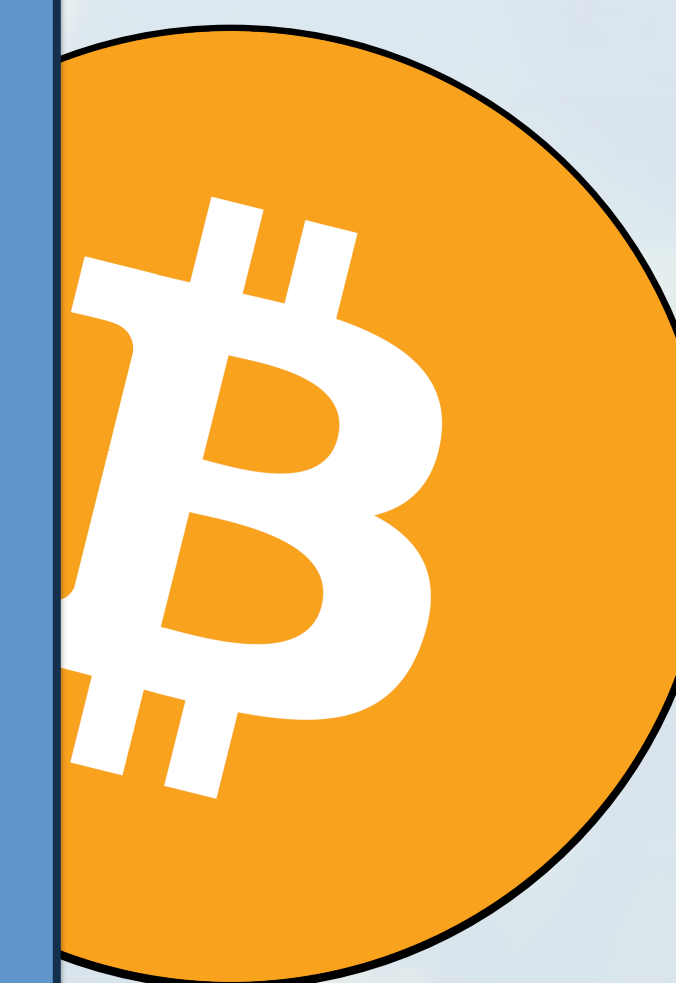


# Recommendations for regulating cryptocurrency offerings as securities

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## Abstract

In 2017, businesses raised over **US\$4 billion** by selling cryptocurrencies through the use of initial coin offerings (“ICOs”). These ICOs—which are similar in namesake and purpose to the more traditional IPO—caught the attention of Canadian and American securities regulators when concerns over investor protection in the cryptocurrency space began to swirl. As a response, the Canadian Securities Administrators (“CSA”) issued a statement saying that ICOs *may* fall under the ambit of securities laws but that there are exemptions available to issuers. This has resulted in two concerns: (1) **uncertainty** for both issuers and investors as to when securities regulation will apply and (2) even if securities laws do apply, issuers may be exempt from certain requirements that would otherwise provide **investor protection**. As a result, research was conducted into various regulatory approaches taken by securities regulators and recommended by academics in an attempt to assess potential options for the CSA. In the end, it was found that Canadian securities regulators should both (1) clarify a specific test or definition for the types of tokens or coins that will be considered securities and (2) develop a list of best practices for which cryptocurrency offerors should follow. These implementations would reduce the current legal grey area created by ICOs, improve issuer and investor certainty, and better protect purchasers of cryptocurrencies.

## Introduction – Context

The possible need for regulation in cryptocurrency offerings came to light shortly after a **2016 cryptocurrency heist** of The DAO’s assets. The DAO, through an ICO, raised approximately US\$150 million. The investors were issued DAO Tokens, which gave them the right to vote on which projects to finance with the hope that, collectively, a positive return on investment would be realized.



Approximately one month after the initial DAO Token offering, on June 17, 2016 a hacker was able to re-route roughly **US\$50 million worth of assets in the fund to another account**. While the funds were subject to a 28-day hold—and thus the transaction was successfully cancelled—this security breach was still enough to lead to the downfall of The DAO in late 2016 for security reasons. The slight scare was also enough to cause many to ask what would happen if the transaction could not have been cancelled. In other words, people wanted to know what the **applicable regulatory regime** was, if there was even one at all.

## Methodology

In order to address some of the concerns related to the current regulatory scheme related to ICOs (or lack thereof), and ultimately propose some recommendations, I conducted secondary research by looking at:

1. current **approaches** taken by the Securities and Exchange Commission (SEC) and the Canadian Securities Administrators (CSA);
2. recent **decisions** by the Autorité des marchés financiers (AMF) and Ontario Securities Commission (OSC) relating to ICOs; and
3. other potential **options** proposed by academics.

## Results

### Current approach (CSA & SEC)

The CSA, in following the SEC’s approach, noted through CSA Staff Notice 46-307 that:

1. Many ICOs would fall under the ambit of securities law (though dealt with on a case-by-case basis using the *Pacific Coin* test);
2. Two common exemptions may apply to crypto-offerors: (1) sales to accredited investors; and (2) the offering memorandum exemption; and
3. It would consider substance over form.

### The issue with the CSA’s recommendation

Two primary issues: (1) dealing with ICOs on a case-by-case basis may be time consuming and costly and is not proactive in protecting investors; and (2) there are many ways for offerors to avoid securities regulations.



### Case study of recent ICOs

#### Impak Coin

In connection with its ICO, Impak asked the AMF for exemption from the following securities laws requirements: (1) dealer registration and (2) prospectus. The AMF, in granting the exemptions, placed some conditions on the distribution. Notably, Impak would be required to conduct KYC and suitability reviews, be barred from providing investment advice to investors, have to make certain information available quarterly, and refrain from publicly listing MPK on any exchange (meaning MPK could only be transferred between merchants and holders).<sup>1</sup>

#### Token Funder

In its application to the OSC, Token Funder looked to rely on the OM prospectus exemption in National Instrument 45-106.<sup>2</sup> The OSC largely followed the AMF’s decision in the case of Impak (above) and granted the exemption with similar conditions, though there were some minor differences. For one, Token Funder was required to share investor purchase amounts and investor complaints with the OSC. In addition to this, Token Funder had to become a registrant immediately after the ITO.<sup>3</sup>

### Remaining Issue – Utility Tokens

Of primary concern is that there has been no indication of how multidimensional tokens—also known as “utility tokens”—will be treated in Canada. These tokens, which give the holder certain rights (such as the right to use a certain technology or purchase certain goods, as opposed to the right to a return on investment), may *not* constitute a security. With no insight into whether or not utility tokens would be caught by the web of securities laws, offerors and purchasers of tokens and coins are left uncertain if such regulations will apply to them or not.

### Potential other approaches (and concerns)

1. Ban (harsh; suppresses innovation)
2. Warnings (puts burden on investor)
3. Extend existing laws (easy to circumvent)
4. Best practices/code (non-binding)
5. Int’l convention (overburdens and complicates)

### Recommendation

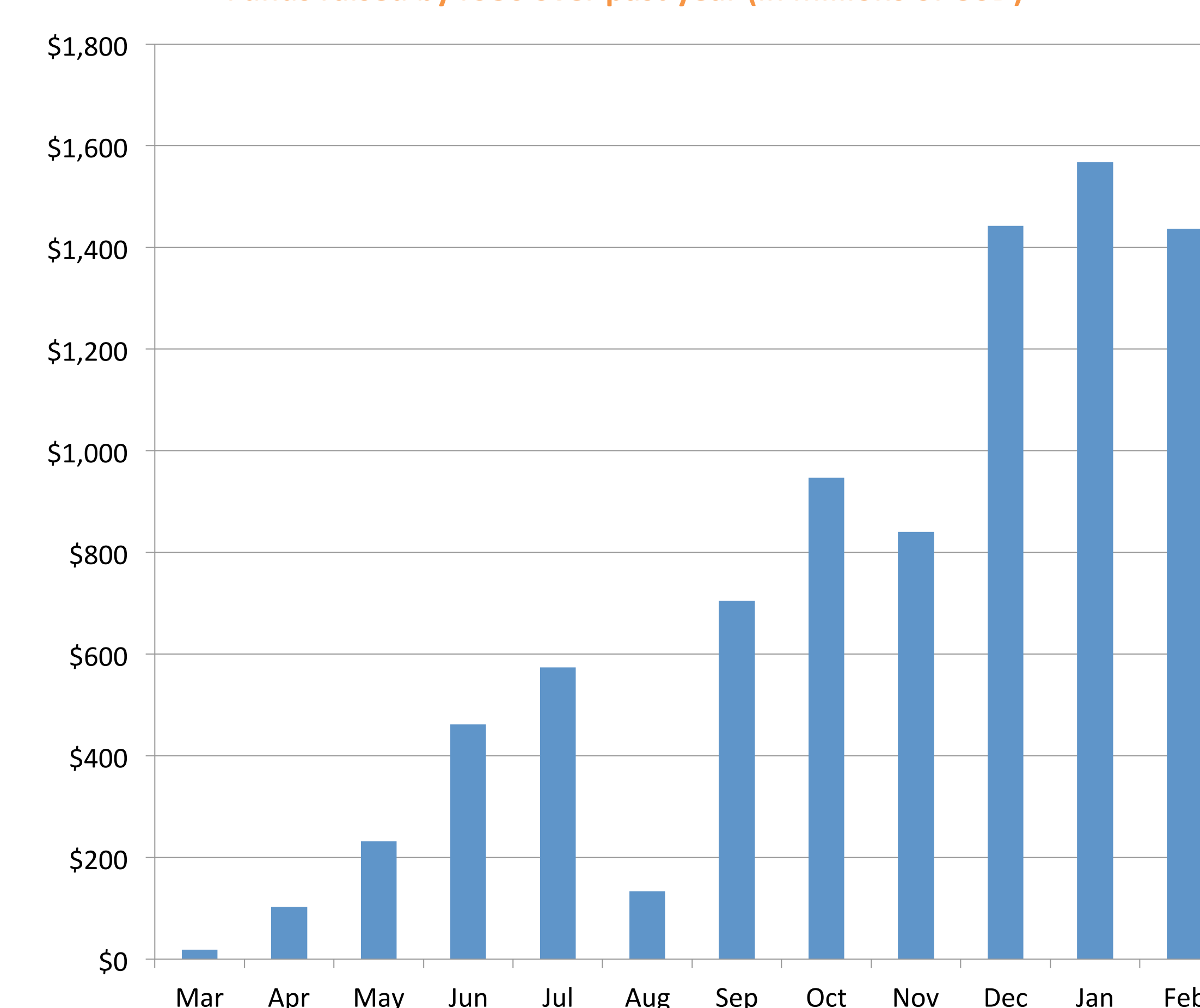
Must find middle ground; recommended that securities regulators should:

- (1) clarify a specific test/definition for the types of tokens to be considered securities, and
- (2) develop a list of best practices.

### References

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2. Mindy B Gilbert, Geoffrey L Rawle & Zain Rizvi, “OSC Invites TokenFunder to Play in the CSA Sandbox” (26 October 2017), Davies (blog), online: <[www.dwpv.com/en/Insights/Publications/2017/OSC-Invites-TokenFunder-to-Play-in-the-CSA-Sandbox](http://www.dwpv.com/en/Insights/Publications/2017/OSC-Invites-TokenFunder-to-Play-in-the-CSA-Sandbox)>.
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Funds raised by ICOs over past year (in millions of USD)



## Conclusions

Despite the recent efforts by the CSA through Staff Notice 46-307, there is still a large regulatory grey area within Canada when it comes to ICOs. The reasons for this are substantial and range from the complex nature of cryptocurrency to the rigid existing securities laws framework. Despite this, there are still a number of different ways to improve upon the existing regime. In response, **Canadian securities regulators should look to better define what it will consider a security** when it comes to the offering of tokens and coins by fintech businesses. This will not only act as a way to introduce greater certainty into the cryptocurrency industry in Canada, but it should also attract positive investments in the Canadian blockchain. Further, **a series of best practices should be outlined by regulators such as the OSC and CSA** in order for investors to become more confident in the types of businesses in which they invest. While these are baby steps in comparison to more sweeping changes such as the creation of an entire new regulatory framework for ICOs, these are important foundations on which cryptocurrency offerings may grow within Canada.

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