KEY POINTS

- US courts continue to apply the *Howey* and *Reves* tests to the particular facts and circumstances of evolving markets to determine if new financial instruments are securities.
- Relying on judge-made law to address these difficult questions can be inefficient and contribute to uncertainty in the financial markets, as regulation by analogy to historical asset classes provides backward-looking, fact-specific conclusions that do not produce clear guidance that would facilitate financial institutions and innovators in developing new products and markets.
- Congress now has the opportunity and obligation to develop legislation to modify and modernise the regulatory framework and balance all interests.

Feature

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The need for a modernised response to financial product regulation

In this article, the authors consider recent federal court decisions that have addressed how two evolving financial products and markets – namely syndicated loans and crypto tokens – should be classified in the US regulatory system. They then highlight the need for policy-oriented reforms to address the current uncertainty.

In recent months, federal courts have addressed how two evolving financial products and markets – namely, syndicated loans and crypto tokens – should be classified in the US regulatory system. In *Kirschner v JP Morgan Chase Bank*, the Second Circuit affirmed the dismissal of state-law securities claims, concluding that the syndicated loans at issue were not securities.[1] Two recent orders out of the Southern District of New York in *SEC v Ripple Labs* and *SEC v Terraform Labs* called attention to the ongoing uncertainty concerning whether and which crypto tokens are securities.[2] In both cases, courts have attempted to apply existing and possibly outdated case law to new contexts, without necessarily addressing the policy question of how the overall goals of securities regulation are best served. The result is an increasingly unpredictable regulatory landscape, highlighting the need for policy-oriented reforms through well-thought-out legislation or rulemaking. Until Congress acts to modernise financial regulations, the US regulatory system will continue to struggle with today's novel financial products and evolving markets and likely will miss opportunities to both encourage capital formation and protect investors, possibly at significant loss to the US economy.

BACKGROUND

Congress enacted the Securities Act of 1933 (1933 Act) to restore trust in the capital markets following the Great Depression, imposing registration requirements on publicly sold securities that required issuers to provide certain information in connection with such offerings and providing exemptions for certain private offerings. Further regulation came the next year with the Securities Exchange Act of 1934 (1934 Act), which created the Securities and Exchange Commission (SEC) and gave the SEC the authority to regulate the securities industry. The 1933 Act and the 1934 Act were designed to accomplish key policy objectives in the wake of such uncertainty and distrust: investor protection, capital formation and fair and orderly markets.

Since then, the SEC and Congress have implemented reforms to address developments in the market over time, including the adoption of r 144 in 1972 to improve liquidity for investors, the establishment of EDGAR in 1984 to allow electronic access to disclosures, the requirement that all companies file electronically beginning in 1996, the adoption of new rules and amendments to facilitate alternative trading systems in the late 1990s, and the expansive securities offerings reform of 2005 that, among other things, created the well-known seasoned issuer (WKSI) classification and allowed WKSIs to use automatic shelf registration statements, which increased flexibility for registered offerings and attracted more foreign issuers.[3] These periodic reforms and others have been necessary to ensure that the 1933 Act and 1934 Act continue to achieve its intended goals as existing markets shift, new markets emerge, and technology advances.

Faced with the growth of new markets and the advent of new financial products, however, our regulatory system has not kept pace and instead is falling behind. As a result, whether and how certain products should be classified for regulatory purposes has fallen to the courts. In the 1946 case *SEC v W.J. Howey*, the Supreme Court addressed how to determine what is an "investment contract" (and accordingly a security subject to federal securities laws). The *Howey* test has been applied countless times since 1946, analysing if a certain product meets the criteria of a security: whether it is an investment of money in a common enterprise with the expectation of a profit derived from the efforts of others. In 1990, the Supreme Court revisited the question of identifying securities with respect to notes, creating the *Reves* family resemblance test that considers the motivations of the buyer and seller, the plan of distribution, the reasonable expectations of the investing public and any risk-reducing considerations, such as the existence of another regulatory scheme, to find certain financial products do *not* fall within the purview of the SEC's security regulation scheme.

The US financial regulatory system is more than just the SEC, which has jurisdiction over securities markets, but not other types of investments, and certain financial products may be better suited to other agencies within the regulatory ecosystem. For instance, some commentators (and legislators) have suggested that the Commodity Futures Trading Commission

(CFTC), which regulates the markets for futures contracts, derivatives, and certain other commodities, may be a better fit for digital asset products. The Federal Reserve and the Comptroller of the Currency play important roles in overseeing banking services and related aspects of the financial markets, and these agencies may be better placed to determine whether and what regulations are appropriate in certain new products and markets, including loan related products like the ones involved in *Kirschner v JP Morgan Chase*.

UNCERTAINTY CONCERNING APPLICATION OF THE SECURITIES LAWS TO SYNDICATED LOANS

One recent area of uncertainty has been syndicated loans, a $2.5trn market that faced an "existential threat" when claims were brought alleging these syndicated loans were securities.[4] The subset of the syndicated loan market at issue is what is referred to as "Term Loan B", which is a loan arranged by commercial banks and generally made to non-investment borrowers. Term Loan B as an asset class has grown substantially over the last twenty years, during which time there has been in many cases a convergence of terms with high yield bonds.[5] Applying the *Reves* family resemblance test, and relying on one of its prior decisions considering loan participations,[6] the Second Circuit affirmed the dismissal of securities claims in *Kirschner v JP Morgan Chase* on 24 August 2023,[7] concluding that the syndicated loan at the heart of the dispute was not a security.

The loan in *Kirschner* was evidenced by Notes and syndicated by arranging banks to institutional investors. The question that the district court, and ultimately the Second Circuit (the Court), had to answer to resolve the dispute was whether the syndicated loan was a "security". The Court sought guidance from the SEC on the issue, but after granting several extensions of time for the SEC to respond with its views, the SEC notified the Court that it was "not in a position to file a brief".[8]

The Court analysed the *Reves* factors as follows:

- **Motivations of the parties**: The Court first concluded that the "lenders' motivation was investment because the lenders expected to profit from their purchase of the Notes".[9] But, the Court held, the borrowing company's motivation was commercial in nature because the loan was not meant to raise funds for its business or to finance its investments, but rather to pay back outstanding debt, to make a shareholder distribution, and to pay back fees and expenses related to the loan transaction itself.[10] Accordingly, the Court concluded that "the parties' motivations were mixed" but that the first factor "tilt[ed] in favor of concluding that . . . the Notes are securities".[11]
- **The plan of distribution**: Because the banks had offered the Notes "*only* to sophisticated institutional entities" and proceeded to allocate the Notes to sophisticated institutional entities exclusively, the Court held that "the pleaded facts do not plausibly suggest the Notes were "offered and sold to a broad segment of the public".[12] The Court pointed to several restrictions on the assignment of the Notes that "rendered them unavailable to the general public", including that the Notes could not be assigned to a "natural person", that they could not be assigned without prior written consent from both the borrower and bank (with some limited exceptions), nor could an assignment be for more than $1m unless it was to a lender, a lender's affiliate, or an approved fund.[13] Thus, the Court concluded that the second *Reves* factor weighed against concluding that the Notes were securities.
- **The public's reasonable perceptions**: The Court relied on certifications made by the loan participants that they "made their own appraisal of an investigation into the business, operations, property, financial, and other condition and creditworthiness of the borrower and made their own decision [to lend]" in determining this factor did not support the conclusion that the Notes were securities.[14]
- **Other risk-reducing factors**: Considering whether another regulatory scheme applied and whether the instrument was secured by collateral or was insured, the Court noted that here bank regulators – the Comptroller of the Currency, the Federal Reserve and the FDIC – had specific policy guidelines addressing syndicated loan terms.[15] In addition, the Notes were secured by a perfected first-priority security interest in tangible and intangible assets of the borrowing company.[16] The fourth *Reves* factor therefore weighed against concluding that the Notes were securities.

Determining that the last three *Reves* factors weighed clearly against finding that the Notes were securities, the Court affirmed the dismissal of the claims. In affirming the district court's ruling, the Second Circuit upheld the present regulatory framework for syndicated loans. The Second Circuit's decision avoided a significant risk of disruption in the primary and secondary loan markets and a contrary decision could have adversely affected the ability of borrowers to access capital, in particular during time periods when they are unable to access the capital markets through an issuance of securities. It will also incentivise market participants and gatekeepers in the syndicated loan market to take greater care with disclosures to investors and how loans are syndicated.[17]

At the same time, the decision is highly fact intensive and avoids digging deep into the nuances of the Term Loan B products at issue and the underlying trends in those markets. The decision also relies perhaps too heavily on difficulties in loan settlement, which has been a concern of market participants. In addition, by relying on the existence of a regulatory scheme that applies to commercial banks, the decision creates future uncertainty as to whether the result could be different if it involved non-bank lenders, which is a burgeoning asset class.[18]

As the loan market continues to evolve, the question of "is it a security?" seems increasingly outdated and a source of continued uncertainty.

THE NEED FOR SENSIBLE, FORWARD-LOOKING REGULATION OF DIGITAL ASSETS

Digital assets are another area of exponential growth for which no clear regulatory answer exists. In 2019, the SEC published its Framework for "Investment Contract" Analysis of Digital Assets, a first step at providing interpretive guidance on the application of *Howey* in the sector. While this framework aimed to provide clarity, it fell short of doing so in an actionable manner, stopping short of identifying what characteristics and marketing approaches would meet the *Howey* criteria and subject issuers and entrepreneurs to SEC regulation.

Since then, the SEC has increasingly taken the approach of enforcement-as-regulation in the digital assets sector. Yet, despite this increased enforcement activity, the regulatory environment for digital assets remains uncertain and fails to offer clear guidance for those hoping to enter the digital assets ecosystem without risk of SEC enforcement action. The SEC's approach has also led to disparate results as judges apply standards developed decades ago based on less sophisticated financial instruments to cutting-edge digital products. For example, two recent S.D.N.Y. cases, *SEC v Ripple Labs, Inc.* and *SEC v Terraform Labs Pte. Ltd.*, issued just weeks apart, reached different conclusions on whether the digital assets at issue were securities. In *Ripple*, the court held that the digital asset XRP is not in and of itself an investment contract, and distinguished between Ripple's institutional sales of XRP and its programmatic sales on a blind trading platform, finding the latter do not fulfill the third *Howey* prong concerning whether investors have a reasonable expectation of profits derived from the efforts of others.[19] In *Terraform*, however, the court determined that, taken as true, the SEC's well-pleaded allegations showed that while the digital assets themselves were not inherently securities, the issuer's public statements there meant that both digital assets sold directly to institutional investors and those sold in the secondary market were investment contracts under *Howey*.

While there are factual distinctions between the cases and the cases were at different stages, subject to different procedural standards, the disparate results highlight that even within the same district, there is no clear application of existing law. Absent legislative intervention, judges will continue to address individual fact patterns that will then be appealed, particularly as subsequent cases apply alternative reasoning, resulting in a lengthy and inefficient process. The orders, together, increase uncertainty in an already uncertain market.

Further, even if issuers agree that their token is a security, there is no clear path to registration. And those who may be working to design tokens that would explicitly not be securities struggle in the absence of controlling guidance. The *Terraform* court suggested that pegged coins, like those that explicitly track a non-security instrument (eg the US dollar) and are not exchangeable for a security, may not be a security, but that discussion is non-binding, stopping short of providing forward-looking, actionable guidance.

In such an uncertain environment, innovators and entrepreneurs, including would-be token issuers, have already begun relocating overseas, choosing to establish themselves in jurisdictions that – more than just being "crypto friendly" – provide clear and comprehensible guidelines for innovation and issuance. The US has an option to address the current uncertainty head on, and today's inefficient regulatory environment provides an opportunity for a policymaking body to carefully examine and understand the digital assets ecosystem and establish a sensible regulatory approach that cultivates innovation and entrepreneurship while satisfying overarching goals of investor protection and functioning, fair and orderly markets.

CONCLUSION

Today's ever-evolving financial markets require an evaluation and modernisation of the regulatory regime applicable to new financial products. Thoughtful review and research into the appropriate regulatory system is necessary, requiring a policy-making body to balance existing regulatory interests, including the protection of investors and the goal of fair and orderly markets, with the needs of innovators to address novel products and markets, including those still to come.

Courts continue to apply the *Howey* and *Reves* tests to the particular facts and circumstances of evolving markets to determine if new financial instruments are securities, but relying on judge-made law to address these difficult questions can be inefficient and contribute to uncertainty in the financial markets, as regulation by analogy to historical asset classes provides backward-looking, fact-specific conclusions that do not produce clear guidance that would facilitate financial institutions and innovators in developing new products and markets. Investors may also receive less protection to the extent it is not practical to apply existing requirements to new products. Courts may have a tendency to avoid disruption in financial markets, rather than focusing on the underlying policy objectives of the securities laws.

The objectives underlying the creation of the federal securities laws remain important and relevant in today's financial ecosystem, but the current structure of the US financial regulatory system is inefficient, and its application to evolving products and markets poses significant questions as to whether and how the 1933 Act applies. In the period of innovation in which we find ourselves, we recommend the adoption of one of the following pathways to modify and modernise the regulatory framework and balance all interests.

- First, Congress can pass a resolution to fund a special study charged with developing a recommended regulatory framework to address the challenges associated with new financial products and evolving markets, as it did in 1961, which led to a 1963 report that in turn resulted in legislation and rulemaking that modernised the capital markets.[20] One of the authors of this article, Edward Greene, was involved in the study and the production of the 1963 report.
- Second, Congress can hold hearings aimed at investigating and enacting an appropriate legislative response to new

financial products and evolving markets, allowing for input from innovators, investors and other interested parties.

- Third, in the absence of Congressional action, the SEC and the CFTC can work to co-ordinate an appropriate regulatory framework within their statutory bounds and provide co-ordinated guidance to market participants.

Regardless of the path taken, it is clear that action is needed to address the markets of today that have changed drastically since many financial regulations were enacted decades ago. ■

1 *Kirschner v JP Morgan Chase Bank*, N.A., No. 21-2726 (2d Cir. 2023).

2 *SEC v Ripple Labs, Inc.*, 2023 U.S. Dist. LEXIS 120486 (S.D.N.Y. 2023); *SEC v Terraform Labs Pte. Ltd.*, 2023 U.S. Dist. LEXIS 132046 (S.D.N.Y. 2023).

3 Edward F Greene, et al., *U.S. Regulation of the International Securities and Derivatives Markets, §3.01 (2017)*, https://www.clearygottlieb.com/-/media/files/isdm-12th-edition/07-chapter-3-pdf.pdf.

4 Reuters, *SEC Punts on Whether Syndicated Loans are Securities, in Closely Watched Appeal* (2023), https://www.reuters.com/legal/transactional/column-sec-punts-whether-syndicated-loans-are-securities-closely-watched-appeal-2023-07-19/

5 IFLR, *How High Yield and TLBs are Converging* (2018), https://www.iflr.com/article/2a63b19yxwvlgf9r60v71/how-high-yield-and-tlbs-are-converging.

6 In 1992, the Second Circuit applied the family resemblance test to loan participations in *Banco Español de Crédito v Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), and found they were not securities.

7 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023).

8 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 310.

9 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted).

10 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted).

11 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted).

12 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted).

13 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted) at 307.

14 *Kirschner v JP Morgan Chase Bank, N.A.*, 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted) at 308 (alterations omitted).

15 *Kirschner v JP Morgan Chase Bank, N.A., 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted)* at 309.

16 *Kirschner v JP Morgan Chase Bank, N.A., 79 F.4th 290 (2d Cir. 2023) at 306 (italics omitted)* at 309.

17 Cleary Gottlieb Steen & Hamilton, *Second Circuit Affirms Syndicated Loans Are Not Securities, Avoiding Market Disruption* (2023), https://www.clearygottlieb.com/news-and-insights/publication-listing/second-circuit-affirms-syndicated-loans-are-not-securities-avoiding-market-disruption.

18 Financial Times, *Private Credit Funds Step in for Companies Facing Mountains of Debt* (2023), https://www.ft.com/content/7c4a994b-024e-4e6e-992c-7409de8943ed.

19 On 19 October 2023, the SEC dismissed with prejudice aiding and abetting claims related to Ripple's institutional sales against two company executives, following their successful summary judgment motion, which resulted in the Court dismissing all of the primary liability claims against them. The executives now have the full dismissal of all of the SEC's claims against them. Cleary Gottlieb Steen & Hamilton LLP, the author of this article, represented one of the executives.

20 *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), https://www.sechistorical.org/collection/papers/1960/1963_SSMkt_Chapter_01_1.pdf

Further Reading:

- SEC Guidance provides clarity for digital asset issuers (2019) 7 JIBFL 481.
- Crypto headwinds: an overview of regulations in Singapore, the EU, UK and US (2023) 6 JIBFL 410.
- Lexis+® UK: Banking & Finance: Practice Note: Fintech – USA – Q&A guide.

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