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The SEC takes action against peddler of allegedly fraudulent ICOs

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On Friday, September 29, the Securities and Exchange Commission (SEC) filed an emergency action in Federal District Court in New York against Maksim Zaslavskiy and two of his companies, REcoin Group and Diamond Reserve Club. The SEC alleges in its complaint that Zaslavskiy sold unregistered securities in the form of cryptographic tokens through so-called initial coin offerings (ICOs) and deceived investors as to their value – namely by claiming the tokens he was selling were the first to be backed by real estate (in the case of REcoin) and diamonds (in the case of Diamond Reserve Club) when they were, in fact, non-existent and without any financial backing.

Background on ICOs and the SEC

Sales of cryptographic tokens that facilitate the functionality of a decentralized, blockchain-based computer platform have gained rapid popularity in 2017. The SEC is paying particular attention to these transactions because digital tokens (sometimes referred to as "coins") are not well understood by the public and are therefore relatively easy tools to defraud consumers. Despite the novel technology being discussed, the activities at issue here are a classic case of fraudulent misrepresentation and the unregistered sale of securities. The SEC's recent Report of Investigation on The DAO (DAO Report) detailed the SEC's analysis of a specific token sale and concluded that digital tokens can be securities, as defined by federal case law, though it recognized that not all cryptographic tokens are securities. In July, in conjunction with the DAO Report, the SEC issued an investor alert on ICOs. The alert provided information on the technology used in these ICOs and token sales and reiterated the golden rule of investing: if it seems too good to be true, it probably is. While digital tokens and ICOs are a new tool to raise capital, in some cases the tokens (depending on facts and circumstances, as well as the manner in which the tokens are marketed and sold) should be properly viewed as securities.

The SEC alleges the ICOs at issue in this case constitute the unregistered sale of securities. Thus the investors in the REcoin and Diamond Reserve Club ICOs should have been provided with prospectuses and disclosure statements that would have provided more information (the apparent falsity of which would have been more apparent and may have exposed the fraud more quickly). Instead, Zaslavskiy misstated the nature of the offerings and the business operations of both entities on their respective websites and in a "whitepaper" issued by REcoin.

Summary of the complaint

According to the complaint, Zaslavskiy made a series of false and misleading statements, including:

- that investors were purchasing tokens or coins, although, in truth, no tokens or coins actually existed;
- that he and the companies had raised more than US$2 million (later, he claimed he had raised more than US$4 million), although, in fact, they had raised only US$300,000;
- that both REcoin and Diamond Reserve Club employed experts (and, in the case of REcoin, lawyers, brokers, and accountants) who would invest the proceeds of the ICOs into the best products to generate large returns, although, in truth, they had not hired or consulted any such lawyers, brokers, or other professionals;
- that the U.S. government had forced REcoin to suspend operations, although, in fact, Zaslavskiy shut it down when he realized his promised token was impossible to deliver; and
- that investors in the ICOs could expect to make returns from the investments, although, in fact, the Defendants could not pay any returns because they had no real operations.

Remedies sought

The SEC's prayer for relief seeks immediate action from the court, as well as longer term remediation, in the form of permanent injunctions and monetary penalties. The complaint requested an immediate court order to: (i) freeze the Defendants' assets; (ii) allow expedited discovery; (iii) require the Defendants to provide verified accountings of proceeds; (iv) repatriate any assets the Defendants moved abroad; (v) prohibit Zaslavskiy from traveling abroad (accomplished by the surrender of his passport) until he has provided the verified accounting and repatriated any and all assets moved abroad; and (vi) prohibit Defendants from destroying or altering any evidence.

Further, the complaint seeks the disgorgement of the ill-gotten gains (and payment of prejudgment interest thereon), the payment of civil money penalties, and a permanent injunction against Zaslavskiy from acting as an officer or director of any public company and from participating in any offering of digital securities.

The SEC has already obtained an emergency court order to freeze the assets of Zaslavskiy, REcoin, and Diamond Reserve Club.

Key takeaways

Don't think that labels will shield you. This action makes it clear that the SEC is monitoring ICOs and token sales and will not let the semantics of offering materials forestall regulatory scrutiny or enforcement. For instance, according to the complaint, Zaslavskiy called the Diamond Reserve Club ICO an "initial membership offering" or "IMO," claiming (in a Facebook post) that was a "brand new instrument of facilitating tokenized membership" and that "although it appears to be similar to an ICO or IPO, the similarities are scarce, if not nonexistent." In the complaint, the SEC noted that "these distinctions were a sham," and "an attempt to skirt the

registration requirements of the federal securities laws." In short, while regulatory agencies may welcome innovation, misleading labeling is not a way of exempting yourself from their reach.

Winter is coming. As noted above, the SEC's enforcement action comes about two months after the DAO Report. Though some commentators wondered whether the DAO Report was just a one-off "shot across the bow," this action indicates the SEC's intention to keep firing when it sees a deserving target. As stated in its complaint, the SEC's Enforcement Division first contacted Zaslavskiy on August 15, 2017 – and filed its enforcement action 45 days later. And just last week, the SEC also announced the creation of a Cyber Unit to address, among other things, violations involving distributed ledger technology and ICOs.

The SEC is not the only regulatory player looking at cryptocurrencies and token sales. The U.S. Department of the Treasury, the CFTC, the FTC, and other agencies, state and federal, are considering – and, where appropriate, exercising – their jurisdiction in this space. And several other countries ranging from China to Switzerland to Singapore and beyond have signaled their intention to scrutinize, regulate, and in some cases forbid, ICOs.

Tread carefully. ICOs and token sales can be legitimate and efficient ways for businesses to raise capital, but the structure of the token, and the terms of any solicitation or offer to purchase it must be carefully reviewed in the context of existing regulations, guidance, and other signals from relevant agencies. Given the amount of personal, financial, and reputational resources put into such coin and token offerings, issuers and others in the cryptocurrency community should ensure that they have a clear line of sight into the potential legal and regulatory pitfalls.

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If you would like more information on this SEC action, SEC guidance on ICOs, or information on ICOs more generally, please contact Gregory Lisa, Lewis Rinaudo Cohen, or Loyal Horsley.

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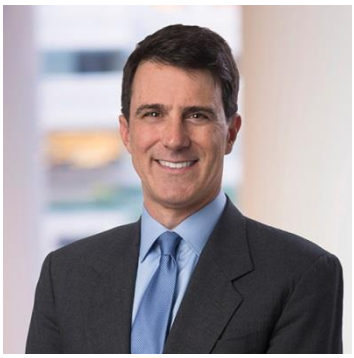

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