

# MCMILLAN ADVISES ON FIRST INITIAL COIN OFFERING GRANTED EXEMPTIVE RELIEF BY CANADIAN SECURITIES REGULATORS

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McMillan recently advised Impak Finance Inc. (“**Impak**”) on the first initial coin offering (“**ICO**”) to be granted exemptive relief, on August 15, 2017 by the Autorité des Marchés Financiers (the “**AMF**”). Similar in some ways to an initial public offering (“**IPO**”), ICOs are being used by financial technology (“**fintech**”) businesses to issue cryptocurrency and raise funds for various purposes. On August 24, 2017, the Canadian Securities Administrators (the “**CSA**”) published *CSA Staff Notice 46-307 – Cryptocurrency Offerings* (the “Staff Notice”) to provide guidance on the applicability of securities laws to ICOs. The Staff Notice states that securities laws will apply to an ICO if it is an offering of a “security”.<sup>[1]</sup> The Staff Notice was published in all jurisdictions of Canada except Saskatchewan. It is expected that the Financial and Consumer Affairs Authority of Saskatchewan will advise of its approach to cryptocurrency after September 7, 2017.

## Background

### **What is a cryptocurrency?**

A “cryptocurrency” is a digital currency that is exchanged electronically. The cryptocurrency itself is represented by virtual ‘coins’ or ‘tokens’. Unlike fiat currency which is issued by a government body, cryptocurrency is not issued by a central authority. At a basic level, cryptocurrencies are just entries on a distributed ledger with account numbers and balances (known as a “**blockchain**”). All transactions are recorded on the blockchain. There is no central authority keeping track of the blockchain – it is decentralized. Any user can keep track of the blockchain. To this end, the integrity of the blockchain is upheld by virtue of the many users keeping track of the same blockchain.

When users exchange cryptocurrency, a sender will send out a transaction message to the entire peer-to-peer network of computers (known as “**nodes**”) including: (1) the sender’s account number, (2) the recipient’s account number and (3) the amount of cryptocurrency exchanged. As new transactions are created, the transactions go into a pool of pending transactions waiting to be verified by a node (known as a “**miner**”). Miners select a set of transactions (known as a “**block**”) from the pool and compete to add the transactions to

the blockchain.

The miners will validate the transaction message to determine that the request is authentic and that the sender's account holds a sufficient amount of cryptocurrency to satisfy the transfer. Every account number is associated with a 'private key' (only known to the account holder) and 'public key' available to all the nodes. The private key is used to create the 'digital signature' by encrypting the transaction message. The miners test the digital signature using the associated public key and try to decrypt it. If successfully decrypted, this proves that the digital signature was created by the true account holder.

Miners compete to solve a complex mathematical problem known as a 'hash function'. The hash function is extraordinarily special in that there is no trick to solving it faster, other than by increasing computing power. The first miner to solve the hash function gets to add their block of transactions to the end of the blockchain and all other miners update to this new version of the blockchain. The transaction is settled once it is added to the blockchain. Thereafter, a new hash function is created and the process repeats.

Miners incur great costs to build computers to solve the hash functions. The miners are incentivized to do this because every time a miner adds a new block of transactions to the blockchain, the miner is rewarded with a certain number of newly-issued cryptocurrencies.

### **What is an ICO?**

Similar to an IPO, an ICO or initial token offering ("**ITO**") is a means by which fintech businesses raise funds for a new cryptocurrency venture. In an ICO or ITO, an investor exchanges fiat currency or another type of cryptocurrency for coins or tokens issued by the company. These coins or tokens can have different functions. For example, Impak released a new digital currency is to be used in the Impak's own platform, *impak.eco*. Investors then use the coins to participate in the impact economy, and donate to projects that have a positive impact on society.

### **Cryptocurrencies and CSA Staff Notice 46-307**

The legislative scheme used by securities regulators in Canada is a 'catch-then-exclude' mechanism whereby a security is defined broadly to catch all transactions and then exemptions carve-out situations where regulation is not justified. Cryptocurrencies may be characterized as an 'investment contract' and thus may be caught within the definition of a security.

The CSA published the Staff Notice on August 24, 2017 addressing ICOs/ITOs. While there are technical differences between coins and tokens for the purposes of the Staff Notice, coins and tokens are treated similarly, as the analysis focused on the triggering of securities laws in Canada. The Staff Notice encouraged ICOs/ITOs but raised investor protection concerns due to issues around volatility, transparency and the

potential for cryptocurrencies to be used in unethical practices or illegal schemes.

The Staff Notice states that ICOs/ITOs are similar to IPOs in many ways. The coins/tokens can be analogized to shares of a company because the value of a coin/token may increase or decrease depending on the success of the business conducting the ICO/ITO.

### **The Test**

In determining whether or not an 'investment contract' exists, the Staff Notice advised that businesses should apply the following four-prong test from the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*<sup>[2]</sup> to determine whether the ICO/ITO involves:

1. an investment of money
2. in a common enterprise
3. with the expectation of profit
4. to come significantly from the efforts of others?

The Staff Notice stated that, in many cases, when the totality of the offering or business is considered, cryptocurrencies should properly be considered securities. However, the Staff Notice stated that every ICO/ITO is unique and must be assessed on its own characteristics.

If a cryptocurrency offering is considered an offering of securities, the business conducting the offering will need to meet the prospectus, registration and/or market place requirements.

### **Prospectus**

To date, no business has used a prospectus to complete an ICO/ITO in Canada. The CSA anticipates that businesses looking to sell cryptocurrencies may do so under prospectus exemptions such as the 'accredited investor' exemption or the 'offering memorandum' exemption.

The CSA is aware that some fintech businesses publish 'whitepapers' with respect to their ICOs/ITOs. Although whitepapers are a form of disclosure document for investors, they often do not meet the specific disclosure requirements to be properly considered a prospectus/offering memorandum. It is important to note that investors can sue for misrepresentation in the prospectus/offering memorandum and investors may have civil remedies against fintech businesses failing to comply with the securities laws.

### **Registration**

Businesses completing ICOs/ITOs may be trading in securities for a business purpose (the "**business trigger**"), which would therefore require dealer registrations. Fintech businesses that meet the business trigger must

meet certain obligations to investors, including the know-your-client requirement (“**KYC**”) and the suitability requirement. These obligations may require businesses conducting ICOs/ITOs to collect information regarding an investor’s identity, investment objectives and risk tolerance. The Staff Notice acknowledged that it is possible to fulfill the KYC and suitability obligations through an automated online process.

### **Marketplace**

The exchanges upon which cryptocurrency can be bought and sold often operate without oversight or regulation, and can be found around the world. A cryptocurrency exchange that offers cryptocurrencies that are securities must determine whether it is a marketplace. If the exchange is doing business in a jurisdiction in Canada, it must apply to that jurisdiction’s securities regulatory authority for recognition or an exemption from recognition.

The Staff Notice states that fintech businesses should seek legal and/or other professional advice to assess whether or not securities laws apply to avoid placing the ICO/ITO offside securities laws. For example, coins or tokens that constitute securities being used to trade on cryptocurrency exchanges could result in the issuer violating restrictions on secondary trading pursuant National Instrument 45-102 *Resale of Securities*.

### **Cryptocurrency Investment Funds**

The CSA is also aware of ‘investment funds’ as defined under securities laws being set up to invest in cryptocurrencies. The Staff Notice encouraged fintech business looking to establish cryptocurrency investment funds to consider the following:

1. prospectus requirements, as well as investment fund rules and the suitability of the investment,
2. due diligence on any cryptocurrency exchange that the investment fund uses to purchase or sell cryptocurrencies, specifically looking at the policies and procedures around identity verification, anti-money laundering, counter-terrorist financing and recordkeeping,
3. appropriate registration requirements,
4. valuation methods used to value the cryptocurrencies in the investment fund’s portfolio, and
5. expertise of custodians holding portfolio assets to ensure expertise are relevant to holding cryptocurrencies.

With respect to the expertise of custodians, the CSA provided guidance in the form of a non-exhaustive list of items as to what expertise may be required of custodians dealing with cryptocurrency, including experience with hot and cold storage, experience with security measures to protect the cryptocurrency from theft, and the ability to segregate cryptocurrency from other holdings as needed.

### **CSA Sandbox**

The recently launched CSA Sandbox is an initiative to support fintech businesses seeking to offer innovative products, services and applications in Canada. The CSA Sandbox allows businesses to register and/or obtain exemptive relief from securities requirements, under a faster and more streamlined process than through a standard application.

### **Conclusions from the Staff Notice**

While acknowledging the emergency of a new mechanism for capital raising, the Staff Notice provided issuers of cryptocurrency with a warning that their activities may violate prospectus requirements, registration requirements, and the general disclosure requirements that were created to protect investors in capital markets. While regulation of cryptocurrency remains in its infancy, increased scrutiny of transactions involving the issuance of virtual coins or tokens is expected to ultimately bridge a regulatory scheme for such cryptocurrency in line with securities requirements.

### **The Impak ICO**

McMillan recently acted for Impak in its CSA Sandbox application for exemptive relief with respect to Impak's ICO. Pursuant to its ICO, Impak proposes to issue a new digital currency (known as "MPK") to fund the development of an online social network by way of a private placement in reliance on the offering memorandum exemption.

In consultation with the other members of the CSA Sandbox, the AMF granted Impak exemptive relief from the dealer registration and prospectus requirements in connection with proposed MPK ICO. The AMF stated that, in the absence of a prospectus relief, the first trade of MPK will be a distribution.

The AMF granted the registration relief under the following conditions:

- Impak will conduct KYC and suitability reviews and verify accredited investors,
- Impak will not provide investment advice to investors,
- Impak will deal fairly, honestly and in good faith with its investors, and
- Impak will establish procedures to manage the risks associated with its business.

The AMF stated that the prospectus requirement will apply to a first trade in MPK, unless the first trade is made between an Impak user and an impact organization (i.e., businesses, non-governmental organizations, not-for-profit corporations and social enterprises) in either of the following cases:

- (i) an Impak user pays in MPK for goods and services offered by an impact organization, or
- (ii) an impact organization rewards the Impak user for such purchase.



The AMF also imposed the following conditions:

- Impak will make certain quarterly information reasonably available to participants,
- MPK issued in the ICO will not be listed and traded on any exchange, and
- Impak will provide the AMF with any report or information that may be requested.

In addition to the Provinces of Quebec and Ontario, and in reliance on *Regulation 11-102 respecting Passport System*, the AMF's decision is intended to be relied upon in British Columbia, Alberta, Saskatchewan, Manitoba, New Brunswick, and Nova Scotia. The AMF's decision document has been published as of August 15, 2017, and can be under the following link: [Impak Finance Inc.](#)

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[1] Securities Act, RSO 1990, c S.5, s 1.[ps2id id='1' target='']

[2] (1977), [1978] 2 SCR 112, 80 DLR (3d) 529.[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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