

Ruling On What Isn't A Security Needed For ICO Clarity

By **Dunstan Prial**

Law360 (May 9, 2018, 7:31 PM EDT) -- A ruling in the case of a businessman charged with fraud in an initial coin offering in Brooklyn federal court has the potential to provide clarity on the contentious issue of whether cryptocurrency tokens are securities subject to regulation by the U.S. Securities and Exchange Commission, legal experts say.

If U.S. District Judge Raymond J. Dearie dismisses charges against Maksim Zaslavskiy — who was **indicted** by the U.S. Department of Justice for allegedly making fraudulent statements to lure in ICO investors, and who is facing a parallel SEC civil suit — based on the argument his digital tokens weren't securities, experts believe ICO issuers will have a model on which to base future offerings outside the SEC's jurisdiction.

While there's considerable doubt Judge Dearie will dismiss the case based on Zaslavskiy's securities defense, it's the first time the question of whether an ICO is a security subject to SEC regulation has been put before a federal judge, and experts say at some point a ruling that a particular digital coin isn't a security will be needed to alter the current landscape in which the SEC has treated virtually all ICOs.

"The critical ruling will come from a judge who says the way this token's ICO was structured is not a security. If you get one of those that says this is not a security, then everyone will latch onto that and structure their token offering like that one. We don't have one of those yet," said Nick Morgan, a partner at Paul Hastings LLP.

So far, the SEC in various reports, enforcement actions and guidance has only referred to specific ICOs as offering securities under federal law, Morgan noted.

"We've got a string of, 'Yeah, this is a security, this is a security, this is a security,'" he said. "What we haven't seen anyone say is, 'If you structure your token this way, it's not a security.' That would help immensely."

Zaslavskiy is accused of using his companies REcoin Group Foundation and DRC World Inc., also known as Diamond Reserve Club, to dupe investors into buying nonexistent digital tokens in his REcoin and Diamond initial coin offerings, which he is alleged to have falsely claimed were backed by real estate and diamonds.

Zaslavskiy appeared in court Tuesday, arguing his case should be dismissed because his digital coins are currencies rather than securities and thus aren't subject to the securities law upon which the charges are based.

The government **has argued in court documents** that the REcoin and Diamond tokens pass the U.S. Supreme Court's so-called Howey test for determining if a financial instrument is an investment contract and therefore a security, since both of the purported tokens were "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."

The SEC cited the Howey ruling last summer in a **widely distributed report** explaining why an ICO

had been defined as a security, and Chairman Jay Clayton has made no secret of his belief that most ICOs are securities that should be registered with the SEC, **telling a Senate Committee** in February, "You can call it a coin, but if it functions as a security, it's a security."

The SEC declined to comment for this story, referring to Clayton's past comments.

David Chase, a former SEC prosecutor and now principal in his own Florida-based defense firm, said cryptocurrency technology may be new, but the legal principles on which the SEC is basing its definition of a security are not.

"The Supreme Court articulated the elements of what constitutes a security in the seminal *Howey* case," he said. "These cryptocurrencies are clearly cutting-edge, new technology. But the same old boring kind of principles that were articulated years ago apply."

JR Lanis of Drinker Biddle & Reath LLP said the SEC's position that most ICOs are securities has led him to advise his issuer clients to behave as if their digital coin offerings are securities.

"The way that the SEC has approached this is that there's not much that doesn't fall under their jurisdiction," Lanis said. And that's not likely to change until there is a court ruling that says the SEC is wrong, that a particular ICO is not a security that falls under their jurisdiction, he added.

Lanis said the *Zaslavskiy* case is likely to provide a "partial" answer, but the issue will likely end up before the Supreme Court. "That's why I say it's the first watershed moment," he said.

"I think that what we have with ICOs are something that the current security laws weren't meant to contemplate," Lanis said. "The Security Act was written in 1933. There was nothing like a cryptocurrency in 1933. They're trying to fit a modern concept into a very old set of laws."

Lanis said he'd like to see either a separate or a modified set of laws that applies to cryptocurrencies. "I think right now the SEC is saying, 'Attorneys, you're the gatekeepers.' But we don't know what the rules are for somebody to pass through the gate," he said.

Judge Dearie on Tuesday didn't rule on *Zaslavskiy's* motion to dismiss and is expected to issue a decision some time before the scheduled start of the trial in January 2019. At various points in the hearing, the judge expressed skepticism of *Zaslavskiy's* argument and hinted that he may not be inclined to dismiss fraud charges based on an ongoing technology debate.

Morgan predicted the judge will limit his ruling to the specifics of *Zaslavskiy's* offering and likely side with the SEC's position, allowing the fraud charges to move forward and doing little to dispel the lack of clarity on ICOs. "This case wouldn't have been my first choice to get the first ruling on ICOs from a federal judge," he said.

Going forward, Morgan predicted each ICO case is likely to be decided differently because of the variety in how the offerings can be structured. Eventually, there will be a "critical mass or a body of legal opinions" that will resolve the issue for most token offerings, Morgan said, but given the myriad options for the technology, there will probably always be issuers claiming their offering is an exception. "I think we're going to be hearing a lot of different opinions under different factual scenarios," he said.

Judge Dearie concluded Tuesday's hearing by saying, "It would be nice if the regulators got into the 20th century, much less the 21st. But I have to deal with the cards that have been dealt to me."

Zaslavskiy is represented in the DOJ case by Mildred Whalen and Len H. Kamdang of the Federal Defenders of New York Inc. He's represented in the SEC case by Jason Nagi of Polsinelli PC.

The government is represented by Julia Nestor and Andrey Spektor of the U.S. Attorney's Office for the Eastern District of New York.

The case is *U.S. v. Zaslavskiy*, case number 1:17-cr-00647, in the U.S. District Court for the Eastern District of New York.

--Editing by Philip Shea and Alanna Weissman.

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