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SEC v. *Binance: The Dis-Embodiment of Howey?*

On Friday, June 28, 2024, Judge Amy Berman Jackson of the U.S. District Court for the District of Columbia struck a serious blow to Securities and Exchange Commission ("SEC") Chair Gary Gensler's regulation-by-enforcement campaign against secondary crypto asset market exchanges. In *SEC* v. *Binance*, an SEC enforcement action seeking to impose federal securities regulations on a variety of transactions involving foreign (Binance.com) and domestic (Binance.us) digital asset trading platforms, Judge Jackson partially granted the Binance defendants' motions to dismiss the SEC's complaint.[1] Among other things, Judge Jackson's decision reaffirmed that crypto assets themselves are not "securities" subject to SEC oversight, rejected the SEC's allegations that crypto tokens somehow "embody" investment contract securities, and dismissed the agency's claims relating to secondary market sales of crypto tokens and certain other crypto asset products and services.[2] Judge Jackson's nearly 90-page Memorandum Opinion and Order disposing of the motions, perhaps the most thoughtful and detailed judicial reckoning yet to address a panoply of regulatory issues impacting the crypto asset sector, may have far-reaching consequences for all market participants. Most importantly, the Order casts doubt on the SEC's authority to regulate secondary spot market transactions on crypto exchanges.

In the Order, Judge Jackson *granted* the Binance defendants' motions to dismiss the SEC's claims relating to secondary sales of BNB tokens, offers and sales of the BUSD stablecoin, and offers and sales made in connection with the Simple Earn token lending program. Judge Jackson *denied* motions to dismiss the SEC's claims relating to alleged initial and ongoing offers and sales of BNB tokens; alleged offers and sales under the BNB Vault program and Binance.us' staking program; the alleged failure to register the Binance.com and Binance.us platforms as securities exchanges, broker-dealers, and clearing agencies; and Binance.us' alleged violations of the federal securities laws' anti-fraud provisions, among other claims.

Judge Jackson started her analysis by pointing out that the fundamental question underlying each of the claims at issue is whether the defendants' *offers and sales* of crypto assets constituted investment contract transactions under *Howey*[3] and therefore were appropriately deemed "securities" transactions for the purposes of the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). After considering the *Howey* jurisprudence and its relatively limited application to date by courts to activity in the crypto sector, Judge Jackson concluded that *Howey* is inherently a facts-and-circumstances specific test that applies to each offering separately and requires an examination of the entirety of the circumstances surrounding each offering.[4]

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[1] *SEC* v. *Binance Holdings Ltd.*, *et al.*, No. 23 Civ. 1599, ECF No. 248 (D.D.C. June 28, 2024) (the "Binance Order" or "Order").

[2] Cahill represents Binance Holdings Limited in several ongoing matters.

[3] *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946).

[4] This is consistent with the position taken in November 2022 in "*The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities*," a paper published by Cahill partners Lewis Cohen, Greg Strong, and Sarah Chen, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4282385 ("Ineluctable Modality"). The paper, which was based on a thorough review of all 266 relevant federal appellate and Supreme Court decisions applying *Howey*, considered whether a particular contract, transaction, or scheme involving crypto assets should be deemed to constitute an investment contract transaction in the context of

Consistent with the approach advocated for in *Ineluctable Modality*, Judge Jackson distinguished between the digital assets themselves and the offers to sell them, and assessed each of the challenged offerings separately. Critically, similar to the position taken by the court in *SEC* v*. Ripple Labs, Inc.*,[5] Judge Jackson expressly rejected the SEC's theory that a crypto asset can be "the *embodiment* of the investment contract" conveying the asset, instead assessing the various offerings identified by the SEC in their complaint individually, stating:

> [T]he 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, [and] 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[.][6]

Similarly, citing various *Howey* precedents, including early cases in the crypto asset industry,[7] Judge Jackson found that a contractual arrangement is unnecessary for a transaction or scheme to qualify as an "investment contract" under the federal securities laws.

With respect to secondary market transactions involving crypto assets, Judge Jackson was troubled by the SEC's argument that if a crypto asset was initially sold *as a part of* an investment contract, then any secondary sale of the crypto asset *itself* must be a sale of security. As a policy matter, the Judge observed that:

> 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.[8]

Similar issues were also considered in 2023 by Judge Analisa Torres of the Southern District of New York in *Ripple Labs*[9] and by Judge Jed Rakoff of the Southern District of New York in *SEC* v. *Terraform Labs Pte Ltd.*,[10] where the two judges took different approaches when considering *initial* (rather than *secondary*) sales of crypto assets, arriving at different conclusions. Recognizing the different approaches taken by other courts, Judge Jackson agreed with the

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secondary market activity. The paper argued that the *Howey* test must be applied on a *transaction-by-transaction* basis, and that non-financial "objects" of an investment contract transaction are not themselves "securities" (or the "embodiment" of an investment scheme) solely as a result of being sold as part of such a transaction. However, it is important to bear in mind that a given crypto asset could be used to represent an interest in an ongoing business and therefore be found to be a security.

5 *SEC* v. *Ripple Labs, Inc.*, No. 20 Civ. 10832, ECF No. 874 (S.D.N.Y. July 13, 2023) ("Ripple Labs") (citation omitted; emphasis in original).

6 *Binance Order* at p. 20.

7 *See, e.g., SEC* v. *Telegram Group Inc.,* 448 F. Supp. 3d 352 (S.D.N.Y. 2020); *SEC* v. *Kik Interactive, Inc.,* 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

8 *Binance Order* at p. 21.

9 In ruling on competing motions for summary judgment made by both the SEC and the defendants in *Ripple Labs*, Judge Torres rejected the SEC's theory that a crypto asset initially sold in an investment contract transaction thereafter *embodies* the elements of that investment contract and instead recognized that *Howey* is a facts-and-circumstances specific test that must be applied to a given "contract, transaction or scheme." Accordingly, Judge Torres applied the *Howey* test to each identified category of XRP distribution at issue in the case (*i.e.*, whether the XRP tokens were transferred in "face-to-face" negotiated sales made with promises of ongoing efforts, in blind bid/ask sales on a crypto asset marketplace into an existing highly liquid market in the relevant crypto asset, or when exchanged by the defendants for non-cash consideration, as with employees or service providers), reaching different outcomes depending on the facts surrounding the different circumstances of each type of transaction.

10 Judge Rakoff declined to analyze different types of sales of the relevant digital assets by the defendants or draw a distinction between the manner of sale of these assets. Of particular importance, in his decision denying the defendants' motion to dismiss, Judge Rakoff expressly rejected Judge Torres' approach as set out in the *Ripple Labs*. *See SEC* v. *Terraform Labs Pte Ltd.*, No. 1:23 Civ. 01346 (JSR), ECF No. 51 (S.D.N.Y. July 31, 2023).

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approach taken by the *Ripple* court and took the further step of criticizing the SEC's position, finding that it would leave the court, the industry, and market participants with no clear differentiating principle between crypto assets in the marketplace that are securities and those that are not.[11] In addition, because Judge Jackson concluded the SEC's complaint plausibly alleged that at least one token, BNB, and certain investment programs were offered as investment contracts, the allegations that the defendants operated unregistered securities exchanges, broker-dealers, and clearing agencies had enough support to move forward into discovery. As a result, Judge Jackson chose not to address the merits of whether any of the ten other crypto assets[12] identified by the SEC in its complaint as "crypto asset securities" being traded on the Binance.com and Binance.us exchanges qualified as securities.[13]

With these principles in mind, and noting that the court must accept all well-plead allegations in the complaint as true at this early stage in the proceedings, Judge Jackson decided the motions to dismiss as follows:

- <u>Claimed Violations of Section 5 of the Securities Act:</u>
  - BNB:
    - The SEC plausibly alleged that Binance offered and sold BNB tokens in an initial coin offering (ICO) and in ongoing post-ICO sales in arrangements that were unregistered securities.
    - However, the SEC failed to plausibly allege that secondary market transactions in BNB satisfied the *Howey* test, and the court dismissed the SEC's claims relating to secondary market sales of BNB tokens by sellers other than Binance.
  - BUSD:
    - The SEC failed to allege sufficient facts to suggest that Binance offered and sold the stablecoin BUSD in an investment contract arrangement, and the court dismissed those claims.
    - The court also rejected the SEC's allegations that Binance's BUSD reward program, in which BUSD purchasers were allegedly offered interest-like payments for holding BUSD on the Ethereum blockchain, turned offers and sales of BUSD into investment contracts.
  - BNB Vault, Simple Earn, and Staking Programs:
    - The SEC alleged facts sufficient to show that the BNB Vault program was offered and sold as an unregistered security.
    - The SEC failed to allege facts sufficient to show that the Simple Earn token lending program was offered and sold as unregistered securities and dismissed those claims.
    - The SEC alleged facts sufficient to show that the staking program was offered and sold as unregistered securities.
- <u>Claimed Violations of Sections 5, 15(a) and 17A(b) of the Exchange Act:</u>
  - Since the SEC alleged sufficient facts to suggest that BNB and the BNB Vault program were offered and sold as unregistered securities, the SEC's claims that Binance Holdings Limited (d/b/a "Binance.com")

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[11] *See Binance Order* at p. 43.

[12] These crypto assets are: SOL, ADA, MATIC, FIL, ATOM, SAND, MANA, ALGO, AXS, and COTI.

[13] *See Binance Order* at p. 57 ("it would be highly irregular to [address the merits of whether these tokens were securities], since the issuers are not parties to this action and have not had an opportunity to weigh in on the claims that the offerings satisfy the requirements of an 'investment contract' or security.")

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and two BAM entities (d/b/a "Binance.us") failed to register as securities exchanges, broker-dealers, and clearing agencies could proceed to the discovery phase of the litigation.

  - Specifically, the court explained that the registration requirements are triggered by transactions involving just one alleged security.

- <u>Extraterritoriality Defense:</u>
  - The court applied *Morrison* when considering whether the relevant sections in the Securities Act and the Exchange Act are extraterritorial[14] and agreed with the U.S. Court of Appeals for the Second Circuit's recent decision in *Williams* v. *Binance*,[15] concluding that the SEC's factual allegations plausibly pled that irrevocable liability was incurred in the United States when customers in the United States placed trade orders and sent payments on the Binance.com platform.

- <u>Major questions doctrine and fair notice defenses:</u>

  - The court took the view that the major questions doctrine did not apply for lack of "the economic reach" that other regulatory actions subject to the doctrine would have had.

  - The court found that the defendants had fair notice of the SEC's position on crypto tokens, pointing to several lawsuits previously filed in which the SEC asserted that certain crypto assets were securities.

Judge Jackson's decision has already been welcomed by many in the crypto asset industry, especially in contrast with New York Southern District Judge Katherine Polk Failla's ruling earlier this year on Coinbase's pre-discovery motion, seeking a judgment on the pleadings dismissing the SEC's complaint in *SEC* v. *Coinbase Inc.*[16] In her opinion in *Coinbase*, Judge Failla declined to reject the SEC's "embodiment theory" and held that the allegations in the SEC's complaint against Coinbase were sufficient to conclude that at least some Coinbase customers purchased crypto assets on the Coinbase platform as investment contracts because they alleged facts sufficient to show an investment in a common enterprise (namely, each token's purported "ecosystem") with a reasonable expectation of profits from the managerial efforts of the tokens' alleged "issuers" in promoting the development of the relevant ecosystems. In the *Binance* Order, Judge Jackson reached the opposite conclusion, rejecting the embodiment theory and finding that the SEC failed to allege sufficient facts to support a plausible inference that any particular secondary sales of BNB tokens satisfy the *Howey* test. It is likely only a matter of time before a federal appellate court will need to address these conflicting district court approaches.

The importance of Judge Jackson's definitive rejection of the SEC's embodiment theory cannot be overstated. As Judge Jackson observed, if the SEC is to be taken at its word that it does not believe that the various crypto assets they identified are themselves securities, then the only way for the SEC to avoid the nearly impossible task of alleging and proving that specific secondary sales of tokens on marketplaces like Binance.com and Binance.us are separate *Howey* investment contract transactions is through judicial adoption of the embodiment theory — that is, the idea that an investment scheme is so intertwined with a given token that the specific facts-and-circumstances of a given purchase and sale of the token are irrelevant and all such transactions are necessarily securities transactions. In dismissing that theory, Judge Jackson's Order undermines the SEC's claimed authority to regulate secondary spot market transactions on crypto exchanges.

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[14] *Morrison* v. *Nat'l Austl. Bank Ltd.,* 561 U.S. 247, 255 (2010).

[15] *Williams* v. *Binance,* 96 F.4th 129 (2d Cir. 2024).

[16] *See SEC* v. *Coinbase, Inc.*, et al, No. 1:23-cv-04738, ECF No. 105 (S.D.N.Y. Mar. 27, 2024).

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While it is too early in the judicial process to reach any definitive conclusion, Judge Jackson's *Binance* Order, together with the analytic approach taken by Judge Torres in *Ripple Labs*, leave us optimistic that federal courts will apply the *Howey* test to crypto asset transactions, as *Howey* requires, and continue to reject the SEC's unfounded embodiment theory and its larger regulation-by-enforcement approach to crypto.

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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 market 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 Samson Enzer (partner) at 212.701.3125 or senzer@cahill.com; Lewis Rinaudo Cohen (partner) at 212.701.3758 or lrcohen@cahill.com; Gregory Strong (partner) at 212.701.3777 or gstrong@cahill.com; or Sarah Chen (partner) at 212.701.3759 or swchen@cahill.com; or email publicationscommittee@cahill.com.

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