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Securities Litigation Update

Southern District of New York Dismisses Putative Securities Class Action Alleging Sale of Unregistered Cryptocurrency, But Risk Remains for Crypto-Issuers and Exchanges

April 23, 2021

On April 16, 2021, in *In re Bibox Group Holdings Ltd. Securities Litigation*,[1] Judge Denise Cote of the U.S. District Court for the Southern District of New York dismissed a putative class action alleging registration violations under securities laws against a cryptocurrency issuer and exchange, holding that the plaintiff lacked standing to assert class claims based on crypto-assets he did not purchase and did not timely file suit. While a win for the defendants, the decision serves as a reminder that the securities laws apply in full force to cryptocurrencies that qualify as securities, and the failure to register cryptocurrencies, as with any other security, may expose crypto-issuers and exchanges to class action claims.

Background

A cryptocurrency is a decentralized digital asset that can be exchanged online for goods and services. Cryptocurrencies are transferred and recorded on a technology called "blockchain," an electronic ledger system spread across a large network of servers and individual computers and devices. Cryptocurrencies, such as the popular Bitcoin, are used for a variety of purposes, including as an alternative to traditional currency and a store of value, and they are becoming an increasingly popular (if volatile) investment. ERC-20 is a technical standard for creating customizable cryptocurrency "tokens" that operate on a blockchain system called Ethereum. Between 2016 and 2018, users created hundreds of new tokens using the ERC-20 standard. ERC-20 tokens, which all share similar technological features, have been listed on various cryptocurrency exchanges.

In October 2017, Bibox Group Holdings Ltd. and affiliates launched a new cryptocurrency exchange and, to fund the effort, created and issued an ERC-20 token called "BIX." Bibox allegedly promised investors they could trade BIX for other tokens on the Bibox exchange, and

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[1] *In re Bibox Grp. Holdings Ltd. Sec. Litig.*, No. 1:20-CV-02807, 2021 WL 1518328 (S.D.N.Y. Apr. 16, 2021).

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Bibox would use a portion of its offering proceeds to buy back the BIX tokens. Bibox raised approximately $19 million from its initial offering of BIX. Alexander Clifford, an individual cryptocurrency investor, purchased BIX on the Bibox exchange in mid-2018 and, in December 2018, exchanged his BIX for Bitcoin. In addition to BIX, five other ERC-20 tokens traded on the Bibox exchange—EOS, TRX, OMG, LEND, and ELF. Clifford, however, never acquired those tokens.

On April 3, 2020, Clifford filed a putative class action in the Southern District of New York alleging that Bibox violated the federal securities laws and state Blue Sky laws in connection with the trading activities in the six tokens. Clifford asserted claims under the Securities Act of 1933 for sale of unregistered securities and false statements and omissions of material facts in a prospectus, and claims under the Securities Exchange Act of 1934 for sale of securities on an unregistered exchange and operating as unregistered broker and dealer. Clifford sought certification of various investor subclasses, including all investors who purchased the six tokens on the Bibox exchange in the United States. The defendants moved to dismiss the plaintiff's claims prior to class certification, arguing that Clifford lacked standing to assert claims based on the five tokens he did not purchase and his remaining claims were time-barred.

The Court's Decision

Judge Cote granted the motion to dismiss. The Court held that the plaintiff lacked standing under Article III of the U.S. Constitution to assert claims based on the five tokens he did not purchase. To establish Article III standing, a plaintiff must show that he or she has suffered an "injury in fact" that is "fairly traceable" to the defendant's challenged conduct and is likely to be redressed by a favorable judicial decision.[2] In a class action context, a plaintiff additionally must show that (1) the plaintiff "personally has suffered some actual injury as a result of the putatively illegal conduct" and (2) "such conduct implicates the same set of concerns as the conduct alleged to have caused injury to other members of the putative class."[3] According to the Court, the plaintiff could not meet these requirements for claims based on tokens he did not purchase: the plaintiff did not personally suffer any injury from unpurchased tokens, and claims based on such tokens did not "implicate the same set of concerns" as claims based on BIX—the one token plaintiff did purchase—because the claims could not be proven "in a similar way." In particular, the Court noted that the tokens were created by different entities, and each had its own characteristics and advertising history. Thus, despite technological similarities, the plaintiff would have to present different proof to prove the

[2] *Grand River Enters. Six Nations, Ltd. v. Boughton*, 988 F.3d 114, 120 (2d Cir. 2021) (citation omitted).

[3] *Ret. Bd. of the Policemen's Annuity & Ben. Fund of the City of Chicago v. Bank of N.Y. Mellon*, 775 F.3d 154, 161 (2d Cir. 2014) (citation omitted).

claims, including on the threshold question of whether each token constituted a “security” under the U.S. Supreme Court’s *Howey* test.[4] This result, the Court held, foreclosed Article III standing.

The Court also dismissed plaintiff’s remaining claims regarding BIX as time-barred under the applicable one-year statute of limitations. In so holding, the Court rejected plaintiff’s contention that the limitations period did not start to run until plaintiff “discovered” that BIX could be a security, allegedly based on the SEC’s April 3, 2019 publication discussing how the *Howey* test may apply to cryptocurrencies.[5] According to the Court, even if a discovery rule applied, the limitations period commenced as soon as the plaintiff became aware of the “critical facts” regarding his alleged injury—*i.e.*, upon his last transaction. The plaintiff’s “ignorance of his legal rights” at the time, and any subsequent revelation based on the SEC’s guidance, was not a valid defense.[6]

Implications

Although superficially favorable to the defendants, the decision implicitly recognizes that crypto-exchanges and issuers may face class action liability for registration violations as long as a plaintiff meets all applicable requirements, including Article III standing and timely commencement of litigation. Notably, the Court did not question SEC guidance that securities liability may result when a cryptocurrency qualifies as an “investment contract” under *Howey*, i.e., “when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.”[7] Nor did the Court suggest that that there is anything different about cryptocurrencies (as opposed to ordinary securities) that would mitigate liability for crypto-issuers and exchanges that commit securities violations.

Other courts (including the Second Circuit on the appeal in *In re Bibox*) in theory could take a more expansive view of class standing than Judge Cote given the unique technological features of cryptocurrencies. The Supreme Court has held that a plaintiff may have standing to assert class claims on behalf of others where “the same set of concerns is implicated,” a doctrine the Second Circuit has applied to class claims based on mortgage-backed securities issued under the same registration statement.[8] Although Judge Cote concluded that differences in the tokens (including

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[4] *See S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) (holding that “investment contract,” as used in the Securities Act’s definition of a “security,” means “contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party”).

[5] SEC, Framework for “Investment Contract” Analysis of Digital Assets (2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[6] *In re Bibox Grp.*, 2021 WL 1518328, at *9 (citations omitted).

[7] Framework for “Investment Contract” Analysis, *supra* n. 5.

[8] *See NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 149 (2d Cir. 2012) (quoting *Gratz v. Bollinger*, 539 U.S. 244, 267 (2003)).

the fact that they were created by different entities) precluded application of the doctrine,[9] it is not clear that all courts would agree in similar situations. Some may be receptive to the plaintiff's argument that, where tokens are traded on the same exchange, involve the same blockchain, and are based on the same technological standard, the similarities are sufficient to justify proceeding as a class action. Courts could view this result as enticing, given the proliferation of new cryptocurrencies and the efficiencies from adjudicating such claims in a single action. We expect a continued flow of cryptocurrency-related securities filings and ample opportunity for courts to develop this jurisprudence in the months and years ahead.

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[9] For this reason, Judge Cote found *NECA*, in which Second Circuit applied the doctrine to mortgage-backed securities, to be inapposite. Unlike the present case, the securities at issue in *NECA* were backed by mortgages originated by the same originator, and the question in that case was whether that originator abandoned its underwriting guidelines. Given that similar proof would apply to each claim in *NECA* regardless of whether the plaintiff purchased all the securities at issue, Judge Cote reasoned that the claims raised a similar set of concerns to permit class standing. *See In re Bibox Grp.*, 2021 WL 1518328, at *7 (discussing *NECA*, 693 F.3d 145).