CSA Increases Regulatory Clarity In The Cryptic World Of Digital Currencies

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The Staff of the Canadian Securities Administrators issued CSA Staff Notice 46-307 — *Cryptocurrency Offerings* that outlines its views on the application of securities law to cryptocurrencies

The Staff of the Canadian Securities Administrators (the "CSA") issued CSA Staff Notice 46-307 — *Cryptocurrency Offerings* (the "Notice") that outlines its views on the application of securities law to cryptocurrencies, such as "coins" and "tokens". In the Notice, the CSA recognizes that cryptocurrency offerings provide a new and innovative method of capital raising by businesses and opportunities for investors to expand the range of investments. However, the CSA is aware of its responsibility to fulfill its investor protection mandate. The CSA's regulatory concerns have to do with investor protection in light of a number of issues, such as volatility, transparency, valuation, custody, liquidity and the need to protect investors from unethical practices and illegal schemes. While acknowledging the innovation in the use of cryptocurrencies for funding new business enterprises, the CSA presents a discussion of the relevant securities law considerations for entities when engaging in an offering of cryptocurrencies or the sale of securities of a cryptocurrency investment fund.

The CSA confirms that the prospectus and registration requirements under securities laws apply to the distribution or trading in any cryptocurrency that constitutes a "security". In addition, where an investment fund is set up to invest in cryptocurrency or crypto-assets, the prospectus and registration requirements, as well as anti-money laundering and KYC requirements, have to be complied with. Finally, cryptocurrency exchanges may be considered to be marketplaces subject to regulation, which would open them up to the general rules governing stock exchanges or alternative trading systems.

Background

Over the past decade, Bitcoin, Ether and other cryptocurrencies have become increasingly commonplace. Cryptocurrencies are often used in conjunction with distributed ledger technologies, such as blockchain, to conduct fund raising transactions. The market has witnessed a number of entities issuing cryptocurrencies, which may be purchased using either another cryptocurrency or a fiat currency (for

example, Canadian or US dollars). When such cryptocurrencies are offered for the first time they are often referred to as an initial coin offering ("ICO") or an initial token offering ("ITO"). Structurally, they may be compared to a traditional initial public offering ("IPO").

The Threshold Question

Coins and tokens, and the associated ICOs and ITOs, come within the purview of securities regulators when the coins or tokens issued fall within the definition of a "security". What constitutes a security is well established, and is defined in provincial securities legislation as well as applicable court decisions and securities regulatory rulings. However, courts have also commented that what is a security is not a static principle and will adapt to market developments.

An "investment contract" is one of the enumerated definitions of a "security" in securities legislation across Canada and although the term "investment contract" is not defined in legislation, its interpretation has been the subject of a long line of established jurisprudence. The definition of "investment contract" in Canada goes back to a Supreme Court decision from 1978, in which the court adopted the meaning attributed to it by American courts as "an investment of money in a common enterprise, with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others". With this judicial pronouncement in mind, that a number of cryptocurrencies issued pursuant to ICOs and ITOs are, in substance, investment contracts is not a difficult conclusion.

While we have yet to see such jurisprudence or regulatory decisions in Canada, the Securities and Exchange Commission ("SEC") in the United States recently applied this definition of "investment contract" in determining that tokens offered by a virtual organization known as "The DAO" are, in fact, securities. A bulletin published by BLG outlining the SEC's report can be accessed here.

The Notice states that many of the coins or tokens distributed in offerings reviewed by the CSA meet the definition of a security based on an assessment of the economic realities of the particular transaction. Generally speaking, the distribution of a coin or token the value of which is tied to the future profits or success of a business managed by others will likely be considered to be a security by the CSA. The CSA has also indicated that in assessing whether or not securities laws apply, it considers the substance, rather than the form, of the offering. Simply taking the position, as some issuers have, that cryptocurrencies are software products and therefore not subject to securities regulation will not be sufficient.

What it Means to be a Security

If cryptocurrencies offered through an ICO or ITO constitute securities, their distributions need to be completed in accordance with the prospectus requirements imposed by securities laws or in reliance upon an exemption from those prospectus requirements. Relevant prospectus exemptions under National Instrument 45-106 and the *Securities Act* (Ontario) include: securities sold to accredited investors; securities offered to qualifying investors using an offering memorandum in prescribed form ("OM"); and

securities sold pursuant to the crowd-funding exemption, which requires a portal registered as a dealer.

Relying on the OM exemption requires more than merely publishing a description of the projects a company intends to undertake subsequent to its ICO or ITO. The issuer must obtain signed risk acknowledgments from each investor, provide audited financial statements and file certain reports with securities regulators. The OM must also comply with certain content requirements, including a description of the business, features of the cryptocurrency, how the cryptocurrency will be valued, and all material risks associated with investment in the cryptocurrency. In addition, regardless of whether the cryptocurrency is offered pursuant to a prospectus or in reliance upon a prospectus exemption, investors must be given the right to sue or rescind their investment in the event that the disclosure document contains a misrepresentation.

In addition to ensuring compliance with the prospectus requirements, if the coins or tokens offered in an ICO or ITO are determined to be a security, the business completing the ICO or ITO needs to consider whether it may trigger the dealer registration requirement. The trigger for the dealer registration requirement under Canadian securities laws is a "business" trigger, meaning that a person or company that is in the “business” of trading securities requires dealer registration or an exemption from the dealer registration requirement. Whether or not an activity meets the business trigger is fact specific, and in the Notice the CSA identifies certain factors it considers to be important in making this assessment in the context of ICOs and ITOs. These include: soliciting a broad base of investors, including retail investors; using the internet, including public websites and discussion boards, to reach a large number of potential investors; attending public events, including conferences and meetups, to actively advertise the sale of the coins/tokens; and raising a significant amount of capital from a large number of investors.

The CSA also alluded to the fact that cryptocurrencies may be considered to be derivatives, thereby subject to the rules that relate to over-the-counter derivatives. The definition of a derivative is very broad and could easily capture many crypto-assets. We hope, however, that in a manner similar to the product determination rules that came into force in the last few years, the CSA will recognize that it needs to determine whether these assets are either securities or derivatives. They should not fall into both regulatory regimes.

A Contextual Example

The granting of relief for the ICO of Impak Finance Inc. ("Impak") by securities regulators in Ontario and Québec provides a recent example of how this type of offerings could fit into the securities law regime. Impak's offering of a new digital currency called MPK will proceed via private placement in reliance on the OM exemption once Impak's MPK eWallet, which will be used to store, send and receive MPK, has been launched. Impak will be targeting three categories of participants for its ICO; impact organizations (*i.e.*, businesses, non-governmental organizations, not-for-profit corporations and social enterprises), individuals, and high net-worth or professional investor capital partners. Along with relief from the prospectus requirement, Impak also requested relief from the dealer registration requirement.

Impak was granted relief from the prospectus and registration requirements on a number of conditions. The prospectus requirement will apply to a first trade of MPK, unless the trade is between an impact organization and either an individual or capital partner, and MPK must not be listed and traded on any exchange or cryptocurrency exchange. Impak will also be required to supply certain information relating to the value of MPK and transactions involving the cryptocurrency on a quarterly basis. Further, Impak must conduct KYC and suitability reviews for each participant, and limit investment by a participant to $2,500 unless the participant can prove that they are an accredited investor or an eligible investor. Impak must also refrain from providing investment advice to its participants and deal with its participants fairly, honestly and in good faith.

While the regulators in Ontario and Québec indicated that the relief granted to Impak should not be considered precedent, the decision shows that regulators are prepared to work with fintech businesses to support innovation, so long as there are baseline investor protection principles in place. Given the potential need to navigate the prospectus and registration requirements in connection with an ICO or ITO, businesses contemplating an ICO or ITO should carefully consider the appropriate characterization of the relevant cryptocurrency for securities law purposes prior to proceeding with an offering.

Cryptocurrency Investment Funds

Investment funds that invest in cryptocurrencies may provide investors with the opportunity to gain exposure to cryptocurrencies without having to deal with the potential complexities and security concerns that may be associated with holding cryptocurrencies directly. In the Notice, the CSA acknowledges that it is aware of investment funds being set up to invest in cryptocurrencies, and highlights a number of issues that must be considered by firms that are considering launching such funds. In addition to considerations relevant to all investment funds, such as the registration requirements under securities law and whether the securities of the funds will be offered under a prospectus or on a private placement basis, the CSA touches on issues unique to firms seeking to establish cryptocurrency funds. For example, the CSA addresses the need for such firms to establish a process for valuing the funds' cryptocurrency assets, to conduct due diligence to ensure the integrity of the exchanges on which cryptocurrency transactions will be executed, and to engage a custodian with expertise in the safekeeping of cryptocurrencies. Given the relative immaturity of cryptocurrencies as an asset class, and the lack of well-established industry standards relating to the operation of cryptocurrency investment funds, firms contemplating the formation of such funds should be prepared to engage in discussions with the securities regulators on these and other relevant issues.

Conclusion

Commentators have described the cryptocurrency ecosystem as the "wild west" due to the lack of clarity as to how cryptocurrencies will be regulated. The Notice provides some helpful guidance on the matter and, as was the case with the Impak decision, we expect securities regulators to review cryptocurrency offerings on a situational basis and demand compliance with relevant aspects of securities laws if the cryptocurrency falls within the definition of a security. In recognition of the fact that this may come as a

surprise to some issuers of crypto-assets, the CSA also reminds issuers of the services available through the CSA Regulatory Sandbox, which forum was used by Impak in advance of its application for relief. The clarity added by the Notice, coupled with the additional consultation offered by the Sandbox, may inspire more innovative cryptocurrency offerings to be launched and at the same time, provide the investor safeguards that our securities regulatory regime demands.

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Our lawyers act for a variety of clients involved in the FinTech sector, including domestic and foreign financial institutions, payment acquirers and processors, commercial and consumer finance entities, mobile device manufacturers and mobile payments and e-wallet providers. We also provide advice to FinTech entrepreneurs and other digital financial service providers, and institutional and venture FinTech investors.

In addition, we have experience advising clients on the formation and operation of cryptocurrency funds, and the registration and other securities regulatory issues that impact cryptocurrency fund managers.

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