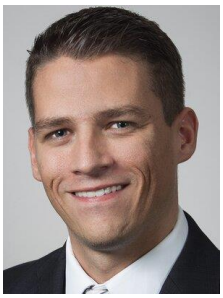
SEC's Crypto Suit Shines Light On Novel Securities Theory

By Christopher Bosch and Elizabette Privat (March 15, 2023)



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The U.S. Securities and Exchange Commission has taken action against Genesis Global Capital LLC and Gemini Trust Company LLC in a recently filed complaint in the U.S. District Court for the Southern District of New York, alleging that the crypto companies violated federal securities laws by engaging in the unregistered offer and sale of securities in the form of their Gemini Earn program.[1]

In doing so, the SEC not only relied upon the mainstay Howey test for determining whether an agreement is a security, but also summoned Howey's lesser-known cousin — the Reves test — notably leading with the latter in its complaint.

These agreements underlie the Gemini Earn program, whereby investors would lend their crypto-assets to Genesis in exchange for a return.

The SEC is seeking an injunction against future violations of Sections 5(a) and 5(c) of the Securities Act, disgorgement and civil penalties. The SEC's reliance upon the Reves test may signal its intention to dust off the U.S. Supreme Court's 1990 Reves v. Ernst & Young decision that established the test in policing interest-bearing crypto products.

Reves v. Ernst & Young

In Reves v. Ernst & Young, the Supreme Court was called upon to determine whether a promissory note issued by a farmer's cooperative amounted to a security governed by the Securities Act.[2] The Securities Act includes any note in the definition of security, without defining what qualifies as such.[3]

The Supreme Court adopted the family resemblance test — now commonly known as the Reves test — to determine whether a financial instrument is a note governed by the federal securities laws.

The Reves test presumes that a note is a security unless it bears a strong resemblance to one of the enumerated categories on a judicially developed list of exceptions.[4]

In considering whether a note bears a family resemblance to one of these enumerated categories or should be added to the list, the Supreme Court weigh four factors:

1. The motivation of the parties;

2. The plan of distribution;

3. The expectations of the investing public; and

4. The availability of an alternative regulatory regime other than the securities laws that "significantly reduces the risk of the instrument" for investors, "thereby rendering application of the Securities Acts unnecessary."[5]

The Supreme Court concluded that the farmer's co-op promissory notes were securities because they bore no resemblance to the judicially developed list of exceptions and did not warrant addition to that list.

In applying the four-factor Reves test, the U.S. District Court for the Southern District of New York found that:

- The co-op was motivated to raise capital for its business operations and purchasers were motivated by profit in the form of interest.

- The notes were sold to a broad segment of the public and "that is all we have held to be necessary to establish the requisite 'common trading' in an instrument."

- The "fundamental essence of a 'security' is its character as an 'investment'" and these notes were advertised as such and would appear to be investments to a reasonable person; and

- The notes were uncollateralized, uninsured and would escape federal regulation if the securities laws did not apply.[6]

Courts have applied Reves in concluding that interest-bearing notes associated with various business models amount to securities, including, for example, a real estate lending program,[7] a small business lending program [8] and an algorithmic stock trading and real estate venture.[9]

The SEC's Application of Reves to the Gemini Earn Program

According to the SEC, the Gemini Earn program functioned as follows: Investors loaned their digital assets to Genesis in exchange for a return, with Gemini acting as the agent for the retail investors to facilitate the transactions.

Genesis sent the investors' interest payments to Gemini, which then deducted an agent fee before distributing the remainder to investors. Genesis pooled investors' digital assets and used them as collateral for its own borrowing or further lent them to institutional counterparties at a higher interest rate than it paid to investors.

Crypto-assets not loaned or used for collateral were held by Genesis on its balance sheet to provide liquidity to meet potential demand for loans.

Applying the Reves factors determined that the Gemini Earn program issuances were notes that had to be registered, the SEC alleged as follows:

1. Motivation: The Gemini Earn program was designed to facilitate institutional lending activities in order to generate profits and pay investors promised returns. As such, the parties were primarily motivated to generate profit.

2. Plan of distribution: The defendants publicly advertised the Gemini Earn program to a broad segment of the general public, including U.S. retail investors, hundreds of thousands of whom invested.

3. Expectations of investing public: The defendants' representations regarding interest rates and the economic realities of the transactions at issue evinced an expectation that the program constituted an investment opportunity.

4. Alternative regulatory regime: No alternative regulatory regime or risk-reducing factors existed to protect investors. The SEC cited Genesis' FAQs, which allegedly stated that digital assets are not covered by the Securities Investor Protection Corp. insurance, participation in the program was not akin to opening a depository or savings account and accounts would not be covered by the Federal Deposit Insurance Corp. protection. The SEC also asserted that while Genesis was registered as a money services business with the Financial Crimes Enforcement Network, that regulatory regime did not "provide the significant disclosures and other investor protections afforded by the federal securities laws."

The SEC acknowledged that Gemini was registered with the New York State Department of Financial Services as a limited-purpose trust company, but asserted that the NYDFS did not have oversight over Genesis, the alleged issuer of the securities. The SEC further alleged that any capital reserve requirements applicable to Gemini did not apply to Genesis and under the Gemini Earn program, Genesis was not required to post collateral for investors' benefit.

Takeaways

The prominence of Reves in the Genesis/Gemini complaint as the lead theory of liability is somewhat novel in the crypto enforcement space wherein the SEC has typically defaulted to Howey.

Here, as noted above, the SEC invoked Howey's investment contract-based analysis only after citing Reves, asserting that the Gemini Earn program issuances were investment contracts and thus securities.

Over the years, the SEC has provided substantial guidance regarding its application of the Howey test to digital assets, which considers whether there is the investment of money in a common enterprise with the expectation of profit derived from the efforts of others.[10]

This guidance includes its 18-page 2017 DAO report in which it applied the Howey test to the operation of a decentralized autonomous organization, which stems from the U.S. Supreme Court's 1946 decision in U.S. Securities and Exchange Commission v. W. J. Howey Co.[11]

In addition, in June 2018, the SEC's then-director of the Division of Corporation Finance — William Hinman — issued extensive public remarks on the subject.[12] In April 2019, the SEC released its Framework for Investment Contract Analysis of Digital Assets, offering an in-depth look into its application of Howey test to digital assets.[13] Howey has also featured prominently in SEC crypto actions to date.

By contrast, the Reves test has flown under the radar in crypto enforcement, largely relegated to passing comments by SEC officials and a handful of enforcement actions, none earlier than 2021.[14] Given the SEC's historically less-than-robust reliance on Reves, its

leading role in the Genesis/Gemini complaint may signal that the regulator intends to increasingly rely upon this lesser-known legal theory in policing crypto lending products going forward.

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[1] Complaint, Sec. & Exch. Comm'n v. Genesis Global Capital, LLC and Gemini Trust Company, LLC, No. 23-cv-00287 (S.D.N.Y. Jan. 12, 2023), ECF No. 1, available at https://www.law360.com/articles/1565438/attachments/0.

[2] 494 U.S. 56 (1990).

[3] See Securities Act of 1933 ("Securities Act"), Section 2(a)(1) (15 U.S.C. § 77b(a)(1)) and Securities Exchange Act of 1934 ("Exchange Act"), Section 3(a)(10) (15 U.S.C. § 78c(a)(10)). While their provisions can be overlapping and complementary, generally speaking, the Securities Act of 1933 governs the registration, offer, and sale of securities while the Securities Exchange Act of 1934 governs the trading of securities. The Supreme Court has deemed the two Acts' definitions of a security "virtually identical" and concluded that their coverage "may be considered the same." See Reves, 494 U.S. at 61 n.1.

[4] This list of exceptions includes (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 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; (6) a note that formalizes an open-account debt incurred in the ordinary course of business; and (7) a note evidencing loans by commercial banks for current operations. Reves, 494 U.S. at 65. It should also be noted that while there is language in both the Securities Act and Exchange Act excluding from the definition of "note" "any note . . . which has a maturity at the time of issuance of not exceeding nine months," see 15 U.S.C. §§ 77c(a)(3) and 78c(a)(10), that exclusion has long been held to apply only to certain types of commercial paper based on an analysis of legislative history and SEC interpretive guidance. See, e.g., Sec. & Exch. Comm'n v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1973); Sec. & Exch. Comm'n Interpretive Release, No. 33-4412, 1961 WL 61632 (Sept. 29, 1961). But see Auctus Fund, LLC v. Sauer Energy, Inc., 444 F. Supp. 3d 279, 280-81 (D. Mass. 2020) (noting that "this approach clashes with the statutory text's plain meaning" but nonetheless declining to "unsettl[e] nearly fifty years of consistent case law" that "Congress could, if it wishes, overrule.").

[5] Reves, 494 U.S. at 67.

[6] Reves, 494 U.S. at 67-69.

[7] See Sec. & Exch. Comm'n v. Davis, No. 18-cv-10481, 2019 WL 6841986 (C.D. Cal. Oct. 15, 2019).

[8] See Sec. & Exch. Comm'n v. Complete Bus. Sols. Grp., Inc., 538 F. Supp. 3d 1309 (S.D. Fla. 2021).

[9] See Sec. & Exch. Comm'n v. Thompson, 732 F.3d 1151 (10th Cir. 2013).

[10] See SEC v. W.J. Howey, 328 U.S. 293 (1946).

[11] Report on the DAO, Exchange Act Release No. 81,207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

[12] William Hinman, Director, Sec. & Exch. Comm'n Div. of Corp. Finance, "Digital Asset Transactions: When Howey Met Gary (Plastic)" (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

[13] Framework for "Investment Contract" Analysis of Digital Assets, Sec. & Exch. Comm'n, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets (last visited June 20, 2022).

[14] See Caroline A. Crenshaw, SEC Commissioner, Digital Asset Securities – Common Goals and a Bridge to Better Outcomes (Oct. 12, 2021), available at https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012; Gurbir Grewal, Director of SEC Division of Enforcement, 2021 SEC Regulation Outside the United States – Scott Friestad Memorial Keynote Address (Nov. 8, 2021), available at https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821; In the Matter of BlockFi Lending LLC, File No. 3-20758 (Feb. 14, 2022), available at https://www.sec.gov/litigation/admin/2022/33-11029.pdf; In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, File No. 3-20453 (Aug. 6, 2021), available at https://www.sec.gov/litigation/admin/2021/33-10961.pdf.