

NYAG Questions Historic Classification of Ethereum's Cryptocurrency in KuCoin Lawsuit

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On the heels of recent legal setbacks and challenges for NFT collections offered by Dapper Labs and DraftKings, the New York Attorney General (NYAG) filed suit in New York state court against the parent companies of cryptocurrency trading platform, KuCoin, for allegedly violating state securities laws by selling cryptocurrencies, including Ether, LUNA, and TerraUSD, without registering as a securities broker and by selling unregistered securities in the form of KuCoin Earn, a cryptocurrency interest earning/staking reward service.

New York's Martin Act^[1] provides that it is unlawful for any dealer, broker, or salesman to sell, offer, or purchase securities from the public unless and until such dealer, broker or salesman files a registration with the attorney general.^[2] For the suit to succeed, the NYAG will need to prove that Ether, LUNA, or TerraUSD are either "commodities"^[3] or "securities" under the Martin Act.^[4]

The complaint seeks a full accounting relating to KuCoin's New York customers, including transaction records covering the last six years, disgorgement of all revenue obtained from New York residents, and reimbursement of the NYAG's court costs.

What is KuCoin?

Founded in 2017, KuCoin is a cryptocurrency platform where individuals can buy and sell cryptocurrencies. In addition to cryptocurrency trading, KuCoin allows users to engage in spot and margin trading, trade futures contracts, and buying and selling NFTs. The platform also allows users to earn interest on and/or staking rewards with their cryptocurrency via its KuCoin Earn service.

According to KuCoin, one in four cryptocurrency holders use its platform.

NYAG's Complaint Against KuCoin

The *KuCoin* complaint asserts that Ether — the cryptocurrency native to the Ethereum blockchain — is a security (as opposed to a commodity) and further alleges that since KuCoin provides a platform where Ether may be traded without being registered as a securities broker or dealer, KuCoin violated the Martin Act.

The complaint is one of the first times a regulator has claimed in public court filings that Ether is a security; an assertion that would likely have significant ramifications for the blockchain, web3, and crypto industries if endorsed by the courts or other regulators.

Central to the NYAG's argument that Ether is a security is the recent shift of the Ethereum blockchain from a "proof-of-work" to "proof-of-stake" method for verifying transactions. The complaint alleges that as a result of this shift, Ether no longer needs to rely on competition between computers for verification, but rather requires Ether to rely on a pooling method that incentivizes users to own and stake Ether and that any Ether holder may now profit from Ether by merely participating in staking. The NYAG argues that this investment-oriented approach contrasts with Ethereum's original proof-of-work framework under which computers on the Ethereum network competed to answer a "mathematical puzzle" to verify transactions on the blockchain and receive digital asset awards.

In addition to this proof-of-work versus proof-of-stake argument, the NYAG makes the argument, albeit obliquely, that Ether, over time, became an investment of money, in a common enterprise, for profit, derived primarily by the efforts of others; characteristics that are typically associated with securities or "investment contracts." To support these allegations, the NYAG asserts that "developers of Ether promoted it as an investment that was contingent on the growth of the Ethereum network." Further, the complaint quotes the Ethereum Foundation, which notes on its website that many users of Ether "see it as an investment, similar to Bitcoin and other cryptocurrencies." The switch from proof-of-work to proof-of-stake, per the complaint, has significantly altered the value proposition of Ether, since "possession of Ether translates directly to profit potential by earning staking rewards."

Additionally, Ether's development and management, per the complaint, is largely driven by a small number of developers standing to profit from the growth and related appreciation of Ether. The complaint also asserts that the revenue generated by Ether sales is reinvested to promote the development of Ethereum, thereby tying the fortunes of token holders to management. Finally, the NYAG asserts that the Ethereum Foundation retains significant influence over Ethereum, often being a catalyst behind major initiatives that impact Ether's functionality and price. As such, according to the complaint, the growth and development of the Ethereum network, as well as any promised profits for "investors," are dependent upon the managerial efforts of the network's founders and management teams. All of which, according to the complaint, are indicative of securities.

Next Steps

This *KuCoin* complaint, while unique in many ways, is unremarkable in its attempted broad application of securities laws to cryptocurrency and other blockchain based tokens. Given that this complaint represents the first instance in which Ether is alleged to be a security under New York law and the major repercussions such a finding could have, it is notable that the NYAG chose not to

provide a more in-depth analysis of Ether's (or LUNA's or TerraUSD's) status as a security under the Martin Act.

It will be interesting to see if other states elect to commence enforcement against KuCoin and the sponsors of other crypto assets under their securities laws.

Yusef Abutouq also contributed to this article.

FOOTNOTES

[¹] Article 23-A of New York General Business Law (GBL).

[²] GBL § 359-e (3).

[³] GBL § 359-e (14).

[⁴] Under the Martin Act, investments of money in common enterprises with profits to be derived primarily from the efforts of others are considered "securities."

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