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The SEC’s Action Against BlockFi: Are DeFi Lending Platforms Investment Companies? And, if So, How To Move Forward



BlockFi Lending LLC (BlockFi) – like several other lending platforms in the decentralized finance (DeFi) space – provides a platform through which a retail investor can lend crypto assets to BlockFi in exchange for the company’s promise to provide a variable monthly interest payment. DeFi lending platforms generally generate the interest payments to retail investors based largely on revenue the platforms earn from lending the retail investors’ crypto to institutional and corporate borrowers.

On Feb. 14, 2022, the Securities and Exchange Commission released an order (Order) finding BlockFi failed to register the offers and sales of its retail crypto lending product and failed to register as an investment company under the Investment Company Act of 1940.¹ To settle these charges, BlockFi and its parent company have agreed to pay a combined fine of \$100 million, register the BlockFi crypto lending product interests² and comply with the Investment Company Act.³ However, how BlockFi intends to comply with the Investment Company Act going forward is not clear. Below we examine issues under the Investment Company Act and explore possible ways for DeFi lending platforms to move forward.⁴

Background

An “investment company” is defined, in part, as any issuer of securities that owns “investment securities” having a value exceeding 40% of the value of the issuer’s total assets (not including cash or government securities).⁵ This is known as the “40% Test.” For purposes of this test, the term “investment securities”⁶ has been interpreted to include commercial instruments such as loans.⁷ As a result, based in part on BlockFi’s holding of notes evidencing loans of crypto assets to institutional and corporate borrowers, the SEC found that BlockFi had run afoul of the 40% Test.⁸ Interestingly, because the Order focuses on BlockFi’s loan portfolio, it does not allege that any of the crypto assets themselves were investment securities.

Entities That Make or Hold Loans

Because entities that make or hold loans can easily fall into the definition of an investment company under the 40% Test, the Investment Company Act contains a number of investment company exceptions for such entities. For example, Section 3(c)(3) excepts, among other similar businesses, banks and savings and loan associations; Section 3(c)(4) excepts entities substantially all of whose business is confined to making small consumer loans or to industrial banking; Section 3(c)(5)(B) excepts specialty finance lenders and Section 3(c)(5)(C) excepts mortgage lenders. Given the number of lending business exceptions, it is not surprising that the SEC took aim in its Order against BlockFi on the extent of its loan portfolio.

Market Intermediary Exclusion

BlockFi did claim reliance on an Investment Company Act exception. It claimed reliance on Section 3(c)(2) which, in part, excludes from the definition of investment company any person that is primarily engaged in the business of acting as a “market intermediary” and whose gross income normally is derived principally from such business. A “market intermediary” is a person that regularly engages in the business of entering into transactions on both sides of the market for a “financial contract.” In turn, a “financial contract” is, among other things, an individually negotiated agreement or transaction structured to accommodate counterparty objectives.

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The Order found that BlockFi did not satisfy the terms of the market intermediary exclusion – which was drafted to apply to swap dealers⁹ – because BlockFi did not regularly engage in the business of entering into transactions on both sides of the market and because the instruments involved were not individually negotiated financial contracts and were not structured to meet counterparties' objectives.

Addressing Section 3(c)(2) in her dissent from the BlockFi order, Commissioner Hester Peirce noted that: "If BlockFi seeks refuge in this rarely used exclusion, it has a challenging path to prove that it qualifies, particularly with the Commission staff's typical heightened scrutiny for crypto companies."¹⁰

How To Move Forward

In light of the reluctance of the current SEC to show flexibility with crypto companies and in light of the time that would be required to attempt to procure SEC staff guidance, crypto platforms should look to comply with current investment company exceptions.

Options may include:

Structuring the retail lending product and the crypto loan arrangements to fall more squarely into Section 3(c)(2)'s market intermediary exclusion.

- Forming an entity that qualifies as a "bank" under Section 3(c)(3) to engage in the retail lending product and the crypto loan arrangements. Incidentally, banks also can issue securities without registration under the Securities Act of 1933, pursuant to Section 3(a)(2) of that Act.
- Structuring crypto loans to comply with Section 3(c)(5)(B), such that the obligations held by the company represent "part of all of the sales price of merchandise, insurance or services."
- Registering as an investment company. This, however, is not as easy as it sounds since, as Commissioner Peirce noted, Section 18 of the Investment Company Act limits the amount of debt that management investment companies can issue. Moreover, the SEC staff has frowned upon investment company direct holding of crypto assets.¹¹ There is, however, one form of investment company that is permitted to issue unlimited debt and which is not subject to the full set of Investment Company Act provisions – an old-fashioned structure called a face-amount certificate company. This is almost certainly a stretch replete with regulatory landmines, but it would be an interesting and unexpected format for a DeFi lending platform.

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¹ Order Instituting Cease and Desist Proceedings, BlockFi Lending LLC, 2 (Feb. 14, 2022) available at <https://www.sec.gov/litigation/admin/2022/33-11029.pdf>.

² According to the Order, the retail crypto lending products are securities because the promises to pay interest qualify as "notes" under *Reves v. Ernst & Young*, 494 U.S. 56 (1990), and the products were offered and sold as "investment contracts" under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

³ Securities and Exchange Commission, BlockFi Agrees to Pay \$100 Million in Penalties and Pursue Registration of its Crypto Lending Product, (Feb. 14, 2022), available at <https://www.sec.gov/news/press-release/2022-26>.

⁴ We note that, although an important indication of the SEC's current stance, the Order is merely a "settled" action and does not serve as a pronouncement of the law; as such, the Order is not binding on any court.

⁵ Investment Company Act Section 3(a)(1)(C).

⁶ Investment Company Act Section 3(a)(2).

⁷ See e.g., Joseph A. Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, Stanford Journal of Law, Business, and Finance, Vol. 7, No. 1, (2001).

⁸ The other assets the SEC pointed to as investment securities were intercompany receivables and interests in other funds.

⁹ See H.R. 622, 104th Cong. 54 (1996) (accompanying H.R. 3005).

¹⁰ Commissioner Hester M. Peirce, Statement on Settlement with BlockFi Lending LLC, SEC (Feb. 14, 2022), available at <https://www.sec.gov/news/statement/peirce-blockfi-20220214>.

¹¹ See Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm> (identifying a series of questions under five broad topic headings and concluding that “[u]ntil the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products”). See also Staff Statement on Funds Registered under the Investment Company Act Investing in the Bitcoin Futures Market (May 11, 2021), <https://www.sec.gov/news/public-statement/staff-statement-investing-bitcoin-futures-market> (acknowledging the growth of the Bitcoin futures market and stating that the staff intends to “closely monitor” any mutual fund investments in Bitcoin futures).

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