

Tokens, ICOs & ITOs - Canadian Legal Framework, Investor Protection, and Market Trends

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- ICOs & ITOs
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What Is a Token?

- A token is a digital asset that is used in connection with decentralized services, applications and communities.
- Tokens are also known as “blockchain protocol tokens” because the rules that govern what is a valid transaction using these tokens are determined by the blockchain’s protocol on which it exists.
- There are generally two types of tokens:
 1. Security token: a highly liquid substitute for traditional securities like corporate stock or limited partnership interests.
 2. Utility token: offers intrinsic utility that powers a decentralized network, which delivers users a consumptive good or service.
 - Pre-functional utility token:
 - A token launched before its genuine utility has been achieved.
 - Buyers are exclusively reliant on the issuing party’s technical and managerial skills to achieve utility.
 - Functional utility token:
 - A token that has achieved genuine utility and is no longer exclusively reliant on the issuing party’s efforts to achieve that utility.
 - Price is driven by supply and demand.
- Not all tokens can be labelled as a security or utility token because every token possesses unique features and characteristics that offers holders access to a digital asset or rights.
- The two most popular tokens are:
 - Bitcoin: cryptocurrency used primarily as a store of value and currency.
 - Ether: cryptocurrency that allows users to write smart contracts and build decentralized applications.

- An Initial Coin Offering (“**ICO**”) and an Initial Token Offering (“**ITO**”) are offerings of a newly created token or coin to the public.
- An ICO/ITO is launched by a group looking to raise capital from investors in order to realize the tokens’ purpose as set out in a white paper.
- The goal of an ICO/ITO is the same as an Initial Public Offering (“**IPO**”), but often have been undertaken without adherence to the rigorous disclosure and compliance requirements under securities laws.
- Groups launching ICOs/ITOs usually do so by publishing a white paper for potential investors to read, digest and evaluate and then allow investors to contribute both fiat and cryptocurrency capital in exchange for the token or coin.
- All of these funds are raised over the internet, without the use of bank drafts, wire transfers or other intermediaries.
- Advantages of raising capital through an ICO/ITO:
 - Potential for rapid and exponential return due to pre-mines/pre-sales.
 - Exposure to a larger group of potential investors, often worldwide.
 - Ability for founders and early investors to exit and access liquidity much quicker.
 - Little regulatory oversight if the token is “not a security”.
 - No third party intermediary expenses.
- ICOs raised \$6.3 billion USD worldwide in the first quarter of 2018. A staggering amount compared to the \$5.5 billion USD raised worldwide through ICOs in all of 2017.¹
- In comparison, US IPOs raised \$16 billion USD and US venture capital markets raised \$23 billion USD in the first quarter of 2018.
 - This shows how impactful ICOs have been as a vehicle for raising capital.²

¹<https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017/>

²<https://www.forbes.com/sites/caitlinlong/2018/07/22/icos-were-45-of-ipos-in-q2-2018-as-cryptos-disrupt-investment-banks/>

Canadian Legal Framework: When Is a Token a “Security”?

- Definition of “security” has a long list of enumerated items including “investment contract”.
- Pacific Coast/Howey test for investment contract:
 1. An investment of money
 2. In a common enterprise
 3. With the expectation of profit
 4. To come significantly from the efforts of others
- CSA Staff Notice 46-307
 - Affirms Pacific Coast/Howey test in its application to ICOs/ITOs.
 - CSA will consider substance over form when determining whether a token is a security and that every situation will be assessed on its own merits.
- CSA Staff Notice 46-308
 - Defines utility token as: a token that has one or more specific functions, such as allowing its holder to access or purchase services or assets on blockchain based platforms.
 - When determining whether a token constitutes a security, regulators will take into account the economic realities of the offering as a whole, not just the technical characteristics.
 - If the group raising the capital promotes the token only for its utility and not investment value, implication of purchaser’s expectation of profit may be reduced.
 - A token offering may be defined as a security because the offering involves a distribution of an investment contract.
- The million dollar question: is the token and network fully functional?

Canadian Legal Framework: When Is a Token a “Security”?

- CSA Staff Notice 46-308 cont’d
 - Examples of situations and their possible implication on one or more of the elements of an investment contract:
 1. An investment of money
 2. In a common enterprise
 3. With the expectation of profit
 4. To come significantly from the efforts of others
 - Situations outlined:
 - If the platform is still in development:
 - This could indicate that the purchaser is not purchasing the tokens for immediate utility, but because of an expectation of profit.
 - This could indicate the existence of a common enterprise because management’s efforts are still needed to develop the promised platform.
 - *Note:* a functional software is a question of fact and the platform may not be considered developed if there are significant intended functions not yet developed.
 - Tokens not immediately delivered to purchasers:
 - This could indicate that the purchaser is not purchasing the tokens for immediate utility, but because of an expectation of profit.
 - Stated purpose of offering is to raise capital to perform key actions:
 - This could indicate that that the purchaser will be dependent on the issuer’s ability to perform key actions.
 - Marketing of the offering suggests that the token will appreciate in value:
 - This could indicate that the offering is being sold as an investment and create an expectation of profit.
 - Tokens are not fungible or interchangeable and any objective future market value of the token is based primarily on market forces and not continued business development by the issuer:
 - This could indicate that the value of tokens are based on its unique characteristics, not the efforts of others.
 - This could indicate that there is no common enterprise.

Canadian Legal Framework: What Is a Trade and Distribution?

- Definition of Trade and Distribution in Section 1(1) of the Ontario Securities Act:
 - “trade” or “trading” of securities includes [...] any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of a distribution of securities, and thus triggers the prospectus requirement.
 - “distribution”, where used in relation to trading in securities, means,
 - a) a trade in securities of an issuer that have not been previously issued,
 - b) a trade by or on behalf of an issuer in previously issued securities of that issuer that have been redeemed or purchased by or donated to that issuer,
 - c) a trade in previously issued securities of an issuer from the holdings of any control person,
 - d) a trade by or on behalf of an underwriter in securities which were acquired by that underwriter, acting as underwriter, prior to the 15th day of September, 1979 if those securities continued on that date to be owned by or for that underwriter, so acting,
 - e) a trade by or on behalf of an underwriter in securities which were acquired by that underwriter, acting as underwriter, within eighteen months after the 15th day of September, 1979, if the trade took place during that eighteen months, and
 - f) any trade that is a distribution under the regulations,
 - g) and on and after the 15th day of March, 1981, includes a distribution as referred to in subsections 72 (4), (5), (6) and (7), and also includes any transaction or series of transactions involving a purchase and sale or a repurchase and resale in the course of or incidental to a distribution and “distribute”, “distributed” and “distributing” have a corresponding meaning; (“placement”, “placer”, “placé”).

Canadian Legal Framework: Registration Requirements

- National Instrument 31-303 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* requires that anyone in the business of trading, advising, holding themselves out as being in the business of trading or advising, acting as an underwriter, or acting as an investment fund manager must register with the relevant Canadian regulator.
 - The regulators use what is known as the “business trigger” to determine whether someone is in the business of advising or trading securities.
 - They will look “at the type of activity and whether it was carried out for a business purpose” and consider a list of enumerated factors.
- Groups raising capital through ICOs/ITOs must be cognizant of these requirements because of the broad language used.
- Many ICOs/ITOs successfully completed outside of Canada would likely have been caught by this definition if employees were compensated for their capital raising activities.
- In 2017, First Block Capital Inc. was the first Canadian corporation to successfully register as an Investment Fund Manager and Exempt Market Dealer completely dedicated to token investments.
 - The registration came with extremely rigid restrictions, but was widely celebrated by other industry participants.
- The OSC has since issued a notice requiring registrants who plan to advise, trade or manage portfolios with tokens or cryptocurrencies to file a notice of change of registration information and warn additional restrictions may be applied.

Canadian Legal Framework: Issuing a Token Pursuant to Canadian Securities Regulation

- Prospectus
- Prospectus Exemptions:
 - Accredited Investor (NI 45-106)
 - Investor must qualify under one of several accredited investor definitions outlined in NI-45-106.
 - Crowd Funding (MI 45-105)
 - New exemption adopted by Ontario, Quebec, New Brunswick, Manitoba and Nova Scotia in 2016.
 - Allows for online capital raising by start ups.
 - Offering Memorandum (NI 45-106)
 - Generally for investors who don't qualify as an Accredited Investor.
 - The Offering Memorandum circulated under this exemption must be in the prescribed form.
 - Definition of Offering Memorandum in Section 1(1) of the Ontario Securities Act:
 - “offering memorandum” means a document, together with any amendments to that document, purporting to describe the business and affairs of an issuer that has been prepared primarily for delivery to and review by a prospective purchaser so as to assist the prospective purchaser to make an investment decision in respect of securities being sold in a distribution to which section 53 would apply but for the availability of one or more of the exemptions contained in Ontario securities law, but does not include a document setting out current information about an issuer for the benefit of a prospective purchaser familiar with the issuer through prior investment or business contacts; (“notice d’offre”)
 - “Offering Memorandums” are also circulated to investors in connection with other exemptions, however, they may not be in the prescribed form.
 - Liability for misrepresentations in an offering memorandum as set out in Section 130.1 of the Ontario Securities Act applies to both prescribed form offering memorandums and those that fall under the definition, but are not in prescribed form.
 - Section 130.1 provides the purchaser a right of action for damages and a right of recession.
 - A white paper circulated to investors may constitute an “Offering Memorandum” and issuers may liable for misrepresentations set out in them.
- Simple Agreement for Future Tokens (SAFT)
 - A SAFT is an investment contract and security.
 - Generally executed by token issuers in two steps.

Canadian Legal Framework: The Sandbox Approach

- In 2017, the CSA launched the Regulatory Sandbox, an initiative to support fintech businesses advancing new and innovative technology in Canada.
- The initiative allows firms, both large and small, to submit its business model to securities regulators and work directly with them to determine what registration or exemptive relief is necessary or available.
- Impak Finance Inc. (2017)
 - Launched a coin, MPK, designed to support the growth of their community focused on socially responsible enterprises.
 - First regulated ICO in Canada under securities regulation.
 - The MPK network did not exist at the time of the raise and no tokens were issued at closing.
 - The regulator granted exemptive relief from prospectus filing and registration requirements, but with the following conditions:
 - KYC and suitability reviews for each participant.
 - Quarterly information must be provided to the participants.
 - MPK cannot be listed on any exchange or organized market.
 - Used an offering memorandum.
 - Exemption expires 24 months from the date of decision.
- TokenFunder (2017)
 - Launched a coin, FNDR, to build a platform that allows entrepreneurs to launch their own ICOs and raise funds.
 - FNDR holders are entitled to a share in distributions arising from the use of the platform by entrepreneurs and investors.
 - FNDR holders are entitled to voting rights regarding proposals for new token issuance projects on the platform once the platform is ready.
 - The regulator granted exemptive relief from registration requirements, but with the following conditions:
 - KYC and suitability reviews for each participant.
 - Must provide details of investor complaints to the OSC within 10 days of receiving such.
 - FNDR cannot be listed on any exchange or organized market.
 - Used an offering memorandum.
 - Exemption expires 12 months from the date of the decision.

Canadian Legal Framework: Resale Rules & Exempt Distribution Report

- In Canada, resale of securities issued pursuant to a prospectus exemptions have rigorous resale restrictions outlined in NI 45-102 *Resale of Securities*.
 - If the issuer is a non-reporting issuer, the securities are subject to an indefinite hold period.
 - These tokens may only be sold pursuant to another prospectus exemption and never become freely tradeable so long as the company remains a non-reporting issuer. E.g.. one accredited investor may resell to another accredited investor.
- Recent amendments to NI 45-102 and the enactment of OSC Rule 72-503 addresses sales and resales outside of Canada.
 - NI 45-102 (June, 2018):
 - Securities issued from a non-reporting foreign issuer either through a prospectus or prospectus exemption are not subject to resale rules if:
 - It was made through an exchange or to a person or company outside of Canada (Section 2.15)
 - The Issuer is a foreign issuer on date of distribution.
 - This means an issuer that is not incorporated or organized under the laws of Canada, or a jurisdiction of Canada, unless any of the following applies:
 - (a) the issuer has its head office in Canada; or
 - (b) the majority of the executive officers or directors of the issuer ordinarily reside in Canada.
 - The issuer is not a reporting issuer in Canada on the date of distribution
 - This amendment does not apply to Alberta or Ontario.

Canadian Legal Framework: Resale Rules & Exempt Distribution Report

- OSC Rule 72-503 (March, 2018):
 - Prospectus exemption available for issuers distributing to purchasers outside of Canada if:
 - Section 2.1 – Distribution Under Public Offering Document In Foreign Jurisdictions
 - Issuer has filed a registration statement in accordance with the 1933 Act; or
 - Issuer has filed an offering document that permits the public offering pursuant to the securities law in the specified foreign jurisdiction.
 - Specified foreign jurisdictions: Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, The Netherlands, New Zealand, Singapore, South Africa, Spain, Sweden, Switzerland, United Kingdom & Northern Ireland, and any other member of the EU.
 - Prospectus requirements do not apply to a distribution by a non-reporting issuer to a person or company outside of Canada if the issuer has materially complied with the securities laws of the foreign jurisdiction or the distribution is exempt from such requirements. (Section 2.4)
 - “Outside of Canada” means neither the seller nor any person acting on its behalf has reason to believe that the distribution has been pre-arranged with a buyer in Canada. (Section 2.5)
 - Prospectus requirements do not apply for first trades in securities of a non-reporting issuer distributing under a prospectus exemption if: (Section 2.7)
 - Issuer was not a reporting issuer in Canada on the distribution date;
 - At the distribution date, residents of Canada:
 - Did not own directly or indirectly more than 10% of the outstanding securities class, and
 - Did not represent in number directly or indirectly more than 10% of the total number of owners; and
 - The trade was made through an exchange or market outside of Canada, or to a person or company outside of Canada.
 - Section 2.8 is the equivalent of Section 2.15 of NI 45-102.
 - Anti-avoidance provision to prevent schemes designed to distribute to a person or company in Canada using Sections 2.1,2.4,2.7 or 2.8. (Section 2.6, 2.9)
- Those using the Accredited Investor or Offering Memorandum exemptions must file an exempt distribution report with the CSA within 10 days after the distribution. (Form 45-106F1)
 - These reports must include detailed information about the purchasers, underwriters and agents associated with the offering.

Canadian Legal Framework: Marketplace Regulation

- Establishing a cryptocurrency exchange in Canada is an onerous process that requires diligence, disclosure and patience.
- If an exchange is doing business in a jurisdiction of Canada, it must apply to that jurisdiction's securities regulatory authority for recognition or an exemption from recognition.
- Marketplaces are required to comply with the rules governing exchanges or alternative trading systems.
- A marketplace is defined in NI 21-101 as a facility that:
 - brings together buyers and sellers of securities;
 - brings together the orders for securities of multiple buyers and sellers; and
 - uses established non-discretionary methods under which the orders interact with each other.
- An exchange is a marketplace that may:
 - list the securities of issuers;
 - provide a guarantee of a two-sided market for a security on a continuous or reasonably continuous basis;
 - set requirements governing the conduct of marketplace participants; or
 - discipline marketplace participants.
- Application to operate an exchange consists of:
 - An application statement;
 - To contain information on governance, fees, access, information sharing, fitness of directors and officers, systems and technology, company rules and financial viability.
 - Audited financial statements for the previous year; and
 - A fully completed Form 21-101F1.

- Protecting investors is a priority of Canadian regulators and below are some of the most prominent hurdles in being able to achieve such in this new and evolving space:
 - Valuation
 - The unregulated nature of the majority of the prominent cryptocurrency exchanges pose a problem for investors who rely on such for pricing information and access. Moreover, many exchanges are believed to be involved in wash trading and price manipulation.
 - Liquidity
 - Not all tokens have the same level of liquidity as Bitcoin and Ethereum.
 - Many investors have a hard time liquidating at favourable prices.
 - Custody:
 - The nature of digital wallets present a challenge to investors and traditional custodial services.
 - The safeguarding and storage of private keys for both cold and hot wallets have not been perfected and no industry standard has been adopted.
 - Anti-Money Laundering
 - Amendments to the Proceeds of Crime and Terrorist Financing Act were proposed in 2014 to reflect the prevalence of virtual currencies.
 - These amendments have not yet come into force, but once they do, entities dealing in virtual currencies will be required to register with FINTRAC and report their transactions. In the meantime, exchanges that allow for trades of utility tokens are a gateway for terrorist financing.
 - No Legal Recourse
 - Investors who are defrauded have limited legal recourse against persons who have raised money through ICOs/ITOs because of the anonymity of many digital wallets.

Key Canadian Tax Considerations (In Brief)

- The Canadian revenue authority view: Cryptocurrencies are not official legal tender, rather they are commodities, like gold or oil. This would have a number of implications:
 - This may mean that using crypto to purchase goods or services are “barter” transactions for tax purposes.
 - Tax treatment of ICOs/ITOs may not be the same as IPOs or other capital raising transactions involving the issuance of equity or debt, where the issued token is a utility token (and not a security token representing equity in the issuer).
 - In an IPO, share issuances to investors from the treasury of the corporation are not taxable transactions for the issuer.
 - However, in an ICO/ITO, tokens issued to investors by the issuer may be taxable transactions if the token is not a security token.
 - Using a token to purchase goods or services may also be a taxable transaction both,
 - to the merchant, as income in the amount of the value of the goods or services sold, and
 - to the buyer, as a capital gain (if any) on the disposition of the token.
 - GST/HST applies to barter transactions and it is possible that an exchange of one cryptocurrency for another may require you to collect GST/HST on the value of the token you are disposing of and may also require you to pay GST/HST on the token you are acquiring in the transaction.

- Market Cap
 - The total market cap for cryptocurrencies declined from a high of \$810 billion in January, 2018 to a low of \$191 billion in August, 2018.¹
 - The rapid decline in prices across the board have spooked most retail investors from investing new money into the space.
- Bitcoin ETFs
 - The SEC has rejected several Bitcoin ETF applications in the recent months.
 - They note that, among other issues, the prominent exchanges have failed to establish a resistance to price manipulation.
 - They do note, however, that the rejections are not an evaluation of whether Bitcoin or blockchain has utility or value as an innovation or an investment.
- A new blockchain focused ETF launched on the TSX September 20, 2018.
 - Coin Capital Investment Management Inc. launched LDGR, a research focussed ETF giving investors exposure to businesses making investments in the studies and development of blockchain technology.
- World Economic Forum released a report that said blockchain technology could bolster trade by approximately \$1 trillion by 2028.
- Theorists suggest that cryptocurrencies with finite supply could eventually replace parts of the monetary system enacted in many countries because of the incredible reduction in purchasing power attributed to most fiat currency over the course of the last 100 years.

- Hacks
 - Exchanges losing large sums of money from hacks have been a persistent trend since their inception.
 - Most recently, Zaif, a Japanese exchange, had approximately \$60 million worth of cryptocurrency stolen.¹
 - Early this year, Coincheck had \$547 million worth of cryptocurrency stolen.²
- Pump & Dump Schemes
 - Bitconnect, BCC, touted outrageous payouts to investors and watched its price decline from \$463/BCC in December 2017, to \$5.92/BCC as of January 20, 2018.³
 - In early 2018, regulators from Texas and North Carolina issued a cease and desist order against the exchange it had been operating.
 - This is just one example of many that have plagued the evolution of this space and continue to hinder adoption.
- Price Arbitrage/Wash Trading
 - Cryptocurrency exchanges are extremely fragmented and prices are inconsistent among them.
 - This gives sophisticated parties ample opportunity to take advantage of the arbitrage and disadvantage retail investors.
 - It is widely believed that many of the prominent exchanges are wash trading in order to portray volume that is not actually present.
 - Wash trading is when the same investor buys and sells to their own order.

¹<https://www.coindesk.com/japan-regulators-seek-answers-in-wake-of-zaifs-60-million-crypto-hack/>

²http://www.record-eagle.com/nation_world/japan-digital-currency-exchange-hacked-losing-million/article_2e470443-c1fd-5aad-8bc1-74fc11b1b3b4.html

³<https://coinmarketcap.com/currencies/bitconnect/>

Expectations Moving Forward

- ICOs/ITOs
 - Capital will continue to be raised through ICOs/ITOs, however, the platforms on which they're raised will change.
 - The most popular platform to raise funds has been Ethereum, but newer platforms like EOS will see a drastic increase in ICOs/ITOs launched on them.
- Canadian Legal Landscape
 - CSA notices 46-307 and 46-308 have been helpful, however, Canadian regulators must eventually enact firm legislation to address the uniqueness of tokens and cryptocurrencies.
 - If Canadian regulators opt not to do so in the immediate/near term, these uncertainties will be brought before the courts and the courts will be the ones to decide the law.
 - Decisions are fact specific and not easily applied to other scenarios. Any decision in this new space may provide further uncertainty and will be subject to interpretation.
- Investors
 - Ability to purchase tokens and cryptocurrencies will continue to become easier for investors as more fiat on ramps are becoming readily available in Canada and the U.S.
 - Investors who participated in the run up of prices at the end of 2017 and subsequently experienced a tremendous downturn in price, exchange hacks and pump & dump schemes will be more cautious investing if prices ever recover.

Thank You

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