

CLIENT ALERT

SEC Enforcement Action Scrutinizes Governance Token Design

January 30, 2023

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Introduction

On January 20, 2023, the U.S. Securities and Exchange Commission (“**SEC**”) brought a civil enforcement action in federal district court against Avraham Eisenberg (“**Eisenberg**”) in connection with an alleged market manipulation scheme involving a Solana-based decentralized crypto asset trading protocol called Mango Markets (“**Mango Markets**”) and MNGO, the native governance token of Mango Markets. The SEC’s complaint alleged that Eisenberg manipulated the price of MNGO to fraudulently withdraw crypto assets valued at approximately \$116 million from Mango Markets.¹ The allegations contained in the SEC’s complaint raise novel questions related to crypto governance constructs, secondary trading of crypto assets and the line between the SEC’s and CFTC’s jurisdiction over crypto assets.

Notably, this case represents the first enforcement action in which the SEC has closely scrutinized a governance token (*i.e.*, a crypto asset that gives the holder a right to propose and/or vote on the governance features of a crypto network, organization or protocol, such as Mango Markets). Moreover, the SEC did not name as defendants the issuer of the

¹ *United States Securities and Exchange Commission v. Avraham Eisenberg*, Civil Action No. 1:23-cv-00503 (S.D.N.Y. Jan. 20, 2023) (the “**Complaint**”).

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governance token or the developer of the associated crypto protocol; instead the complaint only alleges securities laws violations against Eisenberg.

The SEC action follows a criminal action brought by the U.S. Department of Justice and another civil enforcement action in federal court brought by the U.S. Commodity Futures Trading Commission (“**CFTC**”) related to the same alleged facts.²

Alleged Violations

All three proceedings involve allegations that Eisenberg created two anonymous accounts on Mango Markets that he controlled.³ In one of Eisenberg’s accounts, Eisenberg allegedly established offsetting synthetic long and short positions in so-called perpetual futures tied to the value of MNGO relative to USDC.⁴ To determine the value of MNGO and USDC, Mango Markets relied on an oracle (*i.e.*, computer code that pulls data from certain off-chain and/or on-chain sources and provides such information to on-chain protocols), which calculated the relative value of crypto asset pairings by relying on the exchange rate published on three other crypto asset trading platforms, and transmitted such price information to Mango Markets.⁵

Eisenberg then allegedly acquired MNGO tokens in spot transactions on the trading platforms from which the oracles sourced pricing data.⁶ Eisenberg’s buying activity inflated the market price of MNGO, which artificially increased the value of his long perpetual futures positions on Mango Markets.⁷ According to the lawsuits, he then used the long perpetual futures positions as collateral to withdraw a combination of different crypto assets from Mango Markets worth approximately \$116 million.⁸

The SEC alleged that in carrying out the scheme, Eisenberg violated Section 10(b) of the Securities Exchange Act of 1934 (the “**Exchange Act**”) and Rules 10b-5(a) and (c) promulgated thereunder.⁹ Section 10(b) makes it unlawful for any person to engage in fraudulent or manipulative behavior in connection with the purchase or sale of a security.¹⁰ The SEC

² For a more detailed description of the facts, please refer to our Client Alert covering the CFTC’s enforcement action against Eisenberg, which is titled “CFTC Alleges Manipulative Trading on a Decentralized Digital Asset Platform” and is available [here](#).

³ Complaint at 12.

⁴ *Id.*

⁵ *Id.* at 14.

⁶ *Id.* at 12–13.

⁷ *Id.* at 13.

⁸ *Id.* at 14.

⁹ *Id.* at 18.

¹⁰ 15 U.S.C. § 78j(b).

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also alleged that Eisenberg violated Section 9(a)(2) of the Exchange Act, which makes it unlawful for any person to engage in a securities transaction if the purpose of such transaction is to affect the price of the security in order to induce others to buy the security.¹¹

Security Status of MNGO

The assertion that MNGO is a security is a central predicate to the SEC's claims. The SEC must establish that MNGO is a security to succeed in an action against Eisenberg for fraud and manipulation. Even if it is determined that Eisenberg manipulated the price of MNGO to benefit his perpetual futures position, which the CFTC has indirectly alleged are commodity-based swaps (and not security-based swaps), the SEC will not have a basis to seek remedies from Eisenberg unless MNGO is deemed to be a security.

Under the U.S. federal securities laws, the term "security" is defined to include a variety of enumerated financial instruments, including, among other things, any note, stock or investment contract. Like numerous other civil enforcement proceedings alleging that transactions in crypto assets involve violations of the federal securities laws, the SEC's complaint alleged that the MNGO tokens were initially sold as investment contracts and continue to trade in secondary markets as investment contracts.¹²

The test applied by the SEC and courts for determining whether an instrument is an investment contract, known as the "Howey test," originates from a 1946 Supreme Court opinion in the case of *SEC v. W.J. Howey Co.*¹³ Under the *Howey* test, an investment contract is a contract, transaction or scheme through which a person (i) invests money (ii) in a common enterprise and (iii) reasonably expects profits or returns (iv) derived from the entrepreneurial or managerial efforts of others. A transaction, contract or scheme must meet all four elements of the *Howey* test to be deemed an investment contract. Legal practitioners and scholars sometimes collapse the third and fourth elements into a single element, as the SEC has done in the Eisenberg complaint.

The SEC complaint asserted that MNGO is an investment contract because, according to the complaint, each element of the *Howey* test is satisfied:

Investment of Money. To satisfy the investment of money element, the purchaser of the relevant financial instrument or scheme must give up "some tangible and definable consideration in return for an interest that [has] substantially the

¹¹ *Id.* at 19; 15 U.S.C. § 78i(a)(2).

¹² *Id.* at 7–11.

¹³ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301, 66 S. Ct. 1100, 1104, 90 L. Ed. 1244 (1946).

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characteristics of a security.”¹⁴ The SEC alleged that Mango Labs, LLC (“**Mango Labs**”), a company involved in the development of Mango Markets, engaged in a two-day public token sale of MNGO tokens and publicly promoted the offer and sale of the MNGO tokens through a “Litepaper,” which generally described the offering and rights MNGO token holders would obtain.¹⁵ Moreover, Mango Labs used Twitter to tweet the names of the crypto asset trading platforms where MNGO tokens were available for trading.¹⁶ Participants in the public token sale were allegedly able to deposit USDC, which is a stablecoin pegged to the U.S. dollar, in exchange for a corresponding amount of MNGO tokens.¹⁷ Although U.S.-based persons were purportedly ineligible to participate in the token sale, certain participants, including Mango Markets’ creators, resided in the United States during this time.¹⁸

Common Enterprise. To satisfy the common enterprise element, the success of the purchaser’s interest must rise and fall with others involved in the enterprise. In evaluating the common enterprise element, courts distinguish between “horizontal commonality” and “vertical commonality.” Horizontal commonality requires the “tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits.”¹⁹ The SEC asserted that the price of MNGO tokens rose and fell equally for each MNGO token holder so that each holder profited or experienced losses on a pro-rata basis relative to its ownership of MNGO tokens.²⁰ Moreover, Mango Labs explained in publicly available materials that the proceeds from the token sale were to be pooled together to pursue projects and a portion to be allocated to the Mango DAO, which was the governing body of Mango Markets.²¹ The SEC’s complaint included statements allegedly made by Mango Labs related to how a percentage of the MNGO token supply went to the “creators” of Mango Markets and a significant portion went to the Mango DAO treasury, and such tokens were only able to be unlocked/distributed via governance proposals.²²

Expectation of Profits Derived from the Efforts of Others. To satisfy the expectation of profits derived from the efforts of others element, the purchaser of the relevant financial instrument or scheme must expect profits to be derived substantially from the efforts of others. “Profits” can either be in the form of capital appreciation resulting from the initial

¹⁴ *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 (1979).

¹⁵ Complaint at 7.

¹⁶ *Id.* at 8.

¹⁷ *Id.* at 7.

¹⁸ *Id.*

¹⁹ *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994).

²⁰ Complaint at 8.

²¹ *Id.* 8—9.

²² *Id.* at 9.

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investment (e.g., price appreciation) or a participation in earnings resulting from the use of investors' funds (e.g., distributions or rewards to the crypto asset holder).²³ Moreover, the efforts made by those other than the investor must be the undeniably significant ones, those essential managerial efforts that affect the failure or success of the enterprise.²⁴

The SEC alleged that MNGO token holders could earn interest on their MNGO tokens by acting as a liquidity provider and deploying their tokens into Mango Markets where they could earn additional MNGO tokens as a reward.²⁵ Moreover, the SEC focused on the future development plans set forth in the Litepaper, which detailed certain past and future efforts by the creators that would help develop Mango Markets.²⁶ In particular, the complaint highlighted the following actions allegedly taken by the creators:

1. Developing and deploying software code for various versions of Mango Markets;
2. Creating content for the Mango Markets' website and Twitter account;
3. Submitting and voting on Mango DAO governance proposals; and
4. Responding to questions from MNGO token holders and others on the Mango Markets' Twitter and Discord feeds.²⁷

The SEC asserted that the MNGO token therefore forms part of an investment contract under the *Howey* test and is a security.²⁸

²³ *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975).

²⁴ See, e.g., *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973); *In the Matter of Munchee Inc.*, Securities Act Release No. 10445 (Dec. 11, 2017) (the SEC alleged the investor's profits were to be derived from Munchee and its agents who were to revise the Munchee App, create the "ecosystem" and support secondary markets); *In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree*, Securities Act Release No. 10961, Exchange Act Release No. 92588 (Aug. 6, 2021) (the SEC alleged that the Respondents performed essential managerial efforts by managing the DMM business and creating a trading market for DMG tokens); *In the Matter of GTV Media Group, Inc., Saraca Media Group, Inc., and Voice of Guo Media, Inc.*, Securities Act Release No. 10979 (Sep. 13, 2021) (the SEC alleged that the Respondents via the G Entities discussed plans to develop the GTV online platform's capability to process transactions using GCoins and G-Dollars and touted the "management, financial, investment, and merger and acquisition" experience of the G Entities' management team and agents); *In the Matter of BlockFi Lending LLC.*, Securities Act Release No. 11029, Investment Company Act Release No. 34503 (Feb. 14, 2022) (the SEC alleged that BlockFi had complete ownership and control over the borrowed crypto assets, and determined how much to hold, lend and invest).

²⁵ Complaint at 9.

²⁶ *Id.* at 9 (the SEC pointed out how the Litepaper contained a "Project Status and Roadmap" section that detailed the efforts taken and to be taken to develop the platform).

²⁷ *Id.* at 9—10.

²⁸ *Id.*

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Illusory Governance Rights

A notable aspect of the SEC's complaint is the SEC's allegation that the Mango Markets' governance construct was "illusory."

To satisfy the "efforts of others" element of the *Howey* test, the purchaser of the relevant contract, transaction or scheme must expect profits to be derived substantially from the efforts of others. Specifically, "the efforts made by those other than the investor [must be] the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."²⁹ The SEC staff has stated in a 2019 "framework" for evaluating the investment contract status of crypto assets, that a crypto asset is less likely to be an investment contract if all "essential tasks or responsibilities [are] performed and expected to be performed by . . . an unaffiliated, dispersed community of network users."³⁰ In recent years, one method of diffusing managerial control over a crypto protocol is to distribute a governance token to users of a protocol so that users can vote on all major decisions related to the protocol and steward the protocol as part of a broad and dispersed community. In certain circumstances the collective community of governance token holders may be referred to as a "decentralized autonomous organization" or "**DAO**."

Although it is not clear whether the current SEC administration endorses decentralized governance as a path to non-security status, in its complaint against Eisenberg the SEC alleged that the governance rights associated with the MNGO tokens were "illusory."³¹ As a result, the SEC asserted that Mango Markets was necessarily operated by the Mango Markets development team rather than a broad and dispersed community of users.

The SEC alleged that the governance rights afforded to MNGO token holders were limited and minimal, and were non-existent for those MNGO token holders that did not deposit the required amount of tokens to participate in governance.³² In the Mango DAO governance framework, the amount of MNGO tokens required to be deposited to submit a proposal varied depending on the type of proposal being submitted, which had the practical effect of preventing some MNGO token holders from submitting certain types of governance proposals.³³ The SEC also emphasized how, according to the Litepaper, "[p]roposals are executable code, not suggestions for a team or foundation to implement," which served to

²⁹ See, e.g., *Glenn W. Turner Enterprises, Inc.*, 474 F.2d at 482; *In the Matter of Munchee Inc.* (the SEC alleged the investor's profits were to be derived from Munchee and its agents who were to revise the Munchee App, create the "ecosystem" and support secondary markets).

³⁰ Strategic Hub for Innovation and Financial Technology, Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), <https://www.sec.gov/files/dit-framework.pdf>.

³¹ Complaint at 10.

³² *Id.*

³³ *Id.*

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further limit the number of MNGO token holders who could meaningfully participate in governance, as not all MNGO token holders had the requisite technical skills to submit a governance proposal.³⁴

The SEC further alleged that the development team had at least 50% of the governance voting power.³⁵ Indeed, the SEC argued that governance was not spread among a broad and dispersed community of users because out of the thousands of wallet addresses holding MNGO tokens, on average, approximately five to ten addresses voted on any given proposal, and a few repeat wallet addresses, including wallet addresses controlled by several of the developers of Mango Markets, dominated the votes.³⁶ As a result of the voting parameters and limitations, the SEC alleged that only a small number of MNGO token holders actually exercised their voting rights.³⁷

The SEC complaint also noted that a governance proposal was submitted shortly after the public token sale to form an upgrade council consisting of seven members (including the developers) who would have the ability to unilaterally control upgrades to Mango Markets through a majority vote.³⁸ The SEC explained that the proposal passed with 2.29% of the MNGO token supply voting in support of the proposal, however, of the supporting votes, at least 70% (1.64% of the 2.29%) were cast by two developers of Mango Markets.³⁹

Key Takeaways

The SEC's enforcement action against Eisenberg is the first in which the agency has closely scrutinized the features of a governance token. It remains to be seen whether Eisenberg will challenge the SEC's predicate allegation that MNGO is a security, but if no such defense is advanced, this case may serve as instructive precedent for the SEC to use as leverage against issuers of governance tokens more broadly.

Additionally, the SEC's assertion that the governance rights associated with the MNGO token are "illusory" seems to imply – at the very least – that the agency does not view some constructs for decentralized protocols as sufficiently diffuse, but may reflect a broader skepticism about decentralization in crypto networks generally. The purpose of a governance token is typically to provide users of a crypto network with voting rights over, among other things, modifications and upgrades to the protocol, features and functionalities of a protocol, use of protocol treasury assets and/or initiatives of a DAO. Market participants have argued that these rights can serve to minimize or eliminate the role of the development team or some other affiliated group of third parties and thereby reduce token holders' reliance on the efforts of the team or any related

³⁴ *Id.*

³⁵ *Id.* at 11.

³⁶ *Id.*

³⁷ *Id.* at 10.

³⁸ *Id.* at 11.

³⁹ *Id.*

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person who might be considered an “other” under *Howey*. Governance tokens can encourage governance among a broad and dispersed community of users so that future developments and ongoing decisions are made by the community and not in the sole discretion of the development team. It is clear from the complaint, however, that the SEC views as futile a governance model that, either by design or in practice, incorporates mechanisms for central actors to assert control.

Moreover, this complaint highlights the SEC’s view that a crypto asset that may have been subject to U.S. federal securities laws when originally issued can continue to be subject to the securities laws in the secondary markets. While the SEC has relied on this theory in several other enforcement actions against crypto asset exchanges and traders,⁴⁰ SEC Commissioner Peirce has recently questioned whether it is legally sound, noting that “secondary market-based transfers of crypto assets do not create an investment contract unless they sufficiently ‘convey a bundle of rights and obligations’ or the facts and circumstances of the secondary transaction itself are otherwise sufficient to do so.”⁴¹

Finally, viewed alongside the corresponding CFTC action, the SEC’s case illustrates the murky line between the SEC’s and CFTC’s jurisdiction over crypto assets. The CFTC’s complaint is silent as to whether MNGO is a non-security commodity, but its assertion that USDC-MNGO perpetual futures are “swaps” rather than “security-based swaps” or “mixed swaps”⁴² appears to be based on a predicate finding that MNGO is a commodity, which is potentially at odds with the premise of the SEC’s allegations. Generally, a swap with a non-security commodity as the underlying asset is a “swap” within the CFTC’s jurisdiction and a swap with a single security or narrow-based security index as the underlying asset is a “security-based swap” within the SEC’s jurisdiction. If MNGO is a security, as the SEC has alleged, then the perpetual futures that are the basis of the CFTC’s complaint may also be subject to the SEC’s jurisdiction over security-based swaps. Although the CFTC asserts that USDC is a commodity and therefore it should have jurisdiction over USDC-MNGO perpetual futures, a swap involving a security and commodity could be regulated as a mixed swap, which would be subject to both the SEC’s and CFTC’s jurisdictional authority. That said, neither agency has alleged that the USDC-MNGO perpetual futures constitute mixed swaps. While the SEC’s complaint includes language alleging that Eisenberg’s conduct artificially increased the price of both MNGO tokens and the USDC-MNGO perpetual futures, the SEC’s

⁴⁰ See, e.g., *In the Matter of Zachary Coburn*, Rel. No. 84553 (Nov. 8, 2018), available at <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>; *In the Matter of Poloniex, LLC*, Release No. 93207 (Aug. 9, 2021), available at <https://www.sec.gov/litigation/admin/2021/34-92607.pdf>; *Securities and Exchange Commission v. Ishan Wahi, Nikhil Wahi, and Sameer Raman*, Civil Action No. 2:22-cv-01009 (W.D.W.A. Jul. 21, 2022).

⁴¹ Hester Peirce, Commissioner, Securities and Exchange Commission, “Outdated: Remarks before the Digital Assets at Duke Conference” (Jan. 20, 2023) (speech), <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

⁴² A mixed swap is a transaction that is both a swap and a security-based swap (7 U.S. Code § 1a(47)). The Final Product Release defining swaps, security-based swaps and mixed swaps issued by the CFTC and SEC provides examples of mixed swaps, stating that the definition “also would include certain Title VII instruments called “best of” or “out performance” swaps that require a payment based on the higher of the performance of a security and a commodity (other than a security).” (Further Definition of “Swap,” “Security-Based Swap”, and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207, 48291).

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manipulation count only articulated a charge for manipulative trading in securities, not manipulative trading in swaps. Many will be hoping to see further clarity regarding the various agency jurisdictional hooks provided by these actions.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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