

## The CSA Confirms that Utility Token Distributions May Not Escape the Reach of Securities Regulations

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On June 11, 2018, the Canadian Securities Administrators (**CSA**) issued CSA Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens (SN 46-308)*. This latest Staff Notice builds on the guidance contained in [CSA Staff Notice 46-307](#), released in August 2017, which offered a preliminary assessment of the application of Canadian securities laws to cryptocurrency offerings.

SN 46-308 moves the conversation one step forward, drawing on the CSA's recent experience reviewing proposed initial coin offerings (ICOs) and initial token offerings (ITOs). More particularly, SN 46-308 focuses on the regulatory treatment of "utility tokens"—digital tokens that enable their holder to access or purchase a particular service or asset.

### When Is a Token a Security?

The CSA reaffirmed that regulators will focus on substance over form to determine whether a proposed offering displays the hallmarks of an investment contract, or whether the tokens themselves fall within one of the other enumerated definitions of "security" under securities legislation.

The CSA repeated its previous guidance that businesses and their professional advisors should consider and apply the case law when interpreting whether an offering constitutes an "investment contract", i.e. does it involve:

- an investment of money
- in a common enterprise
- with an expectation of profit
- that arises significantly from the efforts of others.

While the CSA acknowledges the importance of fintech innovation in Canada, it cautions that ICOs and ITOs involve a high risk of loss to investors. Accordingly, it endorses a broad and purposive approach to determining whether a token offering should be subject to securities laws, with a view to investor protection. This approach incorporates a review of the token's technical characteristics, as well as the economic realities of the offering as a whole.

Following this strategy, the CSA concluded that most of the proposed utility token offerings it has encountered involve the distribution of a security. The mere fact that a token has some utility "is not, on its own, determinative as to whether an offering involves the distribution of a security."

### What Has the CSA Seen so Far?

The CSA went on to provide an assessment of several examples of proposed offerings it has seen to date, providing the following guidance:

- The fact that a purchaser is able to or reasonably expects they will be able to trade their tokens on an online secondary marketplace (including decentralized or peer-to-peer trading platforms) suggests there is an **expectation of profit**, as do circumstances in which management retains tokens as compensation. On the other hand, if the tokens are not fungible, or have a fixed value and the platform issues them regularly to purchasers, the expectation of profit is minimal. Given that the expectation of profit is a critical factor in the identification of a security, we anticipate that securities regulators will be particularly attuned to it.

- In determining whether a token can reasonably be expected to trade in the secondary market, the CSA will consider the representations made by the issuer or issuer-endorsed third parties, including statements made in whitepapers or informally through social media platforms, including messaging platforms, community meetups and online videos.
- The fact that the distribution occurs before the platform is fully developed, or the tokens are not distributed immediately to purchasers, indicates a high degree of reliance on management's efforts and therefore suggests there is a **common enterprise**. Similarly, if the issuer's management represents that they have specific skills that can enhance the value of the token, the existence of a common enterprise is likely.

Risk of loss follows expectations of profit—particularly where the profit arises from management's efforts. The CSA's emphasis on risk and its mandate to enhance investor protection is a recurring theme throughout this Staff Notice, and risk of loss is likely a factor to be weighed in all proposed token distributions. We note that a regulator's assessment of a token will be holistic and involve a consideration of all of the factors discussed above. However it is clear that regulators will consider the substantive, rather than the technical, qualities of the token: How is it used? Who bears the risk? Can it be traded? Why would a purchaser have acquired the token?

#### **Can Tokens Offered in Multiple Steps Still Be Considered Securities?**

The CSA also weighed in on the practice of structuring token distributions in two steps. This form of agreement is often made under a prospectus exemption and is sometimes called a "simple agreement for future token", i.e. a "SAFT":

- In the first step, the purchaser agrees to contribute money in exchange for a right to receive tokens at a future date.
- In the second step, the token is distributed to the purchaser, generally with a representation that the particular platform for which it was designed is ready to be used.

The CSA views the first step, in which a purchaser acquires a right to a future token, as a distribution of a security. As such, SAFTs are subject to prospectus requirements. Issuers may rely on prospectus exemptions (such as the accredited investor exemption), which are typically subject to resale restrictions. Such resale restrictions will limit the token's saleability on a cryptocurrency trading platform, and purchasers should remain mindful of this. In sum, two-step distribution structures cannot be used to avoid securities regulation.

#### **Will We See Enforcement Activity Soon?**

The CSA advised that its staff are actively monitoring ICOs and ITOs to identify securities laws violations and conduct that is contrary to the public interest. As regulators catch up with this evolving industry, we expect that its enforcement arms will follow suit. As recently as last month, the US Commodity and Futures Trading Commission reportedly subpoenaed four cryptocurrency exchanges to obtain trading data as part of their probe into whether there has been market manipulation of bitcoin futures.

*This Bulletin is intended as general information only and is not to be taken as legal advice. If you require additional information please contact the authors [Joanne Luu](#) or [Sylvie Welsh](#).*