

Unfortunately, the release stating this fact does not discuss how data analytics was employed in uncovering the cases. It appears, however, that it was used to help uncover trading trends that tie to the practice. No doubt the staff will continue to employ and refine this approach.

Third, while the four areas in which most actions were filed are traditional areas of focus for SEC Enforcement, the other cases discussed in this series reveal a much different story. Those cases represent 18 different areas, in addition to the four largest categories of case. They include a range of areas and theories such as municipal bonds, Regulation BI, transfer agents, identity theft, complex products and free riding. Collectively, this paints a picture of a Division reaching not just traditional areas of focus, but pushing out to police the edges of the marketplace to protect investors. The approach also builds on one that appears to have been initiated in the second quarter of last year.

Finally, the results from the first three quarters of 2022 should be welcomed by all investors while serving as a caution to some. In one sense it reassures investors that the markets are being effectively policed.

At the same time, it should serve as a caution to all to carefully consider and evaluate their actions. Regulated entities, for example, typically have compliance programs keyed to certain areas. The breadth of the enforcement activities evidenced by the cases brought in the first three quarters of 2022 should serve as a cautionary note to all CCOs, prompting and examination of existing programs to ensure effectiveness.

The same is true of all other investors in the markets. To be sure, not every firm has the kind of compliance programs typically maintained by regulated entities. Clearly individual investors and traders do not. Yet the expanding reach of SEC Enforcement as reflected in the results from the first three quarters of calendar year 2022 should serve as notice that the Division is intent on bringing new ethics to the

marketplace, envisioned by the federal securities laws. Those efforts should be welcomed by all. They should also serve as a caution to carefully adhere to the fundamental principles on which the federal securities laws are based, a result which can only serve to improve overall effectiveness of the markets for all.

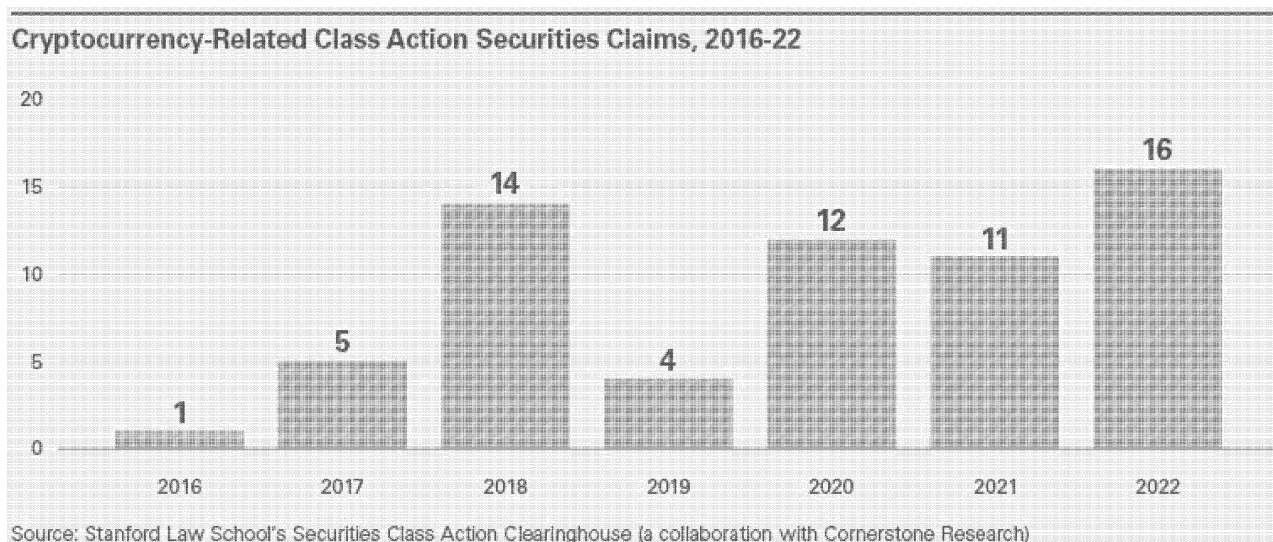
RISE IN CRYPTO SECURITIES FILINGS COULD PERSIST

By Alexander C. Drylewski, Lara A. Flath, Daniel Michael, Peter B. Morrison and Andrew R. Beatty

Alexander Drylewski, Lara Flath and Daniel Michael are partners, and Andrew Beatty is an associate, in the New York office of Skadden, Arps, Slate, Meagher & Flom LLP. Peter Morrison is a partner in the firm's Los Angeles office. Contact: alexander.drylewski@skadden.com or lara.flath@skadden.com or daniel.michael@skadden.com or peter.morrison@skadden.com or andrew.beatty@skadden.com.

- The number of cryptocurrency-related class action securities litigation filings has been building in recent years and may set records in 2023.
- The SEC's newly added resources and attention to the digital asset space are expected to lead to an uptick in enforcement actions next year.
- The question of extraterritoriality and the *Howey* test will likely remain a central debate in future lawsuits given the global nature of the industry and the ever-evolving question of whether cryptocurrencies are securities.

Increased regulatory oversight and recent turmoil in the digital asset market have led to a rising number of securities litigations focusing on cryptocurrencies. Sixteen cryptocurrency-related class actions have been filed this year—more than in any single year since the first such filing was recorded in 2016, according to Stanford Law School's Securities Class Action Clearinghouse.



Suits against cryptocurrency exchanges in particular are up significantly, according to Cornerstone Research, accounting for almost half of all cryptocurrency-related class action filings since the start of 2020. This stands in contrast to filing activity between 2016-19, when less than 10% included exchange-related allegations.

Despite recent turmoil in the cryptocurrency market, it is unclear whether the pace of filings will continue. It may slow due to lack of investor interest, but on the other hand, securities litigation is often driven by decreases in the underlying asset's value. (Consider, for example, the number of mortgage-backed securities cases in the wake of the 2007-09 global financial crisis.) If the cryptocurrency sector remains turbulent, and if enforcement ramps up as expected, 2023 could be another record-breaking year.¹

SEC Enforcement

The Securities and Exchange Commission (SEC) continues to be a main regulator in the cryptocurrency space. Its actions have focused on two allegations: (1) unregistered securities offerings and (2) fraudulent securities offerings or sales.

Actions rise. The number of cryptocurrency-related enforcement actions brought by the SEC has increased in recent years, from 97 total in 2013-21, to 20 in 2021 alone, according to Cornerstone.

Forces expand. The SEC has increased its resources devoted to the digital asset space. In the first half of 2022, it nearly doubled the size of its Crypto Assets and Cyber Unit, with six dedicated trial counsel and an expanded leadership team, including a new permanent chief and deputy chief. Additionally, the SEC's Division of Corporation Finance created an Office of Crypto Assets within its Disclosure Review Program. While these resources are not all directed at litigation, the SEC's increase in spending and attention to the digital asset space will likely lead to an uptick in related enforcement actions in 2023.

Other enforcement trends we're watching:

- the SEC's apparently increased commitment to resolving digital asset cases through litigation rather than settlement when compared to the general trend across all the agency's enforcement actions;
- more scrutiny of market intermediaries, such as exchanges and broker-dealers, rather than issuers or promoters of single tokens. As such, these intermediaries may bear the brunt of any increased enforcement activity; and
- the SEC's interest in a relatively new area of digital asset enforcement: insider trading. In its July 2022 complaint in *SEC v. Wahi*, the agency asserted insider trading claims against a former Coinbase product manager, his brother and a friend. The SEC alleged

that nine of the digital assets purchased and sold by the defendants were securities under *Howey*. A concurrent Department of Justice (DOJ) indictment alleged that the same defendants engaged in insider trading with respect to 25 digital assets. Why the SEC and DOJ amounts differed remains unsolved, but it presumably relates to the former's determinations under the *Howey* framework.²

Recent Case Law Developments and Areas of Focus

With respect to recent case law developments, the question of extraterritoriality and the so-called *Howey* test have been areas of focus that will likely extend into 2023, given the industry's global nature and the ever-evolving question of whether cryptocurrencies are securities.

Extraterritoriality: Plaintiffs Hit Roadblocks

Anderson v. Binance. In a March 2022 decision involving cryptocurrency trading platform Binance, Judge Andrew Carter of the U.S. District Court for the Southern District of New York granted the defendants' motion to dismiss after concluding that the plaintiffs had failed to plead an adequate connection to the U.S., as required by the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd.* The court held that Binance's alleged use of U.S.-based servers was not enough to demonstrate that either it was a domestic exchange or the transactions themselves were otherwise domestic.

Williams v. Block.one. In an August 2022 ruling involving blockchain software developer Block.one, Judge Lewis Kaplan of the Southern District of New York rejected the plaintiffs' theory that the location of the token purchaser in the U.S. was dispositive under *Morrison*. Consistent with the holding in *Binance*, Judge Kaplan observed that such a theory "arguably is at odds with Second Circuit cases holding that the purchaser's location is not determinative."

The bottom line. Given the global nature of the industry, litigants undoubtedly will continue arguing about the question of extraterritoriality and whether transactions are or are not domestic.

The *Howey* Test: Continued Development

The application of the *Howey* test remains a developing

area and highly fact dependent. The test sets out factors to determine what qualifies as an investment contract, and thus a security: (1) whether there is an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits from the efforts of others.

Audet v. Fraser. In a June 2022 ruling, Judge Michael Shea of the U.S. District Court for the District of Connecticut reviewed the first-ever jury verdict that considered whether digital assets were securities (and concluded they were not). Notably, with respect to assets called "Hashlets," which allegedly represented shares in profits from the defendants' computing power, Judge Shea upheld the jury's verdict that they were not securities under *Howey*, because they lacked a common enterprise or expectation of profits based on others' efforts. Judge Shea, however, did grant a new trial with respect to whether Paycoin was a potential investment contract.

SEC v. LBRY, Inc. In November 2022, Judge Peter Barbadoro of the U.S. District Court for the District of New Hampshire granted the SEC's motion for summary judgment as to whether software company LBRY, Inc. offered tokens (called "LBRY Credits" or "LBC") in securities transactions. Among other things, Judge Barbadoro ruled that potential investors would understand that "LBRY's overall messaging . . . was pitching a speculative value proposition for its digital token," thus satisfying the expectation-of-profits prong of the *Howey* test.

The bottom line. We anticipate that, as more cryptocurrency litigations are filed, the application of the *Howey* framework will continue to evolve.

In Sum

Cryptocurrency market participants may face continued cases in 2023—whether in the form of private securities litigation or SEC enforcement actions—and they will likely focus on complex issues such as the application of the *Morrison* and *Howey* tests. Other forces, such as continuing market turmoil and changing regulatory scrutiny, could result in new and unpredictable developments in this evolving industry.

ENDNOTES:

¹For a broader discussion on securities litigation trends, see “Trends in Forum Selection Provisions, Merger Objection Class Actions and SPACs Continue To Shape Securities Litigation”: <https://www.skadden.com/insights/publications/2022/12/2023-insights/litigation-developments/trends-in-forum-selection-provisions>.

²*See also* “Enforcement Priorities Could Shift in a Downturn”: <https://www.skadden.com/insights/publications/2022/12/2023-insights/a-possible-recession/enforcement-priorities-could-shift-in-a-downturn>.