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Not “Securities” — A Victory for Crypto-Related Products

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A jury recently held that four cryptocurrency-related products were not “investment contracts,” giving cryptocurrency market participants some much-needed and rarely received comfort that their digital asset(s) or product(s) ***may not*** be subject to state and federal securities laws.

In *Audet v. Fraser*, the plaintiffs filed a class-action lawsuit, alleging that the defendants made false and misleading statements to investors about their virtual currency mining operations, bringing claims for violations of the Securities Exchange Act of 1934 (Exchange Act) and the Connecticut Uniform Securities Act (CUSA).[1]

The plaintiffs alleged that the defendants created a payment system to defraud investors that worked as follows: The defendants sold shares in the returns of their mining operations by allowing the plaintiffs to purchase “Hashlets.” These “Hashlets” represented the purchaser’s share of “hashing”/computing power that the defendants had allegedly devoted to mining virtual currency. The plaintiffs alleged that the defendants then began selling “Hashpoints,” which were promissory notes that could be converted to a digital currency that the defendants had also launched called “Paycoin.” These Paycoins could be held in a digital wallet also created by the defendants called “HashStakers.”

Whether the defendants had liability for violating the Exchange Act or CUSA depended on whether the plaintiffs could prove that either the Hashlets, Hashpoints, HashStakers, or Paycoin were “investment contracts.” By way of brief background, the term “security” is broadly defined in the Exchange Act to include stocks, bonds, “investment contracts,” and numerous other types of securities.[2] To date, Congress has not updated the definition to address the various digital assets and digital-asset products prevalent today.[3] In response to the lack of specific statutory authority, courts have relied on the Supreme Court’s *Howey* test to analyze whether a specific digital asset or product is an “investment contract” and, thus, a security subject to federal securities laws.[4]

In *Audet*, the jurors were asked to apply the *Howey* test to the facts of the case to determine whether Hashlets, Hashpoints, HashStakers, or Paycoin constituted “investment contracts.” The jurors answered that none of the products were investment contracts, resulting in a complete victory for the defendant on the state and federal securities law claims.

The verdict will have wide-reaching implications, including the following:

First, *Audet* involved four very different crypto products similar to many other crypto or crypto-related products on the market. Accordingly, some issuers of such products may conclude that, if litigated, their products would not be

considered “securities” and, therefore, not subject to state and federal securities laws. It may strengthen their resolve to litigate or resist enforcement.

Second, the decision could change the balance of power when plaintiffs or regulators try to enjoin certain companies. For example, in a case styled *Securities and Exchange Commission v. Telegram Group Inc.*, the Securities and Exchange Commission (SEC) obtained an injunction against a messaging app company called Telegram to prevent Telegram from delivering a crypto product called “Grams.”[5] To grant the injunction, the SEC had to show that it had a substantial likelihood of success in proving that a series of contracts and understandings between Telegram and the initial purchasers of the Grams were a security. Using the *Howey* test, the court concluded that the “SEC has shown a substantial probability of success in proving that the series of understandings, transactions, and undertakings are investment contracts and, therefore, are securities, under *Howey*.”[6] Following the *Audet* verdict though, courts may be less inclined to find that a plaintiff has a “substantial probability of success” in proving that a certain digital asset or product is a security under *Howey*.

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[1] *Audet v. Fraser*, No. 3:16-cv-00940-MPS (D. Conn.).

[2] 15 U.S.C.S. § 77b(a)(1).

[3] *Id*.

[4] *S.E.C. v. W.J. Howey Co.* (*Howey*), 328 U.S. 293, 299 (1946).

[5] *Securities and Exch. Commn. v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020).

[6] *Id.* at 368.

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