Simple Agreements for Tokens (SAFTs) and the Regulatory Risk of ICOs and Token Sales

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Initial Coin Offerings ("ICOs") have dominated news headlines recently as blockchain technology continues to disrupt the way we do business. ICOs provide early-stage developers of blockchain projects with an opportunity to raise funds by selling tokens created in connection with the blockchain project. The tokens are expected to then become functional units of currency or services upon the launch of the project.

Over the past two years, developers have completed over 370 ICOs and have raised almost $4 billion from investors, while largely ignoring securities-regulatory compliance and avoiding the associated costs. However, due to the extremely large sums of money being invested in ICOs, regulators in the United States and Canada are increasingly scrutinizing ICOs and taking action for non-compliance. This publication considers the regulatory framework around token sales in Canada and the Simple Agreement for Tokens ("SAFT") that has been developed as a response.

ICOs versus Prospectus Offerings

Traditionally, many early-stage companies raise money by "going public" and completing an Initial Public Offering or "IPO" by selling an ownership interest in the corporate entity. With ICOs this is not the case. ICOs are fundamentally different from IPOs because in an ICO, capital is raised without providing investors with an ownership stake. This type of ICO should not be confused with offerings of investment tokens or "tokenized securities", which are clearly securities offerings that would need to comply with securities legislation similar to a traditional IPO or private placement of securities.

Unlike an offering that conveys an ownership interest, under an ICO, digital assets, known as "tokens", are sold to investors to raise capital to fund the development of the project in anticipation of the tokens being used to exchange for products and services upon the launch of the project. Investors typically purchase tokens hoping that the project will be successful when launched and that the value of their tokens will increase due to a demand for the tokens from consumers or participants in the network.

As a fairly new innovation, tokens do not squarely fit within any of the enumerated definitions of a "security" under applicable law in Canada and because an ownership stake is not typically sold under an ICO, many developers take the position that tokens are not securities and that, therefore, there is no need to comply with securities

regulations that govern the sale of securities, such as the prospectus and registration requirements. However, securities regulators in various jurisdictions, including the Canadian provinces and territories and the United States, have cautioned that tokens may well be securities and thus subject to securities regulation, a determination that is fact specific. See Canadian Securities Administrators Staff Notice 46-307 — *Cryptocurrency Offerings* and our publication available on blg.com.

Many in the blockchain community are searching for solutions and practical ways to undertake ICOs without incurring substantial compliance costs in connection with securities regulations, so as to not constrain innovation and the anticipated benefits that cryptocurrencies and blockchain technology offer developers, participants and investors. One of the proposed (although not fully developed) solutions being used in Canada, the United States and elsewhere is known as the SAFT framework.

What is a SAFT?

SAFTs are based loosely on the Simple Agreement for Future Equity, or "SAFE", another fairly recent creation of the start-up world. A SAFE is a simple standardized agreement that resembles a traditional convertible note that can convert into equity of a company. It attempts to streamline the capital-raising process by addressing some of the drawbacks associated with using convertible notes, such as the time it takes to draft and negotiate the complex deal terms. However, while a SAFE offers equity in exchange for an investor's early-stage investment, the SAFT comes with a promise to provide functional future tokens at a fixed price to be delivered to the investor once the developer's proposed blockchain project is operational.

Why are SAFTs Used?

SAFTs are used by early-stage developers that have not yet launched their blockchain project to raise funds, which are then used to develop (or further develop) the project. The SAFT framework replaces a direct presale of tokens via an ICO and allows a developer to obtain funding for its blockchain project in a manner that is compliant with existing securities laws, and is intended to permit the resulting functional tokens created in connection with the project to be put into operation without falling under the definition of a security.

The SAFT framework is not intended to be used for all tokens. Rather, SAFTs are tailored for those developers offering "utility tokens" or "user tokens" for use in connection with their blockchain projects. As noted above, utility tokens are likely to constitute securities in their "pre-functional" form, particularly where they are used to raise capital. They are created to provide users of a developer's project with access to the developer's product or service and, in contrast to traditional securities, have a consumptive use as part of the blockchain project. In other words, the utility tokens possess certain consumptive or redemptive qualities.

How do SAFTs Work?

To understand how the SAFT framework works, it is important to first look at how Canadian courts have defined when an investment vehicle will be considered an "investment contract" and, therefore, a security. In *Pacific Coast Coin Exchange v. Ontario Securities Commission* [1978] 2 SCR 112 ("*Pacific Coast*"), the court adopted

the following test for determining if there is an investment contract, noting that an investment contract exists when there is: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profit; and (4) that comes significantly from the efforts of others.

Accordingly, a fully-functional utility token may not meet the Pacific Coast test of an investment contract if the network on which the token may be used has been fully developed and the expectation of an increase in value of the token is not attributable to the further development efforts of the issuer or others. On the other hand, a "pre-sale" of pre-functional utility tokens is likely to result in the tokens being considered securities if they are being distributed to raise funds for the development of the project.

If funds are raised for the completion of a developer's non-functional project through the distribution of pre-functional utility tokens, the tokens will likely only have value or show an increase in value upon the project being launched and becoming functional. In that case, the value of the token will be based on the efforts of the developer (*i.e.* the "efforts of others") satisfying the *Pacific Coast* test for an investment contract, and leading to the determination that the token constitutes a security. Thus, notwithstanding that a developer offering utility tokens may not intend for its utility tokens to be considered securities, if such utility tokens are sold in a direct presale ICO that is intended to raise funds from investors expecting to profit from an increase in the value of their tokens, the sale of the utility tokens is likely subject to securities regulation. This is where the SAFT framework becomes useful as an instrument to allow accredited investors and other investors in the exempt market to enter into an agreement to acquire tokens pursuant to which the investor pays the issuer the full amount of the subscription funds up front and the issuer agrees to distribute the tokens to the investor upon completion of the network at the time of its launch.

Typically SAFTs meet the *Pacific Coast* test for an investment contract. SAFTs are intended to be sold to qualified investors as a security under a prospectus exemption (*i.e.* to accredited investors or to purchasers under the "offering memorandum" exemption), as would be the case with any other security (unless the developer is willing to file a prospectus for the sale of the security).

However, SAFT proponents suggest that the functional utility tokens that are received upon conversion of the SAFT once the blockchain project is operational may not meet the definition of an investment contract in *Pacific Coast* and therefore are not securities. By creating a separate investment vehicle (*i.e.* the SAFT), the intention is to separate the utility token from any pre-launch determination of whether the utility token is or is not a security.

SAFT proponents advocate that the utility tokens are not being distributed as a funding mechanism, so any tokens created in connection with the developer's blockchain project in the future would not meet the third part of the test in *Pacific Coast*. The theory here is that it is the SAFT that is sold with the "expectation of profit", not the underlying utility token. Generally, Canadian securities laws would permit the subsequent distribution on a prospectus-exempt basis of tokens pursuant to the terms of a SAFT that is sold to an investor in reliance upon a prospectus exemption.

Additionally, since the utility tokens are not offered to SAFT holders until the blockchain project is functional, SAFT proponents argue that the developer has already expended

the significant effort required to make the project functional. This means the utility tokens should not meet the fourth part of the *Pacific Coast* test because, at that point, it is no longer the efforts of the developer driving the value or price of the token, rather it is the market forces of supply and demand as they relate to the project and the corresponding utility token.

So what about the resale of utility tokens for a profit on the secondary market? Surely, SAFT purchasers purchase SAFTs for the purpose of reselling some of their tokens, when functional, on the secondary market. SAFT proponents suggest that this should not defeat the SAFT framework, noting that any secondary market for fully functional utility tokens is not unlike the market for commodities. Any purchaser of a utility token expecting to profit from an increase in value on the secondary market is likely influenced by a whole host of factors, not unlike those that affect other commodities. As the developer has already spent the effort to make its project and corresponding utility token functional, SAFT proponents suggest that any “efforts of others” in the secondary market should not outweigh the other factors that impact the markets for other commodities. To be sure, Canadian securities regulators have not ruled on this specific issue at this time and further consideration and analysis would be required on a case-by-case basis in order to make a determination of whether or not a functional utility token constitutes a security.

Issues with the SAFT Framework

Despite the potential of the SAFT framework, it has a number of weaknesses. The market for SAFTs is limited, since most SAFTs likely fall within the definition of securities. This means SAFTs can only be offered to investors under an existing prospectus exemption (unless the developer is willing to file a prospectus), which limits the potential investor pool that a developer can access and subjects the SAFTs to the corresponding restrictions on trading and resale. This eliminates some of the appeal of conducting an ICO, since the majority of the investing public is precluded from participating in the initial distribution of the SAFTs.

Another risk associated with the SAFT framework is that the test in *Pacific Coast* is highly context specific. Certain facts may cause an already-functional utility token to meet the definition of a security, despite the fact that it was never intended for that to be the case. As an example, suppose that a developer developed its blockchain project when the project’s already functional tokens were issued, but promised to increase the project’s sophistication in the future through further enhancements. In this case, a purchaser of the utility tokens (through a SAFT or on the secondary market) that is looking to profit may still be substantially relying on the "efforts of others" (*i.e.* the efforts of the developer) if he expects to profit from the increase in the project’s increasing functionality and sophistication. Accordingly, a developer may wholly comply with the SAFT framework, but still end up having its utility tokens deemed to be securities by the regulators, ending up in the same position that the developer would have been in had it completed a direct presale of tokens via an ICO in accordance with existing securities regulations.

Ultimately, we need to be mindful of the application of Canadian securities laws where a fully functional token that is sold to an investor pursuant to a SAFT is considered by securities regulators to continue to be a security despite its value being attributable to market forces and not to be dependent on the efforts of the developer or others. In

those circumstances, the "tokenized security" will be subject to resale restrictions in Canada for an indefinite period of time pursuant to National Instrument 45-102 — *Resale of Securities* assuming the issuer has not filed a prospectus and become a reporting issuer. This means that the investor may not resell the token except in reliance upon a prospectus exemption. For example, the investor may sell his token to another accredited investor without filing a prospectus but it will be unable to sell the token on a market or freely to others.

The further question arises of any restrictions faced by the investor holding a "tokenized security" in its ability to sell the token outside of Canada, whether the sale is to a person outside Canada or the sale takes place on a market outside Canada. This is the subject of an evolving body of rules (particularly in Ontario) that are applicable to all securities, not specific to tokenized securities and their application to digital assets will be examined in further publications.

Conclusion on SAFTs

The SAFT framework has the potential to be a unique approach to addressing some of the overarching securities laws issues surrounding pre-sale token ICOs, but it is not a one-size fits all solution. Whether the SAFT framework actually takes hold and becomes more widely accepted is uncertain, and will be determined as regulators continue to develop their positions on ICOs. For the time being though, the SAFT framework is a good starting point in the broader discussion of the application of the securities regulatory framework to a new and revolutionary technology.

Contact Us

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