Industry Responds to CSA Guidance on Cryptocurrency Offerings
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The rise in popularity of cryptocurrencies and the spread of cryptocurrency offerings have attracted increased attention from securities regulators in Canada and abroad. Recently, staff of the Canadian Securities Administrators (CSA) (other than Saskatchewan) published Staff Notice 46-307 – Cryptocurrency Offerings (Staff Notice), in response to requests from fintech businesses for guidance on the applicability of Canadian securities laws to cryptocurrency offerings, cryptocurrency exchanges and cryptocurrency-focused investment funds.

The Staff Notice articulated a general view that “in many instances” cryptocurrencies are securities, and reminded business that if a particular cryptocurrency is a security, sales of that cryptocurrency are subject to the prospectus and registration requirements of Canadian securities laws. In addition, the Staff Notice noted that any platform that is a marketplace and facilitates trades in securities that are cryptocurrencies must comply with the marketplace requirements of Canadian securities laws.

The Staff Notice provided only brief discussion in general terms about when a cryptocurrency token is a security, enumerating the general case law tests, rather than discussing them in context. While the Staff Notice did indicate that each token offering “is unique and must be assessed on its own characteristics”, implying that a cryptocurrency token may or may not be considered a security, the CSA did not provide any clear guidance on those characteristics that would indicate that “securities may not be involved”.

INDUSTRY RESPONSE

Fintech organizations and companies are concerned that the Staff Notice did not provide specific guidance on the characteristics of a cryptocurrency that would result in it being considered a security. In a letter dated August 28, 2017, addressed to the federal and provincial ministers of finance, the Blockchain Association of Canada said the Staff Notice provided “very little clarity” in this regard, and expressed particular concern that the CSA would take a “narrow view” by treating all project financing activities using blockchain technology as securities offerings, and that restrictive conditions to exemptive relief “would effectively stifle development of blockchain initiatives in Canada”.

On September 18, 2017, the Chamber of Digital Commerce announced the formation of the Token Alliance, an industry-led initiative to educate, promote and help shape the responsible growth of token and digital asset issuances. The Token Alliance is co-chaired by former Chairman of the U.S. Commodity Futures Trading Commission, Dr.
Jim Newsome, and former U.S. Securities and Exchange Commissioner, Paul Atkins. The Token Alliance will work with the community to address regulatory uncertainty by recommending legal frameworks that drive innovation and promote investment, balanced with protections for market participants. Blakes is a founding participant in the Token Alliance.

WHAT ARE CRYPTOCURRENCIES?

“Cryptocurrencies” are digital representations of value that use cryptography as a security feature and, in contrast to traditional “fiat” currencies, are not issued by a central bank or governmental authority. Cryptocurrency units, often referred to as “coins” or “tokens”, can be exchanged initially either for fiat currencies (such as U.S. dollars) or for other cryptocurrencies such as Bitcoin or Ethereum. Cryptocurrencies of the same units can be traded on individual platforms or over-the-counter between holders, or can be further exchanged for other currencies (fiat or crypto) on platforms or on a cryptocurrency exchange on which multiple cryptocurrencies are traded.

WHEN IS A CRYPTOCURRENCY A SECURITY AND WHEN IS IT NOT?

In the Staff Notice, the CSA indicated that they will evaluate cryptocurrency offerings on a case-by-case basis to determine whether a particular token is a security under Canadian securities laws.

In many instances of the cryptocurrency offerings reviewed by the CSA to date, the tokens being offered constituted securities for the purposes of provincial securities laws, with the result that the distributions were subject to the prospectus and registration requirements of Canadian securities law. The CSA did not indicate what it was about any of those offerings reviewed that did or did not result in their characterization as securities.

The provincial Securities Acts have expansive definitions of “security” that include an “investment contract,” which is the category that Canadian courts and securities regulators have generally used to assess whether a new type of transaction involves a security. The Staff Notice repeated the four-prong test usually used by Canadian courts to determine whether a transaction involves an investment contract: if it is an investment of money in a common enterprise with the expectation of profit to come significantly from the efforts of others.

The primary factors in determining whether a particular cryptocurrency is considered a security are likely to be the use to which that cryptocurrency may be put and what rights it represents. For example, a token earned as compensation for contributions to the development of a business’ platform that may only be exchanged or used on a business' platform to purchase its services or goods is not likely to be considered a security. On the other hand, if a tokenholder is entitled to share in the business’ profits
in some fashion, then the token is likely to be considered a security. Where a token’s market value is indirectly reflective of the general attractiveness of a business, such as where its value fluctuates based on speculation about that future attractiveness, the linkage and characterization is less clear. The Staff Notice drew no distinctions between tokens that have utility at the time of sale and those for which the relevant platform remains to be developed.

SECURITIES LAW REQUIREMENTS

The Staff Notice reiterates the fundamental principles of Canadian securities laws that securities may only be distributed under a prospectus or in reliance on an exemption from the prospectus requirement, and that any company or individual in the business of trading in, or advising on, securities must be registered under Canadian securities law or rely on an exemption from the registration requirement.

If a token is a security, then any distribution of that token will be subject to the requirements of applicable provincial securities laws, including the prospectus and registration requirements.

To date, some initial coin offerings (ICO) and pre-sales in Canada have taken place in reliance on exemptions from the prospectus requirement. In such a case, tokens purchased in an ICO are subject to restrictions on resale pursuant to National Instrument 45-102 – Resale of Securities (NI 45-102). For example, NI 45-102 generally prohibits (among other things) resale of a security purchased under the accredited investor exemption unless either the issuer of the security has been a reporting issuer in a jurisdiction of Canada for the four months preceding the trade, or the resale is made under a prospectus exemption (in which case further resale restrictions may apply). Other exemptions from the resale restrictions may be available, depending on how large the distribution was in Canada.

CRYPTOCURRENCY EXCHANGES

The Staff Notice also highlights the CSA’s concern that platforms facilitating trades in cryptocurrencies that are securities may be marketplaces, and notes that, if they are marketplaces, they are required to comply with the rules governing exchanges or alternative trading systems. This does apply, however, only to cryptocurrencies “that are securities”. Under Canadian securities laws, exchanges are required, among other things, to apply for recognition by the securities regulatory authority of any Canadian jurisdiction in which it operates, or obtain exemption from the recognition requirement. An alternative trading system is required to provide specified information in a prescribed form to the securities regulatory authority in any Canadian jurisdiction in which it operates.
NEXT STEPS

Some Canadian token sales to date have been conducted in reliance on a prospectus exemption or a discretionary exemption ruling. The Staff Notice reminds fintech businesses of the CSA Regulatory Sandbox initiative (for more information, see our January 2017 Blakes Bulletin: Blockchain: Things to Consider Before the Securities Industry Leaves the Sandbox). The next step may be for a digital token offering to be made under a Canadian prospectus — i.e., in a public offering. As cryptocurrencies become more common and are offered to the public, securities regulators may adopt rules or regulations that apply to the new asset class of cryptocurrencies in particular.

Given the case-by-case approach adopted by the CSA and other securities regulators, organizations considering undertaking an ICO would be well advised to seek legal advice early in their processes to determine the relevant securities law considerations.

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