

Are the Rules Defining What is a Security Clear?

Since crypto assets launched with the claim of being off the grid, one of the constant refrains has been that “the rules” defining what is a security and what is not are not clear. From the beginning many of those involved in the crypto industry worked to develop their own names for items such as “white paper” for what securities regulators might call a prospectus or registration statement, a “smart contract” for a standard form agreement and “blockchain” for what is actually a digital excel spreadsheet and so on. While the terms sounded good, none of these new terms were actually tied to products that even began to approach the kind of information investors typically obtain from an SEC registration statement or filing to guide their investments.

New lingo did, however, give the products an air of mystery as the public scrambled to understand what the new terms meant while watching prices spike up and down with huge profits being made one minute and equally large losses being generated the next. The mystery, the romance, the fun and the profits attracted millions of investors who put their money down and took a chance in a wild west atmosphere. Some got profits; others got losses.

A new case filed by the SEC might be seen as a kind of “pulling the rug” off at least some segments of the industry and its claim that the rules are not clear, *SEC v. Binance Holdings Limited*, Civil Action No. 1:23-cv-01599 (D.D.C. Filed June 5, 2023). Named as defendants are: Holdings, one of a number of entities using the well-known Binance name, a group that includes Binance.com and Binance.US Platform -- crypto trading platforms; BAM Trading Services Inc. and BAM Management US Holdings Inc., two entities recently created by Changpeng Zhao, generally called CZ, the control person of all entity Defendants.

Collectively, the Binance named entities deliver a wide variety of well-known securities type services. Those include trading crypto assets like a stock exchange, buying and selling those assets like a broker-dealer and transferring those assets like a securities transfer agent. The difference between the Binance entities delivering those services to

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investors and those in the securities industry is regulation and oversight. Those in the securities industry are registered, regulated by the SEC and required to disclose material information about their services to investors. The Binance entities are not registered and not regulated. Those entities are not required to furnish investors information about their services. As the CCO of Binance stated: “we do not want [Binance].com to be regulated ever.”

The case focuses 2018 and the aftermath of actions then initiated when Mr. Zhao and the Defendants took a series of steps to ensure that the vision of their CCO continued – no regulation. BAM Management and BAM Trading were created. The entities were designed to control the Binance.US Platform. These steps were followed by public representations that the Binance.com Platform did not provide services to U.S. persons. In fact, nothing changed according to the SEC’s complaint. Mr. Zhao continued to control everything just as he did prior the creation of the two new entities and U.S. investors were still served – only the talking points delivered to the public that U.S. investors were not being served were added.

Behind the BAM façade Defendants transferred the millions of dollars of U.S. investor assets they held at will among the various entities. In some instances, the crypto assets and fiat assets held were commingled and diverted to an account held by a Zhao-controlled entity known as Merit Peak Limited. Later the assets were at times moved to a third party. While BAM Management and BAM Trading touted their surveillance and controls, in fact they seemed to be lacking. For example, there was none stopping the “wash trading” and self-dealing on the Binance.US Platform that began in 2019 when Sigma Chain AG, another Zhao owned and controlled entity, engaged in wash trading that artificially inflated the trading volume of crypto assets securities on the Binance.US Platform.

The complaint alleges violations of Securities Act Sections 5(a), 5(c), and 17(a)(2) and (a)(3) and Exchange Act Sections 5, 15(a) and 17A(b). The case is in litigation.

Comment

The intentional steps taken by the Binance Defendants to evade regulation by creating a new façade presents serious questions about the often-repeated claim that the rules of the road are not clear to those in the crypto asset industry. Creating new entities and touting regulation and investor protections which do not exist more than suggest that the regulations are sufficiently clear and understandable.

More importantly, the rules for determining what is a security and what should be regulated have been on the books and interpreted and reinterpreted by courts and others for decades – since the 1930s when Congress enacted the securities laws. Similarly, the fundamental test for determining what is a security has been on the books for years – at least since 1946 when the Supreme Court handed down its definition of what is a security *SEC v. Howey*, 328 U.S. 293 (1946) the same definition used today for create the dividing line. With decades of guidance, the rules of the road are more than clear. And, if there was any question about this issue, the steps taken by at least one leading

industry player to evade regulation should end the debate: the rules are clear.