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Why Coinbase Was Destined To Lose Its Battle With The SEC

By **John Reed Stark** (September 21, 2021, 12:56 PM EDT)

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Coinbase dodged a bullet when it **stopped its Lend program** dead in its tracks, giving up its fight against the U.S. Securities and Exchange Commission.[1]

The spat started when high-flying media darling Coinbase — a popular, and now publicly traded, crypto trading platform — began marketing a cryptocurrency product called Lend. The Lend program purportedly planned to allow some Coinbase customers to earn interest on certain assets on Coinbase, starting with 4% annually on USD Coin, or USDC.[2]

U.S. regulators have raised concerns about these kinds of programs, including that the products are securities that require state and federal registration.

According to Coinbase, its lawyers reached out to the SEC to discuss Lend. But rather than helping, the SEC staff opted to serve Coinbase with a Wells notice, informing Coinbase of its intention to seek approval from the SEC commissioners to file a civil enforcement action against Coinbase for violating federal securities laws.

Coinbase asserted that the SEC issued the Wells notice because of Coinbase's failure to file a registration statement with the SEC for the offering of its Lend product, which the SEC believes is a security.[3]

After Coinbase received the Wells notice, Coinbase orchestrated an online firestorm, beginning with a posting on its blog by its chief legal officer decrying the SEC's actions,[4] followed by a Twitter thread by its CEO dubbing the SEC's behavior "sketchy."[5]

Together with their audacious defiance of, and crowdsourcing public relations campaign against, the SEC, Coinbase also brazenly continued to market Lend. In fact, Coinbase continued soliciting its customers for Lend and created an online waiting list for customers seeking Lend "pre-enrollment." Lend's terms were even included in Appendix 6 of Coinbase's user agreement.

The SEC's response to Coinbase's bluster and bravado? Radio silence. Given that the SEC cannot comment on even the existence of an investigation, the only way that the SEC could actually address Coinbase's conduct was with the filing of an enforcement action against it, which was likely imminent.

Given that Coinbase has now not only retreated, but also openly raised a flag of surrender, the SEC has significantly less justification for filing an emergency restraining order against Coinbase

and Lend.

This article explains why Coinbase would have lost its battle with the SEC, i.e., why Lend was obviously a security, and why Coinbase's defenses and strategies would have failed miserably.

The Lend Program

In a typical decentralized finance, or DeFi crypto lending program — though they can vary in terms of description:

- A DeFi platform user deposits/invests crypto with the DeFi platform;
- The DeFi platform pools the crypto from that investor with other investors.
- The DeFi platform lends that crypto to other DeFi customers who pay interest.
- Profits or losses on the program depend on the platform's skill and expertise in investing the loaned crypto; and
- The DeFi platform pays some or all of the interest to the investors in the pool.

Based on Coinbase's representations, Coinbase was proposing to structure Lend solely with a type of stablecoin called USD Coin.[6]

One USDC token is meant to be worth exactly one real U.S. dollar. It is therefore common to say that USDC is a stablecoin because its price supposedly demonstrates little to no volatility around the intended value.

Despite its nomenclature, the U.S. government has nothing to do with USDC; it is not legal tender; and it is not insured by the U.S. government. Moreover, investing in stablecoins carries certain unique and dangerous risks.[7]

Howey, Reves and the Definition of a Security

The two cases that Coinbase claimed the SEC cited as support for its Wells notice were the U.S. Supreme Court's 1946 decision in SEC v. Howey[8] and 1990 decision in Reves v. Ernst & Young,[9] the seminal cases when mulling questions of whether an investment product is a security.

Howey and Reves reinforce the notion that, plainly drafted to contemplate not only known securities arrangements at the time, the definition of "security" encompasses any prospective instruments created by those who seek the use of the money of others on the promise of profits.[10]

Specifically, Howey addressed whether a product is an investment contract, and hence a security, applying the eponymous Howey test, and Reves addressed whether a product is a note, and hence a security, applying the so-called familial resemblance test.

Howey

Applying the four-pronged Howey test, Coinbase's Lend is clearly offering a security:

1. Investment of Money

Coinbase customers would have invested USDC in Lend.

2. Common Enterprise

For this prong, courts can look for horizontal commonality — or pooling of money from multiple assets and pooling of profit/loss allocations — and/or vertical commonality — investors' profits or losses depend on the efforts of the others such as the promoter of the product, even if no other investors exist.

Lend easily meets both commonalities. Horizontally, Coinbase was a pooling the USDC of its customers to fund Lend loans to other customers, and then allocating profits along the lines of that pooling. Vertically, whether a Lend participant would profit would have depended on the efforts of Coinbase in lending out the USDC.

3. Expectation of Profits

Lend customers were not investing for their health; they wanted to profit.

4. Profits Solely from the Efforts of the Promoter or a Third Party

Lend investors were putting their trust in Coinbase to profit. Lend investors had no control over how Coinbase would run Lend, and Lend did not permit investors to participate in Lend-related decisions.

Reves

Another possibility is that Lend was a note, rather than an investment contract.

The Supreme Court in Reves established the family resemblance test, to determine whether a note is a security.[11] Applying the four-pronged family resemblance test below, Lend is also clearly offering a note, and hence a security.

1. A consideration of the motivation of the seller and buyer — e.g., is the seller looking for investment and the buyer looking for profit?

Coinbase likened Lend to a savings account, where the Lend customer was looking for a profitable investment and Coinbase was looking for investors.

2. The plan of distribution of the note — e.g., Is the product being marketed as an investment?

Coinbase was marketing the Lend program as an investment.[12]

3. The expectation of the creditor/investor — e.g., Would the investing public reasonably expect the application of the securities laws to the product?

Investors, especially disgruntled ones, would have certainly expected that securities regulation applied.

4. The presence of an alternative regulation — e.g., Will the product be registered as a banking product and the offeree registered as a bank?

Coinbase is not a bank, so its so-called savings account fell under no other regulatory jurisdiction and protection.

Indeed, Coinbase stated clearly on its Lend website:

> USDC is a digital currency and NOT legal tender. Coinbase is not a depository institution, and your USDC wallet is not a savings or a checking account. Your USDC wallet is not insured by the Federal Deposit Insurance Corporation (FDIC) or the securities investor protection corporation (SIPC).[13]

Coinbase's Losing Defenses, Tactics and Strategies

Coinbase's arguments on its blog and on Twitter amount to a dissertation of irrelevant, anecdotal and unpersuasive grievances, all easily rebutted as follows.

The vagaries of the SEC definition of a "security" and the SEC's random assortment of regulatory pronouncements render compliance too challenging.

The definition of security is historically flexible so as to be "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," according to the Supreme Court's 2004 decision in SEC v. Edwards.

Indeed, by emphasizing elasticity in the regulation of securities, Congress and the Supreme Court intentionally anticipated and contemplated that issuers would devise new investment vehicles to raise funds from the public.[14]

Moreover, this "vagueness" argument, oft repeated and celebrated by crypto believers on the lecture circuit, is a red herring — and, after dozens of crypto-related SEC enforcement actions, is déjà vu all over again. With respect to digital tokens and digital assets, never in its history has the SEC taken such drastic measures to make their views known.

For example, the SEC has used multiple distribution channels to share its message and concerns regarding cryptocurrencies, digital trading platforms, initial coin offerings, etc. The SEC has publicized their position through countless enforcement actions,[15] multiple speeches,[16] a series of investor alerts,[17] a rare Section 21(a) report of investigation,[18] congressional testimony[19] and several official SEC statements[20] and proclamations.[21]

In fact, Former SEC Chair Jay Clayton engaged in a massive multiyear crypto tour, always speaking bluntly and thoughtfully about the need for digital token offerings to be registered and the many misconceptions in the digital asset marketplace.

Speaking at a legal gathering in January 2018,[22] Clayton even went so far as to admonish the lawyers counseling clients engaged in digital coin and token offerings. To claim a lack of clarity and meaning amid such a concerted SEC effort for transparency, notice and candor seems sorely misguided to say the least.

Using SEC enforcement litigation to make law is wrong.

The stark reality is that litigation is how most securities regulation becomes law. Moreover, securities laws are often intentionally vague and require adjudication to clarify.

Indeed, Howey and its progeny provide clear, explicit standards that courts have applied to SEC enforcement actions for decades, from investments in eel farms[23] and ostrich breeding[24] to

fictional prime bank securities[25] and digital coin offerings.[26]

Consider the bulk of insider trading laws, a hallmark of U.S. market protection, which are almost entirely judge-made.

Coinbase has taken their case to the public via their blog and Twitter — rallying supporters against the SEC.

Fighting with the SEC in public, whether via blog, Twitter,[27] CNBC appearance or otherwise, never works out well. Good SEC defense lawyers always advise that companies should never poke the bear. Defiance and combat can trigger an SEC emergency enforcement action, which will cost tens of millions to defend and which typically results in a devastating loss.

Coinbase had only started awaiting list, and had not actually officially launched Lend, hence the matter was inchoate and not actionable.

The SEC always strives to arrest securities violations before investors are hurt and has undertaken similar preemptive strikes in the past.[28] Indeed, intervening as early as possible to protect investors is a pivot that Congress expects the SEC to make, and will often criticize the SEC for not doing.

Moreover, though Coinbase had not begun its Lend program, it had begun aggressively marketing Lend's benefits to its customers for "pre-enrollment," stating:

> All eligible customers are currently invited to pre-enroll for USDC Lending by joining our waitlist. We will invite customers off the waitlist as the program becomes available. Once you are invited off the waitlist, you will automatically start earning interest on your entire USDC balance.

Other financial market crypto players had been marketing programs similar to Lend, and the SEC had not sued them.

This argument is wholly irrelevant. The SEC is forever limited in its resources and seeks out cases that will generate big headlines and provide the biggest bang for the buck.

Moreover, that the SEC had singled out Coinbase was no accident. The SEC wanted to send the loudest programmatic message to change industry behavior, by hitting the highest profile players while using as little of its precious resources as possible.

The issue was also not one of first impression. Several state regulators,[29] including a recent New Jersey action against BlockFi,[30] had accused other crypto lending platforms of violating securities laws — and the others that Coinbase referenced, well, those crypto lenders might also receive Wells notices too.

The SEC has unfairly targeted Coinbase.

This is precisely the point. The SEC likely undertook special scrutiny of Coinbase because, despite its marketing and nomenclature, Coinbase is not a registered exchange with the SEC and lacks the myriad investor protections federal exchange registration entails.[31]

Indeed, for the typical crypto trading platform, there exists no U.S. federal regulatory framework — it's not just the Wild West, it's not just caveat emptor — it's global economic anarchy. So when a customer has a problem with a cryptocurrency transaction, the customer is not afforded the

myriad protections and safeguards afforded by federal registration.[32]

SEC registration of Lend serves no meaningful purpose.

SEC registration of Lend would mean that the SEC, an independent and impartial third party, with only investor protection in mind, would ensure the fair, transparent and accurate depiction of all relevant information. The SEC would not render judgment as to the merits of the Lend program, but rather the SEC would police the candor, fulsomeness and clarity of its representations, to ensure that potential purchasers can make informed investment decisions.

While Coinbase might not want to register its Lend program as a securities product, given Coinbase's lack of federal registration as an exchange, it is hard to imagine any investor objecting. SEC registration would clearly keep Coinbase honest and keep its sales and marketing force in check. Is this really such a terrible thing?

Looking Ahead

On March 30, just weeks before Coinbase went public in a hotly anticipated debut on the Nasdaq Stock Market, Coinbase announced a major hiring coup d'état, snagging former SEC Division of Trading and Markets Director Brett Redfearn.

At the SEC, Redfearn oversaw a staff of 250 that took an active role in delineating the rules that would govern cryptocurrencies. That included the SEC's oversight of bitcoin exchange-traded funds, custody of digital assets and alternative trading systems used for crypto trading.

At the time, Coinbase Chief Product Officer Surojit Chatterjee wrote that Redfearn:

> will be responsible for defining and driving a vision and strategy to set the global standard for crypto capital markets, including digital asset securities and our crypto trading platform.[33]

Redfearn similarly gushed:

> Working hand-in-hand with the outstanding engineers at Coinbase and innovators in the new crypto economy, I intend to help build a market ecosystem that creates new efficiencies and democratizes the investment process while being 100% compliant with our securities laws.[34]

About three months later, Redfearn left Coinbase on what Coinbase described as "amicable" terms, apparently smack dab in the middle of the SEC's investigation.

Perhaps Redfearn had personal reasons to leave — or perhaps Redfearn felt uncomfortable with Coinbase's aggressive market posture, and disregard of the SEC's admonitions. My guess is that Redfearn advised that Coinbase should cease Lend's marketing efforts while discussions with the SEC continued, lest its defiance provoke the SEC to file an SEC emergency enforcement action.

Under any circumstance, cooler heads have prevailed. Given its abrupt stop to its Lend program, perhaps Coinbase's senior management now understands that the SEC's actions were not sketchy, rogue, regulatory turf-grabbing or political skullduggery.

The SEC's Wells notice against Coinbase was spot on, falling squarely within its mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.[35]

Designed to "eliminate serious abuses in a largely unregulated securities market,"[36] the Securities Act and the Securities Exchange Act (and four others that followed),[37] among other things, mandated public registration of securities and created the SEC to police that registration. These acts ended years of the kind of libertarian, laissez-faire policy of business regulation that Coinbase epitomizes, ushering a new era of extraordinary prosperity for investors, while simultaneously rendering U.S. capital markets the most desirable in the world.

There are two final lessons to be learned from this Coinbase-SEC whirlwind that may somehow become lost in translation. First, let cooler heads prevail. By halting the implementation of its Lend program, Coinbase may have eliminated any imminent threat to investors, which in turn, perhaps assuaged SEC concerns, and kept the SEC from marching into federal court seeking a slew of devastating emergency relief, including an emergency restraining order to stop Lend.

Second, and even more importantly, don't get too caught up in your own hype. Painting stripes on a horse will never make it a zebra, no matter how much crypto patter exists asserting otherwise.

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[1] https://blog.coinbase.com/sign-up-to-earn-4-apy-on-usd-coin-with-coinbase-cdad79e5f5eb.

[2] https://www.coinbase.com/learn/tips-and-tutorials/how-to-earn-crypto-rewards.

[3] The SEC may have informed Coinbase of other allegations in its Wells Notice — such as fraud, unregistered broker-dealer activity, unregistered fund activity and a host of other concerns —but Coinbase has only discussed a charge relating to its failure to file an SEC registration statement for Lend.

[4] https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009.

[5] https://twitter.com/brian_armstrong/status/1435439291715358721.

[6] https://www.coinbase.com/legal/user_agreement/united_states.

[7] https://www.wsj.com/articles/risks-of-crypto-stablecoins-attract-attention-of-yellen-fed-and-sec-11626537601.

[8] https://supreme.justia.com/cases/federal/us/328/293/.

[9] https://supreme.justia.com/cases/federal/us/494/56/.

[10] Historically, the courts and the SEC have taken an extremely broad view of whether any kind of investment is a security. Indeed, the definition of "security" under Section 2(a)(1) of the Securities Act of 1933 (at https://www.law.cornell.edu/uscode/text/15/77b) (and the nearly identical definition under Section 3(a)(10) of the Exchange Act of 1934 at

https://www.law.cornell.edu/uscode/text/15/78c)) includes not only a number of specific types of financial instruments, such as notes, bonds, debentures and stock, but also broad categories of financial instruments, such as evidences of indebtedness and investment contracts.

[11] Per Reves, a presumption that a note is a security can only be rebutted if the note bears a resemblance to one of the enumerated categories on a judicially developed list of exceptions. The exceptions are: (1) a note delivered in consumer financing; (2) a note secured by a mortgage on a home; (3) a short-term note secured by a lien on a small business or some of its assets; (4) a note evidencing a character loan to a bank customer; (5) a short-term note secured by an assignment of accounts receivable; and (6) a note which simply formalizes an open-account debt incurred in the ordinary course of business (such as a trade payable for office supplies); and (7) a note evidencing loans by commercial banks for current operations. https://supreme.justia.com/cases/federal/us/494/56/.

[12] https://www.coinbase.com/lend.

[13] https://help.coinbase.com/en/coinbase/trading-and-funding/staking-rewards/lend.

[14] https://www.lexisnexis.com/community/casebrief/p/casebrief-sec-v-edwards.

[15] https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

[16] https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03.

[17] https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_icorelatedclaims.

[18] https://www.sec.gov/litigation/investreport/34-81207.pdf.

[19] https://www.sec.gov/news/testimony/gensler-2021-05-26.

[20] https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[21] https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[22] https://fortune.com/2018/01/23/sec-ico-cryptocurrency/.

[23] https://apnews.com/article/7a6127d81f18ba353a40c204b49367b5.

[24] https://www.sec.gov/litigation/litreleases/lr15079.txt.

[25] https://caselaw.findlaw.com/us-7th-circuit/1054989.html.

[26] https://www.sec.gov/spotlight-initial-coin-offerings-and-digital-assets.

[27] https://markets.businessinsider.com/news/currencies/mark-cuban-coinbase-sec-aggressive-engaging-crypto-industry-exemptions-internet-2021-9.

[28] https://www.sec.gov/news/press/pressarchive/1999/99-49.txt.

[29] https://www.theblockcrypto.com/linked/113124/kentucky-regulator-blockfi-interest-security.

[30] https://www.nj.gov/oag/newsreleases21/BlockFi-Cease-and-Desist-Order.pdf.

[31] https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html.

[32] For instance, with respect to U.S. federal regulation of crypto trading platforms, there exists:

- No team of SEC, Federal Reserve, OCC, FINRA or other federal auditors and compliance experts not only inspecting and scrutinizing the fairness, execution and transparency of transactions and but also policing for fraud, manipulation and chicanery;
- No liquidity, net capital or other depository or financial federal requirements;
- No record-keeping and archiving requirements with respect to operations, communications, trading or any other aspect of business;
- No requirements regarding the pricing or order flow of crypto transactions or the use internal platforms and payment systems by employees;
- No adherence to federal statutes and rules prohibiting manipulation, insider trading, and other fraudulent behavior by customers or employees;
- No mandated cybersecurity requirements or standards to combat hackers and protect customer privacy;
- No mandated training or code of conduct requirements;
- No mandated internal compliance, customer service or whistleblower teams to address and archive customer complaints;
- No anti-fraud guarantee from a U.S. registered financial institution and, if any dispute or problem arises, no reversing of charges (typical cryptocurrency transactions are by definition irreversible);
- No mandated process for customer complaint handling (and even if there was a formal complaint filing structure, the pseudo-anonymous nature of virtual currencies, ease of cross-border and interstate transport, and the lack of a formal banking edifice creates enormous challenges for law enforcement to investigate and apprehend any individuals who use cryptocurrencies for illegal activities); and
- None of the vigorous U.S. federal safeguards historically rooted in the DNA of U.S. financial institution registration and regulation. These sacrosanct standards and practices are not only the hallmark of U.S. financial institutions such as banks, investment companies, brokerages and other financial firms but have also rendered U.S. capital markets the most transparent, efficient, reliable, safe, trustworthy -- and most sought after in the world.

[33] https://blog.coinbase.com/coinbase-hires-brett-redfearn-as-vp-capital-markets-41df20c7a934.

[34] https://blog.coinbase.com/coinbase-hires-brett-redfearn-as-vp-capital-markets-41df20c7a934.

[35] Back then, in response to the lack of investor confidence after the stock market crash of 1929, Congress enacted the Securities Act of 1933 (regulating the initial distribution of securities) and Securities Exchange Act of 1934 (regulating the post-issuance trading of securities). The '34

Act also created a "superagency" called the SEC to oversee intermarket issues and to enforce the '33 and '34 Acts. https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1815&context=lsfp.

[36] https://supreme.justia.com/cases/federal/us/421/837/.

[37] The Public Utilities Holding Company Act of 1935; the Trust Indenture Act of 1939; the Investment Company Act of 1940; and the Investment Advisors Act of 1940.
