

SEC Clobbers Crypto Lending Platform but Allows Some Retooling

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The SEC has settled its first enforcement action against what SEC Chair Gary Gensler calls a “crypto lending platform.”

Although the SEC entered into this settlement with BlockFi Lending in February, the matter holds continuing interest. This is because the SEC has been willing to work with the company in retooling its products and structure to comply with the federal securities laws. As stated in a June speech by Commissioner Hester Peirce, “The Commission, in its settlement, set out a path pursuant to which BlockFi could register under the Securities Act and register or take steps to qualify under an Investment Company Act exemption from registration. The specific path laid out in [the] settlement agreement crafted between BlockFi and the SEC, if successful, is likely to become the standard for regulation of crypto lending.”

Indeed, it is conceivable that life insurance companies will want to involve crypto in their products. Life insurance companies, for example, may want to give contract owners the option of paying premiums in cryptocurrencies. They also may want to offer investment options in the form of mutual funds investing in crypto assets.

SEC Determination

The SEC determined that BlockFi violated:

- Sections 5(a) and (c) of the Securities Act of 1933 in offering and selling unregistered securities and had to stop offering and selling in the United States and to U.S. persons abroad until the company had an effective Form S-1 registration statement for a new version of the product;

- Section 7(a) of the Investment Company Act of 1940 in operating as an unregistered investment company and had to stop operations until the company had worked out its status with the SEC under that act; and
- Sections 17(a)(2) and (3) of the 1933 Act by making a false or misleading statement in the offer or sale of a security, namely, misrepresenting the company's risk to investors by stating that most of its loans were overcollateralized when only 17% were overcollateralized.

The SEC did not allege that BlockFi failed to pay investors any money due to them or seek disgorgement of profits. The SEC fined the company \$100 million — half goes to the SEC, and half goes to 32 state regulators.

Peirce dissented, chiefly on the ground that the SEC's approach is not the best way to protect crypto lending customers. She does not believe that the federal securities framework is best suited to provide transparency to customers around the terms and risks of crypto lending products. She also does not believe that the SEC has accommodated innovation through thoughtful use of the SEC's exemptive authority.

Unregistered Securities

BlockFi, with \$14.7 billion in assets, has been operating since March 2018.

The company offered and sold BlockFi interest accounts, under which an investor lends to the company cryptocurrency like Bitcoin or Tether in return for the company's promise to pay the investor interest on the investor's account. The company lends the investor's cryptocurrency to institutions, charging them interest, and conducts other activities involving the cryptocurrencies that realize income.

The company then uses the interest it earns from the institutions and income from its other business activities to pay interest to investors. The interest rate varies from month to month, depending on the yield that the company earns from its loans to institutions and other activities. For example, as of November 1, 2021, BlockFi was paying 9.5% for up to 40,000 Tether. The company pays interest to investors in cryptocurrency.

An investor can recover his or her assets at any time. An investor can also borrow money in U.S. dollars against the amount of crypto assets deposited in the BlockFi interest account.

The SEC found the BlockFi interest accounts to be unregistered securities, based on U.S. Supreme Court precedents, as both notes and investment contracts.

Unregistered Investment Company

BlockFi’s various business activities caused it to hold securities assets in the form of loans of crypto assets and U.S. dollars to counterparties, investments in crypto asset trusts and funds, and intercompany receivables, with a particular focus on loans that the company makes to counterparties.

The SEC found BlockFi to be an unregistered investment company as an issuer of securities engaged in the business of investing, reinvesting, owning, holding, or trading in securities that are worth more than 40% of its total assets. The SEC also found that the company does not qualify for the exclusion in Section 3(c)(2) of the 1940 Act for a “market intermediary.”

The SEC gave BlockFi 60 days (with the potential for a 30-day extension) to provide the staff “with sufficient credible evidence that it is no longer required to be registered under the Investment Company Act.”

Peirce pointed out that BlockFi would have problems fitting under the 1940 Act because it issues debt securities that can violate Section 18 of that act and holds digital assets that raise valuation, liquidity, and custody problems. She called for the SEC staff to work with BlockFi to “craft” a set of conditions under Section 6(c) of the 1940 Act to resolve these legal problems.

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