# SEC allegations against Binance and Coinbase

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The recent legal actions taken by the Securities and Exchange Commission (SEC) against Binance and Coinbase have cast a spotlight on regulatory scrutiny within the cryptocurrency industry. We describe and compare the SEC's allegations against these two leading cryptocurrency platforms.

## 1. Summary of allegations

**Date**: June 5, 2023
**Defendants**: Changpeng Zhao (founder of Binance) and American affiliate Binance.US
**Allegations**: The SEC filed 13 charges against Binance and Mr Zhao, summarized below:

1. The defendants have disregarded federal securities laws, risking investors' assets and profiting billions of dollars for themselves.
2. Defendants unlawfully solicited U.S. investors through unregistered trading platforms, engaged in unregistered sales of securities, and deceived investors about surveillance and controls.
3. Binance and BAM Trading illegally provided securities market functions without registering with the SEC, evading regulatory oversight meant to protect investors.
4. Binance and BAM Trading conducted unregistered offers and sales of crypto asset securities, withholding crucial information from investors about risks.
5. BAM Trading and BAM Management deceived investors about implemented controls, while raising significant funds and attracting large trading volumes.
6. Defendants, led by Zhao, intentionally planned to evade U.S. laws by avoiding registration, with the aim of keeping Binance.com unregulated.
7. Zhao and Binance created BAM Management and BAM Trading to retain control of the Binance.US platform, deceiving employees and preventing them from freely operating the platform.
8. Zhao and Binance falsely claimed that the Binance.com Platform did not serve US customers while secretly assisting high-value U.S. customers in bypassing controls, evading accountability and regulatory oversight.

9. Defendants' evasion of U.S. regulation jeopardized billions of dollars of investor capital, as they freely transferred and commingled assets in ways that registered entities would be disallowed to.
10. Defendants acknowledged the importance of credibility and implemented surveillance and controls on crypto trading platforms.
11. BAM Trading and BAM Management boasted about surveillance and controls on the Binance.US Platform.
12. However, Defendants failed to implement the promised controls, allowing fraudulent practices like wash trading and self-dealing to occur.
13. Binance and BAM Trading engaged in unregistered offers and sales of crypto asset securities, combining securities market functions while evading registration and violating disclosure requirements intended to protect investors and the capital markets.

**What are the risks of this lawsuit?**

The SEC has asked a court to decide that Binance is an unlicensed exchange. The remedy could be an injunction that would forbid Binance from offering its trading services in the U.S., which regulators say is one of the firm's main markets.

We believe that forbidding Binance from operating in the U.S. can have broader consequences for Binance and the cryptocurrency industry as a whole.

First, Binance could face severe reputational damage. The allegations shed light on the fact that the company has put users' assets at risk. If customers lose confidence in Binance's ability to safely handle their assets and adhere to regulatory standards, they might choose to withdraw their funds and close their accounts, leading to a significant loss of business for the platform. In the longer term, these issues could also have implications for Binance's strategic direction. For example, they might have to invest heavily in compliance and risk management processes to regain the trust of users and regulators, which could divert resources away from other areas of their business.

Second, the lawsuit against Binance could also have broader implications for the cryptocurrency industry as a whole. If the regulatory authorities succeed in these cases, it could set a precedent for future actions against other platforms and potentially lead to a more heavily regulated environment for digital assets in the U.S. These developments could in turn affect investor trust in the market and shape the future trajectory of the industry.

**Are there other lawsuits against Binance?**

Yes, the Commodity Futures Trading Commission (CFTC) sued Binance in March 2023 focusing on the sale of crypto derivatives. U.S. law largely forbids the practice of offering derivatives unless an exchange is registered with the CFTC. Binance also failed to have an effective program for detecting terrorist financing and money laundering, according to the CFTC.

# 2. Unregistered exchange, broker-dealer, and clearing agency allegations

According to the SEC, Binance should have registered its American affiliates as an exchange, clearing agency and broker-dealer. In particular, the SEC charges Binance, BAM Trading and Zhao for violations of the federal securities laws. According to the SEC, both Binance and BAM Trading have operated as unregistered national securities exchanges, broker-dealers, and clearing agencies.
The SEC charges against Binance and BAM Trading also target the unregistered offer and sale of Binance's own crypto assets (including an exchange token (BNB), a stablecoin (BUSD), certain crypto-lending products, and their staking-as-a-service program), commodity derivatives, and crypto lending programs such as "Simple Earn," "BNB Vault."

# 3. Wash trading allegations

The complaint alleges that the strategic and targeted wash trading practice is largely perpetrated by the Binance.US platform's primary undisclosed "market making" trading firm **Sigma Chain**, also owned by Zhao.

The allegations state: 'Most notably, from at least September 2019 until June 2023, Sigma Chain AG engaged in wash trading that artificially inflated the trading volume of crypto asset securities on the Binance.US platform. Sigma Chain was an active trader on Binance and described itself as "the main market maker for Binance.com". Since Binance.US started offering OTC trading and its Convert Trading and One Click Buy Sell ("OCBS") services to customers, Sigma Chain has served as one (at times, only) counterparty to Binance.US Platform customers.

Wash trading took the form of inflated trading volume through dozens of accounts affiliated with Sigma Chain from 2019 through at least June 23, 2022. The allegations state that the wash trading activity corrupted the Binance.US platform's reported trading volume in a strategic pattern that coincided with at least 3 critical periods for crypto asset investors and the equity investors:

- The Binance.US platform's launch in September 2019 (in the initial hour, Sigma Chain constituted over 99% of trading volume in at least one crypto asset).
- BAM Trading making available certain new crypto asset securities for trading on the Binance.US platform (between January 2022 and June 2022, Sigma Chain accounts engaged in wash trading in 48 of 51 newly listed crypto assets).
- The months leading up to BAM Trading's seed funding round starting in September 2021.

The SEC's allegation is consistent with the patterns documented in "Crypto Wash Trading" by Cong, Tang, Li, and Yang, the first rigorous and systematic study of wash trading written as early as 2019. The article shows that wash trading is rampant on unregulated centralized crypto exchanges whereas the regulated ones seem to exhibit little wash trading. The article also pointed out that vertical integration and the lack of regulation constitute serious issues for CeFi, well ahead of the downfall of FTX and the like. Both the recent SEC allegations and academic studies demonstrate that regulation is important and that investors should be careful in this emerging sector.

# 4. Binance.US and US operations allegations

When prompted to interrupt their service to the U.S. public in 2019, Binance created an ad-hoc platform for U.S. users called Binance.US. Binance announced that it would implement controls to block U.S. customers from the Binance.com platform. But it did the opposite. In August 2019, Binance estimated that the Binance.com platform had over 1.47 million customers in the United States. Of these, 3,500 U.S. customers were referred to as VIPs. These customers were important to Binance because they would generate substantial revenues and provide considerable liquidity to the Binance.com platform.
Binance contacted each of these customers and prompted them to use VPN services and to create new KYC information omitting any U.S. nexus in order to continue trading on Binance.com. While trying to keep VIP customers on Binance.com, Binance set up two U.S. corporate entities behind Binance.US in order to continue operating with U.S. customers: **BAM Management** and **BAM trading**.
The US business presents several serious issues according to the SEC. Most of the allegations target the affiliated company **Merit Peak**.
Merit Peak describes itself as “a proprietary firm trading with our owner’s Zhao’s self-made wealth from the digital asset business”. The company acted as one of the earliest market makers on the Binance.US platform.
Merit Peak was involved in two fraudulent activities:
1- Merit Peak was used as an intermediary to buy Binance’s stablecoins (BUSD). U.S. Customer’s assets would go through Merit Peak first to then buy BUSD in an undisclosed manner. Hence, creating undisclosed counterparty risk for investors.
2- Merit Peak acted as market maker for the Binance.US platform (similarly to Sigma Chain) in an undisclosed manner hence involving a conflict between Zhao’s interest and those of Binance.US Platform’s customers.
As depicted in Figure 1, Merit Peak and Binance.US are not affiliated companies. They are both owned by Zhao but are not part of the same group. According to the SEC, this is a major issue as, legally speaking, Binance.US should have disclosed to its customers that their funds transit through a third party, Merit Peak.

# 5. Comparison with Coinbase

The allegations from the SEC against Coinbase and Binance have some similarities. In fact, the SEC claims that both Binance and Coinbase moved around customer’s fiat and crypto “as defendants pleased”. They are also both charged with putting customers at risk by operating as an “unregistered broker, exchange, and clearing house” and by trading unregulated securities (that should have been registered as securities) including those related to their staking program.

However, there are important differences that make Binance’s troubles bigger than Coinbase’s ones.

First, Binance (and in particular Zhao) are alleged to have diverted billions of dollars of customer funds to a bank account for an entity controlled by Zhao (Merit Peak). Coinbase was not accused of this type of activity. Coinbase's main allegations consisted of combining three functions (broker, exchange, and clearing agency) that are typically separated in traditional securities markets, but had never registered any of these things, violating securities law.

Secondly, Binance was accused of "secretely" allowing major US customers to trade on the crypto exchange Binance.com that was not intended to be available to US customers. In Coinbase's complaint, on the other hand, the SEC does not allege that the exchange unlawfully offered services to customers it was not meant to do business with.

Thirdly, the charges against the Binance CEO. The SEC complaint against Binance include the name of the founder and chief executive, Changpeng Zhao over 200 times. Zhao is at the core of the case, as billions of dollars of US customers' funds went to bank accounts of Merit Peak, owned by Zhao. In the Coinbase complaint, Coinbase's founder and chief executive, Brian Armstrong is only mentioned once.

Finally, the Binance assets freeze. The SEC asked the court to freeze Binance assets related to its U.S.-based customers and move any such assets back to the United States. In the Coinbase case, state securities regulators required Coinbase to register before offering its products in their states.

# 6. Concluding remarks

In recent years, the SEC has been increasingly proactive in issuing guidance about digital assets, asserting that many of them meet the legal definition of a security and therefore fall under their jurisdiction. This view was emphasized in 2017 when the SEC issued a report about the DAO, an Ethereum-based funding vehicle, asserting that its tokens were securities.

The charges against Binance and Coinbase represent an accentuation of this stance, demonstrating that the SEC is prepared to take significant legal action against cryptocurrency platforms that it believes are violating securities laws. Looking forward, it is likely that the SEC will continue to scrutinize crypto platforms, particularly those that offer complex financial products, operate in multiple jurisdictions, or have unclear compliance procedures. These cases serve as a clear signal to other platforms of the potential consequences of falling afoul of securities laws.

Both the Binance and Coinbase cases highlight the regulator's commitment to applying traditional securities laws to the burgeoning digital asset field. Indeed, these lawsuits could signify a turning point where centralized finance (CeFi) platforms face more stringent regulation, much like traditional finance (TradFi). The implications are twofold: On one hand, such regulatory scrutiny might temporarily unsettle investor trust in platforms like Binance. On the other, it can potentially enhance long-term investor confidence as the sector integrates more rigorous governance akin to TradFi, thereby decreasing risk and fraud. Ultimately, this trend towards heavier regulation is likely to strengthen the cryptocurrency industry, enhancing its credibility and maturity.

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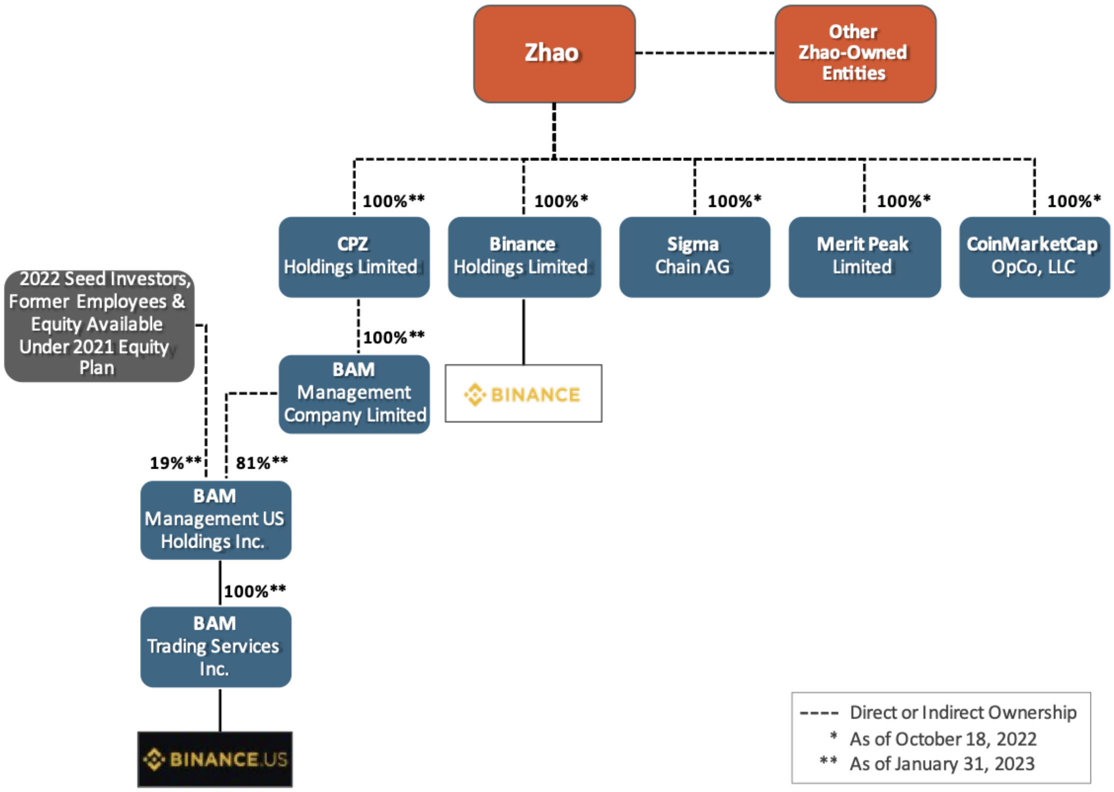
# Figure 1: Group structure




Source: SEC