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### FINANCE

# Is the SEC's Regulation of Crypto Lenders Self-Defeating?

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Cryptocurrency lending has been increasing at a blistering pace over the last several years. By some measures, the volume of cryptocurrency lending has surpassed the volume of lending on traditional peer-to-peer lending platforms, which are limited to fiat currency loans. U.S. holders of cryptocurrency have been eager to participate in this lending market, but recent actions by the U.S. Securities and Exchange Commission are causing unexpected, and likely unintended, changes in how these loans are made. In fact, the SEC's actions may well reduce the amount of lending done through products registered with the SEC and increase the amount of lending on platforms that are not operated by licensed U.S. companies.

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### Lending Lessons From 'Prosper'

While cryptocurrency lending may have surpassed traditional peer-to-peer lending in volume, there was a time when the value of peer-to-peer fiat loans was increasing so quickly that some viewed them as a threat to traditional banking. It appeared possible that peer-to-peer lending platforms could “disintermediate” banks, who were profiting from the difference between the rate of

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interest paid by banks to depositors and the rate of interest paid to banks by borrowers whose loans were funded with deposits.

While changes in the interest rate environment contributed to the slowing growth of peer-to-peer

lending, another significant factor was the SEC's decision to treat peer-to-peer loans as securities. The SEC staked out this position in 2008, when it issued a cease-and-desist order against Prosper Marketplace based on the assertion that the promissory notes issued on the peer-to-peer Prosper marketplace were securities that Prosper had failed to register with the SEC. After the SEC's action against Prosper, some peer-to-peer lenders tried to register their products with the SEC and comply with the regulations that apply to securities issuers. Others simply went out of business rather than incur this expense.

### The SEC Slams the Door on Coinbase's Lend Program

The SEC's position on cryptocurrency lending began to emerge publicly late last year. In September 2021, Coinbase revealed that the SEC had sent it a “Wells Notice,” which is a preliminary determination by the SEC's staff that it will recommend a civil enforcement action, if Coinbase

allowed customers to participate in its proposed “Coinbase Lend” program. That product would have allowed eligible Coinbase customers to earn interest on select assets on Coinbase, starting with 4% APY on USD Coin (USDC).

Rather than quietly withdraw its proposed Lend program, Coinbase publicly expressed its disagreement with the SEC. Coinbase’s chief legal officer articulated Coinbase’s grievances in an article posted on The Coinbase Blog. The blog post noted that the SEC had told Coinbase that it viewed the Lend product as a security under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (*Howey*), and *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (*Reves*), but that the SEC had not explained to Coinbase how it came to this conclusion.

### BlockFi Is Fined \$100 Million

While the SEC never publicly explained how it applied *Howey* and *Reves* to Coinbase Lend, in February 2022, it articulated how it would apply these cases to cryptocurrency lending products when it issued a cease-and-desist order against BlockFi Lending. The SEC alleged that BlockFi unlawfully failed to register the offer and sale of its retail cryptocurrency lending products, the BlockFi Interest Accounts (BIAs), as securities. The SEC further charged that BlockFi violated the registration provisions of the Investment Company Act of 1940, and made a false and misleading

statement on its website concerning the level of risk in its loan portfolio and lending activity. To settle the SEC’s charges, BlockFi agreed to pay \$50 million to the SEC and agreed to pay another \$50 million to 32 states to settle similar charges.

As described by the SEC, BlockFi offered and sold BIAs to holders of crypto assets, who lent these assets to BlockFi in return for BlockFi’s promise to pay a variable monthly interest in cryptocurrency. BlockFi then pooled the loaned assets, over

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which it had legal ownership and control, and exercised discretion over how to invest them, including by lending them to institutional borrowers. BlockFi set the variable interest rate paid to the lenders based, in part, on the yield that it could generate. BlockFi offered and sold BIAs to retail and other lenders in various ways, including through advertising and general solicitation on its website and social media.

The SEC concluded that the BIAs were securities because they fell within two categories of instruments—“investment contracts” and “notes”—listed in the definitions of securities in §2(a)(1) of the Securi-

ties Act of 1933 and §3(a)(10) of the Securities Exchange Act of 1934.

The SEC based its conclusion that the BIAs were investment contracts on *Howey*. The *Howey* test for whether an instrument is an “investment contract” asks whether the instrument evidences “[1] an investment of money [2] in a common enterprise [3] with [a reasonable expectation of] profits [4] to come solely from the efforts of others.” *Howey*, 328 U.S. at 301. The SEC concluded that loaning digital assets to BlockFi was an “investment of money,” that BlockFi’s deployment of pooled digital assets created a “common enterprise,” that the purchasers of BIAs had a “reasonable expectation of profits” in the form of variable monthly interest paid, and that these profits came “from the efforts of others” because BlockFi’s success in determining how to invest the pooled digital assets would determine whether the common enterprise was profitable.

The SEC based its conclusion that the BIAs were securities notes on *Reves*. Under *Reves*, a note is presumed to be a security unless it falls into certain categories of financial instruments that are not securities (which clearly did not apply to BIAs), or if the note in question bears a “family resemblance” to notes in those categories based on a four-factor test. 494 U.S. at 64-66. Those factors are the motivations of a reasonable seller and buyer, the note’s

“plan of distribution,” the reasonable expectations of the investing public, and whether other risk-reducing factors exist, making unnecessary the application of the securities laws to protect the public. The SEC concluded that each of these factors supported the finding that BIAs were notes because (1) BlockFi’s motivation was to sell BIAs and obtain crypto assets for the general use of its business and BIA purchasers’ motivation was to receive interest, (2) BIAs were offered and sold to a broad segment of the general public, (3) BlockFi promoted BIAs as an investment, specifically as a way to earn a consistent return on crypto assets and for investors to build their wealth, and (4) no alternative regulatory scheme or other risk reducing factors exist with respect to BIAs.

### **Is the SEC Pushing Crypto Lenders to DeFi?**

While the SEC described its enforcement action against BlockFi as part of an effort to ensure that cryptocurrency lenders have more “information and transparency,” it seems at least as likely to have the opposite effect. First, as SEC Commissioner Hester M. Peirce noted in her dissent from the SEC’s action against BlockFi, it is likely to discourage other companies from offering lending products that are registered with the SEC. The size of the penalties, which Commissioner

Peirce described as “disproportionate,” will lead many companies based outside the United States to decline to offer cryptocurrency lending products to United States customers, rather than encourage them to offer these products with more accurate disclosures. In addition, the SEC’s decision to force BlockFi to register as an investment company imposes a difficult and time-consuming burden that is more severe than registering the BIAs as securities, without providing additional protection to cryptocurrency lenders. As Commissioner Peirce observed, “Inviting people to come in and talk to us only to drag them through a difficult, lengthy, unproductive, and labyrinthine regulatory process casts the Commission in a bad light and thus makes us a less effective regulator.”

Second, retail cryptocurrency lenders now have options other than licensed entities such as BlockFi. Holders of crypto assets increasingly lend cryptocurrency using DeFi platforms. Some of these platforms are controlled by stakeholders located in jurisdictions outside the United States; others are controlled only by automated “smart contracts” that are not subject to anyone’s control. Many holders of crypto assets view these DeFi lending platforms as investor-friendly innovations. It seems unlikely, however, that the SEC is purposely driving retail cryptocurrency lenders to these DeFi platforms and away

from companies like BlockFi. After all, BlockFi makes detailed disclosures to customers, blocks transactions with sanctioned jurisdictions and entities, operates an anti-money laundering program, and has successfully applied for dozens of state lending and money transmission licenses. While a few DeFi products have some of these features—permissioned liquidity pools are one example—most do not.

The SEC’s current enforcement-driven approach to regulating cryptocurrency lending appears to be likely to reduce the availability of innovative lending products registered with the SEC and to increase the use of unlicensed cryptocurrency lending platforms by retail investors. It is difficult to know how this interaction between innovation and regulation will play out, but if the SEC does not alter its current approach, it may be disappointed with the results.