



EDNY: US securities laws can be used to prosecute ICO fraud

Securities Enforcement Alert

18 SEP 2018

By: Deborah R. Meshulam | Benjamin Klein

On September 12, 2018, Judge Raymond J. Dearie of the US District Court for the Eastern of New York (EDNY) issued an order finding that a federal indictment adequately pled that Maksim Zaslavskiy promoted digital tokens through initial coin offerings (ICOs) in violation of US securities laws. Judge Dearie applied the Howey test to determine whether the indictment sufficiently alleged that the transactions at issue involved investment contracts, a form of security. He concluded that the indictment was sufficient and denied Zaslavskiy's motion to dismiss.

This is the second known instance where a federal judge has found that offer or sale of digital tokens can qualify as investment contracts subject to federal securities laws and one of only a few cases that have considered the application of the Howey test to digital assets. As detailed in our prior alert, the first finding appeared in the June 2018 Report and Recommendation (yet to be adopted by the District Court) of a Florida magistrate judge in a class action lawsuit brought against financial services startup Centra Tech as well as its founders and president.

While the most recent *Zaslavskiy* order allows the criminal prosecution to advance, it does not settle the investment contract debate. As explained by Judge Dearie, whether an investment contract exists depends on the facts, and the jury will likely serve as "the ultimate fact-finder" on the question of whether the digital token offers/sales at issue qualify as securities. Judge Dearie's decision to leave the answer to this question with the jury is not entirely surprising in light of his statement during oral argument on the motion that "[t]here's going to be some sort of factual resolution down the road, not

by me, presumably by a jury."

Factual and procedural overview

Last fall, the US Department of Justice (DOJ) and US Securities and Exchange Commission (SEC) brought parallel proceedings against Maksim Zaslavskiy for securities fraud in connection with two ICOs. In its September 2017 complaint, the SEC alleged that Zaslavskiy's companies – REcoin Group Foundation, LLC (REcoin) and DRC World, Inc. (Diamond) – offered and sold digital tokens in a pair of ICOs that qualified as unregistered offerings of securities and that Zaslavskiy made false or misleading representations and omissions in connection with both token sales.

On October 27, 2017, the DOJ filed a criminal complaint charging Zaslavskiy with securities fraud conspiracy for similar misconduct – engaging in illegal unregistered securities offerings and making material misstatements to deceive investors in connection with the ICOs. The DOJ accused Zaslavskiy of marketing REcoin as "The First Ever Cryptocurrency Backed by Real Estate" and touting Diamond as an "exclusive and tokenized membership pool" that was hedged by physical diamonds despite knowing that "no real estate or diamonds were actually backing the investments." On November 1, 2017, the DOJ filed an indictment against Zaslavskiy containing similar allegations. The SEC suit was stayed pending the outcome of the DOJ action.

Zaslavskiy filed a motion to dismiss the indictment in February 2018, arguing, among other things, that securities laws do not apply to cryptocurrencies and that the token offerings did not constitute "investment contracts" under the Supreme Court's *Howey* test – the long-recognized standard for determining if an investment instrument is a security.

Both the DOJ and the SEC opposed Zaslavskiy's motion. The DOJ characterized Zaslavskiy's brief as a failed attempt to recast REcoin and Diamond tokens as "currencies" rather than securities, when both tokens constituted "prototypical investment contract[s]" under *Howey*. The SEC agreed, characterizing Zaslavskiy's token ICOs as "old-fashioned fraud dressed in a new-fashioned label." Both regulators encouraged the court to evaluate the token offerings by focusing on their economic reality as they were advertised rather than the terminology used by Zaslavskiy.

Zaslavskiy responded by accusing the government of "advanc[ing] a vision of nearly limitless regulatory jurisdiction by the SEC" and requesting "carte blanche to regulate industries whether it has the legal authority to do so or not." Zaslavskiy challenged the government's interpretation of *Howey* as applied to REcoin and Diamond, arguing that the regulators failed to satisfy two prongs of the test. In addition, Zaslavskiy warned of a "regulatory agency goldrush" in which "every American regulatory agency that has considered jurisdiction of cryptocurrencies has concluded it has the authority to regulate cryptocurrencies."

Findings

At this preliminary stage, the question before the court was whether prosecutors adequately alleged the "elements of a profit-seeking business venture" such that, if proven at trial, "a reasonable jury could conclude that investors provided the capital and shared in the earnings and profits; and the promoters managed, controlled and operated the enterprise."

Judge Dearie applied the *Howey* test, a "highly fact-specific inquiry" to assess whether an offering or sale qualifies as an "investment contract." The test defines "investment contract" as a "contract, transaction, or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of the promoter or third party." Judge Dearie's order concluded that each of these elements was adequately pled:

- **Investment of money:** The court rejected Zaslavskiy's claim that there was no "investment of money" since the transactions involved only the exchange of "one medium of currency for another." Judge Dearie held that "cash is not the only form of contribution or investment that will create an investment contract," noting that an "investment" may include "goods and services" or "some other exchange of value."
- **Common enterprise:** While different courts apply different "commonality" tests, Judge Dearie applied a "horizontal commonality" analysis consistent with Second Circuit precedent. Horizontal commonality "is characterized as the tying of each individual investor's fortunes to the fortunes of . . . other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." Judge Dearie found that it could "readily be inferred from the facts alleged that the REcoin and Diamond investment strategies depended upon the pooling of investor assets to purchase real estate and diamonds," and that the "[i]ndictment makes clear that REcoin and Diamond profits would be distributed to investors pro-rata." The court highlighted several allegations in the indictment supporting a finding of horizontal commonality, including:

- White paper statements that REcoin "invests its proceeds into global real estate based on the soundest strategies" and Diamond was "hedged by physical diamonds" which "were [purportedly] stored in secure locations in the United States and [were] fully insured for their value."
 - Emails from Zaslavskiy to REcoin and Diamond investors which included minimum growth forecasts and urged investors to purchase Diamond and trade on external exchanges.
 - Certificates issued by REcoin memorializing investors' "individual ownership in REcoin tokens."
- **Expectation of profits from Zaslavskiy's managerial efforts:** Judge Dearie concluded that the indictment alleged sufficient facts to allow a finder of fact to "conclude that investors were led to expect profits . . . to be derived solely from the managerial efforts of Zaslavskiy and his co-conspirators." The court once again pointed to promises made to investors in the white paper, for instance: "REcoin is led by an experienced team . . . and invests . . . based on soundest strategies." The court also cited content from Zaslavskiy's emails, including a forecast of "minimum growth of 10% to 15% per year." In addition, Judge Dearie noted that there was "no indication that investors were to have any control over the management of REcoin or Diamond."

Implications

In reaching its conclusions, the court evaluated the offer and sale of digital tokens by assessing the economic reality of how the tokens were promoted rather than the terminology used to describe them. As explained by Judge Dearie, quoting Supreme Court precedent, "form should be disregarded for substance and the emphasis should be on economic reality." This is a standard approach for determining whether something is a security and highlights the point that carefully curated language will not insulate digital token sellers from regulatory oversight if the economic realities of their activities amount to the offer or sale of investment contracts.

Finally, this order is a win for both the DOJ and SEC, and reflects a growing body of judicial precedent supporting the SEC's position that digital tokens offered and sold to the public are securities. While both the *Zalavskisy* enforcement actions and *Centra Tech* lawsuit involve allegations of fraud, with each ruling that digital tokens are or may be investment contracts, even at the preliminary stages of a case, the likelihood of a different finding in cases where there is no allegation of fraud becomes more remote.

Learn more about this development by contacting any of the authors.

A version of this article was originally published in the New York Law Journal on September 18, 2018.

AUTHORS



Deborah R. Meshulam

Partner
Washington, DC | T: +1 202 799 4000
deborah.meshulam@dlapiper.com



Benjamin Klein

Of Counsel
Washington, DC | T: +1 202 799 4000
ben.klein@dlapiper.com