Hughes Hubbard & Reed

The Case of Audet v. Fraser: Hashlets, Hashtakers, Hashpoints and PayCoin, Oh My!

Andrew F. Fowler
Articles & Press

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

Regulatory Background: Crypto-related Products as Possible "Securities"

In recent years, numerous crypto-related products have emerged, rapidly coalescing into a large and ever-growing eco-system of digital assets like "coins", "tokens" and blockchain-driven platforms, often with colorful names, internet mascots, memes, and widespread media and public attention. These crypto-related products raise novel policy and legal questions as regulators and courts wade into the mix. The recent case of *Audet v. Fraser* (*Audet v. Fraser*, 3:16-cv-00940-MPS (D. Conn.)), successfully litigated in November 2021 in Connecticut federal court by my colleagues Dan Weiner, Marc Weinstein, Amina Hassan and Hannah Miller at Hughes Hubbard & Reed LLP, is the first case where a jury addressed whether crypto-related products constituted securities — specifically, a particular type of security, called an "investment contract". *Audet* provides a useful lens to examine the key question of what factors may (or may not) cause certain crypto-related products to be considered securities.

The United States Securities and Exchange Commission ("SEC") has historically been reluctant to offer specific guidance on what exactly is a "security". To some degree, the old adage of "we know it when we see it" has applied, allowing regulators to cast a wide net in policy-driven efforts to deter fraud and misconduct. In dealing with crypto-related products, the SEC and courts have generally applied existing criteria, including the long established "*Howey* test" (*SEC v. Howey Co.*, 328 U.S. 293 (1946)) and relied on specific items within the definition of "securities" under federal securities law, including the United States Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). The *Howey* test has three (sometimes presented as four) fact-specific prongs, as discussed in further detail below. In parallel, the definition of a "security" under federal

categories covered under the list of "securities" under the 1933 Act. The SEC seems especially focused on tokens or coins tied to a currency or basket of assets or traded on exchange platforms. Recently, the SEC has used its enforcement resources to prioritize the possible risks to retail "mom and pop" investors and expressed special interest in trading platforms that function in a way similar to traditional fee-driven securities trading exchanges. In a virtual press conference on January 19, 2022, Chair Gensler emphasized regulating crypto exchanges, and told reporters he has "asked [his] staff to look at every way to get these platforms inside the investor protection remit."

Before plaintiffs filing of their lawsuit against Stuart Fraser (former vice-chair of financial services firm Cantor Fitzgerald), the SEC had filed a securities fraud enforcement case against Fraser's former business associate Homero Joshua Garza, alleging that Hashlets offered by GAW Miners, LLC and/or ZenMiner LLC (d/b/a Zen Cloud) constituted "investment contracts." Mr. Garza did not contest the SEC's allegations. Instead, he settled with the SEC and agreed to entry of a judgment against him. In *Audet*, the plaintiffs relied heavily on the SEC's allegations that the Hashlets were "investment contracts" – and therefore securities.

So, why did the jury disagree?

Case Background, Specifics and Significance of the Determination of Status as Securities

In *Audet*, plaintiffs accused Fraser of secondary liability for fraud that plaintiffs alleged Mr. Garza and his companies committed in the offer and sale of various crypto-related products causing them to lose tens of millions of dollars. Plaintiffs' case hinged on the argument that the four separate crypto-related assets — Hashlets, Hashtakers, Hashpoints and PayCoin — were "investment contracts". Plaintiffs initially asserted primary violation claims against Mr. Garza and the company defendants, including securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 and the Connecticut Uniform Securities Act (the "CUSA"), as well as a securities registration claim under the CUSA. Plaintiffs asserted secondary liability claims against Mr. Fraser, including a control person securities fraud claim under Section 20(a) of the 1934 Act, and control person and aiding and abetting securities claims under the CUSA. Plaintiffs also asserted a common law fraud claim against Mr. Garza and the company defendants and a related aiding-and-abetting common law fraud claim against Mr. Fraser. Plaintiffs then entered into a cooperation agreement with Mr. Garza, dropping him from the case (he also pleaded guilty to wire fraud and was sentenced to 21 months in a related criminal case).

The evidence at trial undermined plaintiffs' "control person" and "aiding and abetting" claims against Mr. Fraser. It showed that Mr. Fraser lost many millions to Mr. Garza, did not control the companies and was not involved in the alleged fraud. Moreover, plaintiffs' allegations of culpability against Mr. Fraser were based on the self-serving testimony of Mr. Garza, the architect of the fraud, who agreed to point the finger at Mr. Fraser after signing a cooperation agreement with plaintiffs. More fundamentally, if the products at issue were not securities, the jury had no basis to even reach plaintiffs' securities fraud claims against Mr. Fraser.

Plaintiffs alleged that all four products at issue were securities because they were "investment contracts." Mr. Fraser's defense counsel saw an opening to question whether or not this critical building block of plaintiffs' case had a factual basis. Accordingly, they requested that the jury instructions go back to the basics, by looking at the

Defense counsel challenged plaintiff's proof (or lack of proof) under *Howey* for each of the four products. Regarding Hashlets, for instance, defense counsel demonstrated to the jury that plaintiffs' evidence failed the second and third *Howey* factors. Defense counsel elicited testimony from plaintiffs' witnesses to show that the returns Hashlet owners received were not tied to the success or failure of any overall common enterprise, nor to the "fortunes" of the company defendants, which received a fixed maintenance fee for maintaining and operating the miners, with no regard to how much profit a Hashlet owner made from his or her Hashlet. Hashlets therefore failed the "common enterprise" prong of *Howey*. Defense counsel also presented evidence to the jury and argued that, because individual customers could control how their Hashlets were deployed to earn a profit — by choosing and changing, if desired on a daily basis, which cryptocurrency to mine and which pools to mine — those customer allocation decisions (not choices made by the companies) drove results. A plaintiff class representative testified for instance that he closely monitored his Hashlets, and actively chose and changed the mining pools for his Hashlets. This operational distinction contrasted with a typical investment in a company, where passive investors' returns depend on decisions made by company management and individual investors have no control. This distinction also undermined the "efforts of others" prong of *Howey* in the case of Hashlets. Customers' profits or losses were driven by their level of success in their own choices.

The jury agreed, finding that the Hashlets, and the other three crypto-related products, were not investment contracts, and thus were not securities.

Takeaways and Lessons Learned

If a crypto-related product is not included in the laundry list of specific "securities" enumerated under the 1933 Act or 1934 Act (as may be applicable in a case), and is characterized by plaintiffs or the SEC as an "investment contract," then the fact-specific analysis of the *Howey* test is in order. *Audet* reminds us that a fact-finder's reversal of an SEC determination on security status is possible, and that deference to such regulatory determinations is not a given. The proliferation of digital assets may make this scenario more common. If any one or more prongs of the *Howey* test is not met, as was the case in *Audet*, then the liability regime for securities will not apply.

Although there may be other avenues to avoid the characterization of a crypto-related product as a security, the lack of "profit [...] to be derived from the efforts of others," also applicable in *Audet*, may prove to be the factor more likely to provide some flexibility in structuring a digital asset. As *Audet* demonstrates, when an individual customer retains "significant control," and is not simply a passive investor, then under the current regulatory regime the products would not be a security. The second prong (a common enterprise) also may provide some room for structuring creativity to possibly silo individual holders' profits from those of the other holders, or use other measures to avoid the conclusion that there was a common enterprise.

So, where do we go now? Given that the SEC leadership remains skeptical of the crypto ecosystem and is wary of risks to the public, it will be interesting to see if the *Audet* verdict drives any clarifications of the SEC's definitions of what constitutes a "security" in the crypto space. Possibly to keep maximum flexibility to regulate from a policy standpoint, the SEC has typically not sought to offer further clarity on what is a security in the crypto context. We

Related People

Andrew F. Fowler

Daniel H. Weiner

Marc A. Weinstein

Amina Hassan

Hannah Miller

Related Areas of Focus

Securities & Capital Markets
Banking & Financial Services
Securities Litigation