

Professional Perspective

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Current State of Crypto Regulation in New York

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In these days of crypto platforms coming under increasing scrutiny, the state of New York in particular has been establishing clear regulatory expectations through enforcement actions involving two crypto exchanges.

On Feb. 22 and March 9, 2023, Letitia James, the Attorney General of the State of New York (the NY AG), filed enforcement actions against CoinEx and KuCoin for engaging in crypto transactions with users in New York in violation of the state's blue sky law. These enforcement actions are consistent with other recent actions taken against crypto platforms by the NY AG, in addition to other state authorities, the U.S. Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and Department of Justice (DOJ). Of course, the actions also come on the heels of the well-publicized, high-profile bankruptcies of other crypto platforms.

This article examines these recent developments, providing context and highlighting the legal theories involved.

Crypto Enforcement Efforts to Date

Beginning as early as 2013, U.S. regulators have expressed concern regarding crypto activities, marked by enforcement actions brought by the SEC in that year—and every year since—against crypto platforms that failed to register with the SEC in accordance with the Federal securities laws. While early cases largely involved the issuers of individual crypto tokens alleged to be securities, the SEC has recently pursued actions against crypto exchanges, especially those whose service offerings include crypto lending programs.

These programs allow customers to “lend” their crypto to the exchanges, in return for fiat currency-based sums secured by the tokens, or for a fixed amount of monthly interest to the customers for the duration of the lending agreement. Meanwhile, the crypto exchanges use the tokens for various purposes, including to fund their operations or to trade with the tokens. The NY AG, in concert with the authorities of other states, has commenced and settled parallel actions against a number of the same exchanges involved in SEC actions.

Starting in mid-2022, a downturn in the crypto market saw crypto users begin to convert their crypto holdings to fiat currency or recall them from lending agreements. Several crypto platforms, some of which were engaged in fraudulent conduct, quickly became insolvent and/or filed for bankruptcy protection. This resulted in significant losses to retail users, giving authorities a mandate to go after crypto platforms with even stricter scrutiny as to their business models and regulatory compliance efforts, even where no fraud is apparent or alleged.

Staking services, the quintessential way for crypto token holders to profit from their holdings outside of price appreciation, appear to be among the next areas of focus for regulators. Staking is arguably similar to the crypto lending programs discussed above as it involves users transferring their crypto tokens to an exchange so that the exchange can pool and use those tokens to earn a profit.

While the SEC recently entered into a settlement agreement regarding staking activities, the NY AG's allegations against both CoinEx and KuCoin are court-based actions that contain arguments that crypto staking activity constitutes a security offering. If successful, the actions could create precedent lacking from the SEC settlement, at least pursuant to New York law. Additionally, certain aspects of the pleadings suggest that the NY AG seeks to push the envelope even further as to what makes crypto offerings of various kinds become securities offerings.

CoinEx Platform & Enforcement Action

CoinEx is a virtual currency trading website headquartered in Hong Kong and operated by VINO Global Limited. CoinEx offers for sale and purchase numerous crypto tokens and provides information regarding staking to its customers, but, notably, does not offer staking services itself.

On Feb. 22, 2023, the NY AG initiated a special proceeding in the Supreme Court of the State of New York seeking a permanent injunction banning CoinEx from engaging in buying and selling commodities and securities with New York users. The NY AG is also seeking an order directing CoinEx to provide New York users with restitution and the option to rescind their transactions, as well as the disgorgement of CoinEx's revenue from those transactions.

To facilitate the requested relief, the NY AG has also asked the court to direct CoinEx to provide an accounting of transactions and associated fees involving New York users for the last six years and to implement IP address and GPS location geo-blocking to prevent New York users from being able to access CoinEx's website and mobile application. Because New York has a very restrictive law requiring crypto platforms to be licensed—i.e., the so-called BitLicense, which is required for entities engaged in “virtual currency business activity”—most crypto platforms already specifically reject customers from New York and/or geo-block New York IP addresses.

The petition comes after CoinEx failed to appear in January of this year in response to a subpoena issued by the NY AG. The petition and subpoena were brought under New York Executive Law § 63(12), which empowers the NY AG to bring expedited proceedings to enjoin “repeated fraudulent or illegal acts”. The legal basis for the action is the NY AG's allegations that CoinEx, in its operation as a crypto exchange, persists in violating two provisions of the Martin Act. New York General Business Law §§ 352 et seq.

Alleged Violations

The NY AG alleges that CoinEx, without being registered to do so, operates as a commodity broker-dealer and a securities broker and dealer—read: facilitates transactions in commodities and securities—to New York users in violation of § 359-e(3) of the Martin Act. In support of this allegation, the NY AG identified four crypto tokens traded on CoinEx that are purportedly both commodities and securities: the LBC, LUNA, AMP, and RLY tokens.

The other alleged violation, of § 352-c(3) the Martin Act, is that CoinEx represents itself as an “exchange” despite not being registered with the SEC as a national securities exchange and not being designated as a contract market by the CFTC. To that end, the NY AG notes that the platform's website states CoinEx is a “global crypto exchange” and has a section titled “Exchange” in which it streams real-time and historical data of crypto tokens. Additionally, the NY AG alleges that the “Ex” in “CoinEx” is intended to be an abbreviation of “exchange”.

Legal Analysis

The NY AG's case against CoinEx turns upon whether CoinEx effects transactions in commodities or securities with New York users as a matter of law. It is important to note, however, that the court need only find that one of the tokens at issue is either a security or commodity in order for the NY AG to succeed on the merits.

Courts have frequently held that crypto tokens writ large fall within the definition of “commodity” within the CFTC's enforcement jurisdiction under the Commodity Exchange Act of 1936 (CEA), including the two leading tokens, Bitcoin (BTC) and Ether (ETH). To that end, the NY AG asserts that the definition of “commodity” under the Martin Act is even broader than that under the CEA.

However, no such broad findings have been made with respect to whether crypto tokens fall under the definition of “security” set forth in the Securities Act of 1933. Accordingly, the SEC has been forced to take a more ad hoc approach in its enforcement actions against individual crypto issuers and exchanges alike, which is also reflected in the NY AG’s petition against CoinEx.

A test set forth in a 1946 SEC case, the *Howey* test, is one of the prevailing standards used to determine whether a crypto token is a security. In fact, the *Howey* test was used in a SEC decision on Nov. 22, 2022, relating specifically to LBC tokens, where the District Court for the District of New Hampshire found in favor of the SEC in holding that LBC tokens were offered and sold as a security by the token’s issuer, LBRY. Notably, prior to this case, courts had only found crypto tokens sold in initial coin offerings to be securities.

Citing the *LBRY* decision as precedent, the NY AG applied the *Howey* test to the remaining tokens at issue in the case against CoinEx and argued that since LBC was found to be offered as a security, the remaining tokens are securities under New York and Federal law for the same reasons. However, whether the court will find the reference to the *LBRY* case persuasive remains to be seen—no decision in a case citing *LBRY* has been rendered yet by any court.

Generally, a token issuer’s references to terms associated with securities—for example, “investment”, “profit”, and “return”—and evidence that the token’s ecosystem creates a common enterprise for its holders who reasonably expect to receive profits derived from the efforts of the issuer’s managerial team can land an instrument in “security” territory under the *Howey* test. The NY AG’s petition alleges that all of the foregoing was at play, arguing that each of the tokens in question “were used to finance and promote their respective networks’ enterprises and were also promoted as profit-accruing investments” and citing specific examples of this from the token issuers’ websites and social media.

Next, the NY AG analyzed the tokens pursuant to a 1932 New York case called *Waldstein*, which sets forth a test of whether an instrument constitutes a security under the laws of New York State, which the NY AG argues is a similar analysis to *Howey*. Significant about this argument is that this appears to be the first time *Waldstein* has been cited in a crypto-related enforcement action in New York. Should the court find in favor of the NY AG, this would establish the *Waldstein* test as precedent, potentially broadening the scope of which crypto tokens can be classified as securities for purposes of New York law.

The NY AG also detailed CoinEx’s alleged promotion of staking activities to bolster its arguments that the tokens at issue are commodities, under the definition of “commodity contract” in the Martin Act, and securities, under the “common enterprise” analysis of the *Howey* Test.

KuCoin Platform & Enforcement Action

Similarly, on March 8, 2023, the NY AG initiated another special proceeding in the Supreme Court of the State of New York under New York Executive Law § 63(12)—this time against the operators of the KuCoin platform, a virtual currency trading website headquartered in the Republic of Seychelles. KuCoin’s service offerings include the sale and purchase of numerous crypto tokens as well as what the NY OAG describes as both a savings and staking product, known as “KuCoin Earn”.

The NY AG’s allegations against KuCoin are largely the same as those against CoinEx—i.e., that KuCoin operates as a commodities broker-dealer and a securities broker and dealer without the proper registration, and unlawfully represents itself as an exchange. However, the NY AG has made an additional allegation against KuCoin: that it unlawfully issues its own security, KuCoin Earn, without proper registration.

The NY AG is seeking the same remedies as in *CoinEx*, including a permanent injunction against transacting with New York users, restitution, disgorgement, and orders directing KuCoin to provide an accounting and implement geo-blocking. KuCoin also failed to appear in response to a subpoena issued by the NY AG earlier this year.

Legal Analysis

To support the allegation that KuCoin has failed to properly register, the NY AG identified three crypto tokens traded on CoinEx that are purportedly both commodities (again, due to the broad definitions of “commodity” under the CEA and Martin Act) and securities (pursuant to both *Howey* and *Waldstein*, which the NY AG again asserts are similar analyses): the ETH, LUNA, and UST tokens.

By way of background on these crypto tokens, the mid-2022 downturn in the crypto market is largely attributed to the plummet in market value of two interconnected crypto tokens issued by Terraform Labs: LUNA and UST. The prices of these previously widely traded tokens fell to nearly zero in May 2022 after the value of UST—which was intended to be a so-called “stablecoin”, or a token always equal in value to \$1—fell below \$1, wiping out tens of billions of dollars of market capitalization and rattling confidence in the stability of the crypto ecosystem.

The SEC filed a complaint against Terraform Labs on Feb.16, 2023, though the investigation into Terraform Labs began before the collapse of its tokens. In addition to registration violations for its offerings of LUNA, UST, and a third crypto token, the SEC has alleged that Terraform engaged in fraud. The NY AG's allegations against KuCoin regarding the LUNA and UST tokens may be strategic given their outsized role in the crypto market's fallout and the SEC's ongoing enforcement action against Terraform Labs, although this background was not mentioned in the KuCoin petition.

However, the NY AG's allegation that ETH is a security is certainly strategic: in late 2022, the Ethereum Blockchain, to which ETH is the native token, shifted the method by which ETH transactions could be verified by consensus from “proof-of-work” to “proof-of-stake”. When the consensus mechanism was proof-of-work, meaning that transactions were verified through the expenditure of computational power by the participants in the network, there seemed to be an agreement among both the SEC and the CFTC that ETH was a commodity and not a security.

However, the shift to proof-of-stake, in which transactions are validated only when participants stake ETH tokens behind the requested transaction, combined with the SEC's application of the *Howey* test to staking activities in recent enforcement actions, may have inspired the NY AG to pursue a court finding that ETH is a security. If ETH is deemed to be a security, even just for purposes of New York law, the enforcement floodgates could be opened for a number of other crypto tokens previously thought to be “safe” from such a designation; ETH—widely regarded as the #2 token behind only BTC in terms of value, adoption, and long-term stability—serves as the base for a variety of other tokens in the marketplace, including virtual assets that are not crypto “currencies”, such as most non-fungible tokens.

Finally, the NY AG alleges that KuCoin Earn constitutes a security offering under both *Howey* and *Waldstein*. Users who deposit their crypto token holdings into a KuCoin Earn account are paid interest and/or staking rewards generated as a result of KuCoin pooling users' assets together. In support of its allegation, the NY AG employs a similar analysis to that set forth with respect to ETH.

What's Next

While staking services may be the next clear crypto regulatory battleground, any crypto platform or service offering or aspect thereof in which a federal or state authority has reason to believe that consumers' assets may be at risk should be considered fair game for regulatory action. The high level of interconnectedness between parties and funds in the crypto space that continues to be revealed—in the bankruptcy proceedings of failed crypto platforms and otherwise—has prompted even stricter scrutiny on the business models and regulatory compliance efforts of crypto platforms, including those that remain solvent and out of trouble...at least for now.

For example, in the case of parties connected to bankrupt crypto exchange FTX and its venture capital arm, Alameda Research, whose executives are facing actions from the SEC, CFTC, DOJ, and others, the sources of platforms' operational funds—and how the funds should be used while the sources are being figured out—have been called into question. Relatedly, the SEC, New York State Department of Financial Services (which issues BitLicenses), and DOJ came out against a proposed deal in a Chapter 11 proceeding in which crypto exchange Binance.US would buy the assets of now-bankrupt crypto exchange Voyager Digital due to concerns over Binance.US's business model. Then, on March 27, 2023, the CFTC filed a civil enforcement action against separate global entities in the Binance family of companies, along with its CEO and former CCO, for “engaging in a calculated strategy of regulatory arbitrage”.

And, in relation to the recent failures affecting the global banking markets, Silicon Valley Bank, Signature Bank, and Silvergate Bank were all among the most popular institutions that crypto platforms banked with, and all three either failed or halted operations in the same week earlier this month. While it may seem easy enough for depositors to switch banks, many crypto platforms are regulated in such a way that advance regulatory approvals are required before they are able to move their funds.

What's clear for now is that the NY AG's petitions in *CoinEx* and *KuCoin* are building upon current momentum in regulatory enforcement by pursuing holdings that staking activity constitutes a security offering and that the *Waldstein* test can be appropriately applied to crypto-related actions. Both holdings could potentially open the door to a significant number of additional crypto tokens being designated as securities under New York law.