February 23, 2022

# SEC Settles Charges against BlockFi Lending

On February 14, 2022, in one of the largest penalties ever imposed in the crypto space, the Securities and Exchange Commission (SEC) settled charges against BlockFi Lending LLC (BlockFi).[1] The SEC charged BlockFi with failing to register as an "investment company" and failing to register its retail crypto lending product, BlockFi Interest Accounts (BIAs), as securities. The SEC also charged BlockFi with making materially false and misleading statements concerning the risks associated with BIAs. Although this was the SEC's first enforcement action against a crypto lending platform, the SEC's activity in the crypto space is intensifying significantly.[2]

## Background

Beginning in March 2019, BlockFi offered and sold BIAs to the public in the United States. BlockFi advertised BIAs as a tool for investors to "build their wealth," and promoted "great [interest] rates."[3] Investors could lend crypto assets to BlockFi and, in exchange, receive monthly interest payments in crypto. The returns generated for BlockFi and BIA investors were directly tied to BlockFi pooling the loaned crypto assets and lending and investing the pooled assets at its sole discretion. As of December 2021, BlockFi held approximately $10.4 billion in BIA investor crypto assets.

The critical case to determine whether a product is a "security" is set out under *SEC v. W.J. Howey Co.* (the "*Howey* Test").[4] The SEC found that the BIAs were securities under the *Howey* Test because there was (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) as a result of the efforts of others. Furthermore, the SEC found that the BIAs were "notes" and thus securities under the test articulated in *Reves v. Ernst & Young*.[5] Under *Reves*, a "note" is presumed to be a security unless it meets or resembles a category of exceptions, such as a note secured by a mortgage on a home. BIAs do not fall under the judicially created categories, nor do they bear a "family resemblance" to the exceptions, since BlockFi advertised and sold BIAs broadly to the public as investments that would yield high returns on loaned crypto assets, while BlockFi used the loaned crypto assets to operate its core business. Important to this analysis, no alternative regulatory scheme exists with respect to BIAs.

Therefore, because the BIAs were securities under both the *Howey* test and the *Reves* test, BlockFi should have filed a registration statement with the SEC for the offer and sale of BIAs. Exceptions to registration can apply, for example, if a firm offers the product only to a limited number of accredited investors. Here, however, BlockFi marketed the BIAs to a broad segment of the general public.

Further, the SEC found that BlockFi made materially false and misleading statements in the offer and sale of securities under Sections 17(a)(2) and 17(a)(3) of the Securities Act. BlockFi made several posts on its website regarding the level of risk in its loan portfolio, stating that the institutional loans BlockFi made were "typically" overcollateralized, when only about 17% of its crypto loans were overcollateralized from 2020 through June 2021. Therefore, BlockFi did not provide complete and accurate information regarding the risks to investors in the offer and sale of BIAs (deemed securities under the tests described above).

Last, the SEC found that BlockFi violated Section 7(a) of the Investment Company Act by failing to register as an investment company. Since BIAs met the definition of securities, BlockFi was therefore an issuer of securities and, from at least December 31, 2019 to at least September 30, 2021, held assets meeting the definition "investment securities" that had a value exceeding 40% of its total assets as set forth in Section 3(a)(1)(C) of the Investment Company Act. During that period, BlockFi was not registered as an investment company, and did not qualify for any statutory exemptions or exclusions by seeking an order from the SEC.

## The Settlement

As part of the settlement, BlockFi agreed to pay $50 million to the SEC and $50 million to thirty-two states in a parallel action, signaling cooperation between federal and state regulators. BlockFi also agreed to cease offering BIAs to new investors in the United States and cease accepting further investments from current U.S. BIA investors. BlockFi

indicated in a press release that it intends to submit a Form S-1 with the SEC for a new investment product, which, if approved, would be the first SEC-registered crypto interest-bearing security.[6] For now, BlockFi will not be allowed to engage in crypto lending in the United States until it registers its new crypto lending product on Form S-1, which can be a "months-long, iterative process,"[7] especially when crypto is involved. Additionally, the SEC found that BlockFi operated as an unregistered investment company. However, because BlockFi issues debt securities, it cannot register as an investment company and will need an exemption or exclusion from registration.[8] It is yet to be seen if this is feasible in the sixty-day time frame allotted to BlockFi under the terms of the settlement, even if granted a thirty-day extension.

In a pointed statement in response,[9] Commissioner Hester M. Peirce questioned whether the SEC's application of the securities regulatory framework to crypto lending is the most effective way to protect crypto lending customers. After all, she stated, there is no allegation here that BlockFi failed to pay its customers the money due to them. She argued that settlements of this type could stop crypto lending from being offered to customers in the United States. Far more important in her view is to encourage crypto firms to "come in and talk to [the SEC]" in order to encourage transparency around the terms and risks of crypto lending products. BlockFi's misrepresentations were, in her view, BlockFi's greater failing—but, even so, disproportionate to the combined $100 million penalty.

## Looking Ahead

As Commissioner Peirce predicts, the Order will likely have far-reaching consequences across the crypto lending industry in the United States. The SEC had previously made clear that it considered crypto lending products securities when it forced Coinbase to cancel its plans to roll out a crypto lending product in September 2021.[10] The increasing scrutiny of crypto lending products demonstrates that these and similar products are a particular focus of state and federal regulators. The regulatory burden may be too demanding for small players in the crypto space, who could be forced to withdraw these products altogether, despite their popularity amongst investors. Other companies offering similar products in the U.S. will have to either make their products compliant with securities regulations, or risk facing enforcement actions.

State and federal enforcement agencies agree that the approximately $3 trillion crypto industry needs clearer regulation. It is yet to be seen how the SEC will tackle decentralized platforms like DeFi and DAOs, or if a new regulatory framework will emerge altogether to deal with these innovations. Deputy Secretary of the U.S. Treasury Wally Adeyemo recently remarked that the U.S. government is seeking to create a regulatory landscape "that fosters responsible innovation, writing clear rules of the road that mitigate these risks while preserving the economic opportunities this technology creates."[11] Although the legal analysis in the SEC's Order against BlockFi is not definitive and BlockFi admitted to no wrongdoing, it is the clearest guidance available to crypto lending platforms operating in the United States.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

1. https://www.sec.gov/litigation/admin/2022/33-11029.pdf.
2. *See, e.g.*, https://www.sec.gov/news/press-release/2021-90; https://www.sec.gov/news/press-release/2021-145.
3. https://www.sec.gov/litigation/admin/2022/33-11029.pdf.
4. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).
5. *Reves v. Ernst & Young*, 494 U.S. 56, 64–66 (1990).
6. https://blockfi.com/pioneering-regulatory-clarity.
7. https://www.sec.gov/news/statement/peirce-blockfi-20220214.
8. *See* Section 18 of the Investment Company Act of 1940, 15 U.S.C. § 80-18. *See also* https://www.sec.gov/news/statement/peirce-blockfi-20220214.
9. https://www.sec.gov/news/statement/peirce-blockfi-20220214.
10. https://www.reuters.com/technology/sec-threatens-sue-coinbase-over-crypto-lending-programme-2021-09-08.
11. https://home.treasury.gov/news/press-releases/jy0466.