

The Current State of the Crypto Industry

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Is the crypto industry in the United States dead? In the absence of formal legislation regulating the crypto industry in the United States, the Securities and Exchange Commission (SEC) has taken matters into its own hands and is singlehandedly going after crypto firms for violating federal securities laws by failing to register their activities with the SEC. The SEC's aggressive stance against the industry has ratcheted up following criticism for its failure to act quickly enough to stop the death spiral of FTX last year. The latest crypto firms caught in the crosshairs include two of the largest, Binance and Coinbase, which are the subjects of recent SEC enforcement actions.

In recent years, the SEC, under the leadership of Chairman Gary Gensler, has repeatedly taken the position that crypto assets¹ constitute "securities" subject to regulatory oversight by the Commission under the test set forth in the U.S. Supreme Court case, *SEC v. W.J. Howey Co.*,^{328 U.S. 293} (1946). Specifically, the SEC contends that crypto assets are "investment contracts" in which persons invest money in a "common enterprise" and reasonably expect to receive profits derived from the managerial or entrepreneurial efforts of others. Meanwhile, the crypto industry and its leaders have denounced this classification in the absence of specific regulation or guidance.

SEC's Suit against Coinbase

On June 6, 2023, the SEC filed suit against Coinbase, Inc. (Coinbase) and its parent company, Coinbase Global Inc. (CGI) for violating federal securities laws.² Coinbase is a Delaware corporation founded in 2012 that operates a crypto asset trading platform that services U.S. customers. A wholly owned subsidiary of CGI, Coinbase is registered with the SEC and trades under the ticker symbol "COIN" on the Nasdaq Global Select Market. The SEC's lawsuit contends that Coinbase is operating as an unregistered securities exchange, broker and clearinghouse in violation of the Securities Exchange Act of 1934 (Exchange Act). In addition, the SEC contends that CGI is jointly and severally liable as a "control person" under the Exchange Act.

Background

By way of background, Coinbase operates one of the largest global trading platforms that allows customers to buy, sell and trade crypto assets. Coinbase reportedly services more than 108 million customers accounting for billions of dollars in daily trading volume. As explained by the SEC, crypto asset trading platforms enable customers to purchase and sell crypto assets for fiat currency (legal

tender issued by a country) or for other crypto assets. These platforms typically possess and control the crypto assets deposited and/or traded by their customers and, thus, function as a central depository.

Similar to traditional securities exchanges, Coinbase's platform (1) lists names, ticker symbols, prices, market cap and trading volume for crypto assets; (2) enables customers to place various buy/sell orders; (3) matches buy/sell orders through an electronic automated matching system; and (4) settles customer trades in exchange for fees charged by Coinbase.

Since 2021, Coinbase has offered "Coinbase Prime," which is akin to prime brokerage services marketed to institutional clients for digital assets. Prime routes orders to the Coinbase platform and to third-party platforms so that customers have access to the broader crypto marketplace.

Since 2017, Coinbase has offered "Coinbase Wallet," which is made available to both retail and institutional customers. Wallet routes customer orders through third-party decentralized trading platforms or decentralized exchanges (DEXs) to access liquidity outside of the Coinbase trading platform. Unlike orders to buy or sell crypto assets placed through the Coinbase platform or Prime, Coinbase does not maintain custody over the crypto assets traded through Wallet. Instead, these crypto assets are "self-custodied" by customers who hold the private keys.

According to the SEC, all of the crypto assets made available for trading on the Coinbase platform, Prime and/or Wallet are "securities" within the meaning of the *Howey* test discussed above.³ In particular, the SEC claims that these "Crypto Asset Securities [were] offered and sold ... as an investment contract and thus a security." For each of these assets, "statements by the crypto asset issuers and promoters have led investors reasonably to expect profits based on the managerial or entrepreneurial efforts of such issuers and promoters." Further, "This was investors' reasonable expectation whether they acquired the Crypto Asset Securities in their initial offering, from prior investors, or on crypto asset trading platforms, including the Coinbase Platform (or through Prime or Wallet)."⁴

The Complaint

According to the Complaint, the function of "exchanges," "broker-dealers" and "clearing agencies" are typically carried out by separate legal entities that are independently registered and regulated by the SEC. This regulatory oversight is designed to protect investors from manipulation and fraud. In addition, registered entities must comply with SEC record-keeping and inspection requirements. Here, Coinbase purportedly violated securities laws by failing to register as a national securities exchange, broker and clearing agency for transactions involving the purchase, sale and trading of crypto asset "securities."

The SEC also claims that the Coinbase "Staking Program" constitutes the unregistered offer and sale of securities in violation of the Securities Act of 1933. Staking is a consensus mechanism or protocol used by a blockchain to validate transactions involving digital assets. The two most popular consensus mechanisms are known as "proof of work" and "proof of stake." Under the latter protocol, crypto asset owners who commit or "stake" their assets can obtain a reward or payment.

Coinbase allegedly markets its Staking Program to customers as an investment with an expected rate of return of up to 6.00% APY. Under the *Howey* test for securities, participants in the Staking Program (1) invest money in the form of eligible crypto assets; (2) participate in a common enterprise with Coinbase (e.g., the Staking Program); (3) reasonably expect to profit from their participation in

the Staking Program; (4) are merely “passive” investors, based primarily on Coinbase’s efforts, which are essential to the success or failure of the enterprise.

SEC’s Suit against Binance

The same week the SEC filed suit against Coinbase, on June 5, 2023, it filed a separate enforcement action for securities law violations against Binance, which operates one of the largest international crypto asset trading platforms; its U.S. affiliates BAM Management and BAM Trading; and Changpeng Zhao (Zhao), the founder, principal owner and CEO of these entities.⁵ Similar to the suit against Coinbase, the SEC alleges that the Binance entities were operating unregistered national securities exchanges, broker-dealers and clearing agencies for crypto assets that are securities. However, unlike the case against Coinbase, the SEC also accuses the Binance entities and Zhao of engaging in widespread nefarious activities to defraud customers and investors, reminiscent of similar allegations against FTX and its founder, Sam Bankman-Fried.

For instance, in 2019, Binance created BAM Management and BAM Trading to launch its U.S. trading platform ostensibly created to comply with U.S. laws and regulations. U.S. customers were supposedly barred from trading on Binance’s international platform. According to the SEC, defendants allowed “VIP” U.S. customers to circumvent these restrictions by masking their U.S. IP addresses to access the international trading platform in addition to forgoing Know Your Customer (KYC) documentation, which is a lynchpin of U.S. banking regulation.

In addition, the SEC Complaint highlights defendants’:

- Lack of oversight over how U.S. customers’ crypto assets are stored, secured and transferred (and potentially diverted and commingled)
- Internal controls deficiencies identified by auditors with respect to custody of digital assets
- Use of two Zhao-controlled entities (Merit Peak and Sigma Chain) as “market makers” to create liquidity for crypto assets traded on the platforms, creating a conflict of interest
- Ongoing control by Binance and Zhao of BAM’s U.S. operations and lack of independence
- Manipulative “wash trading” to artificially inflate the volume of trading activity on the platforms and price of crypto assets.

Shortly after filing its Complaint, the SEC filed an emergency motion in court seeking a temporary restraining order to freeze assets held by the defendants for U.S. customers. In support of its motion, the SEC contends that:

- There is lack of transparency regarding the custody and control more than \$2.62 billion in customer assets deposited, held or traded on the U.S. platform
- Binance and Zhao have admitted their intent to circumvent U.S. laws and regulatory compliance

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- Binance and Zhao continue to maintain control over U.S. customers' crypto assets
 - BAM's lack of internal controls or trading data confounded auditors' ability to verify that the company was fully collateralized for customers' crypto assets
 - Binance and Zhao followed a pattern and practice of commingling customer funds and moving funds outside the United States.

For now, it remains to be seen whether the Binance saga unfolds in the same vein as the collapse of FTX.

Conclusion

The lack of clear federal legislation in the United States regarding crypto assets means that this industry will remain subject to the whims of various state and federal regulators for the foreseeable future. For instance, earlier this year, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) issued a Joint Statement acknowledging the "crypto-assets risks to banking organizations."⁶ These agencies continue to assess safety and soundness concerns with banking services "that are concentrated in crypto-asset-related activities or have concentrated exposure to the crypto-asset sector." Meanwhile, in May 2023, the New York Attorney General proposed legislation to tighten regulation of the cryptocurrency industry to protect consumers and investors.

In contrast, other countries are at the forefront of crypto legislation. According to PwC, the "European Union is at advanced stages of finalizing the new Markets in Crypto-Assets Regulation. In the United Arab Emirates, Dubai authorities are setting up the world's first authority focusing solely on virtual assets. Switzerland has integrated one of the more mature regulatory framework for digital assets."⁷

For now, the lack of an established regulatory framework in the United States, in addition to the aggressive stance taken by the SEC and other regulators against the crypto industry, may cause a flight to safety and predictability in crypto-friendly nations. Meanwhile, U.S. companies in this space should take heed of the risk of engaging in issuing, selling and/or trading unregistered crypto assets that may be viewed as securities.

¹ The SEC broadly defines crypto assets to include digital assets, tokens, cryptocurrencies, virtual currencies, and digital coins issued and/or transferred using blockchain or distributed ledger technology.

² *SEC v. Coinbase, Inc., et al.*, Case No. 1:23-cv-04738 in the U.S. District Court for the Southern District of New York.

³ These crypto assets specifically include those traded under the following ticker symbols: SOL, ADA, MATIC, FIL, SAND, AXS, CHZ, FLOW, ICP, NEAR, VGX, DASH, and NEXO.

⁴ *SEC v. Coinbase, Inc.*, Complaint, par. 126.

⁵ *SEC v. Binance Holdings Limited, et al.*, Case No. 1:23-cv-01599 in the U.S. District Court for the

District of Columbia.

⁶ Federal Reserve, FDIC and OCC Joint Statement on Crypto-Asset Risks to Banking Organizations (January 3, 2023).

⁷ PwC Global Crypto Regulation Report 2023 (December 19, 2022).

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