BlockFi Settlement: A New Era in Crypto Regulation?

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By Daniel Spungen on February 24, 2022

On February 14, 2022, BlockFi Lending LLC (BlockFi) settled charges with the SEC and state securities regulators for a total of $100 million in penalties. BlockFi was charged with a failure to register the offer and sales of its retail crypto lending product and violating the registration provisions of the Investment Company Act of 1940. At first glance, this appears to be a landmark case regarding the regulation of cryptocurrency; however, it really is a straightforward application of long standing securities laws.

BlockFi offered its customers a BlockFi Interest Account (BIA) wherein customers would deposit crypto assets, most frequently Bitcoin and Ethereum, supported by BlockFi and in return receive substantial interest in the form of crypto deposited back into the customer's account on a monthly basis. In essence, this framework functioned similar to a savings account at a bank, it simply utilized crypto assets instead of dollars. BlockFi was able to provide much higher returns than a standard savings account because it would lend crypto to institutional traders and other collateralized borrowers and receive much higher interest rates based on the demand and limited access to crypto for borrowers. The issue with this framework, from the SEC and state regulators viewpoint, is that this functions as a security and therefore would either need to be registered as a security or otherwise exempt from registration.

After the Great Depression, the US enacted federal securities laws to ensure that investors had adequate information to make informed decisions on whether to invest in a security. For products that are not clearly a security, like the BIAs, regulators employ what is commonly known as the *Howey* test. A product functions as a security if it is an investment of money in a common enterprise with the expectation of profits derived solely from the efforts of others. Investors in BIAs invested their crypto into BlockFi's pool of assets with the expectation that more crypto would be returned to them in the form of profits based on the efforts of BlockFi. The SEC and state securities regulators' position is that BlockFi should provide disclosures to investors about their financial position, the use of proceeds, and risks related to the lending of investors' crypto. The SEC is not taking the position that the product, or crypto itself, is illegal, rather the product needs to be properly registered with regulators and disclose information to investors before it can be offered. A similar analysis has been employed regarding any number of products, from peer to peer lending platforms, to Florida orange groves.

What does this mean moving forward? This result is not a statement on crypto assets themselves, rather the investment in interest accounts. BlockFi will likely register its BIA product at both the state and federal level. Once effective, it can return to offering its services to its customers. There are numerous platforms out there that offer similar services as BlockFi, and similar registration requirements may be incoming for those companies. In the crypto world, many other products may meet the criteria in the *Howey* Test. DeFi protocols rely on centralized teams for development, but nearly all of these protocols have governance tokens that allow holders to vote on everyday decisions of the protocol. Will this added utility negate the "solely from the efforts of others" prong of the *Howey* Test? Similarly, DAOs and fractional NFT ownership are gaining popularity through token issuances that could be a security. Ultimately, both companies and individuals need to be thinking of whether money, in either crypto or dollars, that is invested or received might fit within the *Howey* Test framework.