a section heading that "The Crypto Assets Are Not Themselves Investment Contracts" (Order at 19). The judicial criticism of the SEC's approach was even more pointed in the *Binance* Order, where the Court stated:

> In the Court's view, then, the SEC's suggestion that the token is "the *embodiment* of the investment contract," . . . as opposed to the *subject* of the investment contract, muddied the issues before the Court, ignored the Supreme Court's directive that the analysis is supposed to be based on the entire set of understandings and expectations surrounding the offering, and unnecessarily invited the defendants' argument that a decision in the government's favor here would somehow encroach on the jurisdiction of the Commodities Futures Trading Commission.
> *Binance* Order, at 20 (emphasis added).

[12] Order at 15 (emphasis in the original).

[13] *See* Lewis Cohen, Greg Strong, Freeman Lewin & Sarah Chen, *The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities* (Nov. 10, 2022) at pp. 55-58 (available at https://www.cahill.com/docs/Ineluctable-Modality.PDF) ("***Ineluctable Modality***"). There is a line of reasoning that Congress never intended the concept of "investment contract" to apply to sales of non-security assets where the purchaser takes possession of the asset and the only "profit" expectation arises from the

of the Complaint, however, shows that it referred to the Identified Assets as “crypto asset securities” (or each of them as “a crypto asset security”) on 41 separate occasions.[14] Accordingly, it is difficult to see how the SEC could have been more clear in the Complaint about its intended position: that when crypto assets are sold in primary market transactions “as investment contracts,” they become and remain “crypto asset securities” for an undetermined period of time.[15]

Rather than an inadvertent pleading error, the drafting of the Complaint appears to reflect a deliberate tactical decision by the SEC to try to avoid one of the defects in its claims against Kraken and the operators of other crypto exchanges. If the crypto assets available on the Kraken Market are themselves securities, then no further inquiry would need to be made as to the specific “facts and circumstances” of the various secondary market transactions involving those assets — they would all inherently be securities transactions and the Exchange Act would of necessity apply. However, if the assets available on the Kraken Market are not themselves securities (*i.e.*, if they are non-security assets), then a highly fact intensive transaction-by-transaction inquiry would need to be made as to the circumstances surrounding each of those transactions to show that they meet the elements of an “investment contract” under *Howey*. To say the least, that is a much more difficult burden of proof for the SEC to meet, given the practical realities of most secondary market transactions in which buyers of crypto assets provide no capital to, and have no communications or business relationship with, the alleged “issuers” of the assets.

Nevertheless, after this reframing of the Complaint to focus on the status of *transactions* occurring on the Kraken Market (rather than on the status of the *assets* conveyed in those transactions), Judge Orrick adds a corollary conclusion: that the *Howey* test properly applies when determining whether any given *transaction* involving crypto assets constitutes an investment contract transaction. In fact, to the extent that the crypto assets available on the Kraken Market are non-security assets, the very distinction between a “primary” and “secondary” transaction becomes much less relevant: each transaction, whether primary or secondary, must be analyzed on its own. As discussed in more detail below, a further corollary to Judge Orrick’s decision is that non-security assets do not have “*issuers*” (at least in the securities law sense) — they have *sellers*.

Understanding Howey *and Asset Resales*

Of the many federal appellate decisions applying *Howey* to transactions involving the offer and sale of non-security assets[16] in a manner such that these offers and sales were found to “*form the basis*” of investment contract

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purchaser’s disposition of that asset due to the inherent impossibility of clear line-drawing between legitimate commercial transactions and disguised securities transactions; however, we do not develop that reasoning further here.

[14] The SEC uses the phraseology of Judge Orrick, *i.e.*, that the Identified Assets “*form the basis of investment contracts,*” in the Complaint only once, although the Complaint does use the much more ambiguous wording that the Identified Assets are sold “*as an investment contract* and therefore a security” more frequently, in addition to mixing in the phrase “*and is therefore a security,*” further muddying the water as to the SEC’s true semantic intention.

[15] *See* the heading used by the SEC for Section VI(B) of its Complaint (“Many of the Crypto Assets Available Through Kraken Are Securities”). The SEC has frequently referred to crypto assets as “securities” or “crypto asset securities” in speeches, settlements and many other complaints and motions, making it appear even more unlikely that the usage of the term “crypto asset security” in the Complaint was a simple “semantics error.” *See*, e.g., Gary Gensler, Chair, SEC, Kennedy and Crypto (Sept. 8, 2022), https://www.sec.gov/news/speech/gensler-sec-speaks-090822 ("Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities"); In the Matter of Stoner Cats 2, LLC, File No. 3-21655 (Sept. 13, 2023) (claiming that the defendants conducted an unregistered offering of crypto asset securities in the form of non-fungible tokens called Stoner Cats).

[16] Examples of non-security assets the offer and sale of which were found by courts to have “formed the basis of” an investment contract transaction include chinchillas grown for their pelts (*Miller* v. *Cent. Chinchilla Grp., Inc.*, 494 F.2d 414 (8th Cir. 1974)); whiskey ageing in casks (*Glen-Arden Commodities, Inc*. v. *Costantino*, 493 F.2d 1027 (2d Cir.1974)); and earthworms for sale to fishermen (*Smith* v. *Gross*, 604 F.2d 639 (9th Cir. 1979)).

transactions,[17] with the notable exception of the *Hocking* case (discussed below), before the advent of crypto assets, none directly deals with *resales* of those assets by someone who was (i) not the original seller of the asset or (ii) not in some way the agent of, or working on behalf of, the original seller. This is essential as the SEC did not allege in its Complaint that the Kraken Market was either the original seller of any of the Identified Assets or working on behalf of any of those entities.[18]

Facing a dearth of applicable case law on resales of non-security assets under *Howey*, the Court in *Payward* focuses on the statements of persons the Order sometimes characterized as “promoters” of the non-security assets being traded on the Kraken Market and also on the “republication” of these promotional statements by Kraken on their website, while not addressing what standard should be applied to evaluate how those statements should be understood in the context of a *Howey* analysis. This is not a question that arises in the prior jurisprudence because, in earlier cases, the original seller of the asset that forms the basis of the investment contract scheme is almost without fail directly involved in the case.

In fact, as discussed in *Ineluctable Modality*, the *Howey* jurisprudence can be best understood as a remedial doctrine that, in certain circumstances, allows a party to an otherwise commercial sale of a non-security asset to receive the benefit of securities law remedies against the person or entity with whom the party has transacted.[19] Outside of cases involving crypto assets, *Howey* has never been applied to impose federal securities law liability on persons making available facilities for third parties to re-sell non-security assets between each other. To do so would impose an almost insurmountable ongoing diligence requirement not only on marketplaces, but also on virtually all third-party activity in the crypto asset space in the U.S. — an implication the Order does not address. For example, there are vibrant secondary markets for premium watches, luxury handbags, trading cards and even sneakers that could all then be considered securities exchanges, depending on statements made by third party promoters of these assets. Do the federal securities laws require the operators of these markets to conduct a diligence exercise on each of the assets made available for sale or trading to ensure that the assets were not offered or sold “as an investment contract” by the original seller?

Reading Hocking

Perhaps the most interesting aspect of the *Payward* decision is observing how Judge Orrick grapples with the Ninth Circuit’s ruling in *Hocking* v. *Dubois,*[20] the only federal appellate case to apply *Howey* in the context of the resale of a non-security asset. *Hocking* involved alleged misrepresentations made by a real estate broker in connection with a secondary sale of a condominium unit for which the condo developer made available a rental pool agreement. When a balloon payment on the condominium mortgage came due, the plaintiff defaulted, losing his condo unit. Aggrieved, the condo purchaser alleged that the purchase was actually a securities transaction and accordingly sought the benefits of federal securities law remedies against the broker, the party with whom the plaintiff dealt and the defendant in the case.

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[17] For a complete discussion and analysis of the appellate jurisprudence on this topic through the date of publication, *see Ineluctable Modality*. The paper, which was based on a thorough review of all 266 relevant federal appellate and Supreme Court decisions applying *Howey*, considers whether a particular contract, transaction, or scheme involving crypto assets should be deemed to constitute an investment contract transaction in the context of secondary market activity.

[18] Perhaps even more relevant, in the extensive body of *Howey* case law where the sale of a non-security asset, such as chinchillas, whiskey or earthworms, was found to have *formed the basis* of an investment contract transaction, to our knowledge, it has not ever been suggested that those assets were themselves “securities.”

[19] *Ineluctable Modality* at 37-40 n.12.

[20] 885 F.2d 1449 (9th Cir. 1989) (*en banc*).

After a summary judgment for the defendant broker by the trial court, a three-judge panel of the Ninth Circuit reversed on appeal, finding the offering of a condominium with a rental pool agreement "*automatically*" makes the transaction an investment contract.[21] However, the case was reheard by the full Ninth Circuit sitting *en banc*, which disagreed and remanded the case back to the district court for further consideration of whether the particular circumstances of the condo purchaser's secondary transaction supported the conclusion that this was an "investment contract" (and thus a securities transaction). This makes sense, since *Hocking* involved a single transaction that occurred at a single moment in time between a condo buyer and his broker involving a single asset, and so a "*Howey* examination" of the circumstances of that transaction would be straightforward. But *Payward* and the SEC's cases against the other secondary crypto marketplaces do not involve any single transaction — they involve millions of transactions taking place across a period of many years between tens of thousands of buyers and sellers, all with different (reasonable) expectations, motivations, and access to, and awareness of, different sets of information — not to mention the changing facts around the projects to which the various Identified Assets relate.

At this early stage in the proceedings, Judge Orrick did not need to address these issues. Instead, acknowledging that *Hocking* requires the court to evaluate the "facts and circumstances" of the secondary market transactions taking place on the Kraken Market, Judge Orrick states that *Hocking*:

> [D]oes not require that the court ignore anything that happened in a primary market transaction; if a reasonable investor would understand representations made during the primary market transactions to carry forward into the secondary market, then those representations may be considered. What matters are the reasonable expectations of the investor. That a transaction does not involve the asset's primary issuer does not foreclose the possibility that the primary issuer's representations follow the asset through to the secondary market.[22]

But when would statements made by an initial seller or "promoter" of a non-security asset "follow the asset through to the secondary market?" Using ALGO tokens as an example, Judge Orrick draws these statements from the Complaint as illustrative:

- "We believe in the underlying value of the Algorand blockchain, the Algo, and the potential of the borderless economy."
- "We will use our founder's tokens to support the ecosystem and encourage development."
- Algorand Foundation publicly stated that it had started a new program to incentivize the "growth of the ecosystem, which is the fundamental need of a maturing blockchain. The program includes a series of loans to help the growth of our DeFi network and to expand the institutional investments in the ecosystem . . . The Algorand Ecosystem team facilitates the development and growth of the ecosystem and developer pipeline[.]"
- [Participating in governance is] "the best way to earn rewards for holding Algo, with [annual percentage yield] of 10.02% - 14.05% seen in previous periods."[23]

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[21] *Hocking* v. *Dubois*, 839 F.2d 560, 565 (9th Cir.) (emphasis in original), withdrawn, 863 F.2d 654 (1988).

[22] Order at 18.

[23] Order at 5-6.

Judge Orrick also notes that Kraken's website contains descriptive information about the Algorand project as well as an analysis about the price of ALGO.[24]

However, two pressing questions remain to be answered: *first*, how is it that the above statements (none of which are alleged to be couched as representations by any party) "follow the [ALGO token] through to the secondary market" as a matter of law (and is this intended to be a revival of the SEC's "embodiment theory" so clearly rejected by Judge Jackson in *Binance*)? And, *second*, even though some information about the Algorand project was available on the Kraken Market website, if this (or similar) information is generally available to the public from a variety of other sources (the alleged promoters' websites, other marketplaces, third-party crypto analytic firms), how does one establish that it was Kraken's "republication" of this information that turned what would otherwise have been an ordinary purchase and sale transaction of a non-security asset between two third parties into an investment contract (securities) transaction?

Interestingly, not discussed in the *Payward* decision is that the SEC filed an amicus brief in the *Hocking* case (the "**SEC *Hocking* Amicus**"), arguing that unless there is an affiliation or selling arrangement between the seller of the condominium and the rental pool operator, the (secondary) condominium sale and the procurement of management services are two separate transactions and the condominium sale does not result in an investment contract transaction under *Howey* having occurred.[25] Although expressly not relied on by the majority opinion in *Hocking*,[26] the SEC went on to elaborate in its amicus brief that:

> An affiliation or selling arrangement requirement stems from the nature of an investment contract. An investment contract requires both an investment of money and an expectation of profits from the efforts of others. An investment of money in the purchase of a condominium is not, in itself, a securities transaction, nor is the independent procurement of management services from others. *Unless there is link between the seller of the property (or his agent) and the provider of services, these are two separate transactions*, and the property sale is not covered by the securities laws. . . Since in this case there is no suggestion of any *affiliation or selling arrangement* between the sellers of the condominium (or the real estate agent) and the operator of the rental pool, the sale of the condominium was not a transaction that involved an investment contract.[27]

Mapping this onto the facts in *Payward*, the SEC is in effect arguing that without a demonstrable "affiliation or selling arrangement" or other "link" between the initial sellers of the Identified Assets and the operators of the Kraken Market (something not alleged in the Complaint), the third-party sale transactions taking place on the Kraken Market should not be viewed as involving investment contracts.[28]

An Enterprising Approach to Commonality?

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[24] It is instructive to compare this with the price analysis and descriptive information available from marketplace operator Chrono24.com about another non-security asset, Rolex watches, traded on their secondary market. *See, e.g.,* https://www.chrono24.com/chronopulse/rolex.htm.

[25] *See* Brief for SEC as Amicus Curiae, *Hocking* v. *Dubois*, No. 85-1932 (9th Cir. Oct. 1988).

[26] *See Hocking* at 1457.

[27] SEC *Hocking* Amicus at 10-11 (emphasis added).

[28] It is important to note that the SEC *Hocking* Amicus does not express a view as to whether an affiliation or selling arrangement is necessary in cases not involving real estate condominiums, except to note that "*in . . . cases [other than those involving real estate condominiums] the management services must at least be related in some manner to the activities of the promoter.*" (appropriately caveating that it would be an "easy evasion" of the federal securities laws for a third party seller and a promoter to avoid formal documentary arrangements between themselves and nonetheless have an understanding by custom and usage or otherwise). SEC *Hocking* Amicus at 11 (emphasis added).

Specifically, as to the crypto asset transactions on the Kraken Market, the Court in the Order found that the SEC had alleged sufficient facts to establish each *Howey* prong.[29] Of greatest interest to us, though, is the "common enterprise" prong, which Judge Orrick calls the "closest question." We concur.

While the Court makes it clear that whether the record ultimately supports the SEC's allegations will be decided after fact discovery, we respectfully believe the court reached the wrong conclusion as to the allegations on the presence of the "common enterprise" prong of the *Howey* test. Although it is without doubt true that purchasers of a fungible crypto asset such as ALGO or SOL share a ***common interest*** in the price of the crypto asset along with initial sellers or "promoters" that also own the asset, the common interest shared among otherwise unrelated persons that own a fungible asset alone is not sufficient to result in all of those persons being engaged in a "common enterprise" with each other for purposes of *Howey*.[30] As argued in the SEC *Hocking* Amicus, a demonstrable ***affiliation or selling arrangement*** is essential to connect the activity of one party (*e.g*., making available a rental pool agreement) and the purchase of a non-security asset by another party.

Without at least a business relationship connecting the various purported "promoters" with crypto asset purchasers transacting on the Kraken Market, a mere common interest in the price of a fungible non-security asset is the very hallmark of an asset that is a ***commodity*** and not a security, even if purchasers might reasonably expect some interested parties to undertake more efforts than others to support the price of that asset.[31]

The Illusive "Issuer"

In fact, the presence or absence of a "common enterprise" goes to the heart of when the sale of a non-security asset becomes a securities transaction (with all of the regulatory requirements that accompany that characterization), and when it does not. Judge Orrick, recognizing the critical importance of the "common enterprise" prong of *Howey* to the case, invokes the broad scope of the federal securities laws as defined by Congress, stating:

> The Court in *Howey* said nothing about an investment of money requiring privity between the issuer and the investor, nor has Congress ever drawn such boundaries around what constitutes an investment contract. It defies common sense to suggest that when someone purchases crypto assets from a reseller or another investor, that person or entity does not understand themselves to be investing money in the asset.[32]

Surely, the buyer of a crypto asset understands that she is investing money in that asset, but that misses the point. The question under *Howey* is whether the buyer is making an investment of money *in a common enterprise*,

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[29] Judge Orrick observed that in the Ninth Circuit, these elements are distilled into a three-part test: "To qualify as an investment contract, there must be '(1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others.'" (Order at 12 (internal citations omitted)).

[30] Of the total of 266 relevant federal appellate and Supreme Court decisions that considered whether an investment contract transaction existed, approximately 62 have more than a cursory reference to the concept of "common enterprise." Of those, 37 decisions either found that an investment contract transaction or scheme was present or remanded for further fact finding. In each of these decisions, the one constant, even in the decisions taking the most plaintiff-friendly position, was that the common enterprise was based on some sort of business relationship between the sponsor and the participant. *See Ineluctable Modality* at 48-49.

[31] As an example, an investment fund acquiring certain cartel-supported commodities (like diamonds or crude oil) for investment purposes may reasonably expect the relevant cartel (*e.g.,* De Beers or OPEC) to maintain production levels that support publicly announced unit price targets that would benefit both the buyer and the cartel members. However, *without some business relationship* between the cartel and the investment fund, a "common enterprise" for purposes of *Howey* would not be formed, even if it was shown that the fund purchased the diamonds or crude oil specifically for investment (profit) purposes and specifically because of its awareness of, and reliance on, those public statements.

[32] Order at 20.

which is not the case in the vast majority of purchases of (or "investments" in) non-security assets.[33] Moreover, there is another much more difficult question raised by Judge Orrick's conclusion in the Order. Throughout the federal securities laws, it is clear that all securities must have an "issuer"—an identifiable person or entity against whom a security holder's rights or interests can be exercised. If at least some of the transactions involving the Identified Assets on the Kraken Market may be securities transactions, then who is the "issuer" of the security?

When a security has been issued, many different obligations and potential liabilities are imposed on the issuer of that security under the federal securities laws, including the responsibility for filing periodic reports where the issuer has registered with the SEC or the security otherwise falls within the ambit of the Exchange Act. The federal securities laws contemplate securities with more than one issuer (*e.g.*, a guarantor of security is also considered an "issuer"), but absent a clear change in the terms of the security, *Congress has never contemplated a security with a variable or indeterminate issuer*. In all other *Howey* cases finding the presence of an "investment contract," some person or persons are purchasing an asset and thus providing capital to another party, which for Exchange Act purposes would be the "issuer" of the relevant investment contract security, so this question would not arise. However, having recognized in the Order that the Identified Assets are not themselves securities, if Judge Orrick is going to find that at least some transactions occurring on the Kraken Market are securities transactions, then the SEC must address the Congressionally mandated question—"Who is the issuer of those securities?"

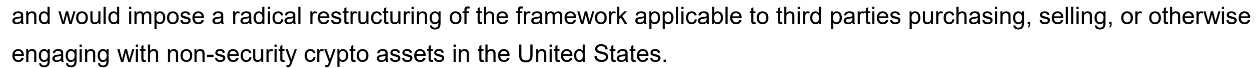
This could prove challenging. For the various Identified Assets there are multiple "promoters" whose activities and statements may vary from time to time. The "promoters" with an interest in the Identified Assets and an ability to impact the value of those assets are not just the associated "foundations" and "labs" entities identified in the Complaint, but also other large community stakeholders, such as venture capital firms and "decentralized autonomous organizations" as well as developers and "key opinion leaders." The idea that a security could have multiple, indeterminate, and varying "issuers" is something wholly outside of the Exchange Act as promulgated by Congress.

This question is intertwined with another critical issue of constitutional due process: under federal securities laws, it is essential that all parties engaging in some way with non-security crypto assets, including intermediaries like Kraken, as well as others acting as purported securities brokers or dealers, exchanges, or clearing agencies are able to determine with reasonable certainty whether and when they are engaging in regulated securities activity, who the issuer of that security is, and what rights or duties that issuer may have in respect of those securities. This is particularly important because the federal securities laws can impose strict liability on those who violate them (for example, operating an unregistered exchange for the transfer of securities or acting as an unregistered "broker" or "dealer" in securities).

Conclusion

With the denial of the defendants' motion to dismiss in *SEC* v. *Payward et al*., the litigation will now move to discovery, where the SEC will seek to further develop the facts alleged in their Complaint. Yet this may prove a Pyrrhic victory for the agency. Given the paucity of alleged facts, it will be interesting to observe how the case proceeds and whether either the defendants or other interested parties filing amicus briefs at the summary judgment phase are able to help the Court understand that the SEC's allegations here are ungrounded in *Howey* jurisprudence

[33] Many people acquire a wide variety of non-security assets, large and small, including artworks, high-end watches, collectible automobiles, thoroughbred horses, rare books, etc., purely for investment purposes without any suggestion that they are entering into a "common enterprise" with anyone else through that purchase.



and would impose a radical restructuring of the framework applicable to third parties purchasing, selling, or otherwise engaging with non-security crypto assets in the United States.

Following the *Coinbase* and *Binance* Orders, the Order can be seen as raising even more questions about the proper treatment of secondary transactions in non-security crypto assets. How these questions get resolved will be essential to the future of the crypto asset sector in the United States.

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The CahillNXT team continues to monitor developments in crypto asset cases as they unfold, as well as pending legislation, and other relevant events. If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Lewis Rinaudo Cohen (partner) at 212.701.3758 or lrcohen@cahill.com; Samson Enzer (partner) at 212.701.3125 or senzer@cahill.com; Gregory Strong (partner) at 302.884.0001 or gstrong@cahill.com; Sarah Chen (partner) at 212.701.3759 or swchen@cahill.com; Morrease Leftwich (associate) at 212.701.3681 or mleftwich@cahill.com; or email publicationscommittee@cahill.com.

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