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SEC Showcases Lesser-Known Legal Theory in Crypto Lending Suit

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The Securities Exchange Commission ("SEC" or "Commission") has taken action against Genesis Global Capital, LLC ("Genesis") and Gemini Trust Company, LLC ("Gemini") (collectively, "Defendants") in a recently-filed complaint 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 Agreements." In doing so, the Commission 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 this 1990 Supreme Court decision in policing interest-bearing crypto products.

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.

Under Section 2(a)(1) of the Securities Act of 1933, the definition of a security includes any "note." *See* 15 U.S.C. § 77b(a)(1). In its complaint, the SEC took the position that a note is presumed to be a security unless it bears a strong resemblance to instruments that are not securities, which courts have assessed by examining 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.” *Reves v. Ernst & Young,* 494 U.S. 56, 67 (1990).

Applying the *Reves* factors in concluding that Gemini Earn Agreements were notes that had to be registered, the SEC alleged as follows:

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.

Plan of Distribution: 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.

Expectations of Investing Public: Defendants’ representations regarding interest rates and the economic realities of the transactions at issue evinced an expectation that the program constituted an investment opportunity.

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 SIPC insurance, participation in the program was not akin to opening a depository or savings account, and accounts would not be covered by FDIC protection. The SEC also asserted that while Genesis was registered as a money services business with FinCEN, 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 (“NYDFS”) as a limited purpose trust company, but asserted that 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 Agreement, Genesis was not required to post collateral for investors’ benefit.

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 Agreements 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: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of profit; (4) derived from the efforts of others. *See SEC v. W.J. Howey*, 328 U.S. 293 (1946). This guidance includes its July 25, 2017 DAO Report in which it applied the *Howey* Test to the operation of a decentralized autonomous organization. In addition, in June 2018, the then-Director of the Division of Corporation Finance, William Hinman, issued extensive public remarks on the subject. 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* to digital assets. *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. 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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