ALERT MEMORANDUM

SEC Takes Aim at Crypto Lending in BlockFi Settlement; Calls on Market to "Come into Compliance": Is Regulatory Clarity Coming Soon?

February 28, 2022

On February 14, 2022, the Securities and Exchange Commission announced a settled enforcement action charging BlockFi Lending LLC ("BlockFi") with allegedly failing to register its interest-bearing crypto lending product as a security, failing to register itself as an investment company, and making false statements about its product. BlockFi agreed to pay a total of $100 million in fines to the SEC and a consortium of states.[1] As the SEC noted in the settlement Order, BlockFi publicly announced on the same day that it intended to register a new interest-bearing crypto product as a security, and the Commission provided BlockFi 60 days to either register as an investment company or demonstrate that it was no longer required to do so.[2]

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[1] The state actions were based on the failure to register securities under state law. *See, e.g.*, BlockFi Lending LLC, Consent Order, State of New Jersey Bureau of Securities (Feb. 14, 2022), https://www.nj.gov/oag/newsreleases22/2022-0214-BlockFi-Consent-Order.pdf.
[2] Under the state settlements, BlockFi has also agreed to file state securities registrations for its new crypto lending product. *See, e.g.*, *id.*

The settlement sounds a clear message to entities offering customers a return in exchange for deploying their crypto assets—whether in the form of lending, staking, or similar services—that the SEC may soon be targeting those services as unregistered securities offerings. The SEC's Order raises a host of unanswered questions about BlockFi's future, but signals potential willingness by the SEC to approve some form of regulated crypto lending. However, distinct regulatory clarity will have to wait until BlockFi chooses which path to take and receives the SEC's verdict.

Background

In 2019, BlockFi began offering BlockFi Interest Accounts ("BIAs"), which are essentially interest-bearing digital asset accounts. With these accounts, a customer loans crypto assets to BlockFi and, in exchange, is promised a variable monthly interest payment based on the yield BlockFi generates by pooling BIA investors' crypto assets and deploying them in various ways, such as lending crypto to institutional borrowers, providing crypto staking services, purchasing crypto asset trust shares and interests in private funds, and investing in equities and futures.[3] With limited exceptions, customers are entitled to recoup their loaned assets and accumulated interest on demand. By 2021, BlockFi held as much as $14.7 billion in BIA investor assets.[4]

In the settlement, BlockFi consented to the entry of an administrative Order Instituting Cease-and-Desist Proceedings (the "Order"), while neither admitting nor denying the SEC's allegations.[5] It charged three violations: (1) Section 5(a) and 5(c) of the Securities Act of 1933 for failure to register BIA as a security, (2) Section 7(a) of the Investment Company Act of 1940 for failure to register BlockFi as an investment company, and (3) Sections 17(a)(2) and 17(a)(3) of the Securities Act for making a false or misleading statement in the offer or sale of a security.

Failure to Register BIA as a Security

It was no surprise that the SEC targeted a crypto lending product as an unregistered security. In July 2021, BlockFi was alerted by New Jersey and other state regulators that it may have been selling unregistered securities.[6] Then, in September 2021, Coinbase announced it would not proceed with the planned launch of its interest-bearing "Lend" product, after the SEC threatened to sue to stop the release.[7] Also in September 2021, the SEC filed suit in federal court against BitConnect and its top executives, claiming that the company's crypto "Lending Program" was both an unregistered security and a massive fraud in which the executives misappropriated much of the $2 billion BitConnect raised.[8] What was notable in the BlockFi settlement was how the SEC came to conclude BlockFi's product was a security. As it has done in at least one other crypto settlement,[9] the SEC asserted that BIAs were *both* a "note" under the *Reves* test and an "investment contract" under the more commonly invoked *Howey* test.

The Reves Test: In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Supreme Court held that "because the Securities Acts define 'security' to include 'any note,'" courts should "begin with a presumption that every note is a security."[10] The presumption that "an instrument denominated a 'note' is a security . . . may be rebutted only by a showing that the note bears a strong resemblance" to instruments that had been

[3] BlockFi Lending LLC, AP File No. 3-20758 (Feb. 14, 2022) at 7, https://www.sec.gov/litigation/admin/2022/33-11029.pdf.
[4] *Id*. at ¶ 1.
[5] *Id*.
[6] BlockFi Inc., Summary Cease and Desist Order, State of New Jersey Bureau of Securities (July 19, 2021), https://www.nj.gov/oag/newsreleases21/BlockFi-Cease-and-Desist-Order.pdf.
[7] Matthew Goldstein & Ephrat Livni, *Coinbase says the S.E.C. has Threatened to Sue It over a Plan to Pay Interest*, N.Y. TIMES (Sept. 8, 2021), https://www.nytimes.com/2021/09/08/business/coinbase-sec.html#:~:text=Daily%20Business%20Briefing-,Coinbase%20says%20the%20S.E.C.%20has%20threatened%20to%20sue%20it%20over,Securities%20and%20Exchange%20Commission%20said.
[8] Press Release, *SEC Charges Global Crypto Lending Platform and Top Executives in $2 Billion Fraud*, U.S. SEC. & EXCH. COMM'N (Sept. 1, 2021), https://www.sec.gov/news/press-release/2021-172.
[9] *See* Blockchain Credit Partners, AP File No. 3-20453 (Aug. 6, 2021) at ¶50-54.
[10] 494 U.S. at 66.

judicially determined not to constitute securities, primarily on the basis that they were used for commercial rather than investment purposes. This "family resemblance" analysis looks to four factors: (1) the motivations of the buyer and seller, (2) whether the instrument's "plan of distribution" involves "common trading for speculation or investment," (3) what the "reasonable expectations of the investing public" would be, and (4) whether "some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument."[11]

Some observers may be surprised that the SEC applied the *Reves* test here at all. The agency has brought numerous cases against businesses that use investor funds to finance commercial loans or accounts receivable, involving very similar economic arrangements to BlockFi, but in those cases, the instrument was denominated as a note and there was no dispute it could be considered one.[12] Here, however, the SEC is doing something different. The SEC did not allege that BlockFi and its investors entered into notes; indeed, the SEC did not spell out how the BIA arrangement was memorialized. The SEC used *Reves* not just to state its view on whether a note is a security, but also to establish whether the arrangement could be characterized as a note in the first place.[13] It remains to be seen how courts would respond to this new application of *Reves*.

The Howey Test: Although the SEC sought in the Order to treat the BIAs as notes and thus governed by *Reves*, it asserted that the BIAs also qualified as "investment contracts"[14] and thus were governed by the test set forth in *SEC v. W.J. Howey Co*.[15] This is not surprising in light of the novel use of *Reves* to argue that an arrangement not expressly alleged to involve notes should nevertheless be treated as if it did.

In any event, the SEC's *Howey* analysis was straightforward. *Howey* defined an investment contract as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[16] The SEC concluded that these criteria were satisfied by the BIAs, through which BlockFi "pooled the BIA investors' crypto assets, and used those assets for lending and investment activity that would generate returns for both BlockFi and BIA investors," such that "each investor's fortune was tied to the fortunes of the other investors" and hinged on BlockFi's deployment of the assets.[17] The SEC appears intent on telegraphing to the marketplace that it will use both tests together to cast a wide net, irrespective of the particular form of the product or arrangement at issue.

Failure to Register BlockFi as an Investment Company

The SEC also charged BlockFi with violating Section 7(a) of the Investment Company Act for failure to register as an investment company.[18] The SEC alleged that BlockFi was acting as an investment company because (1) it was an issuer of securities in the form of BIAs and (2) it was engaged in the business of investing, reinvesting, owning, holding, or trading in securities that are worth more than 40 percent of its total assets. According to the SEC, BlockFi's investment securities included "loans of crypto assets and U.S. dollars to counter parties, investments in

[11] 494 U.S. at 67.

[12] For example, the SEC recently argued in litigation that both *Reves* and *Howey* applied to a security—*notes* sold to fund a payday lending business—but in that case the court did not reach the *Howey* analysis. *SEC v. Sky Group USA LLC*, 2022 WL 309378 (S.D. Fla. Feb. 2, 2022). It is not surprising the court in *Sky Group* did not address *Howey* in light of the Supreme Court's treatment of *Howey* in this context, as we discuss below.

[13] *See* Order at ¶ 30 ("Applying the *Reves* four-part analysis, the BIAs were notes and thus securities.").

[14] Order at ¶ 30 (alleging that in addition to being *Reves* notes, "the BIAs were also offered and sold as 'investment contracts'").

While the *Reves* Court "rejected the approaches of those courts that have applied" only the *Howey* test to notes, 494 U.S. at 64, the SEC appears to read *Reves* as permitting application of both tests to the same transaction.

[15] 328 U.S. 293 (1946).

[16] *Id*. at 298-99.

[17] Order at ¶ 31.

[18] Section 7(a) makes it unlawful for an unregistered investment company to "[o]ffer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security" or to "engage in any business in interstate commerce." 15 U.S.C. § 80a-7(a).

crypto asset trusts and funds, and intercompany receivables,"[19] with particular focus on "[l]oans that BlockFi made to counter parties."[20] The SEC has historically taken the position that "securities" is defined broadly under the Investment Company Act and can include loans that would not constitute securities under the 1933 and 1934 Acts.[21]

The Order does not explain how BlockFi can remedy its Investment Company Act dilemma. If BlockFi were to register as an investment company, the Act would prohibit it from issuing debt securities, as noted by Commissioner Hester Peirce in her dissent,[22] yet the Order suggests that BlockFi's proposed new product, BlockFi Yield, will also be a debt-like security with an indenture. BlockFi could revive its argument that it is not required to register by qualifying as a "market intermediary," but the SEC clearly signaled in its Order that it does not view this as a viable approach.[23] BlockFi may instead be angling for what Commissioner Peirce suggested the Commission should do: "work with BlockFi" to "craft a bespoke set of conditions" under Section 6(c) of the Investment Company Act, which gives the Commission authority to exempt an entity from any or all provisions of the Act if the Commission deems it "necessary or appropriate in the public interest and consistent with the protection of investors."[24] As Commissioner Peirce noted, this exemptive authority could be used to craft any "additional protections" the SEC believes are necessary "to make up for not being covered by the Investment Company Act."[25] The SEC also could use the authority to exempt BlockFi from the prohibition on issuing debt securities while otherwise subjecting it to the Act, or craft other relief.

False and Misleading Statements

The SEC also brought a negligence-based fraud charge for violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. For two years, BlockFi described its institutional loans on its website as being "typically" over-collateralized, when in practice most institutional loans were not over-collateralized.[26] According to the SEC, the false over-collateralization statement meant that BIA investors "did not have complete and accurate information with which to evaluate the risk" to their investment if BlockFi's institutional borrowers defaulted.[27] The SEC's Order gives brief treatment to this two-year false statement, alleging only that "[t]hrough operational oversight, BlockFi's personnel failed to take steps to update the website statement."[28] The SEC press release likewise buried the fraud charge.[29] But the negligent fraud charge nonetheless served an important purpose for the SEC, providing a

[19] Order at ¶26.
[20] Order at ¶27; *see also id.* ¶37 (investment securities "include the loans that BlockFi made to counter parties").
[21] *See, e.g.,* DIV. INV. MGMT., U.S. SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 67 n.251 (May 1992); Treatment of Asset-Backed Issuers Under the Investment Company Act, 76 Fed. Reg. 55308, 55310 & n.17-18 (Sept. 7, 2011).
[22] Commissioner Hester M. Peirce, *Statement on Settlement with BlockFi Lending LLC*, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.sec.gov/news/statement/peirce-blockfi-20220214#_ftnref5 (citing Section 18 of the Investment Company Act).
[23] The SEC noted that BlockFi claimed to be a market intermediary, which along with certain brokers, underwriters, and dealers are exempt from ICA registration. "Market intermediary" is defined as an entity that regularly engages in transactions on both sides of the market for financial contracts, for example dealers in individually negotiated swaps and derivatives. But as the SEC concluded, BlockFi did not regularly stand on both sides of the market for a financial contract, and the BIAs were not financial contracts because they were not individually negotiated or drafted in response to customer inquiries. Order at ¶¶ 29, 38-39.
[24] In 2020, for instance, the SEC granted a Section 6(c) exemption to a consumer lending platform with seven conditions, including limiting its securities activities to lending. *See* Upstart Holdings, Inc., Inv. Co. Act Release No. 34124 (Dec. 1, 2020) (order), https://www.sec.gov/rules/ic/2020/ic-34124.pdf; Upstart Holdings, Inc., Inv. Co. Act Release No. 34088 (Nov. 9, 2020) (notice), https://www.sec.gov/rules/ic/2020/ic-34088.pdf; Upstart Holdings, Inc., AP File No. 812- (Nov. 5, 2020) (application), https://www.sec.gov/Archives/edgar/data/1647639/000119312520285907/d27815d40app.htm.
[25] Commissioner Hester M. Peirce, Statement on Settlement with BlockFi Lending LLC, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.sec.gov/news/statement/peirce-blockfi-20220214#_ftnref5.
[26] Order at ¶¶ 22-23, 35.
[27] *Id.* at ¶¶ 23, 35.
[28] *Id.* at ¶ 22.
[29] Press Release, *BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product*, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26.

clear investor protection rationale for applying the securities laws to BlockFi's crypto lending program.

Remedies and a Possible Path Forward

Securities Registration: The most instructive part of the SEC's Order is the announcement that BlockFi intends to pursue registration with the SEC of a new investment product called BlockFi Yield. The SEC's Order included diagrams depicting how the proposed structure of the BlockFi Yield product differs from the BIA structure. The most obvious differences are:

— *Separation of Issuer and Lender*. Parent company BlockFi Inc. will act as the BlockFi Yield issuer, will pay interest to investors, and will lend and borrow crypto with BlockFi Lending "as needed." BlockFi Lending will lend crypto to institutional borrowers and borrow crypto from institutional lenders and high-net-worth individuals. Under the existing BIA structure, BlockFi Lending was both the BIA issuer *and* the lender of crypto to institutional borrowers.

— *Trust Indenture Act Filings*. BlockFi will seek to register BlockFi Yield by filing an S-1 registration statement and an indenture and Form T-1 under the Trust Indenture Act of 1939. A Form T-1 is filed by the issuer of debt securities and provides information about its trustee, typically a bank or trust company.

There are plenty of unanswered questions about what BlockFi's new security will look like, including whether it will still have a variable return and be payable on demand, and whether BlockFi Lending will continue to engage in the same broad range of yield-generating activities in addition to borrowing and lending crypto assets. These and other features will shape how the SEC responds to the registration statement.

Existing accounts: Pending the outcome of its registration statement, BlockFi will stop opening new BIA accounts in the U.S. and stop accepting new assets into existing U.S. accounts.[30]

Regulatory registration: BlockFi also agreed that, within sixty days, it would "come into compliance with Section 7(a) of the Investment Company Act" by either filing a registration with the SEC, or by "[c]ompleting steps such that BlockFi is no longer required to be registered" and "providing the Commission with sufficient credible evidence" to that effect.[31] BlockFi has also committed to pursuing state registration. For example, as part of its settlement with New Jersey, BlockFi agreed that before it would offer or sell securities, it would apply to be a broker-dealer or agent in that state, engage a registered broker-dealer, or establish that it is exempt.[32]

Civil penalties: BlockFi will pay the SEC a $50 million civil penalty, while agreeing to pay an additional $50 million to the states to settle similar charges.[33] BlockFi was not required to disgorge any of the profits it received during the long period in which the Commission alleged it was in violation of the law. This contrasts with other settlements involving crypto companies, which have featured significant disgorgement but often smaller penalties.[34] It remains to be seen whether the no-disgorgement/high penalty

[30] Order at ¶ 42.
[31] Order at ¶¶ 43-44.
[32] BlockFi Lending LLC, Consent Order, State of New Jersey Bureau of Securities (Feb. 14, 2022) at ¶ 46, https://www.nj.gov/oag/newsreleases22/2022-0214-BlockFi-Consent-Order.pdf..
[33] BlockFi settled with 32 states acting together as the North American Securities Administrators Association. The $50 million state settlement is intended to be divided equally among the 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands, if BlockFi enters similar consent orders with each state.
[34] For instance, when Poloniex settled charges of operating as an unregistered digital asset exchange for two years, it disgorged profits of almost $8.5 million, while paying a $1.5 million penalty. Press Release, *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. Similarly, when three media companies GTV Media Group Inc., Saraca Media Group Inc., and Voice of Guo Media Inc. settled charges of conducting an unregistered offering of the GTV stock, G-Coins and G-Dollars, GTV and Saraca disgorged more than $434 million, and each paid a civil penalty of $15 million, while Voice of Guo disgorged more than $52 million and paid a civil penalty of $5 million. Press Release, *SEC Charges Three Media Companies with Illegal Offerings of Stock and Digital Assets*, U.S. SEC. & EXCH. COMM'N (Sept. 13, 2021), https://www.sec.gov/news/press-release/2021-175.

settlement, or the generous two-year payment plan allowed by the SEC and the states, mark a change in the SEC's approach to crypto settlements, or whether they are unique features of what appears to have been a heavily negotiated agreement.[35]

Key Takeaways

— The SEC is taking a broad view of what is a security, aggressively apply existing judicial tests, and looking past the labels on products to the underlying economic arrangement. The Order takes a pro-registration stance on yield-generating crypto products and services.

— The SEC made clear in its accompanying investor bulletin[36] and its focus on BlockFi's over-collateralization statements that it views crypto lending products as substantially more risky than traditional bank deposits. Market participants likely will want to consider addressing some of those risks, and consider whether and how they disclose them, if they hope to pass muster with the SEC.

— The existing regulatory regime for investment companies, with its prohibition on issuing debt securities, is a poor fit for crypto lending products with debt-like features. This could create an advantage for entities that can qualify for an exemption, like banks or brokers-dealers. On the other hand, if the SEC opts to use its exemptive authority and work with the industry to craft solutions, this would mark a sea change in the SEC's approach to crypto, one that Commissioner Peirce seems to doubt the SEC is actually interested in or capable of.

— Other market participants will have to weigh their options in light of Director of Enforcement Gurbir Grewal's warning that they "should take immediate notice of today's resolution and come into compliance with the federal securities laws."[37] Given this statement from the Enforcement Division, coming into compliance may involve lengthy negotiations with SEC staff, a freeze on new lending,[38] a settled enforcement action, and a hefty fine as the price of engagement.

Chair Gary Gensler wants the settlement to signal "the Commission's willingness to work with crypto platforms to determine how they can come into compliance with" the securities laws.[39] But the Order raises many unanswered questions and gives BlockFi and the SEC a short time period in which to address them. Commissioner Peirce said she doubts the SEC staff can deliver in that time frame. However, Chair Gensler rose to prominence by pushing the staff of the Commodity Futures Trading Commission to complete an aggressive Dodd-Frank rulemaking agenda under time pressure, and he has set a similarly blistering rulemaking pace at the SEC. Perhaps Chair Gensler will exert the same kind of pressure here.

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[35] The SEC also claimed to have considered BlockFi's "cooperation" and "remedial acts promptly undertaken," but did not describe the cooperation or remedial action and did not specify the particular benefit BlockFi achieved.

[36] Investor Bulletin, *Crypto Asset Interest-bearing Accounts*, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-97.

[37] Press Release, *BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product*, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26.

[38] BlockFi was ordered to stop accepting new BIA accounts and assets in the U.S., and at least one competitor has announced it will do the same. *See Changes to Nexo's Earn Interest Product in the U.S.*, NEXO, https://support.nexo.io/hc/en-us/articles/4439664841618-Changes-to-Nexo-s-Earn-Interest-Product-in-the-U-S- (last visited Feb. 28, 2022).

[39] Press Release, *BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product*, U.S. SEC. & EXCH. COMM'N (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26.