

## Takeaways From SEC's Russian Crypto Ponzi Scheme Action

By **Haima Marlier, Lauren Wands and Justin Young** (August 23, 2022, 2:19 PM EDT)

In the 1920s, a new form of investment fraud roared into the markets with the advent of the Ponzi scheme.

Earlier this month, the U.S. Securities and Exchange Commission filed a complaint captioned SEC v. Okhotnikov in the U.S. District Court for the Northern District of Illinois, alleging that 11 crypto founders and promoters used the same illegal money-making tactics employed by Charles Ponzi a century ago.[1]

The SEC alleged that the defendants employed a "textbook pyramid and Ponzi scheme," fraudulently raising more than \$300 million from millions of retail investors worldwide, in connection with the crypto platform Forsage.

This action continues the wave of aggressive SEC enforcement in the crypto space.

### Forsage Complaint

The SEC's complaint alleges a pyramid and Ponzi scheme under which investors profited off the participation of recruits.

According to the SEC's complaint, Forsage was launched in January 2020 by four Russian nationals who aggressively marketed online crypto investments to U.S. and foreign investors.

In addition to the four Russian founders, the SEC also sued seven U.S. nationals and residents who allegedly promoted the scheme using YouTube channels and social media platforms.

The SEC alleged that investors were induced to enter into crypto transactions via smart contracts that operated on the Ethereum, Tron and Binance blockchains.

According to the complaint, each platform contained at least three smart contracts that had slots available for purchase by investors. These slots could later be sold to other individuals, who were recruited by the investors, as a way for the investors to earn compensation.[2]

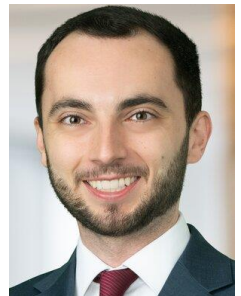
As it must, the SEC started with an analysis of whether the slots in the smart contracts were securities



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under the U.S. Supreme Court's 1946 decision in SEC v. W. J. Howey Co.[3]

Under the Howey test, an asset is considered a security, and thus subject to SEC regulation, where there is: (1) an investment of money, (2) in a common enterprise, (3) with expectations of profit, (4) derived from the efforts of others.[4]

The SEC alleged that the slots investors bought, and the investors' attendant rights to earn compensation from slot resales, were securities because

[i]Investors made an investment of money — using Ethereum, Tron, or Binance tokens — in a common enterprise from which they were led to expect profits solely from the efforts of Defendants or third parties.[5]

Because the slots were not registered with the SEC and did not qualify for a registration exemption under the Securities Act, the SEC alleged that the defendants violated Section 5 of the Securities Act.

As to the nuts and bolts of the fraud, the SEC alleged that Forsage was not providing a bona fide investment opportunity for its investors, but rather was a pyramid scheme whereby "[t]he primary way for investors to make money from Forsage was to recruit others into the scheme." [6]

The SEC alleged that "all payouts to earlier investors were made using funds received from later investors" — the hallmark of a classic Ponzi scheme.[7]

Forsage's investors also allegedly participated in "profit sharing in the form of spillover payments from other investors in the larger Forsage network." [8] These spillover payments were tied to the number of slots that were purchased or sold; more slots purchased or sold translated into more earnings for the pool of Forsage investors in accordance with the applicable smart contract.[9]

Despite the defendants' "aggressive promotion of Forsage as an income-generating opportunity," the SEC alleged that the significant level of earnings touted by the defendants "simply was not attainable for most investors given that Forsage operated as a pyramid scheme." [10]

As a result, the SEC alleged that the defendants violated Section 17(a) of the Securities Act, and Section 10(b) and Rule 10b-5 of the Securities Exchange Act.

The SEC has asked the court to enjoin the defendants from further violations of the federal securities laws — including their engagement in this alleged scheme — along with disgorgement, civil monetary penalties and other relief.[11]

Notably, the SEC is not the first regulatory body to take issue with this scheme. In September 2020 and March 2021, the Securities and Exchange Commission of the Philippines and the Montana commissioner of securities and insurance, respectively, issued "cease-and-desist actions against Forsage for operating as a fraud." [12]

## **Key Takeaways**

***The SEC continues to conclude that smart contracts are securities.***

A threshold issue for all SEC enforcement actions in the crypto space is whether the crypto asset under

consideration — be it a token, a smart contract or another digital asset — is a security under the federal securities laws. With the exceptions of cryptocurrencies, such as bitcoin, the SEC has long maintained that many other digital assets qualify as securities under the Howey test.

As stated by former SEC Chair Jay Clayton in 2018, and repeated by current SEC Chair Gary Gensler in 2021, SEC leadership continues to be of the view that every initial coin offering is a security,[13] sweeping many digital assets into the purview of federal securities law enforcement.

Even SEC Commissioner Hester Peirce, who often dissents from the SEC's aggressive stance on crypto enforcement, noted that "the SEC has been very clear" that "digital assets can be securities if they meet the Howey test." [14]

The Forsage complaint makes clear that the SEC continues to conclude that smart contracts that operate on blockchain applications and allow for transactions of digital assets are securities under the Howey test.[15]

This is consistent with the SEC's previous smart contracts enforcement, including a 2018 **enforcement action** against the founder of EtherDelta, described by the SEC as "a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a 'smart contract' run on the Ethereum blockchain." [16]

### ***The SEC continues to aggressively pursue foreign defendants in crypto enforcement.***

The SEC continues to aggressively pursue what it deems to be fraudulent crypto schemes, even where key defendants are foreign nationals and the agency will no doubt face challenges in collecting civil penalties or other monetary relief.

In the Forsage complaint, for example, four of the 11 defendants are Russian nationals "believed to reside" in Russia, Georgia and Indonesia. The SEC alleged that these four Russian nationals founded and operated the Forsage platform.

The remaining seven defendants are U.S. residents who allegedly promoted Forsage to the public.

This follows other recent examples where the SEC has pursued foreign defendants in crypto actions. In July, the SEC charged two Indian nationals with insider trading on the Coinbase platform in SEC v. Wahi.[17] In December 2021, the SEC charged a Latvian national with defrauding retail investors of at least \$7 million through digital asset securities offerings in SEC v. Auzins.[18]

Historically the SEC has faced obstacles in collecting monetary judgments against foreign defendants, particularly where, as here, the SEC is uncertain where the defendants even reside.

In the case of one defendant, Lola Ferrari, the SEC acknowledges that this is merely her public persona and her "actual identity is currently unknown." [19] Apparently, this did not deter the SEC from dedicating staff and other resources to pursuing the Forsage international defendants.

### ***The SEC continues to increase crypto enforcement.***

The SEC's heavy scrutiny of crypto markets is here to stay. In May, the SEC nearly doubled the number of attorneys in the Division of Enforcement's Crypto Assets and Cyber Unit, which, since its inception in

2017, has brought more than 80 enforcement actions in the crypto space.[20]

Since expanding the size of its Crypto Assets and Cyber Unit, in addition to the complaints against Forsage and Coinbase, the SEC has also brought an enforcement action against Bloom Protocol LLC for conducting an unregistered initial coin offering of crypto asset securities.[21]

We expect this trend of aggressive crypto enforcement to continue.

***Digital Ponzi schemes persist, despite SEC warnings.***

The Forsage complaint illustrates the ease with which online promoters can dupe potential investors in the crypto space. The SEC warned against a rise in this conduct as far back as July 2013, saying:

We are concerned that the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi and other schemes in which these currencies are used to facilitate fraudulent, or simply fabricated, investments or transactions.[22]

Yet digital Ponzi schemes persist. Earlier this month, investors filed a securities class action against "Shark Tank" personality Mark Cuban, captioned Robertson v. Cuban, for his promotion of "a massive Ponzi scheme" involving the cryptocurrency brokerage Voyager Digital.[23]

Also this month, the U.S. Commodity Futures Trading Commission filed for an injunction against an Ohio man for allegedly orchestrating a \$12 million Ponzi scheme by fraudulently soliciting investments under the guise that he operated a private equity investment fund with a focus on trading digital assets like Bitcoin. The case is CFTC v. Giri.[24]

**Conclusion**

The SEC continues to aggressively pursue potential federal securities laws violations in the crypto world, even where there may be a low likelihood of recovery for investors due to the alleged perpetrators residing — and presumably, the ill-gotten gains being located — outside the U.S.

We expect that the SEC will continue to flex its muscles in the crypto space, and those involved in crypto offering and lending should monitor these developments closely.

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[1] Complaint, SEC v. Okhotnikov et al., No. 1:22-cv-03978 (N.D. Ill. Aug. 1, 2022) ("Forsage Complaint").

[2] Forsage Complaint ¶¶ 30-31.

[3] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[4] Id. at 301.

[5] Forsage Compl. ¶ 9.

[6] Id. ¶ 4.

[7] Id.

[8] Id. ¶ 31.

[9] Id. ¶¶ 32-33.

[10] Id. ¶ 61.

[11] Two of the U.S. defendants have settled the SEC's claims, subject to court approval: one agreed to pay disgorgement and civil penalties, while the other will be required to pay disgorgement and civil penalties as determined by the court. Press Release, SEC, SEC Charges Eleven Individuals in \$300 Million Crypto Pyramid Scheme (Aug. 1, 2022), <https://www.sec.gov/litigation/litreleases/2022/lr25460.htm>.

[12] Id.

[13] Statement, Gary Gensler, Chair, SEC Remarks Before the Aspen Security Forum (Aug. 3, 2021), <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

[14] How We Howey, Hester M. Peirce, Commissioner, SEC, Remarks at the Securities Enforcement Forum (May 9, 2019), <https://www.sec.gov/news/speech/peirce-how-we-howey-050919>.

[15] See Howey, 328 U.S. 293.

[16] See Press Release, SEC, SEC Charges EtherDelta Founder with Operating an Unregistered Exchange (Nov. 8, 2018), <https://www.sec.gov/news/press-release/2018-258>.

[17] Press Release, SEC, SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action (July 21, 2022), <https://www.sec.gov/news/press-release/2022-127>.

[18] Press Release, SEC, SEC Charges Latvian Citizen With Digital Asset Fraud (Dec. 2, 2021), <https://www.sec.gov/news/press-release/2021-248>.

[19] Forsage Compl. ¶ 13.

[20] Press Release, SEC, SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit (May 3, 2022), <https://www.sec.gov/news/press-release/2022-78>.

[21] Press Release, SEC, Unregistered ICO Issuer Agrees to a Springing Penalty of Up to \$30.9 Million (Aug. 9, 2022), <https://www.sec.gov/enforce/33-11089-s>.

[22] Investor Alert, SEC, Ponzi Schemes Using Virtual Currencies (July 2013), [https://www.sec.gov/files/ia\\_virtualcurrencies.pdf](https://www.sec.gov/files/ia_virtualcurrencies.pdf).

[23] Complaint, Robertson et al. v. Cuban et al., No. 1:22-cv-22538-RKA (S.D. Fla. Aug. 10, 2022).

[24] Complaint, CFTC v. Giri et al., No. 2:22-cv-03091-ALM-KAJ (S.D. Ohio Aug. 11, 2022).