

Clients & Friends Memo

Wild West No Longer: The SEC Brings Enforcement Actions Against Two Initial Coin Offerings

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Ending months of speculation about when regulators would wade into the world of Bitcoin and other digital currencies, the U.S. Securities and Exchange Commission (“SEC”) recently brought its first enforcement actions against two Initial Coin Offerings (“ICOs”) which it alleges effectively operated as high-tech Ponzi schemes.¹ The two investment schemes, both run by the same New York businessman, Maksim Zaslavskiy, solicited money from investors in exchange for digital currency (“tokens” or “coins”) which were purportedly tied to investments in real estate and diamonds that would appreciate in value over time. According to the SEC, both schemes were complete frauds with no investments or infrastructure behind them. However, the most significant takeaway is the SEC’s position, confirming its prior guidance on the subject, that the digital tokens were themselves securities and not simply a form of virtual currency due to Zaslavskiy’s claim that they were “backed” by investments. This action is a significant development for the SEC, which appears poised to allow ICOs to continue but increasingly willing to step in to prevent fraud in the space.

I. Existing SEC Guidance on Initial Coin Offerings

An ICO is a means of raising funds for a new company or enterprise, similar to an Initial Public Offering (“IPO”). However, unlike an IPO, which issues stock or other traditional securities to its investors, ICOs issue digital tokens to investors, often in the form of Bitcoin, Ethereum (“ETH”), or one of several other alternatives. Each of these relies on “Blockchain” technology which, among other uses, provides a platform for exchanging digital currency. Blockchain has been cited as having great potential for data security and reliability because it is decentralized – users can conduct transactions peer-to-peer without a financial intermediary between them, so there are no bank accounts to be hacked and no single storage database that could potentially fail. And, because of its open source nature, all users can see every transaction in digital currency in real time which means that transaction history cannot be fraudulently modified.

¹ *Securities and Exchange Commission vs. REcoin Group Foundation, LLC et al.*, Case No. 1:17-cv-05725 (E.D.N.Y. Sep. 29, 2017), available at <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf>.

The open question has been how these ICOs would be viewed by the SEC, and whether the digital currency issued to investors would constitute securities subject to registration and the anti-fraud provisions contained in the federal securities laws. In July 2017, the SEC's Office of Investor Education and Advocacy issued guidance stating that while ICOs could be fair and lawful investment opportunities, the digital currency they offer or sell *may* be considered securities subject to registration (absent an exemption to registration, such as those for private placements under Regulation D and overseas offerings under Regulation S).² The guidance cautioned investors against being enticed with the promise of high returns, particularly in a new and untested investment space.

At the same time, the SEC's Enforcement Division released details on its investigation of Slock.it UG, a German corporation, and The DAO, a "decentralized autonomous organization" designed to replace a traditional corporate structure with a user-driven collaborative.³ The concept of The DAO was described in a white paper issued by Slock.it with the purpose of creating and holding assets through the sale of DAO Tokens to investors in exchange for ETH. These assets would be used to fund "projects" from which the holders of DAO Tokens would share in anticipated earnings. DAO Token holders could monetize their investments by re-selling DAO Tokens using a web-based platform that supported secondary trading. By the close of its offering period, The DAO issued DAO Tokens in exchange for ETH valued at approximately \$150 million.

The SEC set about to determine whether the DAO Tokens issued to investors constituted securities under Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 (the "Exchange Act"), which include an "investment contract." According to Supreme Court precedent in *SEC v. W.J. Howey Co.*, an investment contract is "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."⁴ In applying the factors from *Howey* to the facts underlying The DAO, the SEC found that:

- Investors in The DAO Invested Money. The SEC determined that the investment of "money" is not limited to fiat currency (*i.e.*, cash), but also can include goods, services, or some other exchange of value including digital currency. Investors in The DAO used ETH to receive DAO

² SEC Investor Bulletin: Initial Coin Offerings (Jul. 25, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

³ SEC Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (Jul. 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁴ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); *SEC v. Edwards*, 540 U.S. 389, 393 (2004); see also *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.").

Tokens, and such investment is the type of contribution of value that can create an investment contract under *Howey*.

- Investors in The DAO Had a Reasonable Expectation of Profits. The SEC found that investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise. In doing so, the SEC looked to the white paper describing The DAO, which characterized it as a for-profit entity whose objective was to fund projects in exchange for a return on investment. As a result, a reasonable investor would have been motivated by the prospect of profit on their investment of ETH in The DAO.
- Profits Were to be Derived from the Managerial Efforts of Others. Finally, the SEC found that investors' profits were to be derived from the managerial efforts of others – specifically, Slock.it and The DAO's curators, who were responsible for managing The DAO and putting forth project proposals. The individuals were responsible for safeguarding invested funds, and investors had limited direct input and control over decision-making of the enterprise.

As a result, the SEC determined that the DAO Tokens were securities and, therefore, The DAO was an issuer of securities under the Exchange Act. Because of this, The DAO was subject to registration, disclosure, and anti-fraud provisions despite its not taking the form of a traditional corporation and its solicitation of investments in the form of digital currency rather than in fiat currency. Since this determination regarding The DAO, companies contemplating ICOs have been awaiting the SEC's next regulatory move in this space.⁵

II. Enforcement Action Against RECoin and DRC World

Consistent with its finding in The DAO case, the SEC is asserting that the ICOs offered by Zaslavskiy were illegal offerings of securities.

According to the SEC, Zaslavskiy described his two companies, REcoin Group Foundation and DRC World Inc. (or the Diamond Reserve Club), as “managed, tracked and authenticated through blockchain technology.” In promoting the first company, Zaslavskiy published a white paper on the Internet encouraging investors to invest in RECoin, which he described as “The First Ever Cryptocurrency Backed by Real Estate,” and “an attractive investment opportunity” that “grows in value.” The website provided investors with links to invest in RECoin, and later in the Diamond Reserve Club, using fiat currency (either with a credit card or via PayPal) or digital currency, in exchange for the promise of individualized digital “tokens” or “coins” that would be backed by investments in real estate and diamonds, respectively. According to Zaslavskiy, investors would receive returns based on the appreciation of the value of the investment which would, in turn, cause

⁵ See, e.g., Digital-Coin Companies Shrug Off SEC Scrutiny, *The Wall Street Journal* (Jul. 26, 2017), available at <https://www.wsj.com/articles/digital-coin-companies-shrug-off-sec-scrutiny-1501110893>.

the value of and demand for the tokens to also appreciate. Over the course of several months, Zaslavskiy reportedly collected over \$300,000 from investors in the two companies.

Ultimately, the SEC alleged that Zaslavskiy's entire ICO scheme was a fraud because he had in fact never invested any of the \$300,000 he had received from investors, had no internal staff or infrastructure, never issued any digital tokens, and made material misstatements in the white paper and on the company website. In addition, the SEC argued that Zaslavskiy actively attempted to avoid securities registration requirements by refashioning the sale of interests in the Diamond Reserve Club as "memberships in a club" and an "Initial Membership Offering." In fact, the memberships promised in the Diamond Reserve Club were identical to the digital tokens promised to investors in RECoin.

III. Conclusion

The SEC's action against Zaslavskiy was likely an easy call. Few would argue with the conclusion that the offerings by RECoin and Diamond Reserve Club constituted securities under the Howey test here. In addition, Zaslavskiy's operation appears to be nothing more than a typical Ponzi scheme masquerading as an ICO. However, there are a few takeaways that should be considered by companies considering ICOs going forward.

The SEC does not appear interested at this point in asserting jurisdiction over ICO, generally. However, if advocates and asset managers hoped that the SEC's apparent hesitation meant that ICOs would remain unregulated, they should expect to be disappointed. The SEC has clearly responded and asserted its authority in the digital currency space. What remains to be seen is whether the SEC will bring actions related to ICOs that would require a much broader interpretation of securities definitions. Will the SEC extend Howey to a situation where the digital currency's value comes not from a direct promise of profit-sharing, but rather from the scarcity of the coin itself? How will the SEC view situations where a digital token has an articulable function, similar to a virtual product, and is less akin to an investment of money with the expectation of future profits? It seems like the SEC will take a measured approach – at least for now.

It also remains to be seen what steps the Commodity Futures Trading Commission ("CFTC") will likely take in this area. The CFTC has previously indicated that it considers Bitcoin and other digital currencies to be "commodities" as defined by the Commodity Exchange Act.⁶ As such, and particularly since the SEC has asserted itself in this area, it is likely the CFTC will follow suit. Therefore, a likely outcome is shared enforcement responsibility for ICOs between the SEC and the CFTC dependent on the facts and circumstances of each case.

⁶ See *In the Matter of Coinflip, Inc. et al.*, CFTC Docket No. 15-29 (Sep. 17, 2015), available at <http://www.cftc.gov/idc/groups/public/%40renforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

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