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ICO'S: CRYP-TOEING AROUND SECURITIES REGULATION?

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Cryptocurrencies: the new bubble or the way of the future?

The increasing prevalence of Initial Coin Offerings ("**ICOs**") or Initial Token Offerings ("**ITOs**") has observers wondering just how far companies can go before securities regulation brings it to a halt.

What is an ICO?

An ICO refers to a virtual method of fundraising through the sale of digital assets using distributed ledger technology ("**DLT**") or block chain technology. DLT allows for the dissemination of data through a database that can be shared across a network cryptographically through the use of keys. This decentralized network allows for a direct peer-to-peer programmable blockchain. The use of blockchain allows for a record to be created and a continuous recording of transactions within this network.

A company will typically issue a whitepaper highlighting its business, fundraising objectives, the project for which funds are being raised, the number of tokens or coins being retained by management and the length of offering. Investors can then purchase a coin or token being offered under the ICO or ITO using tokens of accepted cryptocurrency, such as Bitcoin, Ether or fiat currency. A token allows its purchaser to use services that the company offers; however, it does not promise dividends or voting rights from the company.

Legal Roadblocks

The question on industry observer's minds is whether securities laws are applicable to ICOs? Regulators on both sides of the border have been faced with this question in light of the increasing number of ICOs.

OSC and CSA

On March 8, 2017, the Ontario Securities Commission ("**OSC**") issued an advisory news release which provided that offerings using DLT may be subject to Ontario securities law requirements such as the requirement to file a prospectus. More recently, the Canadian Securities Administrators ("**CSA**") released Staff Notice 46-307 - *Cryptocurrency Offerings*, which generally stated the CSAs position that in many cases these offerings should be considered securities. The CSA urges a case by case approach to considering the individual offering, focusing on substance over form. Where the value of an ICO is tied to some type of future profit, it is likely to meet the four prong test for an investment contract as outlined by the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario (Securities Commission* (1978), 2 S.C.R. 112, which is the following: (1) was there an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) to come significantly from the efforts of others. Under securities law, an "investment contract" is by definition a "security". If an ICO/ITO is a security, the offering would need to comply with

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securities laws, including the prospectus and registration requirements, unless an exemption from such requirements is otherwise available.

An ICO may attempt to rely on the accredited investor or offering memorandum exemptions to avoid the requirement of filing a prospectus. The CSA Staff Notice notes that the "whitepapers" that are often published by fintech firms with respect to such offerings are often lacking the disclosure that is required in an offering memorandum that is relying on the offering memorandum exemption.

SEC

In the U.S., the Securities and Exchange Commission ("**SEC**") has also cautioned the market that securities laws do apply to ICOs. On July 25th, the SEC released a report investigating the Decentralized Autonomous Organization (DAO) operations, and concluded it was likely not in compliance with U.S. securities laws. The SEC considered whether those who purchased DAO tokens, which gave purchasers the ability to vote on the projects undertaken by the company, in exchange for Ethereum blockchain currency (Ether) constituted an "investment contract" as set out in the *Howey Test*.

To make this determination, the SEC applied the test for an investment contract set out by the U.S. Supreme Court in *SEC v. W.J. Howey Co.* (1946) 328 U.S. 293., using the well-known standard of "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others". In many cases, the consideration invested in an ICO does not involve an investment of cash, but rather a virtual currency. However, it has been well established by the U.S. courts that contribution for an investment does not need to be in the form of cash for the creation of an investment contract. (*Uselton v. Comm. Lovelace Motor Freight, Inc.*, (1991) 940 F.2d 564, 574). In purchasing DAO tokens, an investor would rely on the creators for its operation, and for distribution of selected proposals to be voted on. Ultimately, the SEC made the determination that all elements of the Howey Test had been satisfied, concluding that DAO tokens were an investment contract under U.S. securities law. Further, the DAO met the criteria for an "exchange" under sections 3(a)(1) and 3(b)(1) of the *Exchange Act*, but failed to meet the registration requirements as an exchange under sections 5 and 6 of the *Exchange Act*.

On both sides of the border, the SEC and the CSA have noted the importance of considering ICO offerings on an individual basis. Establishing that a virtual sale constitutes an offering of a security is essential to then determining whether a proper exemption has been met. Given the SEC's consideration of the DAO case individually, this may prompt the further examination of these types of cases not only by the SEC but by provincial regulators in Canada moving forward.

International Regulation

The challenge of regulation of ICO's has spread globally. On September 4th, 2017, China's central bank made a bold statement banning the use of ICO's coining them "a form of unapproved illegal public financing." This statement not only triggered a dip in the value of Bitcoin and Ethereum but causes one to speculate if regulators in Canada and the U.S. will follow suit.

Where do we go from here?

With the proliferation of virtual currency, the corresponding question of investor protection is of major concern. The susceptibility of these digital offerings to errors, hacking and fraudulent behaviours is becoming pressing. Examples of such activity include: $460 million in Bitcoin disappearing from trading hub Mt. Gox; hackers stealing $32m worth of Ether by exploiting a critical security vulnerability in wallet software; and $1.3M in Ethereum lost from an ICO due to coding issue by REX, a real estate platform start-up. Red flags are raised

not only for those thinking of investing in these virtual ICOs, but also in their regulation for the protection of those who already have holdings.

Even if registration and prospectus exemptions are relied upon for an ICO, the susceptibility to risks of hacking, error and fraud may still compromise the investment. The investigative report by the SEC and statements from the OSC and CSA show promise to address some of the issues facing ICOs, however, many questions still remain about the regulation of ICOs and the protection of those who invest.