

Goodmans^{LLP} Update

Focus on Substance Over Form - CSA Provides Further Guidance on Token Offerings

On June 11, 2018, staff of the Canadian Securities Administrators (CSA) published CSA Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens* (the “**Staff Notice**”). This is the second pronouncement from the CSA on the application of Canadian securities laws on initial coin offerings (ICOs) and initial token offerings (ITOs).

In our [August 30, 2017 Update](#) discussing the CSA's previous Staff Notice 46-307 on cryptocurrency, we noted staff did not provide much practical guidance on the matter, which was somewhat expected as the use of ICOs and ITOs was then still in its nascent stage. The current notice contains a chart of 14 examples provided as illustrations based on fact patterns the CSA has encountered in an effort to provide more practical guidance.

The Staff Notice confirms most of the offerings discussed with the CSA involved securities requiring compliance with Canadian securities law requirements.

Use of “Utility Tokens”

The Staff Notice states that use of the industry term “utility token” does not, in itself, rule out the application of securities laws. “Utility token” is an industry term often used to describe a token that has one or more specific functions – for example, allowing the holder to access or purchase services or assets based on blockchain technology. The fact that a utility token has multiple functions is not in itself determinative in whether an offering qualifies as an offering of securities. Rather the CSA points out that it will look to the substance of an offering (discussed in detail below) to determine whether such offerings involve an offering of securities.

When a Token Offering Involves a Security Offering

The Staff Notice confirms every offering is unique and needs to be assessed on its individual characteristics. In general, an offering of tokens may constitute a distribution of securities if:

- the offering involves the distribution of an investment contract; and/or
- the offering and/or tokens issued are securities under one or more of the other enumerated categories of the definition of “security” or may be a security not covered by the non-exclusive list of enumerated categories of securities in the legislation.

As previously noted, the case law on investment contracts has identified the following four elements for determining whether an investment contract exists:

- an investment of money;
- in a common enterprise;
- with the expectation of profit; and
- to come significantly from the efforts of others.

The Staff Notice makes clear that the term “investment contract” must be given a purposive interpretation including the objective of investor protection. In analyzing whether a token offering involves an investment contract, an issuer must assess not only the technical characteristics of the token itself, but the economic realities of the offering as a whole, with a focus on substance over form.

As previously noted, the Staff Notice contains a table of 14 examples describing various fact patterns and the rationale in each case for determining whether one or more elements of an investment contract exists. If any of the four indicia of an investment contract appears to exist in an offering, the securities regulatory authorities will likely determine that such an offering involves a distribution of securities.

Tokens Reasonably Expected or Marketed to Trade on Cryptoasset Trading Platforms

To the extent that the tokens are reasonably expected or marketed to trade on one or more cryptoasset trading platforms, the CSA suggests that purchasers may be purchasing the tokens with an expectation to resell them at a profit. The CSA will consider representations made by the issuer either formally in a whitepaper or informally through social media channels, as well as representations made by third parties that have been explicitly or implicitly endorsed by the issuer or management as evidence of promoting the expectation of profit.

Furthermore, the CSA notes the possible absence of control over secondary trading is generally not, on its own, relevant in assessing whether purchasers expect a profit. It may be one factor to consider in the analysis, but it is not determinative in finding the token offering does not involve a securities offering.

Multi-Step Offerings

The Staff Notice also discusses the potential issues with the use of multi-step transactions to avoid the application of securities legislation.

A typical multi-step transaction consists of the following: the distribution of a right to a future token pursuant to an agreement commonly referred to as “simple agreement for future tokens” (SAFT) often made under a prospectus exemption such as an accredited investor exemption; and then the delivery of the token at a time when the issuer has generally represented that the platform or application is built or the goods and services are available and the token is functional.

Although many issuers have taken the position that the token delivered in the second step is not a security, the CSA commented that the token delivered in the second step may indeed qualify as a security despite the fact that the token may have some utility. For example, there may still be a profit sharing interest notwithstanding the token may now be used on the platform. If the token is found to be a security even in second step, the issuer will be subject to the prospectus requirements, and the person or company that is in the business of trading in such security will be subject to the dealer registration requirements under Canadian securities laws.

Conclusion

The key takeaway from this Staff Notice is that in determining the applicability of securities laws to a token offering, businesses and their professional advisors must assess the economic realities of a potential token offering as a whole, with a focus on substance over form. Businesses contemplating offerings of tokens should consider the securities law implications of such offerings, and be prepared for close scrutiny of the substance of their offerings. Using certain structures or terminology will not be sufficient to avoid the designation of such offerings as securities offerings.

The CSA also indicated its willingness to evolve with the fast-changing cryptocurrency space by highlighting the availability of exemptive relief through the CSA Regulatory Sandbox initiative (details available at www.securities-administrators.ca). The CSA also encouraged businesses contemplating an offering to contact their local securities regulatory authority directly to discuss a potential offering, and in doing so be prepared to provide the regulator with a draft whitepaper, a business plan and a detailed description of the proposed offering.

For further information relating to this bulletin, please contact any member of our [Securities Law Group](#) or [Technology Group](#).

Goodmans Technology Group

To assist clients in the technology sector, Goodmans brings together our acknowledged expertise in corporate/commercial, private equity, corporate finance, mergers and acquisitions, outsourcing, licensing, intellectual property, privacy, regulatory and media, tax, litigation, human resources, corporate restructuring and administrative law. We do so both for innovative businesses in their start-up phase and for well established businesses of all types. Goodmans continues to lead in the technology sector and is partnered with the DMZ at Ryerson University. The DMZ is a leading business incubator (selected by UBI as the top-ranked university incubator in North America, and third in the world), which connects its startups with resources, customers, advisors, investors, and other entrepreneurs. Goodmans is also a proud partner of IDEABOOST, an initiative of the Canadian Film Centre's Media Lab; building the next generation of technology-based media entertainment products, services and brands. Through these partnerships, Goodmans provides legal advice, mentorship and networking opportunities to assist startups in maximizing their potential. Outsourcing technology functions and technology procurement is also a major strength of Goodmans, where we have assisted technology users to transform their businesses. Finally, Goodmans has represented in court and in arbitrations major technology providers, and users of technology, in ground-breaking cases that have made important contributions to the development of technology law. Members of our Technology Group teach internet and communications law at Canada's largest law schools, are regular lecturers at technology industry events and legal conferences, and have published articles in the technology law field.

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