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COMMISSIONERS OFFICE

COMMONWEALTH OF KENTUCKY
PUBLIC PROTECTION CABINET
DEPARTMENT OF FINANCIAL INSTITUTIONS
DIVISION OF SECURITIES
ADMINISTRATIVE ACTION NO. 2023-AH-0011

DEPARTMENT OF FINANCIAL INSTITUTIONS COMPLAINANT

vs.

COINBASE GLOBAL, INC. and
COINBASE, INC. RESPONDENTS

ADMINISTRATIVE COMPLAINT

The Kentucky Department of Financial Institutions (the "Department"), pursuant to Kentucky Revised Statutes ("KRS") 292.470, KRS 292.500, and 808 Kentucky Administrative Regulation ("KAR") 10:225, hereby brings this **Administrative Complaint** against Coinbase Global, Inc. and Coinbase, Inc. In support thereof, the Department states as follows:

PARTIES

1. The Commissioner is responsible for administering the provisions of KRS Chapter 292, the Securities Act of Kentucky ("the Act"), as well as any applicable rules, regulations and orders entered pursuant to the Act.

2. Coinbase, Inc. was founded in 2012 as a cryptocurrency exchange platform.

3. Coinbase Global, Inc. was founded in 2014 as a holding company for Coinbase, Inc. and its subsidiaries. Coinbase, Inc. is today a wholly owned subsidiary of Coinbase Global, Inc.

4. Coinbase Global, Inc. and Coinbase, Inc. (collectively, "Coinbase") are remote-first companies with no physical headquarters. Prior to May 2020, Coinbase was headquartered at 548 Market Street, Suite 23008, San Francisco, California 94104. Coinbase, Inc. has a registered

agent for service of process in Kentucky of Corporation Service Company, 421 West Main Street, Frankfort, Kentucky 40601. Coinbase Global, Inc. has a registered agent for service of process in Delaware of Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808.

STATEMENT OF FACTS

5. Coinbase operates a cryptocurrency platform that offers a staking rewards program, cryptocurrency borrowing, and cryptocurrency exchange services, among others, to retail and institutional investors.

6. Coinbase conducts business in the United States through its mobile application and its public website, accessible at https://www.coinbase.com. The Coinbase application and website are available to the general public, including residents of Kentucky.

7. From as early as November 6, 2019, Coinbase has offered and sold unregistered securities, in the form of cryptocurrency asset staking rewards offerings (together the "Coinbase Staking Offerings," each a "Coinbase Staking Offering") made to the United States public at large and to Kentucky residents.

Cryptocurrency

7. Coinbase describes cryptocurrency as "decentralized digital money designed to be used over the internet."

8. Cryptocurrencies do not rely on middlemen like banks or payment processors to execute transactions.

9. Rather, cryptocurrencies rely on blockchains, which are persistent, replicable, constantly re-verified records of every transaction ever made using a particular cryptocurrency.

10. The blockchain for a given cryptocurrency is distributed across participants of that cryptocurrency's entire digital network.

Proof of Stake

11. Transactions in certain cryptocurrency blockchains are verified by "proof-of-stake" algorithms.

12. Blockchains are decentralized groups of servers, known as "nodes," which maintain the agreed-upon ledger of all transactions on the blockchain.

13. For cryptocurrencies that use a proof-of-stake blockchain, transactions are added to the blockchain by "validators." Coinbase defines a validator as "a node on a proof of stake blockchain that is responsible for securing the network, storing the history of transactions and confirming the validity of new transactions added to the next block in the chain."

14. Coinbase has explained staking as follows in its March 20, 2023 comment letter to the Securities and Exchange Commission:

> The protocol rules of a blockchain are often referred to as its "consensus mechanism" and they dictate how the computers in the network reach agreement on what transactions and blocks to add to the blockchain. . . . The most commonly-known consensus mechanisms are based on what are called "proof-of-work" and "proof-of-stake" protocols. . . .
>
> Proof-of-stake is generally considered to be faster and less resource-intensive [than proof-of-work]. In proof-of-stake, participants must lock up, or "stake," their cryptocurrency in order to validate transactions and add new blocks to the blockchain. These "validators" receive rewards from the protocol for their contribution to securing the blockchain.

15. A proof-of-stake blockchain chooses validator nodes to validate transactions in a pseudo-random process, but typically the chance of a particular validator node being chosen to validate a transaction is proportional to the amount of cryptocurrency being staked. If a given validator successfully validates a block, that validator is awarded the staking reward.

16. For cryptocurrencies in which a validator node's chance of being chosen to validate a transaction is proportional to the amount of cryptocurrency being staked, participants in larger

pools of funds staked by a single node are more likely to receive a share of rewards than sole participants, who cannot afford to stake as much cryptocurrency and are thus less likely to ever receive a reward.

17. Per Coinbase, to participate as a validator in a proof-of-stake blockchain requires "a minimum number of tokens, technical knowledge, and a dedicated computer that can perform validations day or night without downtime."

18. Participating as a validator comes with security considerations and a risk of loss, because downtime or failure to comply with blockchain rules can cause a validator's stake to be "slashed," meaning their staked cryptocurrency is not returned. According to Coinbase, "[s]lashing is a penalty enforced at the protocol level associated with a network or validator failure."

19. Coinbase advertises that a simpler way to participate in staking is through a cryptocurrency exchange like Coinbase and encourages customers to participate in staking through its Coinbase Staking Offerings.

Coinbase Staking Offerings

20. The Coinbase Staking Offerings are offered exclusively by Coinbase through Coinbase's smartphone application and public website; prospective investors can open accounts on either. The Coinbase Staking Offerings public website is https://www.coinbase.com/earn.

21. Coinbase's staking rewards program website makes the following representations:

a. "Earn up to 6.00% APY on your crypto. Put your crypto to work and earn rewards."

b. "We'll help you put your assets to work in the cryptoeconomy so you can grow your crypto holdings with little effort."

c. "We take measures to mitigate risks and allow you to opt-out anytime."

22. To participate in the Coinbase Staking Offerings, investors deposit designated cryptocurrency assets into their Coinbase accounts or purchase the designated cryptocurrency assets from Coinbase's platform and maintain a minimum amount of those designated cryptocurrency assets in Coinbase's custody. The minimum amounts Coinbase requires to participate in its staking program are generally lower than the amounts that would be required for an individual to operate a validator node on their own.

23. Coinbase then pools those investors' assets, operates its own validator node, and stakes the aggregated amount on the blockchain. In its sole and absolute discretion, Coinbase facilitates the staking of investors' cryptocurrency assets by:

a. Aggregating investors' deposits of cryptocurrency assets in an omnibus cryptocurrency wallet.

b. Performing on-chain operations to configure validator nodes on the relevant blockchain network.

c. Bonding investors' cryptocurrency assets to validator nodes for any period of time. These operations may be conducted for multiple investors in a single batch and typically incur on-chain fees borne by Coinbase and not passed on to investors.

d. Operating or engaging third parties to operate validator nodes that use the staked assets to validate transactions on the underlying protocol.

e. Maintaining rewards received from investors' staked cryptocurrency assets in a Coinbase omnibus wallet and re-staking any rewards earned in un-staked form.

f. Taking a percentage commission of staking rewards, and then periodically crediting investors' Coinbase accounts with a pro rata share of the remaining rewards.

g. In certain cases, voting on investors' behalf on matters related to the governance of the underlying cryptocurrency protocol.

h. Drawing down or exiting validator nodes when an investor requests to un-stake an asset, which may be done in conjunction with multiple investors in a single batch.

24. As of mid-January 2023, Coinbase employed 64 engineers to support the Coinbase Staking Offerings.

25. Coinbase has promoted its services and products, including the Coinbase Staking Offerings, in the United States through its smartphone application, website, blog, and Twitter account, among other media networks. In its marketing of its staking rewards program, Coinbase has touted the program as secure and accessible to the retail investor, as compared to those investors staking on their own. For example, Coinbase has stated:

a. "It's easy. Start earning with a couple of clicks. You can earn on as little as $1."

b. "It's secure. We take measures to mitigate risks and allow you to opt-out anytime."

c. "You shouldn't have to be an expert crypto trader to grow your crypto wealth. Offering an easy way for our customers to earn rewards from staking is an important step in building an open financial system."

d. "With today's launch, Coinbase is offering an easy, secure way for anyone to actively participate in the Tezos network. While it's possible to stake Tezos on your own or via a delegated staking service, it can be confusing, complicated, and even risky with regard to the security of your staked Tezos. We're changing that with staking rewards on Coinbase."

26. On its public website, Coinbase notes that there are risks associated with the Coinbase Staking Offerings, including: "the possible slashing [*i.e.*, non-return due to validator or protocol failures] of staked assets or rewards. Although it's unlikely, there is a possibility you could lose your staked assets or rewards in case of a network or validator failure. We've taken measures to reduce these risks, but some events are outside our control." In the event that cryptocurrencies invested by Coinbase Staking Offerings investors are partially or completely lost or reduced due to slashing, Coinbase may, in some circumstances, replace investors' slashed assets staked in the Coinbase Staking Offering at no additional cost.

27. Coinbase has no contractual obligation to retain a like amount of investors' cryptocurrency assets or comparable ones in reserve in its possession or control to fully cover investors' staked assets in the event of loss.

28. Investors assume all other risks related to the Coinbase Staking Offerings. For instance, investors take the risk of market events affecting the value of their staked assets during the designated lock-up period. On its public website, Coinbase states: "Staking requires assets to be locked on the protocol in order to earn rewards. During this time you won't be able to trade or transfer your assets."

29. In return for locking up their cryptocurrency through Coinbase, investors earn rewards in the form of like-kind cryptocurrency assets. Coinbase takes a commission from earned rewards and pays the remainder to investors based on the type and amount of cryptocurrency assets they have staked through each Coinbase Staking Offering.

30. On its website, Coinbase publishes a list of cryptocurrency assets that it transacts in for the Coinbase Staking Offerings. That list states each of these assets' rewards rate in terms of an estimated annual earnings rate, up to a 14.34% APY "estimated reward rate" for one asset as of April 14, 2023. In essence, Coinbase promotes investors' share of staking rewards, less Coinbase's commission, as interest investors earn on staked assets.

31. Coinbase finances its payments to Coinbase Staking Offering investors through revenue from its business activities, including operating validator nodes, which verify transactions on proof-of-stake blockchains. Investors neither provide nor facilitate these activities or services.

32. Whether investors in the Coinbase Staking Offerings receive rewards payments depends entirely on the success of Coinbase as a business and on its managerial and entrepreneurial efforts. These investors do not engage in any substantive program activities beyond depositing cryptocurrency assets into a Coinbase Staking Offering.

33. Coinbase's payments to investors in the Coinbase Staking Offerings function like those for pooled investment vehicles. But Coinbase and its customers are not protected by investor- and consumer-protection organizations, such as the Securities Investor Protection Corporation or the Federal Deposit Insurance Corporation.

34. As of March 29, 2023, 28,038 Kentucky residents were active investors in the Coinbase Staking Offerings, with investments totaling at least $24,485,428 equivalent in US dollars.

35. Coinbase has never registered its Coinbase Staking Offerings with the Department, nor filed a claim of exemption from registration with the Department.

36. Coinbase similarly has never registered the offers or sales of its Coinbase Staking Offerings, nor filed a claim of exemption from registration with the Department.

STATUTORY AUTHORITY

37. KRS 292.310(19) defines a "security", in pertinent part, as:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, life settlement investment, voting-trust certificate, certificate of deposit for a security; fractional undivided interest in oil, gas, or other mineral rights; or, in general, any interest or instrument commonly known as a "security[.]"

38. KRS 292.340 states "[i]t is unlawful for any person to offer or sell any security in this state, unless the security is registered under this chapter, or the security or transaction is exempt under this chapter, or the security is a covered security."

39. KRS 292.470 states, in pertinent part,

> Whenever it appears to the commissioner that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule or order under this chapter, the commissioner may in his or her discretion bring any or all of the following remedies:
>
> (1) Issue a cease and desist order, with or without a prior hearing, appealable to Franklin Circuit Court, against the person or persons engaged in the prohibited activities directing that person or persons to cease and desist from illegal activity. . . .
>
> (3) Issue a final order, after notice and an opportunity for a hearing, containing findings of fact and conclusions of law, directing any person or persons found to have engaged in, or about to be engaged in, activity that constitutes a violation of this chapter or any rule or order under this chapter:
>
> (a) To cease and desist from the activity;
>
> (b) To perform any other reasonable mandates directed by the commissioner pursuant to an appropriate remedy fashioned by the commissioner

and reasonably calculated to carry out the provisions of this chapter; or

(c) To pay fines assessed under KRS 292.500(14) and costs assessed under KRS 292.500(15).

40. KRS 292.500 states, in pertinent part:

(1) The administration of the provisions of this chapter shall be under the Department of Financial Institutions. . . .

(3) The commissioner may promulgate, amend, and repeal administrative regulations, forms, and orders as are necessary to carry out the provisions of this chapter . . .

(9) Every administrative hearing shall be conducted in accordance with KRS Chapter 13B and the provisions of this chapter, and shall be public unless the commissioner in his discretion grants a request joined in by all the respondents that the hearing be conducted privately. . . .

(14) The commissioner may impose civil fines against any person who violates any provision of this chapter or any rule or order or voluntary agreement entered into under this chapter. The fine shall not exceed twenty thousand dollars ($20,000) per violation, except when the violation is directed at or results in monetary damage to one (1) or more individuals who are sixty (60) years of age or older, the commissioner may impose an additional fine not to exceed twenty thousand dollars ($20,000) per violation. Each act or transaction which violates this chapter or administrative regulation, or orders or agreements entered into under this chapter, shall constitute a separate violation. Any employer or principal shall be jointly and severally liable for fines imposed in connection with the conduct of employees or agents. . . .

(16) In addition to any fines imposed under subsection (14) of this section, the commissioner may also assess the costs of any investigation, including attorney's fees incurred as a result of bringing enforcement actions under the provisions of this chapter and costs of holding any hearing as a result of an enforcement action. Costs and attorney's fees may only be imposed if there has been a final determination that a violation has occurred, and

> in an amount reasonably related to the costs of investigation and enforcement for those violations only. Costs and attorney's fees may be included as part of an agreement in settlement of an enforcement action. . . .
>
> (18) The remedies provided by this section are not exclusive and may be sought and employed in any combination to enforce the provisions of this chapter.

VIOLATIONS

41. Based on the definition contained in KRS 292.310(19) and *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946), Coinbase is offering investment contracts in exchange for the deposit of assets with Coinbase in the form of its Coinbase Staking Offerings. The Coinbase Staking Offerings allow passive investors to earn profit in the form of a percentage of blockchain rewards on assets deposited with and staked by Coinbase and qualify as securities under the Act.

42. Neither of the Respondents have registered the Coinbase Staking Offerings with the Department at any time, nor have they registered the offer or sale transactions in the Coinbase Staking Offerings, nor have they filed a claim of exemption from registration for the Coinbase Staking Offerings or those transactions.

43. The Coinbase Staking Offerings are not covered securities nor do they qualify for an exemption from registration under the Act.

44. Based on the foregoing, the Respondents offered and sold unregistered securities in Kentucky through a publicly available website and app in contravention of KRS 292.340.

REQUEST FOR RELIEF

The Department respectfully requests the Commissioner find the aforementioned violations, and in so finding, the Commissioner further order:

1. Respondents shall **CEASE AND DESIST** from offering or selling any security, including the Coinbase Staking Offerings, in Kentucky unless that security is registered with the Department pursuant to KRS 292.340;

2. Respondents shall specifically **CEASE AND DESIST** from accepting the deposit of additional assets into staking rewards program accounts and from allowing the renewal of investment terms on those accounts, including allowing the staking of any new cryptocurrency;

3. Respondents shall **CEASE AND DESIST** from any and all activity which would otherwise violate the Act; and

4. Respondents be jointly and severally assessed a civil fine, immediately due and payable, not to exceed $20,000.00 per violation.

Respectfully submitted,

/s/ Michael Barnett

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2 SW 19
Frankfort, Kentucky 40601
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NOTICE TO RESPONDENTS

1. You are hereby notified that you must respond to the complaint by filing a written answer to the allegations in the complaint with the Department within twenty (20) days of service of the complaint. An answer, and any other pleadings, may be directed to:

Michael Barnett
Staff Attorney
Kentucky Department of Financial Institutions
500 Mero Street
2 SW 19
Frankfort, Kentucky 40601
michael.barnett@ky.gov

You have a right to a hearing but you must request such a hearing in the response to the administrative complaint. If requested, an administrative hearing shall be held pursuant to the provisions of KRS Chapter 13B and 808 KAR 10:225. If an answer is not filed within twenty (20) days, the Department shall seek a final order from the Commissioner granting the relief requested in the complaint. You are hereby advised that you have a right to legal counsel at all stages of these proceedings, including but not limited to, preliminary matters, and including a hearing, if one is requested.

2. You are advised that all parties to these proceedings, that is the Respondents and the Department, have a right to examine, at least five (5) days prior to any hearing in this matter, a list of witnesses the parties, including the Department, expect to call at the hearing, any evidence to be used at the hearing, and any exculpatory information in the possession of the Department. The time limits established herein shall accrue from the actual date of the hearing once that date is established. However, no hearing will be set if the parties fail to timely request a hearing.

3. You are advised that any party who fails to attend or participate as required at any stage of the administrative hearing process may be held in default under this chapter.

CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing Administrative Complaint was sent on this the 12th day of June, 2023 by the method indicated below to the following:

Via certified mail, return receipt requested:

Coinbase, Inc.
ATTN: Corporation Service Company, Registered Agent
421 West Main Street
Frankfort, Kentucky 40601
Respondent

Coinbase Global, Inc.
ATTN: Corporation Service Company, Registered Agent
251 Little Falls Drive
Wilmington, Delaware 19808
Respondent

Via electronic delivery:

Michael Barnett
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DEPARTMENT OF FINANCIAL INSTITUTIONS
500 Mero Street, 2 SW 19
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Counsel for Respondents

Kentucky Department of Financial Institutions

Name: Tasha Stewart for Allison Reed

Title: Information Officer III