CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 46-307

Cryptocurrency Offerings[1]

August 24, 2017

Introduction and purpose

Staff (**we** or **staff**) of the Canadian Securities Administrators (**CSA**) are aware of an increase in the number of cryptocurrency offerings, such as initial coin offerings (**ICO**), initial token offerings (**ITO**)[2] and sales of securities of cryptocurrency investment funds.

Cryptocurrency offerings can provide new opportunities for businesses to raise capital and for investors to access a broader range of investments. However, they can also raise investor protection concerns, due to issues around volatility, transparency, valuation, custody and liquidity, as well as the use of unregulated cryptocurrency exchanges[3]. Also, investors may be harmed by unethical practices or illegal schemes, and may not understand the properties of the investment products that they are purchasing.

Many of these cryptocurrency offerings involve sales of securities. Securities laws in Canada will apply if the person or company selling the securities is conducting business from within Canada or if there are Canadian investors. Given the significant growth in this area and requests for guidance, we are publishing this Staff Notice to help financial technology (**fintech**) businesses understand what obligations may apply under securities laws.[4]

We note that these products may also be derivatives and subject to the derivatives laws adopted by the Canadian securities regulatory authorities, including trade reporting rules.

Businesses should consider if and how prospectus, registration and/or marketplace requirements apply to their cryptocurrency offerings. Specifically and as described in more detail in this Staff Notice:

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[1] This Staff Notice is being published in all of the jurisdictions of Canada except Saskatchewan. The Financial and Consumer Affairs Authority of Saskatchewan will advise of its approach in this matter after the provincial by-election in Saskatchewan on September 7, 2017.

[2] Cryptocurrency may also be referred to as virtual or digital currency, among other terms. ICOs and ITOs may also be referred to as token generation events (TGE), among other terms.

[3] The term "exchange" used in this context is not intended to be the same as the term used in National Instrument 21-101 *Marketplace Operation* and securities legislation of the jurisdictions of Canada, but instead reflects what these entities are commonly referred to today.

[4] Many authorities have recently cautioned that sales of digital assets may be subject to securities laws: https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/Consumer-Advisory-on-Investment-Schemes-Involving-Digital-Tokens.aspx

- Securities may only be sold after a receipt has been received from a securities regulatory authority for a comprehensive disclosure document called a "prospectus", or pursuant to a private placement in reliance on a prospectus exemption;

- Businesses and individuals in the business of trading in or advising on securities must be properly registered or rely on an exemption from registration; and

- A platform that facilitates trades in coins/tokens that are securities may be a marketplace and need to comply with marketplace requirements or obtain an exemption from such requirements.

This Staff Notice will:

- Respond to requests from fintech businesses for guidance on the applicability of securities laws to cryptocurrency offerings and what staff will consider in assessing if an ICO/ITO is a distribution of securities;

- Discuss what steps fintech businesses can take if they are raising capital through ICOs/ITOs, so that they comply with securities laws;

- Highlight issues that fintech businesses looking to establish cryptocurrency investment funds should be prepared to discuss with staff;

- Discuss how the use of cryptocurrency exchanges may impact staff's review of ICOs/ITOs and cryptocurrency investment funds; and

- Explain how the CSA Regulatory Sandbox can help fintech businesses with cryptocurrency offerings comply with securities laws through a flexible process.

This Staff Notice focuses on ICOs/ITOs and cryptocurrency investment funds, and their intersection with cryptocurrency exchanges. However, this guidance should also be considered in the context of other cryptocurrency or distributed ledger technology-based offerings that may trigger securities law requirements.

What is a cryptocurrency exchange?

Cryptocurrency exchanges are online exchanges that allow investors to buy and sell cryptocurrencies. Purchases and sales of cryptocurrencies can be made using either fiat currency (e.g., buying bitcoin using CAD or USD) or cryptocurrency (e.g., buying bitcoin using another cryptocurrency such as ether). We understand that in addition to cryptocurrencies such as bitcoin and ether, cryptocurrency exchanges may also offer coins/tokens that have been sold pursuant to ICOs/ITOs.

Cryptocurrency exchanges operate across the world, in many cases without government oversight or regulation. Prices for cryptocurrencies may differ significantly among exchanges, allowing for arbitrage opportunities. While arbitrage opportunities may not exist for extended

periods in efficient markets, they can persist in inefficient ones. Investment funds that purchase cryptocurrencies from these exchanges for their portfolios should be aware that standards among exchanges can vary significantly.

Recently, several jurisdictions have taken steps to impose requirements on cryptocurrency exchanges, including with respect to identity verification, anti-money laundering, counter-terrorist financing and recordkeeping.

A cryptocurrency exchange that offers cryptocurrencies that are securities must determine whether it is a marketplace. Marketplaces are required to comply with the rules governing exchanges or alternative trading systems. 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. To date, no cryptocurrency exchange has been recognized in any jurisdiction of Canada or exempted from recognition.

Allowing coins/tokens that are securities issued as part of an ICO/ITO to trade on these cryptocurrency exchanges may also place the business issuing the coins/tokens offside securities laws. For example, the resale of coins/tokens that are securities will be subject to restrictions on secondary trading.[5]

Coin and token offerings

Background

ICOs/ITOs are generally used by start-up businesses to raise capital from investors through the internet. These investors are often retail investors. An ICO/ITO is typically open for a set period, during which investors can visit a website to purchase coins/tokens in exchange for fiat currency or a cryptocurrency such as bitcoin or ether. The structures of ICOs/ITOs will vary, and they may be used to raise capital for a variety of projects, including the development of a new cryptocurrency, distributed ledger technology, service or platform. Anyone with internet access can create or invest in an ICO/ITO; in many cases, they can do so anonymously.

In many ways, an ICO/ITO can be very similar to an initial public offering (**IPO**). The coins/tokens can be similar to traditional shares of a company because their value may increase or decrease depending on how successfully the business executes its business plan using the capital raised.

Trades in securities

Staff is aware of businesses marketing their coins/tokens as software products, taking the position that the coins/tokens are not subject to securities laws. However, in many cases, when the totality of the offering or arrangement is considered, the coins/tokens should properly be considered securities. In assessing whether or not securities laws apply, we will consider substance over form.

[5] National Instrument 45-102 *Resale of Securities* restricts secondary trading in securities of non-reporting issuers.

Although a new technology is involved, and what is being sold is referred to as a coin/token instead of a share, stock or equity, a coin/token may still be a "security" as defined in securities legislation of the jurisdictions of Canada. Businesses should complete an analysis on whether a security is involved. Legal and/or other professional advice may be useful in making this determination.

Every ICO/ITO is unique and must be assessed on its own characteristics. For example, if an individual purchases coins/tokens that allow him/her to play video games on a platform, it is possible that securities may not be involved. However, if an individual purchases coins/tokens whose value is tied to the future profits or success of a business, these will likely be considered securities.

We have received numerous inquiries from fintech businesses and their legal counsel relating to ICOs/ITOs. With the offerings that we have reviewed to date, we have in many instances found that the coins/tokens in question constitute securities for the purposes of securities laws, including because they are investment contracts. In arriving at this conclusion, we have considered the relevant case law[6], which requires an assessment of the economic realities of a transaction and a purposive interpretation with the objective of investor protection in mind.

In determining whether or not an investment contract exists, businesses should apply the following four-prong test. Namely, does the ICO/ITO involve:

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

Securities law requirements that apply

Businesses issuing coins/tokens that are securities must identify and address fundamental securities law obligations, including the following:

Prospectus requirement or exemption

To date, no business has used a prospectus to complete an ICO/ITO in Canada. We anticipate that businesses looking to sell coins/tokens may do so under prospectus exemptions. Sales may be made to investors who qualify as "accredited investors" as defined under securities laws, in reliance on the accredited investor prospectus exemption[7]. For retail investors who do not qualify as accredited investors, sales will typically need to be made in reliance on the offering memorandum (**OM**) prospectus exemption.[8]

[6] The Supreme Court of Canada's decision in *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 S.C.R. 112; as well as the various judicial and administrative decisions that have been issued subsequent to that case.
[7] Section 2.3 of National Instrument 45-106 *Prospectus Exemptions* (**NI 45-106**).
[8] Section 2.9 of NI 45-106.

We are aware that some fintech businesses publish whitepapers for their ICOs/ITOs, which may describe things such as the fundraising goal, the business, the project for which capital is being raised, how many coins/tokens management of the business will retain and how long the offering will remain open. Although whitepapers are a form of disclosure document for investors, it is important to note that they are often not structured in the same way as prospectuses or OMs. Investors must be provided with a document that complies with the requirements of securities laws. Under securities laws, prospectuses and OMs have specific disclosure requirements and trigger certain ongoing obligations and other protections for investors. For example, investors can sue for misrepresentations by management of the business in prospectuses and OMs.

It should also be noted that investors may also have civil remedies against persons or companies that fail to comply with securities laws, including a right to withdraw from the transaction and/or damages for losses on the grounds that such transactions were conducted in breach of securities laws.

Unless relief is granted from the applicable securities regulatory authority, businesses relying on the OM prospectus exemption must meet all of the conditions of that exemption, including:

- Meeting the content requirements for the document;
- Obtaining a signed risk acknowledgement form from each investor;
- Complying with investor investment limits, as required;
- Providing audited annual financial statements and ongoing disclosure to investors, as required;
- Complying with resale restrictions, which will generally preclude coins/tokens from trading on cryptocurrency exchanges; and
- Filing reports of exempt distribution with the securities regulatory authorities.

Examples of material information to be disclosed in an OM are:

- A description of the business itself;
- The ecosystem on which the coin/token operates;
- Any minimum or maximum offering amounts;
- The intended use of proceeds;
- How long the offering will remain open;
- Features of the coins/tokens, including potential returns on investment, exit strategies and liquidity;
- How the coins/tokens will be valued on an ongoing basis;
- The number of coins/tokens that will be held by management compared to the number that will be offered for sale to the public;
- The timeline for achieving different milestones and any ongoing updates that will be provided;
- Management members' identities and backgrounds, including any regulatory or legal proceedings against them;
- Remuneration paid or payable to the management team and/or any advisors; and
- All material risks of investing.

Any disclosure provided to investors, whether an OM or otherwise, must not be false or misleading. The disclosure must focus on material facts and be relevant, clear, balanced, in plain language and not overly promotional.

Registration requirement or exemption

Businesses completing ICOs/ITOs may be trading in securities for a business purpose (referred to as the "business trigger"), therefore requiring dealer registration or an exemption from the dealer registration requirement. Whether or not an activity meets the business trigger is facts specific.[9]

With the ICOs/ITOs that we have reviewed, we have found the following factors, among others, as important considerations for whether a person or company is trading in securities for a business purpose:

- Soliciting a broad base of investors, including retail investors;
- Using the internet, including public websites and discussion boards, to reach a large number of potential investors;
- Attending public events, including conferences and meetups, to actively advertise the sale of the coins/tokens; and
- Raising a significant amount of capital from a large number of investors.

Individuals or businesses that meet the business trigger must meet fundamental obligations to investors, including know-your-client (**KYC**) and suitability. Collecting little to no information on investors, for example only names, email addresses and/or IP addresses would not be sufficient to meet this obligation. Businesses conducting ICOs/ITOs that meet the business trigger must verify investors' identities and collect sufficient information to ensure that purchases of coins/tokens are suitable, including on investment needs and objectives, financial circumstances and risk tolerance.

It is possible that a business that meets the business trigger could fulfil its KYC and suitability obligations through a robust, automated, online process that incorporates investor protections. These investor protections could include limits on investment amounts and concentration, as well as risk warnings.

Persons or companies facilitating ICOs/ITOs of coins/tokens that are securities must have strong compliance systems in place, with policies and procedures that address cybersecurity risks. As cyberattacks are becoming more frequent, complex and costly, businesses in the cryptocurrency space should ensure that they have strong cybersecurity measures to safeguard the business and its investors.

[9] A business should consider the factors outlined in section 1.3 of the companion policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* to determine if its offering meets the business trigger.

Cryptocurrency investment funds

We are aware of "investment funds" as defined under securities laws being set up to invest in bitcoin and/or other cryptocurrencies. We understand from our discussions with the fintech community that one of the key purposes of this type of investment fund is to provide investors with the opportunity to obtain exposure to cryptocurrencies, or baskets of cryptocurrencies, that they may not otherwise have.

We encourage a fintech business looking to establish a cryptocurrency investment fund to consider the following:

- Retail investors: In certain jurisdictions of Canada, the OM prospectus exemption cannot be used by investment funds to distribute securities to investors.[10] Therefore, if investors in the investment fund will include retail investors, businesses will need to consider prospectus requirements, applicable investment fund rules and whether the investment is suitable.

- Cryptocurrency exchanges: Due diligence must be completed on any cryptocurrency exchange that the investment fund uses to purchase or sell cryptocurrencies for its portfolio, including on whether it is regulated in any way and the cryptocurrency exchange's policies and procedures for identity verification, anti-money laundering, counter-terrorist financing and recordkeeping. Businesses should be prepared to discuss with staff how trading volumes on the cryptocurrency exchanges that the investment fund intends to use may affect the ability to buy and sell cryptocurrencies and to fund redemption requests.

- Registration: Businesses must consider appropriate registration categories in respect of the investment fund, including dealer, adviser and/or investment fund manager.

- Valuation: How will cryptocurrencies in the investment fund's portfolio be valued? How will securities of the investment fund be valued? Will one or multiple cryptocurrency exchange(s) be used; and how will such exchange(s) be selected? Will there be an independent audit of the investment fund's valuation?

- Custody: Securities legislation of the jurisdictions of Canada generally require that all portfolio assets of an investment fund be held by one custodian that meets certain prescribed requirements. We expect a custodian to have expertise that is relevant to holding cryptocurrencies. For example, it should have experience with hot and cold storage, security measures to keep cryptocurrencies protected from theft and the ability to segregate the cryptocurrencies from other holdings as needed.

The above list is not exhaustive. Fintech businesses should be prepared to engage in discussions with staff on other relevant issues that may be identified.

[10] The OM prospectus exemption cannot be relied upon by investment funds in certain jurisdictions of Canada, per subsection 2.9(2.2) of NI 45-106.

How can the CSA Regulatory Sandbox help?

We want to encourage financial market innovation and facilitate capital raising by fintech businesses, while at the same time ensuring fair and efficient capital markets and investor protection. As cryptocurrencies become more popular and mainstream, balancing the demand for new investment opportunities and the need to protect investors from high-risk or fraudulent activities is extremely important.

In order to avoid costly regulatory surprises, we encourage businesses with proposed cryptocurrency offerings to contact their local securities regulatory authority to discuss possible approaches to complying with securities laws. We welcome digital innovation and we recognize that new fintech businesses may not fit neatly into the existing securities law framework.

The CSA Regulatory Sandbox is an initiative of the CSA to support fintech businesses seeking to offer innovative products, services and applications in Canada. It allows firms to register and/or obtain exemptive relief from securities law requirements, under a faster and more flexible process than through a standard application, in order to test their products, services and applications throughout the Canadian market on a time-limited basis.

A fintech business is invited to contact the securities regulatory authority in the jurisdiction where its head office is located:

Province	**Contact Information**
British Columbia	The BCSC Tech Team at TechTeam@bcsc.bc.ca
Alberta	Mark Franko at Mark.Franko@asc.ca or Denise Weeres at Denise.Weeres@asc.ca
Saskatchewan	Dean Murrison at dean.murrison@gov.sk.ca or Liz Kutarna at liz.kutarna@gov.sk.ca
Manitoba	Chris Besko at chris.besko@gov.mb.ca
Ontario	The OSC LaunchPad Team at osclaunchpad@osc.gov.on.ca
Québec	The Fintech Support Team at fintech@lautorite.qc.ca.
New Brunswick	Susan Powell at registration-inscription@fcnb.ca
Nova Scotia	Jane Anderson at Jane.Anderson@novascotia.ca