PAUL HASTINGS

Stay Current

August 2021

Follow @Paul_Hastings

SEC Defies "DeFi" Market Convention and Advances Chairman Gary Gensler's "Duck Test"

By Michael L. Zuppone

On August 6, 2021, the SEC instituted and settled cease and desist proceedings pursuant to Section 8A of the Securities Act of 1933 (the "Securities Act") and Section 21C of the Securities Exchange Act of 1934 (the "Exchange Act") against Blockchain Credit Partners d/b/a DeFi Money Market ("DMM") and its two founders.[1] This enforcement action defies peer-to-peer DeFi (decentralized finance) market convention which suggests that the decentralization inherent in DeFi applications eliminates SEC jurisdiction and comes just three days after SEC chairman Gary Gensler's widely reported remarks before the Aspen Security Forum, which presaged increased scrutiny of the digital asset marketplace.

In his scripted and unscripted remarks before the Aspen Security Forum on August 3, 2021,[2] SEC chairman Gary Gensler highlighted his regulatory concerns and previewed an enforcement agenda in which he warned that the SEC "will continue to take our authorities as far as they go." He advanced his "duck test," observing "basically, if it quacks like a duck and it walks like a duck, it's a duck," seemingly referring to the Supreme Court's *Howey* and *Reves* decisions often relied upon to determine what is a security conferring jurisdiction for federal securities law purposes.

The action taken by the SEC against DMM is not surprising, given the prior enforcement action taken against an early innovator in peer-to-peer lending, Prosper Marketplace, Inc.[3] In 2008, the SEC commenced and settled a cease and desist proceeding with findings that echo its findings with respect DMM's DeFi token product. The SEC found that Prosper's peer-to-peer lending program instruments were securities under *Howey* and *Reves* and were offered in an unregistered public offering in violation of the Securities Act.

Background on DMM's Tokens and Offerings

According to the SEC's findings, during the period February 2020 to February 2021, the respondents offered and sold $30 million of securities in unregistered securities offering by using smart contracts and DeFi technology to sell digital tokens through DMM. Investors were offered 6.25% interest on digital assets backed by income generating assets sufficient to pay promised interest and generate surplus profits. Two tokens were sold in the offering—mTokens that accrued 6.25% interest, and DMG governance tokens that conferred certain voting rights and offered holders a share of excess profits and the ability to profit from resales of the token in the secondary market. DMM and the two tokens were promoted "at conferences, on podcasts, in conversations with reporters, through paid advertising, and through multiple social media channels, including Twitter, Telegram, Medium, and YouTube." mTokens were sold without regard to geography or accredited investor status, and, as publicly touted by the respondents, were sold without any required "Know Your Customer" (KYC) documentation. DMM's website was publicly available and was not password-protected or geographically restricted, and, according to the SEC, U.S. persons were able to and did purchase mTokens.

In addition, the SEC noted that 250 million DMG governance tokens were originally minted on the Ethereum blockchain, of which, 80 million were allocated to respondents, 20 million were allocated to other parties, and 150 million were to be offered and sold over time. The respondents conducted an initial coin offering of 25 million DMG tokens, first to private investors and then to the general public at auction. They later sold tokens to a market maker and distributed tokens through a Uniswap liquidity pool smart contract enabling anyone to trade into and out of DMG tokens with other digital assets. The SEC observed that no efforts were undertaken to offer and sell DMG tokens to only accredited investors or to take reasonable steps to verify accredited investor status. As with the mToken sales, no KYC documentation was required. In the first stage of the ICO, U.S. persons were expressly invited to participate; however, an effort was made to limit the second stage of the ICO to non-U.S. residents by using an internet protocol (IP) blocker, but that effort failed and ultimately, U.S. persons purchased DMG tokens in both stages of the ICO.

The SEC analyzed the tokens under the *Howey* investment contract test as well as the *Reves* family resemblance test used to determine whether a note is a security.[4] In *SEC v. W.J. Howey Co.*,[5] the Supreme Court held that whether something constitutes an investment contract and, therefore, a "security," depends on "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." In *Reves v. Ernst & Young*,[6] the Supreme Court held that "[a] note is presumed to be a 'security,' and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of . . . four factors . . .) to one of the enumerated categories of [commercial/consumer] instrument[s]" that are not treated as securities for federal securities law purposes.[7] The four factors to be considered in determining whether a particular "note" bears a "family resemblance" to one of the specified categories of commercial/consumer instruments are: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) the existence of another regulatory scheme which significantly reduces the risk of the instrument, thereby rendering application of the federal securities laws unnecessary.

"Security" Status Analysis

The SEC concluded that the mTokens were securities because they were notes and also because they were offered and sold as investment contracts. It concluded that the DMG tokens were offered and sold as investment contracts and, thus, were securities as well.

In reaching its conclusions as to the security status of the tokens, the SEC considered various assertions made in the DMM platform's White Paper and website. It noted that the White Paper touted the mTokens as a way for investors to earn a 6.25% consistent return on digital assets "'backed by real-world assets that generate income greater than interest owed . . . .'" To earn this return, as the SEC explained, (1) investors deposit a specified digital asset (such as Ether) to a smart contract in exchange for mTokens, (2) the deposited digital asset are used to acquire income producing assets visible on chain, (3) the assets would pay out interest to DMM, and (4) mTokens "'are freely swapped back'" by their holders in exchange for the original digital assets deposited plus interest.

As noted by the SEC, the White Paper described the DMG tokens as governance tokens, the holders of which would control the profits created by the DMM business and vote on changes to the business and the deployment of profits to purchase and then burn DMM tokens trading in the secondary trading market. The White Paper emphasized that the real-world assets backing the mTokens would generate between 8% and 12% interest, exceeding the 6.25% interest payable to mToken holders. Finally, the SEC noted that "DMG token sale proceeds would be used for purposes[,] including operations, protocol development, business development, funding loans for the introduction of additional asset classes into the mToken ecosystem, and seeding a secondary market."

The SEC also observed that DMG governance tokens were offered in exchange for an investment of money in the form of U.S. dollars and digital assets, and the proceeds of the DMG token sales were pooled to fund DMM, create profit, and boost the value of the investment. Purchasers had a reasonable expectation that they would earn profits derived from the respondents' essential efforts managing DMM's day-to-day mToken business and creating a trading market for DMG tokens. The SEC downplayed the DMG token voting rights, which conferred the right to vote on some proposals to change DMM's business (such as the digital assets to accept from investors) and underscored that DMG token holders had no role in running DMM's core business identifying, buying, and servicing loans and then using the proceeds to pay mToken holders. The SEC advised that a right to vote on some aspects of the business would not preclude the token from being treated as a security, emphasizing that "[d]etermining whether a transaction involves a security does not turn on labelling – such as characterizing a token as [a] 'governance token' – but instead requires an assessment of 'the economic realities underlying a transaction [citation omitted]."

The SEC applied the *Reves* four-part analysis for notes and concluded the mToken are securities. Although not stated in its order, the SEC must have concluded that the mToken arrangement was equivalent of note and that the absence of an actual note specifying an obligor and payee did estop the arrangement from treatment as a note under the definition of security in the Securities Act and Exchange Act. Applying *Reves*, the SEC noted the following:

1. mTokens were sold to raise fund for general use in the DMM business (namely to purchase income-generating assets to pay interest on redeemed mTokens and excess interest to DMG token holders), and purchasers bought mTokens solely to earn the 6.25% interest on their digital assets.

2. mTokens were offered and sold to the general public.

3. mTokens were promoted as an investment, specifically as a way to earn a consistent return of 6.25% on digital assets.

4. No other regulatory scheme or other risk reducing factors exist with respect to the mTokens.

The SEC also noted that mTokens were offered and sold as investment contracts. The tokens were sold in exchange for an investment of money in the form of digital assets and the respondents pooled proceeds in smart contracts and represented that the proceeds would be used to buy assets that would generate income to be split among the smart contracts and paid out to token holders upon redemption. The respondents claimed their experience, combined with their selection of assets for purchase, would generate sufficient interest to pay 6.25% interest to token holders. The SEC concluded that respondents created a reasonable expectation that purchasers would earn profits derived from their efforts managing the DMM business.

No registration statement was filed or in effect with the SEC for the mToken and DMG token offerings, nor did the offerings qualify for an exemption from registration. As a result, the SEC concluded that the respondents violated Sections 5(a) and 5(c) of the Securities Act when they offered and sold the tokens.

False and Misleading Representations

In addition to the Securities Act registration violations, the SEC order emphasizes that the respondents made materially false and misleading representations concerning the operations and profitability of DMM when marketing the tokens. The DMM website publicly displayed a detailed list of car loans secured by vehicles and the respondents represented to investors that DMM's assets both protected against losses and ensured surplus income. The SEC noted that the respondents disclosed in a YouTube video that "'[t]he underlying value of the ecosystem are hard, realworld assets … [T]hey're overcollateralized [] and we have a first lien, senior-secured position. What that means is if anything goes wrong, we actually get to recover the assets.'" Separately, the respondents failed to disclose a significant roadblock encountered in the business, i.e., they did not account for fluctuations (particularly appreciation) in the digital assets underlying the mTokens. The SEC also pointed out that the respondents falsified lien documentation to conceal the fact that the car loans backing the mTokens had not been transferred to DMM and personally funded payments to redeeming mToken holders to make it appear that DMM assets generated interest.

As a result of the false and misleading representations, the SEC concluded that the respondents violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

Sanctions

On February 5, 2021, the respondents announced that DMM was shutting down and they voluntarily ceased offering and selling mTokens by disabling the DMM website and redirecting website visitors to a page where they could redeem outstanding mTokens. The respondents took steps to return and/or preserve DMM assets for the benefit of mToken and DMG holders and used personal funds to provide sufficient funding to the mToken smart contracts to enable the redemption of all outstanding mTokens for the original digital asset amount and interest accrued. The respondents also withdrew the DMG tokens from the Ethereum blockchain liquidity pool contract to which they had contributed the tokens.

Despite these remediating efforts, the respondents agreed to sanctions in the settlement with the SEC. The respondents consented to an order cease and desist any future violations, the two founders agreed to an officer and director bar for five years, the respondents agreed to disgorge $12,949,354, plus $258,052 in prejudgment interest, and the two founders each agreed to fines of $125,000.

Takeaways

The SEC's action against DMM is instructive insofar as it makes clear that decentralization of DeFi token networks does not provide a safe harbor from the treatment of tokens as securities. The two founders who conceptualized the investment product, organized and directed the development of the code used to create the smart contract technology underpinning the tokens, and conducted the token sales were readily determined to be responsible for the securities law violations. The absence of an actual note in an arrangement (tokenized or otherwise) under which digital assets are transferred in exchange for a specified interest or yield will not stop the SEC from examining the arrangement as a note (and an investment contract) within the definition of security. Thus, any product offering an investment yield in exchange for digital assets, irrespective of whether the underlying network is decentralized, will likely be scrutinized by the SEC as a securities offering requiring registration under the Securities Act or an exemption therefrom.

The SEC's action against DMM serves as a cautionary reminder that more scrutiny of the digital asset marketplace can be expected from the SEC under Chairman Gensler's leadership, particularly as the agency adheres to his mantra to "take our authorities as far as they go" and as he lobbies Congress for "additional . . . authorities to prevent transactions, products, and platforms from falling between regulatory cracks."

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings New York lawyer:

Michael L. Zuppone
1.212.318.6906
michaelzuppone@paulhastings.com

[1] In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree, SEC Release Nos. 33-10961 and 34-92588 (August 6, 2021).

[2] Gary Gensler Remarks Before the Aspen Security Forum (August 3, 2021) (The American public is buying, selling, and lending crypto on these trading, lending, and DeFi platforms, and there are significant gaps in investor protection); *See also Crypto bros stay loyal despite gathering crackdown,* CyberBizSource (August 6, 2021) *available at* https://cyberbizsource.com/2021/08/06/crypto-bros-stay-loyal-despite-gathering-crackdown/.

[3] In the Matter of Prosper Marketplace, Inc., SEC Release No. 8984 (November 24, 2008).

[4] Section 2(a)(1) of the Securities Act defines a "security" as:

[A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The definition of "security" in Section 3(a)(10) of Exchange Act is, in all relevant respects, identical to the definition of that term in the Securities Act.

[5] *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[6] *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

[7] The list includes: (i) a note delivered in consumer financing, (ii) a note secured by a mortgage on a home, (iii) a short-term note secured by a lien on a small business or some of its assets, (iv) a note evidencing a "character" loan to a bank customer, (v) short-term notes secured by an assignment of accounts receivable,(vi) a note which simply formalizes an open-account debt incurred in the ordinary course of business and (vii) notes evidencing loans by commercial banks for current operations. *Id* at 66.