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Demystifying Crypto in Canada: Will 2018 Be the Year of Blockchain?

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The year 2017 was one of tremendous growth for blockchain, as the technology underlying Bitcoin gained attention from mainstream media outlets, financial institutions, investment funds and securities regulators across the globe. Blockchain's rise to prominence was led by an interest in blockchain-based token sales, commonly referred to as initial coin offerings (ICOs), which raised almost US$4 billion in 2017 alone. Yet despite blockchain's impressive growth, many commentators believe we have just scratched the surface, labelling 2018 the "Year of Blockchain."

We previously discussed some of the major legal developments in the blockchain space that occurred in 2017, including the positions taken by Canadian and U.S. regulators on the application of securities laws to blockchain businesses. Since then, the U.S. Securities and Exchange Commission (SEC) has issued a cease-and-desist order against Munchee Inc., a restaurant review mobile application, in respect of its recent ICO, and SEC Chairman Jay Clayton and Commodity Futures Trading Commission Chairman Christopher Giancarlo have testified before the U.S. Senate on the regulation of virtual currencies in the United States.

Given these recent developments and the increased scrutiny of blockchain-based activities, below are key considerations for those active or looking to get active in this space.

The ICO Dilemma – Is the Token a Security?

- **"Securities tokens" versus "utility tokens."** The SEC's report on the "DAO" (Decentralized Autonomous Organization) was interpreted by many in the blockchain legal community as an indication that the SEC was concerned with "securities tokens" (which carry an expectation of profit) rather than "utility tokens" (which carry an expectation of use). Signalling a move away from this industry-developed distinction, SEC Chairman Clayton noted in his U.S. Senate testimony that "by and large, the structures of ICOs that I have seen involve the offer and sale of securities" and that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security." The determination of whether a token is a security will not be isolated to whether or not the token has "utility" but will ultimately depend on the relevant facts and circumstances.
- **The evolution of a token.** Securities regulators have acknowledged the possibility of a "securities token" changing its characteristics such that it will no longer be considered a security. Although specific guidance has not yet been provided by Canadian regulators on when a token will no longer be considered a security, the practical utility of the token and reliance on the efforts of others for profit will be key considerations in making this determination.
- **Capital raising may taint the offering.** There are a number of legitimate purposes for conducting an ICO other than raising capital. For example, some blockchain entities use an ICO to distribute tokens to parties interested in using the platform, effectively creating a user base and kick-starting the network. ICO issuers that do not wish to be subject to the restrictions imposed by securities laws should be thoughtful in their approach and expect heavy scrutiny from regulators on any ICO used to raise capital for an issuer's business.
- **Airdrops and free token issuances.** Recently, token "airdrops," or distributions of free tokens, have increased in popularity. Where an issuer wishes to avoid any form of capital raising that may potentially trigger a review by securities regulators but still wishes to disseminate its token, an airdrop could be used in lieu of an ICO. In theory, airdrops can be limited to persons that have provided

evidence of their intended use of the platform, thereby ensuring only active users receive tokens. While Canadian regulators have not addressed airdrops, an argument could be made that an "investment of money" has not occurred in an airdrop scenario, and that the first prong of the test for investment contracts set out in *SEC v. W.J. Howey Co.* (*Howey*) fails on this basis.

- **Avoid creating an "expectation of profit."** If a token issuer primes investors to expect an appreciation in the value of the tokens or promises dividends or other income streams, the tokens will likely be considered securities. Even where issued tokens have utility, a secondary expectation of profit may render a token a security. For example, in the recent Munchee order referred to above, the SEC stated that "[e]ven if MUN tokens had a practical use at the time of the offering it would not preclude the token from being a security."
- **Marketing activities.** When marketing an ICO, whether through formal documentation such as a white paper or through informal channels such as blog posts, podcasts or YouTube videos, issuers should avoid discussing any profits to be gained by acquiring a token, as this will likely be seen as priming investors' expectations for future profits.
- **Exchange listings and secondary market trading.** Any action taken by a token issuer's development team to list tokens on an exchange or otherwise facilitate secondary market trading may be seen as creating an expectation of profit. However, in a truly decentralized platform, there are limited methods available to prevent other members of a token ecosystem from setting up an exchange listing independent of the development team. In addition, certain decentralized exchanges allow for the trading of Ethereum-based "ERC20" tokens, notwithstanding that the token issuer hasn't consented to or otherwise been involved in such listing in any way.
- **Targeting broader markets.** Issuers should limit marketing and sales activities to current or potential users of the tokens. Where the issuer's business focuses on a niche industry or geographic market, its ICO should not target cryptocurrency investors or investors overseas who cannot use tokens for their intended purpose. The SEC criticized Munchee, a restaurant review application only available in the United States, for targeting crypto investors by advertising on cryptocurrency message boards and translating the offering documents into various languages, since it indicated the tokens were being sold for profit rather than for use.
- **Limit speculative investment.** Issuers should take concrete measures to limit participation in an ICO based on pure speculation that the token price will increase. Imposing an investment cap of a low amount with no investment floor may help to ensure tokens are widely distributed and deter speculation due to the limited upside of such a small investment. Elements of consumptive tokens (i.e., tokens that are extinguished or surrendered upon use or after a certain period) also serve to reduce speculation. For example, some platforms have instituted a "use it or lose it" approach, whereby tokens are extinguished if not used by a certain date. "Tethering" or tracking the value of a token to a physical asset may similarly deter speculative investment.
- **Determining the "efforts of others": how much effort is enough?** Reliance on the efforts of others – the fourth prong of the *Howey* test – will be satisfied where the founders or management have control over the business or platform. This may include developing a mobile application, creating an ecosystem for the platform or negotiating contracts with commercial parties. However, it is unclear whether this prong will be satisfied where the management team performs purely administrative functions, such as managing or updating a mobile application.
- **Tokens in development.** Tokens issued in respect of platforms that are not fully developed (and hence do not have any immediate use) will not be considered utility tokens and should properly be considered securities due to the reliance on the efforts of others. This point was emphasized by SEC Chairman Clayton in his testimony to the U.S. Senate, where he contrasted tokens being issued in respect of a "participation interest in a book-of-the-month club" to an offering analogous to an interest in a "yet-to-be-built publishing house with the authors, books and distribution networks all yet to come."
- **Accurate and honest disclosure.** Securities regulators have been quick to shut down ICOs where the issuer discloses false or inaccurate information in its white paper or other offering materials, including in respect of the credentials of team members or relationships with advisers. For example, the SEC recently halted AriseBank's ICO due to numerous alleged misrepresentations made by the company, including for the failure to "disclose the criminal background of key executives." The SEC is also carefully

looking at public companies that have recently shifted their business models to focus on blockchain and cryptocurrencies, and recently suspended three companies for misleading disclosure in respect of their blockchain-related activities.

- **Limiting sales to investors outside of the United States and Canada.** Some blockchain enterprises have limited the issuance of tokens to investors outside of the United States or Canada on the basis that securities laws of those jurisdictions would not apply to such investors. Issuers that pursue this route should be mindful of jurisdiction-specific rules or policies such as the risk of "flowback" or other connecting factors to the jurisdiction that result in the application of local law to foreign distributions. Starting on March 31, 2018, Ontario issuers will not be subject to a prospectus requirement for a distribution of a security (including a securities token) outside Canada if the issuer of the token materially complied with the disclosure requirements under the securities laws of the non-Canadian jurisdiction in which the tokens were distributed or the distribution was exempt from any such requirements. However, tokens issued under this exemption will be subject to a "restricted period" under Ontario securities laws, which means that the unrestricted transfer of such tokens to persons in Canada will require the issuer to be a reporting issuer in Canada. Issuers intending to rely on this exemption may instead wish to consider taking measures to ensure that the tokens "come to rest" outside of Canada.
- **Crypto collectibles are likely not securities.** In a statement confirming that not all tokens issued in an ICO are securities, the British Columbia Securities Commission stated that tokens underlying crypto collectibles (e.g., CryptoKitties, a blockchain-based game in which players collect virtual cats, similar to a modern day Tamagotchi) are not subject to securities laws. This is likely due to the fact that no expectation of profit has been formed as a result of the issuance of these crypto collectibles.

Simple Agreements for Future Tokens (SAFTs) – A Way Forward?

- **SAFTs are typically securities.** A SAFT is a written instrument entered into prior to release of a blockchain platform that effectively provides its holder with the right to fully functional tokens, delivered once the platform is completed. Designed to be sold to accredited investors as a means of raising capital, a SAFT (which is more clearly a security) must comply with applicable securities laws. SAFTs will also typically set out the rights of holders on insolvency or the failure of the issuer to complete a functional platform. Once the platform is released and the tokens gain sufficient utility, proponents of the SAFT model argue, the underlying tokens issued upon conversion of a SAFT are not securities and should be freely transferable outside of the ambit of securities laws.
- **Tokens issued on conversion of a SAFT may still be securities.** Whether the underlying tokens issued upon conversion of the SAFT are securities will depend on the facts and circumstances of each case. For example, if token holders are reliant on the efforts of the management team to finalize development of the blockchain platform following the conversion of a SAFT, securities regulators may still consider the underlying tokens to be securities, notwithstanding their practical use and the fact that the bulk of work to develop the platform has been completed by the time the tokens are issued.
- **Offering discounts on SAFTs.** A common issue arises when discounts are offered on tokens, since it is an acknowledgment that the tokens are being acquired for speculative purposes. Offering discounts on SAFTs, but not on the tokens upon conversion, may help alleviate this issue (i.e., it acknowledges that the SAFTs, which are securities, are speculative but the tokens themselves are not). Alternatively, offering a discount when the token is used rather than when it is distributed (i.e., as part of the SAFT offering or ICO) would motivate holders to use the token for its intended purpose, thereby increasing utility.
- **SAFTs and hold periods.** In some cases, a SAFT holder will be subject to a lockup, pursuant to which such holder will be unable to convert its SAFT for a specified period. Hold periods have been used to prevent significant holders from dumping the tokens at a profit as soon as the platform is released and the tokens are freely tradable. However, securities regulators may view holding periods as an acknowledgement that the issued tokens are a speculative investment and therefore securities, since the lockup is often instituted to prevent price manipulation. As well, a hold period effectively prevents the holder from using the token for a specified period, undermining its status as a utility token. While not recommended, token issuers that wish to implement a hold period on a SAFT should start the clock upon the issuance of the SAFT itself and not on the date the tokens are issued, to avoid indirectly acknowledging the token has security-like features.

Process and Timing – Conquering Logistics

- **Go public.** Enterprises with sufficiently broad-based appeal may consider accessing the public capital markets to raise funds and elevate investor interest. Issuers in the crypto space have successfully achieved public listing through reverse takeovers (RTOs). RTOs involve acquiring a publicly listed shell company and may offer advantages over the traditional initial public offering (IPO) process, such as reduced exposure to transient market volatility. Promoters should anticipate the possibility of enhanced regulatory scrutiny and proactively manage their process and disclosure accordingly.
- **Soliciting investors online.** Many token offerings are accessed by way of websites and online portals that process prospective purchasers automatically. For securities tokens, use of an online interface may trigger securities law restrictions on operating a marketplace and engaging in the business of trading. Issuers will need to design their website or sales portal with these rules in mind.
- **Mitigating risk while avoiding delay.** Canadian regulators have indicated they are available for a dialogue to help innovators navigate evolving regulation. Engaging with regulators offers increased certainty and can substantially reduce execution risk. But bringing regulators up to speed takes time, and dialogue can introduce delays. In addition to considering regulatory issues early on, blockchain enterprises should make realistic judgments on timing to facilitate a smooth and efficient route to market.

Investment Funds and Exchanges

- **Crypto funds face increased scrutiny.** Recognizing that funds established solely to invest in one or more cryptocurrencies are a novel business model, Canadian securities regulators have mandated increased reporting requirements and conditions for the registration of such investment funds. While several Canadian cryptocurrency investment funds have been granted an investment fund registration, none have been authorized to go beyond trading in established cryptocurrencies such as bitcoin and ether. Prior approval of the applicable regulator must be sought before a fund may invest in any alternative currencies or "altcoins," likely due, in part, to custodial and valuation concerns. Investment funds that wish to deal in altcoins may be subject to further requirements, depending on whether these assets are considered securities. Regulators are also entertaining whether additional qualifications (such as computer science training) should be required for funds investing in crypto assets.
- **Custodial challenges.** Due to the "bearer-form"-like nature of many cryptocurrencies, holders of this new asset class are familiar with balancing competing needs for secure storage and expedient access. Securities laws impose heightened custodial standards on investment funds' asset storage. Promoters of crypto investment funds should anticipate a dialogue with regulators prior to launch, especially those contemplating altcoin holdings, where sourcing adequate service providers may prove challenging.
- **Valuation and volatility.** Prospective fund operators should anticipate establishing a robust valuation methodology for the crypto assets they intend to hold. Regulators are likely to consider the volatility and valuation sources of underlying assets in assessing whether the fund itself can satisfy its valuation and reporting obligations to investors.
- **Facilitating and filtering transfers.** The ability to transfer and dispose of tokens, whether by trading, spending or "burning," is ubiquitous among crypto asset platforms. Sophisticated platforms may help connect holders to facilitate token transfers, or may filter prospective buyers. For securities tokens, facilitating and filtering may trigger rules applicable to securities exchanges, other marketplaces or investment dealers. Parties interested in setting up these platforms should engage legal advisers early in the process to design around hurdles, line up required licences or initiate a dialogue with regulators.

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