

# SEC Sues Coinbase to Establish Jurisdiction Over Cryptocurrencies and Crypto Exchanges

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The U.S. Securities and Exchange Commission sued Coinbase, Inc., alleging the crypto assets Coinbase made available for trading on its exchange met the definition of “securities.” Because Coinbase did not register the assets as securities, and because it did not itself register as a securities broker or exchange operator, the SEC alleges it has jurisdiction to prosecute Coinbase for these securities registration violations. If the court accepts the SEC’s position that the SEC has jurisdiction to regulate crypto assets, it could broadly impact the trajectory of crypto as an accepted currency, investment, and trading medium.

## ***The SEC Says the Test for Investment Contracts Set Forth in the 1946 U.S. Supreme Court Opinion SEC v WJ Howey[1] Applies to Determine Whether Crypto Assets Are Securities***

In a June 6, 2023, federal court complaint filed in the Southern District of New York, the SEC alleges that Coinbase, Inc. operated a trading platform for the purchase, sale, and trading of crypto asset securities without registering as a securities broker, as a securities exchange, or as a clearing agency.[2] The Coinbase complaint takes the position that Coinbase’s crypto assets are “investment contracts” under the U.S. Supreme Court’s test set forth in *SEC v. WJ Howey*.[3] Based on this finding, the SEC alleges it has jurisdiction to require Coinbase to register as an exchange under Section 5 of the 1934 Exchange Act, a broker under Section 15(a) of the Exchange Act, and a clearing agency under Section 17A(b) of the Exchange Act.[4] By failing to register, and combining the activities of a broker, exchange, and clearing agency in one entity, the SEC alleges Coinbase puts investors at significant risk by avoiding the registration, disclosure, inspection, and anti-conflict of interest protections of the securities laws.[5]

## ***General Overview of Cryptocurrency and Cryptocurrency Markets***

Cryptocurrencies are digital currencies that trade through an exchange medium that does not rely on a central governmental or banking authority to uphold or maintain its value. These decentralized systems eliminate the need for traditional intermediaries, like banks, to validate cryptocurrency transfers. Speaking very generally, a cryptocurrency is a digital currency represented by a “coin” or “token,” whose ownership is tracked by a “blockchain.” Blockchains act as ledgers of sorts to track the issuance or transfer of coins. Blockchains are so named because their list of records—or blocks—are linked and secured using cryptographic encryption. A coin owner can access, receive, trade, or transfer her coins using her “wallet,” which allows her to access the blockchains that hold her coins using her private keys. Owners of cryptocurrency assets can buy and trade them for money or other digital currencies on cryptocurrency exchanges.

Cryptocurrency transactions that are processed by the coin’s exchange medium[6] are validated by a process called “mining.” If a miner successfully validates a transaction, the miner receives cryptocurrency as a reward. This validation process is important because it is the way blocks are added to a blockchain, thus providing a consensus among users as to the existence and ownership of their cryptocurrencies, and because the rewards to miners increase the supply of currency. The two main mining mechanisms in blockchains are “proof of work” or “proof of stake.” Proof of work uses computers called “validator nodes” to “mine” crypto transactions in a block by using trial and error to solve a difficult mathematical problem. The first miner that finds a solution to this problem and has other miners validate and accept it

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can update the blockchain and, in return, receive the blockchain's native crypto asset as a reward. Proof of stake involves selecting "validators" for a block from crypto asset owners who then "stake" a minimum number of crypto assets as collateral for their mining performance.

A company may use an "initial coin offering (ICO)" as a means to raise funds for its crypto venture.[7]

Because proof of work cryptocurrency mining involves solving very complicated mathematical problems, it requires complex computers and consumes significant electrical power. Thus, the cost of computing equipment and electricity can be a significant expense. Miners have to gauge whether the expense is worth the payoff of receiving cryptocurrency rewards if their mining efforts are successful. This has caused miners to pool assets and resources to "split" the cost of mining. The *Audet v Fraser* case, discussed below, analyzed the *Howey* test to determine whether the value of the mining process was predominantly derived from the company hosting the mining computers, or whether the value was in the process of the miners—who bought shares in the computers—in successfully mining for new currencies. If the value was mainly born from the efforts of the company, the assets are more likely securities. If the value is driven mainly from the efforts of the miners, then the assets are less likely securities. The *Audet* court decided differently as to various assets in that case.

### ***SEC's Application of Howey to the Coinbase Assets in the Coinbase Complaint***

Coinbase operates a trading platform through which consumers can buy, sell, and trade cryptocurrency. The Coinbase platform has 108 million users and trades hundreds of crypto assets and accounts for billions of dollars of trading per day. Coinbase also offers a broker product for routing orders through the Coinbase platform (Coinbase Prime), and a wallet which routes orders through third-party platforms (Coinbase Wallet).[8] Central to the SEC's liability theory is its definition of 13 crypto assets that trade on the Coinbase platform as securities using the *Howey* test (crypto asset securities). The crypto asset securities are generally different native tokens available on different blockchains. The SEC alleges that Coinbase solicits customers and facilitates their trading of cryptocurrency assets on its platform. These securities are made available on the Coinbase platform and through Coinbase Prime and Coinbase Wallet. The SEC applies the *Howey* test to these crypto asset securities in paragraph 126 by calling them "investment contracts" based on statements by the crypto asset issuers, promoters, and Coinbase that have led reasonable investors to expect profits from the "managerial or entrepreneurial" efforts of the issuers and promoters.[9]

The SEC also applied the "common enterprise" element in *Howey* to a different class of crypto asset securities in which Coinbase allowed investors to take "stakes." Blockchains that rely on proof of stake for adding blocks use "validators" to reach agreement about which transactions on the blockchain are valid. This is done by validators committing—or "staking"—a set amount of the blockchain's native asset, which is held as collateral. If the validator succeeds in proposing new blocks, voting on proposed blocks, or other consensus activities, then the validator receives rewards such as added amounts of native assets. If the validator underperforms, he loses his collateral of staked assets. But staking is expensive. Besides having to stake minimum amounts of native assets to participate, validators also have to have access to and run a "validator node"—which is computing software and hardware to run staking activities full time.[10]

Coinbase's staking program allowed investors to pool their assets to meet minimum staking amounts for five crypto asset securities. Coinbase also offers and operates its own validator node that it uses for staking activities. In exchange for providing stake program investors with the ability to pool stakes and use of its validator nodes, Coinbase charges a

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25% or 35% commission based on the total rewards obtained from the staking activity, which Coinbase distributes *pro rata* to stake program investors. The SEC devotes almost 30 paragraphs in the Coinbase complaint describing how the staking program, as it applies to the five stakeable crypto asset securities, satisfies the elements of the *Howey* test.[11] The Coinbase complaint alleges 3 elements of the *Howey* test: 1) "Participants in the Coinbase Staking Program Invest Money;" 2) "Coinbase Staking Investors Participate in a Common Enterprise;" and 3) "Coinbase Staking Program Investors Reasonably Expect to Profit from Coinbase's Efforts." [12]

The Coinbase complaint defines each of these elements consistent with the analysis of these elements in the *Audet v. Fraser* decision, discussed below. For example, the SEC alleges that staking eligible crypto assets meets the "investment of money" prong of the *Howey* test.[13] And although the Coinbase complaint does not mention them by name, it describes the two ways a plaintiff can meet the common enterprise element as defined in the *Audet* opinion:

- Horizontal commonality—the fortunes of staking program investors are tied to those of other investors because all their assets are pooled into a Coinbase staking wallet and returns are delivered *pro rata*:[14] and
- Vertical commonality—the fortunes of the investors in the five staking crypto asset securities are tied to the fortunes of Coinbase because Coinbase's commissions increase with the increase of the rewards from the staking activities.[15]

Finally, the SEC alleges satisfaction of the third *Howey* factor because public statements made by Coinbase in its marketing and investor materials cause investors "to reasonably expect that they may obtain investment returns generated by Coinbase's efforts with respect to the Staking Program." [16]

Because the allegations in the Coinbase complaint are just that, it helps to understand how a court may apply the *Howey* elements to crypto assets and facts somewhat akin to those in the Coinbase complaint.

### ***Audet v Fraser* —A Template for the SEC v. Coinbase Analysis**

A 2022 federal trial court decision from Connecticut, *Audet v Fraser*, [17] illustrates how a court has analyzed similar crypto assets under the *Howey* test. In *Audet*, the court overturned part of a federal jury verdict which found that cryptocurrency-related assets of a crypto mining company were not "securities" under the federal *Howey* test for investment contracts. GAW Miners, LLC ("GAW") sold and marketed several crypto products: 1) "Hashlets," which were computers used by GAW to mine for cryptocurrency; 2) "Paycoin," GAW's cryptocurrency; 3) "Paybase," which was a platform funded with the goal of having merchants adopt consumer payment methods to use Paycoin at their stores more quickly and seamlessly; 4) "Hashpoints," which served like a GAW credit-card on which owners of the Hashlet machines could earn "Hashpoint" credits they could trade for Paycoin; and 5) "Hashstakers," which served as a wallet where owners could lock their Paycoins for a time and gain interest. A federal jury found that none of these crypto assets met the *Howey* test for investment contract securities. The court upheld the jury verdict as to all of the crypto assets except Paycoin, which the court found was a security and thus granted a new trial as to the securities fraud claims related to Paycoin.

The *Audet* court instructed the jury as to three main elements of the *Howey* test: "(1) an investment of money, (2) in a common enterprise; (3) with profits to be derived solely from the efforts of others." [18] The Court analyzed each of these factors for the Hashlet and Paycoin crypto products.[19]

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### ***Investment of Money***

The court held that cash is not the only form of investment that will meet this *Howey* factor. The defendant argued that the plaintiffs did not invest money because they paid for their Paycoin by using Hashpoint credits they earned, rather than with money or other cryptocurrency. The court rejected this argument, collecting cases that held that “cash is not the only form of contribution or investment that will create an investment contract . . . [T]he ‘investment’ may take the form of ‘goods and services’ or some other ‘exchange of value.’”[20] The court found that exchanging Hashpoints for Paycoin was an adequate exchange of value because plaintiffs gave up rights to receive Bitcoin or mining payouts in exchange for Hashpoints, which they used to acquire Paycoin. “In turn, GAW retained the Bitcoin or other cryptocurrency it would have paid out to the plaintiffs and ultimately gave the plaintiffs Paycoin in exchange for Hashpoints.”[21]

### ***Common Enterprise – Horizontal and Vertical Commonality***

The court found that the common enterprise element requires a finding of either “horizontal commonality or strict vertical commonality.”[22] Horizontal commonality exists when the fortunes of investors are tied to each other. Vertical commonality exists when the fortunes of investors are linked to the fortunes of the company.

The court found there was no horizontal commonality for the Hashlet owners because they could make profits or sustain losses “independent of the fortunes of other purchasers.”[23] This was because the Hashlet owners could receive vastly different payouts depending on which pools each owner mined each day. Even if two owners were mining in the same pool, one owner could “boost” his or her Hashlets to generate a larger payout. Because owners could receive different payouts depending on which pools they mined, or whether they boosted their Hashlets, the court found support for the jury verdict that the fortunes of one Hashlet owner were not tied to those of fellow owners.

The court also found there was no vertical commonality for Hashlet owners because their fortunes were not tied to GAW’s fortunes. Owners paid an upfront, flat fee for their Hashlet. GAW did not profit directly from an owner’s mining activities or the use of mining power in various mining pools. In other words, “GAW’s profit was not proportional to that of the Hashlet owner --- it earned the same amount regardless of whether the Hashlet owner earned a huge profit or a small one.”[24]

But the court did find horizontal commonality among the Paycoin owners. GAW’s promotional materials said it created a “Coin Adoption Fund” as part of its initial coin offering that was used to facilitate widespread adoption of the use of Paycoin.[25] When a purchaser received their Paycoin, the price of the Paycoin rose and fell at one time across the board, such that Paycoin owners gained or lost profit and value in proportion to the amount of Paycoin they owned. The court found this similar to other crypto cases in which courts found horizontal commonality where investors paid money to receive cryptocurrencies whose value was tied to the companies’ success of developing a blockchain or other parts of a “digital ecosystem, which if successful would increase the value of the cryptocurrency.[26] Here, investors in Paycoin pooled their assets for GAW’s use with the Coin Adoption Fund to promote Paycoin, which if successful would increase the owner’s Paycoin value. Because the court found horizontal commonality for Paycoin, it didn’t need to analyze vertical commonality.

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### **Expectation of Profit from the Efforts of Others**

The court found a reasonable jury could conclude that the profits an owner of Hashlets earned were not “derived primarily from the entrepreneurial or managerial efforts of GAW . . .”[27] The court found that GAW’s activity was limited to housing the physical mining equipment and providing sufficient electricity for the equipment. But the Hashlet owners selected the mining pools and how they allocated their mining power. As a result, some Hashlet owners did much better than other owners based on their mining decisions. GAW’s role as the court saw it was limited to housing and operating the mining equipment the owners used. So a Hashlet owner’s profits were not primarily based on GAW’s managerial or entrepreneurial efforts. The court distinguished other cases where the value of the crypto assets depended almost entirely on the company’s success in launching and operating a blockchain or digital ecosystem.[28]

The court did find that the profits an owner of Paycoin earned were based largely on the efforts of GAW. The value of Paycoin was tied to its unique efforts to driving the adoption of Paycoin in the market and with merchants. The more merchants adopted Paycoin as a payment method, and the more consumers who used Paycoin, the more valuable Paycoin became. GAW used three rounds of initial coin offerings to create the “world’s first” Coin Adoption Fund as a value-generation process for Paycoin. There was no evidence that general Paycoin purchasers with no affiliation with GAW had any control or role in this value-creation process for Paycoin. The court rejected the argument that Paycoin did not depend on GAW’s efforts because it used open-source software that anyone could recommend changes to, which Bitcoin and other owners can’t do. The court pointed out that GAW still controlled what changes were made to the Paycoin software, and that these software changes did not impact the growth in value of Paycoin as much as the merchant adoption efforts of GAW.[29] The court also rejected the argument that because Paycoin was traded on public exchanges its value was not tied to GAW’s efforts as much as market forces. The court said this ignored evidence of GAW’s “essential role” of establishing the market for Paycoin.[30]

Finally, the defendants argued that GAW failed to promote Paycoin as an investment. Rather, the defendants argued purchasers of Paycoin were mainly interested in consuming Paycoin as a medium to make purchases from merchants. The court pointed out that while some Paycoin owners may have had “consumptive intent,” the merchant adoption efforts undertaken by GAW for Paycoin were attempts to build an ecosystem that would add value to Paycoin that owners could realize by holding Paycoin and trading it following a public launch for a profit.[31] Thus, the evidence predominantly showed that purchasers of Paycoin were interested in the profits tied to its value and “not because they were excited at the prospect of using it to buy groceries.”[32]

### **Conclusion**

While human beings and machines may increasingly find ingenious ways to leverage technology to create and use capital for investment, the tests employed to determine whether those sophisticated assets are securities have stood the test of time. It will be interesting to see whether securities regulators and the courts use cases like *Coinbase* to develop additional or different standards to determine whether cryptocurrency assets should be treated as securities, and if so, whether the existing securities laws and regulations are sufficient.

[1] 328 U.S. 293 (1946).

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[2] *U.S. Securities and Exchange Commission v. Coinbase, Inc. and Coinbase Global, Inc.*, Case No. 23-Civ-4738 (SDNY June 6, 2023.)

[3] *See id.* at ¶¶6, 18, 103-10, 126.

[4] The SEC also sued Coinbase’s public holding company, Coinbase Global, Inc, as a “control person” of its wholly owned subsidiary Coinbase, Inc. *See id.* at ¶16, 381-85.

[5] *See id.* at ¶¶1-3.

[6] Exchanges often obtain cryptocurrency tokens for their own account and allow their users to trade amongst themselves. As these transactions are not processed on the cryptocurrency’s exchange medium, they are referred to as “off chain transactions.”

[7] *See generally* Coinbase complaint, ¶¶44-59.

[8] *See id.* at ¶¶1-6.

[9] *See id.* at ¶126.

[10] *See id.* at ¶¶309-21.

[11] *See id.* at ¶¶339-67.

[12] *See id.* at pp. 89-90, 93.

[13] *See id.* at ¶¶340-45.

[14] *See id.* at ¶¶346-53.

[15] *See id.* at ¶¶353-56.

[16] *Id.* at ¶361.

[17] 605 F. Supp. 3d 372 (D. Conn. 2022).

[18] *Id.* at

[19] The court noted the “scant” evidence presented at trial as to whether the Hashpoint or Hashstaker products were securities, and in a paragraph upheld the jury’s verdict on those products. *See id.* at 399.

[20] *Id.* at 395 n6 (cleaned up).

[21] *Id.* at 389.

[22] *Id.* at 394 n5.

[23] *Id.* at 390.

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[24] *Id.* at 392.

[25] *See id.* at 394.

[26] *See id.* at 394-95.

[27] *Id.* at 393.

[28] *See id.* at 393-94.

[29] *See*

[30] *See id.* at 397.

[31] *See id.* at 397-98.

[32] *Id.* at 398 n7. The court noted that the subjective intent of the purchasers was not determinative of whether Paycoin buyers has a reasonable expectation of profit. Instead, the *Howey* test focuses on the objective test of what purchasers were led to expect. However, the subjective intent of a purchaser "is probative on the issue of what a reasonable purchase would have expected." *Id.*