

INSIGHTS

## The Questions Around Prometheus's SEC-Compliant Strategy

January 30, 2024

By: [Keith Blackman](#)

Regulatory uncertainty remains a major hurdle in the way of widespread adoption of cryptocurrency. While the US Securities and Exchange Commission (SEC) has sought to apply traditional securities concepts to the crypto marketplace, the cryptocurrency industry is pushing for specific regulations governing the trading of digital assets. It's the industry's apparent hope that, with clear-cut rules, it can define its products and services outside the regulator's purview.

But a previously obscure player called Prometheus has uniquely positioned itself as the SEC's darling, building a trading platform and broker-dealer based on regulatory compliance. Prometheus is already the first crypto company approved by the SEC to be a "qualified custodian" for digital assets, and it expects to open up shop in the coming months.

Did Prometheus discover the key to unlocking the mainstream implementation of digital assets, or — as the rest of the industry suspects — will its attempts at compliance ultimately prove unworkable?

### **The Key Question: Is Cryptocurrency a Security?**

Of all the questions facing cryptocurrency, the most important one from a regulatory perspective is whether cryptocurrencies are properly classified as securities. If they are, the SEC can regulate them like stocks or bonds, and require disclosure-laden registration by issuers, brokers and exchanges. If not, cryptocurrency would fall outside the jurisdiction of the SEC, like fiat currencies and commodities.

The SEC, however, has declined to promulgate rules that would categorize digital assets as securities or nonsecurities. Believing that existing laws are sufficient, the commission has instead sought to establish judicial precedent by bringing enforcement actions against some of the biggest players in the industry.

In court, the SEC has urged judges to assess digital assets using the Howey test — an analysis for determining whether transactions are investment contracts, derived from the US Supreme Court's 1946 case, *SEC v. W.J. Howey Co.*, involving investments in Florida orange groves. Applying the Howey test, the commission claims that virtually all cryptocurrencies, apart from bitcoin, constitute securities.

While the SEC's enforcement-first policy provides it with flexibility, the downsides have become apparent as courts have not uniformly sided with the regulator.

In July 2023, US District Judge Analisa Torres, in *SEC v. Ripple Labs Inc.* before the US District Court for the Southern District of New York, delivered a major victory for the industry by determining that XRP — a token issued by Ripple Labs — is not a security in and of itself under the Howey test. Judge Torres concluded that, unlike traditional securities, XRP's utility and value stem from its independent functionality within the Ripple network, not from Ripple's actions or promises.

Less than three weeks later, however, US District Judge Jed Rakoff granted summary judgment to the SEC in a similar case — *SEC v. Terraform Labs Pte Ltd.*, also before the Southern District of New York — holding that Terraform Labs' LUNA and MIR tokens were unregistered securities under the Securities Act. In stark contrast to Judge Torres, Judge Rakoff held that these tokens met the Howey test's criteria for investment contracts.

These conflicting court rulings—along with [\*\*the SEC's potential inability to hold individuals criminally liable for the knowing violation of securities laws\*\*](#)—have only fueled uncertainty and have prevented the SEC and the industry from coming to terms.

## **The Industry**

For its part, the crypto industry has generally spoken with one voice, arguing for a tailored framework that would acknowledge the unique characteristics of digital assets. The implication of the industry's position is that large swaths of cryptocurrency should fall outside the definition of a security, and be bought and sold outside the strictures of the SEC.

In an attempt to force the commission's hand, crypto exchange Coinbase filed a writ of mandamus with the US Court of Appeals for the Third Circuit in April 2023 seeking to compel the SEC to respond to its petition demanding the proposal of crypto-focused rules, which had languished at the commission since July 2022.

According to its mandamus filing, Coinbase argued that “existing SEC registration and disclosure requirements are incompatible with digital assets, which differ fundamentally from the stocks, bonds, and investment contracts for which the securities laws were designed and that the SEC traditionally has regulated.”

The SEC remained unmoved. On Dec. 15, 2023, it denied Coinbase's petition: “The commission disagrees with the petition's assertion that application of existing securities statutes and regulations to crypto asset securities, issuers of those securities, and intermediaries in the trading, settlement, and custody of those securities is unworkable.” Coinbase immediately sought review by the Third Circuit, arguing that the SEC's determination was arbitrary and capricious.

## **Enter Prometheus**

While the rest of the crypto industry has been engaged in a long-running battle to escape the SEC's jurisdiction, a once-obscure startup called Prometheus Inc. has instead embraced the

commission's view, even going so far as to parrot its talking points. Meanwhile, the company has hired former staff from the Financial Industry Regulatory Authority, the SEC and the New York Stock Exchange to fill out its executive staff.

And so far, its compliant strategy has seemed to work. In July 2021, a Prometheus affiliate was approved by the SEC and FINRA to act as an alternative trading system, permitting it to transact orders for digital asset securities across the US.

And in May 2023, a separate Prometheus affiliate — Prometheus Ember Capital — became the first crypto firm to receive a license from FINRA to operate as a special-purpose broker-dealer, permitting it to serve as a qualified custodian with respect to digital assets. The license was expanded in December 2023, allowing Prometheus to clear and settle digital asset trades.

According to Prometheus co-CEO Aaron Kaplan, Prometheus now has a “clear path” to operate within existing federal securities laws, and it expects to launch its custody platform in the first quarter of 2024.

Along with announcing its intention to play within the rules, Prometheus has also sought to curry favor with the SEC through its public statements. For example, during a [House Financial Services Committee hearing](#) last year, Kaplan explicitly defended the SEC's approach, opining that existing securities rules are sufficient to govern cryptocurrencies and criticizing his competitors as behaving recklessly.

And the SEC has returned the fawning praise, using Prometheus's example to squelch the complaints of the crypto companies — and many US representatives and senators — that special rules especially tailored to cryptocurrencies are needed. Indeed, when the SEC denied Coinbase's petition for rulemaking in December, SEC Chair Gary Gensler [specifically pointed](#) to Prometheus as an example, demonstrating that broker-dealers can engage in cryptocurrency transactions under the existing securities laws.

### **But Will It Work?**

Prometheus's “if you can't beat them, join them” strategy has earned it the enmity of its fellow crypto firms, which believe Prometheus's strategy is unworkable and serves only to support the SEC's inflexibility.

And there is something to their arguments. Despite Kaplan's optimistic view that he has a clear path to clear and settle digital asset trades in compliance with the federal securities laws in the near future, Prometheus's naysayers rightfully identify major obstacles.

First off, as an alternative trading system, Prometheus would only be able to match orders for registered securities. Even if the SEC and Prometheus are correct in characterizing virtually all cryptocurrencies as securities, it would be up to the issuer — not Prometheus — to register them. But few if any issuers have announced plans to register their tokens with the SEC, nor are they likely to do so given the industry's unanimous refusal to classify tokens as securities.

Second, Prometheus has not yet explained how it, or the token issuer, could make the disclosures required by the SEC under existing securities laws. For example, extensive corporate

governance and financial disclosures concerning the issuer are impossible to make — or, at least, wholly beside the point — when dealing with tokens governed exclusively by computer code. And whether Prometheus could comply with federal anti-money laundering laws while trading in decentralized digital currencies is an open question.

Finally, [\*allegations\*](#) that Prometheus has improper ties to the Chinese Communist Party — strongly denied by Prometheus — continue to dog the company and may ultimately result in congressional or regulatory intervention.

That said, Prometheus has already achieved first-in-industry status as a crypto security special-purpose broker-dealer, and has positioned itself as the SEC's poster child. Whether it can turn its favored status into a workable business remains to be seen.

[\*Article originally published by Law360 on January 30, 2024.\*](#)