

## Case Alleging Cryptocurrencies Are Securities Can Proceed to Trial

### IN SHORT

**The Situation:** Federal prosecutors have asserted that two cryptocurrencies sold in initial coin offerings ("ICOs") are "securities" for purposes of federal securities laws in a criminal indictment alleging fraud against the promoter of the ICOs. The SEC has made similar allegations in a related civil case that has been stayed pending the outcome of the criminal proceeding.

**The Case:** A federal district court in New York denied a motion to dismiss the criminal indictment on September 11, 2018, after concluding that the prosecutors had adequately alleged that the two cryptocurrencies were "securities."

**Looking Ahead:** The SEC has asserted for over a year that federal securities laws may apply to cryptocurrencies, depending on the facts and circumstances of the case. Until now, no federal district court had issued a ruling addressing that question. This ruling provides support to the SEC's position, even as it leaves the ultimate question to be decided by a jury.

United States District Court Judge Raymond Dearie of the Eastern District of New York, issued a ruling on September 11, 2018, rejecting arguments made in a motion to dismiss a criminal indictment that federal securities laws do not apply to cryptocurrencies. The ruling was issued in a case alleging that Maksim Zaslavskiy ("Zaslavskiy") and his companies, REcoin Group Foundation, LLC ("REcoin") and DRC World Inc., also known as Diamond Reserve Club ("Diamond"), made fraudulent representations and omissions in connection with the ICOs for the cryptocurrencies. *U.S. v. Zaslavskiy*, 1:17-cr-00647 (E.D.N.Y. Sept. 11, 2018). This is the first federal district court decision to rule that violations of federal securities laws were adequately alleged in connection with cryptocurrencies sold in ICOs and provides support to the SEC's position that federal securities laws may apply to cryptocurrencies depending on the facts and circumstances.



Judge Dearie ruled that a reasonable jury could conclude that, based on the facts alleged, the REcoin and Diamond tokens meet the definition of "investment contracts" under *Howey*.



### Background

Maksim Zaslavskiy founded two companies in 2017: REcoin, which invested in real estate and developed related smart contracts, and Diamond, which invested in diamonds. REcoin offered and marketed a new cryptocurrency that was backed by the company's domestic and international real estate investments. The REcoin ICO was expected to run from August 7, 2017, through October 9, 2017. However, according to the criminal indictment, REcoin never made any real estate investments and the tokens were never issued, despite more than 1,000 investors purchasing the tokens.

Following the REcoin ICO, Zaslavskiy allegedly launched what he called an "initial membership offering" that provided investors with a cryptocurrency backed by physical diamonds. REcoin investors were given the option to convert their REcoin tokens into Diamond tokens. However, according to the indictment, the Diamond tokens were never developed, and the REcoin investors who transferred their funds from REcoin to Diamond allegedly never received any tokens. It is alleged that Zaslavskiy raised at least \$300,000 from investors through various material misrepresentations and deceptive acts relating to supposed investments of REcoin and Diamond tokens.

The SEC filed a civil complaint against Zaslavskiy and his two companies on September 29, 2017, in the United States District Court for the Eastern District of New York, for engaging in illegal unregistered securities offerings in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act") and making fraudulent representations in connection with the offerings in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). *SEC v. REcoin Group Foundation, LLC, et al.*, 17-cv-05725. Federal prosecutors in the Eastern District of New York filed criminal charges against Zaslavskiy based on similar allegations on October 27, 2017. *U.S. v. Maksim Zaslavskiy*, 17-cr-00934. The SEC's case was stayed pending the resolution of the parallel criminal proceeding on January 31, 2018.

On March 26, 2018, Zaslavskiy moved to dismiss the criminal indictment for unconstitutional vagueness and for lack of subject-matter jurisdiction on March 26, 2018. The motion made two arguments:

- The REcoin and Diamond tokens were not "investment contracts" under *SEC v. W.J. Howey Co.*, 338 U.S. 293 (1946) and thus not "securities" as defined by Section 3(a)(10) of the Securities Act and Section 2(a)(1) of the Exchange Act; and

- The federal securities laws are unconstitutionally vague as applied to cryptocurrencies.

### Discussion of the Ruling

In rejecting the motion to dismiss, Judge Raymond Dearie concluded that there "can be no serious debate" that the indictment satisfies due process and is not unconstitutionally vague. He further ruled that a reasonable jury could conclude that, based on the facts alleged, the REcoin and Diamond tokens meet the definition of "investment contracts" under *Howey*. In doing so, Judge Dearie recognized that the *Howey* test is a "highly fact-specific inquiry" that "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

Judge Dearie concluded that the indictment sufficiently alleges facts that, if proved at trial, could lead a reasonable jury to find that the REcoin and Diamond tokens were "investment contracts." First, based on the alleged facts, a reasonable jury could find that the investors invested money in the ICOs by giving up money or other assets in order to participate in the ICOs. Second, the indictment sufficiently alleged a common enterprise based on the claim that profits from REcoin and Diamond would be distributed to investors pro rata. Finally, the court held that a reasonable jury could conclude, if the alleged facts are proved, that investors were led to expect profits in REcoin and Diamond tokens derived from the managerial efforts of Zaslavskiy.

### FOUR KEY TAKEAWAYS

1. This ruling is the first from a federal district court to address the question of whether a cryptocurrency could be a "security" under federal securities laws.
2. The ruling does not decide that issue but rather concludes that the allegations in the indictment, if proved, are sufficient for a jury to find that the cryptocurrencies at issue are securities. It, thus, leaves the ultimate decision regarding whether the two cryptocurrencies are securities to a jury based on evidence presented at trial.
3. The ruling reaffirms the principle that the SEC has espoused since at least July 2017—whether a cryptocurrency is an "investment contract" under *Howey* is highly fact specific and depends on the facts and circumstances of the case.
4. Firms considering an ICO should carefully analyze whether the cryptocurrency they are offering is a "security" and take appropriate measures to comply with applicable federal and state securities laws.



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