

# DIVERGENT REGULATORY APPROACHES TO CRYPTOCURRENCY OFFERINGS: DEVELOPMENTS IN CANADA, THE UNITED STATES, AND CHINA

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Cryptocurrency is a digital currency that utilizes cryptography for security, and is used as a medium of exchange between parties. One of the most well known cryptocurrencies is Bitcoin, though there are a significant number of such currencies available for purchase and sale. The currency itself is represented by virtual 'coins' or 'tokens'.

The issuance of cryptocurrency has become more common as a capital raising mechanism, which has caused considerable attention to be paid to cryptocurrency offerings by both the investing public and the governmental authorities responsible for securities regulation in various jurisdictions around the world. This bulletin considers the statements made by such regulators as they adopt their respective mechanisms for dealing with cryptocurrency as a new investment vehicle.

## The Canadian Approach

The Canadian approach to cryptocurrency offerings appears to be to apply the current regulatory system for securities to the offerings, once the test for a security has been met on the basis of the individual set of facts related to the type of cryptocurrency and the offering itself.

On August 24, 2017, the Canadian Securities Administrators ("CSA") released CSA Staff Notice 46-307 *Cryptocurrency Offerings* (the "Notice"), pursuant to which the CSA provided guidance for issuers seeking to raise capital through the sale of cryptocurrency. The staff notice was published in all jurisdictions except Saskatchewan, and it is expected that the Financial and Consumer Affairs Authority of Saskatchewan will advise of its approach to cryptocurrency after September 7, 2017.

## Offering Cryptocurrencies

The primary analysis related to offerings of cryptocurrency relate to whether such currency is an investment contract under Canadian law, which is a type of security. Specifically, the test for investment contracts in Canada rests in the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario*

(Securities Commission)<sup>[1]</sup>. To be an investment contract, the offering must involve an investment of money in a common enterprise with the expectation of profit to come significantly from the efforts of others.

If the sale of cryptocurrency constitutes an investment contract in accordance with the test outlined in *Pacific Coin*, then the requirement to distribute such securities under a prospectus or under an exemption from prospectus requirements applies. Further, issuers who distribute coins or tokens in connection with such an offering may be trading in securities for a business purpose, requiring dealer registration or an exemption from such dealer registration requirements.

### *Cryptocurrency Exchanges*

The exchanges upon which cryptocurrency can be bought and sold often operate without oversight or regulation, and can be found around the world. The CSA warns that coins or tokens that constitute securities being issued to trade on such cryptocurrency exchanges could result in the issuer violating restrictions on secondary trading pursuant to National Instrument 45-102 Resale of Securities.

### **The U.S. Approach**

The United States appears to be independently adopting a similar approach as to Canada's, in that the current regulatory system for securities is starting to recognize cryptocurrency as potentially being a security, and therefore already being subject to a comprehensive set of requirements related to registration, disclosure, and similar matters.

While the U.S. Securities and Exchange Commission (the "SEC") has not come out with a comprehensive bulletin in the way the CSA had regarding the specific test for determining whether a cryptocurrency was a security, the SEC has published a bulletin meant to act as guidance for investors as well as a Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934, related to an investigation conducted of The DAO, an entity which began offering and selling their own tokens (the "DAO Tokens") to raise capital.

In past publications issued by the SEC, a major theme related to cryptocurrency has been the warning of investors of potential fraud perpetrated through the use of Bitcoin and other virtual currencies. The SEC indicated that it has a concern that the rise of virtual currencies is allowing fraudsters to facilitate Ponzi and other schemes, or engage in fabricated investments or transactions, specifically noting a recent case it prosecuted in which an alleged Ponzi scheme was advertised as a Bitcoin "investment opportunity"<sup>[2]</sup>. The SEC has taken enforcement action against such schemes, and issued several investor alerts over the past number of years.

More recently, the analysis provided by the SEC appears to contemplate the treatment of coins or tokens sold pursuant to Initial Coin Offerings or Initial Token Offerings as a security<sup>[3]</sup>. Among other items, the most recent

investor bulletin related to Initial Coin Offerings outlines that the offer and sale of such coins may need to be registered with the SEC or be performed pursuant to an exemption, and further that investment professionals and the firms that transact, offer, or advise on investments of cryptocurrency, may be required to be licensed or registered, if such cryptocurrency constitutes a security<sup>[4]</sup>.

The SEC's investigation of the DAO provides a valuable case study in how the SEC approaches the issue of cryptocurrency offerings within its regulatory system.

### *The DAO Investigation*

The DAO was created as a for-profit entity that creates and holds assets through the sale of DAO Tokens to investors, and those assets would then be used to fund the projects undertaken by DAO. The holders of the DAO Tokens were anticipated to receive earnings from the projects, and had the right to vote on those projects on the basis of their DAO Token holdings. Further, the holders of DAO Tokens could sell their DAO Tokens on various online platforms that supported this trading. The DAO Tokens were sold to investors in exchange for approximately 12 million Ether, which is another virtual currency used on the Ethereum blockchain, which the SEC indicated had a value of approximately US\$150 million.

Similarly to the approach taken by the CSA, the SEC had sought to establish whether the DAO Tokens were a security on the basis of whether they could be characterized as an investment contract<sup>[5]</sup>. The test for investment contracts in the United States was adopted by the U.S. Supreme Court in *SEC v WJ Howey Co.*<sup>[6]</sup>, which was considered by the Supreme Court of Canada in *Pacific Coin*, leading to the two tests being very similar. The test articulated in *Howey* is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Ultimately, the SEC found that the test articulated above was satisfied. The concept of money does not need to be cash, and the SEC determined that the sale of DAO Tokens for Ether met the first stage of the test, namely that an investment was made. The SEC's analysis further included investors who were purchasing the DAO tokens were investing in a common enterprise and they expected to earn profits from that enterprise, which could include both dividends or other periodic payments and also an increase in the value of their investment. This profit was further to be derived from the managerial efforts of others, including those who managed the DAO and put forward project proposals that could generate profits for the DAO's investors. Additional evidence of reliance that was specifically mentioned by the SEC was the marketing efforts put forward by the managers of the DAO, and specifically with how they held themselves out to be experts in Ethereum, which was the blockchain protocol upon which the DAO operated. The persons who selected the projects that would be voted on were held out to investors to be experts in the area, which further indicated to the SEC that DAO Token holders were acting in reliance on such persons. Finally, the SEC found that the limited voting rights

afforded to the DAO Token holders were not enough to vitiate the reliance on third parties. The DAO was therefore obligated to register the offer and sale of the DAO Tokens under the Securities Act of 1933, unless a valid exemption applied.

### **The Chinese Approach**

On September 4, 2017, reports emerged that China was banning the practice of capital raising through the sale of cryptocurrency. China in particular has been a jurisdiction in which a significant number of Initial Coin Offerings have been conducted, particularly recently, as data emerging from a government organization that monitors such activity stated that between January and July of 2017, there had been 65 Initial Coin Offerings raising a combined 2.62 billion yuan (estimated to be approximately US\$394.6 million) from 105,000 individuals<sup>[7]</sup>. Some reports drew conclusions related to the fall of value of Bitcoin and Ethereum, two of the most popular cryptocurrencies available, after the news of China's ban emerged<sup>[8]</sup>.

### **Comparison of Regulatory Approaches**

Each of the SEC and the CSA did not categorize all cryptocurrency as being a security, but rather outlined the tests that apply to the determination of whether something is a security, and specifically whether it is an investment contract. The SEC specifically stated in the DAO investigation report “[w]hether or not a particular transaction involves the offer and sale of a security – regardless of the terminology used – will depend on the facts and circumstances, including the economic realities of the transaction.<sup>[9]</sup>” The result of such an approach is that there could be cryptocurrencies that on the facts may not be considered a security, and so the regulatory system in place would presumably not apply, however the exact set of facts that would need to exist to eliminate one or more of the factors in the *Howey* test or the Pacific Coin test is not readily apparent at this time.

China has taken a different approach, opting not to allow investors to engage with cryptocurrency. It is uncertain whether such restrictions will prove to be permanent or will be loosened over time, however there is significant disparity with this approach in comparison to that adopted by Canada and the United States, which does serve to impact the global community of investors in cryptocurrency as well as the issuers offering such virtual currency.

South Korea initially appeared to be taking a different approach from China, as reports emerged that it will seek to strengthen regulations related to the offer, sale, and trade of virtual currencies, and will punish Initial Coin Offerings conducted in violation of the capital markets legislation in the jurisdiction. The regulations were anticipated to be in the form of strengthening user authentication procedures and banks' suspicious transactions reports, monitoring overseas transactions of service providers who use digital currencies to transfer money, and introducing new regulations related to domestic trading of virtual currencies<sup>[10]</sup>. In

September 2017, the Financial Services Commission in South Korea released a statement that ICOs were banned as a fundraising tool, and that penalties would be issued on financial institutions or any other parties involved in issuing cryptocurrency through an ICO<sup>[1]</sup>.

## Conclusion

At present, there is no unified global approach to the regulation of cryptocurrency, and while some of the jurisdictions such as Canada and the United States may have minor differentiations in their approaches, other jurisdictions such as China can significantly diverge. As each jurisdiction decides on its approach, it is clear that governments and regulatory authorities are aware of the growing popularity and use of cryptocurrency as a capital raising mechanism, and that such attention by the authorities will mean enforcement of regulation and at times perhaps even the introduction of new regulations that issuers, investors, and virtual currency exchanges, will have to contend with.

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[1] [1978] 2 SCR 112, [1977] 2 ACWS 1063 (SCC) [Pacific Coin].<sup>[ps2id id='1' target='']</sup>

[2] US, US Securities and Exchange Commission, Investor Alert: Ponzi Schemes Using Virtual Currencies (Sec Pub No 153-7/3) (July 23, 2013), online: <[https://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf)>.<sup>[ps2id id='2' target='']</sup>

[3] US, US Securities and Exchange Commission, Investor Bulletin: Initial Coin Offerings (July 25, 2017), online: <[https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings)>.<sup>[ps2id id='3' target='']</sup>

[4] Ibid.<sup>[ps2id id='4' target='']</sup>

[5] US, US Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Release No 81207) (July 25, 2017) at 11, online: <<https://www.sec.gov/litigation/investreport/34-81207.pdf>> [DAO Investigation].<sup>[ps2id id='5' target='']</sup>

[6] 328 US 293 (1946) [Howey].<sup>[ps2id id='6' target='']</sup>

[7] John Ruwitch & Jemima Kelly, "China hits booming cryptocurrency market with coin fundraising ban" (September 4, 2017), Reuters, online: <<https://www.reuters.com/article/us-china-finance-digital/china-hits-booming-cryptocurrency-market-with-coin-fundraising-ban-idUSKCN1BF0R7>>.<sup>[ps2id id='7' target='']</sup>

[8] "China just banned initial coin offerings, calling them illegal fundraising" (September 4, 2017), Business Insider, online: <<http://www.businessinsider.com/r-china-bans-initial-coin-offerings-as-illegal-fundraising-2017-9>>.<sup>[ps2id id='8' target='']</sup>

[9] DAO Investigation supra note 5 at 17-18.<sup>[ps2id id='9' target='']</sup>

[10] Yoon Yung Sil, "Regulating Bitcoin Trading: Financial Authorities to Strengthen Regulations on Digital

Currency Trading” (September 4, 2017), Business Korea, online:

<<http://www.businesskorea.co.kr/english/news/money/19180-regulating-bitcoin-trading-financial-authorities-strengthen-regulations-digital>>.[ps2id id='10' target='/']

[11] “South Korea bans all new cryptocurrency sales” (September 28, 2017), CNBC, online: <

<https://www.cnn.com/2017/09/28/south-korea-bans-all-new-cryptocurrency-sales.html>>.[ps2id id='11' target='/']

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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