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Client Alert

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A Tale of Four Cryptocurrency Enforcement Actions

On September 11, 2018, four new and important regulatory actions and rulings were announced against cryptocurrency firms. A federal district court denied a motion to dismiss, finding that the cryptocurrency tokens offered as part of an initial coin offering (ICO) may be deemed "securities" and therefore subject to U.S. federal securities laws. The Securities and Exchange Commission (SEC) issued two settled orders, one against a hedge fund manager and the other against a cryptocurrency trading platform. Finally, the Financial Industry Regulatory Authority (FINRA) filed a complaint involving a broker who sold unregistered securities called HempCoins. Each matter is individually summarized below.

Jury to Decide Whether Cryptocurrencies Are Securities in Criminal Action – *U.S. v. Zaslavskiy*

In the first cryptocurrency case of its kind, the federal district court in Brooklyn declined to dismiss a criminal indictment against Maksim Zaslavskiy. The complaint alleged Zaslavskiy fraudulently offered cryptocurrencies via two ICOs, REcoin and Diamond, purportedly backed by real estate and diamonds. Zaslavskiy's motion to dismiss was denied on the grounds that a determination as to whether the tokens were securities, as opposed to currencies, is inherently fact-intensive and thus more appropriate for a jury rather than a judge to decide pursuant to a motion to dismiss.

In the complaint, Zaslavskiy was alleged to have made materially false statements to induce potential investors to invest in his ICOs. Contrary to his promises, the enterprises did not purchase any real estate or diamonds, were not supported by experts and no "blockchain virtual currency" token was ever created or distributed to investors.

According to the district court, whether Zaslavskiy's investment scheme constitutes an investment contract (i.e., a security), pursuant to the 1946 Supreme Court case of *SEC v. Howey*, 328 U.S. 293 (1946), is "undoubtedly a factual one." The court determined that a reasonable jury could conclude that the facts alleged in the indictment satisfy the *Howey* test. In particular, the *Howey* test defines an investment contract as a contract, transaction or scheme whereby a person (1) invests money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of the provider or third party. All three elements must be established for a scheme or transaction to qualify as an investment contract. Whether a transaction or instrument qualifies as an investment contract is a "highly fact-specific inquiry." This is especially true in the context of relatively new hybrid vehicles, which require a case-by-case analysis of the "economic realities" of the transaction.

Here, the court found that a reasonable jury could conclude, based on the facts alleged in the indictment, that investors invested money in order to participate in Zaslavskiy's ICO schemes and that such schemes constituted a "common enterprise" (i.e., the

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pooling of money and commonality between the investors). A jury could also find that the investors expected to receive profits from the efforts of Zaslavskiy, since the investors were told that their investments were expected to grow by 10 to 15 percent per year as a result of his entrepreneurial efforts.

In denying the defendant's motion to dismiss, the court noted that Zaslavskiy overlooked the fact that simply labeling an investment opportunity as "virtual currency" does not transform an investment contract – which is a security – into a currency. The court also noted that despite Zaslavskiy's pleas, the United States securities laws are not unconstitutionally vague with respect to ICOs.

This is the first district court to weigh in on the status of ICOs, and the case may cause more cryptocurrency cases to proceed toward trial instead of being decided by judges via dispositive motions.

A copy of the ruling can be found here (https://www.courtlistener.com/recap/gov.uscourts.nyed.409850/gov.uscourts.nyed.409850.37.0.pdf).

First SEC Enforcement Action Involving a Hedge Fund's Investments in Cryptocurrencies – Crypto Asset Management

The SEC entered its first settled order (the "Order") against a hedge fund manager relating to investments in cryptocurrencies. In this case, the SEC found that Crypto Asset Management (CAM) caused Crypto Asset Fund LLC (the "Fund") to violate the Investment Company Act (ICA) by failing to register as an investment company with the SEC. CAM acted as the investment adviser to the Fund, which was formed for the purpose of investing in cryptocurrency-related investments. In addition, CAM and its founder and sole principal, Timothy Enneking, were found to have violated certain provisions of the Investment Advisers Act of 1940 and the Securities Act of 1933 by making untrue statements of material fact to investors in connection with the Fund's offering of securities on CAM's website and elsewhere.

In particular, Section 3(a)(1)(c) of the ICA defines an "investment company" as any issuer that is engaged or purports to engage in the business of investing, reinvesting, owning, holding or trading securities and that owns or purports to acquire securities having a value exceeding 40 percent of the value of such issuer's total assets. According to the Order, during the relevant period, the Fund invested in certain cryptocurrency-related investments that constituted securities, and such securities had a value exceeding 40 percent of the value of the Fund's total assets. Thus, as CAM made a public offering of the Fund's securities, it was required to register the Fund under Section 7(a) of the ICA.

In making these findings, however, the SEC included no information as to exactly what cryptocurrency-related assets were traded by the Fund. A review of CAM's website indicates that the nature of the Fund's investments were primarily ICOs and/or blockchain and technology-related investments. While the SEC or its staff has determined that common cryptocurrencies such as Bitcoin and Ether are not securities, this Order provides little, if any, additional clarity regarding the analysis of other cryptoassets. In fact, it does not even mention the Howey test (discussed above in connection with the Zaslavskiy matter), which is the test traditionally used to determine whether a transaction involves a security.

Pursuant to the Order, CAM and Enneking were (1) ordered to cease and desist from future violations, (2) censured and (3) required to pay $200,000, jointly and severally, in civil monetary penalties. As part of its remedial efforts, CAM also made a rescission offer and disclosed its previous misstatements to investors. In January 2018, CAM began offering securities pursuant to the Regulation D Rule 506(c) exemption under the Securities Act and presumably pursuant to the exception in Section 3(c)(1) or 3(c)(7) of the ICA.

This case serves as a warning to hedge fund managers who wish to trade in cryptocurrencies to determine beforehand whether such investments constitute securities. If such assets are deemed securities by the SEC, then proper regulatory compliance will be expected.

A copy of the Order can be found here (https://www.sec.gov/litigation/admin/2018/33-10544.pdf).

SEC Finds That Platforms Cannot Engage in Certain Cryptocurrency Transactions Without Registering as Broker-Dealers – TokenLot

The SEC issued another settled order (for purposes of this section, also the "Order") involving TokenLot, LLC and related respondents (collectively "TokenLot") for failing to register as a broker-dealer in connection with the operation of a cryptocurrency trading platform. TokenLot called itself the "ICO Superstore," where investors of "all experience levels" could make investments in cryptocurrency-related assets. For approximately one year, TokenLot solicited investors, promoted digital tokens, took thousands of customer orders for digital tokens, processed investor funds and handled more than 200 different digital tokens in connection with ICOs and secondary market activities. Citing to Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Securities Exchange Act of 1934, but

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without mentioning the Howey test, the SEC found that the digital tokens included securities. Accordingly, TokenLot's activities required broker-dealer registration with the SEC.

In determining to accept TokenLot's offers of settlement, including a decision not to impose greater penalties, the SEC considered TokenLot's cessation of all activities and offerings, winding down of the business, and refunding of payments for certain customer transactions. Also in connection with the settlement, TokenLot agreed to cease and desist from future violations and respondents Lenny Kugel and Eli Levitt agreed to be barred from various broker-dealer, investment adviser and other securities-related matters (with the right to reapply to the appropriate self-regulatory organization for re-entry after three years). In addition to disgorgement and prejudgment interest totaling more than $478,000 to be paid by TokenLot, Kugel and Levitt were each individually subject to a civil penalty of $45,000. This action was thus a rather stern signal that token platforms that effectuate what the SEC deems to be trades in securities are subject to the SEC's jurisdiction and related broker-dealer registration requirements.

A copy of the Order can be found here (https://www.sec.gov/litigation/admin/2018/33-10543.pdf).

More Unregistered Security and Broker-Dealer Failures – Ayre

In its first disciplinary proceeding relating to cryptocurrencies, FINRA filed a complaint alleging that Timothy Ayre violated various securities laws in connection with the offer and sale of cryptocurrencies. FINRA alleges that Ayre attempted to attract public investment in his allegedly worthless public company, Rocky Mountain Ayre, Inc. (RMTN); Ayre made material misstatements in RMTN's public filings; and Ayre sold to the public unregistered cryptocurrency securities that he touted as "the first minable coin backed by marketable securities."

By way of background, in 2015, RMTN was alleged to have acquired the rights in a cryptocurrency, HempCoin, and repackaged it into a security to offer to the public. RMTN was then said to have issued and reserved 500 million shares of common stock for the sole purpose of supporting the maximum number of coins offered to the public. Ayre was also said to have marketed HempCoin as "the world's first currency to represent equity ownership" in a publicly traded company. Additionally, he represented that each coin was equivalent to 0.10 shares of RMTN common stock. The complaint alleged that RMTN was a faltering business, comprised mostly of a poorly performing bistro.

FINRA's complaint also alleges that Ayre, by backing HempCoins with the marketable securities of RMTN, transformed HempCoin into a security tied to RMTN stock. However, no registration statement for HempCoin was ever filed with the SEC, nor were sales exempt from registration. In addition, during the period at issue, FINRA alleges that Ayre was employed by a broker-dealer but failed – as required pursuant to his firm's written supervisory procedures – to disclose any of the above-listed activities or other activities that would have been relevant to his employer. As a result of his conduct, Ayre is facing claims relating to material misrepresentations and omissions, the unlawful offer and sale of unregistered securities, and improper private securities transactions.

A copy of FINRA's complaint can be found here (https://www.finra.org/sites/default/files/Ayre_Complaint_091118.pdf).

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