CSA Provides Guidance On Securities Law Implications For Token Offerings

June 20, 2018

On June 11, 2018, the Canadian Securities Administrators (the "CSA") issued CSA Staff Notice 46-308 — Securities Law Implications for Offering of Tokens (the "Notice"). The Notice provides additional guidance on the applicability of securities laws to offerings of coins and tokens, including those commonly referred to as “utility tokens.” The Notice provides examples of situations where the CSA has determined that the offering is a security and draws special attention to establishing the criteria of investment contracts. The Notice also advises businesses to consult qualified securities legal counsel about the potential application of, and possible approaches required to comply with, securities legislation.

Background

Cryptocurrencies are increasingly coming within the purview of securities regulators. In August 2017, the CSA published Staff Notice 46-307 — Cryptocurrency Offerings (SN 46-307), which confirmed that many cryptocurrency offerings involve the sales of securities.

Since the publication of SN 46-307, the CSA Staff has engaged with numerous businesses, and their advisors, who wish to complete offerings of coins or tokens. From their discussions, the CSA found that most of the offerings met the criteria for a security. The current Notice supplements SN 46-307, and attempts to provide additional guidance to businesses who may find themselves having to adhere to securities regulations. Specifically, the Notice (1) provides examples of situations where a token may be subject to securities laws, and (2) addresses multiple step token offerings.

Key Points of the Notice

When an offering of tokens may involve an offering of securities

The Notice states that a token or coin may fall within the definition of a “security” if it constitutes an investment contract. In determining whether the offering is that of an investment contract, a purposive interpretation that includes considering the objective of investor protection should be used. Additionally, businesses and their advisors are

directed to apply the case law interpretation of investment contract, which includes considering whether the offering involves: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to come significantly from the effort of others.

The Notice stressed that every offering is unique and must be assessed on its own characteristics. Businesses and their advisors should asses not only the technical characteristics of the token, but the economic realities for the offering as a whole, with a focus on substance over form.

Examples of where a token may constitute an investment contract

The Notice provides illustrative examples of situations in which tokens might meet certain investment contract criteria. The examples presented in the Notice should not be used as a mechanical checklist, instead businesses and their advisors should complete a meaningful analysis based on the totality of the circumstances of the offering.

The Notice draws particular attention to situations involving utility tokens. The CSA received submissions that proposed offerings of utility tokens do not involve securities because the tokens have a specific function, such as in software or an online platform. However, the Notice states that most of the tokens the CSA assessed involved the distribution of a security based on the application of case law. Therefore, the fact that a token has utility is not determinative as to whether the offering involves the distribution of a security. For example, looking at whether the purchaser of the tokens has an intention to sell them on a secondary platform or trading market may be indicative of an expectation of profit under the investment contract criteria.

Offering of tokens that are structured in multiple steps

The Notice also provides that securities regulations may apply to offerings of tokens that are structured in multiple steps. The Notice outlines an example of a multiple-step transaction and provides guidance as to how securities law may apply.

Step 1: The purchaser agrees to contribute money in exchange for a right to receive tokens at a future date. A “simple agreement for future tokens,” or “SAFT,” typically governs the future transaction. At this step, there is usually a distribution of a security — specifically, the right to a future token. If there is a security at this stage, issuers typically rely on a prospectus exemption.

Step 2: The token is delivered to the purchaser, as outlined in the SAFT. At this step, the issuer has generally represented that the software or platform is built or the goods or services are available, and the token is functional. The CSA states that it may consider that a token delivered at this second step or a later step is a security, despite the fact that it may have some utility. This is because the token likely fulfils the criteria of an investment contract or has other security-like attributes, such as a profit sharing interest.

Complying with securities legislation

The Notice acknowledges that trends in the cryptocurrency industry are evolving quickly and encourages businesses and their advisors to consult qualified securities legal

counsel about the potential application of, and approaches to complying with, securities legislation. Applicable securities law requirements include, among other things, reliance upon available prospectus requirements and related resale restrictions as well as compliance with dealer registration requirements. The Notice also recommends that businesses explore possible flexible approaches to complying with securities laws, including time-limited exceptive relief from certain securities law requirements. Consultation with the CSA Regulatory Sandbox, an initiative of the CSA that supports fintech businesses, is another option for businesses looking to engage in cryptocurrencies.

Conclusion

The Notice is a useful supplement to SN 46-307 as it provides additional examples of where certain tokens or coins may be considered securities. When considering whether offering token meets the criteria of an investment contract, the CSA stresses the importance of a purposive interpretation that includes considering the objective of investor protection. Further, the CSA emphasizes that even if the proposed function of a token is utility, it may still meet the criteria for an investment contract if an expectation of profit, or other criteria are established. It is evident that the application of securities laws to cryptocurrencies will continue to advance and that businesses should protect themselves by consulting with qualified securities legal counsel and exploring more flexible approaches through the CSA Regulatory Sandbox.

Contact Us

If you have any questions regarding cryptocurrencies, digital currencies and whether you may trade in such instruments, please contact one of the authors of this bulletin or any member of the BLG Cryptocurrency and Blockchain Group.

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