Hearing On

"SEC Enforcement: Balancing Deterrence with Due Process"

Before the United States House of Representatives Financial Services Committee Subcommittee on Capital Markets

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Prepared Statement

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Chairman Wagner, Ranking Member Sherman, and Members of the Subcommittee:

Thank you for inviting me to testify at today's hearing. My name is John Reed Stark, and I am the President of John Reed Stark Consulting LLC. I have spent the past 35 or so years working as a lawyer in multiple roles at the intersection of law, business, and technology. My experience includes over 18 years at the Enforcement Division of the U.S. Securities and Exchange Commission (SEC) (including 11 years as Chief of the SEC's Office of Internet Enforcement). In addition, I have been teaching various courses on securities regulation and cybersecurity law at the Georgetown and Duke law schools for the past 20 years or so. I also spent 5 years at the Washington, D.C. office of data breach response and digital forensics firm Stroz Friedberg (4 years of which as Managing Director in Charge of the office). The views expressed today are my own.

Some catchphrases are iconic, like, *May the Force Be With You*. Some catchphrases are hilarious, like, *More Cowbell*. And some catchphrases are baseless and misleading, like Theranos' famed mantra, *One Tiny Drop Changes Everything*. The catchphrase of *SEC Regulation by Enforcement*, which has served as a rallying cry for SEC critics and which I predict you will hear a lot today, falls into that last category — a complete and utter falsehood.

Today, I want to focus my remarks specifically on the digital assets industry. I do this both because crypto promoters represent the most important recent example of industry players accusing the SEC of unfairly policing the markets, but also because, over the course of my decades in the industry, I have never witnessed such a well-funded, coordinated, and unfounded assault on the SEC and its mission.

In court pleadings, op-eds and social media postings, digital asset enthusiasts claim that the SEC has gone rogue with *Regulation by Enforcement*, casting aside its mission of investor protection by manipulating its catalogue of antiquated statutes to stifle innovation, to strip individuals of their fundamental entrepreneurial rights and to wreak havoc upon legitimate technological transformation. Along these lines, the digital asset industry has come to embrace the following talking points:

- *The SEC is suppressing innovation and ceding America's technological leadership by failing to provide the digital asset industry with "regulatory clarity;"*

- *The SEC consistently violates the "Due Process" rights of legitimate firms by failing to provide "Fair Notice" that certain digital asset transactions and business models violate the law; and*

- *The SEC repeatedly and recklessly exceeds its authority and is an irresponsible and runaway regulator, practicing "Regulation by Enforcement" and restricting technological progress and investor empowerment.*

Incredibly, even after the debacles of FTX, BlockFi, Celsius, Terraform Labs, Voyager and so many other crypto failures, the digital asset industry continues to repeat these talking points in the vain hope that the more they say it, the more people will believe it.

But what the digital asset industry calls SEC Regulation by Enforcement, the rest of us call enforcing the law.

Some Salient History of SEC Enforcement

The SEC Regulation by Enforcement argument touted by digital asset enthusiasts may have some appeal on its face. After all, what could be more frustrating than being charged with the violation of a law that no one knew existed? However, a cursory review of the history of SEC enforcement and the application of the federal securities laws demonstrates just how specious the SEC Regulation by Enforcement argument actually is.

First off, from policing foreign bribery payments[1] (before the Foreign Corrupt Practices Act),[2] to municipal securities fraud,[3] to derivatives scams[4] and unlawful insider trading,[5] to fictional prime bank instruments[6] and subprime grifts,[7] to non-existent eel farms[8] and bogus ostrich farms,[9] the SEC has addressed emerging issues via enforcement actions, and without the benefit, or the hindrance, of precise prescriptions.

The all-encompassing definition of investment contract was reinforced almost exactly 78 years ago in the oft-cited Supreme Court case of *SEC v. Howey*,[10] where the Court held that investment interests in orange groves constituted securities. Since then, courts have applied the Howey Test for decades, covering investments of every conceivable (and inconceivable) iteration.[11]

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[1] https://www.youtube.com/watch?v=dCQu3EjOIgw
[2] https://www.justice.gov/criminal/criminal-fraud/foreign-corrupt-practices-act
[3] https://www.sec.gov/about/divisions-offices/office-municipal-securities/enforcement-actions
[4] https://www.reuters.com/article/sec-insidertrading/sec-probes-derivatives-in-insider-trading-cases-idUSN2535917220091125/
[5] https://www.sec.gov/spotlight/insidertrading/cases.shtml
[6] https://www.sec.gov/divisions/enforce/primebank/howtheywork.shtml
[7] https://www.sec.gov/spotlight/enf-actions-fc.shtml
[8] https://www.sec.gov/news/digest/1995/dig082595.pdf
[9] https://www.sec.gov/news/digest/1993/dig123093.pdf
[10] https://supreme.justia.com/cases/federal/us/328/293/
[11] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

But even before the Howey Test, in the first several years of U.S. federal securities laws, some entrepreneurs were notified[12] that they had to register their offerings of chinchillas, whiskey warehouse receipts, oyster beds, and live silver foxes as securities offerings.

As one former SEC Enforcement Director wrote so poignantly almost 30 years ago, "*In many respects, the SEC has shown itself adept at responding to changes in the capital, markets and reacting to conduct that is fraudulent and inimical to investor protection.*"[13] Along these lines, whatever the technologies or innovations involved, the SEC "*has relied on the general proscriptions contained in the federal securities laws and has tried to apply them practically and with common sense*."[14] And merely because no blackletter rule exists does not somehow violate Due Process or render the SEC's efforts into "*ex post facto punishment*."[15]

Throughout history, with every new high-tech advancement, "*those whose behavior is challenged, and the lawyers who represent them, cry foul*,"[16] arguing that without specificity and clarity, the SEC's efforts amount to Regulation by Enforcement, and a misguided "*bureaucratic proclivity to expand power and to broaden jurisdiction*,"[17] or even worse, a nefarious plan to implement a selfish and personal political objective.

But just like financial markets, securities regulation must remain flexible, adaptive, and evolving.[18] Therefore, since its genesis, the SEC has typically adopted a reasonable and necessary application of the basic requirements of the federal securities laws to new and evolving market conditions, to emerging financial technologies and to transformative industrial breakthroughs.

Regulation by Enforcement, Due Process and Fair Notice

In digital asset-related court proceedings and pleadings, the Regulation by Enforcement argument has now become a rhetorical staple, with crypto-defendants frequently arguing that:

- The SEC failed to provide Fair Notice to the cryptoverse of what the securities laws actually require; and

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[12] https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422
[13] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf
[14] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf
[15] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf
[16] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf
[17] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf
[18] https://sites.duke.edu/thefinregblog/2022/08/08/grewal-v-grewal-what-coinbases-gc-should-expect-from-the-sec-enforcement-director/

- Rather than create regulations that provide specificity and clarity to the cryptoverse, the SEC unlawfully uses enforcement actions to develop the law on a case-by-case basis, violating critical Due Process rights by molding securities regulation into whatever best suits the SEC staff at the time.

These arguments are not only fatally flawed – they are also nothing new.

In 1998, when the SEC Office of Internet Enforcement was created and I became its chief,[19] critics dwelled on the same humdrum of complaint, i.e., the vagueness of SEC regulation; the lack of clarity about what is a security; and that SEC Regulation by Enforcement would strangle the growth of the Internet.

In response, I co-authored an article entitled, *The SEC's Statutory Weaponry to Combat Internet Fraud*, laying out the SEC's crucial commonsense strategy of ramped-up Internet-related enforcement efforts.[20] My thesis echoed notions that had already been championed by:

- Famed Georgetown Law School professor Donald Langevoort in 1993, in *Rule 10b-5 as an Adaptive Organism* ("*Rule 10b-5s survival is largely due to the flexibility of its language which has enabled the rule to embrace malleable social perceptions of the securities market and the securities business.*");[21] and

- Legendary former SEC Enforcement Director Bill McLucas and then SEC senior enforcement staff member Mark Lewis in 1996, in *Common Sense, Flexibility and Enforcement of the Securities Laws* ("*The apparent anomaly of a direct correlation between criticism of government action and a government agency's creativity should not be surprising. . . . Somewhere between a literal approach to enforcing the law, and the obvious unfairness that would accompany the wholesale retroactive application of newly announced standards, is a reasoned middle ground. To judge the effectiveness, fairness and propriety of the SEC efforts, we should look at the gravity of the conduct being challenged, the legal basis for the approach taken by the Commission, and the relationship of the two to the achievement of the Commission's overall mission – the protection of investors and the integrity of the capital market.*").[22]

In hindsight, relying upon the inherent elasticity of securities regulation to police the Internet cleared out the more egregious instances of early online securities fraud. Moreover, vigorous online SEC enforcement efforts also paved the way for legitimate high-tech innovations to flourish, rendering markets more efficient and transparent, thereby allowing investors almost infinite opportunities for success.

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[19] https://www.sec.gov/news/press/pressarchive/1998/98-69.txt

[20] https://www.johnreedstark.com/wp-content/uploads/sites/180/2014/12/1999_The-Securities-Reporter_The-SECs-Statutory-Weaponry-to-Combat-Internet-Fraud.pdf

[21] https://ir.lawnet.fordham.edu/flr/vol61/iss6/2/

[22] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf

Principles-Based Regulation

Securities regulation is rarely prescriptive. By design, it is a *principles-based* regulatory framework, much like other U.S. laws. For example, U.S. laws do not specify that one cannot steal a neighbor's lawnmower from their garage, but rather prohibits the theft of someone else's property, which covers all things, including lawnmowers. The same goes for securities regulation.

Application of a principle-based approach to law is why the definitions of "security" in Section 2(a)(1) of the Securities Act of 1933 ('33 Act),[23] and Section 3(a)(10) of the Securities Exchange Act of 1934 ('34 Act),[24] include not only conventional security labels, such as a "stock" and "a bond" but also the more general term "investment contract."

Crafted to contemplate not only known securities arrangements at the time, but also to prospective instruments created by those who seek the use of others' money on the promise of profits, the definition of "security" is broad, sweeping, and intentionally designed to be flexible enough to capture new instruments that share the common characteristics of stocks and bonds.

Take so-called prime bank notes[25] for example, which were pitched in a series of global financial schemes that began to surface in the 1990s. Con artists shilled prime bank notes as sound and safe financial instruments purporting to derive their value from secondary European markets for standby letters of credit, operating outside the requirements of U.S. securities laws. Prime bank notes, while appearing sophisticated and a safe investment option, were actually a complete fiction and wholly fraudulent investments.

In the seminal prime bank case, *SEC v. Lauer*,[26] some purveyors of prime bank notes argued that prime bank notes were not securities because they were fictional, so the SEC lacked jurisdiction. The 7th Circuit disagreed, noting that the Howey Test did not require that the securities actually "existed" but rather whether the investment, if true, had the characteristics of an investment contract — underscoring just how broad the definition of investment contract is.[27]

That our securities laws adapt well to technology should come as no surprise – they were drafted with that specific notion in mind. Consider the 1989 case, *Reves v. Ernst & Young*, where, in one of the last opinions written by Associate Justice Thurgood Marshall, the Supreme Court stated:

> *The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.' . . . In defining the scope of the market that it wished to regulate,* ***Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable***

[23] https://www.govinfo.gov/content/pkg/COMPS-1884/pdf/COMPS-1884.pdf
[24] https://www.law.cornell.edu/uscode/text/15/78c
[25] https://www.johnreedstark.com/wp-content/uploads/sites/180/2014/12/2003_Securities-and-Regulations-Law-Journal-SEC-and-Prime-Banks-Securities-Frauds.pdf
[26] https://casetext.com/case/sec-v-lauer-3
[27] https://casetext.com/case/sec-v-lauer-3

> ***schemes devised by those who seek the use of the money of others on the promise of profits****, SEC v. W.J. Howey Co., 328 U.S. 293, 328 U.S. 299 (1946), and determined that the best way to achieve its goal of protecting investors was 'to define the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.' . . . Congress therefore did not attempt precisely to cabin the scope of the Securities Acts . . . Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."*[28] (emphasis added)

Per *Reves* and countless other legal precedent, judges have agreed that Congress never meant to "cabin the scope"[29] of securities regulation but instead, crafted definitions to contemplate not only known securities arrangements at the time, but also any future investment instruments created by those who seek the use of others' money on the promise of profits.

In addition, while it is an interesting academic exercise to debate the Howey Test, the reality is that the SEC is granted tremendous latitude with respect to its jurisdiction. This is probably why former SEC Chair Jay Clayton once testified before Congress: "*I believe every ICO [initial coin offering] I have ever seen is a security . . . ICOs should be regulated like securities offerings. End of Story.*"[30]

To prove their point, digital asset enthusiasts ironically point to the many different types of digital asset offerings that the SEC has charged for failing to register without specifying them as such beforehand. But this argument fails on its face, and fatefully proves the contrary, i.e. that securities laws are indeed adaptable to new technology.

As U.S. District Court Judge Katherine Polk Failla recently wrote in an order denying, in large part, Coinbase's motion to dismiss an SEC's lawsuit[31] against them: "[T]he "crypto" nomenclature may be of recent vintage, but the challenged transactions fall comfortably within the framework that courts have used to identify securities for nearly eighty years."[32]

SEC Crypto-Related Enforcement Actions and Fair Notice/Due Process

The SEC has spoken with an extraordinarily clear voice regarding crypto, via regulatory pronouncements such as the July 2017 DAO 21A SEC Report of Investigation;[33] administrative directives like the December 2017 SEC Munchee Administrative Order;[34] and via close to 200

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[28] https://supreme.justia.com/cases/federal/us/494/56/
[29] https://supreme.justia.com/cases/federal/us/494/56/
[30] https://www.coindesk.com/markets/2018/02/06/sec-chief-clayton-every-ico-ive-seen-is-a-security/
[31] https://www.sec.gov/news/press-release/2023-102
[32] https://storage.courtlistener.com/recap/gov.uscourts.nysd.599908/gov.uscourts.nysd.599908.105.0.pdf
[33] https://www.sec.gov/files/litigation/investreport/34-81207.pdf
[34] https://www.sec.gov/files/litigation/admin/2017/33-10445.pdf

SEC crypto-related Enforcement actions,[35] all approved by the SEC, disseminated worldwide and discussed by SEC staff at countless conferences, events, meetings, etc.[36]

In fact, the SEC first made investors aware of the dangers of investing in cryptocurrency as far back as 2013 when the SEC's Office of Investor Education and Advocacy issued an Investor Alert on "Ponzi Schemes Using Virtual Currencies."[37] And since then the SEC has used "multiple distribution channels to share its message and concerns regarding crypto, digital trading platforms, initial coin offerings, and other digital asset products and services over the past decade."[38]

In addition, before SEC Chair Gary Gensler's tenure began, his Republican-appointed predecessor, former SEC Chair Jay Clayton, often spoke to the applicability of the securities laws in the crypto space[39] testifying before Congress, speaking to lawyers, and addressing Wall Street financiers – even appearing on CNBC[40] to share his views.

Along these lines, I cannot recall an area of securities regulation where the SEC has taken so many opportunities to broadcast its position as it has done regarding digital assets. Yet, the digital asset industry continues to stick to its claim of ignorance as to the SEC's crypto-related posture and viewpoints.

SEC Chair Gensler, on September 8, 2022, tackled this "ignorance of the law" defense head-on in a speech reflecting on the flexibility of the securities laws and the SEC's consistency in applying those laws to digital assets. In his speech, Chair Gensler noted that of the 10,000 different cryptocurrencies in the market, "the vast majority are securities." Chair Gensler went on to note that the SEC has spoken with a "pretty clear voice" when it comes to cryptocurrency "through the DAO Report, the Munchee Order, and dozens of enforcement actions." Chair Gensler concluded with this powerful rebuke directed at the digital asset industry: "*Not liking the message isn't the same thing as not receiving it.*"[41]

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[35] https://www.cornerstone.com/insights/press-releases/sec-enforcement-of-cryptocurrency-reaches-a-new-high/. See also, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions

[36] In most of these SEC enforcement actions, the SEC has applied the Howey Test to argue that the cryptocurrency in question is an investment contract, and therefore a security subject to SEC registration and disclosure requirements.

[37] https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf

[38] https://sites.duke.edu/thefinregblog/2022/11/28/big-cryptos-bogus-demands-for-regulatory-clarity-2/

[39] https://corpgov.law.harvard.edu/2018/04/18/ten-crypto-financing-caveats/

[40] https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html

[41] https://www.sec.gov/news/speech/gensler-sec-speaks-090822

A Few Important SEC Digital Asset Judicial Decisions

While digital asset firms and their supporters may allege the SEC's Due Process and Fair Notice failures as much as they please, it ultimately falls on the courts to determine whether this is in fact the case.

Remarkably, in only a few years, within the tens of thousands of pages of comprehensive pleadings and court filings associated with numerous SEC digital asset-related enforcement actions,[42] the Due Process and Fair Notice defenses have received intense scrutiny from an array of federal judges. Not surprisingly, judges have rejected the Due Process and Fair Notice defenses time and again, including in some of the most notorious crypto-related SEC enforcement actions, such as the SEC enforcement actions involving Kik, LBRY, Terraform Labs and Coinbase.

KIK

On June 4, 2019, the SEC filed a complaint against Kik Interactive, Inc., alleging that Kik sold digital asset securities to U.S. investors without registering their offer and sale as required by the U.S. securities laws.[43]

Kik argued that the SEC's lawsuit against it should be considered "void for vagueness."[44] But the court granted the SEC's motion for summary judgment on September 30, 2020, finding that the undisputed facts established that Kik's sales of "Kin" tokens were sales of investment contracts (and therefore of securities) and that Kik violated the federal securities laws when it conducted an unregistered offering of securities that did not qualify for any exemption from registration requirements. The court further found that Kik's private and public token sales were a single integrated offering and that Kik's Fair Notice defense failed, stating:

> *First, the law regarding the definition of investment contract gives a reasonable opportunity to understand what conduct and devices it covers. Howey provides a clearly expressed test for determining what constitutes an investment contract, and an extensive body of case law provides guidance on how to apply that test to a variety of factual scenarios. See United States v. Smith, 985 F. Supp. 2d 547,588 (S.D.N.Y. 2014) ("[I]t is not only the language of a statute that can provide the requisite fair notice; judicial decisions interpreting that statute can do so as well."). That is constitutionally sufficient. See United States v. Zaslavskiy, No. 17 CR 647 (RID), 2018 WL 4346339, at *9 (E.D.N.Y. Sept. 11, 2018) ("[T]he abundance of caselaw interpreting and applying Howey at all levels of the judiciary, as well as related guidance issued by the SEC as to the scope of its regulatory authority and enforcement power, provide all the notice that is*

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[42] https://www.cornerstone.com/insights/reports/sec-cryptocurrency-enforcement/

[43] https://www.sec.gov/news/press-release/2019-87

[44] https://storage.courtlistener.com/recap/gov.uscourts.nysd.516941/gov.uscourts.nysd.516941.77.0.pdf ; https://storage.courtlistener.com/recap/gov.uscourts.nysd.516941/gov.uscourts.nysd.516941.82.0.pdf

> *constitutionally required."). Second, for similar reasons, the law provides sufficiently clear standards to eliminate the risk of arbitrary enforcement. Howey is an objective test that provides the flexibility necessary for the assessment of a wide range of investment vehicles. Kik focuses much of its argument on the SEC's failure to issue guidance on securities enforcement related specifically to cryptocurrencies, SEC officials' inconsistent public statements on the issue, and the SEC's failure to bring enforcement actions against other issuers of digital tokens. However, the law does not require the Government to reach out and warn all potential violators on an individual or industry level . . .*[45]

LBRY

On March 29, 2021, the SEC filed a complaint against LBRY, Inc., alleging that the software firm had sold unregistered crypto asset securities called "LBRY Credits" or "LBC."[46]

LBRY argued that the SEC's attempt to treat LBC as a security violated its right to Due Process because the agency did not give LBRY Fair Notice that its offerings of LBC were subject to the securities laws. But Judge Paul J. Barbadoro addressed the Fair Notice and Due Process defenses head-on in a summary judgment ruling – and rejected them,[47] granting the SEC's summary judgment motion against LBRY stating:

> *The SEC has not based its enforcement action here on a novel interpretation of a rule that by its terms does not expressly prohibit the relevant conduct. Instead, the SEC has based its claim on a straightforward application of a venerable Supreme Court precedent that has been applied by hundreds of federal courts across the country over more than 70 years . . .*[48]

Terraform Labs

On February 16, 2023, the SEC filed a complaint against Singapore-based Terraform Labs PTE Ltd and Do Hyeong Kwon, alleging that Terraform Labs and Kwon had orchestrated a multi-billion-dollar crypto asset securities fraud involving an algorithmic stablecoin and other crypto asset securities.[49]

Terraform Labs and Kwon argued that the SEC had violated their Due Process and had not provided Fair Notice of their alleged violations. In a ruling denying a motion to dismiss by Terraform and Kwon, Judge Jed Rakoff addressed the Fair Notice/Due Process defenses head-on – and rejected them, noting:

> *Next, defendants argue that the SEC violated their due process rights by bringing this enforcement action against them without first providing them "fair notice" that their crypto-assets would be treated as securities. See FCC v. Fox Television Stations Inc., 567 U.S. 239, 253-54 (2012) (ruling that the Due Process Clause requires that agencies*

[45] https://casetext.com/case/us-sec-exch-commn-v-kik-interactive-inc
[46] https://www.sec.gov/litigation/litreleases/lr-25060
[47] https://www.sec.gov/litigation/litreleases/lr-25573
[48] https://www.johnreedstark.com/wp-content/uploads/sites/180/2022/02/Library.pdf
[49] https://www.sec.gov/news/press-release/2023-32

bringing an enforcement action "provide," through written guidance, regulations, or other activity, "a person of ordinary intelligence fair notice" that the regulated conduct was "prohibited").

According to the defendants, the SEC has long maintained that cryptocurrencies are not securities, but here, they claim it has for the first time taken the position that all cryptocurrencies are securities and enforced this understanding against the defendants without any prior indication that it had changed its view. This sudden about-face, the defendants say, deprived them of their constitutional right to "fair notice" and, by implication, the opportunity to conform their behavior to the SEC's regulations. In response, the SEC argues that it has never taken either of the black-and-white positions that the defendants ascribe to it. Indeed, rather than state that all crypto-currencies are securities or that none of them are, the SEC insists that it has broadcast the same position on this issue all along: that some crypto-currencies, depending on their particular characteristics, may qualify as securities.

Prior to its bringing this case, moreover, the SEC asserted the exact same position it has taken in this case in several enforcement actions brought against other crypto-currency companies for allegedly fraudulent conduct in the offer and sale of their crypto-assets. . . These relatively high-profile lawsuits -- which involved substantially similar allegations and millions of dollars in allegedly fraudulent crypto-currency transactions -- would have apprised a reasonable person working in the crypto-currency industry that the SEC considered some crypto-currencies to be securities and that the agency would enforce perceived violations of the securities laws through the development, marketing, and sale of these crypto- currencies.

Following this prior litigation, moreover, a department of the SEC issued written guidance in April 2019 that admonished those "engaging in the offer, sale, or distribution of a digital asset" to consider "whether the digital asset is a security" that would trigger the application of "federal securities laws." Sec. & Exchange Comm., Framework for "Investment Contract" Analysis of Digital Assets (April 2019). Within this document, the SEC also provided "a framework for analyzing whether a digital asset is an investment contract" and a list of characteristics that, if present in a given digital asset, would make the SEC more likely to view the given crypto-asset as a "security." Id. The instant lawsuit, in sum, is just one example of the SEC's longstanding view that some cryptocurrencies may fall within the regulatory ambit of federal securities laws . . . In short, defendants' attempt to manufacture a "fair notice" problem here comes down to asserting the SEC's position in this litigation is inconsistent with a position that the SEC never adopted. So long as the SEC has -- through its regulations, written guidance, litigation, or other actions -- provided a reasonable person operating within the defendant's industry fair notice that their conduct may prompt an enforcement action by the SEC, it has satisfied its obligations under the Due Process Clause . . .[50]

[50] https://www.johnreedstark.com/wp-content/uploads/sites/180/2023/07/RakoffTerra.pdf

Coinbase

On June 6, 2023, the SEC filed a complaint against Coinbase, Inc., alleging that Coinbase was operating its crypto asset trading platform as an unregistered national securities exchange, broker, and clearing agency and also that Coinbase had failed to register the offer and sale of its crypto asset staking-as-a-service program.[51] In a recent court order rejecting, in large part, Coinbase's motion to dismiss SEC charges, Judge Katherine Polk Failla addressed Coinbase's Due Process and Fair Notice defenses head-on — and rejected them, noting:

> *The very concept of enforcement actions evidences the Commission's ability to develop the law by accretion. The SEC has a long history of proceeding through such actions to regulate emerging technologies and associated financial instruments within the ambit of its authority as defined by cases like Howey — a test that has existed for nearly eight decades. See, e.g., SEC v. SG Ltd., 265 F.3d 42, 44 (1st Cir. 2001) (applying federal securities laws to "virtual shares in an enterprise existing only in cyberspace").* ***Using enforcement actions to address crypto-assets is simply the latest chapter in a long history of giving meaning to the securities laws through iterative application to new situations***.[52] (emphasis added)

Court after court has recognized what should be obvious from an extensive and storied history of SEC regulation and enforcement — and there is certainly no need to reinvent the wheel in the name of "Due Process" and "Fair Notice."

Why SEC Regulation Matters

The digital asset industry's claim of SEC Regulation by Enforcement is a barely concealed effort to operate free from the constraints that apply to traditional financial institutions. As millions of crypto users and customers have unfortunately found out over the past two years, these constraints exist for a reason – to protect investors from financial ruin.

While billions of dollars have been lost in numerous crypto failures – to say nothing of crypto enabled ransomware attacks, terrorist financing, money laundering, sanctions evasion, and scams[53] – we continue to wait for crypto's long promised benefits to materialize.

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[51] https://www.sec.gov/news/press-release/2023-102

[52] https://www.johnreedstark.com/wp-content/uploads/sites/180/2024/04/CoinbaseOrder.pdf

[53] Crypto has evolved into a killer app for criminals, which is perilous for everyone everywhere. For instance, perpetrators of ransomware attacks demand crypto to unlock corporate IT systems and data that the attackers have surreptitiously encrypted. Collecting crypto in extortion transactions allows ransomware attackers not only to conceal their tracks and identities, but also to conduct their schemes from anywhere in the world. Traditional crimes have also increased exponentially because of crypto, including: drug-dealing, terrorism financing; human sex trafficking; money laundering; sanction evasion by countries like Russia, North Korea and Iran, who use crypto to transfer funds outside financial systems; assassins and other killers seeking payment for murder-for-hire services; and a slew of other financial crimes. Meanwhile, U.S. law enforcement is often helpless to investigate, let alone, prosecute, crypto-related crimes. Of course

For over a decade, promoters touting cryptocurrencies, decentralized finance, non-fungible tokens, and other digital assets have promised that their products will benefit society in countless ways, including by transforming the way businesses conduct financial transactions; verifying transactions instantaneously, eliminating significant costs, uncertainty and fraud; promoting financial inclusion and dramatically improving the way all U.S. citizens carry out our daily lives. But these ambitious promises continue to remain unfulfilled, amounting in almost every case to nothing more than hype and bluster."[54]

Moreover, when it comes to the valuation of digital assets, investors are most often flying completely blind. Digital assets typically have: no cash flow, no yield, no employees, no management, no balance sheet, no product, no service, no history operations, no earnings reports, no proven track record of adoption or reliance, and the list goes on (and on). How can any financial analyst, let alone any everyday investor, conduct a proper valuation amid such a boundless data vacuum?

Meanwhile, digital asset trading platforms might look like traditional brokerage apps to everyday users, but they are not. Behind the crypto-curtain, there exists scant government oversight and inadequate consumer protections and no mechanism to provide investors with the kind of safety and protection that are fundamental in the realm of traditional financial services. SEC oversight fills that void.

SEC registration of securities and financial firms: (1) mandates that investor funds and securities be handled appropriately; (2) ensures that investors understand the risks involved in purchasing securities; (3) makes buyers aware of the last prices of securities traded on registered exchanges; and (4) provides adequate disclosures regarding their trading policies, practices and procedures.

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the U.S. Department of Justice (DOJ) can occasionally catch crypto-using culprit (e.g. discovering crypto during a search warrant "under blankets in a popcorn tin stored in a bathroom closet" (https://www.theregister.com/2022/11/07/us_bitcoin_silk_road/)). However, those apprehensions and interdictions are few and far between. This is because the cross-border nature of digital asset technologies requires collaboration with foreign law enforcement partners to locate and gather electronic records and digital evidence involving off-shore digital asset issuers, trading platforms, service providers and other online infrastructure; to seize and prevent further distribution of digital assets linked to crime; and to identify and hold responsible criminal actors who exploit pseudonymity features of Defi and blockchain technologies to avoid detection, identification and prosecution. Indeed, acknowledging that U.S. DOJ has seen a tremendous increase in crypto-related crime over the past several years, then U.S. DOJ's Director of its National Cryptocurrency Enforcement Team (NCET), Eun Young Choi recently stated: "*We are seeing cryptocurrency and digital assets really touch every aspect of criminal activity we investigate . . . By its very nature the technology is built in order to not rely on intermediaries, cross-border transactions that are immutable and irreversible. Law enforcement can freeze conventional transactions, but they can't do that with digital asset transactions*." https://www.linkedin.com/pulse/manifold-fallacies-coinbases-deceptive-perverse-propaganda-stark/ ; See, also, https://www.linkedin.com/pulse/crypto-traceability-dont-believe-hype-john-reed-stark/

[54] https://www.linkedin.com/pulse/10-axioms-crypto-shills-dont-want-you-know-john-reed-stark/

Overall, entities providing financial services must carefully handle access to, and control of, investor funds, and provide all users with adequate protection and fortification.

With traditional SEC-registered financial firms, the SEC has absolute, unlimited and instantaneous visibility into every aspect of operations. In glaring contrast, with digital asset trading platforms, the SEC lacks any sort of oversight and access — and has no ability to surveil transactions, to detect suspicious activity and to investigate and deter fraudulent conduct in real-time. As a result, the digital asset marketplace operates without much, if any, genuine and objective supervision, lacking:

- The hallmarks of the traditional transparent surveillance program of a financial firm like an SEC-registered broker-dealer or investment adviser, so the SEC cannot analyze or verify market trading and clearing activity, customer identities and other critical data for risk and fraud;

- SEC and/or Financial Industry Regulatory Authority (FINRA) licensure of individuals involved in crypto trading, operation, promotion, etc., so the SEC cannot detect individual misconduct and enforce violations;

- Traditional accountability structures and fiduciaries of financial firms, so the SEC cannot ensure that every customer's interest is protected and held sacrosanct;

- The compliance systems, personnel and infrastructure, so the SEC cannot know where crypto came from or who holds most of it; and

- The verification and investigatory routine and for cause SEC or FINRA examinations, inspections and audits, so the SEC and FINRA cannot patrol, supervise or verify critical customer protections and compliance mechanisms.

Registering with the Financial Crimes Enforcement Network, with New York State as a “Trust,” with a non-U.S. regulator, or with all 50 states as a “money service business” is a far cry from U.S. SEC registration.

To be clear, registration with the SEC or any other federal regulatory agency is no guarantee against fraud or failure. Throughout our nation’s history, there have been several high-profile bank and broker-dealer failures. But in these rare instances, there are statutory guardrails to protect and help depositors and customers, such as insurance from the Federal Deposit Insurance Company (FDIC), insurance from the Securities Investor Protection Corporation (SIPC) or related special conservator/receiver frameworks. When fiscal crisis occur, the U.S. government can step-in swiftly and responsibly. But when a digital asset trading firm fails (like FTX, BlockFi, Voyager, Celsius, etc.) there exist few, if any, traditional U.S. government protections, and the customer’s access to assets can become suddenly locked out or frozen. Bankruptcy often then becomes inevitable, and the customer (depending on the user agreement and other factors) can become just another “unsecured creditor,” last in line for recovery and possibly left with nothing.

Crypto's Cognitive Dissonance

My point today is that it's time to stop the constant SEC-bashing, the shameless demonizing of SEC Chair Gary Gensler and other self-serving sophism disseminated by the digital asset industry.

Wherever their source, crypto-criticisms of Chair Gensler, crypto-denunciations of the SEC, and crypto-pleas for regulatory clarity, have evolved into little more than distorted, dissembling rhetoric. It's like arguing that banning asbestos means banning building construction, when in reality, just as asbestos asphyxiates and contaminates the lawful construction of buildings, digital assets can pollute and suppress benevolent technological transformation.

Like clearing out organized crime in a big city, digital asset regulation and transparency clears the way for legitimate technological innovation, progress, and development, rendering it free from abuse and criminal exploitation.

Financial intermediaries like banks, brokerages, credit card companies, financial apps, etc. play a critical beneficial role for all consumers. They offer redress and relief when there is fraud, negligence or even a mere mistake. They allow for reversal, remedy and recourse. And most importantly, they are policed by sophisticated regulatory oversight and intricate consumer protections such as mandatory auditing, inspections, record-keeping, net capital requirements, licensure of individuals and so much more. Why shouldn't we expect the same from this new and volatile digital asset industry that, *by design*, does not offer the kinds of institutional checks and recourses that banks, brokerages and other traditional financial intermediaries provide?

Thankfully, U.S. securities laws create an across-the-board financial protective framework to safeguard all people and businesses from the systemic risk created by perilous digital assets, which if entangled into the U.S. financial system, could trigger a financial crisis akin to the sub-prime debacle of 2008 or even the stock market crash of 1929.[55] Simply stated, whether buying Apple stock or a random crypto token, the SEC wants the same investor protections to apply.

The problems at FTX, BlockFi, Voyager, Terraform Labs, Celsius and so many others were not isolated incidents, but were part of a cascade of interconnected failures in the highly volatile, sparsely regulated and vastly leveraged crypto financial system. That is why the common sense and flexibility of the U.S. federal securities laws is sacrosanct – because principle-based securities laws protect us all from the epic personal and systemic risk the digital asset industry has created.

Along these lines, SEC Chair Gensler has said he encourages crypto companies to "come in and talk to us"[56] but has also consistently reminded digital asset promoters that most cryptocurrencies are securities, that most cryptocurrencies will require registration and that he remains committed to expanding the digital asset enforcement efforts of the SEC's Enforcement

[55] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4331362
[56] https://www.sec.gov/news/testimony/gensler-2021-09-14

Division. And as Chair Gensler has famously avowed, when it comes to policing the cryptoverse, *"market participants may call this SEC Regulation by Enforcement, I just call it enforcement."*[57]

It is axiomatic that litigation is precisely how securities regulation works. Meanwhile, the digital asset industry seems precariously predisposed to prioritize growth over SEC compliance, all the while preaching the old adage that it is "better to beg for forgiveness than to ask for permission."[58] To combat this dangerous game of "regulatory arbitrage," the SEC files enforcement actions – both to punish those who fail to comply with regulations and to deter future violations from not just the nefarious, but also the over-eager.

Above all else, it is the flexibility of SEC statutory weaponry, an SEC hallmark, which allows the SEC to protect investors and to guard against systemic risks to financial markets, to counter novel or uncontemplated investor threats, and to prosecute those who attempt to circumvent critical consumer protections, especially those promoting newfangled get-rich-quick investment opportunities.

A Note About the SEC Enforcement Staff

Digital asset enthusiasts will often personify the SEC's actions as politically motivated, contending that the SEC's regulatory agenda is driven by political allies in Congress and the White House. As a former SEC employee of almost 20 years, (and self-proclaimed SEC historian), I respectfully disagree.

What makes the SEC so different from other U.S. agencies is not just their unique investor protection mandate and impartial authority but also their inherent, intrinsic and built-in statutory independence.

For instance, there are a broad range of political appointees at many U.S. agencies at all levels of senior leadership. But at the SEC, other than the SEC Commissioners themselves, there are very few political appointees, and the few that exist typically work in supporting offices handling legislative affairs or communications — not in operational departments like the SEC Enforcement Division.

Along these lines, it is not unusual for SEC enforcement staff, even SEC Division Directors and SEC Regional Administrators, to remain in charge after a change in Presidential administration, sometimes even throughout multiple different administrations. Having worked in the SEC Enforcement Division for almost 20 years, including 11 as Chief of the SEC's Office of Internet Enforcement, I served under many different SEC Chairs. Rarely, if ever, did I experience political pressure with respect to the investigations and enforcement actions that I worked on. Of course, priorities would change, but fraud is fraud and investor protection was never negotiable.

The federal securities laws empower the SEC with broad authority over all aspects of the securities industry. The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[59] For SEC staff, especially SEC Enforcement Division

[57] https://www.sec.gov/news/speech/gensler-securities-enforcement-forum-20211104
[58] https://www.justice.gov/opa/pr/binance-and-ceo-plead-guilty-federal-charges-4b-resolution
[59] https://www.sec.gov/about/mission

staff, this sacred SEC mission is not a matter of politics, nor an opportunity to "round corners and notch wins"[60] — but is instead a matter of simply doing the right thing and "standing up each and every day for the investing public."[61]

Looking Ahead

The bedrock principles of U.S. securities laws not only protect investors and safeguard capital markets but have also enabled the creation of a thriving financial marketplace of boundless invention and enormous reward. And by enforcing the effective, proven and evolving U.S. securities law framework, the SEC has not gone rogue, but is instead simply doing its job.

As SEC Enforcement Director Gurbir Grewal stated so eloquently in a speech just a few weeks ago:

> *[O]ver the past decade, we have confronted significant non-compliance and many, many creative attempts by market participants to avoid our jurisdiction, with some claiming that we are making it up as we go or regulating by enforcement, and others arguing that we are recklessly exceeding our authorities. . . At the same time, we've been accused of picking winners and losers, stifling innovation, and driving crypto businesses to more favorable, foreign jurisdictions, wherever they may be. A decade's worth of verbal gymnastics that are just a backhanded way of saying, "we want a different set of rules than those that apply to everyone else." A decade's worth of arguments that have served as nothing more than a distraction from the very real issues and risks that the crypto markets present for the investing public. And most importantly, a decade's worth of arguments that have been serially rejected in one way or another by court after court. As we have consistently maintained, and as court after court has confirmed, the federal securities laws apply equally to everyone.* ***You don't get your own rules***.[62] (emphasis added)

So-called digital assets *"are not laundromat tokens. Promoters are marketing and the investing public is buying most of these tokens, touting or anticipating profits based on the efforts of others."*[63] That triggers the '33 Act.

So-called digital asset "exchanges," "brokers," and "market-makers," are not auction houses selling baseball cards, Beanie Babies or American Girl dolls,[64] they are sophisticated financial conglomerates trading securities and have coopted historically powerful nomenclature that

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[60] https://www.sec.gov/news/speech/gurbir-remarks-sec-speaks-04032024
[61] https://www.sec.gov/news/speech/gurbir-remarks-sec-speaks-04032024
[62] https://www.sec.gov/news/speech/gurbir-remarks-sec-speaks-04032024
[63] https://www.sec.gov/news/speech/gensler-sec-speaks-090822
[64] https://www.courtlistener.com/docket/67478179/36/securities-and-exchange-commission-v-coinbase-inc/

implies trust and creates a counterfeit veneer of assurances, integrity, expertise and regulatory oversight.[65] That triggers the '34 Act.

The Stark reality is that the SEC is just enforcing the law. Period. You may not like the outcome, but that doesn't amount to an absence of Due Process and Fair Notice or somehow translate into rogue SEC Regulation by Enforcement. It just means the digital asset industry needs to get its act together and adapt to the laws that apply to it — not the other way around.

[65] As an aside, I can't help but note that these so-called "crypto-exchanges" claim to be champions of the future of finance and digital couriers of transformative technological revolution that are the future of money. Yet, in an almost amusing hypocritical twist, when the SEC comes knocking, they argue in court papers that selling digital assets is just like selling baseball cards, American Girl dolls or Beanie Babies. See, e.g., https://www.courtlistener.com/docket/67478179/36/securities-and-exchange-commission-v-coinbase-inc/