

Drawing the Line in Crypto Cases

One of the key complaints about the SEC by crypto enthusiasts is that the line between which crypto coins are securities and which are not is unclear. Many, for example, look at a coin and are puzzled – when is it a security and when is it not a security. This “now it is, now it is not” approach can cause confusion.

There is nothing unclear about the rules that apply to making the determination. Those lines were drawn by the Supreme Court decades ago in *SEC v. W. H. Howey*, 328 U.S. 293 (1946). There the Court focused not on an object such as a coin or a bit of paper but the economic reality of the transaction. Viewed through this lens the issue is straight forward: Are the funds of the investor pooled with those of other investors with the hope and expectation that the pool will increase in value not because of something the investor did but through the efforts of others? If, and when, this happens the investment is a security – not the coin itself which is actually a commodity.

The case

The recent case involving celebrity Kim Kardashian is a good illustration. *In the Matter of Kimberly Kardashian*, Adm. Proc. File No. 3-21197 (October 3, 2022). Ms. Kardashian was retained to promote a crypto token called EMAX. She was paid \$225,000 to promote the token. The token, called a “crypto security” in the Order, was promoted beginning in May 2021 on social media and in marketing materials. Ms. Kardashian also posted about the coins on her Instagram account which included an introductory video.

In the advertising materials the company that issued the coins assured purchasers that the coins would be traded in the secondary market. The marketing materials also discussed the management of the company.

Prior to the EMAX promotion, the Commission issued the DAO Report of Investigation on July 25, 2017, according to the Order. The Report focused on the economic reality test of *Howey*. The Commission’s Order also discussed what has now become known as the “ecosystem” surrounding the crypto coins – the efforts of others part of the *Howey* test

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that creates the hoped for profits with the pooled investor money.

It is not disputed that Ms. Kardashian promoted the coin as promised. Also not disputed is the fact that she did not disclose the fact that she was a paid promoter of the coins or the amount of money paid for her services. This violated Section 17(b) of the Securities Act which prohibits touting absent the required disclosures.

Ms. Kardashian resolved the proceedings by cooperating with the Commission and agreeing not to receive any form of compensation for three years for promoting a crypto asset security. She also promised to cooperate with the agency. The proceedings were resolved with the entry of an order based on consent, of a cease-and-desist order centered on the Section cited in the Order. In addition, Ms. Kardashian will pay disgorgement of \$250,000, prejudgment interest of \$10,415.35 and a \$1 million penalty.

Comment

The Commission's Order is straight forward. It lays out the basic principles that are used to analyze if a crypto investment is a security. It cites the key authorities on the subject. And, while noting Ms. Kardashian's past and on-going cooperation, requires a consent decree for touting and the payment of disgorgement, prejudgment interest and a penalty.

Perhaps the most interesting point is not what is not discussed. Specifically, the key to the application of *Howey* here is the so-called ecosystem. The term has generally been used to define the idea of an expectation of profits from the efforts of others. If, for example, one invested money with a company that made widgets, the investor's cash would be pooled with money obtained from other investors, put in the "ecosystem" of the company – that is, the factory of the company and its manufacturing process -- and out comes a widget that is sold.

The Order in Ms. Kardashian's case does not really analyze the ecosystem however. To be sure there are statements, inferences and suggestions in the Commission's Order such as those regarding possible trading of the coins. The difficulty with the analysis is this – the same could be said of any collectable. If, for example, baseball cards are traded and promoted using investor money the value of the cards increases. Nobody is call the baseball cards a security – they are a collectable that has value as long as – and only as long as –others say they do.

In the end, the Commission may well be correct in its analysis of the situation presented by Ms. Kardashian's case. But instead of trying to clarify the line or rule they wanted the case to stand for, the agency left it unclear. Perhaps more importantly, if the Commission had done that, the mass of publicity generated by the case may have served as a good reinforcement of the Commission's view.