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Federal District Court Upholds Securities Indictment for ICOs but Defers Final *Howey* Determination in *United States v. Zaslavskiy*

In what is believed to be the first criminal case examining whether so-called "initial coin offerings" (ICOs) are securities under U.S. law, on September 11, 2018, Judge Raymond J. Dearie of the U.S. District Court for the Eastern District of New York refused to dismiss the indictment against Maksim Zaslavskiy for a deceptive virtual currency scheme and fraudulent ICOs by REcoin Group Foundation, LLC (REcoin) and DRC World, Inc., a.k.a. Diamond Reserve Club (DRC). *United States v. Zaslavskiy*, No. 17-CR-647 (EDNY). Both entities are owned by Zaslavskiy.

Zaslavskiy argued that the indictment was insufficient on its face because (1) the investments solicited by REcoin and DRC were not securities, and (2) the federal securities laws are unconstitutionally vague as applied to cryptocurrency. In allowing the criminal charges to proceed, Judge Dearie rejected those arguments. However, acknowledging the early procedural stage of the case, the Court made no ruling on whether the virtual currencies offered by REcoin and DRC were securities under the U.S. Supreme Court's test in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (*Howey*). The Court deemed that issue a "subsidiary" and highly fact-based question "best left to the finder of fact."

The Court did, however, preview a *Howey* analysis assuming the truth of the facts alleged in the indictment. That discussion, albeit *dicta*, provides insight into how courts might assess virtual currencies and ICOs under the *Howey* test for a security.

ICOs by REcoin and DRC

REcoin, which Zaslavskiy founded in 2017, allegedly invested in real estate and developed real estate-related smart contracts. DRC purportedly invested in diamonds and offered its members discounts from diamond retailers. But contrary to Zaslavskiy's representations, REcoin never acquired any real estate or developed products, and DRC never purchased any diamonds. Nor did purchasers ever receive any coins, tokens or other digital assets from REcoin or DRC.

Based on these and other allegations, the indictment charged Zaslavskiy with one count of conspiracy to commit securities fraud (18 U.S.C. §371) and two counts of securities fraud (15 U.S.C. §§78j(b) & 78ff) for fraudulently inducing purchases of REcoin and DRC virtual currency between January and October 2017.

Facial Pleading Sufficiency of the Indictment

Evaluating only the sufficiency of the indictment, and not the ultimate merit of Zaslavskiy's arguments, the Court held that the indictment "is constitutionally sufficient and meets the pleading requirements set forth in the Federal Rules of Criminal Procedure," and that the securities laws "are not unconstitutionally vague as applied to this case." Judge Dearie noted that "dismissal of an indictment is an 'extraordinary remedy' reserved only for extremely limited circumstances implicating fundamental rights." *United States v. De la Pava*, 268 F.3d 157, 165 (2d Cir. 2001). Furthermore, Federal Rule of Criminal Procedure 7(c)(1) requires only that the indictment contains a "plain, concise and definite written statement of the essential facts constituting the offense charged." *United States v. Pirro*, 212 F.3d 86, 91-92 (2d Cir. 2000) (quoting Fed. R. Crim. P. 7(c)(1)).

Preview of *Howey* Analysis

Although not required, the Court addressed the parties' "spirited debate" as to whether REcoin or DRC in fact offered a security under the *Howey* test, which the Court itself deemed "premature." In *Howey*, the Supreme Court defined a security or other 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." 328 U.S. at 298-99. Assuming the truth of the indictment, Judge Dearie reasoned that "a reasonable jury could conclude that the facts alleged in the Indictment satisfy the *Howey* test" for a security.

- **Investment of Money**—The Court found that "individuals invested money (and other forms of payment) in order to participate in Zaslavskiy's schemes." The Court rejected the notion that REcoin and DRC were simply offering "the exchange of one medium of currency for another." The indictment expressly alleged that "investors gave up money--or other assets--in exchange for 'membership' in [REcoin and DRC]."
- **Common Enterprise**—Citing *In re J.P. Jeanneret*, 769 F.Supp.2d 340, 359 (S.D.N.Y. 2011), the Court employed the test for horizontal commonality, which "is characterized as the tying of each individual investor's fortunes to the fortunes of [] other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." The Court concluded "it can be readily inferred from the facts alleged that the REcoin and [DRC] investment strategies depended upon the pooling of investor assets to purchase real estate and diamonds," and that "REcoin and [DRC] profits 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."
- **Expectation of Profits From Efforts of Others**—The Court concluded that "REcoin and [DRC] investors undoubtedly expected to receive profits on their investments," and such profits were "to be derived solely from the managerial efforts of Zaslavskiy and his co-conspirators, not any efforts of the investors themselves." The Court rejected Zaslavskiy's suggestion that purchasers could trade coins "on an external exchange and make more profit," because there is no indication that investors were "capable of participating in or directing their investments." The Court also rejected the notion "that market forces might contribute to the value of the schemes' underlying assets."

Take-Aways

United States v. Zaslavskiy is a helpful preview of how courts may apply *Howey* to ICOs. But the application of Judge Dearie's reasoning is likely limited, not only because of the narrow questions at issue at the pleading stage but also the unique facts of the REcoin and DRC offerings, which apparently did not involve utility tokens or other cryptocurrency having utility function. No doubt influencing Judge Dearie's conclusions, for example, was his belief that "the challenged Indictment charges a straightforward scam, replete with the common characteristics of many financial frauds." The decision also is a reminder that the facts and circumstances surrounding an ICO are important and will influence a court's analysis under *Howey*.

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