Securities Regulation Daily Wrap Up, TOP STORY—S.D.N.Y.: Crypto assets in alleged ICO fraud passed the Howey test; indictment stands, (Sept. 11, 2018)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

In an indictment for criminal securities fraud involving two initial coin offerings (ICOs), the U.S. successfully argued at the motion to dismiss stage that the investments in the allegedly fraudulent offerings were investment contracts and thus securities under the Securities Act and Exchange Act. The Southern District of New York also found that the Exchange Act and SEC Rule 10b-5 were not unconstitutionally vague as applied in this case (*U.S. v. Zaslavskiy*, September 11, Dearie, R.).

Alleged cryptocurrency fraud. In a 3-count indictment for securities fraud and conspiracy to commit securities fraud, defendant Maksim Zaslavskiy and his two companies (REcoin Group Foundation, LLC, and DRC Club a.k.a. Diamond Reserve Club) were charged with fraudulently inducing investors to buy cryptocurrency "tokens" or "coins" in the companies' ICOs. The defendants allegedly stated in a website that REcoin was backed by real estate investments; that the venture was led by an experienced team of brokers, lawyers, and developers; and that 2.8 million tokens had been sold. However, none of this was true, and no REcoin token or coin was ever developed or distributed to investors.

In September 2017, the defendants declared a successful conclusion to the REcoin ICO and debuted an "Initial Membership Offering" (IMO) for Diamond, which gave REcoin investors the option of obtaining a refund on their investments or converting their REcoin tokens into tokens in Diamond, which were supposedly going to be backed by investments in diamonds. As with REcoin, however, Diamond never invested in the promised assets or developed tokens or coins. At this point, the SEC stepped in and obtained an asset freeze.

Howey test. Cautioning that the question of whether the purported assets were in fact securities was a factual test that would need to be independently conducted by the finder of fact, the federal district court in Brooklyn decided that the indictment called for a trial on the merits. But for purposes of the motion to dismiss, the court found that a reasonable jury could find that the purported investments were securities under the Howey test.

The question was whether the government had sufficiently alleged elements of a "profit-seeking business venture," and the court concluded that it had. First, a reasonable jury could conclude that individuals invested money and other forms of payment in exchange for investments they were told were investment-backed tokens or coins. The "membership" in the two ventures was sufficiently considered an asset. Second, a jury could reasonably find that both REcoin and Diamond constituted a "common enterprise." It could be inferred that the investment strategies depended on the pooling of investor assets to purchase real estate and diamonds, and that the investors' fortunes were necessarily tied together through the pooling of their investments. Third, the facts would enable a jury to conclude that investors were led to expect profits to be derived solely from the managerial efforts of the defendants, not any efforts of the investors themselves.

Finally, the court batted aside Zaslavskiy's argument that the virtual currencies promoted in the ICO were currencies, and therefore by definition not securities. For one thing, no assets of any kind ever materialized, despite promises to the contrary. Also, simply labeling an investment opportunity as "virtual currency" or "cryptocurrency" does not transform a security into a currency, said the court.

Not unconstitutionally vague. The court found that the law under which Zaslavskiy was charged was not unconstitutionally vague as applied to his conduct. First, Zaslavskiy did not show that a person of ordinary intelligence would not have sufficient notice that the charged conduct was prohibited. Combined, the Exchange

Act, Rule 10b-5, and the definition of "investment contract" in Howey, as well as abundant case law and SEC guidance, made it reasonably clear that the charged conduct was criminal. Further, the courts are clear that the securities laws are meant to be interpreted flexibly to effectuate their remedial purpose.

Zaslavskiy's argument that the standards would be enforced arbitrarily also failed. The law articulated clear standards, the conduct charged fell within the core of the statute's prohibition, and enforcement was not subject to unfettered latitude.

Case will proceed. Accordingly, the court denied the motion to dismiss the indictment and stated that the case will proceed to trial.

The case is No. 17 CR 647 (RJD).

Attorneys: Julia Nestor, U.S. Attorney's Office, for the United States. Mildred M. Whalen (Federal Defenders of New York, Inc.) for Maksim Zaslavskiy.

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