

TAYLOR SWIFT AND THE UNANSWERED \$100 MILLION QUESTION



By Cory Olson

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In the fall of 2021, Sam Bankman-Fried, then CEO of the now-defunct cryptocurrency exchange FTX, approached pop superstar Taylor Swift with a proposed sponsorship worth more than \$100 million. According to reports, before the deal was consummated, Swift's team raised what would seem to be a simple question: Are cryptocurrencies "securities"?

Cryptocurrencies, non-fungible tokens (NFTs), decentralized autonomous organizations (DAOs), and other digital assets have come under regulatory scrutiny in recent years. Since 2021, the SEC has commenced more than sixty enforcement actions against people or entities that issued, promoted, or exchanged cryptocurrencies. Last month, the SEC commenced its first-ever enforcement action over the sale of NFTs.

Like Swift's potential nine-figure endorsement, a fundamental question in many of these cases is

whether the digital asset constitutes an "investment contract" (and thus a "security") under the Securities Act of 1933. The term "investment contract" is not defined by the Securities Act, but in *SEC v. W.J. Howey, Co.*, the U.S. Supreme Court held that an "investment contract" is one in which a person invests money "in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ." The SEC has taken the position that *most* cryptocurrencies meet this test because buyers expect the currencies to rise in value as the issuers promote their adoption. The two exceptions are Bitcoin and Ethereum, which have become sufficiently decentralized that the SEC now considers them to be commodities.

While that may be the SEC's position, no court has yet to fully agree. Indeed, in July, Judge Analisa Torres of the Southern District of New York rejected the SEC's blanket characterization of a cryptocurrency as an unregistered security. The underlying case, *S.E.C. v. Ripple Labs, Inc.*, concerns Ripple Labs' creation and sale of a cryptocurrency known as "XRP." When the SEC commenced the case, XRP was the world's third-largest cryptocurrency, with a market capitalization of \$27 billion. This past spring, the SEC and Ripple Labs each moved for summary judgment, based in part on whether XRP constitutes a "security." The outcome was a split decision. The court ruled in favor of the SEC on its claim that Ripple Labs' sale of XRP to institutional buyers violated Section 5 of the Securities Act, reasoning that institutional buyers of XRP purchased the cryptocurrency with the expectation that they would derive profits from Ripple's promotional efforts. But the court reached the opposite conclusion with respect to Ripple Labs' sale of XRP via digital exchanges, since those purchasers did not know they were purchasing XRP from Ripple Labs. While those purchasers may have purchased XRP with the expectation of profit, "they did not derive that expectation from Ripple's efforts (as opposed to other factors, such as general cryptocurrency market trends) . . ." The SEC subsequently

moved to certify the question for appeal, but the court denied the motion.

The lack of clarity leaves financial-services firms in a difficult position. For example, under FINRA Rule 3210, no person associated with a FINRA member firm may, without that member's consent, open or establish at another member or financial institution "any account in which securities transactions can be effected and in which the associated person has a beneficial interest." If an advisor with one of these firms wishes to buy cryptocurrencies, must the account be opened through the member firm or with the firm's permission? Does the answer depend on whether the account will be limited to purchasing currencies through an exchange? If an advisor sells a cryptocurrency, does it constitute a private securities transaction or selling away from the member firm? There are no clear answers.

In October 2022, FINRA created "Crypto Hub" as an enterprise-wide effort to ensure it is prepared to address issues related to digital assets. But without greater clarity on whether digital assets constitute a "security," industry members cannot know whether the rules even apply. The lack of clarity adds regulatory risk to a class of assets already known for their volatility and speculative nature. Firms and their members may wish to avoid these assets altogether, at least until there is greater clarity on the nature of these assets.

That is what Swift chose to do, ultimately rejecting the proposed endorsement because FTX could not provide a straight answer. Other celebrities, including Tom Brady, David Ortiz, Shaquille O'Neal, and Larry David, weren't as shrewd, endorsed the platform, and, after FTX's collapse, were named as defendants in a class-action lawsuit for their role in promoting unregistered securities.

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