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State Crypto Lending Concerns Point To SEC Action Ahead

By **John Reed Stark** (October 22, 2021, 11:41 AM EDT)

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New York state is the latest jurisdiction to inject itself into the growing mix of states outlawing cryptocurrency lending programs — and the U.S. Securities and Exchange Commission cannot be too far behind.

In typical cryptocurrency lending programs, though they can vary:

- A decentralized finance, or DeFi, platform user deposits or invests cryptocurrency with the DeFi platform;
- The DeFi platform pools the cryptocurrency from that investor with other investors;
- The DeFi platform lends that cryptocurrency 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 cryptocurrency; and
- The DeFi platform pays some or all of the interest to the investors in the pool.

This article analyzes the SEC's perspective relating to cryptocurrency lending programs:

- Arguing why the SEC will not and should not permit the increasingly uneven, state-fragmented and disjointed investor protection from the growing crop of innovative, yet inherently risky, digital asset lending products; and
- Predicting an SEC enforcement sweep against the unregistered crypto platforms who offer digital-based lending products, not only for selling unregistered securities but also for any other violations the SEC might discover — including operating as unregistered broker-dealers or exchanges, or even fraud or other chicanery.

State Enforcement Actions

The New York Attorney General's Office reportedly ordered two crypto lending platforms to shut down operations in the state, and demanded information from three others.[1] Nexo Financial LLC reportedly received one of the office's cease letters, which alleges that the company is unlawfully selling securities or commodities in New York without the required registration.[2]

In a redacted version of a letter dated Oct. 18, John D. Castiglione, senior enforcement counsel of the New York Attorney General's Office, stated that his office "was in possession of evidence of unlawfully selling or offering for sale securities and/or commodities."[3]

Along the same lines, New York Attorney General Letitia James asserted, "Cryptocurrency platforms must follow the law, just like everyone else, which is why we are now directing two crypto companies to shut down and forcing three more to answer questions immediately."[4]

Regulators in several other states, including Texas, New Jersey and Alabama, have previously raised concerns that cryptocurrency lending programs peddled by Celsius Network LLC and BlockFi Inc. are unregistered securities in violation of state securities registration laws. Kentucky and Vermont have also charged BlockFi along similar lines.[5]

The Kentucky Department of Financial Institutions' July 29 cease-and-desist order against BlockFi is particularly illuminating. The department specifies that BlockFi Interest Accounts, or BFAs, are unregistered securities, while also emphasizing the risks associated with the lack of SEC registration.[6] Commissioner Charles A. Vice noted:

> The Securities Act of 1933 along with the Securities Act of Kentucky have set up a registration regime that requires companies selling securities to disclose all material information necessary for an investor to make an informed decision. ... The Department of Financial Institutions is responsible for protecting Kentucky's investors, and BlockFi's actions are not consistent with Kentucky statute and decades of legal precedent. The emergency nature of this order is essential to protect the citizens of the commonwealth.[7]

BlockFi addressed BFAs (1) in stark opposition, by disagreeing and stating that BFAs are not unregistered securities, and (2) by disagreeing

and ceasing to accept new lending clients residing in Kentucky immediately.[8]

The SEC and Cryptocurrency Lending Programs

The SEC has actually already begun battling crypto lending programs, albeit without firing a single prosecutorial shot or even uttering a single discouraging public word. Recently, the SEC convinced[9] Coinbase Global Inc. to shut down its crypto lending program of interest-earning cryptocurrency products,[10] despite unusually public online criticism from Coinbase's CEO[11] and general counsel.[12]

Undoubtedly, the SEC enforcement staff has carefully researched the New York, Kentucky, Alabama, Texas, New Jersey[13] and Vermont actions, reached out to the respective state investigators in each case, exchanged investigatory information such as documents and testimonial transcripts, and opened up a slew of related formal investigations.

SEC Chair's Crypto Concerns

The SEC enforcement staff has already begun investigating possible fraud and chicanery at DeFi platforms in particular,[14] especially given SEC Chair Gary Gensler's oft-repeated concerns that unregistered cryptocurrency trading and lending platforms pose a threat to investors and could be unlawfully selling unregistered securities.[15]

Though state blue sky regulations are critical, Gensler clearly believes that SEC regulation of risky securities — such as the myriad crypto-related investment products offered by federally unregulated trading platforms — should not evolve into yet another state-centric regulatory framework, like it has with cannabis, gaming, helmet laws, privacy, etc.

Indeed, Gensler noted in a Sept. 21 livestreamed interview with the Washington Post, that many of "hundreds or thousands" of tokens that trade on cryptocurrency trading and lending platforms are likely securities, which would require any platform on which they trade to register as an exchange or apply for an exemption.[16]

Gensler has remained remarkably consistent in his view of the risks to investors posed especially by unregulated crypto platforms. In an Aug. 5 response to a letter from Sen. Elizabeth Warren, D-Mass., he stated:

> If a lending platform is offering securities, it also falls into SEC jurisdiction. ... It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These products are subject to the securities laws and must work within our securities regime.[17]

Gensler is justifiably concerned about the lack of investor protections at DeFi and cryptocurrency trading and lending platforms where there exists none of the vigorous 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.[18]

Celsius and BlockFi Investors

The state of Texas alleges that BlockFi and Celsius have assets under management of $15 billion and $24 billion respectively.

Specifically, Texas alleges that: (1) the Celsius Network has 348,158 active users worldwide invested in Celsius Earn Interest-Bearing Accounts, with global assets under management exceeding $12.5 billion;[19] and (2) BlockFi has more than 350,000 funded accounts from the sale of its BlockFi Interest Accounts.[20]

The failure of BlockFi and Celsius to register these highly speculative and currently unregulated investment products is not in the best interest of their customers, who deserve to understand the precise nature and risk of their investment.

SEC registration of cryptocurrency lending programs 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 programs, 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 DeFi platforms might want to avoid the costly, exhausting and cumbersome regulatory burdens of registration, it is hard to imagine any investor objecting.

SEC registration would clearly render these DeFi platforms more transparent, candid and trustworthy; keep their sales and marketing forces honest; and mandate a compliance regime designed to prevent fraud, chicanery and carelessness relating to investor funds.

An Easy Target for the SEC

Typical cryptocurrency lending programs easily meet the tests established by the U.S. Supreme Court's 1946 decision in SEC v. Howey[21] and 1990 decision in Reves v. Ernst & Young,[22] the seminal cases applied when determining whether an investment product is a security.[23]

Along these lines, Howey and its progeny provide clear, explicit standards that courts have applied to SEC enforcement actions for decades, from investments in eel farms[24] and ostrich breeding[25] to wholly fictional prime bank securities[26] and cutting-edge digital coin offerings.[27]

In fact, the flexibility of the SEC's statutory weaponry has always been its hallmark. As SEC scholar and Georgetown Law School professor and former SEC staffer Donald Langevoort wrote almost 30 years ago, Rule 10b-5 is an adaptive organism — and it works.[28]

Along those same lines, in 1996, William McLucas, the SEC enforcement director at the time, coauthored an article titled "Common Sense, Flexibility, and Enforcement of the Federal Securities Laws," explaining how enforcement programs such as insider trading, foreign payments, municipal bond fraud and so many others grew out of the intentionally flexible SEC anti-fraud provisions.[29]

In 1999, at the outset of the SEC's Internet Enforcement Program,[30] SEC critics harped on the same humdrum of antiquated criticisms — i.e., that the vagueness of SEC regulation, the lack of clarity about what is a security, and legislation via SEC enforcement would stifle internet growth relating to investing, finance and U.S. capital markets.

In response, I coauthored an article titled "The SEC's Statutory Weaponry to Combat Internet Fraud," reiterating McLucas' thesis in the context of the SEC's internet program,[31] citing the same adaptive capacity extolled by Langevoort and championed by McLucas and the legendary Stanley Sporkin before him.[32]

In hindsight, relying upon the flexibility of securities regulation to police the internet cleared out much of the more egregious instances of early online securities fraud. Moreover, vigorous online SEC enforcement efforts also helped pave the way for legitimate early financial technology innovations to flourish, rendering markets more efficient and transparent, thereby allowing investors more opportunities for profit and success.

In the area of securities violations, the internet provides enforcement staff a glimpse into securities violations in real time, as they unfold, enabling, in many cases, the enforcement division to arrest violations before investors' savings are lost. This preemptive empowerment has proven to be the most profound change wrought by the internet in the field of securities regulation.

Looking Ahead

On Aug. 25, the SEC announced the appointment of famed investor advocate Barbara Roper as senior adviser to the chair. Roper's focus is on issues relating to retail investor protection, including matters relating to policy, broker-dealer oversight, investment adviser oversight and examinations.

Previously, for 35 years, Roper was the unshakable director of investor protection for the Consumer Federation of America, becoming a leading consumer spokesperson on investor protection issues. For 35 years, during the entirety of her tenure, Roper was a staunch, outspoken and well-respected advocate for everyday investors, even if it meant decrying the largest and most esteemed traditional financial firms.

There is no doubt that if Roper still served at the CFA, she would be marching into SEC headquarters with the New York, New Jersey, Texas, Vermont, Alabama and Kentucky orders and demanding SEC federal attention with a bullhorn. Now she has Gensler's ear — and she needs only whisper.

Given the lack of federal regulatory oversight of cryptocurrency lending programs, and the lack of federal licensure for its salesforce, Roper has the ability to lead the charge behind the scenes regarding the risks posed to investors by unregulated DeFi platforms.

In contrast, the growing legion of cryptocurrency promoters will undoubtedly argue that Gensler, Roper and others who seek to register crypto lending programs in the U.S. need to get educated and do the research to understand cryptocurrencies.

Along these lines, crypto promoters often preach how cryptocurrencies will benefit U.S. citizens, such as: transforming the way U.S. businesses conduct financial transactions; rendering U.S. use of energy, water and any other raw material more efficient, more transparent, more reliable and less costly; instantaneously verifying transactions, eliminating significant costs, uncertainty and fraud; and will in general dramatically improve the way we all carry out our daily lives.

This all may be true — but has little to do with cryptocurrency investment programs.

In fact, advocating for SEC registration of crypto-related investment products is not at all anti-blockchain. The two philosophies are too often mistakenly conflated. Yes, the blockchain technology on which DeFi innovations are based may turn out to be the most exciting, disruptive, transformative and efficiency-enhancing breakthrough since the internet itself.

However, no matter how innovative, exciting and technologically advanced, the mere fact that an investment is tied to a digital asset does not somehow exempt that investment product from SEC registration or other regulatory oversight.

Section 5 of the Securities Act is a strict liability statute, so there exist no good faith defenses for promoters peddling unregistered digital lending products.[33] From the SEC's perspective, every cryptocurrency investment program must fall into one of three categories: registered, exempt or unlawful.

This is why an SEC enforcement sweep of digital lending products is not only imminent, but will also be like shooting fish in a barrel.

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[1] https://www.law360.com/securities/articles/1431883/ny-joins-crackdown-on-crypto-lending-products.

[2] https://www.law360.com/securities/articles/1431883/ny-joins-crackdown-on-crypto-lending-products.

[3] https://www.johnreedstark.com/wp-content/uploads/sites/180/2021/10/NY-State-CD-Letter.pdf.

[4] https://ag.ny.gov/press-release/2021/attorney-general-james-directs-unregistered-crypto-lending-platforms-cease.

[5] Find the Texas Order concerning Celsius at https://www.ssb.texas.gov/sites/default/files/2021-09/20210917_FINAL_Celsius_NOH_js_signed.pdf. Find the New Jersey Order concerning Celsius at https://www.njoag.gov/new-jersey-bureau-of-securities-orders-cryptocurrency-firm-celsius-to-halt-the-offer-and-sale-of-unregistered-interest-bearing-investments/. Find the Alabama Order concerning Celsius https://asc.alabama.gov/Orders/2021/SC-2021-0012.pdf. Find the Texas Order against BlockFi at https://www.ssb.texas.gov/sites/default/files/2021-07/Blockfi_NOH_final.pdf. Find the New Jersey Order against BlockFi https://www.nj.gov/oag/newsreleases21/BlockFi-Cease-and-Desist-Order.pdf. Find the Alabama Order concerning BlockFi at https://asc.alabama.gov/Orders/2021/SC-2021-0006.pdf. Find the Kentucky Order against BlockFi at https://kfi.ky.gov/Documents/Blockfi%20Inc%20Blockfi%20Lending%20LLC%20and%20Blockfi%20Trading%20LLC%202021AH00020.pdf. Find the Vermont Order against BlockFi at https://dfr.vermont.gov/sites/finreg/files/regbul/dfr-order-docket-21-025-s-blockfi.pdf.

[6] https://kfi.ky.gov/Documents/Blockfi%20Inc%20Blockfi%20Lending%20LLC%20and%20Blockfi%20Trading%20LLC%202021AH00020.pdf.

[7] https://kfi.ky.gov/Documents/2021.07.30%20Kentucky%20to%20Blockfi%20Cease%20and%20Desist.pdf.

[8] https://twitter.com/BlockFi/status/1420373376582004742.

[9] https://www.johnreedstark.com/wp-content/uploads/sites/180/2021/09/Why-Coinbase-Was-Destined-To-Lose-Its-Battle-With-The-SEC-Law360.pdf.

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

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

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

[13] With respect to Blockfi, New Jersey has extended again the deadline for when it will enforce the ban on the creation of BlockFi's interest accounts. The ban was first meant to go into effect on July 22, but the new extension pushes the deadline to December 1, 2021. New Jersey was the first state in the U.S.to crack down on BlockFiback in July and gave Blockfi until July 22 to cease opening new interest accounts. However, this deadlinewas extendedto September 2 and then later to September 30. And now, BlockFi has announced that it has received a two-month reprieve from the BIA. https://blockfi.com/disclosures-and-complaints/.

[14] https://www.sec.gov/news/press-release/2021-145.

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

[16] https://www.youtube.com/watch?v=aatNpmgNHRA.

[17] https://www.warren.senate.gov/imo/media/doc/Draft%20SEC%20Crypto%20Exchange%20Letter%2007.7.2021%20clean.pdf.

[18] For example, with respect to the federal regulation of cryptocurrency platforms, so many traditional investor protections do not exist i.e. 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; No requirements regarding the pricing or order flow of crypto transactions or the use internal platforms and payment systems by employees;No mandated cybersecurity, training, code of conduct, whistleblower teams; and a broad range of other critical customer safeguards.

[19] https://www.ssb.texas.gov/sites/default/files/2021-09/20210917_FINAL_Celsius_NOH_js_signed.pdf.

[20] https://www.ssb.texas.gov/sites/default/files/2021-07/Blockfi_NOH_final.pdf.

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

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

[23] The definition of securityis historically flexibleso 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." https://www.lexisnexis.com/community/casebrief/p/casebrief-sec-v-edwards. Indeed, by emphasizing elasticity in the regulation of securities, Congress and the Supreme Court intentionally anticipated/contemplated that issuers would devise new investment vehicles to raise funds from the public. For a more detailed analysis of this issue, see https://www.law360.com/securities/articles/1422905/why-coinbase-was-destined-to-lose-its-battle-with-the-sec.

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

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

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

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

[28] https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=3040&context=flr.

[29] https://www.johnreedstark.com/wp-content/uploads/sites/180/2018/10/3WilliamRMcLucasMarkBLewis.pdf.

[30] https://www.sec.gov/news/press/pressarchive/1998/98-69.txt.

[31] https://www.johnreedstark.com/wp-content/uploads/sites/180/2014/12/1999_The-Securities-Reporter_The-SECs-Statutory-Weaponry-to-Combat-Internet-Fraud.pdf.

[32] https://www.youtube.com/watch?v=dCQu3EjOIgw.

[33] https://www.sec.gov/files/Judg15-cv-2451Whitley.pdf.
