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Decentralized Finance: The Next Frontier of SEC Enforcement

The Capital Commitment Blog on **February 10, 2022**

The SEC's push to regulate the next generation of blockchain-based applications will likely give rise to disputes and enforcement actions, particularly in the developing decentralized finance (DeFi) space. Although DeFi has the potential to enhance or replace traditional financial products by speeding execution and reducing transaction costs using blockchain technology, the SEC presumes that actors in this space are generally offering "securities" subject to its jurisdiction.

For example, in addition to the SEC's continued targeting of allegedly fraudulent ICO offerings, Chairman Gary Gensler has repeatedly called for cryptocurrency exchanges to register with the SEC. Stressing investors' protection, Gensler's position is that platforms that trade or lend crypto are subject to SEC regulation. Meanwhile, the SEC has proposed amendments to Reg ATS that appear to define a securities "exchange" broadly enough to cover those who create protocols for decentralized crypto trading.

In the SEC's first action involving DeFi technology, the SEC sued individuals and an entity offering a decentralized token product known as DeFi Money Market. The SEC found that the smart contracts in that matter qualified as securities subject to regulation because they were offered as investment contracts under the *Howey* test.

The SEC has also informed at least one cryptocurrency exchange that it would be sued if it offered a product enabling customers to earn interest on crypto deposits. Coinbase sought SEC approval to launch a stablecoin-based lending program, which resulted in a *Wells* notice from the SEC, warning the company that it would be sued if the program went forward. Shortly after, Coinbase decided to cancel its launch of the program.

State regulators have also taken action against another major crypto institution for offering a similar type of product, alleging that it sold unregistered securities by offering interest to customers who made crypto deposits with the company.

While innovation continues to proceed at a breakneck pace, we expect the SEC will work harder than ever to keep up, and to continue to use a heavy hand on the DeFi industry and other crypto-adjacent players, including pursuing individual defendants in the space.

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