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Crypto Yield Products in the Crosshairs

J. Ashley Ebersole and Brett R. Orren*

The authors of this article discuss concerns arising after a major U.S. cryptocurrency exchange's receipt of a Wells Notice from the Securities and Exchange Commission, which threatened charges for violating Section 5 of the Securities Act in connection with the planned launch of a "yield farming" product.

A major U.S. cryptocurrency exchange recently disclosed its receipt of a Wells Notice from the Securities and Exchange Commission ("SEC"), which threatened charges for violating Section 5 of the Securities Act in connection with the planned launch of a "yield farming" product ("Yield Product"). These products allow users to deposit their crypto and earn a yield, which is generated by the wallet, custodian, or platform's lending that deposited crypto out to others (similar to fiat currency or securities lending).

Because Section 5 broadly prohibits offering any security absent SEC registration, the Wells Notice has raised questions and concerns about the legal status of the myriad existing Yield Products across the cryptosphere. These concerns are exacerbated by the dearth of information from the SEC regarding the Wells Notice (and, by the exchange's account, the SEC staff's refusal to share the analysis or reasoning that underlie the claimed violations).

Law That May Be in Play

The question has been asked "how can lending be a security?" Given the different varieties of securities and the SEC's history in this space, it is perhaps more pertinent to ask whether lending can be an investment contract or a note (which are the contexts for the SEC's principal analyses of what constitutes a security). While we cannot claim to be privy to the SEC's thoughts or reasoning here, history and interactions with the agency and its digital asset/crypto activities lead us to think its position here may be similar to that

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advanced in the 1985 case *Gary Plastic Packaging Corp. v. Merrill Lynch*.[1]

While *Gary Plastic* applied *SEC v. W.J. Howey Co.*'s[2] "investment contract" analysis, considering Yield Products under the familiar "family resemblance" test from *Reves v. Ernst & Young*[3] for "notes" also yields potential clues. These principles-based "tests" require fact-specific analysis, and so cannot provide generic answers about any particular Yield Product's status under them.

Howey

The *Howey* Court held that offering and selling interests in Florida orange groves to hands-off investors who were located remotely constituted a variety of security known as an investment contract. "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[4]

An agreement constitutes an investment contract when all four factors are met:

1. Investment of capital.
2. In a common enterprise.
3. With a reasonable expectation of profits.
4. Derived from efforts of third parties.

A key factor in *Howey* was that the agreement between the investors/purchasers and the offeror/seller involved more than just the interests in land and fruit. Because the purchasers lived out of town and had no farming expertise, the agreement de facto required engagement of a service to harvest and commercialize the citrus, and entitled the purchaser to participate in profits generated therefrom. The Court thus found the agreement was an investment contract security.

Gary Plastic

The U.S. Court of Appeals for the Second Circuit in *Gary Plastic* applied *Howey* to analyze whether a Merrill Lynch investment product involving bank certificates of deposit ("CDs") could qualify as a security. The Supreme Court had already held in *Marine*

Bank v. Weaver[5] that Federal Deposit Insurance Corporation ("FDIC")–insured CDs are generally not securities. But Merrill Lynch's product offered clients not just CDs, but a selection of CDs Merrill had purchased from banks whose financial soundness it had vetted. Further, Merrill solved the typical hang-up preventing many investors from buying CDs (i.e., the requirement that money be locked into the CD for a predetermined time period) by creating a secondary market to provide liquidity for investors who wanted to resell their CDs before the end of their defined term.

The Second Circuit recognized that Merrill's offering involved not merely a garden-variety bank CD, but rather a new product that also included financial vetting of the issuing bank and a promise of liquidity for resale. The court held that Merrill's efforts to enhance the CDs with these features transformed them into investment contract securities.

The SEC's position on Yield Products will obviously become clear over time. But, whether or not the case is actually at work in the context of the recent Wells Notice, *Gary Plastics* illustrates how investment product vendors may unwittingly offer investment contracts.

Reves

In *Reves v. Ernst & Young*, the Court analyzed whether a demand note was a security. The Court said that *Howey*'s investment contract analysis did not control the status of notes, which are presumed to be securities under the Securities Act. Rather, the *Reves* Court said notes with a commercial purpose, rather than an investment one, are generally not securities, and held that a note is a security unless it falls within, or resembles, those categories of instruments determined not to be securities.[6] Under *Reves*, notes must be examined under the "family resemblance" test's factors, considering:

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 [to reduce] the risk of the instrument, thereby rendering application of the Securities Act unnecessary."[7]

Reves' analysis may thus be even less precise than *Howey*'s, though its factors are arguably more straightforward.

Yield Products do not involve instruments that, *per se*, generate yield without additional intervening actions (such as depositing stablecoins or other cryptocurrency with a platform, which then lends them out to generate a return). Because Yield Products involve an investment offered to the general public with a promised rate of return and governed by no alternative regulatory scheme, *Reves* could apply, depending on the Product's structure. But *Howey* could also be at work, recalling its application in *SEC v. Edwards*, where the Supreme Court held "that an investment scheme promising a fixed rate of return can be an 'investment contract' and thus a 'security.'"[8] The cynic in us suspects the SEC's analysis of Yield Products may not delineate between those product features that are more salient under either *Howey* or *Reves*, and may instead be applying either—or even both—analyses,[9] perhaps with *Gary Plastic* at work in the background.

Potential Solutions?

Some have seen potential avenues around the SEC's apparent conclusion that Yield Products violate the registration provisions of the Securities Act by asking whether these products carry the risk with which securities are typically associated (particularly when such products involve stablecoins). However, even very low investment risk has been sufficient for investment products to be deemed investment contracts. For example, the Supreme Court has held that insurance annuity contracts are investment contracts, despite the "substantially" reduced investment risk assumed by the contract holder.[10]

Although the investment risk overall may be low, the Court has said annuitants under these contracts bear the entire risk of small, or possibly non-existent, cash payments based on the investment efforts of others. Moreover, courts have previously held that products may have "risk of loss is sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed."[11] Conversely, courts have found risk of loss sufficiently diminished to alter this analysis in the context of FDIC-insured CDs, as noted above.[12] But such circumstances would appear difficult to replicate outside the context of regulated, government-insured products, which currently do not exist in the Yield Products space.

Platforms offering Yield Products could always register those offerings with the SEC, though that process can be cumbersome and expensive, and it subjects the issuer to periodic reporting obligations going forward. However, there is the potential to apply the Securities Act's exemptions from registration. Indications are that the SEC's analysis concludes Yield Products may involve securities, whose offering is governed by Section 5 of the Act and its requirement that any such transactions must be registered with the SEC.

Among the exemptions that could provide a solution are Regulation A or Rule 506 under Regulation D (though limited largely to Accredited Investors):

- *Regulation A*:[13] Provides an exemption from registering a public offering of securities, as long as certain requirements are met and required disclosures are made. Regulation A has two tiers permitting offerors to raise $20 million in any 12-month period (Tier 1) or $75 million in any 12-month period (Tier 2). (Tier 2's requirements include audited financials of the offeror, and required ongoing periodic disclosures thereby.)
- *Regulation D, Rule 506*:[14] Rule 506's provisions exempt companies from registering offerings that are made only to an unlimited number of accredited investors and—for 506(b)—up to 35 non-accredited, sophisticated investors. The 506(c) exemption permits general solicitation and advertising in connection with the offering, while 506(b) does not.

Other exemptions from registration, or alternatives like retail-investor products offered under the Investment Company Act, may prove more appropriate for a particular situation, and a skilled securities lawyer may advise on a favored approach.

Conclusion

We must again emphasize that the precise facts behind the reported Wells Notice and the SEC's analysis remain unknown, and different law and conclusions may apply to different products from different providers. This underscores that many may find these analyses unsatisfying until the situation is more fully unfolded.

Notes

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1. *Gary Plastic Packaging Corp. v. Merrill Lynch*, 756 F.2d 230 (2d Cir. 1985).
2. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).
3. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).
4. *Howey*, 328 U.S. at 301.
5. *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982).
6. These "non-security" notes include: (1) consumer financing notes, (2) residential mortgage notes, (3) short-term notes secured by a small business or its assets, (4) notes involving a loan to a bank customer based on creditworthiness or reputation, (5) short-term notes secured by accounts receivable, (6) notes reflecting an open-account debt incurred in the ordinary course of business, or (7) notes involving loans by commercial banks for current operations.
7. *Reves*, 494 U.S. at 67-70.
8. *SEC v. Edwards*, 540 U.S. 389, 397 (2004).
9. This was the SEC's approach in the August 2021 Order against Blockchain Credit Partners d/b/a DeFi Money Market, which concluded that one token qualified as both an Investment Contract under *Howey* and a Note under *Reves*. Exch. Act Rel. No. 92588 (Aug. 6, 2021).
10. *SEC v. United Ben. Life Ins. Co.*, 387 U.S. 202, 211 (1967). *See also SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 71-72 (1959).
11. *United States v. Carman*, 577 F.2d 556, 563 (9th Cir. 1978); *see El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900, 95 (1974) (relying on *Howey* and determination regarding presence of risk capital).
12. *Marine Bank*, 455 U.S. at 560.
13. 17 C.F.R. § 230.251.
14. *Id.* at § 230.506.