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CSA Offers Tips for Token Offerings: Direction or Deterrence?

Authors: Robert S. Murphy, Zain Rizvi, Ghaith S. Sibai and Geoffrey L. Rawle

The Canadian Securities Administrators (CSA) has published CSA Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens* (2018 Notice). Released on June 11, 2018, it provides some long-awaited clarity on the CSA's view on token offerings, commonly known as initial coin offerings (ICOs). While much of the guidance will be familiar to those in the crypto community, the 2018 Notice is encouraging in that it shows the CSA is closely watching industry developments. However, the 2018 Notice falls short of offering a clear path for future ICOs and remains a step behind the recent statements of U.S. Securities and Exchange Commission (SEC) staff regarding its intended treatment of past ICOs.

The CSA Censures Capital Raising ICOs

This is the second pronouncement from the CSA on the application of securities laws to token offerings and comes over a year after the release of CSA Staff Notice 46-307 – *Cryptocurrency Offerings* (2017 Notice). As noted in our commentary at the time, the 2017 Notice sketched out a framework of the CSA's views on the applicability of securities laws to token offerings and indicated that such offerings would be assessed on a case-by-case basis; the regulatory concern being whether a coin or token constituted an "investment contract" to which Canadian securities laws would apply. However, the 2017 Notice primarily discussed when Canadian securities laws may apply and did not provide direction on what sort of offerings would not be subject to the regime, other than providing a narrow example of a token used to play a video game.

By contrast, the 2018 Notice specifically addresses the key industry concept of a "utility token": that is, a token that has one or more specific functions, such as allowing its holder to access or purchase services or assets based on blockchain technology. Many in the crypto community have argued that utility tokens belong outside the purview of securities laws. The 2018 Notice identifies 14 common features of token offerings and how each affects the analysis under the investment contract test. The guidance applies technical concepts in a manner that should serve to eliminate at least some of the regulatory uncertainty for participants operating in this space. Below are some of the key takeaways from the 2018 Notice.

"Utility" is not determinative. Over the last year numerous ICO issuers have claimed their tokens are "utility tokens" in an effort to avoid regulation under securities laws. However, the CSA has confirmed that the mere ability to use a token to access a blockchain platform, purchase a good or service or perform an advertised non-investment function is not determinative of whether an investment contract exists. If the purpose of an ICO or other offering is to raise capital, it suggests that an investment is being made in a developing business. But even if capital raising is not the stated purpose, the CSA's analysis will be one of substance over form, and it will assess the offering based on the economic realities underpinning the offering as a whole.

Emphasis on purchasers' expectations. Both the CSA and the SEC have stated that most of the token offerings they reviewed were, in fact, securities offerings. Given the general alignment of these regulators in their approach toward ICOs, it's not surprising that the 2018 Notice echoes recent SEC guidance – cautioning issuers against creating an expectation of profit in their structuring and marketing of token offerings. For example, marketing a token to individuals who could not be reasonably expected to benefit from its utility, or making public statements through formal or informal channels anticipating that a secondary market will develop or tokens will appreciate in value, will militate in favour of the token being characterized as a security. Earlier this year, we reported on similar developments in the SEC's recent enforcement action against non-compliant ICOs. Many of these were endorsed by the CSA in the 2018 Notice.

More "utility" than "security." One of the most useful sections of the 2018 Notice for entrepreneurs will be five mitigating characteristics of offerings that the CSA identifies as reducing the likelihood that a token is a security:

- offering tokens that have a fixed value that does not change based on non-commercial factors
- offerings where tokens are distributed for free
- offerings where the supply of tokens is continuous or unlimited
- offering tokens that are not fungible or interchangeable, where each token has unique characteristics
- offerings that clearly and uniformly promote the token based on its utility and not on its investment value

Airdrops and free token issuances. As discussed in our March 2018 article, token "airdrops" or distributions of free tokens have increased in popularity as a means to disseminate a token without an investment of funds having occurred. However, in the United States, commentators have said the submission of personal information (such as the name or email address of the purchaser) may nevertheless be characterized as an investment of value, resulting in the dissemination being an offering of securities. The 2018 Notice suggests that the CSA does not share this view where no investment of funds has occurred. That said, the CSA has noted that if free tokens are disbursed in connection with paid secondary or ancillary products or services, regulators may "look through" the token distribution to find that the requisite investment has occurred to categorize the transaction as an offering of securities.

Whitepaper-only offerings, pre-mining and finite supply. The 2018 Notice indicates that the CSA will look less favourably on offerings where token delivery is delayed or the underlying technology is still in development, as these characteristics likely reflect an element of speculation. The CSA cautions that the common enterprise branch of the investment contract test may be triggered where an identifiable central team is needed to manage, develop or maintain the platform, or a significant number of tokens are retained by management (for instance, where there is substantial pre-mining). In a broad statement, the CSA warns that any crypto assets with a finite or limited number of tokens may create an expectation that increased demand for tokens will increase the price of the tokens. Conversely, the CSA also cautions against permitting a purchaser to acquire more tokens than a user can reasonably use on the platform, which may lead to the conclusion that the tokens have been acquired for investment purposes rather than for personal use.

Decentralized exchanges and listings without consent. Tokens are often designed based on established standards, such as Ethereum ERC20. These tokens may be accepted for trading in secondary markets without the consent of the token's issuer. The CSA warns that an issuer's absence of control over secondary trading is generally not relevant in assessing whether purchasers expect a profit.

Tokens delivered through simple agreements for future tokens (SAFTs) may still be securities. In our March 2018 article, we discussed considerations with respect to multiple-step token offerings. The 2018 Notice confirms that structures such as SAFTs do not preclude characterization of tokens delivered in a second step as securities and that the CSA will conduct a securities law analysis regardless of whether a SAFT was used. In particular, the 2018 Notice states that the CSA "will have concerns where a multiple step transaction is used in an attempt to avoid securities legislation."

Recent SEC Developments: Once a Security, Always a Security?

On June 14, speaking at a cryptocurrency conference in San Francisco, William Hinman, Director of the SEC's Corporate Finance division, confirmed what cryptocurrency proponents had long asserted: that neither bitcoins nor Ethereum's ether tokens are securities. Hinman's published statements clarified the SEC's views on blockchain tokens: namely, that while such digital assets themselves are merely code, the way such assets are sold – if as part of an investment, to non-users or by promoters to fund an enterprise – may be indicative of an investment contract under the Howey test, a test articulated by the U.S. Supreme Court, holding that transactions that may be characterized as investment contracts are considered securities. Accordingly, such tokens fall under the purview of U.S. securities laws. However, Hinman went on to indicate that even where the initial issuance of a digital asset was considered a securities offering, once the network on which the token is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the digital asset may no longer be an investment contract. In this way,

the analysis as to whether a specific cryptocurrency is a security is not a static exercise and "does not adhere to the instrument itself," suggesting that, over time, a digital asset that was previously considered a security may stop being a security.

Given the past alignment of Canadian and U.S. securities regulators in their treatment of blockchain tokens, Hinman's statements may shed greater light on the types of ICOs the CSA will attempt to regulate. As the 2018 Notice indicates, CSA staff are actively reviewing ICOs to identify past, ongoing and potential future violations of securities laws. It will be interesting to see whether the CSA will also consider the decentralized nature of blockchain platforms that have previously issued tokens that may constitute securities, or whether a more heavy-handed approach to regulation will be taken than the approach seemingly employed by the SEC. Guidance on this important development would help provide Canadian innovations with the same regulatory advantages as their counterparts south of the border.

Key Contacts: Robert S. Murphy, Zain Rizvi, Elliot A. Greenstone and Brian Kujavsky