

October 13, 2017

Cryptocurrency Update: SEC Files Fraud Charges Relating to ICO Schemes

Two months after warning investors that some digital tokens or coins may qualify as securities under the federal securities laws, the Securities and Exchange Commission (SEC or the Commission) on September 29, 2017 brought its first enforcement action in connection with an initial coin offering (ICO).

Attorneys
[Marc P. Berger](#)
[Helen Gugel](#)

A. SEC v. REcoin Group Foundation, LLC et al.

In a federal complaint, the SEC alleges that Maksim Zaslavskiy and his companies, REcoin Group Foundation (REcoin) and Diamond Reserve Club World (DRC), duped investors into purchasing unregulated securities in the form of digital tokens that were backed by fictitious assets. The alleged stated purpose of each ICO was to generate returns from (i) the appreciation in value of the investments each company would make in real estate (in the case of REcoin) or diamonds (in the case of DRC) and (ii) the appreciation in value of the digital tokens themselves – including one touted as “The First Ever Cryptocurrency Backed by Real Estate” – as the companies’ businesses grew and/or the demand for such tokens increased. The complaint contends that the ICOs were purportedly styled as “Initial Membership Offerings” in an attempt to circumvent the federal securities laws, but the membership interests that were being offered to investors were “in all material respects identical to the ownership attributes of purchasing the purported ‘tokens’ or ‘coins’ and are securities within the meaning of the securities laws.”

According to the SEC, the defendants made false promises that suggested the two companies would have sizable returns, even as neither had “any real operations.” For example, while the companies were touted as having “expert” management teams, neither had “hired or consulted any lawyers, brokers, accountants, developers, or other professionals to facilitate its investments.” The complaint further asserts that investors in the ICOs received nothing in return for their investments because the companies lacked sufficient technological expertise to create and deliver digital tokens. Based on these and other allegations, the SEC obtained an emergency order to freeze the defendants’ assets.

B. ICOs

ICOs are a modern-day twist on initial public offerings (IPOs). They provide a way for companies to raise capital through the issuance of proprietary digital tokens created through a technology called blockchain. These digital tokens confer some sort of value or right to the purchaser (but not necessarily an ownership interest, as would be the case in a traditional IPO). ICOs have become tremendously popular all over the world, raising over \$2.3 billion in funding so far and demonstrating a meteoric growth rate of over 600% just this year. Because most ICOs are fueled by ideas that have yet to be realized – as opposed to shares of an existing company or some measurable proof of concept – both the barrier to entry and the offering price of the digital token are relatively low. This combination can be a boon to legitimate innovation, encouraging more companies to conduct ICOs to support new ideas. On the flip side, however, it can also provide a hospitable environment for fraud.

C. Regulatory Oversight

Against this backdrop, ICOs have been the subject of increasing attention from the SEC. On July 25, 2017, the SEC asserted jurisdiction over ICOs to the extent that the underlying digital tokens fall within the catchall category of

securities known as “investment contracts.” Declining to draw a bright-line rule, the Commission instructed that “whether a particular investment transaction involves the offer and sale of a security – regardless of the terminology or technology used – will depend on the facts and circumstances including the economic realities of the transaction.” Specifically, the SEC will refer to the criteria set forth in the landmark Supreme Court case *SEC v. Howey*, which provides that an investment contract is (i) an investment of money (ii) in a common enterprise (iii) with profits to come solely from the efforts of others. In the ICO context, digital tokens that confer a right to access, use, or license a system – much like a franchise or licensing contract – are not likely to be investment contracts. In contrast, digital tokens that confer an equity or profit interest are likely to qualify as investment contracts and therefore be subject to SEC jurisdiction.

Thereafter, on August 28, the SEC issued an alert to warn investors about potential scams involving ICOs and noted that it has authority to suspend trading in a stock when it determines that such action is in the public interest. The alert provided examples of circumstances that might lead to a trading suspension, such as: (i) a lack of current, accurate, or adequate information about the company; (ii) questions about the accuracy of publicly available information; and (iii) questions about trading in the stock and the ability to settle transactions in the stock. Consistent with this guidance, the SEC suspended trading in company securities of several publicly traded blockchain related businesses. Notably, even in cases where the underlying digital token is not deemed a security, the SEC has jurisdiction to suspend trading or take other enforcement actions with respect to a company that is otherwise subject to its regulation.

On September 25, the Commission announced the creation of a Cybersecurity Unit that will, among other things, focus on “violations involving distributed ledger technology [i.e., blockchain] and initial coin offerings.” On the same day, the SEC also announced the creation of a retail strategy task force that will “develop proactive, targeted initiatives to identify misconduct impacting retail investors.” Given its apparent breadth, this task force may also implicate ICOs or other digital token-related activity.

The Commission’s increasing engagement with digital tokens, coupled with the rapid growth of ICOs, suggests that this will be a key enforcement focus in the future.