Crypto Not So Cryptic: Southern District Applies Traditional Securities Law Analysis to Digital Currency

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It is a common complaint, from inventors and lawyers alike, that the law tends to have trouble keeping up with new technologies, especially when they become widespread and assimilated in unexpected ways. It is certainly true that applying decades old statutes in new contexts can present substantial challenges. But sometimes, once the tech trappings are stripped away from the latest shiny new thing, courts find a familiar structure underneath and the applicable law becomes more clear.

An example of this arose recently in the world of crypto. The term "crypto" refers to a class of digital assets (including cryptocurrencies and non-fungible tokens or NFTs) backed by an unalterable digital ledger called a "blockchain". No single person or entity controls the blockchain—it is "distributed" among multiple servers—and every transaction in the associated asset is recorded on it. It is functionally impossible to alter, delete, or destroy records once they are entered on the blockchain. In theory, this system permits the creation of a digital asset that can be tied to an "owner" (who may remain anonymous) and never counterfeited. A "cryptocurrency" (such as Bitcoin) is a digital asset backed by a blockchain, intended for use as an investment or to purchase goods and services. (Other systems, such as NFTs, attempt to use blockchain technology to guarantee "uniqueness" of a digital object or backstop intellectual property or contractual rights.)

At first glance, cryptocurrency would seem to present many of the classic difficulties faced by courts assessing new technologies. It is generally a purely non-tangible asset, often developed by companies or individuals with limited presence in the United States. Many cryptocurrencies are designed to be untraceable or anonymous, and transactions in them are, by definition, highly distributed—spread out over computers and servers around the world. Courts must therefore ask some basic questions: where are cryptocurrencies "located?" Where do transactions involving them take place, and where can they be regulated? These new assets also present definitional questions: what is cryptocurrency and which legacy statutes apply to it? Is it a currency? A commodity? A security? What form of regulation is most applicable to this new construct?

Courts and regulators have sometimes struggled to answer these questions in the face of the rapid growth of digital assets. The language around crypto can be somewhat overblown and intimidating, and the technological underpinnings of the systems are certainly esoteric. But in many cases, if a court can look past the technology and focus on the underlying function of these digital assets as financial tools, some fairly clear answers emerge.

A recent case in the Southern District of New York provides an interesting example. *Owen v. Elastos Foundation*, 2021 WL 586871 (S.D.N.Y. Dec. 9, 2021).

Background

The Elastos Foundation is a cryptocurrency company registered in Singapore with primary place of business in Chinda. Elastos seeks to "create a new kind of internet powered by blockchain technology" in which it developed a "a platform of decentralized applications—connected to each other but not connected to the rest of the internet—to facilitate the ownership, purchase, and sale of digital assets without third-party companies like Amazon and Apple." In addition to developing that network of connected applications, Elastos developed a cryptocurrency, called "ELA Tokens" to serve as the exclusive currency on its platform.

In order to raise money, Elastos first conducted a private sale of its ELA Tokens followed by an "Initial Coin Offering" (or ICO) through which it offered pre-cleared individuals the opportunity to purchase its ELA Tokens at an agreed-upon price. Due to a ban on ICOs in China, Elastos primarily focused its marketing and promotional efforts to the United States, including through use of U.S.-based social media platforms and through physical marketing campaigns in the United States. Throughout 2017, two of the founders of Elastos, Feng Han and Rong Chen, gave presentations and attended cryptocurrency-themed conferences in the United States in major U.S. cities, including San Francisco, New York, and Cambridge. In January 2018, Elastos conducted three rounds of sales of ELA Tokens to its investors.

Shortly thereafter, Elastos announced that its ELA Tokens would begin trading on a secondary market on Feb. 1, 2018. Through that secondary market, individuals who had not participated in the ICO could purchase ELA Tokens from those that had purchased them directly from Elastos through the ICO. Elastos and its founders continued to actively market their business in the United States after secondary trading began, including by attending over fifteen speaking engagements, discussing the value of ELA Tokens on social media, and retaining an Illinois-based firm to assist with "promotion of ELA Tokens." At no time did Elastos file a registration statement under the Securities Act of 1933 (the Securities Act).

On Jan. 31, 2019, a year after the conclusion of the ICO, Mark Owen filed a lawsuit alleging that Elastos, Feng Han, and Rong Chen violated §15 of the Securities Act by failing to register ELA Tokens that he purchased on the secondary market. On May 28, 2019, Owen and James Wandling filed a putative class action complaint, which they amended on July 29, 2020. The amended complaint alleged that Elastos violated §15 of the Securities Act by selling, and soliciting the sale of, unregistered securities through both the ICO and secondary trading of ELA Tokens. Defendants moved to dismiss on procedural grounds—citing an alleged lack of personal jurisdiction—and on the grounds that the individual defendants were not "sellers" under the Securities Act.

The Court's Ruling

On Dec. 9, 2021, Judge Woods of the Southern District denied the motion to dismiss, finding that the procedural arguments were without merit and that the individual defendants were "sellers" under the Securities Act (for purposes of the secondary market sales) because they solicited purchases on the secondary market "motivated at least in part by a desire to serve [their] own financial interests." Owen, at *13.

First, the court considered defendants' jurisdictional argument, applying the well-known two-step test to determine first whether "there is jurisdiction over the defendant under the relevant forum state's laws" and then "whether an exercise of jurisdiction under these laws in consistent with federal due process rights." Because there was a statutory basis—the Securities Act—for the claim, the first prong was met under New York law, so the sole issue for analysis was whether the second prong was satisfied: that is whether the defendants had sufficient "minimum contacts" with "the forum" to satisfy due process.

To answer that question, the court had to address an issue that it noted the Second Circuit has not decided: whether the "minimum contacts" analysis under the Securities Act (or any federal statute authorizing nationwide service of process), "should be assessed based on the state in which the court sits" or "the United States as a whole." Id. at *7. Following the approach adopted by other circuits, Judge Woods found the latter, because "when the national sovereign is applying national law, the relevant contacts are the contacts between the defendant and the sovereign nation." Id.

Applying that approach, the court easily concluded that the defendants had sufficient connection to the United States to exercise either general or specific personal jurisdiction over them. In particular, the court noted that the defendants "repeatedly and continuously promoted Elastos and the ELA Tokens in the United States," which, in the court's view, made the jurisdictional question not a particularly close call. And while the individual defendants argued that an exercise of jurisdiction would be "unreasonable" because they lived far from New York (and in Han's case had moved out of the United States and back to China), the court found that exercising jurisdiction was reasonable because the United States had a strong interest in resolving a case brought under "U.S. federal law," and the individual defendants' distance from the forum was less burdensome due to "the realities of modern transportation and communication." In other words, the very technologies that made defendants' cryptocurrency possible also made it less burdensome for them to face trial in a New York court.

Second, the court considered defendants' argument that the claims related to the ICO purchases were untimely "because Owen—who purchased ELA Tokens only in the secondary market—lacks standing … while Wandling—who purchased ELA Tokens in the ICO—did not join this action until after the expiration of the one-year statute of limitations." The court did not find either argument compelling. As

to the first, the court found that Owen had "class standing" to "bring claims *on behalf* of putative class members" because he alleged an injury (the purchase of unregistered ELA Tokens on the secondary market) that was "sufficiently similar" to the injuries alleged by potential class members who were ICO purchasers.

Further, even if Owen did *not* have class standing to assert claims on behalf of ICO purchasers, the court found that Wandling (who had purchased in the ICO, but did not join the complaint until more than a year after his purchase) had nonetheless timely pled his claims because the filing of Owen's claim within the one-year limitations period) "tolled the statute of limitations of limitation as to the ICO purchases." Thus the court held that claims relating to the ICO sale could go forward.

Third, the court considered the individual defendants' argument that they could not be held liable under the Securities Act for the secondary market transaction because they do not "qualify as 'sellers' of the ELA Tokens on the secondary market." Section 5 of the Securities Act states "[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly … to … sell such security." Defendants did not dispute (for purposes of this motion) that their tokens constituted "securities" or that they had not registered them, but because the transactions in the secondary market were between ICO purchasers and third-parties, defendants argued they, as non-participants in the transaction could not be held liable for the unregistered sales. The court rejected this argument, noting that nothing in §12(a)(1) of the Securities Act limits its scope to initial offerings.

Applying the same standards applicable to sales of more traditional securities, the court found that liability under the Act also extends to secondary sales, and "to those who actively solicit the sale of securities with a motivation to serve his or her own financial interest or those of the securities owner." Id. at *14. Because the complaint was "replete with allegations describing the individual defendants' efforts to solicit purchases of ELA Tokens on the secondary market" and the fact that the individual defendants benefitted from those sales, both through their positions at Elastos and as owners of "large quantities of ELA Tokens," Judge Woods found that the individual defendants qualified as "sellers" for purposes of the Securities Act and denied their motion to dismiss.

Disrupting Disruptors

Although the *Owen* decision is detailed and carefully reasoned, it is perhaps most notable for its relative straightforwardness. For all that hype that technologies like blockchain get as "disruptors" requiring new legal paradigms, sometimes the existing legal regime works just as well. A "cryptocurrency system" is, at root, simply an agreement between a group of people to exchange tokens for value. The tokens are digital (mostly), and they are generally backed by a technologically complex system for transaction authentication and auditing (a "blockchain"). They may have various built-in features enforced by technology or contract (or both) designed to add to their utility or investment value, but that back-end complexity does not necessarily have to create a legal headache: if the result of all that technology is something that functions

very much like a share of stock offered on the NYSE, courts should not be shy about applying the same sets of laws to it.

But that analysis will not always be straightforward. In *Owen*, defendants did not contest that "the ELA Tokens constituted securities" and therefore the Securities Act applied. That may not hold true in future cases (or even as the case progresses and defendants are permitted to develop a factual record). If the primary purpose of a cryptocurrency is not investment, but purchase (or something even more esoteric), or if it does not gain value from outside promotion, the application of the Securities Act may be less clear. At that point the "features" of the system (whether enforced by contract or technology) may come under the microscope.

The same goes for the jurisdictional analysis. This was simplified in *Owen* by defendants' presence in the United States. But the sale of digital assets does not require a physical marketing presence, and some of the most popular cryptocurrencies emphasize their anonymity and decentralization features. Future cases may present more difficult challenges: What if Elastos and its employees never "entered" the United States at all? What if they marketed their digital assets entirely on social media? Would the use of social media in the United States be enough to confer jurisdiction? Likely not, but the potential harm to U.S. investors (and thus its interest in applying the Securities Act) would be no different—after all social media marketing is arguably more damaging than any physical "road show" presented to qualified investors. Whether and how the existing statutory and jurisprudential framework will adapt to those types of changes remains to be seen.

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