Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Are ICOs In The Crosshairs Of New York's Martin Act?

By **Daniel Alter** (March 15, 2018, 12:50 PM EDT)

Daniel Alter

Over the past several months, the U.S. Securities and Exchange Commission has launched a major enforcement initiative against initial coin offerings, otherwise known as ICOs. An ICO is defined as a "means of crowdfunding centered around cryptocurrency, which can be a source of capital for startup companies."[1] The marketed coins are "preallocated to investors in the form of 'tokens,' in exchange for legal tender or other cryptocurrencies ... These tokens supposedly become functional units of currency if or when the ICO's funding goal is met and the project launches."[2]

The SEC has concluded that most of the coins marketed in recent ICOs constitute "investment contracts," and are therefore "securities" for the purposes of the 1933 Securities Act.[3] As such, an ICO must be registered with the SEC before any tokens may be issued and sold by a company. The SEC firmly maintains that failure to do so is a serious violation of the federal securities laws, and has thus issued numerous subpoenas to, and brought several enforcement actions against, ICO promoters — several of which have raised hundreds of millions of dollars via fraudulent coin sales that are marked by false representations and wild promises of enormous profit.[4] There is even a criminal prosecution pending in the U.S. District Court for the Eastern District of New York for securities violations related to an unregistered ICO.[5]

Although much attention has been paid to the SEC's actions in the cryptocurrency space, apparently little thought has been given to the applicability of New York state's own securities fraud statute. That could be a serious oversight. The Martin Act both civilly and criminally bans "fraudulent practices," very broadly defined, in the purchase or sale of securities within New York state.[6] The power of the New York attorney general to investigate Martin Act violations is "extremely broad," having been described by New York's highest court as "inquisitorial."[7] The Martin Act also gives the New York attorney general "broad regulatory and remedial powers to prevent fraudulent securities practices by investigating an intervening at the *first indication of possible* securities fraud on the public."[8] But perhaps most importantly, New York courts have concluded that what constitutes a security is "defined more broadly" under the Martin Act than under federal law."[9] That wider application potentially makes New York law a serious factor in the evolution of ICO regulation.

In determining that ICOs can qualify as securities under federal law,[10] the SEC has invoked the definition of an "investment contract" that the U.S. Supreme Court first articulated in SEC v. W.J. Howey Co.[11] The Howey test, as it's known, states that an instrument is an "investment contract, and

therefore a "security," if it is: (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, and that (4) the profits are derived from the entrepreneurial or managerial efforts of others.[12] The SEC contends that ICO tokens generally satisfy each of these conditions. Indeed, SEC Chairman Jay Clayton recently stated, "I believe every ICO I've seen is a security."[13]

But no one has yet discussed whether or how the Martin Act's own definition of a "security" would embrace an ICO. In relevant part, the statute defines a security as "any stocks, bonds, notes, evidences of interest or indebtedness or other securities."[14] And like the term "investment contract" in federal law, the Martin Act's reference to "other securities" is understood as "a broad catch-all category of securities" covered by state law.[15]

New York's highest court has already "expressly adopted" the Howey test "as *one set of criteria* for [defining] 'other securities' under the Martin Act."[16] But it is not the only set of criteria for defining a security for Martin Act purposes. When analyzing whether an instrument is a security under the statute, the New York State Court of Appeals has also applied what is known as the Waldstein test.[17] Lower New York courts have likewise applied that standard.[18]

The Waldstein test defines a security "as any form of instrument used for the purposes of financing and promoting enterprises, and which is designed for investment."[19] On its face, this analysis seems far more elastic than the Howey test, and may represent an "important difference between the State statute and its Federal counterpart."[20] Arguably, it could have wider application to cryptocurrencies than the federal "investment contract" model. That question remains open.

Another possible difference has been barely considered by the New York courts. In at least two cases, New York courts have recognized that the Martin Act "includes evidences of interest in its definition of a security."[21] But in finding that the instruments at issue were both "evidences of interest," and hence securities, neither court provided any real analysis of what that statutory provision means or whether it implicates a distinct test for identifying a "security." Is a digital token an "evidence of interest?" And in what — a blockchain business enterprise?[22] The slate on that issue is nearly blank.

With the SEC's crackdown on ICOs, some coin enthusiasts have discussed engineering around the Howey test by designing tokens to resemble more closely simple contracts and franchise agreements.[23] Whether that goal is achievable remains to be seen. Nonetheless, in managing the ongoing paradigm shift in securities regulation, lawyers should not lose sight of New York law. In New York, when an issue of statutory interpretation "is a close call, then the Martin Act should be held to apply."[24]

Daniel S. Alter is a shareholder in the New York office of Murphy & McGonigle PC. He has previously served as the general counsel of the New York State Department of Financial Services and as a senior adviser to the New York state attorney general.

[1] Wikipedia.

[2] Id.

[3] See SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).

[4] Nathaniel Popper, Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings, New York Times (Feb. 28, 2018); see also Press Release, SEC Halts Alleged Initial Coin Offering Scam (Jan. 30, 2018).

[5] United States v. Zaslavskiy, 17 Cr. 647 (E.D.N.Y.) (RJD).

[6] New York General Business Law Article 23-A.

[7] In re Attorney General, 10 N.Y.2d 108, 111, 113, 217 N.Y.S.2d 603, 604, 606 (1961); Gonkjur Assocs. v. Abrams, 88 A.D.2d 854, 855, 451 N.Y.S.2d 747,749 (1st Dep't 1982); Charles H. Greenthal & Co. v. Lefkowitz, 41 A.D.2d 818, 818, 342 N.Y.S. 415, 417 (1st Dep't 1973).

[8] Assured Guaranty (UK) Ltd. V. J.P. Morgan Investment Management Inc., 18 N.Y.3d 341, 349-50, 939 N.Y.S.2d 274, 277 (2011) (emphasis added); Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership, 12 N.Y.3d 236, 244, 879 N.Y.S.2d 17, 22 (2009).

[9] People v. Morris, 28 Misc. 3d 1215(A) (Sup. Ct. New York Co. July 29, 2010), 2010 Slip OP. 51331(U); State v. Justin, 3 Misc. 3d 973, 986, 779 N.Y.S.2d 717, 727 (Sup. Ct. Erie Co. 2003).

[10] See 15 U.S.C. §§ 77b-77c.

[11] 328 U.S. 293 (1946).

[12] See id. at 301.

[13] Stan Higgins, SEC Chief Clayton: 'Every ICO I've Seen Is a Security,' Conindesk (Feb. 7, 2018).

[14] New York General Business Law § 352.

[15] People v. Thomas, 134 Misc. 2d 649, 651, 512 N.Y.S.2d 618, 620 (Sup. Ct. New York Co. 1986).

[16] People v. First Meridian Planning Corp., 86 N.Y.2d 608, 618, 635 N.Y.S.2d 144, 149-50 (1995) (emphasis added).

[17] All Seasons Resorts Inc. v. Abrams, 68 N.Y.2d 81, 92, 506 N.Y.S.2d 10, 16 (1986) (citing Matter of Waldstein, 160 Misc. 763, 767, 291 N.Y.S. 697 (Sup. Ct. Albany Co. 1936).

[18] See e.g., People v. Van Zandt; 43 Misc. 3d 563, 567, 981 N.Y.S.2d 275, 277 (Sup. Ct. Bronx Co. 2014); State v. Kozak, 91 Misc. 2d 394, 395, 398 N.Y.S.2d 15, 15-16 (Sup. Ct. New York Co. 1977).

[19] Waldstein, 160 Misc. at 767, 291 N.Y.S. 697.

[20] People v. Landes, 84 N.Y.2d 655, 660, 621 N.Y.S.2d 283, 285 (1994).

[21] Kozak, 91 Misc. 2d at 395, 398 N.Y.S.2d at 15-16; see also People v. Stern, 86 Misc. 2d 101, 103, 381 N.Y.S.2d 951, 953 (Sup. Ct. New York Co. 1976).

[22] Cf. 16 U.S.C. § 796 (16) (defining “security” in connection with regulating water power and resources as “any note, stock treasure stock, bond, debenture, or other *evidence of interest in* or indebtedness of a corporation”(emphasis added)).

[23] Passing the Howey Test: How to Regulate Blockchain Tokens, BitTrust (March 4, 2017); see also, A Securities Law Framework for Blockchain Tokens (Dec. 7, 2016).

[24] Schneiderman v. Barclay’s Capital Inc., 47 Misc. 3d 862, 871, 1 N.Y.S.3d 910, 917 (Sup. Ct. New York Co. 2015).