Securities Regulation Daily Wrap Up, SECURITIES OFFERINGS—S.D.N.Y.: Coinbase operates as unregistered exchange, broker, and clearing agency, SEC says, (Jun. 6, 2023)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Rodney F. Tonkovic, J.D.

In April, Coinbase said litigation would put the Commission's own actions on trial. That time has now arrived, and time will tell if that prediction bears out.

The SEC has charged Coinbase, Inc. with violations arising from its trading platform and staking program. According to the complaint, filed in the Southern District of New York, Coinbase has intertwined the services of an exchange, broker, and clearing agency, but is not registered to perform any of these functions. Plus, it has been engaging in unregistered securities offerings through its staking-as-a-service program. The SEC says that Coinbase's refusal to follow the rules has deprived investors of the protections to which they are entitled (*SEC v. Coinbase, Inc*., June 6, 2023).

The charges. Since at least 2019, the Commission says, Coinbase has made billions by facilitating the buying and selling of crypto asset securities. At the same time, it has, through its Coinbase Platform, operated as an unregistered broker, exchange, and clearing agency, having collapsed these three functions into a single platform. Coinbase has: provided a marketplace to bring together buyers and sellers; engaged in the business of effecting securities transactions; served as an intermediary in settling transactions in crypto asset securities; and acted acts as a securities depository. According to the Commission, Coinbase's failure to register deprived investors of significant protections, including inspection by the SEC, recordkeeping requirements, and safeguards against conflicts of interest.

Also, since 2019, Coinbase has offered a crypto asset staking program. Through this program, Coinbase pools investors' crypto assets and then "stakes" (i.e., commits) them in exchange for rewards, which Coinbase distributes pro rata to investors after paying itself a commission. The complaint says that there are five stakeable crypto assets, and that the staking program as applied to these assets is an investment contract, and therefore a security, but Coinbase has never had a registration statement for offers and sales of the staking program.

The Commission alleges that Coinbase's actions violated Exchange Act Sections 5, 15(a), and 17A(b). In addition, Coinbase’s holding company, Coinbase Global Inc. (CGI), is a control person of Coinbase and is also liable for certain violations. Through the staking program, Coinbase allegedly violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act. The Commission seeks a final judgment permanently enjoining Coinbase from these violations, ordering disgorgement of ill-gotten gains, and imposing a civil money penalty.

"We allege that Coinbase, despite being subject to the securities laws, commingled and unlawfully offered exchange, broker-dealer, and clearinghouse functions," said SEC Chair Gary Gensler. "In other parts of our securities markets, these functions are separate, he added.

Gurbir S. Grewal, Director of the SEC's Division of Enforcement, said: "You simply can't ignore the rules because you don't like them or because you'd prefer different ones: the consequences for the investing public are far too great." In addition: "While Coinbase's calculated decisions may have allowed it to earn billions, it's done so at the expense of investors by depriving them of the protections to which they are entitled. Today's action seeks to hold Coinbase accountable for its choices."

Brinksmanship. In March 2023, Coinbase received a Wells notice outlining the SEC's intent to bring charges. At the time, the company said that the notice did not provide much information to respond to, but the company is confident in the way it runs its business: "Tell us the rules and we will follow them," Coinbase said.

In its reply to the notice, Coinbase urged the SEC not to sue. The notice outlined Coinbase's cooperation with the agency through the process of listing its shares followed by an "abrupt move toward litigation" with no new facts about Coinbase's business. Coinbase contends that the litigation is meant to pressure it to accept the Commission's demands that the company agree that the digital assets listed on its platform are securities and to overhaul its entire business model. These objectives are neither supported by law or within the bounds of the Commission's authority, Coinbase says.

The reply asserts that the SEC should be wary of now suing Coinbase not only because of the above, but for other compelling reasons. First, litigation will put the Commission's own practices on trial because the record will show Coinbase's efforts to cooperate with the Commission while the agency never raised any specific concerns. Next, the "laundry list" of proposed charges rest on flawed and untested legal theories. Finally, the departure from the Commission's normal approach will undermine public and judicial confidence in the agency's enforcement practices. The reply asks the Commission to avoid these risks by working with a willing Coinbase.

The case is No. 1:23-cv-04738.

Attorneys: Ben Ninan Kuruvilla for the SEC.

Companies: Coinbase, Inc.; Coinbase Global, Inc.

LitigationEnforcement: Blockchain BrokerDealers ClearanceSettlement Enforcement ExchangesMarketRegulation GCNNews InvestorEducation SecuritiesOfferings NewYorkNews