WINSTON & STRAWN LLP

BLOG

BlockFi's Settlement With the SEC Signals Some Interest-Bearing Crypto Accounts Will be Viewed as Securities

FEBRUARY 25, 2022

On February 14, 2022, the Securities and Exchange Commission (SEC) announced a first-of-its kind enforcement action against BlockFi Lending LLC (BlockFi), a crypto lending platform, indicating that it intends to treat such products as securities and aggressively regulate the crypto area. This is consistent with the warning by SEC Chair Gary Gensler in November 2021, that the SEC will be looking at the economic realities of a financial product, regardless of the label or purported mission. The SEC settled with BlockFi for: (1) offering and selling its retail crypto lending product as securities without a registration statement; (2) violating the Investment Company Act by operating as an unregistered investment company; and (3) materially false and misleading statement on its website. As a result of this enforcement action, BlockFi agreed to pay a penalty of $50 million to the SEC. Separately, BlockFi agreed to pay $50 million in fines to settle with 32 states that had brought similar charges.

BlockFi Interest Accounts

The SEC charges centered around BlockFi's financial product known as BlockFi Interest Accounts (BIAs). BlockFi sold BIAs as a product in which investors could lend their crypto assets to BlockFi in exchange for BlockFi's promise to provide a monthly interest payment in cryptocurrency. BlockFi represented that it used these borrowed crypto assets to lend those assets to institutional investors or invest in "SEC-regulated equities and predominantly CFTC-regulated futures"[1] which would generate income both for BlockFi and BIA investors. According to the SEC's order, BlockFi "pooled the loaned assets, and exercised full discretion over how much to hold, lend, and invest[,] had complete legal ownership and control over the loaned crypto assets [and] regularly touted the profits investors may earn by investing in a BIA."[2]

Crypto Lending under *Howey* and *Reves*

The SEC found BIAs to be securities subject to registration under both the *Reves* test and the *Howey* test. Under Section 2(a)(1) of the Securities Act[3] and Section 3(a)(10) of the Exchange Act,[4] any "note" or "investment contract" is considered a security, which must be registered with the SEC under Section 5 of the Securities Act.[5]

The U.S. Supreme Court provided the foundational test for interpreting which products are subject to registration as "securities" in *SEC v. Howey*. Specifically, in *Howey*, the Court considered whether an offering of units of a citrus grove coupled with a contract for serving the grove was an "investment contract" under Section 2(a)(1) of the Securities Act.[6] The *Howey* test entails an analysis of the four characteristics of an "investment contract": (1) the investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) derived solely through the efforts of others.[7]

In *Reves v. Ernst & Young*, the U.S. Supreme Court rejected the *Howey* test for analyzing notes. Instead, it applied a two-step analysis to determine whether a financial product is a "note" that is subject to registration.[8] First, the Court looked to a list of judicially created categories that are exempt from registration.[9] Second, after finding that a rebuttable presumption was not established through the first step, the Court looked to four factors to determine whether the product had a strong "family resemblance" to the established list. In conducting the second step, the Court considered (1) the motivation for entering the transaction; (2) the plan of distribution; (3) the reasonable expectations of the investing public; and (4) whether any risk-reducing factors exist that would make the application of the securities laws unnecessary.[10]

The SEC contended that BlockFi offered BIAs as "investment contracts" and "notes." The SEC noted that BlockFi sold BIAs in exchange for investment of crypto assets and used those assets to generate returns for the investors and BlockFi.[11] Through its advertisements of BIAs, BlockFi led investors to reasonably expect to earn profits from their accounts.[12] Hence, according to the SEC, the BIAs satisfied all four prongs of the *Howey* test.

The SEC further found that BlockFi's BIAs were "notes" according to the four-part analysis expounded in *Reves*.[13] The BIAs were created to generate revenue for BlockFi, through its lending and investment activities, and they were offered to a broad segment of the public. As mentioned earlier, BlockFi created a reasonable expectation of profit for investors by earning profits derived from BlockFi's managing the loaned crypto assets. There were no other laws or regulations that would reduce the risk posed by the BIAs. As a result, the BIAs were notes and therefore securities under SEC regulation.

Going Forward

The settlement with BlockFi is noteworthy as a first-of-its-kind action against a crypto lending platform. In September 2021, when Coinbase was compelled to cancel its similar Lend program after receiving a Wells notice, the company had complained that the SEC was unclear in its assessment of crypto lending in relation to the *Howey* and *Reves* tests.[14] The SEC has now answered.

The settlement portends the SEC's willingness to rein in an area that was described by Chair Gensler as the "Wild West."[15] It is now increasingly likely that the SEC will readily view crypto financial products as "securities" subject to its regulatory framework. Gensler remarked that "[t]oday's settlement makes clear that crypto markets must comply with time-tested securities laws [and that crypto lending platforms] should take immediate notice of today's resolution and come in compliance with the federal securities laws."[16] Businesses that offer crypto-related financial products should be mindful of the message that this settlement implies.

BlockFi, for its part, announced that it intends to file or submit a S-1 registration with the SEC for its new product, BlockFi Yield, which would be the first crypto interest-bearing security registered with the SEC.[17] It is unclear whether BlockFi will realize this ambition. As Commissioner Hester Peirce noted in her dissent, even if BlockFi completes its S-1 process, it must still register as an investment company under Section 3(a)(2) of the Investment Company Act.[18] However, BlockFi cannot register as an investment company as long as it issues debt securities, unless it is entitled to an exemption.[19] It remains to be seen how BlockFi and other crypto platforms will navigate this regulatory landscape.

Winston & Strawn Associate Jeremy Chu contributed to this blog post.

---

[1] BlockFi Lending LLC, Order Instituting Cease-and-Desist Proceedings, Securities Act Release No. 11029 (Feb. 14, 2022).

[2] *Id*. ¶¶ 9, 15.

[3] 15 U.S. Code § 77b.

[4] 15 U.S. Code § 78c.

[5] 15 U.S. Code § 77e.

[6] 328 U.S. 293 (1946).

[7] *Id*. at 301.

[8] 494 U.S. 56, 64-66 (1990).

[9] *Id*. at 64-65.

[10] *Id*. at 66-70.

[11] BlockFi Lending LLC, *supra* note 1, ¶ 31.

[12] *See id*.

[13] *Id*. ¶ 30.

[14] Paul Grewal, *The SEC Has Told Us It Wants to Sue Us Over Lend. We Don't Know Why*, The Coinbase Blog (Sep. 7, 2021), https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009.

[15] Gary Gensler, *Remarks Before the Aspen Security Forum*, U.S. Securities and Exchange Commission (Aug. 3, 2021), https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03.

[16] U.S. Securities and Exchange Commission, Press Release, *BlockFi Agrees to Pay $100 Million* (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26.

[17] *BlockFi Enters Landmark Resolution with Federal and State Regulators*, BlockFi (Feb. 14, 2022), https://blockfi.com/regulatory-developments/.

[18] Hester M. Peirce, *Statement on Settlement with BlockFi Lending LLC*, U.S. Securities and Exchange Commission (Feb. 14, 2022), https://www.sec.gov/news/statement/peirce-blockfi-20220214#_ftnref5.

[19] See 15 U.S. Code § 80a–18.

5 Min Read

Related Locations

Chicago

Related Topics

Cryptocurrency | Regulations | Securities and Exchange Commission (SEC) | CFTC

Related Capabilities

Financial Services Transactions & Regulatory | Private Investment Funds | Securities, M&A & Corporate Governance Litigation | Litigation/Trials

Technology, Media & Telecommunications

Cryptocurrencies, Digital Assets & Blockchain Technology

Financial Services

Related Regions

North America

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.