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Cryptocurrency events

By Neill May

It being 2017, if something walks like a duck and quacks like a duck, then there must be a vigorous debate about whether it's entitled to its own pronouns. Securities regulators have begun to respond to the exponentially growing market for cryptocurrencies, which often walk and quack like securities.

In that technology is my personal Kryptonite, a sophisticated explanation of cryptocurrencies is a challenge (Kryptocurrencynite, in effect). At a high level, cryptocurrencies (like bitcoin) are digital currencies that operate independently of a central bank like traditional sovereign currencies such as the Canadian dollar. They are technological constructs that use encryption techniques to regulate issuances and transfers.

Cryptocurrency offerings have quickly become a significant source of funding for early-stage technology companies, outstripping traditional forms of venture capital financing. This growth has been fuelled, at least in part, by the absence of regulatory oversight. Until recently, businesses selling cryptocurrencies appear to have generally proceeded on the basis that the coins or tokens they are distributing are not securities (being more in the nature of prepayments for services to be offered by the businesses) and, therefore, not subject to traditional securities law requirements (which impose time and cost on offerings). Initial coin offerings can, if unregulated, be completed quickly over the internet, with minimal documentation and without providing any meaningful rights or ongoing disclosure to purchasers. For example, the former CEO of Mozilla reportedly raised US\$35 million via an ICO to fund development of a new web browser in less than 30 seconds.

The nature of these financings presents unique risks. For example, in connection with an unregistered US\$150-million token sale by an organization called The DAO, a hacker exploited a flaw in the tokens' code to steal approximately US\$50 million of the tokens that had been sold to investors. Those risks (and the other risks that typically affect investments) beg the question of whether these are offerings of "securities."

Late this past summer, the Canadian Securities Administrators released a staff notice seeking to provide some guidance on the application of Canadian securities laws to ICOs and other cryptocurrencies. The staff notice summarizes the well-established four-prong test used to determine what is a "security": (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation of profit that (iv) comes significantly from the efforts of others.

Not surprisingly, the application of the test is more challenging than its expression. A coin or token that is designed to permit the holder to use a service once developed (for example, to play video games on a platform) may not look in substance like a traditional security, but when the coins begin to actively trade in an organized market then there begin to be echoes of Donald and Daffy. Specifically, concerns are raised that the "white papers" often used to provide some disclosure regarding ICOs should comply with Canadian securities law requirements, that those engaged in soliciting and facilitating these trades need to be properly registered as gatekeepers and that the online exchanges that facilitate secondary trading in cryptocurrencies need to be formally recognized as a "marketplace" under Canadian securities laws.

The regulatory challenges are clear — seeking traditional balance between investor protection and fostering capital

formation (of particular importance for innovative companies in growth sectors), compounded by the difficulty in providing specific guidance to a technology and market evolving at breakneck pace. In the wake of the CSA staff notice, Kik Interactive, an Ontario-based tech innovator, announced that it would exclude Canadians from its ICO offering. The company, which developed a popular messaging app, created a cryptocurrency called kin to be used as the application's primary transaction currency, and it announced plans to raise a total of US\$125 million by way of an ICO. The offering was not structured to comply with securities laws, presumably on the basis of a conclusion that kin is not a security. Kik cited "weak guidance" from the Ontario Securities Commission as to whether Canadian securities law would apply as the reason for its exclusion of Canadians.

Other regulators are grappling with the same issue. China's central bank recently declared ICOs illegal in China and required an immediate halt to all ongoing ICO activity as well as a refund of all money previously raised by way of ICO. Other jurisdictions, such as Hong Kong's Securities and Futures Commission and the U.S. Securities and Exchange Commission, are taking an approach similar to the CSA, disclosing that they're monitoring ICOs and similar currencies and will apply securities laws where appropriate.

Perhaps the biggest challenge will be in enforcement. If Canadian regulators determine that a cryptocurrency is a "security" and Canadians are not to participate, the exclusion of investors participating through anonymous accounts and borderless technologies would be difficult. It would be as if once the ducks are identified in the lake, they're to be prevented from swimming in areas of the lake but in specific water molecules. Those challenges are ducking daunting. **CI**

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