Currency or Security?

What *United States v. Zaslavskiy* Means for the Future of Cryptocurrency Regulation

Whether you call them cryptocurrencies, virtual currencies, digital assets, or tokens, a new asset class has developed. Cryptocurrency is a digital currency that uses encryption techniques for governance and security and operates independently of any central bank.[1] Like any other financial instrument, however, the use of digital currency brings with it a risk of fraud. This article examines the implications of a recent decision from the Eastern District of New York against Maksim Zaslavskiy, the first case to address whether cryptocurrency is subject to federal securities laws.

On September 11, 2018, Judge Raymond J. Dearie of the US District Court for the Eastern District of New York ruled that prosecutors could move forward with their securities case against Zaslavskiy, a Brooklyn resident who was arrested in November 2017 on charges that he defrauded investors in initial coin offerings (ICOs) for two cryptocurrencies—"REcoin," which Zaslavskiy claimed to be backed by real estate, and the eponymously named "Diamond," which he said was backed by diamonds. ICOs have been attractive to certain investors who are looking to make a quick profit—a new-age "penny stock," if you will.[2]

From July 2017 to October 2017, Zaslavskiy was alleged to have "fraudulently raised at least $300,000 from investors through various material misrepresentations and deceptive acts relating to supposed investments in digital 'tokens' or 'coins' offered by REcoin and Diamond during their respective ICO processes."[3] According to the SEC, Zaslavskiy posted "false and misleading statements" on his companies' websites, "including in a 'whitepaper' issued by REcoin ... as well as in numerous other online fora such as social media, websites, and press releases."[4] The Government similarly accused Zaslavskiy of marketing REcoin as the "First Ever Cryptocurrency Backed by Real Estate" and making Facebook posts that touted Diamond as an exclusive, "tokenized membership" club that was "hedged by physical diamonds."[5] Yet, according to the Government, neither company was backed by any real estate or diamonds.[6]

Zaslavskiy argued that the Indictment should be dismissed, because, among other things: (1) ICOs did not constitute "investment contracts" under the Supreme Court's decision in *SEC v. W.J. Howey Co.* (the "Howey test"); (2) the virtual currencies promoted in the REcoin and Diamond ICOs were "currencies" and thus, by definition, not "securities" under 15 U.S.C. § 78c(a)(10); and (3) the federal securities laws were unconstitutionally vague. The gravamen of his assertion was that the ICO offerings for both REcoin and Diamond amounted to nothing more than a sale of a currency backed by a commodity, and thus could not be subject to the federal securities laws.[7]

The Government, in response, maintained that the REcoin and Diamond ICOs indeed qualified as investment contracts, because Congress intentionally "defined a security broadly to encompass practically any instrument

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that might be sold as an investment."[8] Thus, in analyzing whether ICOs constituted investment contracts pursuant to the *Howey* test, the Government urged the court to employ a "flexible" analysis, as such an approach was consistent with Congress's recognition of "the virtually limitless scope of human ingenuity in creating investment enterprises."[9] Moreover, the Government asserted that Zaslavskiy—by focusing merely on the use of the word "currency" in the definition of "cryptocurrency"—overlooked the critical fact that federal courts, in defining what constitutes a "security," focus on the "economic realities underlying [the] transaction, and not on the name appended thereto."[10] "Indeed," the Government wrote, "REcoin and Diamond are no more a currency than are rare coins, the sale of which the [Eastern District of New York] recently held to be 'securities.'"[11] Finally, with regard to Zaslavskiy's constitutionality argument, the Government contended that Zaslavskiy "had more than sufficient notice that this conduct constituted securities fraud," because the ICOs at issue "comfortably fit" within the definition of an investment contract.[12]

Judge Dearie sided with the Government. First, he found that an ICO qualified as an "investment contract" because, under the *Howey* test, a jury could find that REcoin and Diamond ICOs amounted to schemes whereby individuals (1) invested money (2) in a common enterprise and (3) were led to expect profits solely from Zaslavskiy's promotion efforts.[13] "For these reasons," Judge Dearie concluded, "we find that the allegations in the Indictment, if proven, would permit a reasonable jury to conclude that Zaslavskiy promoted investment contracts (*i.e.*, securities), through the REcoin and Diamond schemes."[14]

Regarding the currency/security distinction, the Judge ruled that it will ultimately be up to the jury to decide whether the ICO at issue

was a security, but that the allegations in the Indictment were sufficient to support such a finding at the motion to dismiss stage. Judge Dearie reasoned that Zaslavskiy "overlook[ed] the fact that simply labeling an investment opportunity as 'virtual currency' or 'cryptocurrency' does not transform an investment contract—a security—into a currency."[15] Likewise, Judge Dearie noted that Zaslavskiy "ignore[d] the fact that, per the Indictment, no diamonds or real estate, or any coins, tokens, or currency of any imaginable sort, ever existed—despite promises made to investors to the contrary."[16] Thus, according to Judge Dearie, the facts alleged in the Indictment were sufficient to allow a jury to find that the investment opportunities "meet the definition of 'security.'"[17]

As for Zaslavskiy's constitutionality argument, Judge Dearie held that U.S. securities laws are not void for vagueness. It is "clear," Judge Dearie wrote, "that the securities laws are meant to be interpreted flexibly to effectuate their remedial purpose."[18] Judge Dearie held that the Indictment fell squarely within the statutes' protections, because it "describe[d] REcoin and Diamond as schemes devised by Zaslavskiy and his co-conspirators to 'use the money of others on the promise of profits.'"[19] In Judge Dearie's view, "[t]he Exchange Act (and Rule 10b-5) [were] intended to prevent just that: their aim is to 'protect the American public from speculative or fraudulent schemes of promoters' like Zaslavskiy and ensure 'full and fair disclosure' with respect to securities."[20] Judge Dearie therefore concluded that Zaslavskiy had fair notice that his conduct would be subject to federal securities law and accordingly denied his motion to dismiss.[21]

For now, Judge Dearie's ruling stands to have a meaningful impact on the SEC and DOJ's oversight of ICOs. In reaching his conclusions, he took the view that the legality of an ICO—irrespective of the fact that involves digital, unregulated currencies—constitutes an economic transaction under U.S. securities law. Quoting the Supreme Court's 1975 decision in *United Housing Foundation v. Forman*, Judge Dearie observed that "form should be disregarded for substance and the emphasis should be on economic reality."[22] By adopting a well-established standard for assessing whether something is a security, Judge Dearie made clear that digital currencies cannot avoid regulatory oversight, so long as their activities are tantamount to the offer or sale of investment contracts.

Going forward, defense attorneys—and particularly those practicing in the field of white collar crime—would be wise to monitor the *Zaslavskiy* case, as it presents an important issue of first impression for the courts. Likewise, counsel should caution their clients to be wary of ICOs, particularly those that fit the deceitful model of online salesmanship allegedly adopted by Zaslavskiy.

NOTES:

[1] The most popular cryptocurrency is "bitcoin," which was invented in 2009 during the nadir of the Great Recession and was the basis for the recent Netflix documentary *Banking on Bitcoin*.

[2] "The term 'penny stock' generally refers to a security issued by a very small company that trades at less than $5 per share." Because they are "difficult, or even impossible, to accurately price," the SEC has warned penny stock investors to "be prepared for the possibility that they may lose their whole investment." *See Penny Stock Rules*, SEC, available at https://www.sec.gov/fast-answers/answerspennyhtm.html.

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