

Securities Law and Technology

December 6, 2017

Read this Before Your ICO: Exploring the SAFT Framework for Compliant Token Sales in Canada

To date in 2017, technology startups have raised over US\$3 billion through more than 200 initial coin offerings (ICOs). As discussed in our August 30 Update, *Initial Coin Offerings in Canada: The CSA Weighs In*, and our September 12 Update, *Cryptocurrencies: Further Legal Developments*, ICOs are catching the attention of investors and securities regulators in Canada and abroad. While blockchain and cryptocurrencies carry the promise of creating new growth opportunities for startup ventures and transforming the financial services industry, undertaking an ICO can be fraught with regulatory risk. The Simple Agreement for Future Tokens (SAFT) has been developed as one way to potentially mitigate this risk by bifurcating the securities and tokens components of a transaction while preserving many of the benefits associated with ICOs.

While we are not aware of any Canadian-based issuers using the SAFT model to complete an ICO, it is gaining some traction in the US. For example, Filecoin, a blockchain-based storage network and cryptocurrency, incorporated the SAFT into its ICO process in raising over US\$257 million this past summer. Purchasers entered into SAFTs that entitled them to receive tokens that will be redeemable for electronic storage space provided through the Filecoin platform in the near future while being immediately tradeable on cryptocurrency exchanges. Similarly, tZERO, a company developing blockchain technologies for capital markets applications, is beginning its SAFT-modelled ICO on December 18, 2017, and expects to raise over US\$200 million. Whether issuers adopting this untested model will ultimately avoid regulatory oversight remains to be seen.

What is an ICO?

An ICO is a new way for early stage companies to attract investment in which the issuer designs and sells digital currency. Unlike a traditional initial public offering, the “tokens” sold in an ICO usually do not represent an ownership stake in the organization. Instead, they are digital assets used in connection with applications and communities (“**Token Networks**”). To date, tokens are most often intended to represent the right to a certain value of the future goods or services the issuer plans to develop – such tokens are usually known as “utility tokens.” Unlike utility tokens, “investment tokens” provide investors with economic and voting rights akin to shares. Investment tokens, like those sold in the Digital Autonomous Organization (DAO) ICO,¹ are clearly securities and will not be discussed further in this article.

Suppose that, by way of a truly Canadian example, Canadian Tire was born in 2017. Before its retail operations existed, the company decided to sell Canadian Tire money as “tokens” to the public online (at that stage, “**Non-Functional Tokens**”). Canadian Tire, as a Token Network, would use the proceeds from that sale of Non-Functional Tokens to develop its retail business and, once launched, the tokens would be redeemable for household goods and automotive services (at that stage, “**Functional Tokens**”). The value of the Non-Functional Tokens may be tied to expectations of a future functional Canadian Tire business in which tokens become redeemable for goods and services.

Are Tokens Securities?

According to the Canadian Securities Administrators (CSA), tokens may be considered securities and if so trigger the same rigorous disclosure and registration requirements that apply to securities under Canadian securities law, such as shares of a public company. The purchasers of Non-Functional Tokens who want to resell the tokens in the secondary market may be

¹ See our August 30 Update, *Initial Coin Offerings in Canada: The CSA Weighs In*. The DAO was a digital decentralized autonomous organization that raised over US\$150 million through an ICO. An anonymous hacker exploited a flaw in the tokens' code stealing approximately US\$50 million of the tokens sold to investors. The U.S. Securities and Exchange Commission issued a report focused on the ICO and concluded the DAO tokens were securities.

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subject to restrictions on transfer or dealer registration requirements. These regulatory obligations would significantly diminish the benefits of raising money through an ICO such as speed, cost, and liquidity.

In Canada, as reiterated in the CSA Staff Notice 46-307 on Cryptocurrency Offerings dated August 24, 2017 (the “**Cryptocurrency Notice**”), a token may be considered a security if it satisfies a well-established four-part test (the “**Securities Test**”), which entails determining whether the token involves

- (i) an investment of money,
- (ii) in a common enterprise,
- (iii) with an expectation of profit,
- (iv) which comes significantly from the efforts of others.

However, the CSA stressed that every ICO is unique and must be assessed on its own characteristics. Tokens do not fit neatly into the judicial framework for determining whether something is a security, and other factors, including policy considerations, may be taken into account.

The Cryptocurrency Notice suggested it is possible some kinds of Functional Tokens would not be considered securities when it said that “...if an individual purchases coins/tokens that allow him/her to play video games on a platform, it is possible that securities may not be involved.” In contrast, “...if an individual purchases coins/tokens whose value is tied to the future profits or success of a business [i.e., a Non-Functional Token], these will likely be considered securities.”

Non-Functional Tokens

Based on the limited regulatory guidance provided to date, Non-Functional Tokens sold to the general public in a process called the Direct Token Presale will likely be deemed securities under the Securities Test.

The first two parts of the Securities Test – (i) an investment of money and (ii) in a common enterprise – would fairly clearly be met in the average sale of Non-Functional Tokens for a Token Network. The third part of the Securities Test – (iii) an expectation of profit – would also likely be satisfied as the Token Network would typically sell Non-Functional Tokens to purchasers at a discount to their future expected value, such

that regulators may determine purchasers have a manifest expectation of profit. The fourth part of the Securities Test – (iv) which comes significantly from the efforts of others – may also be satisfied as the Non-Functional Tokens are sold to the public before the developers have produced a functional network. The Non-Functional Tokens arguably have no utility as their value depends on the efforts of developers to successfully launch the Token Network.

In addition to the probable result of applying the Securities Test to the characteristics of Non-Functional Tokens, public interest considerations may encourage the regulators to characterize Non-Functional Tokens as securities given, in most cases, they are clearly purchased for investment or speculative purposes. As Non-Functional Tokens sold in Direct Token Presales lack intrinsic value, there is greater danger of promoter fraud and of purchasers misunderstanding the investment risk, and therefore greater need to impose regulatory requirements to protect the investing public.

Functional Tokens

In contrast to Non-Functional Tokens, Functional Tokens appear to be less likely to be considered securities because of parts (iii) and (iv) of the Securities Test. With respect to part (iii), there may be no “expectation of profit” for Functional Tokens; instead, many purchasers may have an expectation of utility because of the now functional marketplace in which the tokens can be redeemed for products or services. Purchasers’ expectations for use of the tokens are comparable to that of purchasers of foreign currency who intend to use such currency to buy goods and services internationally. With respect to part (iv), the value of the Functional Tokens is not tied to future utility that comes “significantly from the efforts of others” (e.g., developers); the value largely depends on market factors in the existing functional marketplace. Finally, the policy concerns previously mentioned are likely less acute, since Functional Tokens typically have a transparent, intrinsic value in fiat currency and are less likely to be purchased as investments given their immediate functionality.

The SAFT Framework

Based on the Simple Agreement for Future Equity (SAFE) commonly used in venture capital, the SAFT

model attempts to mitigate the risk of utility tokens being deemed securities. A SAFT transaction operates as follows:

1. The developers of the Token Network publish an operational plan for their Token Network, usually in a peer-reviewed whitepaper.
2. Instead of advertising the sale of Non-Functional Tokens to the general public, the Token Network seeks investment from accredited investors who are eligible to purchase securities on a prospectus-exempt basis. The SAFTs operate as investment contracts between developers and accredited investors, providing investors with the right to receive Functional Tokens in the future when the Token Network becomes operational.
3. The developers use the funds raised through the SAFTs to create a functional Token Network.
4. When the network becomes operational, the Token Network distributes Functional Tokens to its investors as specified in the SAFTs. Once the Token Network is functional, investors and developers may then be able to freely trade the tokens on the assumption they will not be viewed as securities at that point.

Unlike the Direct Token Presale model, the SAFT framework aims to separate the investment contract (security) and Functional Token (non-security) components of the transaction. At the Non-Functional Token stage, the issuer raises money in compliance with securities laws through an investment contract (the SAFT) with accredited investors. At the Functional Token Stage, the Token Network distributes Functional Tokens to accredited investors which can be freely traded over trading platforms or otherwise.

Concerns with the SAFT Framework

Unfortunately, the SAFT-modelled ICO is not a silver bullet and it is far from clear that Functional Tokens will necessarily be exempt from regulation as securities.

First, as indicated in the Cryptocurrency Notice, application of Canadian securities laws to tokens will depend on the particular characteristic of each token and the circumstances in which it was issued. While it may be the case that some Functional Tokens could be exempt from regulation, it does not necessarily follow that all of them will be. Therefore, using a SAFT to ensure tokens are only issued to retail investors as

Functional Tokens may not be determinative of whether regulators believe the tokens are securities. It also seems the details and context of the use of SAFTs in an ICO will likely play a role in the characterization of its tokens. Embellished promotional materials, a prevalence of speculators or unreasonable token pricing (i.e., at a deep discount to enhance the expectation of profit) increase the risk that tokens sold under a SAFT framework would be deemed securities.

Second, the bifurcation of the SAFT investment and the sale of Functional Tokens may be more complicated than expected. A Token Network's developers may unintentionally promote their platform to both accredited investors and potential token users. For instance, promotional material and messages targeted at accredited investors may be received by potential purchasers of Functional Tokens, creating an expectation of profit and influencing their buying decisions. Furthermore, while the lion's share of developer efforts may typically occur before the distribution of Functional Tokens, many developers continue to maintain, improve and further develop the Token Network throughout its lifetime. These activities may be necessary for a successful network and may trigger the fourth prong of the Securities Test – relating to the efforts of others – with regard to the Functional Tokens.

Third, SAFTs may hinder liquidity and create perverse incentives. Reliance on the accredited investor exemption subjects investors to a “closed system” of securities regulation and restrictions on trading, precluding the resale of SAFTs to retail investors and eliminating many of the most appealing characteristics of ICOs generally. The SAFT structure may also encourage initial investment from speculators who are solely interested in short-term gains. After holding the relatively risky and illiquid SAFT investment contract during the development phase, investors may be eager to sell Functional Tokens quickly and pressure developers to focus on a profitable token sale rather than a high-quality Token Network.

All of these factors underline the biggest potential problem with SAFTs - that the attempted bifurcation of the security and non-security portions of the transaction will not necessarily affect how regulators

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will assess the transaction. An issuer could follow the SAFT framework only to find that regulators do not treat the sale of a token differently at the Non-Functional and Functional Token stages. For instance, in September 2017, Waterloo-based Kik Interactive Inc. did not allow Canadians to participate in the public sale of KIN, a Functional Token that would be used as currency on its existing messaging app, which the OSC had apparently determined qualified as a security.

Conclusion

ICOs are a novel way to raise capital and their use presents securities law quandaries in Canada. While the SAFT model appears to be an improvement on the Direct Token Presale, its impact on the treatment of tokens under Canadian regulation remains unclear. At this point, it is not at all clear that SAFTs could be used in Canada to reliably eliminate the risk that tokens issued in an ICO will be characterized as securities. We will continue to track developments related to the regulation of ICOs and the use of SAFTs as this method of fundraising evolves.

For further information on the SAFT model, ICO compliance with securities laws, or guidance on the cryptocurrency regulatory environment and risk management, please contact any member of our Securities Law Group or Technology Group.

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