Federal Court Evaluates When Cryptocurrency May Constitute a Security in a Criminal Case

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The regulatory framework for virtual currencies is evolving, as federal and state regulators and courts wrestle with the circumstances in which cryptocurrencies are securities. For instance, the staff of the Securities and Exchange Commission ("SEC") has observed that tokens, which start as securities, can become something other than a security over time as a token's network becomes "sufficiently decentralized."[1] In fact, the SEC staff indicate that more comprehensive yet "plain English" guidance will be forthcoming before the end of this year.[2] In the meantime, we highlight a recent court case considering the question. In *U.S. v. Zaslavskiy*[3], a federal court considered whether a cryptocurrency can be regarded as a security. That case involved criminal charges against Maksim Zaslavskiy accused of promoting digital currencies backed by investments in real estate and diamonds that prosecutors said did not exist.[4] The U.S. District Judge in New York decided that the prosecutors could proceed with their case alleging that the cryptocurrencies at issue were securities for purposes of federal criminal law.

Prosecutors argued that investments offered by Zaslavskiy in two initial coin offerings ("ICOs")—REcoin Group Foundation and Diamond Reserve Club—were "investment contracts" that were securities under the federal securities laws. Zaslavskiy, on the other hand, filed a motion to dismiss the prosecutors' securities fraud claims, arguing that the virtual currencies promoted in the ICOs are "currencies," and therefore, by definition, not securities.[5]

As the SEC and many commentators have noted, the test for whether a financial instrument or transaction constitutes an "investment contract" under the federal securities laws is set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (the "Howey Test"). The Howey Test defines an 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."[6] The Howey Test, however, is "not static and does not strictly inhere to the instrument."[7] Instead, "[c]entral to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers."[8]

Zaslavskiy argued that investments in the two ICOs did not involve an investment of money because they involved the exchange of "one medium of currency for another."[9] The indictment, however, sufficiently alleged that investors gave up money or other assets in exchange for "membership" in the two ventures.[10] The court also found that a reasonable jury could find that the ICOs constituted a "common enterprise" because it could be inferred from the facts alleged in the indictment that the ICOs' investment strategies depended upon the pooling of investor assets to purchase real estate and diamonds, and that investors' fortunes were necessarily tied together through the pooling of their investments. Additionally, profits from the ICOs would be distributed to investors pro-rata—given that investors were promised "tokens" or "coins" in exchange for, and proportionate to, their investment interests in the schemes. Zaslavskiy's promise of tokens in exchange for investments did not undercut the Court's conclusion that the Indictment sufficiently alleged a pooling of assets in a common enterprise. Finally, the Court determined that a jury could conclude that investors were led to expect profits in the ICOs to be derived solely from the managerial efforts of Zaslavskiy and his team, not any efforts of the investors themselves. The investors undoubtedly expected profits on their investments because the ICOs were advertised as attractive investment opportunities that would grow in value.

Ultimately, the Court found the allegations in the indictment could allow a reasonable jury to find that Zaslavskiy promoted investment contracts (*i.e.*, securities), through the REcoin and Diamond schemes, and therefore meet the definition of a "security."[11] In rejecting Zaslavskiy's argument that the currencies promoted in the two ICOs are not securities, the Court noted 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 the investors to the contrary."[12] The Court also stated that "simply labeling an investment opportunity as a 'virtual currency' or 'cryptocurrency' does not transform an investment contract—a security—into a currency."[13]

This is the first criminal case in which a federal court considered whether U.S. securities laws may cover cryptocurrency. If upheld on appeal, the Court's ruling could have far-reaching ramifications for future ICOs and tokens under the federal and state securities laws. In the absence of federal legislation, those engaged in digital currencies and ICOs should pay close attention to the developing landscape in enforcement actions, court cases, and guidance from federal and state regulators (which is expected from SEC staff by year-end, as noted above) on when cryptocurrencies are securities.

Contacts:

Jamie Lacy
817.420.8274
jlacy@winstead.com
Gavin Fearey
817.420.8276
gfearey@winstead.com
Andrew Rosell
817.420.8261
arosell@winstead.com
Toby Galloway
817.420.8262
tgalloway@winstead.com

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[1] *See* William Hinman, Director of the Division of Corporation Finance, Securities & Exchange Commission, Yahoo All Markets Summit: Crypto (June 14, 2018), *available at*, https://www.sec.gov/news/speech/speech-hinman-061418 ("Hinman Speech").

[2] JD Alois, *Report: SEC Director of CorpFin Says Cryptocurrency Guidance Coming*, Crowdfund Insider (Nov. 5, 2018), https://www.crowdfundinsider.com/2018/11/140929-report-sec-director-of-corpfin-says-cryptocurrency-guide-coming/.

[3] 17 CR 647 (RJD), Dkt. No. 37 (E.D.N.Y. Sept. 11, 2018).

[4] The SEC and the United States Department of Justice ("DOJ") each filed actions against Zaslavskiy for securities fraud. The filing of these parallel actions reflects the coordinated efforts of the SEC and the DOJ to apply the federal securities laws to token sales.

[5] *See* 15 U.S.C. § 78c(a)(10) (security does not include "currency . . . .").

[6] *Howey*, 328 U.S. at 298-99.

[7] Hinman Speech, *available at*, https://www.sec.gov/news/speech/speech-hinman-061418.

[8] Hinman Speech, *available at*, https://www.sec.gov/news/speech/speech-hinman-061418.

[9] *U.S. v. Zaslavskiy*, 17 CR 647 (RJD), Dkt. No. 37, at p. 11 (E.D.N.Y. Sept. 11, 2018).

[10] *Id.*

[11] *Id.* at p. 17.

[12] *Id*.

[13] *Id*.