

NFTS AND IMPLICATIONS UNDER CANADIAN SECURITIES LAW

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Non-fungible tokens (“**NFTs**”) are a type of digital asset that uses blockchain technology to provide real world objects with unique identification codes and metadata.

Non-fungible means that NFTs are unique and distinct. Each NFT has its own identifying code that certifies its uniqueness and authenticity. As a result, NFTs are not interchangeable. An NFT’s distinctiveness is what differentiates it from other cryptocurrencies such as Bitcoin, which are identical and can be easily exchanged.

Currently, most NFTs are created using the Ethereum blockchain but the number of blockchains that support NFTs is growing. Creators can also mint the tokens to allow the issuer to receive a share of the proceeds every time it is sold in the future.

Different Uses of NFTs

NFTs can have an abundance of different uses. To date the biggest market for NFTs has been collectibles such as digital artwork, sports highlights and video game skins. NFTs can also certify the ownership of physical assets (such as limited edition sneakers, real estate and automobiles).

More recently, there has been a growing trend to issue fractionalized NFTs. Fractionalizing NFTs allows buyers to purchase a percentage of the full NFT. It also allows owners of NFTs to receive some liquidity from the token without having to sell it in its entirety.^[1] Several NFT trading platforms have emerged to help facilitate the creation, sale and trade of NFT fractions.

Regulation of NFTs in the United States

At the time of this publication, we have been unable to locate any decision which considers the regulation of NFTs in Canada or the United States.^[2] Before considering the landscape in Canada, we first offer a Canadian (and thus simplified view) of the United States securities framework that may apply to NFTs.

The *Securities Act* of 1933 and the *Securities Exchange Act* of 1934 have broad definitions for “security”. Those definitions include a number of popular instruments such as stocks, bonds and investment contracts.

The “Howey Test” arises from the 1946 Supreme Court of the United States decision in *Securities and Exchange Commission v. W. J. Howey Co.*^[3] This test is commonly applied to determine whether a transaction

constitutes an “investment contract” and is therefore regulated as a security under the *Securities Act* and the *Securities Exchange Act*. The framework known as the Howey Test considers:

1. Has there been an investment of money or assets?
2. Does the investment of money or assets involve a common enterprise?
3. Is there a reasonable expectation of profit?
4. Does any profit come from the efforts of a promoter or third party?[4]

The United States courts may also consider the “family resemblance” test established by the United States Supreme Court in *Reves v. Ernst & Young*. [5] The family resemblance test asks whether an instrument resembles a security based on four factors:

1. whether there is motivation to profit;
2. whether the plan of distribution resembles common trading for speculation or investment;
3. whether the investing public reasonably expects that the instrument is a security; and
4. whether there is another regulatory scheme that protects the investor.

Due to the lack of direct guidelines relating to NFTs, a registered broker-dealer sent a petition to the SEC in April 2021 requesting that the SEC publish a concept release on the regulation of NFTs and propose rules to address when NFTs are securities. The petition differentiated between collectible and fractionalized NFTs, suggesting the latter was more likely to qualify as a security. [6]

The petition echoed unofficial comments made by the SEC’s Commissioner Hester Pierce who warned people to be cautious selling fractionalized NFTs. She pointed out that the main concept of NFTs is that they are non-fungible and therefore less likely to be a security. However, she added that whether NFTs qualify as securities would largely depend on their use. The SEC’s view appears to be that since NFTs lose their uniqueness when they are fractioned, they are more likely to qualify as “securities”. [7]

Possible Treatment of NFTs in Canada

American securities jurisprudence may be a useful source of persuasive authority in some cases. Ontario’s Court of Appeal has recently held, however, that it is not necessary or advisable to import the family resemblance test into the definition of security in the Ontario context. [8]

The Ontario *Securities Act* is a “catch and exclude” scheme whereby it defines key terms very broadly, and thereby captures broad conduct and then provides for many exemptions. As such, it is unlikely that the American general interpretive laws above will alone provide sufficient legal guidance to dictate the degree to which NFTs will be regulated as securities in Ontario or indeed other Canadian provinces.

In 2018, the Canadian Securities Administrators (“**CSA**”) issued Staff Notice 46-308: Securities Law Implications for Offering Tokens. The Staff Notice provided insight into when an offering of tokens may constitute a distribution of securities. The CSA stated that when offering tokens, businesses should consider whether the tokens constitute investment contracts by considering whether the offering of tokens 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^[9]

These factors were applied by the Supreme Court of Canada many years ago in *Pacific Coast Coin Exchange*^[10] in determining whether a transaction was an investment contract. That case concerned selling bags of silver coins on margin, which the courts held in those circumstances involved commodity account agreements that were investment contracts. Among other things, the Supreme Court considered the Howey Test.

In the Staff Notice, the CSA claimed that NFTs are unlikely to be interpreted as investment contracts since they fail to meet the second (common enterprise) and fourth (efforts of others) branches of the test. However, the CSA highlighted that its views should not be interpreted as determinative.

That was then and this is now. The CSA Staff Notice does not include consideration of the fractionalization or recently high-profile nature of some NFT sales. This leads to interesting and unresolved questions under Canadian law. Would fractionalization impact whether NFTs are held to be securities, as the SEC’s Commissioner suggests? Do certain market activities impact whether creators are in a common enterprise or dictate that NFTs involve profit from the efforts of others?

Recent enforcement action taken by the Ontario Securities Commission (“Commission”) in the blockchain and digital asset space has focused on cryptocurrency asset trading platforms. The most recent proceeding commenced at the Commission concerns a Seychelles-based cryptocurrency trading platform which allegedly focuses on the availability of instruments or contracts related to cryptocurrency assets and crypto asset futures.^[11] These actions tell us little about the Commission’s views or intentions with respect to enforcement in relation to NFTs.

A Jurisdictional Issue?

There are other issues with enforcement regarding NFTs, aside from the issue of whether or not they meet the definition of “security”. Another challenge that any Canadian regulator may have concerning any NFT-related enforcement action would be that of jurisdiction. The Commission’s proceedings commenced in relation to

cryptocurrency trading platforms, for example, purport to be jurisdictionally anchored through sales to Ontario investors. These are instances with established businesses trading in significant volumes in one jurisdiction.

But what of small-scale NFT transfers? Of ten editions of a piece of digital art? Even if Canadian regulators were to take an affirmative view that NFTs are securities, what is the value of enforcement in relation to one foreign-based transaction? Or ten? It would not appear that most investor protection goals would be furthered by such narrow enforcement steps. That said, is there a point at which NFT activity will result in regulators feeling compelled to act as a warning signal, regardless of legal certainty, perhaps after a high-profile investor loss?

McMillan has been a market leader in resolving Ontario cryptocurrency-related enforcement actions in Canada. It has acted for a number of entities in digital asset regulatory and enforcement matters, including disputes resolved without the commencement of contested proceedings. As may be inferred from the above, the application of Canadian securities law to blockchain technology and digital assets will not necessarily mirror that in other nations. Our team has the experience and expertise to explore with technology clients how the Canadian legal landscape may apply to their business.

[1] For example, some musicians have started using fractionalized NFTs to sell a [percentage of their songs' copyright royalties](#).

[2] There have been a number of other SEC [proceedings](#) and [investigations](#) regarding digital assets and initial coin offerings but none on NFTs in particular.

[3] *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946).

[4] U.S. Securities and Exchange Commission, "[Framework For "Investment Contract" Analysis of Digital Assets](#)" (3 April 2019). SEC v W.J. Howey Co, (1946) 328 US 293. (Howey Test)

[5] *Reves v. Ernst & Young*, 494 U.S. 56 (U.S. Ark. S.C. 1990).

[6] Vicent R Molinari, "[Rulemaking Regarding Non-Fungible Tokens](#)" (12 April 2021).

[7] Sophie Kiderlin, "[The SEC's 'Crypto Mom' Hester Peirce says selling fractionalized NFTs could be illegal](#)" (26 March 2021).

[8] *Ontario Securities Commission v. Tiffin*, 2020 ONCA 217.

[9] Canadian Securities Administrators, "[Staff Notice 46-308: Security Law Implications for Offering Tokens](#)" (11 June 2018).

[10] *Pacific Coast Coin Exchange v Ontario (Securities Commission)*, [1978] 2 SCR 112.

[11] *In The Matter Of Polo Digital Assets, Ltd.*, File No. 2021-17.

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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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