

INSIGHTS

## ShapeShift Fine Epitomizes SEC's Crypto Policy, and its Flaws

March 29, 2024

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On March 5, ShapeShift AG, a former cryptocurrency exchange, [agreed to pay a fine](#) imposed by the US Securities and Exchange Commission for failing to register as a securities dealer.

The settlement could have passed unnoticed: The \$275,000 penalty was relatively minor, and ShapeShift's founder, Erik Voorhees, remained relatively quiet. But the case gained attention when two SEC commissioners issued a scathing dissent, accusing their fellow commissioners of purposely adopting an arbitrary, opaque and ultimately untenable crypto strategy designed to sandbag — if not destroy completely — the US crypto industry.

Whether or not the dissenting commissioners correctly interpret the SEC's motives, it cannot be denied that the agency's refusal to promulgate clear-cut rules governing crypto, coupled with its checkered courtroom record, deprives crypto-asset markets of desperately needed clarity.

### A "Crypto Vending Machine"

In 2014, a lifetime ago in crypto terms, Voorhees, an early crypto entrepreneur, founded the Swiss cryptocurrency exchange ShapeShift.

Operating in the US between 2014 and 2021, the company had a simple business model: It maintained an online platform that allowed customers to trade one type of crypto-asset for another. Marketing itself as a "crypto vending machine," ShapeShift generated revenue off the spread — the difference between the price at which it sold crypto-assets and the price at which it bought those assets.

At its peak, ShapeShift allowed its customers to exchange at least 79 crypto-assets, engaging in as many as 20,000 transactions per day. During the course of its six-year run, ShapeShift was not alleged to have harmed its customers, nor were there allegations that ShapeShift defrauded anyone or failed to execute customer transactions.

### The SEC's Order

Despite the lack of any alleged customer harm, the SEC brought an enforcement action against ShapeShift on March 5, alleging that the exchange failed to register as a securities dealer before

transacting in crypto-assets. In an agreed cease-and-desist [order](#), ShapeShift consented to the imposition of a \$275,000 fine.

The SEC's findings of misconduct were far from enlightening. After describing ShapeShift's business, the commission concluded: "The crypto assets offered by ShapeShift included those that were offered and sold as investment contracts and, therefore, securities, under SEC v. W.J. Howey Co." Howey, a 1946 US Supreme Court case involving investments in Florida orange groves, supplies an analysis for determining whether transactions are investment contracts.

Since ShapeShift never registered as a securities dealer or operated under an exception to the Securities Exchange Act's registration requirements, the SEC reasoned, it was in violation of the Exchange Act.

### **The Dissent Strikes Back**

In a striking [dissent](#), two of the five SEC commissioners attacked the order, calling it a manifestation of the SEC's "poorly conceived crypto policy." While playfully comparing the SEC's strategy to a soap opera — incorporating numerous puns and even a mock script — Commissioners Hester Peirce and Mark Uyeda could not mask their frustration with the commission's opaque, regulation-by-enforcement approach.

Given the lack of explicit customer harm, the dissenting commissioners questioned what ShapeShift did wrong when it opened shop a decade ago — a time when the SEC was virtually silent as to the expectations of crypto companies. Even now, the dissent noted, the SEC failed to identify in the order which of the 79 crypto-assets traded at ShapeShift constituted investment contracts under Howey. The commission, according to the dissent, ought to "show its work."

According to Peirce and Uyeda, "In sum, ShapeShift is in trouble because the Commission, nearly ten years after ShapeShift's platform started trading and more than three years after it changed its business model, now contends that some unidentified number of the 79 crypto-assets it traded between 2014 and 2021 were investment contracts without explaining why."

And that ambiguity, according to the dissenting commissioners, serves a purposeful agenda. They implied that the commission, while hiding behind formalities and a 78-year-old Supreme Court case, is intentionally seeking to foster ambiguity and intimidate crypto innovators.

By "expos[ing] well-meaning entrepreneurs to a regulatory sword of Damocles," the dissent states, the SEC is seeking to sabotage the entire industry.

### **The Bigger Picture**

In truth, it seems unlikely that the SEC's intention is to destroy the crypto industry. Indeed, the ShapeShift dissent overstates things a bit when it questions the SEC's transparency: The SEC has made no secret of the fact that it deems all cryptocurrencies aside from bitcoin to be securities.

Instead, the commission's purpose in seeking a relatively modest penalty from a now-shuttered crypto exchange aligns with its strategy of regulating crypto-assets through enforcement

actions, rather than via formal rulemaking.

And that strategy now appears to be set in stone. The SEC spent years refusing to engage with crypto exchange Coinbase's petition that the commission promulgate crypto-specific rules.

In December, the SEC, compelled by the US Court of Appeals for the Third Circuit, finally issued a short, two-page letter denying Coinbase's demand to engage in rulemaking. Coinbase is currently [\*challenging\*](#) that denial as being arbitrary and capricious — interestingly, in its latest brief, Coinbase, like the dissent in the ShapeShift case, demands that the SEC “show its work.”

The problem for the SEC is that its enforcement-first strategy has hit significant snags over the past year.

First, in July 2023, US District Judge Analisa Torres of the US District Court for the Southern District of New York [\*held\*](#) that XRP — a token issued by Ripple Labs — is not a security in and of itself under Howey. 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.

Then, the following month, the US Court of Appeals for the District of Columbia Circuit [\*held\*](#) that the SEC's denial of Grayscale's application to list a spot bitcoin exchange-traded fund was arbitrary and capricious. The circuit's decision ultimately forced the SEC to approve applications from Grayscale and others to list bitcoin ETFs in January. Many in the industry believe it is only a matter of time before spot ETFs for other cryptocurrencies, such as ether, receive approval.

To be sure, the SEC has won its share of litigation, most notably in a case involving Terraform Labs. Less than three weeks after Judge Torres' decision in the Ripple case, US District Judge Jed Rakoff, also in the Southern District of New York, [\*held\*](#) on summary judgment that Terraform Labs' LUNA and MIR tokens were unregistered securities under the Howey test.

But the true tests lie ahead, in the SEC's litigation against major players in the crypto ecosystem like Coinbase, Binance and Kraken. Eventually, the Supreme Court may be called upon to provide the definitive say over whether crypto-assets fall under securities laws.

That's where the ShapeShift case fits in. By targeting smaller players willing to consent to relatively minor penalties, the SEC is subtly strengthening its case that most crypto-assets should be classified as securities. With this and other bits of — admittedly, nonbinding — precedent, the SEC aims to demonstrate that the Howey test can adequately govern the question of which crypto-assets qualify as securities.

### **Is the SEC's Strategy Truly “Untenable”?**

Whether the crypto industry can survive a regulatory environment where any crypto-asset may be deemed a security remains an open question.

For the SEC, the solution is straightforward: All crypto-asset dealers should register as securities dealers, make the appropriate disclosures and sell only the crypto-assets that have been registered by the issuer. And it's had a hand in orchestrating a proof-of-concept, [\*issuing\*](#)

***fawning praise*** for Prometheus, the first crypto company to be approved by the SEC and the Financial Industry Regulatory Authority to operate as a registered, special-purpose broker-dealer.

But despite the efforts of Prometheus and the SEC, there is reason to believe that the ShapeShift dissent is correct in labeling the commission's crypto strategy as "untenable."

First, a registered alternative trading system authorized by the SEC and FINRA to trade in crypto-assets would only be permitted to transact orders for registered securities. It would be up to the issuer — not the dealer or exchange — to complete the registration process. 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.

Nor would it be particularly easy to do so under existing regulations. The SEC has never explained how the dealer, or the crypto-asset issuer, could make the disclosures required by the SEC under current securities laws. For example, extensive corporate governance and financial disclosures concerning the issuer are, at best, difficult to make and, at worst, wholly nonsensical when dealing with tokens governed exclusively by computer code.

And the frustration building in the crypto community is poised only to intensify. In February, the SEC ***announced*** a new rule that would expand the definition of "dealer" to include certain liquidity providers. ***As many have pointed out***, the new rule may subject decentralized finance participants — including those that provide liquidity to crypto-assets — to securities regulation.

In the end, the ShapeShift case epitomizes the SEC's regulation-by-enforcement approach. It underscores the pivotal role of regulators and courts — as opposed to technological innovation — in shaping the crypto industry's trajectory. And the ShapeShift dissent raises valid concerns: So long as the SEC is seen to favor ambiguity over clarity and adheres to outdated and incompatible rules, it risks hampering the growth of the crypto economy.

***Article originally published by Law360 on March 29, 2024.***