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Federal Court Orders New Trial to Consider Whether Cryptocurrency Constitutes a “Security”

A federal court recently rejected a jury’s verdict concluding that a disputed digital asset was not a security, and ordered a new trial to reconsider the issue. In November 2021, a federal jury in the District of Connecticut had become one of the first to deliver a verdict on the frequently discussed issue of whether cryptocurrencies constitute “securities” under governing securities law. The plaintiffs in *Audet v. Fraser* had asserted five claims under state and federal securities laws against the director of a developer of virtual currencies, in connection with the company’s solicitation of cryptocurrency products. After an eight-day presentation of evidence, the jury returned a verdict in favor of the defendant, concluding that none of the products constituted investment contracts, and, therefore, that the four cryptocurrency products did not constitute securities.¹

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The plaintiffs subsequently filed a motion for judgment as a matter of law and a motion for a new trial on the basis that the jury’s findings were against the weight of the evidence. On June 3, 2022, the court denied the motions as to three of the challenged products, but granted a new trial to consider whether one of the products, Paycoin, qualifies as an “investment contract.”² The decision highlights the continued development of this complex and fact-intensive cryptocurrency classification inquiry, which remains a pointed focus of both civil litigants and the SEC in the cryptocurrency space.

Background

The dispute in *Audet* involves the activities of GAW Miners, LLC (“GAW”), a company founded with the objective of selling physical equipment that its customers could use to “mine” for virtual currency. This business model purportedly proved untenable due to inadequate supply of the promised hardware, and GAW consequently resorted to the development of four new products to generate value for its customer base. The four new products were named “Hashlet” (a contract that entitled purchasers to part of GAW’s cryptocurrency mining profits), “Paycoin” (a novel virtual currency), “Hashpoint” (promissory notes convertible into Paycoin), and “HashStaker” (digital wallets in which Paycoin could be stored). The *Audet* plaintiffs, representing a class of individuals who had purchased these products, asserted that GAW’s business model amounted to a Ponzi scheme wherein the company paid existing investors their promised returns using the profits generated by new Hashlet sales. The plaintiffs brought claims under state and federal securities law, as well as for common law fraud, against GAW, its CEO, a member of its board of directors who had invested in the company, and another company that had helped to develop the challenged products. Prior to trial, the two entities defaulted, and GAW’s CEO was dismissed pursuant to a related guilty criminal plea. The lone director defendant proceeded to trial, where the plaintiffs pursued a “control” theory of secondary liability under Section 20(a) of the Securities Exchange Act of 1934, control person and aiding-and-abetting claims under the Connecticut Uniform Securities Act, and a claim for aiding and abetting common law fraud.

Because the plaintiffs’ securities law claims required them to prove that one or more of the four products purchased by the class—Hashlets, Paycoin, Hashpoints, or Hashstakers—constituted securities, the court instructed the jury to begin deliberations by considering this threshold question. The leading case to determine whether a given product constitutes a “security” is articulated in *SEC v. W.J. Howey Co.*; the four-part test is known as the “Howey Test.”³ Under the *Howey* Test, a court must determine whether the product involves (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) as a result of the efforts of others.⁴ With respect to the second prong, courts consider the product to involve a “common enterprise” where there exists either “horizontal commonality” tying each individual buyer’s fortunes to those of other buyers by pooling together their proposed assets, or “vertical commonality” tying each individual buyer’s fortunes to the success of the company.

The jury concluded that none of the four products qualified as “investment contracts.” The verdict was viewed as notable in light of the factfinder’s departure from the Securities and Exchange Commission’s (SEC) repeated warnings that certain cryptocurrency products may constitute securities under the federal securities laws.

District Court's Post-Verdict Rulings

Upon consideration of the plaintiffs' post-verdict motions, the court found that the jury's verdict as to three of the four challenged products—Hashlet, Hashpoint, and Hashstaker—was not against the weight of the evidence.⁵ However, the court rejected the jury's finding that Paycoin is not an investment contract, and ordered a new trial with respect to that product only. In setting forth the basis for its holding, the court primarily focused its analysis on Hashlet and Paycoin only, since little evidence was presented regarding the other two products.⁶

The court focused its analysis of the "Hashlet" product, which provides purchasers with shares of the mining power at GAW mining farms, on the "common enterprise" and "efforts of others" prongs of the *Howey* Test. As to the horizontal commonality dimension of the "common enterprise" requirement, the court credited evidence indicating that Hashlet owners were led to expect that they could select the "pool" in which the Hashlet was mined on any given day, and therefore could make profits or sustain losses independent of other Hashlet owners.⁷ As to vertical commonality, the court determined that the trial evidence supported the finding that GAW earned profits only as a result of the Hashlet acquisition and a flat fee, and did not earn profits directly linked to Hashlet mining.⁸ Finally, the court concluded that the evidence supported a finding that the plaintiffs failed to establish Hashlet owners' reasonable expectation of profit primarily from the efforts of GAW. For example, the court explained, the jury could have reasonably found based on the trial evidence that Hashlet owners can exercise "significant investor control" by retaining control over the selection of their mining pools.⁹

The court reached the opposite conclusion with respect to Paycoin, finding that the "common enterprise" and "efforts of others" prongs of the *Howey* Test had been met, and that the jury's finding to the contrary was against the weight of the evidence. Turning first to the concept of horizontal commonality, the court noted that GAW had promoted the sales of Paycoin—the price of which "rose and fell across the board" such that Paycoin owners' gains or losses were proportional to their degree of ownership—to support the creation of a new digital ecosystem, the success of which would "drive demand" for the cryptocurrency and thus increase Paycoin's value (and investors' profits).¹⁰ Citing case law from sister courts, the court concluded that these facts were sufficient to support a finding of horizontal commonality.¹¹ The court rejected the defendants' argument that "Hashpoints," GAW's internal cryptocurrency, did not constitute "assets" in this context because their rights were not "pooled together" like money or cryptocurrency are, concluding that as long as the instruments contributed are owned and have value, they qualify as "assets" such that horizontal commonality exists.¹²

With respect to the "efforts of others" prong, the court focused on GAW's promotional materials, which stated that Paycoin differed from other cryptocurrencies because of the unique and significant financial, operational, and marketing support of GAW. The court concluded that the "overwhelming" weight of the trial evidence indicated that a reasonable purchaser of Paycoin was motivated by these benefits, and "not by the desire to use Paycoin for a consumptive purpose."¹³ The court rejected the defendant's arguments to the contrary—which included, among others, that unaffiliated users could mine Paycoin, that Paycoin used "open source" software, and that Paycoin traded on public exchanges—as insufficient to undermine its conclusion that Paycoin's development and growth in value would depend on the efforts of GAW.¹⁴ The court thus concluded that the weight of the trial evidence could not support a finding that the plaintiffs had failed to satisfy the *Howey* Test, and ordered a new trial with respect to Paycoin only.

Future Implications for Cryptocurrency Regulation

As the market for cryptocurrencies continues to expand in accessibility—particularly during periods marked by volatility and uncertainty—legislators, agencies, and courts will continue to grapple with how to classify and regulate these instruments. While the ultimate fate of Paycoin will remain unsettled pending re-trial in *Audet v. Fraser*, the court's ruling emphasizes the likely continued proliferation of a fact-intensive, product-specific approach to the question of cryptocurrency classification under the securities law framework.

If you have any questions regarding this decision or other blockchain-related issues, please feel free to contact your usual Ropes & Gray advisor or one of the authors listed below.

1. Verdict Form, *Audet et al. v. Fraser*, 16-cv-00940-MPS, ECF Doc.330 at 2 (Nov. 1, 2021) [hereinafter Verdict Form].
2. Ruling on Post-Verdict Motions, *Audet et al. v. Fraser*, 16-cv-00940-MPS, ECF Doc.370 at 1 (Jun. 3, 2022) [hereinafter Ruling on Post-Verdict Motions].
3. Verdict Form, *supra* note 1, at 10.
4. SEC v. Howey Co., 328 U.S. 293, 296 (1946).
5. Ruling on Post-Verdict Motions at 23.
6. *Id.* at 38-39.
7. *Id.* at 25.
8. *Id.* at 26.
9. *Id.* at 28.
10. *Id.* at 31.
11. *Id.*
12. *Id.* at 32.
13. *Id.* at 38.
14. *Id.* at 34–35.