NOVEMBER 18, 2021

Federal Jury Finds Cryptocurrency Products Not Securities in Landmark Verdict

On November 2, 2021, a federal jury in *Audet* v. *Fraser* found that four cryptocurrency-related products were not securities under the Securities Exchange Act of 1934 and the Connecticut Uniform Securities Act. This case is significant because it appears to be the first time a jury has reached a verdict on whether cryptocurrency products are securities under the test articulated by the Supreme Court in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946). This case thus is instructive in the developing area of law as to whether digital assets and other crypto-related products may be considered to be securities.

Plaintiffs brought suit on behalf of a class of individuals who purchased cryptocurrency-related products called "Hashlets," "Hashpoints," "Paycoin," and "Hashstakers" (the "Products"). Plaintiffs initially sued GAW Miners, LLC and ZenMiner, LLC, the companies that developed the Products, along with GAW CEO Homero Joshua Garza and investor and director Stuart A. Fraser. But the two companies defaulted[1] and plaintiffs later dismissed Garza from the suit after he pleaded guilty to wire fraud in a related DOJ action,[2] leaving Fraser as the sole remaining defendant at trial.

GAW and ZenMiner initially sold physical crypto mining hardware to customers who would use its computing power to "mine" for virtual currency. Customers who purchased GAW and ZenMiner's hardware-hosted mining products were told that they had purchased specific pieces of physical mining equipment and that they could request that their equipment be shipped to them at any time. Plaintiffs alleged that, in reality, the companies never had sufficient designated equipment to support the hosted mining services they sold to customers or to ship to customers upon request.[3] Unable to fulfill customers' orders, the companies introduced "Hashlet contracts," which entitled their customers to a share of the profits from the companies' crypto mining profits. Plaintiffs alleged that defendants sold far more Hashlets worth of computing power than they actually had in their computing centers, and there was no equipment to back up the vast majority of Hashlets sold.[4] Defendants collected roughly $19 million in revenue from their sales of Hashlets.[5] Plaintiffs further alleged that, when the Hashlets scheme began to unravel, defendants pivoted and began selling "Hashpoints,"convertible promissory notes that could be converted into a new virtual currency called Paycoin. Before it launched Paycoin, GAW also sold "HashStakers," which were digital wallets that could lock up

1 GAW Miners Class Action FAQ, available at https://www.gawminersclassaction.com/Home/FAQ.

2 Charlie Osborne, "GAW Miners CEO earns prison time for defrauding customers of $9 million," Zero Day Net (Sept. 17, 2018), available at https://www.zdnet.com/article/gaw-miners-ceo-earns-prison-time-for-defrauding-customers-of-9-million/.

3 *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 57 at ¶ 6 (D. Conn. 2021).

4 *Id*. at ¶ 7.

5 *Id*.

Paycoin for 30, 90 or 180-day terms and generate fixed returns. Defendants launched Paycoin by promoting a $20 price floor and its wide acceptance by well-known merchants, neither of which ultimately proved to be true.[6]

Plaintiffs brought claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and Sections 36b-29(a)(1) and (2) of the Connecticut Uniform Securities Act, as well as claims for common law fraud. With respect to the common law fraud claims, the jury found that GAW Miners had engaged in a fraud concerning Hashlets but that plaintiffs did not prove that Fraser had aided and abetted in the company's fraud.[7]

Some key takeaways from the jury instructions are as follows:

- **The jury found that none of the four Products were securities**. The court explained that four of the plaintiffs' five claims against Mr. Fraser required plaintiffs to prove that one or more of the Products were securities, and that the jury should therefore begin its deliberations with this question.[8] Plaintiffs relied on the fact that the SEC had previously asserted in a successful civil fraud action against Garza that Hashlets were securities.[9] The court instructed the jury on application of the *Howey* test, stating that "to establish that a Product is an 'investment contract,' the plaintiffs must prove that there was, with regard to that Product: (1) an investment of money; (2) in a common enterprise; (3) with profits to be derived solely from the efforts of others." The instructions noted that "[f]or each of these elements, you must focus on what the buyers of the Products were led to expect about the nature of the Products."[10] The court also gave specific guidance on the second and third elements. With respect to the "common enterprise" element, the instructions provided that "Plaintiffs must prove with respect to a specific Product, either: (1) that each individual buyer's fortunes were tied to the fortunes of the other buyers by the pooling of their assets, usually combined with the pro-rata distribution of profits, i.e., distribution proportionate to the buyer's investment; or (2) that the individual buyer's fortunes were tied to the fortunes of GAW Miners, i.e., that the fortunes of the buyers and the Company were linked so that they would rise and fall together."[11] And with respect to third element—whether profits are derived solely from the efforts of others—the court instructed the jury that "[i]f there was a reasonable expectation of significant investor control, then profits would not be considered derived solely from the efforts of others," but "if the expectation was that the participants would be passive investors, then profits would be considered derived solely from the efforts of others."[12] The jury found that none of the four Products were investment contracts.[13]

- **The court instructed the jury that a currency is not a security and defined "currency" as broader than merely fiat**. With respect to the federal securities claim, the court noted in the jury instructions that "there is an exception to the definition of 'securities' available under the Exchange Act that is not available under the [Connecticut Uniform Securities Act]. Specifically, the Exchange Act provides that a currency is not a security. That means that, for the Exchange Act claim only, even if a Product meets the definition of an 'investment contract', it is not a 'security' if it is a currency." Fraser had asserted an affirmative defense that Paycoin, GWC's virtual currency, was properly considered a currency and therefore could not be a security. The court defined currency as "an item (such as a coin, government note, or banknote) that is generally accepted as payment in a transaction and recognized as a standard of value." The court cautioned in the jury instructions that "it is important to note that merely describing a product as a 'currency' does not make it one. You should

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6 *Id*. at ¶ 8.

7 *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 330 at 13-14 (D. Conn. 2021).

8 *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 326 at 20 (D. Conn. 2021).

9 Connecticut-Based Bitcoin Mining Fraudster Sentenced to Prison, SEC Litigation Release No. 24281 (Sept. 20, 2018), available at https://www.sec.gov/litigation/litreleases/2018/lr24281.htm.

10 *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 326 at 21.

11 *Id*.

12 *Id*. at 21-22.

13 *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 330 at 2 (D. Conn. 2021).

focus on the substance and economic reality of Paycoin, not its name or label. The Defendant has the burden of proving that Paycoin is a currency."[14]

Implications

Over the last few years, courts have increasingly grappled with the question of when digital assets constitute securities. For example, in *Securities and Exchange Commission* v. *Telegram,* the court granted the SEC's motion for a temporary restraining order to enjoin Telegram from engaging in a plan to distribute a new cryptocurrency to certain sophisticated entities and high net-worth individuals.[15] And in *United States Securities and Exchange Commission* v. *Kik Interactive Inc.*, the court granted summary judgment in favor of the SEC, holding that the defendant's digital token product was an investment contract under Section 2(a)(l) of the Securities Act.[16] This case is significant because it is the first time a jury has reached a verdict on the question of whether particular cryptocurrency-related assets are securities, let alone found that such assets are not securities. The jury instructions in the *Audet* matter may serve as useful guidance for litigants and market participants considering whether digital assets may be securities. The court also provided a defendant-friendly instruction on the third element of the *Howey* test—often the most hotly contested element—by instructing the jury that profits are not derived solely from the efforts of others where there is "a reasonable expectation of significant investor control." It will be interesting to see how defendants utilize this verdict in future cases.

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[14] *Audet* v. *Fraser*, No. 3:16-cv-940, ECF No. 326 at 20-21 (D. Conn. 2021).

[15] *Secs. & Exch. Comm'n* v. *Telegram, et al*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020).

[16] *Secs. & Exch. Comm'n* v. *Kik Interactive Inc*., 492 F.Supp.3d 169 (S.D.N.Y. 2020).

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