

February 17, 2022

# BlockFi to Pay \$100 Million to Settle with SEC and 32 States over Crypto Lending Business

On February 14, 2022, the SEC announced that it had entered into a consent order (the “Order”) with BlockFi Lending LLC (“BlockFi”), a New Jersey-based financial services company. The SEC found, among other things, that BlockFi had failed to register the offers and sales of its retail crypto lending product, BlockFi Interest Accounts (“BIAs”), and thus violated the registration and antifraud provisions of the Securities Act and the registration provisions of the Investment Company Act of 1940 (“ICA”). BlockFi agreed to pay a \$50 million penalty, cease its unregistered offers and sales of the BIAs and attempt to become ICA-compliant within 60 days. BlockFi also agreed to pay an additional \$50 million in fines to settle a group of parallel investigations—arising from the same conduct found by the SEC—initiated by 32 state attorneys general.

## The SEC’s Findings

According to the Order, investors used BlockFi’s BIAs to lend crypto assets to BlockFi in exchange for a variable monthly interest payment. BlockFi pitched its interest accounts as a way to earn “as high as 9.25 percent”<sup>1</sup> interest on cryptocurrency deposited into the BIA, although the percentage varied from month to month and depended on the volume and quality of assets deposited in the account. BlockFi generated the interest paid to BIA investors in a variety of ways, including by lending crypto assets to corporate borrowers, issuing loans to retail investors and investing in equities and futures.<sup>2</sup> As of December 8, 2021, BlockFi and its affiliates held approximately \$10.4 billion in BIA investor assets and had approximately 572,160 BIA investors, including 391,105 investors in the United States.<sup>3</sup>

The SEC found that the BIAs were unregistered securities because BlockFi offered and sold the BIAs as investment contracts under *SEC v. W.J. Howey Co.*<sup>4</sup> Under *Howey*, to establish that a product is an investment contract, the plaintiffs must prove (1) an investment of money, (2) in a common enterprise, (3) with profits to be derived solely from the efforts of others. With respect to the BIAs, the SEC found that (1) crypto assets loaned by the investors constituted an investment of money, (2) BlockFi’s activities in pooling the BIA investors’ crypto assets and using those assets for lending and investment constituted a common enterprise<sup>5</sup> and (3) BIA investors had a reasonable expectation of (a) obtaining a future profit based on BlockFi’s statements about

<sup>1</sup> Ryan Browne, *Peter Thiel-backed crypto start-up BlockFi to pay \$100 million in settlement with SEC, 32 states*, CNBC (Feb. 14, 2022), available at <https://www.cnbc.com/2022/02/14/crypto-start-up-blockfi-to-pay-100m-in-settlement-with-sec-32-states.html>.

<sup>2</sup> SEC Order, Administrative Proceeding No. 3-20758 at 2 (Feb. 14, 2022), available at <https://www.sec.gov/litigation/admin/2022/33-11029.pdf>.

<sup>3</sup> *Id.*

<sup>4</sup> 328 U.S. 293, 301 (1946).

<sup>5</sup> SEC Order at 8.

generating yield to pay BIA investors interest” and (b) sharing profits from BlockFi’s lending and principal investing activity in the form of interest payments.<sup>6</sup>

The SEC further found that the BIAs were unregistered securities because they constituted notes under the Supreme Court’s test in *Reves v. Ernst & Young*.<sup>7</sup> According to *Reves*, a note is presumed to be a security unless it (1) falls into certain judicially created categories of financial instruments that are not securities (for example, notes given to expedite purchases of particular assets, such as homes and vehicles) or (2) bears a “family resemblance” to notes in those categories based on (i) the motivation of the seller and buyer, (ii) the plan of distribution of the instrument, (iii) the reasonable expectation of the investing public and (iv) the presence of alternative regulatory regimes.<sup>8</sup> The SEC found that the BIAs did not fall into any of the existing judicially created exceptions and did not bear any family resemblance to notes in those categories. Applying the *Reves* four-part analysis, the SEC found that BlockFi’s BIAs bore no family resemblance to any judicially created exceptions (and were thus securities) because (i) BlockFi offered and sold BIAs to obtain crypto assets for the general use of its business; (ii) BIAs were offered and sold to a broad segment of the general public; (iii) BlockFi promoted BIAs as an investment, specifically as a way to earn a consistent return on crypto assets and for investors to “build their wealth”; and (iv) no alternative regulatory scheme or other risk reducing factors existed with respect to BIAs.<sup>9</sup>

Finally, the SEC found that, because BlockFi was an issuer of securities engaged in the business of investing, owning, holding or trading in securities with a value exceeding 40% of the company’s total assets, BlockFi was operating as an unregistered investment company in violation of Section 7(a) of the Investment Company Act.<sup>10</sup> BlockFi agreed in the settlement agreement to attempt to bring its business into compliance with the provisions of the Investment Company Act within 60 days.

Without admitting or denying the SEC’s findings, BlockFi agreed not to violate the registration and antifraud provisions of the Securities Act and the registration provisions of the ICA. BlockFi also agreed to cease offering or selling BIAs in the United States. Although existing customers can continue receiving interest on their present holdings, they will be unable to add new assets to their accounts, nor will new U.S. customers be able to open BIAs

BlockFi further announced that it will file an SEC registration statement for a new crypto-lending product called BlockFi Yield and gradually move investments in its BIAs over to the new product. The BlockFi Yield product would purportedly allow customers to accrue interest on their digital currency holdings in a similar manner.

## Global Settlement with States Attorneys General

New Jersey Acting Attorney General Matthew J. Platkin announced on February 14, 2022, that BlockFi had reached a parallel settlement agreement with New Jersey and 31 other states, arising from the same conduct found by the SEC. The New Jersey Bureau of Securities, along with securities regulators from other states, alleged that BlockFi had raised at least \$14.7 billion worldwide through the sale of unregistered securities.<sup>11</sup> Under this agreement, BlockFi will pay \$50 million to be divided equally among participating members of the North American Securities Administrators Association.

## Implications

The BlockFi settlement provides guidance as to the SEC’s position on cryptocurrency lending as the industry continues to grow. Following the announcement of the BlockFi settlement, SEC Enforcement Division Director Gurbir S. Grewal issued a statement

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<sup>6</sup> SEC Order at 2.

<sup>7</sup> 494 U.S. 56, 64–66 (1990).

<sup>8</sup> *Id.* at 67–60.

<sup>9</sup> SEC Order at 8.

<sup>10</sup> *Id.* at 3.

<sup>11</sup> Dan Gunderman, *BlockFi to Pay SEC, State Regulators \$100M in Penalties*, Bank Info Security (Feb. 14, 2022), available at <https://www.bankinfosecurity.com/blockfi-to-pay-sec-state-regulators-100m-in-penalties-a-18514>.

warning that crypto lenders and other industry participants “should take immediate notice of today’s resolution and come into compliance with the federal securities laws.”<sup>12</sup> BlockFi’s CEO and founder, Zac Prince, has also publicly stated that the settlements will provide helpful clarity for other crypto lenders.<sup>13</sup> Cryptocurrency lending<sup>14</sup> has exploded in popularity in recent years, and loan origination in digital lending has shown a 30.1% year-on-year growth,<sup>15</sup> with centralized exchanges such as Celsius reportedly offering annual percentage yields as high as 17.5%.<sup>16</sup> Recent reporting has noted that the SEC is also scrutinizing the lending practices of other crypto lending firms.<sup>17</sup>

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.

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<sup>12</sup> *BlockFi Agrees to Pay \$100 Million in Penalties and Pursue Registration of its Crypto Lending Product*, SEC Press Release (Feb. 14, 2022), available at <https://www.sec.gov/news/press-release/2022-26>.

<sup>13</sup> *Id.*

<sup>14</sup> The crypto lending industry arose to allow borrowers to secure loans using their digital assets as collateral. Lenders exercise control over the crypto assets until the loan is repaid, generate additional secured loans, and have the option to liquidate the assets if the loan is not repaid within the contract term. The borrowers in these arrangements gain liquidity without being forced to sell off their crypto assets. In De-Fi lending arrangements, multiple lenders pool their assets in apps governed by code (known as “smart contracts”), which generate the loans and automate payouts.

<sup>15</sup> *In a Crypto Industry Full of Buzzwords, “Lending” May Just be the Next*, NASDAQ (Nov. 5, 2021), available at <https://www.nasdaq.com/articles/in-a-crypto-industry-full-of-buzzwords-lending-may-just-be-the-next-2021-11-05>.

<sup>16</sup> *Id.*

<sup>17</sup> Joe Light, Matt Robinson, and Zeke Faux, *Crypto Lending Firms Celsius Network, Gemini Face SEC Scrutiny*, Bloomberg News (Jan. 26 2022), available at <https://www.bloomberg.com/news/articles/2022-01-26/crypto-lending-firms-celsius-network-gemini-face-sec-scrutiny>. In September 2021, the SEC issued a Wells notice to Coinbase, a cryptocurrency exchange platform, stating that it would bring an enforcement action if the company proceeded with the planned launch of its cryptocurrency lending product Lend. Following receipt of the Wells notice, Coinbase announced that it had elected not to proceed with the launch of Lend.