

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

In the matter of

THE STATE OF NEW YORK, by LETITIA JAMES,
Attorney General of the State of New York,

Petitioner,

-against-

MEK GLOBAL LIMITED and PHOENIXFIN PTE
LTD d/b/a KUCOIN,

Respondents.

Index No. 450703/2023

BRIEF OF *AMICUS CURIAE* PARADIGM OPERATIONS LP

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INTERESTS OF AMICUS CURIAE

Paradigm Operations LP (“Paradigm”) is an investment firm that backs entrepreneurs building innovative crypto and Web3 companies and protocols. Paradigm believes that the issues in this litigation have the potential to dramatically impact the entrepreneurs that it backs, as well as many others who seek to utilize new technology. Paradigm seeks leave to participate in this case because it is concerned about the potential for this Court to endorse the Attorney General of the State of New York’s (the “OAG’s”) expansive and unsupported application of the *Howey*¹ test to the widely-used cryptocurrency token Ether (“ETH”), which would adversely affect a large swath of the blockchain industry.

The question of whether ETH is a security is not directly at issue in this case. However, the lack of regulatory guidance on the application of securities laws to tokens, combined with regulators’ practice of relying on statements and actions that are not precedential (such as their own pronouncements or allegations), means the resolution of this case may have an impact beyond the parties.

INTRODUCTION AND SUMMARY OF ARGUMENT

To support the claim that Respondents MEK Global Limited and PhoenixFin PTE Ltd d/b/a KuCoin (collectively, “KuCoin”) violated New York Executive Law § 63(12) for failure to register as a securities broker or dealer, the OAG alleges in its Petition (NYSCEF No. 1, the “Petition” or the “Pet.”) that various tokens sold and purchased by KuCoin are securities. According to the OAG, one of these securities is ETH, the native token of the Ethereum blockchain. Despite the fact that ETH was first distributed to the public in 2014, there has never been any prior finding that ETH is a security.

¹ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

Any action against the creators of ETH would be precluded by the statute of limitations. But the OAG has chosen to make the unprecedented allegation that ETH is a security in this action against a third-party, KuCoin. The OAG's attempt to regulate ETH through enforcement against a third party is highly unjust – and made worse because KuCoin will likely fail to answer the Petition and default. The OAG's allegation that ETH is a security is therefore practically unchallengeable. It would be devastating to the blockchain industry for this Court to enable the OAG to proclaim that a token is a security in litigation against unrelated parties, without meaningful opportunity for review or challenge.

The OAG's allegations about ETH also directly contradict the statements of many regulators. The former director of the Securities and Exchange Commission's (the "SEC") Division of Corporation Finance asserted in a speech that ETH was not a security.² Former SEC Chairman Jay Clayton approvingly cited to that speech multiple times.³ Even current SEC Chair Gary Gensler, who recently opined that the "vast majority" of tokens are securities,⁴ previously stated that ETH could be "off the hook."⁵ The Commodity Futures Trading Commission (the "CFTC") has stated several times that ETH is a commodity.⁶ New York's Department of Financial Services ("DFS") placed ETH on its "Greenlist" of tokens that can be transacted by entities that

² William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto, SEC (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418> (the "Hinman Speech").

³ See Letter from Jay Clayton to The Honorable Ted Budd (Mar. 7, 2019), Coin Center, *available at* <https://www.coincenter.org/app/uploads/2020/05/clayton-token-response.pdf>; Jay Clayton, *Testimony on "Oversight of the U.S. Securities and Exchange Commission"*, House of Representatives Committee on Financial Services (June 21, 2018), <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20180621.pdf>.

⁴ See Gary Gensler, Chairman, Securities and Exchange Comm'n, *Statement on Financial Stability Oversight Council's Report on Digital Asset Financial Stability Risks and Regulation Before the Financial Stability Oversight Council Open Meeting* (Oct. 3, 2022), *available at* <https://www.sec.gov/news/speech/gensler-statement-fsoc-meeting-100322> ("Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities").

⁵ Nathaniel Popper, *A Former Top Wall Street Regulator Turns to the Blockchain*, New York Times (Apr. 22, 2018), <https://www.nytimes.com/2018/04/22/technology/gensler-mit-blockchain.html?mtrref=t.co>.

⁶ See, e.g., Luke Huigsloot, *CFTC declares Ether as a commodity again in court filing*, CoinTelegraph (Dec. 14, 2022), <https://cointelegraph.com/news/cftc-declares-ether-as-a-commodity-again-in-court-filing>.

possess a “Bitlicense,” but are not necessarily securities intermediaries, thus demonstrating that DFS believes that ETH is not a security.⁷

Finally, the legal analysis underpinning the OAG’s allegations about ETH is deeply flawed. The OAG conflates ETH tokens themselves, which are merely software, with the alleged investment contracts pursuant to which those tokens were sold.⁸ Rather than analyzing each individual transaction on its own, as is required under the law,⁹ the OAG paints ETH with a broad brush, asserting that all ETH tokens are securities. The OAG pays no heed to the transaction in which each token was acquired, or what they are used for. But many users may have acquired ETH on KuCoin for reasons that have nothing to do with any “investment contract.” ETH can be utilized in a variety of ways that would distinguish it from a security, including to pay for real world goods and services, to pay for “gas” (network fees) for transactions, or be “staked” in order to help secure the Ethereum network. The fact that the Ethereum blockchain transitioned to “proof-of-stake” in 2022, a fact trumpeted by the OAG, does not alter the securities law analysis.

Paradigm does not take a position on the rest of the OAG’s Petition or their accompanying Memorandum of Law in Support of the Verified Petition (NYSCEF No. 2, the “OAG Memo of Law”). Paradigm narrowly focuses only on the OAG’s declaration that ETH is a security, a statement that, if accepted by this Court, would have enormous implications for the industry and its players, including Paradigm. Accordingly, Paradigm respectfully requests that any ruling that this Court may make in this case – even if the Court grants the OAG’s Petition on default – should

⁷ See *Greenlisted Coins/Tokens*, New York Department of Financial Services (June 3, 2022), https://www.dfs.ny.gov/virtual_currency_businesses#top.

⁸ See, e.g., Lewis Rinaudo Cohen, Gregory Strong, Freeman Lewin, & Sarah Chen, *The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities*, DLx Law (Nov. 10, 2022), <https://dlxlaw.com/wp-content/uploads/2022/11/The-Ineluctable-Modality-of-Securities-Law-DLx-Law-Discussion-Draft-Nov.-10-2022.pdf>.

⁹ See, e.g., *SEC v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352, 368 (S.D.N.Y. 2020) (“*Howey* requires the Court to examine the series of understandings, transactions, and undertakings at the time they were made.”).

be narrowly tailored and explicitly state that the Court is not making any findings that ETH is a security.

STATEMENT OF FACTS

The Petition alleges that ETH is the “native cryptocurrency on the Ethereum blockchain created by Vitalik Buterin and several others.” Pet. ¶ 38. The Ethereum Foundation – a non-profit that “supports the Ethereum Ecosystem,” Pet. ¶ 40 – describes the Ethereum blockchain as an “open-source platform to write computer code that stores and automates digital databases using smart contracts, without relying upon a central intermediary, solving trust with cryptographic techniques.”¹⁰

The “intent of Ethereum” was to “create an alternative protocol for building decentralized applications. . . . Ethereum does this by building what is essentially the ultimate abstract foundational layer: a blockchain with a built-in Turing-complete programming language, allowing anyone to write smart contracts and decentralized applications where they can create their own arbitrary rules for ownership, transaction formats and state transition functions.”¹¹ For example, users can utilize Ethereum’s “ERC-20” standard to build “token applications that are interoperable with other products and services.”¹² Because many applications use Ethereum as a base, Ethereum supports a robust ecosystem of software development.

In 2014, shortly after the creation of the Ethereum Foundation, “an initial coin offering (‘ICO’) was held in which ETH was sold to fund the creation of Ethereum.” Pet. ¶ 40. In July 2016, following a hacking attack on an Ethereum-based project called “the DAO,” disagreement

¹⁰ *What is Ethereum*, Ethereum Foundation (2022) (last visited May 17, 2023), <https://ethereum.foundation/ethereum>.

¹¹ *Ethereum Whitepaper*, Ethereum.org (last updated May 12, 2023), <https://ethereum.org/en/whitepaper/>.

¹² *ERC-20 Standard*, Ethereum.org (last updated Apr. 7, 2023), <https://ethereum.org/en/developers/docs/standards/tokens/erc-20/>.

among some Ethereum developers and miners resulted in a “hard fork,” effectively creating a new version of the Ethereum blockchain and ETH token. After the “fork,” the original chain came to be referred to as “Ethereum Classic,” and the new chain referred to simply as “Ethereum.”¹³ As a consequence, the OAG’s attempt to connect events in 2014 to ETH today is, both metaphorically and technologically, a broken chain, since “ETH” refers to the native token of the new “forked” Ethereum network, not the token that was originally sold in the ICO.

Moreover, while some persons acquired tokens directly in the 2014 sale and subsequently received ETH tokens as a result of the “hard fork,” those participants are just one part of the market. Many current holders of ETH purchased the tokens through a digital asset exchange like KuCoin. Others acquired ETH directly from another party in a peer-to-peer transaction or from “liquidity pools,” with no particular counterparty at all, if trading on a decentralized finance protocol. Some may have even received ETH as a gift, where an individual sends tokens to another’s wallet out of the blue.

Today, ETH has the second-highest market cap of any token¹⁴ and is likely the most widely used. One principal use of ETH is to pay “gas fees” required to execute a transaction on the Ethereum blockchain. As described on the Ethereum website, “[g]as refers to the unit that measures the amount of computational effort required to execute specific operations on the Ethereum network.”¹⁵ “Gas fees are paid in Ethereum’s native currency,” ETH.¹⁶

Another principal use of ETH is to be “staked” by validators in order to process transactions on, and contribute to the security of, the Ethereum blockchain. As described by the OAG, “[u]nder

¹³ See Vitalik Buterin, *Hard Fork Completed*, Ethereum Foundation (July 16, 2016), <https://blog.ethereum.org/2016/07/20/hard-fork-completed>.

¹⁴ See *Today’s Cryptocurrency Prices by Market Cap*, CoinMarketCap (last visited May 17, 2023), <https://coinmarketcap.com/>.

¹⁵ *Gas and Fees*, Ethereum.org (Feb. 16, 2023), <https://ethereum.org/en/developers/docs/gas/>.

¹⁶ *Id.*

proof-of-stake . . . validators pledge or ‘stake’ their holdings in ETH and are randomly chosen to verify transactions on the blockchain and receive an in-kind digital asset reward.” Pet. ¶ 42; Affidavit of Brian Metz (NYSCEF No. 5, the “Metz Aff.”) Ex. 26.

ETH can also be used in all sorts of other ways. Many companies – including Google,¹⁷ AMC,¹⁸ Starbucks,¹⁹ and even the Dallas Mavericks basketball team²⁰ – accept ETH as payment for goods and services. Likewise, PayPal permits users to transfer ETH to other users, including to pay for goods and services.²¹ Recently, BNY Mellon announced that it would accept ETH deposits from retail users, just like it accepts fiat currency.²² In October 2022, Fidelity permitted its institutional clients to trade and custody ETH.²³ And just last month, Fidelity expanded ETH trading to retail customers.²⁴

¹⁷ See Jordan Novet, *Google selects Coinbase to take cloud payments with cryptocurrencies and will use its custody tool*, CNBC (Oct. 14, 2022), <https://www.cnbc.com/2022/10/11/google-selects-coinbase-to-take-cloud-payments-with-cryptocurrencies.html>.

¹⁸ Jamie Crawley, *AMC Theatres to Accept Bitcoin, Ether for Online Payments*, Coindesk (Nov. 12, 2021), <https://www.coindesk.com/business/2021/11/12/amc-theatres-to-accept-bitcoin-ether-for-online-payments/>.

¹⁹ Samyuktha Sriram, *Customers Can Reload Starbucks Card With Bitcoin and Ethereum As Coffeehouse Explores ‘Tokenizing Stars,’* Yahoo! Finance (Nov. 11, 2021), <https://finance.yahoo.com/news/customers-reload-starbucks-card-bitcoin-154130368.html>.

²⁰ Osato Avan-Nomayo, *Mark Cuban Counters Elon Musk, says Mavs will continue to accept Bitcoin*, CoinTelegraph (May 13, 2021), <https://cointelegraph.com/news/mark-cuban-counters-elon-musk-says-mavs-will-continue-to-accept-bitcoin> (stating that the Dallas Mavericks accept ETH as payment).

²¹ See *PayPal Users Can Now Transfer, Send, and Receive Bitcoin, Ethereum, Bitcoin Cash, and Litecoin*, Paypal (Aug. 12, 2022), <https://newsroom.paypal-corp.com/2022-06-07-PayPal-Users-Can-Now-Transfer-Send-and-Receive-Bitcoin-Ethereum-Bitcoin-Cash-and-Litecoin>.

²² Stacy Elliott, *BNY Mellon Launches Bitcoin, Ethereum Custody Services for Investment Firms*, Decrypt (Oct. 11, 2022), <https://decrypt.co/111641/bny-mellon-launches-bitcoin-ethereum-custody-services-investment-firms>.

²³ Nina Bambysheva, *Fidelity Adds Institutional Ether Trading As Investors Await Bull Market, Regulatory Clarity*, Forbes (Oct. 28, 2022), <https://www.forbes.com/sites/ninabambysheva/2022/10/28/fidelity-adds-institutional-ether-trading-as-investors-await-bull-market-regulatory-clarity/?sh=398869ca5b1d>.

²⁴ Nina Bambysheva, *Amid Crypto Bank Crisis, Fidelity Expands Bitcoin, Ether Trading To Most Retail Accounts*, Forbes (Mar. 16, 2023), <https://www.forbes.com/sites/digital-assets/2023/03/16/amid-crypto-bank-crisis-fidelity-opens-bitcoin-ether-trading-for-retail--accounts/?sh=79286d0d1670>.

ARGUMENT

I. THE OAG MAKES THE DAMAGING ALLEGATION THAT ETH IS A SECURITY AGAINST RESPONDENTS LIKELY TO DEFAULT, WITHOUT THE CREATORS OF ETH BEING PRESENT OR ABLE TO INTERVENE

The Petition alleges that KuCoin acted as a securities broker or dealer in New York without having registered with the OAG. Pet. ¶¶ 99-100. The Petition is therefore predicated on the OAG's allegations that certain tokens, including ETH, are securities under the federal *Howey* test and the New York state *Waldstein* test. Pet. ¶¶ 35-43; OAG Memo of Law at 17-21. Even though ETH has been circulating among the public since 2014, Pet. ¶¶ 39-40, there has never been a finding in this Court, or in any other court or administrative proceeding, that ETH is a security.

Yet, the OAG did not name the original creators of ETH as respondents here.²⁵ In a cynical gambit, the OAG has decreed that a piece of software, and the world's second most valuable token, is a security, in an action against a party who it knows is unlikely to appear, and is not incentivized to engage in the expensive and burdensome battle to prove that ETH is not a security. In doing so, the OAG maximized its chances of being able to allege whatever it wants, with minimal risk of being held to account for it.

By the OAG's own evidence, KuCoin failed to respond to the OAG's subpoena issued prior to commencing this litigation. Pet. ¶¶ 81-84. KuCoin also has a history of prior defaults that suggests that KuCoin is likely to default in this action. The OAG alleges that KuCoin did not respond to an investigation by the Ontario Capital Markets Tribunal that ultimately determined that cryptographic tokens sold on the KuCoin platform (not specifically ETH) were securities under Ontario law. *See Metz Aff. Ex. 9* at 1 (stating that "[n]o submissions were made on behalf

²⁵ We note that the OAG also has a statute of limitations problem in this case. Because the ETH ICO occurred in 2014, any action by the OAG against the original creators of ETH under New York Executive Law § 63(12) would undoubtedly be time-barred because the relevant statute of limitations would have run by, at the very latest, 2021 (factoring in the 2020 COVID-related tolling). While deeper discussion of the statute of limitations applicable to § 63(12) is outside the scope of this brief, after sitting on its rights for nine years and missing its opportunity to file an action against the ETH token creators claiming that ETH is a security, the OAG should not be allowed to bring that claim against third parties like KuCoin.

of Mek Global Limited or PhoenixFin Pte. Ltd.”). Likewise, when KuCoin was sued in 2020 by a private plaintiff alleging that KuCoin had engaged in unregistered securities offerings (again, not regarding to the sale of ETH), *see* Amended Class Action Complaint, *Williams v. KuCoin, et al.*, Case No. 1:20-cv-02806-GBD-RWL, ECF No. 44 (S.D.N.Y. Oct. 7, 2020), KuCoin did not respond and the plaintiff obtained a Clerk’s Certificate of Default against KuCoin. Clerk’s Certificate of Default, *Williams v. KuCoin, et al.*, Case 1:20-cv-02806-GBD-RWL, ECF No. 58 (S.D.N.Y. Oct. 23, 2020).

Even if any of the creators or users of ETH had the desire to intervene in this litigation to clarify the critical question of whether ETH is a security, they would not be permitted to do so. *See People v. Bunge Corp.*, 25 N.Y.2d 91, 100 (1969) (“The only reason noted in the Martin Act for intervention of private persons in such a suit is to prove their ownership of already sequestered property. It is apparent from the scheme of the act that this was the only purpose intended for intervention. . . . [t]o allow intervention by private individuals to further their own private aims might seriously jeopardize the purpose of the Attorney-General’s suit”).

The OAG’s approach in this case is not an outlier; it is part of a pattern of regulators decreeing that specific tokens are securities in actions against persons other than the creators of those tokens. For example, the SEC recently filed a complaint alleging that various individuals were insider trading in tokens based on material nonpublic information misappropriated from one of their employers. *See* Amended Complaint, *SEC v. Wahi, et al.*, Case No. 2:22-cv-01009-TL, ECF No. 27 (W.D. Wash. Dec. 22, 2022). Although the SEC’s *Wahi* complaint spent numerous pages arguing that the tokens were securities, the creators of those tokens were not parties to the case. The SEC also recently filed a complaint for securities fraud against Avraham Eisenberg in connection with an alleged scheme to manipulate the MNGO token. In that complaint, the SEC decreed that MNGO was a security, and that its creator “offers and sells MNGO tokens in

unregistered transactions,” all without making the creators a party to the case. *See* Complaint, *SEC v. Eisenberg*, Case No. 23-cv-503, ECF No. 1 (S.D.N.Y. Jan. 20, 2023). Likewise, the SEC filed a lawsuit against the operators of the trading platform “Bittrex” for failing to register as a securities exchange, and spent several pages alleging that various tokens were securities, again without giving the responsible parties a chance to directly respond. *See* Complaint, *SEC v. Bittrex, Inc., et al.*, 23 Civ. 580, ECF No. 1 (W.D. Wash. April 17, 2023). Regardless of the merits of the OAG’s allegations against KuCoin, it is disturbing to see the OAG join the SEC’s bandwagon of asserting highly damaging legal conclusions against parties who are not in the case.

The OAG’s actions caused an immediate decrease in the value of ETH. The ETH token declined from a closing price of \$1,534.09 on March 8, 2023 (the day before the Petition was filed) to \$1,429.16 on March 10 (the day after the Petition was filed), a nearly 7% decrease.²⁶ This decrease in value may be driven by a sudden reluctance to interact with ETH, since treating ETH as a security would require many intermediaries transacting or otherwise dealing with ETH to come under heavy regulatory scrutiny. And because ETH is on the DFS Greenlist, there are regulated entities in New York trading ETH, as well as federally-regulated commodity futures products based on ETH; those market participants will be damaged by this action even though they are trading in products regulated by other entities.

The full scope of the damage the OAG has caused is difficult to know, in large part because there will necessarily be a chilling effect on future projects, and the blockchain industry in general, as token creators may be concerned that the crucial question of whether the token they create is a security will be decided in an action in which they are not a party – and where, like here, the actual

²⁶ *See Historical Data for Ethereum*, CoinMarketCap (last visited May 17, 2023), <https://coinmarketcap.com/currencies/ethereum/historical-data/>.

party is unlikely to actually respond and contest the allegations – without any prior warning or fair opportunity to respond.

II. ETH TOKENS ARE NOT SECURITIES

A. ETH Tokens Themselves Cannot Be Securities

The OAG is taking the position that ETH tokens themselves are securities by virtue of being “investment contracts.” Pet. ¶ 49. But a cryptocurrency token, such as ETH, is just software, “little more than [an] alphanumeric cryptographic sequence.” *Telegram*, 448 F. Supp. 3d at 379. The OAG’s position that ETH itself is a security is unprecedented and unsupported in the law.

I. The OAG’s Legal Analysis Confuses an Investment Contract with the Object of that Investment Contract

Under *Howey*, “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” 328 U.S. at 298-99 (emphasis added). In *Howey* itself, the Supreme Court distinguished the object of the investment contract from the broader “contract, transaction or scheme” involving that object, contrasting “fee simple interests in land” or “a farm or orchard” – which would not themselves be considered investment contracts – with “an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents,” offered and sold to individuals with “no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment” – which would be considered investment contracts. *Id.* at 299-300.

An exhaustive review of nearly a century of appellate case law interpreting *Howey* supports this critical distinction and found no case that treats the object of an investment contract as a security. See Lewis Rinaudo Cohen, Gregory Strong, Freeman Lewin, & Sarah Chen, *The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities*, DLx

Law (Nov. 10, 2022), <https://dlxlaw.com/wp-content/uploads/2022/11/The-Ineluctable-Modality-of-Securities-Law-DLx-Law-Discussion-Draft-Nov.-10-2022.pdf>. See also *SEC v. ETS Payphones, Inc.*, 408 F.3d 727 (11th Cir. 2005) (sale and leaseback of payphones, rather than the leased payphones themselves, constituted investment contracts); *Miller v. Cent. Chinchilla Grp., Inc.*, 494 F.2d 414 (8th Cir. 1974) (chinchilla management agreements, rather than chinchillas themselves, constituted investment contracts); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385 (6th Cir. 1989) (earthworm management agreements, rather than earthworms themselves, constituted investment contracts).

2. *The OAG's Reliance on the Novel and Unsupported "Embodiment" Theory Should Be Rejected*

The OAG is, at least implicitly, relying on a theory that the SEC has articulated in prior cases: that a token originally sold as part of an investment contract that now trades on secondary markets “is the embodiment of those facts, circumstances, promises, and expectations, and today represents that investment contract.” See, e.g., SEC Memorandum of Law In Opposition to the Motion to Intervene, *SEC v. Ripple Labs*, Case No. 20-cv-10832 (AT) (SN), ECF N. 153 at p. 24 (S.D.N.Y. May 3, 2021) (emphasis in original). But neither the OAG nor the SEC has ever cited any case law for this “embodiment” theory, the proposition that an asset that is not a security can “embody” the facts and circumstances under which it was offered and sold. That is because no such case law exists. See Cohen et al., *supra* at 95-98.

The “embodiment theory,” if adopted here, would also present insurmountable difficulties for market participants seeking to buy, hold, or sell cryptocurrency tokens. Such parties would have to apply the *Howey* test to each specific transaction, without any way of knowing all of the “facts, circumstances, promises, and expectations” that a court could later deem to be “embodied” by a token. Moreover, many of these circumstances may not be matters of the public record or capable of discovery by third parties who lack the SEC’s subpoena power. In sum, the embodiment

theory is unprecedented and unworkable, and to the extent that the theory underlies the OAG's papers, it should be rejected.²⁷

3. *The OAG's Misapplication of Howey Is Also Evident When Considering the Other Prongs of the Test*

The OAG asserts that all users of ETH are in a "common enterprise" with each other, merely because ETH's founders, management teams, and developers received tokens in the initial sale and allegedly retain large stakes in those tokens today, "thereby tying the fortunes of the token holder to the fortunes of management." OAG Memo of Law at 19. But the OAG ignores that participants have acquired ETH for many different reasons and therefore cannot to be said to be in any sort of "common enterprise," as their "fortunes" are not necessarily tied to each other or the promoter of ETH.²⁸

The OAG fares no better with its argument that ETH holders are led to expect profits from the efforts of a third party. The OAG points to statements made nine years ago that "described the [original ETH] sale as a means of promoting the development of the Ethereum blockchain by paying expenses incurred by developers, paying for legal contingencies, research, and further development," as well as statements including "representations that ETH production would dramatically slow over time, resulting in ETH becoming increasingly scarce, and thus more

²⁷ *The Ineluctable Modality of Securities Law*, cited above, also refutes the "embodiment" theory.

²⁸ There are two types of commonality: horizontal and vertical. The OAG's Memo of Law is silent as to which type of commonality the OAG invokes. But under neither type of commonality is the "fortunes of management" a relevant consideration. Horizontal commonality exists by virtue of the "tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994). "Broad vertical commonality," where "the fortunes of the investors need be linked only to the efforts of the promoter," does not satisfy *Howey* under Second Circuit law. *Id.* The Second Circuit has not expressly determined whether "strict vertical commonality" – which "requires that the fortunes of investors be tied to the fortunes of the promoter" – satisfies *Howey*. *Id.* In any event, the OAG has not sufficiently pleaded that either form of horizontal or vertical commonality exist here.

valuable.” Pet. ¶¶ 40, 43. These statements have no bearing on the reasonable expectations of ETH tokenholders today.²⁹

The OAG cherry picks statements on the Ethereum Foundation website that some ETH users “see it as a digital store of value” and an “investment,” OAG Memo of Law at 19-20, but the fact that some investors see ETH as a digital store of value or an investment does not mean that all users do, such that ETH tokens as a whole should be considered a security. The OAG also conveniently ignores the other portions of that very same website that the OAG cites and exhibits, which states that “ETH’s valuable in different ways to different people,” and notes the other uses of ETH explained above, such as enabling users to pay for gas for Ethereum transactions and for use “as collateral for crypto loans, or as a payment system.” Metz Aff. Ex. 18.

Moreover, even for those users that do see ETH as an investment or a digital store of value, the OAG has not presented any facts showing that the value is dependent on the efforts of the token creators or the management of the Ethereum Foundation.

4. *The OAG Fails to Distinguish the Original Fundraising Transaction from Subsequent Secondary Market Transactions*

The Petition alleges that KuCoin is a “cryptocurrency trading platform” enabling users to purchase and sell cryptocurrencies such as ETH. Pet. ¶¶ 20-21. In other words, KuCoin facilitates downstream ETH transactions. Yet, in its analysis, the OAG ignores that the transactions in question by KuCoin are all, by definition, secondary market transactions. The law requires the analysis of whether an investment contract exists to be done at the time of each transaction. *See Telegram*, 448 F. Supp. at 368 (“*Howey* requires the Court to examine the series of understandings, transactions, and undertakings at the time they were made.”). Ignoring the law, the OAG paints all ETH tokens with a broad brush, lumping in current downstream transactions with the initial

²⁹ See also Matt Corva & Bill Hughes, *Efforts of Many: An Overview of the Ethereum Protocol*, Consensys (May 9, 2023), <https://consensys.net/blog/blockchain-explained/efforts-of-many-an-overview-of-the-ethereum-protocol/> (describing the dispersed management and development of Ethereum).

sale of ETH that occurred in 2014, Pet. ¶ 99-100, despite the fact that KuCoin did not play any role in that sale.

Even if ETH tokens may have initially been sold in 2014 in investment contract transactions – a question on which Paradigm takes no position – that does not mean that the tokens “embody” that investment contract such that they are securities in perpetuity.

The OAG thus misses the mark in analogizing ETH to the *SEC v. LBRY, Inc.* litigation. See OAG Memo of Law at 20-21. In the *LBRY* case, the court granted summary judgment for the SEC and found that token issuer LBRY failed to register the offer and sale of the digital token LBC in violation of the Securities Act. *SEC v. LBRY, Inc.*, Case No. 21-cv-260-PB, 2022 U.S. Dist. LEXIS 202738 (D.N.H. Nov. 7, 2022). But the court’s decision in *LBRY* (which is not binding here) focused exclusively on LBRY’s initial sales of tokens to third parties. *Id.* at *5-7. Indeed, appearing after the court’s summary judgment decision, the SEC’s counsel conceded to the court that “[t]his case is about only the ones that were offered and sold by LBRY in the manner and fashion in which they did,” and that the “LBC that is circulating out there today, would not be in violation of the securities laws.” Transcript of November 21, 2022 Conference, *SEC v. LBRY, Inc.*, Case No. 1:21-cv-00260-PB, ECF No. 101, at 20:25-21:2, 21:6-7 (D.N.H. Nov. 21, 2022). Thus, the scope of the *LBRY* decision is far narrower than what the OAG seeks to do here in declaring an entire token to be a security.

B. The Transition to Proof-of-Stake Does Not Morph ETH into a Security

The OAG next points to Ethereum’s transition to a proof-of-stake consensus mechanism as evidence that ETH holders are led to expect profits from the efforts of others, Pet. ¶ 43; OAG Memo of Law at 20, but there are no allegations that the switch had any impact on the value of the ETH token. Upon the OAG’s own allegations, ETH holders who choose to stake their holdings receive “rewards” by validating transactions on the Ethereum blockchain. Pet. ¶ 43. They are

being paid for providing a service, not entering into an investment contract or similar security-like arrangement.³⁰

Indeed, even before the shift to a proof-of-stake system, the validation rewards led current SEC Chairman Gary Gensler to state in 2018 (in his personal capacity) that while ETH may have been issued as part of an investment contract, ETH by that point “could get off the hook . . . because its development has been more decentralized recently, and new Ether tokens are given out to so-called miners through a network.”³¹ The DFS agrees: the Ethereum blockchain’s transition to proof-of-stake did not alter ETH’s status as a Greenlisted token.³²

Moreover, the fact that users can obtain additional ETH tokens by staking their ETH and verifying transactions on the blockchain does not mean that the value of each individual ETH token has increased, as the OAG implies, OAG Memo of Law at 20. Staking does not cause ETH to increase in value, and does not provide interest to users, and as such, there are no “profits”; staking is just a way to acquire more ETH.

C. ETH Is Not a Security Under the *Waldstein* Test

The OAG fares no better under the so-called *Waldstein* test, an alternative test utilized in New York courts defining a security as “any form of instrument used for the purpose of financing and promoting enterprises, and which is designed for investment.” *In re Waldstein*, 160 Misc. 763, 767 (Sup. Ct. Albany Cnty. 1936). The New York Court of Appeals has adopted the *Waldstein* test. *See All Seasons Resorts v. Abrams*, 68 N.Y.2d 81, 92 (1986).

³⁰ For a more detailed analysis by Paradigm of why the proof-of-stake model does not turn ETH into a security, see Rodrigo Seira, Amy Aixi Zhang, Jake Chervinsky, *Ethereum’s New “Staking” Model Does Not Make ETH A Security*, Paradigm (Oct. 5, 2022), <https://www.paradigm.xyz/2022/10/ethereums-new-staking-model-does-not-make-eth-a-security>. See also Matt Corva and Bill Hughes, *Staking is Data Validation, Not Investment*, Consensys (Mar. 10, 2023), <https://consensys.net/blog/news/staking-is-data-validation-not-investment/>.

³¹ Nathaniel Popper, *A Former Top Wall Street Regulator Turns to the Blockchain*, New York Times (Apr. 22, 2018), <https://www.nytimes.com/2018/04/22/technology/gensler-mit-blockchain.html?mtrref=t.co>.

³² See Notice Regarding Ethereum’s Upcoming Protocol Change, New York Department of Financial Services (Sept. 14, 2022), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220914_ethereum.

In support of its assertion that ETH is a security under *Waldstein*, the OAG points to the same facts underlying its argument that ETH is a security under *Howey*. But the reality of how ETH is used illustrates that ETH does not meet the *Waldstein* test. At the time of the initial sale, it is possible that ETH was sold in a scheme “used for the purpose of financing and promoting enterprises.” But the Petition and the supporting papers do not contain any facts showing that now, nine years later, there are any ETH transactions effectuated for the purpose of financing and promoting some central enterprise. Nor could there be, as nine years after the initial sale, ETH tokens could have been transacted dozens, hundreds, or thousands of times, principally involving users that have nothing to do with the Ethereum Foundation or any other person involved in the token creation. And there are plenty of uses of ETH that have nothing to do with “investment”; it certainly cannot be said that ETH currently is “designed for investment.” *See All Seasons*, 68 N.Y.2d at 92-93 (no security under *Waldstein* where instrument in question was not utilized for profit, but instead was “selling use”). *See also Matter of Xerox Corp. v. New York State Tax Appeals Trib.*, 110 A.D.3d 1262, 1267 (3d Dep’t 2013) (finding that certain contracts to rent or purchase equipment were not securities under *Waldstein* because “the agreements are not used for the purpose of financing enterprises and promoting a distribution of rights in or obligations of such enterprises or designed as a means of investment”) (quotation marks omitted).

D. Other Regulators Have Stated That ETH Tokens Are Not Securities

The OAG’s allegations that ETH is a security is not only unsupported by law, but also directly contradicted by other regulators. The SEC has stated, explicitly, that ETH is not a security. In 2018, the then-director of the SEC’s Division of Corporation Finance, William Hinman, stated that “putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the

disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.”³³ Then-SEC Chair Jay Clayton subsequently wrote a letter to then-Representative Ted Budd agreeing with the statements made in the Hinman Speech, although Clayton did not reference ETH by name.³⁴ Former Chair Clayton also, in testimony before the House Committee on Financial Services, approvingly cited to the Hinman Speech.³⁵

SEC Chair Gensler, when pressed at recent testimony before the House Financial Services Committee, refused to state whether or not ETH was a security. *See* Nikhilesh De, *SEC Chair Gensler Declines to say if Ether Is a Security in Contentious Congressional Hearing* (Apr. 19, 2023), <https://www.coindesk.com/policy/2023/04/19/sec-chair-gensler-declines-to-say-if-ether-is-a-security-in-contentious-congressional-hearing/>. Chair Gensler’s equivocation was especially concerning given that, when lecturing at MIT prior to joining the SEC, he referred to the Hinman Speech and stated that “[i]n 2018, the Securities and Exchange Commission has said regardless of what it might have been in [20]14 it’s now sufficiently decentralized that we’ll consider it not a security.”³⁶ Chair Gensler also told MIT that “three-quarters of the market is non-securities. It’s just a commodity, a cash crypto.”³⁷

³³ William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto, SEC (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.

³⁴ *See* Letter from Jay Clayton to The Honorable Ted Budd (Mar. 7, 2019), Coin Center, *available at* <https://www.coincenter.org/app/uploads/2020/05/clayton-token-response.pdf>.

³⁵ Jay Clayton, *Testimony on “Oversight of the U.S. Securities and Exchange Commission”*, House of Representatives Committee on Financial Services (June 21, 2018), *available at* <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20180621.pdf> (“Our Corporation Finance Division Director recently further outlined the approach staff takes to evaluate whether a digital asset is a security.”)

³⁶ *See* Mat Di Salvo, *Gary Gensler Says SEC Believes Ethereum Is Not a Security—At MIT in 2018*, Decrypt (Apr. 28, 2023), <https://decrypt.co/138334/gary-gensler-sec-ethereum-not-security-mit-2018>.

³⁷ *See* Arturas Skur, Stefan Trapp and Ciaran Lawler, *Video from 2018 Shows Gary Gensler Saying Most Cryptos Aren’t Securities*, Dailycoin (Apr. 26, 2023), <https://dailycoin.com/video-2018-gary-gensler-saying-most-cryptos-arent-securities/>.

The SEC has made its views known through its prolonged inaction as well. The *New York Times* reported in 2018 that regulators were “considering” whether ETH should be categorized as a security.³⁸ Yet, five years later, those regulators remain silent on the issue.

Other regulators concur. The CFTC has repeatedly and explicitly labeled ETH as a commodity.³⁹ Indeed, in a recent lawsuit against the cryptocurrency exchange Binance, the CFTC claimed that Binance engaged in transactions with “digital assets that are commodities including . . . Ether (ETH) . . .” Complaint, *CFTC v. Changpeng Zhao et al.*, Case No. 1:23-cv-01887 (N.D. Ill. Mar. 27, 2023). As noted above, DFS has placed ETH on its “Greenlist,” meaning that any entity granted a “BitLicense” by DFS to conduct virtual currency activities in New York may custody or list ETH.⁴⁰

Yet, despite these numerous statements by other regulators, the OAG has struck out on its own, making the unprecedented and unsupported assertion that ETH is a security.

CONCLUSION

Not only is the OAG’s claim legally deficient, but there will be detrimental policy implications of any finding that ETH is a security, in light of its wide use in the blockchain industry. That concern is even more acute because KuCoin is likely to default. As such, Paradigm respectfully requests that if the Court is inclined to grant the OAG’s petition, that it expressly state that it is not making a finding that ETH is a security.

³⁸ Nathaniel Popper, *Venture Capitalists Seek ‘Safe Harbor’ for Virtual Currencies*, New York Times (Apr. 19, 2018), <https://www.nytimes.com/2018/04/19/technology/virtual-currency-securities.html>.

³⁹ See Luke Huigsloot, *CFTC Declares Ether as a commodity again in court filing*, CoinTelegraph (Dec. 14, 2022), <https://cointelegraph.com/news/cftc-declares-ether-as-a-commodity-again-in-court-filing>; Andrew Throuvalas, *CFTC Chair Says Ethereum Is a Commodity—Despite Gensler’s ‘Bitcoin Only Position’*, Decrypt (Mar. 8, 2023), <https://decrypt.co/123032/cftc-chair-says-ethereum-is-a-commodity-despite-genslers-bitcoin-only-position>; Jesse Hamilton, *U.S. CFTC Chief Behnam Reinforces View of Ether as Commodity*, CoinDesk (Mar. 28, 2023), <https://www.coindesk.com/policy/2023/03/28/us-cftc-chief-behnam-reinforces-view-of-ether-as-commodity/>.

⁴⁰ See *Greenlisted Coins/Tokens*, New York Department of Financial Services (June 3, 2022), https://www.dfs.ny.gov/virtual_currency_businesses#top.

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