

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Alexander C. Drylewski

Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Stuart D. Levi

Partner / New York
212.735.2750
stuart.levi@skadden.com

Daniel Michael

Partner / New York
212.735.2200
daniel.michael@skadden.com

Ebenezer Ng

Associate / New York
212.735.3724
ebenezer.ng@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Manhattan West
New York, NY 10001
212.735.3000

NYAG Files Action Against Crypto Trading Platform, Takes Position That ETH Is a Security

On March 9, 2023, the New York State Attorney General’s Office (NYAG) filed a lawsuit charging crypto trading platform KuCoin for “failing to register as a securities and commodities broker-dealer and falsely representing itself as an exchange.”¹ In establishing that KuCoin is a market intermediary for securities, NYAG notably alleges that the Ether (ETH) traded on the platform is a security. This is the first time a U.S. regulatory authority has clearly taken this position, and it is in tension with certain statements made by staff at the Securities and Exchange Commission (SEC). While mere allegations have no force of law, this novel position is sure to inject some measure of uncertainty into ETH, the digital asset with the second highest market cap after Bitcoin, and the native token for a blockchain on which a significant part of the Web3 ecosystem, including decentralized finance (DeFi) protocols and NFT projects, has been built.

KuCoin is a virtual currency trading platform that facilitates trading in three types of digital assets — ETH, Luna and TerraUSD (UST). After KuCoin failed to comply with a NYAG investigative subpoena, NYAG filed a complaint bringing three claims against KuCoin under New York state’s securities law, the Martin Act: (1) KuCoin sold, offered to sell, purchased and offered to purchase cryptocurrencies that are commodities and securities — here, ETH, Luna and UST — without being registered with the New York Department of Law as a commodity broker-dealer or a securities broker or dealer; (2) KuCoin issued and sold “KuCoin Earn,” an alleged security that generated income for both KuCoin and investors; and (3) KuCoin wrongfully represented itself as an “exchange” without appropriate registration. NYAG seeks a permanent injunction ordering KuCoin to geo-block New York residents as well as restitution and disgorgement.

Focusing on the allegation that ETH is not only a commodity but also a security, NYAG alleges that Vitalik Buterin, one of the creators of the Ethereum blockchain, and the Ethereum Foundation managed and drove ETH’s development through the significant influence they maintained during Ethereum’s initial launch and, more recently, in allegedly facilitating Ether’s transition from proof-of-work to proof-of-stake.² NYAG also alleges that Mr. Buterin and his co-founders conducted an initial coin offering (ICO) in which ETH was sold to fund the creation of Ethereum. NYAG claims that the developers of ETH promoted it as

¹ Pet’r’s Mem. of L. in Supp. of the Verified Pet., *People v. Mek Global Ltd.*, No. – (N.Y. Sup. Ct., Mar. 9, 2023).

² Proof-of-stake requires network participants to pledge or “stake” their holdings in ETH to verify transactions on the blockchain. The network randomly chooses participants to verify transactions, who receive a digital-asset reward.

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

an investment based on language on the Ethereum Foundation’s website, such as references to ETH as a “store of value” and an “investment.”

NYAG argues that under both New York and federal law, these facts render ETH a security. For New York law, NYAG relies on *In re Waldstein*, 160 Misc. 763, 767 (Sup. Ct. Albany Cty. 1936), which states that “any form of instrument used for the purpose of financing and promoting enterprises, and which is designed for investment, is a security.” And, under federal law, NYAG argues ETH is a security under the Supreme Court’s *Howey* test, which provides guidance for whether an instrument is an investment contract, and therefore a security, by analyzing whether it involves (1) an investment of money (2) in a common enterprise (3) and a reasonable expectation of profits based on the managerial efforts of the promoter or a third party. NYAG argues ETH satisfies both the New York and federal tests primarily based on three factors. First, members of the public invest money in order to buy ETH. Second, investors are in a common enterprise with Mr. Buterin, the Ethereum Foundation and other developers because these individuals and the Foundation received, and allegedly still retain, significant quantities of ETH in the ICO, and funds earned from that ICO were claimed to be used to pay expenses incurred by developers, legal contingences and further development, thereby tying the fortunes of the token holder to the fortunes of management. Third, ETH’s management team promoted it as “profit opportunities,” contingent on the growth of its cryptocurrency network, based substantially on the work of its founders, developers and managers.

NYAG’s position on ETH is in contrast to the much-relied on statements made in a 2018 speech by William Hinman, the then-director of the SEC’s Division of Corporation Finance, in which he expressed the view that the Ethereum network had become sufficiently decentralized such that purchasers no longer reasonably expect a group to carry out essential managerial efforts.³ Therefore, he did not see a “common enterprise” under the *Howey* test and stated that the application of the disclosure regime of the federal securities laws would add little value here.

Recent developments, however, may be impacting how ETH is analyzed under the *Howey* test. On September 15, 2022, Ethereum switched from proof-of-work to proof-of-stake. That same day,

SEC Chair Gary Gensler reportedly said that cryptocurrencies and intermediaries that allow holders to “stake” their coins might pass the *Howey* test as “the investing public is anticipating profits based on the efforts of others,” and compared staking services to lending.⁴

Last month, the SEC brought a settled enforcement action against Kraken for its staking service. According to the complaint, Kraken’s staking services allowed investors to transfer crypto assets to Kraken, which Kraken pooled together to stake on investors’ behalf in exchange for advertised annual investment returns.

Neither of these developments, however, speaks to the issue raised by Mr. Hinman in his 2018 speech — namely, that a system that is sufficiently decentralized may undermine the assertion of a common enterprise or expectation of profits based on the efforts of a definable “other.” In contrast to the Hinman view of Ethereum, Kraken is a centralized actor, and according to the SEC complaint, created both the common enterprise and a reasonable expectation of profits. Similarly, Chair Gensler’s statements in September 2018 assume that there is a centralized actor undertaking the “efforts of others.”

The NYAG complaint, which includes a legal section, asserts that there is centralized activity that gives rise to a common enterprise and a reasonable expectation of profits. Specifically, it alleges that Ethereum’s creator and the Ethereum Foundation “retain significant influence over Ethereum and are often a driving force behind major initiatives on the Ethereum blockchain that impact the functionality and price of ETH,” as demonstrated by their alleged “key roles in facilitating the recent fundamental shift” to proof-of-stake.

It is important to note that NYAG’s allegations are unproven, and it remains to be seen whether KuCoin will appear and defend against these novel claims. While there are likely to be a number of responses to the NYAG’s allegations — including serious questions regarding the constitutionality of its claims — the action is noteworthy because it involves the first allegation in court by a U.S. regulator that ETH constitutes a “security.” Given the ubiquity of the Ethereum blockchain’s use throughout the broader Web3 ecosystem, a judicial determination that ETH is a security could have broad ramifications.

³ SEC, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018).

⁴ Paul Kiernan & Vicky Ge Huang, *Ether’s New ‘Staking’ Model Could Draw SEC Attention*, WSJ (Sept. 15, 2022).