

**The SEC’s Regulatory Crackdown on the Crypto Market**

Gary Gensler, the sitting chair of the Securities and Exchange Commission (“SEC”), has made strides in the digital asset space to protect investors by bringing a wave of regulatory action against cryptocurrency firms, arguing that most cryptocurrencies fall within the legal definition of a security and should therefore be subject federal securities law registration and disclosure requirements.<sup>1</sup> This comes just months after the FTX fallout, a shocking turn of insolvency for what was once considered the safest cryptocurrency exchange on the market.<sup>2</sup> The FTX fallout sent crypto prices plummeting and led to a downturn in the market, an event termed the “crypto crash”. To ensure the public can make informed investing decisions in an otherwise unregulated industry, the SEC launched a regulatory crackdown on a host of digital asset market participants, including cryptocurrency lending firms, exchanges, and promoters.<sup>3</sup>

Cryptocurrency firms were first put on notice by the SEC that the agency would act against market participants offering interest-generating financial products in fall of 2021 when Coinbase, the largest U.S.-based cryptocurrency exchange, was deterred from launching a crypto-back loan product.<sup>4</sup> The legal issue implicated in offering public loan products in the digital asset space is whether the companies that issue these products are engaged in offering securities, which are subject to strict disclosure and registration regulations promulgated by the

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<sup>1</sup> <https://www.nytimes.com/2023/02/18/business/crypto-crackdown-regulation.html> (“Gary Gensler, the chair of the S.E.C., has argued that the vast majority of cryptocurrencies are securities, like shares traded on the stock market, and should be subject to the same strict regulations.”)

<sup>2</sup> <https://pacer-documents.s3.amazonaws.com/33/188450/042020648197.pdf>

<sup>3</sup> *NY Times Crypto Crackdown*, *Supra* note 1.

<sup>4</sup> <https://www.nytimes.com/2021/09/08/business/coinbase-sec.html> (“Coinbase’s Lend offering — an interest-generating service that somewhat resembles accounts traditionally offered by banks — could violate securities laws, the Securities and Exchange Commission said.”)

SEC.<sup>5</sup> “The federal securities laws require all offers and sales of securities, including those involving a digital asset, to either be registered under its provisions or to qualify for an exemption from registration.”<sup>6</sup> Prior to this warning, the SEC also released guidance providing a framework for determining whether a digital asset falls within the legal definition of a security, specifically whether it qualifies as an investment contract under the *Howey* test.<sup>7</sup>

Recently, cryptocurrency lending firms offering programs that resemble interest generating services akin to traditional bank accounts have drawn attention from SEC regulators.<sup>8</sup> In these cases, the cryptocurrency companies are taking a role in the digital asset market somewhat akin to a traditional bank – they are launching loan products and the “bank” is offering investors a high interest rate in exchange for holding customer crypto assets. In February 2022, the SEC filed charges against cryptocurrency lending firm Blockfi regarding their crypto-backed loan product, alleging violations of U.S. Federal Securities Law for offering unregistered securities and failing to register as an investment company.<sup>9</sup> Regulators found the Blockfi program to be an investment contract and reached a \$100 million settlement that required the products to be registered as securities and Blockfi to be registered as an investment company.<sup>10</sup>

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<sup>5</sup> *Id.*

<sup>6</sup> SEC IC framework, <https://www.sec.gov/corpfm/framework-investment-contract-analysis-digital-assets>; See also [https://www.law.cornell.edu/wex/securities\\_act\\_of\\_1933](https://www.law.cornell.edu/wex/securities_act_of_1933) (“Under Section 5 of the Securities Act, all issuers must register non-exempt securities with the Securities and Exchange Commission (SEC).”)

<sup>7</sup> SEC IC framework, *Id.* (“The U.S. Supreme Court’s *Howey* case and subsequent case law have found that an “investment contract” exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.”); See also 15 U.S. Code § 77b - Definitions; promotion of efficiency, competition, and capital formation, <https://www.law.cornell.edu/uscode/text/15/77b> (Federal law defining a security.)

<sup>8</sup> <https://www.nytimes.com/2023/01/12/technology/sec-crypto-gemini-genesis.html>

<sup>9</sup> <https://www.sec.gov/litigation/admin/2022/33-11029.pdf>; See also 15 U.S. Code § 80a–3 - Definition of investment company

<sup>10</sup> <https://www.nytimes.com/2022/02/14/business/blockfi-sec-crypto-loans.html>; See also <https://www.sec.gov/news/press-release/2022-26> (“The order finds that BIAs are securities under applicable law, and the company therefore was required to register its offers and sales of BIAs but failed to do so or to qualify for an exemption from SEC registration. Additionally, the order finds that BlockFi operated for more than 18 months

The SEC subsequently announced the “settlement makes clear that crypto markets must comply with time-tested securities laws, such as the Securities Act of 1933 and the Investment Company Act of 1940”, effectively putting other crypto lending firms on notice that they are subject to federal securities laws.<sup>11</sup>

Cryptocurrency lending firms are facing insolvency issues due to the “crypto crash” that followed FTX’s collapse at the same time regulators take an aggressive enforcement approach to the industry. Following FTX’s implosion in November 2021, Blockfi filed for bankruptcy, “making it one of the first big victims of FTX’s collapse.”<sup>12</sup> A few days after the SEC filed charges against Genesis, a cryptocurrency lender, and Gemini, a cryptocurrency exchange, for violating federal securities law<sup>13</sup>, Genesis filed for bankruptcy in the Southern District of New York, making it the fourth major cryptocurrency lender to fail.<sup>14</sup> Nevertheless, the SEC shows no signs of slowing down. In fact, the SEC recently announced a \$45 million settlement with Nexo, another cryptocurrency lending firm, for violating federal securities laws by failing to register their crypto asset lending product before offering it to the public.<sup>15</sup>

Other actors should brace for regulatory impact as the SEC targets a slew of market participants in the digital asset space. Just last week the SEC announced a \$30 million settlement with Kraken, a popular crypto exchange, for “failing to register the offer and sale of their crypto asset staking-as-a-service program, whereby investors transfer crypto assets to Kraken for

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as an unregistered investment company because it issued securities and also held more than 40 percent of its total assets, excluding cash, in investment securities, including loans of crypto assets to institutional borrowers.”)

<sup>11</sup> SEC press release, *Id.*

<sup>12</sup> <https://www.nytimes.com/2023/01/20/technology/genesis-bankruptcy-crypto.html>

<sup>13</sup> <https://www.sec.gov/litigation/complaints/2023/comp-pr2023-7.pdf> (The SEC filing concerns an investment program called “Gemini Earn” that Defendant’s Genesis and Gemini launched, which promises customers sky-high returns in exchange for depositing their cryptocurrency holdings.)

<sup>14</sup> *Supra* note 12 (“Other major lenders that have gone out of business include Celsius Network and Voyager Digital, whose customers lost billions of dollars in deposits.”); See also <https://restructuring.ra.kroll.com/genesis/Home-Index>

<sup>15</sup> *Supra* note 12; See also <https://www.sec.gov/news/press-release/2023-11>

staking in exchange for advertised annual investment returns of as much as 21 percent.”<sup>16</sup> As a result, Kraken removed their investment product from the U.S. market.<sup>17</sup> In February 2023, the SEC filed suit against Terraform Labs<sup>18</sup> and their Chief Executive Officer for securities fraud, indicating to the market that top officials are also subject to federal securities law.<sup>19</sup> The SEC also reached a \$1.4 million settlement with basketball star Paul Pierce for marketing cryptocurrency without proper disclosures.<sup>20</sup> The agency’s latest move undoubtedly serves to caution all market participants to ensure they are in compliance with federal securities law, regardless of whether they are a major player in the industry or an unsophisticated promoter.

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<sup>16</sup> <https://www.sec.gov/news/press-release/2023-25>

<sup>17</sup> *Supra* note 1.

<sup>18</sup> *Supra* note 1 (“This week, the S.E.C. sued Terraform Labs, the company that developed the digital coins Luna and TerraUSD, which collapsed last spring and triggered a broader meltdown in cryptocurrency prices.”)

<sup>19</sup> <https://www.sec.gov/news/press-release/2023-32>

<sup>20</sup> *Id.*