The Securities and Exchange Commission’s view that most cryptoassets issued as part of initial coin offerings and presales to ICOs are securities was challenged by a federal court in California when it denied the agency’s request for a preliminary injunction in an enforcement action against an individual and his company that purportedly defrauded investors in connection with a digital asset’s ICO. The court held that the SEC, at least for now, had not demonstrated that investors in the relevant cryptoasset expected to profit through the efforts of others – a key requirement to demonstrate that an investment is a security. Unrelatedly, the Chicago Board of Trade penalized an individual over US $100,000 for engaging in three different types of spoofing activity. As a result, the following matters are covered in this week’s edition of Bridging the Weeks:

- California Federal Court Rejects SEC’s View That Purportedly Fraudulent ICO Constituted a Security Offering – At Least for Now (includes Legal Weeds/My View);

- CME Group Exchanges Fine Traders for Disruptive Practices, Wash Trades and Position Limits Violations (includes Compliance Weeds); and more.

Video Version:
Briefly:

- **California Federal Court Rejects SEC’s View That Purportedly Fraudulent ICO Constituted a Security Offering – At Least for Now:** A federal court in California declined to impose a preliminary injunction against defendants accused by the Securities and Exchange Commission of engaging in a fraudulent and unlawful offer and sale of securities, stating that the SEC had not demonstrated that the cryptoassets purchased by investors were securities under applicable law.

The SEC had previously obtained a temporary restraining order against the defendants – Blockvest, LLC, and its chairman and founder, Reginald Buddy Ringgold, III a/k/a Rasool Abdul Rahim El – claiming that they engaged in fraud and the offer and sale of unregistered securities – cryptoassets called “BLV’s” – that initially were sold through presales to an initial coin offering and an ICO.

According to the SEC, the defendants falsely claimed that their ICO received regulatory approval from the SEC and that Blockvest had a relationship with Deloitte, a public accounting firm, when it did not, and made other material misrepresentations. The emergency order froze defendants’ assets and temporarily prohibited them from violating anti-fraud laws. (Click here for further background on the SEC’s TRO action in the article “ICO Claiming SEC Approval Halted by SEC” in the October 14, 2018 edition of Bridging the Week.)

In response to the SEC’s application for a preliminary injunction, the court noted that it could only grant such relief if the SEC demonstrated a "prima facie case" of a prior violation of federal securities laws and a "reasonable" likelihood of a repeat future violation. The court said the SEC satisfied neither of these elements.

The court held that the SEC did not show a prior securities law violation because, among other things, it did not demonstrate that the relevant cryptoassets were securities. This is because the SEC failed to demonstrate each of the three prongs of the so-called "Howey test" – necessary to evidence that an instrument is an investment contract (a type of security) – had been met: (1) an investment of money (2) in a common enterprise (3) with the expectation of profits accomplished through the efforts of others. (Click here to access the Supreme Court’s 1946 decision in SEC v. W.J. Howey Co.) The court concluded that the SEC provided “no evidence” to support that investors expected profits (i.e., capital appreciation derived from “the development of [their] initial investment”) or a sharing of earnings generated from the use of their invested funds.

Moreover, since defendants represented through counsel they would not without prior notice to the SEC engage in any ICO activities going forward, the SEC failed to demonstrate a reasonable likelihood that the wrong would be repeated.

In other legal developments involving cryptoassets:
• **Ohio Accepts Bitcoin for Taxes**: Ohio authorized businesses operating in the state to pay state business taxes with bitcoin. To accommodate this, Ohio will use BitPay to process bitcoin payments on its behalf. Each transaction will be subject to a transaction and network fee assessed by BitPay, and a miner fee utilized to effectuate transactions on the bitcoin blockchain.

• **OFAC Targets Exchangers of Bitcoin Ransom Payments Acting for Purported Iranian Ransomware Orchestrators**: The United States Department of Treasury’s Office of Financial Assets Control prohibited transactions with Ali Khorashadizadeh and Mohammad Ghorbaniyan for their role in helping exchange bitcoin ransomware payments into Iranian real for Iranian persons as part of the so-called “SamSam” ransom scheme. This scheme, which began in approximately December 2015 and continued through at least November 2018, involved use of malware to take over victims’ computers and required payment in a cryptocurrency such as bitcoin to restore the victims’ control. As part of its prohibition, OFAC published the digital currency addresses of Mr. Khorashadizadeh and Mr. Ghorbaniyan; this marked the first time that OFAC has identified digital currency addresses for specially designated persons.

Relatedly, during the last two weeks, the US Department of Justice filed charges against two Iranian nationals – Faramarz Shahi Savandi and Mohammad Mehdi Shah Mansouri – for engaging in the SamSam ransom scheme (click here to access the relevant indictment) and the Department of Treasury issued additional guidance on how to apply OFAC sanctions’ programs in connection with transactions involving cryptocurrencies (click here to access relevant Questions and Answers).

• **LabCFTC Tries to Smarten Public Regarding Smart Contracts**: The Commodity Futures Trading Commission’s LabCFTC issued a primer on smart contract technology, describing its purpose and functionality, and noting some relevant operational and regulatory risks. (Generally, a smart contract references self-executing software code often associated with a blockchain that automatically causes actions to occur between parties based on preprogrammed conditions being met without the involvement of a central authority.) The CFTC noted that, despite the autonomous operation of smart contracts, “[e]xisting law and regulation apply equally regardless of what form a contract takes.”

CFTC Commissioner Brian Quintenz recently warned that all products and transactions within the Commission’s jurisdiction are subject to the Commission’s regulation even if they are executed on a blockchain utilizing autonomous smart contracts. If there are violations of laws or regulations, it may be challenging to identify who is responsible, he said, but someone is.

Shortly afterwards, the SEC brought and settled charges against Zachary Coburn for enabling EtherDelta, an online platform that allows persons to buy and sell cryptoassets, many of which have the attributes of securities, to operate as an exchange for securities in interstate commerce without registering as a national securities exchange or operating pursuant to a lawful exemption. EtherDelta relied on smart contract technology for its exchange operation (Click here for background in the article “Autonomous Doesn't Necessarily Mean Non-Regulated Says SEC in Fining Founder of Securities Cryptoasset Exchange Powered By Automated Smart Contract” in the November 11, 2018 edition of Bridging the Week.)

• **CEO of Decentralized Banking Platform Indicted and Arrested for Purported Fraudulent Conduct**: Jared Rice, Sr., the chief executive officer and co-founder of AriseBank, was indicted in a federal court in Texas and arrested for his role in connection with an alleged cybersecurity fraud engaged in by the purported bank from at least June 2017 through January 2018. The indictment claimed that, during the time, Mr. Rice defrauded “hundreds of investors” of approximately US $4.25 million.

Earlier this year, the SEC filed civil charges against AriseBank, Mr. Rice, and Stanley Ford, the other co-founder of AriseBank, in connection with AriseBank’s allegedly fraudulent ICO. The SEC charged that AriseBank’s ICO constituted the unlawful offer of securities without registration or a qualified exemption. The SEC also charged that AriseBank committed fraud in its solicitations by falsely claiming that a new subsidiary of the firm was an FDIC-insured bank and that it was able to offer an AriseBank-branded VISA card, and by not disclosing the criminal background of Mr. Rice who, at the time, was on probation for felony theft. If convicted, Mr. Rice could serve up to 120 years’ imprisonment.

• **Boxer and Singer Rapped by SEC for Promoting ICOs Without Disclosing Personal Compensation Arrangements**: Two celebrities, Floyd Mayweather, Jr. and Khaled Khaled, were named in SEC enforcement actions for publicly endorsing ICOs of cryptocurrencies that the Commission claimed were securities without disclosing they were paid for their endorsements as required by law (click here to access Section 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b)). Mr. Mayweather agreed pay over $610,000, including a fine and disgorgement, to resolve his SEC matter, while Mr. Khaled agreed to remit over US $150,000.

• **Singapore Exchange Sets Obligations for Listed Companies’ ICOs**: The Singapore Exchange set forth
requirements for listed companies that desire to engage in initial coin offerings where the cryptoassets would not be listed on SGX. Among other things, SGX expects relevant issuers to consult with SGX prior to the ICO, provide it a legal opinion as to the nature of the cryptoassets to be issued, and keep its shareholders informed of material information related to the ICO. If the instruments are of the nature of securities or capital markets products under Singapore law, other requirements would also apply. However, said SGX, the Monetary Authority of Singapore views cryptoassets that can be used to purchase goods and services and have no additional associated rights as not necessarily being required to be regulated as securities.

Legal Weeds/My View: During September 2018, a federal court in Brooklyn, New York, declined to dismiss a criminal indictment against Maksim Zaslavskiy charging him with securities fraud and related offenses in connection with two cryptocurrency investment schemes and their related initial coin offerings.

Mr. Zaslavskiy had argued that the indictment should be dismissed because his activities did not involve securities and that the relevant law prohibiting fraud in connection with the offer and sale of securities was unconstitutionally vague. The court rejected Mr. Zaslavskiy’s arguments, saying that, at least for the basis of the defendant’s motion to dismiss, the government had sufficiently alleged that the relevant digital assets were securities and that the relevant law prohibiting fraud was not unconstitutionally vague as applied in his case.

The government initially charged that Mr. Zaslavskiy, through two companies he founded – REcoin Group Foundation, LLC and DRC Work, Inc. (known as Diamond Reserve Club) – offered investors an opportunity to obtain new cryptocurrencies – REcoin and Diamond – through an ICO and an “initial membership offering,” respectively. The court ruled that the government had alleged sufficient facts demonstrating that REcoin and Diamond were investment contracts under the Howey test. (Click here for background in the article “Brooklyn Federal Court Rules ICO-Issued Digital Assets Could Be Securities” in the September 16, 2018 edition of Bridging the Week.)

Mr. Zaslavskiy pleaded guilty to securities fraud in connection with these ICOs in November 2018. (Click here for details in the article “Defendant Pleads Guilty to Securities Fraud in Connection with Two Initial Coin Offerings” in the November 18, 2018 edition of Bridging the Week.)

The different outcomes between the Blockvest and Zaslavskiy cases – although resting on different preliminary presentations of facts – may herald an ultimate determination by a higher court as to what the expectation of profits accomplished through the efforts of others prong of the Howey test actually means. Although the Department of Justice and SEC have repeatedly argued that cryptoassets issued as part of presales to ICOs and ICOs are most often securities, investors in such digital assets do not typically expect to share any income from the project identified with the ICO and the value of their cryptoassets only remotely, if at all, is tied to the value of such projects. Moreover, investors in digital assets will likely have no claims on the assets of a project if the project goes bankrupt.

Investments in digital assets are very different from the investments in orange groves managed by the promoters of the investments at issue in Howey. It has always seemed to me that cryptoassets that the DOJ and the SEC claim are investment contracts are, in many cases, more like collectibles traded among enthusiasts than securities.


Timothy Roach, a Chicago Board of Trade member, resolved a disciplinary action by the exchange by agreeing to pay a fine of US $90,000, disgorging profits of over US $11,000 and serving a 30-day all CME Group exchanges’ access prohibition for purportedly engaging in three types of disruptive trading practices from February 1, 2016, through May 3, 2017.

On some occasions, said CBOT, Mr. Roach entered multiple layered orders on one side of the soybean futures market to induce execution of a smaller order on the other side. As soon as he obtained execution of the smaller order, he cancelled his opposite side orders. On other occasions, claimed CBOT, Mr. Roach entered orders on one side of the market at the best bid/offfer, and as other traders joined his resting orders, he used self-match prevention software to cancel his resting orders and to trade opposite the other resting orders. Finally, on one occasion, Mr. Roach modified the price of a pending iceberg order to trigger SMP software to cancel various layered orders he had placed on the other side of the market which also had attracted other traders’ interest.

Separately, Transmarket Bulwark LLC and its employee, Josh Matalon, settled charges filed by the New York Mercantile Exchange that Mr. Matalon entered into user-defined spreads to avoid the allocation of futures contracts that should have been associated with the covered options’ instruments. To resolve these matters,
Transmarket agreed to disgorge profits of US $18,430, while Mr. Matalon consented to pay a fine of US $25,000.

Unrelatedly, Gregory Kofford agreed to pay a fine of US $25,000 to the CBOT and serve a 15-business-day all CME Group exchanges’ trading prohibition for matching buy and sell orders of accounts for the same beneficial ownership in US Treasury Bond and corn options markets. The CBOT also claimed that, for half of his orders, he used a Tag 50 identification other than his own, contrary to the exchange’s requirements (click here to access CBOT Rule 576).

Kaushik Tikaria and Ashish Shah also settled Commodity Exchange, Inc. disciplinary actions for engaging in prohibited wash and prearranged trades. According to Comex, from February 11, 2016, through July 14, 2016, each individual engaged in trades between two proprietary accounts with common beneficial ownership with the intent that such trades should match, as well as trades for accounts with different beneficial ownership where the opposite sides were entered within approximately one second; the exchange claimed these were prohibited prearranged trades. To resolve these matters, Mr. Tikaria agreed to pay a fine of US $35,000 and serve a one-month all CME Group exchanges’ trading prohibition, while Mr. Shah agreed to pay a penalty of US $5,000 and sustain a six-month all CME Group exchanges’ trading suspension.

Finally, Marion Rus, a non-member, agreed to pay a fine of US $20,000 to resolve a disciplinary action brought by the Chicago Mercantile Exchange. CME alleged that on June 22, 2018, Mr. Rus violated position limits in June 2018 Live Cattle futures contracts; on the next trade date, he liquidated his positions that caused his violation. According to CME, he did not profit by his trading.

Compliance Weeds: Entering a user-defined spread for the purpose of disadvantaging other market participants can be a violation of general prohibitions against market disruption. (Click here to access CME Group Rule 575D; click here to access the CME Group MRAN regarding disruptive practices, Q/A 22.) In the CBOT disciplinary actions against Transmarket and Mr. Matalon, the exchange claimed that the respondents entered user-defined covered option spreads with the intent to avoid allocation of futures contracts that should have been tied to the covered options instruments. Presumably this was done to obtain more favorable prices for the options instruments then were available in the marketplace. Even though CME Group’s Globex System utilizes reasonability checks aimed to prevent this conduct from occurring, its system is not infallible.

More Briefly:

- **International Bank Sanctioned $1.34 Billion by Five US Regulators for OFAC Sanctions Violations**: Société Générale S.A. agreed to pay penalties totaling US $1.34 billion to resolve various federal and state regulatory matters arising from its purported processing of transactions in violation of US sanctions against Cuba, Iran and Sudan and alleged deficiencies in its anti-money laundering procedures. SG’s settlements were with the US Department of Justice, US Department of Treasury, Office of Foreign Assets Control, the Federal Reserve Board of Governors, the New York Department of Financial Services and the New York County District Attorney’s Office.

- **Spoofing Is Not Fraud Argue Traders Subject to Criminal Prosecution**: Edward Bases and John Pacillo, former Merrill Lynch traders that were criminally charged with wire and commodities fraud for alleged spoofing activities earlier this year, sought to dismiss their indictments in a federal court in Illinois. The defendants argued that their alleged spoofing did not involve a material misrepresentation that “falsely and fraudulently represented to market participants that [they] were willing to trade [orders] when, in fact, they were not” as charged by the Department of Justice. This is because, claimed the defendants, all their open-market orders were real and genuine, as any counterparty could have accepted them, and the defendants would have performed on their executed trades. Moreover, claimed the defendants, Congress’s decision to create separate offenses for spoofing and manipulation and fraud as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act evidenced its view that spoofing is not a form of fraud. (Click here to compare 7 U.S.C. § 6(c)(a)(5)(C), dealing with spoofing with 7 U.S.C. § 9(1) (click here), dealing with manipulative or deceptive devices; click here for background on Mr. Bases’s and Pacilio’s initial indictment in the article “CFTC Names Four Banking Organization Companies, a Trading Software Design Company and Six Individuals in Spoofing-Related Cases; the Same Six Individuals Criminally Charged Plus Two More” in the February 4, 2018 edition of Bridging the Week.)

- **OCC Vows to Fight DFS Lawsuit Challenging FinTech Charter**: The Department of Justice on behalf of the Office of the Comptroller of the Currency indicated it would oppose the lawsuit by the New York State Department of Financial Services that challenged OCC’s decision to potentially grant special purpose national bank charters to qualified financial technology companies. DOJ indicated it will argue that NYDFS had no standing to bring its legal action at this time as it has suffered no harm and, in any case, OCC has authority to issue fintech charters under its interpretation of what constitutes the “business of banking” under its relevant legal authority. OCC announced in July 2018 that it would begin accepting applications for
special purpose charters from fintech companies that propose to engage in one or more “core banking functions” of paying checks or lending money, but not taking deposits. (Click here for background regarding the OCC’s action in the article “OCC and Fintech Charters” in the August 5, 2018 edition of Bridging the Week, and here for information on the NYDFS's lawsuit in the article “NYDFS Sues OCC Over FinTech License; Other State Financial Regulators Say Their Legal Challenge is Right Behind” in the September 16, 2018 version of Bridging the Week.) In response to OCC's letter, NYDFS insisted that its legal action was not premature, and that OCC's proposed fintech charter for entities that won't accept deposits is contrary to OCC's authority solely to license entities engaged in the business of banking. Non-depository institutions are exclusively within the licensing authority of states, claimed NYDFS. The Conference of State Bank Supervisors also filed a lawsuit against the OCC for its fintech charter plans during October 2018 (click here to access a copy of the relevant complaint).

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