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US Federal Court Rules Cryptocurrency Covered Under Securities Laws: Will Canada Follow Suit?

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The US District Court for the Eastern District of New York in United States v. Zaslavskiy (Zaslavskiy) rules that cryptocurrency may be covered by US securities laws as they meet the test generally used to determine whether an instrument is an "investment contract" pursuant to US securities laws.

Key Takeaways

- **Regulators' commitment to crackdown on cryptocurrency-related activities reaching the courts.** Commencing as early as 2017, various regulators around the globe have published their positions on cryptocurrency and the classification of various types of cryptocurrencies. The *Zaslavskiy* decision demonstrates that US courts agree with SEC guidance that cryptocurrencies are, indeed, investments.
- **Courts will use existing case law to determine whether cryptocurrency can be subject to securities laws.** The Court in *Zaslavskiy* applied an existing legal test to cryptocurrency to determine whether it was an instrument that was an "investment contract" and therefore subject to US securities laws. This case provides helpful judicial guidance that may be used by courts in other circumstances and sheds light for all market participants regarding the status of crypotcurrencies as securities instruments.
- **Time will tell whether Canadian courts take a similar approach.** Canadian regulators have provided similar guidance as the SEC on treating cryptocurrencies as investments. It is only a matter of time before Canadian courts are forced to take a position on whether various types of cryptocurrencies are covered by Canadian securities laws.

Overview and Implications

In September 2018, the US District Court for the Eastern District of New York released its decision in *Zaslavskiy*, in which the Court ruled an initial coin offering (ICO) may be subject to US securities laws. This signals the first time in history a US federal district court has rendered a decision regarding whether a cryptocurrency is an instrument governed by securities laws.

As identified in our recently published trends piece, *Canadian Securities Litigation Outlook: Trends to Watch for Capital Markets Participants* (Trends Piece), financial technology, and specifically cryptocurrency, is evolving faster than the law. Up until *Zaslavskiy*, the US cryptocurrency industry, similar to Canada's

cryptocurrency industry, has operated without any judicial guidance.

Instead, regulators have been playing catch up without any direction from the courts. For example, the United States Securities and Exchange Commission (the SEC) began to elaborate on the classification of various types of cryptocurrencies as securities, including that cryptocurrencies that are investment contracts are likely to be classified as securities.[1] Canadian regulators have published a similar position on the status of ICOs, investment funds and exchanges.[2] Specifically, Canadian regulators have commented that they will "look to substance rather than form" in determining whether a cryptocurrency satisfies the established criteria governing the classifications of securities and is, thus, subject to Canadian securities laws. Further, the Ontario Securities Commission and the BC Securities Commission have pledged their commitment to crackdown on fraudulent ICOs and cryptocurrency-related activities.

The Decision

In *Zaslavskiy*, a Brooklyn entrepreneur (Zaslavskiy) founded two companies: one, which supposedly engaged in real estate investment and real-estate "smart contracts," and another, which supposedly invested in diamonds. To fund both companies, Zaslavskiy induced investors to purchase cryptocurrency coins. To encourage the investors to purchase the coins, Zaslavskiy claimed that his companies would soon launch ICOs, thus promising investors security for their investment. Contrary to Zaslavskiy's representations, the companies never invested in real estate or diamonds and neither company developed any coins. Zaslavskiy was indicted under US securities laws but he filed a motion to dismiss, arguing that the ICOs in question were not securities, but currencies instead.

In its decision, the US District Court relied on *Securities Exchange Commissions (SEC) v. W.J. Howey Co.*, a US Supreme Court case that laid out a test to determine whether an instrument was an "investment contract" and therefore subject to US securities laws. The test from *Howey* states that an investment contract is a "contract, transaction, or scheme whereby a person 1) invests his money 2) in a common enterprise and 3) is led to expect profits solely from the efforts of the promoter or third party."

The District Court in *Zaslavskiy* found that each prong from *Howey* had been satisfied: specifically, the first prong of the *Howey* test was met because individuals invested money and other forms of payment in the companies believing they were purchasing investment-backed virtual coins; the second prong was met because there was commonality between the investors of the two companies because each individual's fortunes were tied to the fortunes of the other investors due to the pooling of their assets; and finally, the third prong was met because the investors were led to believe that profits would come from the efforts of Zaslavskiy and his co-conspirators, not from any effort of the investors.

Notably, the District Court rejected Zaslavskiy's arguments that the securities laws were unconstitutionally vague as applied to cryptocurrencies because the courts have made it clear that the securities laws are meant to be interpreted flexibly in order to serve their intended purpose of protecting investors.

Conclusion

Without judicial guidance in Canada, neither the regulators or capital markets will fully understand the boundaries of the digital currency industry. As the commentary from U.S. regulators has been similar to that of Canadian regulators with regard to the treatment of cryptocurrencies, it will be interesting to see how, if at all, *Zaslavskiy* influences Canadian case law. Our Trends Piece identified instances where Canadian courts have found cryptocurrency to be problematic, however, there has yet to be a decision setting out the test to determine whether cryptocurrencies are covered by Canadian securities laws. However, given the *Zaslavskiy* decision, and its alignment with SEC guidance, we can assume Canadian courts will take a similar approach and agree with Canadian regulators.

If you have any questions concerning this case or securities litigation generally, please contact Brigeeta Richdale, Jessica Lewis, Danielle DiPardo, or any other member of the Cassels Securities Litigation Group.

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[1] See for example: https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11
[2] Staff Notice 46-307 — Cryptocurrency Offerings: http://research.osc.gov.on.ca/ld.php?content_id=34149486
