Crypto Ponzi Ruling May Influence Future Howey Analysis

By **Daniel Michael, Alexander Drylewski and Stuart Levi** (July 7, 2022, 5:50 PM EDT)

Daniel Michael

Alexander Drylewski

Stuart Levi

The question of whether a digital asset is a security under the federal securities laws has loomed over the industry for years.

Through its enforcement actions to date, the U.S. Securities and Exchange Commission generally has taken a broad view of which digital assets may constitute securities, which is consistent with SEC Chair Gary Gensler's recent remarks that most crypto tokens bear the "hallmark of an investment contract or a security" under the test set forth in the U.S. Supreme Court 1946 case SEC v. W. J. Howey Co.[1]

And while the SEC's enforcement activity has produced data points, open questions persist in the digital asset space, including in the realm of non-fungible tokens.

The industry received another significant data point last November. In Audet v. Fraser, the U.S. District Court for the District of Connecticut concluded that shares in a crypto mining operation, called Hashlets, were not securities under Howey — contrary to the SEC's own determinations regarding the same assets.

In June, U.S. District Judge Michael Shea issued **a ruling** upholding the jury's verdict as to Hashlets.

In this article we examine the Audet post-trial ruling as it relates to Hashlets, discuss the ways in which the Audet court's approach differed from that of the SEC, and explore ways in which that approach may apply in the NFT space.

The SEC and Private Actions

According to both the SEC's complaint and the complaint filed in the class action, Homero Joshua Garza and Stuart Fraser established GAW Miners LLC in 2014, which would generate profits through the mining of bitcoin and other virtual currencies. GAW issued and sold an asset called Hashlets, which allegedly represented shares in the profits from GAW's hashing power, or computer power.

Both the SEC and class action plaintiffs alleged that GAW sold more Hashlets worth of computing power than they actually had in their mining operation. Lacking the hardware to support all of the Hashlets sold, profits from GAW's mining efforts were insufficient to cover the returns promised to Hashlet purchasers.

According to the SEC and class action plaintiffs, GAW masked this shortfall by using money obtained from the sale of additional Hashlets to pay some of the returns owed. Most Hashlet investors never recovered the full amount of their investments, and few made a profit.

In December 2015, the SEC brought an enforcement action in the District of Connecticut against Garza, GAW and a GAW affiliate, alleging that Hashlets were investment contracts under Howey and

therefore securities that should have been registered with the SEC.[2] The SEC also brought fraud charges and alleged the Hashlets were sold as part of a Ponzi scheme.

After the defendants failed to appear in the SEC's action, the court entered a default judgment against them.

Several months after the SEC brought its case, a private class action was filed in the District of Connecticut against the same defendants and Fraser. Like the SEC, the class action plaintiffs asserted claims based on the alleged sale of an unregistered security, as well as fraud claims.

GAW and its affiliate defaulted and Garza was dismissed from the suit, leaving Fraser as the sole remaining defendant at trial. The jury returned a verdict for Fraser on the question of whether Hashlets were investment contracts under Howey.

Following the verdict, the class action plaintiffs filed a post-trial motion arguing, among other things, that the jury's finding that Hashlets were not securities was against the weight of the evidence.

In a June 6 ruling, the court ruled that the jury reasonably could have concluded that Hashlets were not securities under Howey. Importantly, the court focused its analysis on how Hashlets were supposed to work as promoted, rather than how they actually worked in reality.

As the court explained, the Hashlet project "must be examined as of the time that the transaction took place, together with the knowledge and the objective intentions and expectations of the parties at that time," and not on whether the statements that influenced those expectations were consistent with what happened.[3]

Applying that expectation-focused assessment to Hashlets, the court held that the jury reasonably could have concluded that the "common enterprise" and "efforts of others" prongs of Howey were not met.

As to the "common enterprise" prong, the Audet court found that evidence presented at trial supported the finding that there was no horizontal commonality — which focuses on whether each individual purchaser's fortunes are tied together — or vertical commonality — which focuses on whether the fortunes of the investors and the promoters are tied together.

Not Your SEC's Howey Analysis

The Audet court's analysis of Hashlets diverged from the view of Hashlets reflected in the SEC's complaint and the default judgment in the SEC action in a number of notable ways.

It also diverged from the SEC's general approach to digital assets more broadly — in particular, with respect to the "common enterprise" and "efforts of others" prongs of Howey.

The SEC has taken the view that it "does not require vertical or horizontal commonality per se, nor does it view a 'common enterprise' as a distinct element of the term 'investment contract'" under Howey.[4]

As the Audet ruling recognized, however, courts have required some form of common enterprise under Howey. With respect to horizontal commonality, the Audet court noted that Hashlet owners "could receive 'very different payouts' depending on the mining pool they selected" and whether they opted to "boost the Hashlet."[5]

The court concluded that, as a result, the jury reasonably could have found there was no common enterprise, as "each individual Hashlet owner's fortunes were not tied to the fortunes of the other Hashlet owners."[6]

Contrast this with the SEC's approach to Hashlets: In its complaint, the SEC downplayed the ability of Hashlet owners to choose their own mining pools and instead emphasized GAW's representations that the computing power of the investors' Hashlets would be pooled together and that their returns "would be calculated based on the success of those collective virtual currency mining operations."[7]

The SEC's focus on the collective success of the endeavor — rather than the individualized activities of purchasers — is a hallmark of the SEC's general approach in the digital asset space.

In the September 2020 U.S. District Court for the Southern District of New York case SEC v. Kik Interactive Inc., for example, the SEC successfully argued that it was the overall "success of the ecosystem" that "drove demand ... and thus dictated investors' profits," notwithstanding the fact that tokenholders could receive different payouts depending on when they purchased or sold their digital assets.[8]

The Kik court agreed with the SEC, holding that "the key feature is not that investors must reap their profits at the same time; it is that investors' profits at any given time are tied to the success of the enterprise."[9]

The jury reasonably found that the "efforts of others" prong was not met, according to the Audet court, because Hashlet owners exercised "significant investor control" through their selection of mining pools.[10]

In so doing, the court drew a distinction between the "'messy, technical process' of operating physical mining equipment to GAW" with the Hashlet owners' retention of "control over the selection of mining pools that they would have exercised had they operated mining equipment in their own homes."[11]

This, too, contrasts with the SEC's approach. In its complaint, the SEC alleged that "Hashlet investors were required to do very little to purportedly mine virtual currency" because defendants owned, housed, operated, maintained and connected the computer hardware that would engage in mining, and investors needed only to "click-and-drag their Hashlet icons over to the icons of the mining pools."[12]

This is consistent with the SEC's general approach to digital assets, which has focused generally on the promoter's efforts to generate returns, not on the efforts of the digital asset purchasers themselves.

Indeed, the SEC's 2019 framework lists several factors that "are especially relevant" to the third prong of Howey, such as: "Does the purchaser expect to rely on the efforts of [a promoter]?" and are those efforts "'the undeniably significant ones,' … as opposed to efforts that are more ministerial in nature?"[13]

However, none of the factors listed in the framework focus on the efforts or activity of the digital asset purchasers themselves.[14]

Potential Implications for NFTs

While the Audet court's post-verdict ruling concerns a particular asset tied to an ostensible crypto mining operation, the court's emphasis on the facts that Hashlet purchasers were not similarly situated and that engagement by the purchasers affected their profitability has potentially broader implications in the digital asset space.

This is particularly true for NFTs, which tend to possess one or both of these attributes.

Any reliance on this decision should be tempered by the fact that it does not purport to be an independent Howey analysis but rather is a deferential review of whether the jury could reasonably have reached its findings based on the evidence.

In addition, the decision concerns an analysis that is very facts and circumstances specific, and it represents only one district judge's analysis. Nevertheless, the court drew on a line of cases that similarly speak to certain limits of the Howey analysis that are instructive for assessing the features and attributes that are being created as the NFT space develops.

In concluding that a jury finding of no horizontal commonality was not against the weight of the evidence, the Audet court noted that purchasers' profits depended on the individual choices they made.

The potential implications for the NFT market are significant, as many NFT projects allow holders to choose how to enhance their NFTs. Some, for example, allow for NFTs to be combined.

NFTs tied to video games also have the potential to be affected by the user. For example, a weapon associated with an NFT could increase in effectiveness depending on how its owner uses it in the game. The metaverse is another example because plots of virtual land can be developed by their owners.

In determining whether Hashlet owners depended primarily upon the promoters, the court found that their ability to select mining pools vested them with significant investor control and contrasted that ability with other cases in which the "efforts of others" prong of Howey was satisfied because the investors in those cases were entirely reliant on the asset's promoters.

While the court does not answer the question of how much investor control is sufficient to overcome a finding that profits are derived primarily by the efforts of others, the focus on the efforts of the purchaser is relevant to NFTs. This is because, as NFTs evolve, they offer more opportunities for purchasers to make decisions that influence the value of their NFTs.

This might include, for example, decisions by NFT owners on how to commercialize their own NFT — where such rights are granted — or votes by groups of NFT holders on directions a project associated with the NFT might take.

Conclusion

As the digital asset space continues to evolve, verdicts and rulings like the ones in Audet shed light on how features relating to a digital asset may influence the Howey analysis.

The post-trial ruling also underscores the importance of how a digital asset is offered and marketed. Because the Howey analysis focuses on the reasonable expectation of purchasers, how a digital asset is presented to purchasers — and not what happens after the purchase — is central to the analysis.

Daniel Michael is a partner at Skadden Arps Slate Meagher & Flom LLP. Until last August, he was chief of the Complex Financial Instruments Unit within the SEC Enforcement Division.

Alexander Drylewski is a partner at the firm.

Stuart Levi is a partner at the firm and co-head of the firm's intellectual property and technology transactions group.

[1] See Prepared Remarks of Gary Gensler On Crypto Markets (Apr. 4, 2022).

[2] Complaint, SEC v. Garza, et al., No. 15 Civ. 1760, ECF No. 1 (D. Conn. filed Dec. 1, 2015) ("SEC Complaint").

[3] Ruling on Post-Trial Motions, Audet et al. v. Fraser, -- F. Supp. 3d --, No. 16 Civ. 940, ECF No. 370 at 24-25 (D. Conn. June 3, 2022) ("Order").

[4] See Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019) ("Framework") (citing In re Barkate , 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004)).

[5] Id. at 23-24.

[6] Id.

[7] SEC Complaint ¶ 5.

[8] See SEC v. Kik Interactive Inc. , No. 19 Civ. 5244, ECF No. 88 (S.D.N.Y. Sept. 30, 2020).

[9] Id.

[10] Order at 28.

[11] Id. at 28-29.

[12] SEC Complaint ¶ 40.

[13] Framework at 3.

[14] The closest example is the factor asking whether "[t]here are essential tasks or responsibilities performed and expected to be performed by [a promoter], rather than an unaffiliated, dispersed community of network users (commonly known as a 'decentralized' network')." Framework at 4. But this focuses on whether the profit-driving activity is centralized in an identifiable participant, rather than whether users can dictate their own success through individualized choices.