

CSA REINFORCES POSITION THAT SECURITIES LAWS APPLY TO CRYPTOCURRENCY OFFERINGS, CONFIRMS REGULATORY SCRUTINY FOR INDUSTRY PARTICIPANTS

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Introduction

On June 11, 2018, the Canadian Securities Administrators (the “**CSA**”) published CSA Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens* (the “**Staff Notice**”) providing regulatory guidance on token and coin offerings.

The Staff Notice builds on CSA Staff Notice 46-307 – *Cryptocurrency Offerings* (“**SN 46-307**”). In SN 46-307, the CSA stated its view that cryptocurrency offerings, including initial coin offerings (“**ICO**”) and initial token offerings (“**ITO**”), may involve an offering of securities and therefore may trigger prospectus or registration requirements under applicable securities laws. However, SN 46-307 did not provide much practical guidance to businesses that were contemplating completing an ICO/ITO on when such offerings would constitute the sale of securities. In particular, SN 46-307 did not directly address the concept of “utility tokens”, an industry term commonly used to describe a sub-set of tokens which have one or more specific functions, such as allowing its holder to access or purchase services or assets based on blockchain technology.

The Staff Notice offers some practical guidance on two primary issues relating to crypto-offerings: (i) when an ICO/ITO may constitute an offering of securities and therefore, trigger the application of securities laws; and (ii) ICOs/ITOs structured in multiple steps.

When an ICO/ITO may involve an offering of securities

An ICO/ITO may involve the distribution of securities if: (i) it involves the offering of “investment contracts”; and/or (ii) the tokens that are offered are otherwise considered securities under the broad definition of a “security”. A token may constitute an “investment contract” (and accordingly, a security) by virtue of the presence of the following elements:

- an investment of money;
- in a common enterprise;

- with an expectation of profit;
- coming significantly from the efforts of others.^[1]

To determine whether an offering of tokens involves an offering of investment contracts, the CSA will focus on not only the technical characteristics of the token, but the economic realities of the offering as a whole, with focus on substance over form. The Staff Notice provides non-exhaustive examples of situations that may indicate the presence of one or more elements of an investment contract including^[2]:

- *tokens are not immediately delivered to purchasers*: Purchasers may not be purchasing tokens because of their immediate utility but because of profit expectations. Additionally, a “common enterprise” may be present because of the purchaser’s reliance on management to deliver the tokens;
- *the stated purpose of the offering is to raise capital to be used to perform key actions related to supporting the value of the token, the issuer’s business, or the platform’s usability*: These statements may indicate an expectation of profit and the presence of common enterprise;
- *the issuer suggests that the tokens will be used as a currency or have utility beyond the issuer’s platform but the issuer is not currently able to demonstrate the wide use or acceptance of the token*: A “common enterprise” may be present because of the purchaser’s reliance on management to deliver the tokens;
- *the issuer’s management representing expertise that will increase the token’s value*: These statements may indicate common enterprise via reliance on management and an expectation of profit derived from that expertise;
- *a finite number of tokens*: may indicate an expectation of profit as token value may rise if demand increases in relation to the fixed supply;
- *tokens are sold at a value disproportionate to their purported utility*: may indicate that the tokens’ real value is in the expectation of profit from resale;
- *marketing of the offering is targeted to persons who would not reasonably be expected to use the issuer’s product, service, or app*: indicating the motivation of purchase is profit and not usage of the product, service, or app;
- *statements of management suggesting that the tokens will appreciate in value or comparing them to other cryptocurrencies that have increased in value*: indicative of an investment thereby creating an expectation of profit. In contrast, to the extent management clearly promotes the utility of the token and not its investment value, the implication that purchasers have an expectation of profit may be reduced; and
- *tokens are reasonably expected or marketed to trade on one or more cryptoasset trading platforms including decentralized or “peer-to-peer” trading platforms or to otherwise be freely tradable in the secondary market*: the CSA states that to determine whether tokens are reasonably expected to be

subject to secondary trading, they consider all representations made formally and informally by the issuer including through social media. Considerations are also given to representations by third parties that are endorsed by the issuer.

Offerings of tokens structured in multiple steps

The CSA also acknowledges consistent with their focus on substance over form that the occurrence of ICOs/ITOs occurring in multiple steps may trigger the applicability of securities laws. Specifically, where the offering has been structured on the following basis: (i) the purchaser agrees to contribute money in exchange for a right to receive tokens at a future date and the tokens are not delivered at the time of purchase (often completed via a “simple agreement for future tokens” or “**SAFT**”); and (ii) the token is delivered later than the time of purchase. At the time of delivery, the token issuer typically represents that the software, online platform or app is built, that services are now available or that the tokens are now functional. In relation to such offerings, the CSA states:

- the token delivered at a second or later step may be a security and will be subject to further assessment, including a consideration of the elements set out above;
- the distribution of the security is subject to prospectus or exemption requirements;
- a person or company in the business of trading securities is subject to the dealer registration requirements;
- if the distribution at the first step is made without compliance with securities law, the issuer remains in default of securities law despite the occurrence of subsequent steps; and
- the CSA has concerns where a multiple step transaction structured to attempt to avoid securities legislation.

Compliance and enforcement

Businesses should note that the CSA is conducting active surveillance of coin and token offerings and intend to continue to take enforcement action against non-compliant businesses. To ensure regulatory compliance, the CSA encourages businesses with proposed ICOs/ITOs to consult legal counsel and to contact their local securities regulatory authority to discuss their project. Finally, the CSA promotes the “Regulatory Sandbox”, its initiative supporting fintech businesses seeking to offer innovative products, services, and apps by allowing firms to register and/or obtain exemptive relief from securities laws under a faster and more flexible process than the standard application. Applications are analyzed on a case by case basis. A list of firms that have been authorized in the CSA Regulatory Sandbox is available on the [CSA website](#).

Conclusion

The Staff Notice makes it clear that utility tokens may constitute “investment contracts” depending on the economic realities of the offering as a whole. Accordingly, businesses should complete a meaningful analysis of any proposed ICO/ITO to ensure that the business goals of such offering are achieved in compliance with applicable securities laws.

Please contact a member of McMillan’s Capital Markets Group if you have any questions, are seeking assistance with an ICO/ITO, or wish to seek exemptive relief in relation to an offering via the CSA Regulatory Sandbox.

by Raj Dewan, Jeffrey Gebert, Alex Bruvels and Joseph Osborne, Student at Law

[1] See, for example: *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 SCR 112.[ps2id id='1' target=""]

[2] Refer to the Staff Notice for the complete list of situations outlined by the CSA that may be indicative of the existence of one or more elements of an investment contract and associated implications.[ps2id id='2' target=""]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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