PUBLICATIONS

Canadian Securities Administrators provide new guidance on cryptocurrency offerings and approve exemptive relief for Canadian ICO

Securities and Corporate Finance Alert

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On August 24, 2017, Staff of the Canadian Securities Administrators (the "CSA") released CSA Staff Notice 46-307 - *Cryptocurrency Offerings*[1] ("Staff Notice 46-307"). Staff Notice 46-307 follows the report of the Securities Exchange Commission in the United States regarding tokens as securities, which used The DAO as the example for analyzing the issue (see our previous commentary), and the report of the Monetary Authority of Singapore issued on August 1, 2017.

Over the past year, we have seen a rapid increase in the number of clients approaching us to assist with initial coin offerings ("ICOs"), initial token offerings ("ITOs") and cryptocurrency investment vehicles, including cryptocurrency investment funds. ICOs and ITOs have now raised over US$1,200,000,000 and many commentators expect the market for these offerings to continue to grow.

Staff Notice 46-307 evidences the heightened concern from the CSA regarding cryptocurrency offerings, post-initial offering trading of cryptocurrencies, regulation of cryptocurrency markets and the activities of cryptocurrency investment funds. Although Staff Notice 46-307 was designed to provide securities law guidance to FinTech businesses and focuses on, among other things, ICOs and ITOs in the context of start-up businesses, it is equally applicable to established businesses (including non-FinTech businesses) that may be looking to raise non-dilutive capital or to obtain operational efficiencies through cryptocurrency offerings.

This client update is not intended to be an exhaustive review of Staff Notice 46-307; however, set out below are the key takeaways from Staff Notice 46-307 along with a review of the implications of the exemptive relief order granted to Impak Finance Inc. ("Impak") in connection with its initial coin offering by the CSA's regulatory sandbox (the "CSA Sandbox").

1. Many cryptocurrency offerings involve the sale of securities

The CSA confirmed (as anticipated) that many cryptocurrency offerings involve the sale of securities and are subject to existing securities laws.[2] The existing definition of a "security" for purposes of Canadian securities laws includes an "investment contract". The CSA indicated that many of the tokens and coins issued in the offerings it has reviewed are securities, including because they are investment contracts. The CSA confirmed that in arriving at its view it assessed the economic realities of each transaction and applied a purposive interpretation with the objective of investor protection in mind. For ITOs/ICOs that do not fit within the other categories of a "security", the CSA confirmed that in determining whether or not an investment contract exists, businesses should apply the following test: does the ICO/ITO involve (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation of profit, (iv) to come significantly from the efforts of others.

2. Substance over form

A "token" or a "coin" is not exempt from the application of securities laws simply because it does not fit within the traditional terminology used to denote accepted forms of securities. Each token or coin must be analyzed on its own merits to determine if it is a security. The CSA confirmed that in assessing whether or not securities laws apply, it will consider substance over form.

3. "Use" is not enough

A common misconception exists among many in the cryptocurrency space, namely that creating a token or coin with a "use" or "access" function will ensure that an offering of cryptocurrency does not implicate securities laws in Canada. This is something that we have been regularly addressing when dealing with clients; however, the CSA confirmed that marketing tokens/coins as software products (i.e. the "use" feature) will not necessarily be determinative of whether or not a particular token/coin is a security. The CSA did acknowledge that certain tokens/coins sold with a use or access function may be securities; however, each issuance will need to be considered based upon its characteristics as discussed above.

4. Scope of Canadian securities laws

The CSA confirmed that Canadian securities laws will apply if the person or company selling the securities is conducting business from within Canada or if there are Canadian investors.

5. Certain implications of securities laws

The CSA confirmed that businesses pursuing an ITO/ICO must be prepared to deal with fundamental securities law obligations (to the extent that securities are being offered), including the following:

- **Prospectus Requirements**: Generally, the sale of securities must be qualified by a prospectus or done pursuant to a prospectus exemption. The most common exemptions that are likely to be used in connection with sales of cryptocurrency are sales (i) to "accredited investors" for purposes of applicable securities laws, or (ii) to retail investors (that are not accredited investors) pursuant to the offering memorandum exemption available (the "OM Exemption") available in certain Canadian jurisdictions. Businesses and individuals that have distributed/sold tokens or coins that are securities without a prospectus or a prospectus exemption should be aware of this requirement and discuss how best to mitigate any existing and future risks with their legal advisors.
- **Registration Requirements**: Businesses completing ITOs/ICOs may be trading in securities for a business purpose and may be required to register or obtain an exemption from registration (see the discussion regarding Impak below) as a dealer or otherwise. A determination of whether or not registration is required depends on the factors of each ITO/ICO; however, the CSA indicated that it has found the following to be important considerations for whether a person triggers the registration requirement:
    - soliciting a broad base of investors, usually retail investors;
    - using the internet, including public websites and discussion boards, to reach a large number of potential investors;
    - attending public events, including conferences and meetups, to actively advertise the sale of the tokens/coins; and
    - raising a significant amount of capital from a large number of investors.

In the event that registration is required by applicable securities laws in connection with an ITO/ICO, the relevant businesses and/or individuals must satisfy obligations to investors, including know-your-client and investment suitability (i.e. is the investment suitable given the investor's investment needs and objectives, financial circumstances and risk tolerance); however, the CSA has acknowledged that this could be done through a "robust, automated, online process that incorporates investor protections".

6. White papers

It has become standard procedure for a business looking to pursue an ITO/ICO to publish a "white paper". A white paper typically describes the objectives of the business, the opportunity that the offering will address and the key terms of the offering (i.e. number of tokens/coins to be issued, amount held back, pre-sale discounts, Bitcoin/Ether to Fiat currency exchange calculation and similar matters).

If an ICO/ITO involves the distribution of securities, the white paper must comply with applicable securities laws. In particular, if the white paper is prepared in connection with an offering relying on the OM Exemption, it must include, among other things, disclosure around statutory rights given to investors (including rights to sue for damages and rights of rescission) and audited financial statements.

7. Cybersecurity and ICO/ITO infrastructure

Not surprising given recent circumstances where purchasers of tokens/coins lost their initial investment as a result of insufficient security and/or lack of monitoring, the CSA have indicated that persons or companies facilitating ITOs/ICOs must have strong compliance policies in place, including policies and procedures designed to address cybersecurity risks. Any business looking to outsource the technical support required to complete an ITO/ICO should ensure that sufficient diligence is conducted on the procedures put in place by its technical advisor(s). This is likely going to become a significant factor in whether registration relief can be obtained (see the discussion of Impak below).

8. Cryptocurrency exchanges

The CSA expressed various concerns regarding the lack of oversight and regulation on global cryptocurrency exchanges, including the fluctuations in pricing, extensive opportunities for arbitrage and various investor protection concerns. Cryptocurrency exchanges determine whether they are offering "securities" and, if so, register as a "marketplace" for purposes of applicable securities laws or obtain an exemption from registration. The CSA acknowledged that several jurisdictions have taken steps to impose requirements on cryptocurrency exchanges and we anticipate this trend to increase and the potential risks related to investing in or acquiring investments through unregulated cryptocurrency exchanges to increase.

9. Cryptocurrency investment funds

Staff Notice 46-307 identifies a few of the considerations that those looking to establish cryptocurrency funds should be aware of, including (i) the requirement to register in the appropriate registration category(ies) (i.e. dealer, adviser and/or investment fund manager), (ii) the requirement to complete due diligence on any cryptocurrency exchange that the fund may be investing in, (iii) valuation and audit considerations, and (iv) custodial issues given the security risks involved with cryptocurrency investments and the custody requirements applicable to investment funds.

CSA Sandbox exemptive relief

On August 16, 2017, the CSA Sandbox approved certain relief sought by Impak as evidenced in the decision of the Autorité des marchés financiers and the Ontario Securities Commission.

Impak is proposing to complete an ICO and issue Impak Coins using a digital currency through a third party's blockchain platform. The proceeds from the ICO will fund the "development of impak.eco, an online social network….dedicated entirely to the Impak economy". Transferability of the Impak Coins is fundamental as they are designed to have a "use" function given that they will be used by participants in the Impak economy as a method of paying participating merchants and to enable merchants to further incentivize participants to purchase goods and services from them.

The Impak coins are "securities" and, Impak was granted relief, subject to the conditions set out in the decision, (i) from the dealer registration requirement, and (ii) an exemption from the prospectus requirement on the first trade of Impak Coins on a limited basis such that the Impak Coins could be traded between participants and merchants in the Impak economy.

The relief granted to Impak is significant, particularly in light of Staff Notice 46-307 as it provides the first indication of the type of relief that securities regulatory authorities in Canada are likely to provide to facilitate ICOs/ITOs that are offering securities with a primary "use" or "access" function.

How DLA Piper can help

DLA Piper is a leading global law firm with over 90 offices in more than 40 countries, which uniquely positions us to assist with your ICO, ITO or other cryptocurrency fund or investment or your interest in distributive ledger technology. We can assist clients with all legal aspects that may become relevant in the global cryptocurrency market, including, among others, financial regulations, securities laws, tax structuring, intellectual property, sanctions and anti-money laundering and consumer protection legislation.

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[1] Staff Notice 46-307 was published in all Canadian jurisdictions other than Saskatchewan.
[2] The CSA also confirmed that many of cryptocurrency-related offerings may also be derivatives and subject to the derivatives laws, including trade reporting.

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