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SEC Update

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Crypto Lending Platform Operated as an Unregistered Investment Company

In February 2022, the Securities and Exchange Commission (SEC) charged BlockFi Lending LLC (BlockFi), a wholly-owned subsidiary of BlockFi, Inc., with violating Section 7 of the Investment Company Act of 1940 (1940 Act), among other federal securities laws.[1] This was a first case with respect to crypto lending.[2] BlockFi agreed to pay a $50 million civil penalty, cease offering and selling its interest-bearing accounts in the United States, and attempt to bring its business within the provisions of the 1940 Act.[3] In parallel actions announced on the same day, BlockFi agreed to pay an additional $50 million in fines to over 30 states to settle similar charges. In addition, on the same day, the SEC's Office of Investor Education and Advocacy and Enforcement's Retail Strategy Task Force issued an Investor Bulletin on Crypto Asset Interest-bearing Accounts.

According to the SEC, for about three years, BlockFi offered and sold interest bearing accounts to the general public to obtain crypto assets in order to run its lending and investment activities to pay interest to account investors. Through these accounts (which were promoted as investments), investors lent crypto assets to BlockFi in exchange for BlockFi's promise to make variable monthly interest payments. BlockFi generated the interest to be paid to investors by, among other things, lending crypto to institutional and corporate borrowers, lending US dollars to retail investors, and investing in equities and futures.

BlockFi set the interest rates payable on the accounts based, in part, on the yield that it could generate from its lending and investment activities, and thus the rates were correlated with BlockFi's efforts to generate that yield. BlockFi periodically adjusted its interest rates payable on the accounts in part after analysis of current yield on its investment and lending activity. BlockFi regularly touted the profits investors may earn by investing in an account and offered and sold the accounts to retail and other investors by way of its public website. BlockFi also promoted the accounts through social media. BlockFi did not have a registration statement filed or in effect with the SEC for the offer and sale of the accounts, and no exemption was available under the Securities Act of 1933 (1933 Act).

BlockFi pooled the crypto assets it borrowed from account investors, and commingled and rehypothecated these assets with BlockFi's other assets, including collateral received from institutional borrowers. BlockFi took ownership of the loaned crypto assets from investors in the accounts, and used the commingled assets in its own business to, among

other things, make loans to institutional and retail borrowers, stake crypto assets, and purchase crypto asset trust shares and interests in private funds. These assets generated income both for BlockFi and to pay interest to account investors. BlockFi exercised full discretion over how much crypto assets to borrow, hold, lend, and invest, had complete legal ownership and control over the loaned crypto assets, and advertised that it managed the risks involved.

To find that BlockFi operated as an unregistered investment company, the SEC first needed to find that BlockFi was an issuer of securities under the 1940 Act, and it did. In analyzing BlockFi's activities for purposes of the 1933 Act, the SEC found that the accounts were securities, based on its determination that the interest bearing accounts were "notes" under *Reves v. Ernst & Young,*[4] and its progeny (Reves), and were "investment contracts" under *SEC v. W.J. Howey Co.*,[5] and its progeny (Howey).[6] Among other facts relevant to this analysis, the SEC found that:

1. BlockFi sold the accounts in exchange for the investment of money in the form of crypto assets;
2. BlockFi pooled the account investors' crypto assets, and used those assets for lending and investment activity that would generate returns for both BlockFi and the account investors;
3. The returns (the promised variable interest rate) earned by each investor were a function of the pooling of the loaned crypto assets, and the ways in which BlockFi deployed those loaned assets (in this way, each investor's fortune was tied to the fortunes of the other investors, that is, horizontal commonality);
4. Because BlockFi earned revenue for itself through its deployment of the loaned assets, the investors' fortunes were also linked to those of the promoter (that is, there was vertical commonality);
5. Through its public statements, BlockFi created a reasonable expectation that account investors would earn profits derived from BlockFi's efforts to manage the loaned crypto assets profitably enough to pay the stated interest rates to the investors;
6. BlockFi had complete ownership and control over the borrowed crypto assets, and determined how much to hold, lend, and invest;
7. BlockFi's lending activities were at its own discretion; and
8. BlockFi advertised that it managed the risks involved.

After analyzing the 1933 Act, the SEC simply stated that BlockFi was an issuer for purposes of the 1940 Act,[7] and further found that BlockFi met the definition of "investment company" in Section 3(a)(1)(C).[8] According to the SEC, BlockFi's "investment securities" included: (i) loans of crypto assets and US dollars to institutional borrowers and other counterparties ($1.9 billion); (ii) investments in crypto asset trusts and funds ($1.5 billion); and (iii) intercompany receivables ($847 million),[9] which together constituted well over 40 percent of its approximately $4.8 billion in total assets. Regarding the treatment of loans as securities under the 1940 Act, the SEC simply stated: "Loans that BlockFi made to counter parties are considered investment securities under the [1940] Act."

BlockFi argued that it could rely on 1940 Act Section 3(c)(2), which excludes from the definition of investment company any person that is "primarily engaged in the business of . . . acting as a market intermediary . . . whose gross income normally is derived principally from such business and related activities."[10] The SEC disagreed, and stated that BlockFi was not primarily engaged in the business of acting as a market intermediary; its principal source of gross income was not derived from intermediary business and related activities; and it did not regularly engage in the business of entering into transactions on both sides of the market for a financial contract. The interest-bearing accounts were not "individually negotiated" financial contracts that were entered into in "response to a request from a counter party for a quotation" or structured to accommodate "the

objectives of the counter party." Further, BlockFi only intermittently entered into individually negotiated transactions to borrow crypto assets, and initiated and did not structure those transactions for the counter parties' objectives.

Although this case might seem like a case purely about crypto, do not be fooled. Indeed, the SEC and its Staff have a great interest in crypto and digital assets, and related businesses and platforms.[11] However, this case appears to be a continuation of years of regulatory analysis regarding the treatment of various "accounts" and related business arrangements for purposes of investment company status under the 1940 Act. This historical analysis continues to evolve as more complex and novel financial instruments and accounts, transactions and services develop, including relative to crypto/digital asset platforms, accounts and similar arrangements and transactions. It also serves as confirmation that the SEC and its Staff: (1) have a keen eye on investment company status, arguably even more so of late (for example, since the *National Presto* case)[12]; and (2) continue to view loans as securities for 1940 Act purposes.[13] It also serves as an important reminder to practitioners and their clients regarding the treatment of intercompany arrangements and transactions for investment company status purposes, and the intended scope of 1940 Act Section 3(c)(2).

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NOTES

1. *In re BlockFi Lending LLC*, Investment Company Act Release No. 34503 (Feb. 14, 2022).
2. The SEC has brought actions against various digital asset companies, but not for investment company status.
3. BlockFi and its parent are working with the SEC and other regulators in an effort to find a compliant solution; *https://help.blockfi.com/hc/en-us/articles/4421043037332-February-Regulatory-Update-FAQs*.
4. Reves v. Ernst & Young, 494 U.S. 56, 64–66 (1990).
5. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).
6. The SEC also referenced: *Report of Investigation Pursuant to Section 21(a) Of The Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017), *citing Forman*, 421 U.S. at 852-53 (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.") and *SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1130-31 (9th Cir. 1991) (finding managed account product was an investment contract where investors provided funds in exchange for interest rate earned through the issuer's investment of the funds; specifically the principal borrowed funds from his clients for six months to two years at varying interest rates; deposited all of the funds in a single account and used a large portion of the funds to pay for expenses unrelated to the investments). *See also Investment Company Institute v. Camp,* 401 U.S. 617 (1971); 1940 Act Rule 3a-4 and related releases and enforcement actions, and SEC Staff no-action letters regarding custodial receipts and similar account arrangements. *See also https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets*.
7. The SEC did not specify whether it considered *Reves* (which it had applied, along with *Howey*, in its analysis of the 1933 Act) for 1940 Act purposes, but presumably it did not. See *infra* n.11.
8. Although the release sets out examples of marketing and promotional statements made (including that the return to account investors was dependent on BlockFi's investing activities), the SEC did not address BlockFi's status as an investment company under 1940 Act Section 3(a)(1)(A).
9. Even without the intercompany receivables, BlockFi's unconsolidated asset test results would have been over 70 percent. In this discussion, the SEC did not mention whether any "cash items" were to be deducted from the denominator, as required by the

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statute, and presumably any crypto or similar assets held directly by BlockFi would not have been treated as such. The status of receivables (whether intercompany or otherwise) under the 1940 Act as "securities" is largely dependent on the facts and circumstances (compare current trade receivables generated by an operating company with trade receivables and other obligations acquired from another company; *see* Section 3(c)(5)). The treatment of BlockFi's intercompany receivables appears to be fitting in this case, however.

10 The definition of the term "market intermediary" and related terms are set out in the statute.

11 *See, e.g., https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422*; *https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03* (". . . stablecoins also may be securities and investment companies. To the extent they are, we will apply the full investor protections of the Investment Company Act and the other federal securities laws to these products.").

12 SEC v. National Presto Industries, Inc., 486 F.3d305 (2007). *See, e.g., Dunham & Associates Holdings, Inc., et al.*, Investment Company Act Release No. 2552 (September 22, 2006) *Great Plains Trust Company, Inc*. Investment Company Act Release No. 34037 (September 30, 2020); *Special Purpose Acquisition Companies, Shell Companies, and Projections*, Investment Company Act Release No. 34549 (March 30, 2022).

13 The definition of a "security" in the 1940 Act is not necessarily equivalent to the definition of that term under the 1933 Act or the Securities Exchange Act of 1934, and is construed more broadly under the 1940 Act. The SEC and its Staff generally have taken the position that notes or loans that might not be securities for purpose of other federal securities laws nevertheless can be viewed as securities for purposes of the 1940 Act.

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