WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

SEC Enforcement — Top Four Developments from March 2024

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AUTHORS

Adam S. Aderton | Elizabeth P. Gray | A. Kristina Littman | Erik Holmvik

In March, we saw key litigation results in both the crypto and investment adviser spaces. In addition, the U.S. Securities and Exchange Commission ("SEC" or the "Commission") brought its first enforcement action involving artificial intelligence in March. Finally, the Commission adopted—and soon thereafter voluntarily stayed—its much anticipated issuer Environmental, Social, and Governance rule. In this month's alert, we cover:

- The first enforcement actions addressing misleading statements regarding the use of AI;
- The latest key ruling in the *SEC v. Coinbase* litigation;
- A Second Circuit reversal of a SEC fraud judgment; and
- The turbulent opening of litigation regarding the SEC's new climate disclosure rules that the SEC has now voluntarily stayed.

1. SEC Charges Two Investment Advisers for Making False and Misleading Statements Regarding Artificial Intelligence

On March 18, the SEC brought first-of-their-kind settled actions finding that two investment advisers made false and misleading statements concerning their purported use of artificial intelligence ("AI").[1] Specifically, the SEC alleged that one adviser made false and misleading statements—including in a press release on the firm's website—that it utilized AI and machine learning to incorporate client data into its investment process. As to the second adviser, the SEC alleged that the adviser falsely claimed that it was the first regulated AI financial adviser and that it utilized AI-driven forecasts of market trends. The advisers agreed to pay a total of more than $400,000 in civil penalties.

Chair Gary Gensler and Director of Enforcement Gurbir S. Grewal both made statements in connection with the institution of the cases and signaled a continued focus on "AI washing." Both Chair Gensler and Director Grewal also cautioned that investment advisers that opt to make statements regarding their adoption of AI in their investment processes, models, and marketing materials should take care that their statements are neither false nor misleading. These leadership statements underscore that the SEC's focus on statements relating to AI is the latest iteration of the SEC's perennial focus on accurate disclosures.

2. SDNY Rules with SEC on Coinbase's Motion for a Judgment on the Pleadings

On March 27, Judge Failla of the U.S. District Court — Southern District of New York ("SDNY") ruled against Coinbase on its Motion for a Judgment on the Pleadings, allowing nearly all of the SEC's legal arguments to move forward.[2] The opinion's reasoning largely eschewed the manner-of-sale approach adopted in *SEC v. Ripple*, [3] opting instead to apply the ecosystem analysis from the *Terraform* decision that came two weeks after *Ripple*.[4]

The manner-of-sale approach, which determines whether a particular sale was an investment contract by taking into account the totality of the circumstances surrounding the sales transaction or scheme, has not seen wide adoption by other courts. In contrast, the ecosystem analysis determines whether a particular crypto asset is a security based upon the "full set of contracts, expectations, and understandings" surrounding the asset's sale and distribution—its ecosystem—to determine if it amounts to an investment contract.

The Court also expressed skepticism towards several of Coinbase's asserted defenses, perhaps most prominently with regard to Coinbase's argument that investor expectations should exclude secondary market transactions involving crypto assets from consideration under *Howey*.[5] The Court reasoned there was "little logic" in distinguishing between expectations

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1 The SEC's press release is available here.
2 SEC v. Coinbase, No. 1:23-cv-04738, ECF No. 105 (SDNY). The opinion is available here.
3 SEC v. Ripple Labs, Inc., No. 23-cv-1346, ECF No. 874 (SDNY). The opinion is available here.
4 SEC v. Terraform Labs PTE. Ltd., No. 1:23-cv-1346, ECF No. 51 (SDNY). The opinion is available here.
5 SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

of investors “who buy from an issuer and those who buy on the secondary market.” The Court also rejected Coinbase’s invocation of the Major Questions Doctrine and Fair Notice defenses, which were additional arguments to attempt to limit the SEC’s jurisdictional reach. The Court rejected Coinbase’s Major Questions defense as an attempt to “wield [the] doctrine… as a tool to disrupt the routine work” of the SEC, and also rejected Coinbase’s Fair Notice defense, stating it was an invitation to reduce the Due Process concerns underlying Fair Notice principles to “gamesmanship.”

The ruling was not without a win for Coinbase though, as the Court dismissed the SEC’s Section 15(a) charge that Coinbase acted as an unregistered Broker through its Wallet product.[6] The Court ruled that the Commission had failed to demonstrate that Coinbase had acted as a “broker” within the meaning of Section 15(a) in offering its Wallet product to its customers. With the SEC losing on its wallet claim, pending any appeal, the focus of the case now narrows to Coinbase’s secondary market and staking products. The ruling on Coinbase’s Wallet project may offer useful arguments for others offering similar products for accessing DeFi.

3. Split Second Circuit Panel Reverses SEC Fraud Judgment

On March 13, a divided panel in the Second Circuit reversed a 2020 fraud judgment against a former senior partner of a registered investment adviser.[7] The SEC charged the partner, a former private equity portfolio manager, with defrauding private funds he advised by submitting false expense reports that were ultimately reimbursed by the funds. The partner argued that he could not be liable for fraud because he was unaware that his expenses would be paid by the funds and instead believed that they would be reimbursed by his employer. At trial, the partner was not found liable under Section 206(1) of the Advisers Act because his conduct, while “reckless[ly] indifferent” to the source of his reimbursement, did not reflect recklessness approximating actual knowledge of his alleged fraud. However, he was found liable under Section 206(2) of the Advisers Act because he was “recklessly indifferent,” and thus negligent, as to which entity would ultimately pay his fraudulent expenses.

The Second Circuit reversed the finding of a 206(2) violation because it concluded that it was not reasonably foreseeable to the partner that the funds would reimburse his expenses. Essential to the Second Circuit’s holding was its interpretation of what a reasonable person in the partner's position would have done under similar circumstances. In support of its holding, the Second Circuit cited testimony from the investment adviser’s current and former CFOs, other professionals currently or formerly employed by the adviser, as well as the text of the adviser’s partnership agreements, which all, the Court concluded, supported a conclusion that the expenses would be reimbursed by the adviser itself, not the funds.

Given the unique facts at issue in this case, it remains to be seen what impact this opinion will have on the scope of culpable conduct for which the SEC can bring fraud charges. The Second Circuit’s reliance on traditional principles of negligence,

6 15 U.S.C. § 78o(a).
7 The Second Circuit’s opinion is available here.

including the reasonable person standard and proximate cause, suggest that courts may apply additional scrutiny to litigated negligence-based claims involving the Adviser's Act.

4. SEC's Recently Adopted Climate Rules Stayed Pending Judicial Review

On March 6, the SEC adopted rules to standardize climate-related disclosures by public companies and in public offerings.[8] The same day and in the days that followed, multiple lawsuits challenging the rules were filed across the country by a variety of energy companies and business groups, environmental groups, state attorneys general, and the U.S. Chamber of Commerce. Ultimately, the Judicial Panel on Multidistrict Litigation selected the Eighth Circuit as the venue for hearing the now nine consolidated lawsuits challenging the rules. In recognition of the litigation, the Commission voluntarily stayed implementation of the rules pending judicial review.[9]

The Eighth Circuit will likely hear a number of challenges as the arguments advanced in the new consolidated suit begin to crystallize. It appears likely that the Court will hear a number of arguments premised on administrative law doctrines, including the Major Questions Doctrine (which will almost certainly be revisited when the Supreme Court revisits *Chevron*, the Major Questions Doctrine's key opinion, later this term in *Loper Bright Enterprs v. Raimondo*).

Click here to read this Willkie Client Alert for additional context and analysis regarding the SEC's as-adopted climate disclosure rules.

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

Adam S. Aderton	**Elizabeth P. Gray**	**A. Kristina Littman**	**Erik Holmvik**
+1 202 303 1224	+1 202 303 1207	+1 202 303 1209	+1 202 303 1048
aaderton@willkie.com	egray@willkie.com	aklittman@willkie.com	eholmvik@willkie.com

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8 The SEC's new climate rules press release is available here.
9 The SEC's order issuing the stay is available here.

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