Canadian Securities Administrators Weigh-in on the Applicability of Canadian Securities Laws to Cryptocurrencies, including Coins and Tokens

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On August 24, 2017, Staff of the Canadian Security Administrators (the “CSA”) released CSA Staff Notice 46-307 Cryptocurrency Offerings (the “CSANotice”), published in all Canadian jurisdictions except Saskatchewan.

The CSA Notice addresses a number of considerations of relevance to Fintechs, investors and their advisors, including the potential applicability of Canadian securities laws to initial coin offerings (“ICOs”) and initial token offerings (“ITOs”), cryptocurrency exchanges and cryptocurrency investment funds. It follows a press release issued by the Ontario Securities Commission earlier this year confirming that Ontario securities laws may apply to any use of distributed ledger technologies (“DLTs”), such as blockchain, as part of financial products or service offerings. Our commentary on that press release is here.

The effect of the CSA Notice is to confirm the potential applicability of Canadian securities laws to cryptocurrencies and related trading and marketplace operations and to provide market participants with guidance on analyzing these requirements.

Status as a “Security” and Prospectus Requirement
The CSA Notice clarifies that regardless of whether the instrument distributed is referred to as a coin/token instead of a share, stock or equity, that instrument may still be a “security” under Canadian securities laws. The key takeaways from this clarification are:

- The existing definitions to establish whether an instrument is a “security” also apply to coins/tokens generated from an ICO/ITO. A security includes an “investment contract”. In determining whether a coin/token is an investment contract, a four-prong test should be applied, being does the coin/token 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. Advertisement of a coin or token as a software product is not relevant in determining whether a coin or token constitutes a “security”.

- The “investment contract” test looks at the economic realities of the circumstances and provides a very broad and flexible means of capturing new and innovative arrangements—such as ICOs/ITOs—that do not fit within other definitions of a “security”.

- Generally, “securities” offered to the public in Canada must be offered with a prospectus, which provides details of the venture and the securities being offered and is filed with the relevant securities commissions. However, there are prospectus exemptions that allow an issuer to offer securities on a private placement basis without a prospectus. “Securities” that are coins/tokens are no different. An ICO/ITO of a coin/token that constitutes a “security” requires either the filing of a prospectus, or the use of an applicable prospectus exemption. For example, coins/tokens that meet the definition of securities could be distributed to accredited investors in reliance upon the accredited investor exemption, or could be distributed to retail investors in reliance upon the offering memorandum exemption, without the need to file a prospectus. Whitepapers are not prospectuses and do not fulfill the disclosure requirements applicable under Canadian securities laws. To date, no business has used a prospectus to complete an ICO/ITO in Canada; however, coins/tokens have been distributed in Canada on a prospectus exempt basis.

**Cryptocurrency Exchanges**

As mentioned in the CSA Notice, a number of jurisdictions have also been developing regulation applicable to cryptocurrency marketplaces or exchanges in other areas, particularly with respect to anti-money laundering, recordkeeping, counter-terrorist financing and identity verification requirements. Canada is no exception in this regard, having amended the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (Canada) in 2014 to include within the scope of money services businesses “dealers in virtual currencies” (these changes are not yet in force pending the publication of related regulations). In addition, in *Quebec*, the Autorité des marchés financiers requires such exchanges and virtual currency ATMs to be licensed as money services businesses.

While no cryptocurrency marketplaces or exchanges have registered with securities regulators in Canada to date, CSA Staff emphasizes the need for cryptocurrency exchanges to determine whether the cryptocurrencies that they offer are “securities” and, if so, to register as a marketplace or get an exemption from registration.

**Dealer Registration Requirement**

The CSA Notice also addresses the following with respect to dealer registration or registration exemption and marketplace requirements:

- Businesses that undertake an ICO/TO for a business purpose may be required to register as a dealer or get an exemption from registration. Factors to consider include whether a security is involved, a broad base of investors is being solicited, whether a considerable amount of capital is being raised from a large number of investors, the use of public forums (i.e., the internet) and participation in public events to market the sale of coins/tokens. Any businesses that meet the business purpose must fulfill know-your-client and suitability requirements and other on-going registrant obligations.

- Platforms used for trading coins/tokens that are securities may constitute a marketplace and therefore must comply with marketplace requirements or otherwise seek an exemption from such requirements.
Any platform used for offering coins/tokens that constitute securities must have policies and procedures, including in respect of cybersecurity matters, in place.

**Cryptocurrency Investment Funds**

The CSA Notice also outlines several factors relevant to the operation of cryptocurrency investment funds. As with other funds, a cryptocurrency investment fund should register in the category applicable to it as an investment fund manager and/or adviser, or dealer. The fund should consider how the valuation method of the cryptocurrencies and securities included in the fund’s portfolio will take place, whether this method will be assessed in an independent audit and how the exchange of cryptocurrency will take place. Any exchange used to purchase or sell cryptocurrencies will have to be subject to due diligence by the fund. Moreover, where retail investors invest in the fund, some jurisdictions in Canada will not accept an offering on an exempt basis in reliance upon the offering memorandum prospectus exemption, and instead will require compliance with the prospectus requirement, investment suitability and investment fund regulations. Finally, any custodian that holds the portfolio assets of a cryptocurrency investment fund must have cryptocurrency-related expertise.

**Beyond Canada**

Canada is not the only jurisdiction grappling with this issue. Recently, both the Securities Exchange Commission (“SEC”) in the United States and the Monetary Authority of Singapore (“MAS”) have issued guidance addressing the applicability of securities laws to cryptocurrencies.

On July 25, 2017, the SEC issued an investigative report reminding stakeholders considering using decentralized autonomous organizations or other DLTs to raise capital to take appropriate steps to ensure compliance with U.S. federal securities laws. Like Canada, in the United States, all securities offered and sold must be registered with the SEC or must qualify for a registration exemption. To drive this point home, the SEC analyzed the distribution of tokens in 2016 by “The DAO”, an unincorporated virtual organization on the Ethereum blockchain, and concluded that:

- DAO tokens were unregistered securities;
- The DAO was an unregistered issuer; and
- Platforms allowing DAO tokens to trade “appear” to be unregistered exchanges.

Along the way, the SEC noted that:

- The automation of certain functions through DLT, “smart contracts,” or computer code, does not remove conduct from the purview of U.S. federal securities laws.
- Cash is not the only form of contribution or investment that will create an investment contract. Any contribution of value, such as goods and services, may be considered an investment.
- The marketing efforts of those involved in designing, promoting, distributing and managing the ICOs/ITOs and resulting enterprise will be considered, including their involvement in control and decision-making after the ICO/ITO.
- To prove that investors do not rely on the managerial efforts of others, voting rights given to token holders must allow them to meaningfully control the enterprise.
- Pseudo-anonymity and the wide dispersion of tokenholders may make it difficult for them to argue that they can meaningfully control the enterprise and do not rely on the managerial efforts of others.

The SEC elected to not pursue an enforcement action against The DAO, its co-founders and intermediaries involved in the distributed of DAO tokens.
The CSA Notice is reflective of the increasing scrutiny paid by CSA Staff to the regulation of Fintechs, and can be expected to inform the approach taken by Canadian securities regulators when considering requests for exemptive relief from Canadian securities law requirements and other issues, whether as part of the CSA Regulatory Sandbox initiative or otherwise. Any Fintech businesses seeking to enter the cryptocurrency space in Canada should consult with counsel and be prepared to engage in detailed interaction with securities regulatory authorities.