Goodmans LLP Update

Securities Law and Technology

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Initial Coin Offerings in Canada: The CSA Weighs In

On August 24, 2017, staff of the Canadian Securities Administrators (CSA), published CSA Staff Notice 46-307 – *Cryptocurrency Offerings* (the "**Staff Notice**"). The Staff Notice provides guidance on the CSA's views on the applicability of Canadian securities laws to initial coin offerings (ICO) and the sale of other cryptocurrencies. The Staff Notice makes it clear that cryptocurrencies can qualify as securities and, if so, any distribution of such securities in Canada must comply with fundamental Canadian securities law requirements such as the requirement to qualify the distribution under a prospectus or rely on an exemption from the prospectus requirements.

Background

Cryptocurrency offerings distributed via blockchain technology, such as ICOs, have quickly become a significant source of funding for early stage technology companies.[1] According to research firm Smith + Crown, ICO financings are growing exponentially, with approximately US$900 million raised in the second quarter of 2017 compared to less than US$40 million in the first quarter of 2016. Significantly, the amount of money raised via ICO in the second quarter outstripped traditional forms of venture capital by more than threefold. At least one venture capital fund focused on investing exclusively in ICOs has been formed, and there are a number of online exchanges that allow investors to buy and sell existing cryptocurrencies.

The rise of ICOs has been fuelled, at least in part, by a complete lack of regulatory oversight. Until recently, businesses selling cryptocurrencies seem to have generally proceeded on the basis that the coins or tokens they are distributing are not securities and therefore not subject to traditional securities law requirements, such as the obligation to provide purchasers with a detailed disclosure document (registration statement or prospectus) with statutory liability for misrepresentations or, alternatively, to sell only in reliance on an exemption from those disclosure requirements.

It is not hard to see why technology startups are attracted to ICO fundraising. The process can 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!

It also is not hard to see why securities regulators might be concerned about the explosive growth in ICOs. Without legally mandated disclosure or investor protections, cryptotechnology financings carry significant risks that may not be understood by those who are purchasing the coins or tokens, while the openness of blockchain technology and the often anonymous (or at least pseudonymous) nature of the participants make these financings potentially ripe for abuse.

In response to the growth of this new form of financing and to address concerns that have been highlighted by recent ICO experiences (such as the 2016 US$150 million token sale by an organization called The DAO, in which an anonymous hacker exploited a flaw in the tokens' code to steal approximately US$50 million of the tokens that had been sold to investors), regulators have started providing guidance on how existing securities laws apply to ICOs. In July 2015, the United States Securities and Exchange Commission (SEC) issued a report focused on The DAO's token offering. Not surprisingly (given the nature of the tokens in that

[1] "Coins" or "tokens" typically give the holder a right to participate in a given project or technology. For example, a company might issue tokens that can be used to access a decentralized file storage network over the internet once the network has been developed. The value of these tokens will often increase or decrease based on the success of the underlying project or technology and are frequently traded over online exchanges.

case), the report concluded that The DAO tokens were securities. Since the sale of DAO tokens had not been registered in accordance with SEC requirements, their distribution violated U.S. securities laws. While the SEC report focused exclusively on The DAO tokens – and left open whether other forms of cryptocurrency could also constitute securities – it sent a clear message that the SEC is actively monitoring ICOs.

The Staff Notice

The Staff Notice is the CSA's first official pronouncement on the application of Canadian securities laws to ICOs and other cryptocurrencies, and follows both the SEC report and a press release issued by the Ontario Securities Commission (OSC) in March 2017, in which the OSC cautioned that products or other assets that are tracked and traded as part of a distributed ledger may qualify as securities, even if they do not represent shares of a company or similar ownership interests.

Cryptocurrencies as Securities

The Staff Notice notes that ICOs can be very similar to traditional initial public offerings and summarizes the well-established four-prong test that will determine whether a coin or a token qualifies as a security under Canadian law. This test, which is similar to the U.S. test that the SEC applied to conclude that The DAO tokens are securities, provides that a coin or token is a security if it involves (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.

In considering whether securities laws apply, the CSA will look at the substance of the transaction with the objective of investor protection in mind. Using a new technology and new terminology (i.e., selling a coin or token instead of shares or equity) to raise money does not determine whether securities laws apply. While the CSA did not provide any specific examples of cryptocurrencies that it would classify as securities, based on the similarities of the U.S. and Canadian tests, we expect that the CSA would view The DAO tokens as securities. On the other hand, the CSA also acknowledges that certain coins or tokens may not be securities – for example, a token that allows a purchaser to play video games on a platform.

If a cryptocurrency is a security, its distribution in Canada will be subject to the full panoply of requirements that apply under securities law. These include an obligation to sell securities under a prospectus or pursuant to an exemption from the prospectus requirement, such as selling only to accredited investors or providing investors with an "offering memorandum" containing prescribed information and to which liability attaches for misrepresentations. The CSA notes that many businesses publish "whitepapers" in connection with ICOs that provide some disclosure regarding the offering and the proposed business but that these documents do not comply with Canadian securities law requirements. Furthermore, coins or tokens that qualify as securities and are distributed in Canada will be subject to resale restrictions under Canadian securities laws.

Dealer Registration Requirements

If an ICO involves the distribution of securities, businesses involved in the distribution may need to be registered as a dealer in Canada or qualify for an exemption from the dealer registration requirement. This will depend on whether the business is trading in the coins or tokens for a "business purpose". The Staff Notice highlights the fact that issuers conducting ICOs may engage in various activities could trigger a registration requirement, including soliciting a broad base of investors, including retail investors, through the internet or at public events such as conferences. Registering as a dealer involves compliance with a wide range of obligations, including know your client rules and investor suitability screening.

Cryptocurrency Exchanges

There are a number of online exchanges that facilitate secondary trading in cryptocurrencies – investors can buy and sell a variety of cryptocurrencies (including those that were originally issued in an ICO) in exchange for other cryptocurrencies (e.g., bitcoin or ethereum) or for fiat currency (e.g., US$ or C$). The Staff Notice points out that these exchanges are generally unregulated and may not be efficient markets. If a cryptocurrency exchange facilitates trading in securities and operates in Canada, it would have to be

recognized as a "marketplace" under Canadian securities law or be exempt from recognition (to date, no cryptocurrency exchange has been recognized or exempt from recognition in Canada).

Cryptocurrency Investment Funds

The Staff Notice also highlights a range of potential regulatory issues associated with investment funds that have been established to invest in cryptocurrencies, including whether such funds can be sold to retail investors in Canada without a prospectus, valuation, registration and custody requirements, as well as the use of cryptocurrency exchanges by such funds. The CSA expects cryptocurrency investment funds to be prepared to discuss these issues, amongst others, with staff.

Conclusion

The CSA's conclusion that ICOs are potentially subject to regulation in Canada as securities offerings is hardly surprising and is consistent with a global trend toward increased regulatory scrutiny of this new form of fundraising.

There is little to argue with in the CSA's view that certain cryptocurrencies may constitute securities, but the Staff Notice offers businesses who are considering raising money in Canada via an ICO very little practical assistance in determining whether they will have to comply with Canadian securities laws. However, given the still nascent stage of cryptocurrency financings, it would likely be very difficult – and probably premature – for regulators to offer anything beyond the very general cautions contained in the Staff Notice. Furthermore, the CSA has clearly stated that it wants to encourage financial market innovation and facilitate capital raising by fintech businesses and is prepared to discuss possible approaches to complying with proposed cryptocurrency offerings with proponents. The Staff Notice also points out that the CSA's Regulatory Sandbox – a new initiative designed to support fintech businesses seeking to offer innovative products – can be used to register or obtain exemptive relief from securities law requirements under a faster and more flexible process than under traditional applications. Therefore, at least for now, it appears that cryptocurrency offerings will be dealt with on a case-by-case basis in Canada, creating ongoing uncertainty for potential issuers. Significant practical questions also remain regarding how Canadian laws can actually be enforced against cryptocurrency issuers, particularly those who operate overseas and behind a veil of anonymity.

In the meantime, the popularity of ICOs continues to grow, apparently unabated by the prospect of increased regulation. For example, Filecoin, a decentralized storage network that will use the peer-to-peer InterPlanetary File System to secure and store data, is in the process of raising up to US$250 million by way of ICO – it secured US$186 million in the first hour of the offering and is currently over US$200 million in total funding. The Filecoin ICO is also notable as being one of the first cryptocurrency offerings that has been structured to comply with U.S. securities laws and is available only to accredited investors. It is also being offered over a KYC-enabled platform (CoinList.co) that will allow accredited investors to access a variety of ICOs, another important step in the evolution of cryptocurrency financings.

Closer to home, Kik Interactive, a Waterloo, Ontario-based company that developed a popular messaging app, has announced it is creating its own cryptocurrency called Kin that will be used as the application's primary transaction currency. Kik plans to raise a total of US$125 million by way of an ICO, US$50 million of which has already been received from investors who participated in a "presale" round. Although Kik is requiring purchasers to provide basic personal information to participate in the ICO, it appears that Kik has concluded that Kin is not a security and that the offering will not be structured to comply with U.S. or Canadian securities laws.

Kik's ICO may serve as an early high profile test of the views set out in the Staff Notice. It will be interesting to see if the CSA supplements the Staff Notice with any further commentary in light of Kik's apparent decision that its Kin tokens are not securities. If Kik's ICO proceeds in the manner currently contemplated without regulatory intervention or comment, that may encourage other potential ICO issuers (at least those based in Canada) to proceed in a similar manner, whether or not their coins or tokens have similar characteristics to Kin.

Regulation of cryptotechnology offerings is still at a very early stage. Issuers and regulators continue to grapple with a familiar problem – how to apply "old" laws to "new" technology – and it remains to be seen how that problem will be resolved. What is clear is that ICOs are now squarely in the sights of securities regulators worldwide. It seems inevitable that more specific regulation or guidance will follow, which we hope will strike an appropriate balance between investor protection and fostering a new and innovative way for early stage technology companies to raise money. Until legal requirements are more clearly defined, businesses that are considering an ICO should proceed cautiously and in a way that is cognizant of the emerging regulatory concerns.

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

Goodmans Tech Group

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