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Crypto Crackdown: Will Blockchain Remain Relevant in 2019?

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Read the complete report.

Following blockchain's meteoric ascent to relevance in the second half of 2017, many predicted that blockchain, the technology underlying bitcoin, would spur massive innovation and disrupt numerous industry sectors. But while 2018 was welcomed in as the "Year of the Blockchain," it proved to be a turbulent period for the nascent technology. Cryptoassets across the board were marred by sharp declines in price, and regulators worldwide ramped up enforcement actions. Despite these struggles, blockchain continues to receive mainstream attention and increased acceptance. Canadian and U.S. regulatory pronouncements and enforcement actions in 2018 provided greater clarity on the approach to assessing the legality of initial coin offerings (ICOs), cryptoasset exchanges and other blockchain-based activities. As regulators have intensified their scrutiny of ICOs, security token offerings (STOs) have emerged as a compliant alternative.

Set out below is a summary of recent developments and key considerations relevant to those looking to start or continue developing businesses based on this enigmatic technology.

Token Offerings: ICOs in Decline; STOs on the Rise

- **Securities Laws Apply to ICOs.** Previously, token issuers sought to deny the applicability of securities laws by characterizing their ICOs as sales of "utility tokens" (that serve a specific function on a blockchain network and facilitate access to a product or service) rather than "security tokens" (that represent ownership in an underlying asset, similar to traditional securities). In 2018, Canadian and U.S. securities regulators repeatedly rejected this notion, taking the position that the majority of utility tokens – despite their functionality – constitute "investment contracts" to which securities laws apply.
- **"Sufficiently Decentralized" Tokens Are Not Securities.** The U.S. Securities and Exchange Commission's (SEC's) director William Hinman raised the possibility that a token could change its characteristics over time so that it would no longer constitute a security. The distinction centred on whether the network on which a token is to function is "sufficiently decentralized" so that there is no longer any third party whose efforts are a key determining factor in the enterprise. Hinman pointed to the Ethereum blockchain as an example of a network that no longer relied on the efforts of a centralized authority that would have warranted the application of securities laws.
- **ICOs Remain Clouded by Uncertainty.** To date, only limited guidance on the attributes of a sufficiently decentralized and fully functional network have been provided by regulators. ICO issuers that are raising capital to fund the network's continued development and continue to exercise some level of control over their respective platforms have yet to find a way to avoid the application of securities laws. However, the practical utility of the token, development of a robust ecosystem and reliance on the efforts of others for profit will be key considerations in determining when a token may transform from a security to a non-security.
- **Regulatory Crackdown Continues.** U.S. regulators have increased enforcement actions against ICO issuers and promoters of unregistered ICOs. Despite the emphasis on the utility of tokens issued by Paragon and Airfox, the SEC focused on the creation of an expectation of profit, including through marketing activities in social media, blogs and digital communications. Of particular importance were statements that the purpose of the offerings was to raise capital to fund further development of existing businesses. As part of its enforcement actions, the SEC imposed significant monetary penalties for the first time on ICO issuers and promoters – even without allegations of fraud or misrepresentation.

- **STOs Becoming Compliant with Securities Laws.** As Canadian and U.S. regulators have intensified their scrutiny of ICOs, STOs have emerged as a compliant alternative. STOs are offerings of digital tokens that treat tokens as a "security" under securities laws and are undertaken subject to all the rules applicable to traditional, non-tokenized securities. For token issuers seeking to raise funds and wishing to avoid the costly and time-consuming process of issuing under a prospectus or registration statement, exemptions from applicable securities laws are available. However, currently available exemptions typically contain limitations on the amount raised, subject issuers to some form of ongoing reporting or do not result in tokens that are freely tradable.
- **STO Platforms Gaining Acceptance.** In 2017, we discussed the Ontario Securities Commission's (OSC's) approval of a token offering by Token Funder Inc., which is developing a platform to facilitate the offering of legally compliant blockchain-based securities. Over the past year, several companies have launched similar platforms to facilitate the issuance of compliant security tokens. In 2018, tZero, the blockchain-centric subsidiary of Overstock that is developing a trading platform for security tokens, raised more than US$100 million in its own STO. As the security token market continues to grow, we expect that more companies will turn to STOs to raise capital.
- **SAFT Model Being Revived.** A Simple Agreement for Future Tokens (SAFT) is a written instrument entered into prior to release of a blockchain platform that provides its holder with the right to fully functional tokens, delivered once the platform is completed. Designed to be sold to investors on a prospectus-exempt basis as a means of raising capital in compliance with securities laws, SAFTs declined in popularity following criticisms that artificially dividing the scheme into multiple events does not change the fact that purchasers acquired tokens for an investment purpose. Nor does it guarantee that the tokens, when issued, will not be securities. While the SEC has not opined on SAFT offerings, the notion that tokens initially issued as securities could evolve into non-securities provided renewed optimism in the SAFT model. Whether tokens issued upon conversion of a SAFT are sufficiently decentralized will ultimately depend on the facts and circumstances at the time of such conversion.

Exchanges: Decentralized or Not, It's Time to Comply

- **Regulators Targeting Exchanges.** The launch of "Operation Cryptosweep" – a multijurisdictional campaign aimed at investigating "cryptocurrency-related investment products" by North American securities regulators has resulted in 200 inquiries and nearly 50 enforcement actions against blockchain businesses. Notably, investigations have not been limited to ICO issuers, with inquiry letters delivered to many prominent crypto exchanges. Regulators are concerned about the lack of controls in place to protect investors. In addition, many of these crypto exchanges list tokens that are likely to be characterized as securities, without satisfying the requirements to operate as a securities exchange (or being exempt therefrom).
- **Crypto Exchanges Vetting Tokens.** While there is a regulatory regime that applies to securities exchanges, it is not clear what other rules apply specifically to trading cryptoassets outside of that regime. Although industry best practices have arisen to manage the ambiguity and reduce the likelihood of enforcement action by regulators, some Canadian and U.S. crypto exchanges have implemented stringent vetting procedures to avoid listing tokens that may be characterized as securities in the hopes of avoiding an obligation to register as a securities exchange. Recently, however, prominent crypto exchanges have publicly announced applications or plans to apply for licences to operate an Alternative Trading System, which would allow such exchanges to offer blockchain-based securities in compliance with securities laws.
- **QuadrigaCX May Spur Change.** In February 2019, QuadrigaCX – once Canada's largest cryptocurrency exchange – was granted protection by the Supreme Court of Nova Scotia under the *Companies' Creditors Arrangement Act*. The ruling followed the sudden death of QuadrigaCX's founder and CEO, Gerald Cotten. Long plagued with liquidity issues due to disputes with its payment service providers, QuadrigaCX was reportedly unable to locate as much as US$137 million in funds locked up in offline wallets accessible only by Cotten. The story of QuadrigaCX serves as an example of the dangers of unregulated cryptocurrency exchanges, with many critics calling for regulatory oversight to mitigate potential mismanagement or loss of investor funds. The Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada recently published a proposed framework for the regulation of cryptocurrency exchanges that addresses the heightened investor-protection risks that these platforms present.

However, as the focus of the proposed framework is on exchanges trading in securities, it remains to be seen how non-security cryptocurrency exchanges will be affected.

- **Offshore Exchanges Must Register.** We previously discussed the OSC's approval of a settlement agreement with eToro (Europe) limited, a Cyprus-based brokerage firm that operates an online cryptocurrency and stock trading platform. The settlement signals that the OSC will be taking a tougher enforcement position against offshore exchanges and trading platforms that offer securities to Ontario residents without complying with Ontario registration and prospectus requirements. These platforms include those offering blockchain and cryptocurrency tokens that constitute "investment contracts" and "securities" for the purposes of Ontario securities laws.
- **Unregistered Decentralized Exchanges May Be Sanctioned.** The SEC recently settled charges against Zachary Coburn, founder of the popular crypto exchange EtherDelta, for operating an unregistered securities exchange. Interestingly, EtherDelta was touted as a "decentralized exchange" that facilitated orders between buyers and sellers through a smart contract, but it arguably lacked certain indicia of centralization necessary to meet the criteria of a securities exchange. However, EtherDelta listed over 500 ERC-20 tokens, many of which the SEC considered to be securities, and Coburn exercised some control over how the system looked and operated. By targeting a decentralized exchange, the SEC has signalled that attempts to decentralize operations will not absolve those who exercise some level of control from liability for violations of securities laws.

Investment Funds: Not Ready for Prime Time

- **Bitcoin Investment Fund Is Not "In the Public Interest."** On February 15, 2019, the OSC's Director of Investment Funds and Structured Products (Director) refused to issue a prospectus receipt for "The Bitcoin Fund," an investment fund managed by 3iQ Corp. that would invest substantially all of its assets in bitcoin. In refusing to issue the receipt, the Director cited valuation, market manipulation and custodial concerns, and stated that granting a prospectus receipt "would not be in the public interest" due to the lack of regulation for the bitcoin market at this time. The Director also concluded the prospectus was not in compliance with securities law restrictions on funds holding illiquid assets, since bitcoin does not trade on market facilities on which public quotations in common use are widely accepted. The decision raises questions about when bitcoin will be accepted by regulators as the primary underlying asset of a fund. It also highlights the OSC's lack of confidence that the current market for bitcoin is sufficiently robust to justify allowing retail investors to participate. 3iQ Corp. has filed an application with the OSC for a public hearing to review the Director's decision on the basis that the Director applied tougher standards on The Bitcoin Fund than those imposed on funds investing in more traditional asset classes.

The Road Ahead

The legal landscape for cryptocurrency exchanges and token offerings continues to be wrought with uncertainty. These issues will likely remain unsettled for some time as regulators formulate an appropriate framework to address the risks presented.

The tendency for regulators to "regulate by enforcement" is a trend that is expected to continue in 2019. Increased enforcement actions and joint regulatory initiatives will likely produce a wealth of settlements and judgments from government agencies in North America, providing useful but limited insight on the steps necessary to mitigate regulatory risk for blockchain businesses until more comprehensive regulatory frameworks are developed.

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