

Goodmans^{LLP} Update

Time's Up for Non-Compliant Cryptocurrency Issuers and Exchanges?

Much to the chagrin of crypto investors, the price of bitcoin and other cryptocurrencies fell sharply in the first quarter of 2018, firmly establishing that the laws of gravity apply in cyberspace. As the cryptocurrency boom of 2017 faded, concerns about fraudulent fundraising activity grew.¹ At the same time, securities regulators in Canada and the U.S. shifted focus from simply warning cryptocurrency issuers and exchanges to conduct their operations in compliance with securities laws, to actively investigating and, in some cases, intervening in token distributions.

In the U.S., Securities and Exchange Commission (SEC) Chairman Jay Clayton has repeatedly expressed his view that most initial coin offerings (ICO) involve the sale of securities. *In January*, he criticized lawyers who give “equivocal” advice to token issuers that encourage clients to proceed without regard to securities laws. Mr. Clayton indicated he instructed SEC staff to be on “high alert” for ICOs that may be “contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar”.

With such a clear warning, it is no surprise the SEC moved aggressively in recent months to investigate, and in some cases prosecute, a number of ICOs as potential frauds as well as unlawful securities distributions. In one recent example, two founders of a cryptocurrency firm called Centra were charged with violating the anti-fraud and registration provisions of U.S. securities laws in connection with a US\$32 million ICO completed in 2017. Centra claimed it was developing a debit card backed by Visa and Mastercard that would allow people to convert Centra tokens into U.S. dollars and spend it in stores. The SEC says these claims were simply false and arrested the founders shortly before they boarded a flight departing the U.S.²

Perhaps more significantly, at the end of February, *The Wall Street Journal* reported the SEC is pursuing a broad investigation into ICOs and issued numerous subpoenas and requests for information to various ICO issuers and their advisers. While the SEC has not commented publicly on the investigation, this could signal a further escalation of its enforcement agenda and underlines the SEC's commitment to bringing the “wild west” of token distributions under control.

Canada has not yet seen the same degree of vigorous enforcement activity against ICO promoters, but on April 6 *The Globe and Mail* reported the Ontario Securities Commission (OSC) made a number of inquiries of cryptocurrency firms asking for further information about how the firms operate.

These developments clearly suggest Canadian and U.S. securities regulators are making good on the warnings they have repeatedly issued since mid-2017. It appears, from their perspective, all (or virtually all) ICOs to date involved a securities distribution that must either comply with applicable registration and prospectus requirements or be structured so they are exempt from those requirements (such as by restricting access to accredited investors). We expect the current investigations will lead to additional enforcement actions, and any unregistered ICO made available to the general public in Canada or the U.S. will – if it comes to the regulators' attention – very likely attract regulatory intervention.

Many are of the view this regulatory crackdown was long overdue. This is not to say regulators wish to shut down ICOs, cryptocurrency exchanges or cryptocurrency trading altogether. In fact, the SEC and the OSC recently confirmed their desire to facilitate the evolution of this new digital asset. For example, *at a recent event*, Mr. Clayton firmly rejected the idea all ICOs are frauds and left open the possibility that some tokens might not be regulated as securities. Similarly, the OSC, in *the initial draft of its 2018 – 2019 Statement of Priorities*, emphasized its commitment to “support innovation and capital formation through regulatory compliance” and suggested it would issue enhanced guidance as to when ICOs involve securities. Thus, while time may be up for cryptocurrency issuers and exchanges who do not comply with securities laws, these developments may well facilitate the viability of ICOs and cryptocurrency trading over the longer term, avoiding the need for more punitive and restrictive regulation.

For further information on these developments or the regulation of ICOs and cryptocurrencies generally, please contact any member of our Corporate Securities 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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¹ A January 2018 study by Ernst & Young concluded approximately US\$400 million of the \$3.7 billion raised by 372 ICOs covered by the study had been stolen or lost. More recently, Satis Group, an ICO research and advisory firm, *claimed approximately 80% of all ICOs are fraudulent.*

² The Centra ICO was touted on social media by prominent celebrities such as Floyd Mayweather and DJ Khaled. In a similar earlier case, the SEC issued a cease-and-desist order to halt a \$600 million ICO by AriseBank, a self-described "decentralized banking platform" promoted by Evander Holyfield. The founders of AriseBank were subsequently charged with fraud and conducting an unregistered securities offering. These cases establish, among other things, that investors should perhaps proceed cautiously before participating in investment opportunities endorsed by professional boxers.

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