September 26, 2018

Notable September Developments in the Cryptocurrency Space

Attorneys
Christopher P. Conniff
Sarah Davidoff
Joel A. Wattenbarger
Edward Baer
Charles P. Humphreville
Helen Gugel
Ethan M. Thomas
Catherine Djang

Three notable developments occurred this month in the cryptocurrency space: in *U.S. v. Zaslavskiy*, a federal judge permitted a criminal case to proceed based on a finding that digital tokens issued in an initial coin offering (ICO) could constitute securities for purposes of federal securities laws; in *In the Matter of Crypto Asset Management, LP et al.*, the SEC announced its first enforcement action against a hedge fund manager for violating provisions of the Securities Act, the Advisers Act, and the Investment Company Act in connection with the sale of interest in a private investment fund focused on digital assets; and in *In The Matter of TokenLot LLC et al.*, the SEC announced its first case charging unregistered broker-dealers for selling digital tokens.

I. *U.S. V. Zaslavskiy*

In October 2017, while a civil SEC case was pending based on the same facts (*see SEC v. REcoin Grp. Found.*, LLC, No. 17-cv-05725 (E.D.N.Y., filed Sept. 29, 2017)), the DOJ charged businessman Maksim Zaslavskiy "with securities fraud conspiracy in connection with engaging in illegal unregistered securities offerings and fraudulent conduct and misstatements designed to deceive investors as part of two Initial Coin Offerings."

Zaslavskiy was the sole owner and founder of a pair of companies — one purportedly backed by investments in real estate and the other in diamonds — that sought to raise funding in two ICOs. The marketing materials for each ICO highlighted their respective potential as an investment opportunity, touting potential returns from the appreciation in value of the investments each company would make (*i.e.*, real estate or diamonds) as well as the appreciation in value of the digital tokens themselves. According to prosecutors, however, the companies did not actually have any established business operations. For example, although the marketing materials touted the companies' "expert" management teams, neither had hired nor consulted any lawyers, brokers, accountants, developers, or other professionals to facilitate its investments. In addition, investors received nothing in return for their investments because the companies lacked sufficient technological expertise to develop and deliver digital tokens.

Zaslavskiy filed a motion to dismiss the criminal case on the grounds that (i) neither virtual currencies generally nor the digital tokens at issue constitute securities for purposes of the federal securities laws, and (ii) the securities laws are unconstitutionally vague as applied in his case. Both the SEC and DOJ filed briefs in opposition to the motion and participated in oral argument. In a September 11, 2018 order, Judge Raymond Dearie ruled in favor of the government and denied Zaslavskiy's motion to dismiss.

First, the court held that the indictment alleged sufficient facts to support a conclusion that the digital tokens at issue constituted securities for purposes of surviving a motion to dismiss. However, consistent with his remarks at oral argument, Judge Dearie observed that the "subsidiary question of whether the conspirators *in fact* offered a security, currency, or another financial instrument altogether, is best left to the finder of fact." Pursuant to a four-part test articulated by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (the "*Howey* Test"), an instrument falls under the catch-all category of securities known as "investment contracts" where it involves (i) an investment of money (ii) in a "common enterprise" (iii) with a reasonable expectation of profits (iv) driven solely from the efforts of others. Although Judge Dearie concluded that a reasonable jury could conclude that the facts set forth in the indictment satisfied the *Howey* test, the court described the inquiry as "highly fact-specific" and noted that the parties' "spirited debate" about whether the digital tokens at issue were securities was "undoubtedly premature."

Second, the court dispensed with Zaslavskiy's argument that the Exchange Act and Rule 10b-5 were unconstitutionally vague as applied to cryptocurrencies. The court laid out a two-pronged analysis of the vagueness issue: first, it analyzed "whether the statute gives the person of ordinary intelligence a reasonable opportunity to know what is prohibited," and

second, "whether the law provides explicit standards for those who apply it." The court found both prongs were met and, thus, that the laws were not void for vagueness. The court set a trial date for January 7, 2019.

The case appears to be the first criminal case to consider whether digital tokens are securities, although at least one federal court has considered the issue in a civil context. Together with that decision — issued in the context of a temporary restraining order in a class action against a tech start up — *Zaslavskiy* provides a window into how courts may consider the issue. In any event, notwithstanding that its consideration of the *Howey* factors is not decisive and was limited to the specific facts at issue, the court's decision to allow the case to proceed arguably lends support to the SEC's enforcement efforts in this area and may embolden future enforcement actions.

II. *Crypto Asset Management*

The same day, the SEC announced the first-ever enforcement action against a hedge fund manager, Crypto Asset Management LP (CAM), and its founder and sole principal, Timothy Enneking, for operating an investment fund focused on digital assets in violation of the Securities Act and the Investment Company Act. *Crypto Asset Management*, File No. 3 18740.

According to the Order, CAM formed a pooled investment vehicle, Crypto Asset Fund, LLC (CAF), to invest in digital assets and marketed the fund as the "first regulated crypto asset fund in the United States." The Commission alleged, however, that the fund was not in fact regulated by the SEC, nor had it filed a registration statement. Thus, CAM caused the fund to make untrue statements of material fact in violation of the Securities Act and the Advisers Act. CAM committed an additional violation of the Securities Act by failing to have a registration statement in effect at the time of the sales.

Additionally, the Commission alleged that the respondents caused the CAF to violate the Investment Company Act. The order stated that CAF was "engaged in the business of investing, holding, and trading certain digital assets that were investment securities . . . having a value exceeding 40% of the value of [the fund]'s total assets," but failed to register with the Commission as an investment company or qualify for an exemption from registration. The SEC did not identify the specific digital assets that it determined were investment securities or its rationale in classifying them as such.

Pursuant to a settlement order based on the foregoing violations, the respondents were censured, issued a cease and desist order, and assessed a $200,000 civil penalty for willful violations of the Securities Act, the Investment Company Act, and the Advisers Act.

This action confirms the SEC's view that certain digital assets are securities, therefore requiring managers to consider the concentration of these assets when assessing their registration obligations under the federal securities laws. Because the order did not provide any further insight into which digital assets the SEC currently considers to be securities, it would be prudent for funds to treat all digital assets as investment securities absent express guidance to the contrary from the SEC. Indeed, the order may well have been intentionally vague to prompt such caution within the industry.

More generally, this action confirms what the industry already knew from the uptick in crypto-focused questions during SEC hedge fund exams — issues relating to funds' digital asset holdings are on the SEC's radar. For example, in addition to the accuracy of fund marketing materials and whether fund disclosures match up to its practices, the SEC has also expressed interest in understanding issues such as funds' methods for valuing their assets. Additional hedge fund actions are likely forthcoming as the SEC continues its review, and cases will likely become more involved as the SEC learns more about industry practices.

III. *TokenLot*

In an action filed the same day as the *Crypto Asset* settlement, the SEC brought its first case involving a broker-dealer selling digital tokens. In *TokenLot*, File No. 3 18739, the Commission alleged that TokenLot — which called itself the "ICO Superstore" and sold digital tokens in connection with ICOs and on the secondary market — and its owners violated the Securities Act and the Exchange Act by selling securities without registering with the SEC. The order

summarily concluded that these digital tokens were securities, and respondents were accordingly required to obtain broker-dealer registration. TokenLot and its owners settled the matter by agreeing to pay $471,000 in disgorgement (plus interest), $90,000 in civil penalties ($45,000 against each operator), and a temporary bar from certain trading activities.

Notably, the order contained no analysis explaining the basis for the SEC's conclusion that the tokens were securities. As with *Crypto Asset Management*, market participants are left to speculate about the specific factors that distinguished the digital tokens as securities and are well advised to be prepared to treat all such tokens as securities out of an abundance of caution, subject to the factors articulated by William Hinman, the SEC's Director of the Division of Corporate Finance in June (and discussed in a recent Alert).