Goodmans LLP Update

Securities Law and Technology

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Read This Before Your ICO: Minimizing the Risk of a Securities Token

On December 11, 2017, the U.S. Securities and Exchange Commission (SEC) issued a cease-and-desist order against Munchee Inc. ("**Munchee**") to stop Munchee's Initial Coin Offering (ICO) and require it to return to investors the funds it collected through the sale of its MUN token (the "**Munchee Order**"), which the SEC deemed to be securities. See the discussion in our December 18 Update, *ICO Wars: The SEC Strikes Back*.

The Munchee Order provides insight into some of the token issuer activities the SEC will consider in determining whether tokens issued during ICOs are securities. The SEC employs a four-part test – the Howey Test – to determine whether a financial instrument or investment contract is a security. In the context of tokens, the crucial elements of this test are whether the tokens represent "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others".[1] In Canada, a similar test is set out in the Supreme Court of Canada's decision in *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*.

Drawing from the Munchee Order, and other decisions and commentary by regulators and academics, we have compiled some strategies for token issuers to help mitigate the risk of regulators deeming their tokens to be securities. The following review will focus on the two more contentious prongs of the Howey Test, being whether: (i) the token issuer provided investors with a reasonable expectation of profit; and (ii) those profits are expected to be derived from the efforts of others.

While avoiding the pitfalls outlined below may decrease the risk of having a token deemed a security, there are no guarantees. Regulators have so far chosen to approach ICOs on a case-by-case basis and have indicated each token must be considered in the context of its particular circumstances.

ICO: What NOT to do

The following token issuer activities may suggest to regulators an issuer's token is a security. Token issuers should avoid:

Providing purchasers with a reasonable expectation of profit

- *Posting material online that suggests investors will profit.* Munchee made statements in its White Paper, on blogs, podcasts, and Facebook posts that suggested investors would profit from purchasing MUN tokens. For instance, Munchee (i) published a blog post entitled "7 Reasons You Need To Join the Munchee Token Generation Event" which provided that "As more users get on the platform, the more valuable your MUN tokens become." The Canadian Securities Administrators (CSA) have also suggested that attending public events, including conferences and meetups, to actively advertise the sale of your token could indicate your token is a security. For more on the CSA's current position on ICOs, see our August 30 Update, *Initial Coin Offerings in Canada: The CSA Weights In.*
- *Endorsing third-party posts that suggest investors will profit.* Munchee endorsed other commentators' public statements that touted the opportunity for profit through the purchase of MUN tokens. For example, Munchee created a public post on Facebook with the caption: "199% GAINS on MUN token at ICO price!" and linked the post to a YouTube video in which the person featured claimed if investors got in early enough on ICOs, they would make a profit.

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[1] *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

- *Not soliciting existing stakeholders.* Munchee, which had a functioning restaurant review app in which users would ultimately use MUN tokens, did not specifically target current users of the Munchee App or stakeholders in the restaurant industry. Instead, Munchee targeted forums for people more generally interested in investing in cryptocurrencies.
- *Promoting a secondary market.* Munchee highlighted in its White Paper that a secondary market for MUN tokens would be available shortly after the completion of the offering.
- *Providing a deep discount on token pre-sale pricing.* Though not addressed in the Munchee Order, commentators have suggested that offering early adoption discounts during an ICO or its pre-sale may be considered by regulators to encourage speculative investment and enhance investors' expectations of profit.

Providing purchasers with a reasonable expectation they will profit from the efforts of others

- *Emphasizing the importance of founders and management in creating value.* Munchee highlighted the credentials, abilities and management skills of its agents and employees, suggesting investors would profit from their efforts in building the Munchee marketplace.
- *Not having a developed marketplace.* Munchee provided in its White Paper that the value of the MUN tokens would depend on Munchee's ability to create an effective "ecosystem" for its restaurant review app, suggesting the Munchee team would continue substantial work on its marketplace after the ICO.

Relying on the SAFT

Token issuers should not assume they are securities law compliant simply because they used a Simple Agreement For Future Tokens (SAFT) framework in connection with their ICO. The SAFT framework aims to separate fundraising for an ICO into two stages: (i) before the development of the token marketplace, the issuer raises money by selling rights to future tokens to accredited investors; and (ii) once the token marketplace is developed, the issuer distributes the tokens to the investors. Proponents of the SAFT believe that at the time the tokens are issued to investors, the tokens have inherent utility such that they are not securities and can be sold on exchanges to non-accredited investors. The SAFT framework was discussed in our December 6 Update, *Read this Before Your ICO: Exploring the SAFT Framework for Compliant Token Sales in Canada.*

In the Munchee Order, the SEC suggested a method like the SAFT framework, which relied on a token no longer being deemed a security once it had utility, may not be effective. Specifically, the SEC stated "even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. Determining whether a transaction involves a security does not turn on labelling – such as characterizing an ICO as involving a 'utility token', but instead requires an assessment of the economic realities underlying a transaction."

ICO: Best Practices

Geo-blocking ICOs

Issuers hoping to reduce the chance they will be subject to the review of regulators in certain jurisdictions may want to exclude investors in those jurisdictions by way of geo-blocking. Geo-blocking is a form of technological protection measure where access to Internet content is restricted based upon the user's geographical location. Geo-blocking can be circumvented (e.g., through use of virtual private networks) but even an attempt at geo-blocking could factor in favour of the issuer if regulators in a geo-blocked jurisdiction were to consider whether to take action against an issuer.

Sell tokens using existing securities exemptions

Issuers who are concerned about suffering the same fate as Munchee may choose to delay distributing tokens to the general public until regulators provide clearer guidance on when tokens will or will not be deemed securities (or issue new regulations aimed specifically at cryptocurrencies). In the meantime, issuers eager to raise funds for their new projects could do so now by selling tokens (or future tokens) through existing securities law exemptions, such as selling to accredited investors or utilizing the offering memorandum exemption, or by seeking specific exemptive relief to facilitate the offering through programs like the Ontario Securities Commission's LaunchPad initiative.

For further information on 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.

Goodmans Tech Group

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