

Regulatory and Enforcement Alert

Cryptocurrency Lending Firm BlockFi Announces \$100 Million Settlement With SEC and State Regulators Over Unregistered Sale of BlockFi Interest Accounts

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In a first-of-its-kind enforcement action, the SEC announced today settled charges against BlockFi Lending LLC for failing to register the offers and sales of its retail crypto lending product and violating registration provisions of the Investment Company Act. The SEC further found that BlockFi made materially false and misleading statements concerning the level of risk in its loan portfolio. As part of the settlement and parallel actions by state securities regulators, BlockFi agreed to pay \$100 million in penalties and fines, as well as cease offering its interest-bearing BlockFi Interest Accounts (“BIAs”) to new U.S. customers and accepting new investments from current U.S. investors, and bring its business within the provisions of the Investment Company Act within 60 days. BlockFi also will be required to register its new product, BlockFi Yield, in accordance with SEC rules for the offering of securities. The settlement is the first major enforcement action in the crypto lending sector for SEC Chair Gary Gensler and the case—particularly the allegations that investors were deceived as to the safety of their investments—will likely become an important talking point in the SEC’s intensifying crackdown on the crypto sector.

BlockFi, a New Jersey-based cryptocurrency lending and trading platform, offered and sold BIAs to investors who deposited cryptocurrency in exchange for variable monthly interest payments. BlockFi generated the interest paid to these investors by deploying assets in various ways, including loaning crypto assets to institutional and corporate borrowers, and investing in equities and futures. Account holders received a variable rate of interest tied to the yield on BlockFi’s investment—which, in recent days, was advertised as “up to 9.25% APY.” The company warned that neither rates nor deposits are guaranteed, and that BIA losses are not insured by the Federal Deposit Insurance Corp. or the Securities Investor Protection Corp. Such lapses in investor protection have led to increased regulatory scrutiny, with SEC Chair Gary Gensler stating publicly that crypto platform investors should receive the same protections as they receive in other asset classes.¹

¹ Gary Gensler, Chair, U.S. Sec. & Exch. Comm’n, Remarks Before the Investor Advisory Committee (Dec. 2, 2021).

The SEC Order Concludes That BlockFi Violated Securities Laws in Three Respects:

First, while BlockFi previously took the position that a BIA “is not a security and should not be regulated as one,”² the SEC concludes the opposite—that the BIAs are securities and should be registered because they fit the definition of an “investment contract” under the test established by *SEC v. W.J. Howey Co.*³ Under the *Howey* test, an investment contract is “an investment of money in a common enterprise with profits to come” primarily from the efforts of others. Further, the SEC concludes that the BIAs are securities because they fit the definition of “notes” under the four-part “family resemblance” analysis established by *Reves v. Ernst & Young*.⁴ Under *Reves*, a note is presumed to be a security unless it falls into certain judicially created categories of financial instruments that are not securities, or if the note in question bears a “family resemblance” to notes in those categories.

Second, the SEC concludes that BlockFi operated for more than 18 months as an unregistered investment company in violation of the Investment Company Act because it issued securities, and held more than 40% of its total assets (excluding cash) in investment securities, including loans of crypto assets to institutional borrowers.

Third, according to the SEC’s Order, BlockFi misrepresented on its website that its institutional loans were “typically” over-collateralized, when in fact, most institutional loans were not. Accordingly, the company is alleged to have materially overstated the degree to which it secured protection from defaults by institutional borrowers from collateral.

While the SEC continues to file enforcement actions targeted at specific digital asset securities, it now appears to have turned a sharp focus towards crypto exchanges⁵ and lending products. The \$100 million in penalties and fines is among the largest regulators have imposed on a cryptocurrency firm. Shortly after state regulators brought regulatory actions against BlockFi last July, Chair Gensler expressed concern that many cryptocurrencies, “crypto trading platforms, lending platforms, and other ‘decentralized finance’ [(“DeFi”)] platforms” involved offers or sales of unregistered securities.⁶ A month later, he told the Senate Banking Committee that the SEC would continue to focus on the crypto industry and lenders specifically: “We just don’t have, I believe, enough investor protection in crypto finance, the issuance of these tokens, the trading, and particularly, the lending.”⁷

² @BlockFi, Twitter (July 22, 2021, 4:02 PM), <https://twitter.com/BlockFi/status/1418300548726599680/>.

³ 328 U.S. 293 (1946).

⁴ 494 U.S. 56, 64–66 (1990).

⁵ See *SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange*, U.S. Sec. & Exch. Comm’n (Aug. 9, 2021), <https://www.sec.gov/news/press-release/2021-147> (announcing unregistered online digital asset exchange Poloniex LLC’s \$10 million settlement with the SEC in connection with the entry of a cease-and-desist order against the platform).

⁶ Gary Gensler, Chair, U.S. Sec. & Exch. Comm’n, Remarks Before the Aspen Security Forum (Aug. 3, 2021).

⁷ *Lawmakers Grill SEC Chair Gensler on Crypto*, Yahoo! News (Sept. 14, 2021), <https://news.yahoo.com/lawmakers-grill-sec-chair-gensler-162501648.html>.

Today’s action against BlockFi underscores how—regardless of how a DeFi platform is branded or described—the SEC will scrutinize the economic realities of the platform’s underlying lending activity with the significant flexibility afforded by both the *Howey* and *Reves* tests. And while the SEC Order and press release position BlockFi’s decision to register as securities the offering and sale of its BlockFi Yield product via a traditional Form S-1 process as reflective of the SEC’s willingness to engage with crypto market participants, Commissioner Hester Peirce, in a pointed dissent, disagreed, characterizing the SEC’s regulatory process as “difficult, lengthy, unproductive, and labyrinthine.”

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