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Blockchain, Cryptocurrency and Digital Assets
Canadian Legal Perspectives





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Introduction

Blockchain-related technologies have been in the public eye for many years. In the early 2010s, cryptocurrency began to gain popularity. In 2014, the world's leading bitcoin exchange at the time declared bankruptcy, which made international headlines. Around the same time, the development of alternative cryptocurrencies increased. The late 2010s saw increased public awareness of non-fungible tokens, a trend that has continued into 2021.

To the extent that blockchain technology has been used as a financial vehicle (through cryptocurrencies or digital assets associated with NFTs), such transactions are traditionally independent from formal banking systems. If a transaction occurs but there is no relationship to traditional fiat currencies, the mere tracking of the flow of funds can be challenging.

There is also the issue of jurisdiction; where does a cryptocurrency transaction take place? Is it merely based on the residency of the holder of the "wallet"? Holders of cryptocurrencies, assuming they are individuals not subject to other reporting requirements, are not required to register with any financial services provider.

Other considerations abound.

In light of this background, it is perhaps unsurprising that Canadian law has been slow to respond to issues arising from digital assets. Canada's capital markets have been the primary legal intersection with digital assets to date. Early intersections involved Canadian regulators considering the issuance of ICOs and the regulation of derivatives arising from cryptocurrencies. McMillan's lawyers were involved at the forefront of this regulatory activity. McMillan acted on the first initial coin offering granted exemptive relief by Canadian securities regulators. We also acted on the very first public settlements of regulatory enforcement action regarding cryptocurrency derivatives involving the Ontario Securities Commission. McMillan has remained involved in advising on everything from regulatory compliance to ICOs ever since.

We have also taken pains to consider what may lay on the horizon. It appears inevitable that NFT-associated intellectual property rights will become the centerpiece of a dispute sooner or later.

What follows this introduction is a collection of articles that McMillan's lawyers have published on blockchain, cryptocurrency and digital assets in a conveniently-compiled and easily-accessible source. We hope that you will find the earlier articles useful for their commentary on the state of the law. More recent articles are more predictive, for example covering securities law and intellectual property perspectives about the booming NFT-associated market. We look forward to working with our clients on these issues and those that arise in the future.

Adam Chisholm
McMillan LLP



**McMillan
Articles**

MCMILLAN ADVISES ON FIRST INITIAL COIN OFFERING GRANTED EXEMPTIVE RELIEF BY CANADIAN SECURITIES REGULATORS

Posted on September 4, 2017

by Cory Kent, Sandra Zhao, Sasa Jarvis,, Valenteena Samrac

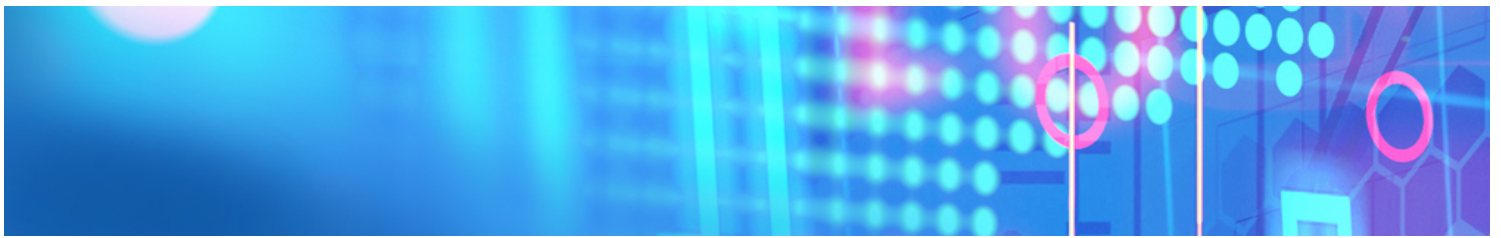
McMillan recently advised Impak Finance Inc. ("**Impak**") on the first initial coin offering ("**ICO**") to be granted exemptive relief, on August 15, 2017 by the Autorité des Marchés Financiers (the "**AMF**"). Similar in some ways to an initial public offering ("**IPO**"), ICOs are being used by financial technology ("**fintech**") businesses to issue cryptocurrency and raise funds for various purposes. On August 24, 2017, the Canadian Securities Administrators (the "**CSA**") published *CSA Staff Notice 46-307 – Cryptocurrency Offerings* (the "Staff Notice") to provide guidance on the applicability of securities laws to ICOs. The Staff Notice states that securities laws will apply to an ICO if it is an offering of a "security".^[1] The Staff Notice was published in all jurisdictions of Canada except Saskatchewan. It is expected that the Financial and Consumer Affairs Authority of Saskatchewan will advise of its approach to cryptocurrency after September 7, 2017.

Background

What is a cryptocurrency?

A "cryptocurrency" is a digital currency that is exchanged electronically. The cryptocurrency itself is represented by virtual 'coins' or 'tokens'. Unlike fiat currency which is issued by a government body, cryptocurrency is not issued by a central authority. At a basic level, cryptocurrencies are just entries on a distributed ledger with account numbers and balances (known as a "**blockchain**"). All transactions are recorded on the blockchain. There is no central authority keeping track of the blockchain – it is decentralized. Any user can keep track of the blockchain. To this end, the integrity of the blockchain is upheld by virtue of the many users keeping track of the same blockchain.

When users exchange cryptocurrency, a sender will send out a transaction message to the entire peer-to-peer network of computers (known as "**nodes**") including: (1) the sender's account number, (2) the recipient's account number and (3) the amount of cryptocurrency exchanged. As new transactions are created, the transactions go into a pool of pending transactions waiting to be verified by a node (known as a "**miner**"). Miners select a set of transactions (known as a "**block**") from the pool and compete to add the transactions to the blockchain.



The miners will validate the transaction message to determine that the request is authentic and that the sender's account holds a sufficient amount of cryptocurrency to satisfy the transfer. Every account number is associated with a 'private key' (only known to the account holder) and 'public key' available to all the nodes. The private key is used to create the 'digital signature' by encrypting the transaction message. The miners test the digital signature using the associated public key and try to decrypt it. If successfully decrypted, this proves that the digital signature was created by the true account holder.

Miners compete to solve a complex mathematical problem known as a 'hash function'. The hash function is extraordinarily special in that there is no trick to solving it faster, other than by increasing computing power. The first miner to solve the hash function gets to add their block of transactions to the end of the blockchain and all other miners update to this new version of the blockchain. The transaction is settled once it is added to the blockchain. Thereafter, a new hash function is created and the process repeats.

Miners incur great costs to build computers to solve the hash functions. The miners are incentivized to do this because every time a miner adds a new block of transactions to the blockchain, the miner is rewarded with a certain number of newly-issued cryptocurrencies.

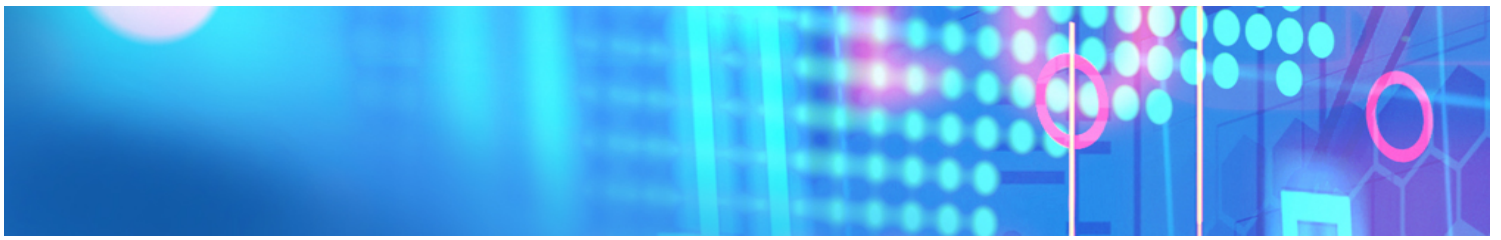
What is an ICO?

Similar to an IPO, an ICO or initial token offering ("**ITO**") is a means by which fintech businesses raise funds for a new cryptocurrency venture. In an ICO or ITO, an investor exchanges fiat currency or another type of cryptocurrency for coins or tokens issued by the company. These coins or tokens can have different functions. For example, Impak released a new digital currency is to be used in the Impak's own platform, *impak.eco*. Investors then use the coins to participate in the impact economy, and donate to projects that have a positive impact on society.

Cryptocurrencies and CSA Staff Notice 46-307

The legislative scheme used by securities regulators in Canada is a 'catch-then-exclude' mechanism whereby a security is defined broadly to catch all transactions and then exemptions carve-out situations where regulation is not justified. Cryptocurrencies may be characterized as an 'investment contract' and thus may be caught within the definition of a security.

The CSA published the Staff Notice on August 24, 2017 addressing ICOs/ITOs. While there are technical differences between coins and tokens for the purposes of the Staff Notice, coins and tokens are treated similarly, as the analysis focused on the triggering of securities laws in Canada. The Staff Notice encouraged ICOs/ITOs but raised investor protection concerns due to issues around volatility, transparency and the



potential for cryptocurrencies to be used in unethical practices or illegal schemes.

The Staff Notice states that ICOs/ITOs are similar to IPOs in many ways. The coins/tokens can be analogized to shares of a company because the value of a coin/token may increase or decrease depending on the success of the business conducting the ICO/ITO.

The Test

In determining whether or not an 'investment contract' exists, the Staff Notice advised that businesses should apply the following four-prong test from the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*^[2] to determine whether the ICO/ITO involves:

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?

The Staff Notice stated that, in many cases, when the totality of the offering or business is considered, cryptocurrencies should properly be considered securities. However, the Staff Notice stated that every ICO/ITO is unique and must be assessed on its own characteristics.

If a cryptocurrency offering is considered an offering of securities, the business conducting the offering will need to meet the prospectus, registration and/or market place requirements.

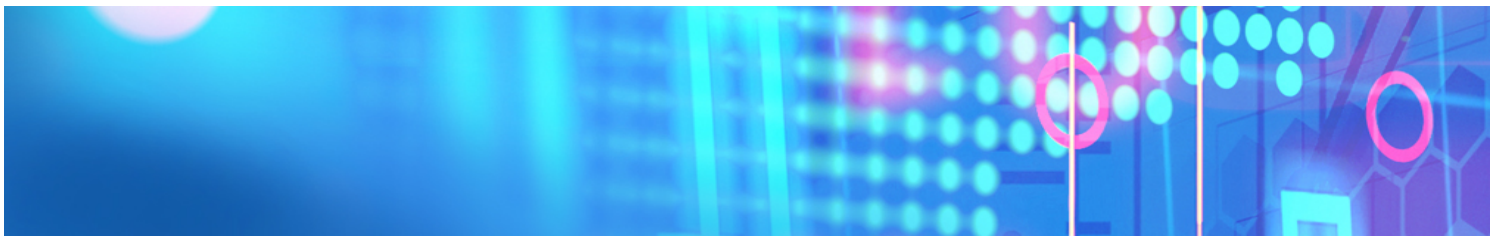
Prospectus

To date, no business has used a prospectus to complete an ICO/ITO in Canada. The CSA anticipates that businesses looking to sell cryptocurrencies may do so under prospectus exemptions such as the 'accredited investor' exemption or the 'offering memorandum' exemption.

The CSA is aware that some fintech businesses publish 'whitepapers' with respect to their ICOs/ITOs. Although whitepapers are a form of disclosure document for investors, they often do not meet the specific disclosure requirements to be properly considered a prospectus/offering memorandum. It is important to note that investors can sue for misrepresentation in the prospectus/offering memorandum and investors may have civil remedies against fintech businesses failing to comply with the securities laws.

Registration

Businesses completing ICOs/ITOs may be trading in securities for a business purpose (the "**business trigger**"), which would therefore require dealer registrations. Fintech businesses that meet the business trigger must



meet certain obligations to investors, including the know-your-client requirement (“**KYC**”) and the suitability requirement. These obligations may require businesses conducting ICOs/ITOs to collect information regarding an investor’s identity, investment objectives and risk tolerance. The Staff Notice acknowledged that it is possible to fulfill the KYC and suitability obligations through an automated online process.

Marketplace

The exchanges upon which cryptocurrency can be bought and sold often operate without oversight or regulation, and can be found around the world. A cryptocurrency exchange that offers cryptocurrencies that are securities must determine whether it is a marketplace. If the exchange is doing business in a jurisdiction in Canada, it must apply to that jurisdiction’s securities regulatory authority for recognition or an exemption from recognition.

The Staff Notice states that fintech businesses should seek legal and/or other professional advice to assess whether or not securities laws apply to avoid placing the ICO/ITO offside securities laws. For example, coins or tokens that constitute securities being used to trade on cryptocurrency exchanges could result in the issuer violating restrictions on secondary trading pursuant National Instrument 45-102 *Resale of Securities*.

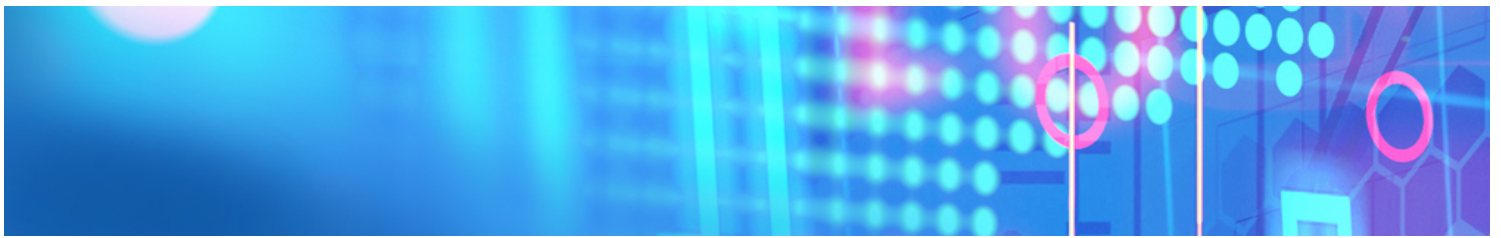
Cryptocurrency Investment Funds

The CSA is also aware of ‘investment funds’ as defined under securities laws being set up to invest in cryptocurrencies. The Staff Notice encouraged fintech business looking to establish cryptocurrency investment funds to consider the following:

1. prospectus requirements, as well as investment fund rules and the suitability of the investment,
2. due diligence on any cryptocurrency exchange that the investment fund uses to purchase or sell cryptocurrencies, specifically looking at the policies and procedures around identity verification, anti-money laundering, counter-terrorist financing and recordkeeping,
3. appropriate registration requirements,
4. valuation methods used to value the cryptocurrencies in the investment fund’s portfolio, and
5. expertise of custodians holding portfolio assets to ensure expertise are relevant to holding cryptocurrencies.

With respect to the expertise of custodians, the CSA provided guidance in the form of a non-exhaustive list of items as to what expertise may be required of custodians dealing with cryptocurrency, including experience with hot and cold storage, experience with security measures to protect the cryptocurrency from theft, and the ability to segregate cryptocurrency from other holdings as needed.

CSA Sandbox



The recently launched CSA Sandbox is an initiative to support fintech businesses seeking to offer innovative products, services and applications in Canada. The CSA Sandbox allows businesses to register and/or obtain exemptive relief from securities requirements, under a faster and more streamlined process than through a standard application.

Conclusions from the Staff Notice

While acknowledging the emergency of a new mechanism for capital raising, the Staff Notice provided issuers of cryptocurrency with a warning that their activities may violate prospectus requirements, registration requirements, and the general disclosure requirements that were created to protect investors in capital markets. While regulation of cryptocurrency remains in its infancy, increased scrutiny of transactions involving the issuance of virtual coins or tokens is expected to ultimately bridge a regulatory scheme for such cryptocurrency in line with securities requirements.

The Impak ICO

McMillan recently acted for Impak in its CSA Sandbox application for exemptive relief with respect to Impak's ICO. Pursuant to its ICO, Impak proposes to issue a new digital currency (known as "**MPK**") to fund the development of an online social network by way of a private placement in reliance on the offering memorandum exemption.

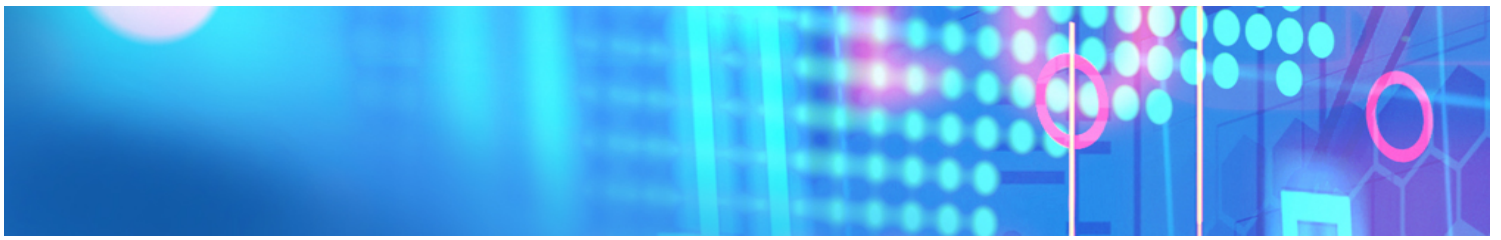
In consultation with the other members of the CSA Sandbox, the AMF granted Impak exemptive relief from the dealer registration and prospectus requirements in connection with proposed MPK ICO. The AMF stated that, in the absence of a prospectus relief, the first trade of MPK will be a distribution.

The AMF granted the registration relief under the following conditions:

- Impak will conduct KYC and suitability reviews and verify accredited investors,
- Impak will not provide investment advice to investors,
- Impak will deal fairly, honestly and in good faith with its investors, and
- Impak will establish procedures to manage the risks associated with its business.

The AMF stated that the prospectus requirement will apply to a first trade in MPK, unless the first trade is made between an Impak user and an impact organization (i.e., businesses, non-governmental organizations, not-for-profit corporations and social enterprises) in either of the following cases:

- (i) an Impak user pays in MPK for goods and services offered by an impact organization, or
- (ii) an impact organization rewards the Impak user for such purchase.



The AMF also imposed the following conditions:

- Impak will make certain quarterly information reasonably available to participants,
- MPK issued in the ICO will not be listed and traded on any exchange, and
- Impak will provide the AMF with any report or information that may be requested.

In addition to the Provinces of Quebec and Ontario, and in reliance on *Regulation 11-102 respecting Passport System*, the AMF's decision is intended to be relied upon in British Columbia, Alberta, Saskatchewan, Manitoba, New Brunswick, and Nova Scotia. The AMF's decision document has been published as of August 15, 2017, and can be under the following link: [Impak Finance Inc.](#)

[1] Securities Act, RSO 1990, c S.5, s 1

[2](1977), [1978] 2 SCR 112, 80 DLR (3d) 529.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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DIVERGENT REGULATORY APPROACHES TO CRYPTOCURRENCY OFFERINGS: DEVELOPMENTS IN CANADA, THE UNITED STATES, AND CHINA

Posted on October 9, 2017

by Cory Kent and Sasa Pudar

Cryptocurrency is a digital currency that utilizes cryptography for security, and is used as a medium of exchange between parties. One of the most well known cryptocurrencies is Bitcoin, though there are a significant number of such currencies available for purchase and sale. The currency itself is represented by virtual 'coins' or 'tokens'.

The issuance of cryptocurrency has become more common as a capital raising mechanism, which has caused considerable attention to be paid to cryptocurrency offerings by both the investing public and the governmental authorities responsible for securities regulation in various jurisdictions around the world. This bulletin considers the statements made by such regulators as they adopt their respective mechanisms for dealing with cryptocurrency as a new investment vehicle.

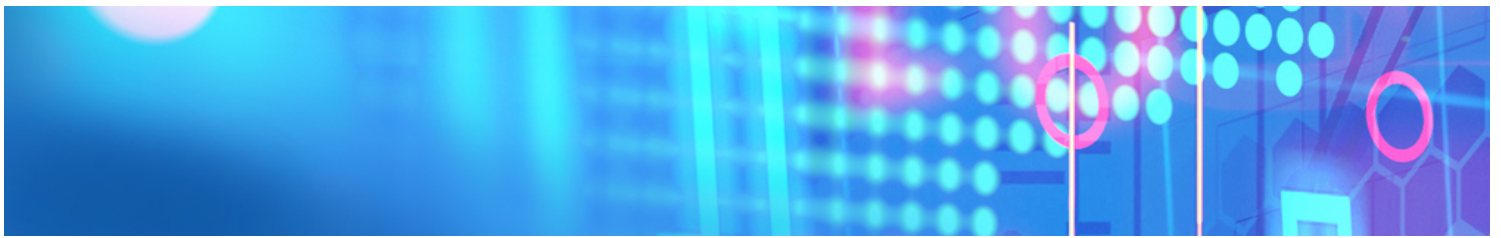
The Canadian Approach

The Canadian approach to cryptocurrency offerings appears to be to apply the current regulatory system for securities to the offerings, once the test for a security has been met on the basis of the individual set of facts related to the type of cryptocurrency and the offering itself.

On August 24, 2017, the Canadian Securities Administrators ("CSA") released CSA Staff Notice 46-307 *Cryptocurrency Offerings* (the "Notice"), pursuant to which the CSA provided guidance for issuers seeking to raise capital through the sale of cryptocurrency. The staff notice was published in all jurisdictions except Saskatchewan, and it is expected that the Financial and Consumer Affairs Authority of Saskatchewan will advise of its approach to cryptocurrency after September 7, 2017.

Offering Cryptocurrencies

The primary analysis related to offerings of cryptocurrency relate to whether such currency is an investment contract under Canadian law, which is a type of security. Specifically, the test for investment contracts in Canada rests in the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario*



(*Securities Commission*)^[1]. To be an investment contract, the offering must involve an investment of money in a common enterprise with the expectation of profit to come significantly from the efforts of others.

If the sale of cryptocurrency constitutes an investment contract in accordance with the test outlined in *Pacific Coin*, then the requirement to distribute such securities under a prospectus or under an exemption from prospectus requirements applies. Further, issuers who distribute coins or tokens in connection with such an offering may be trading in securities for a business purpose, requiring dealer registration or an exemption from such dealer registration requirements.

Cryptocurrency Exchanges

The exchanges upon which cryptocurrency can be bought and sold often operate without oversight or regulation, and can be found around the world. The CSA warns that coins or tokens that constitute securities being issued to trade on such cryptocurrency exchanges could result in the issuer violating restrictions on secondary trading pursuant to National Instrument 45-102 Resale of Securities.

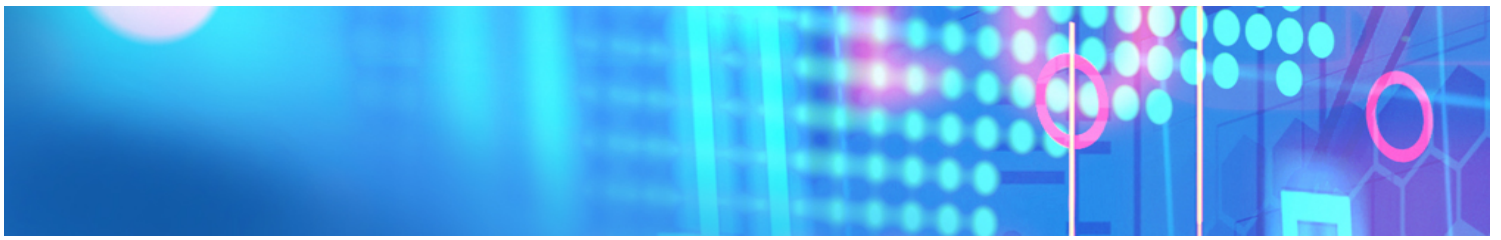
The U.S. Approach

The United States appears to be independently adopting a similar approach as to Canada's, in that the current regulatory system for securities is starting to recognize cryptocurrency as potentially being a security, and therefore already being subject to a comprehensive set of requirements related to registration, disclosure, and similar matters.

While the U.S. Securities and Exchange Commission (the "SEC") has not come out with a comprehensive bulletin in the way the CSA had regarding the specific test for determining whether a cryptocurrency was a security, the SEC has published a bulletin meant to act as guidance for investors as well as a Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934, related to an investigation conducted of The DAO, an entity which began offering and selling their own tokens (the "DAO Tokens") to raise capital.

In past publications issued by the SEC, a major theme related to cryptocurrency has been the warning of investors of potential fraud perpetrated through the use of Bitcoin and other virtual currencies. The SEC indicated that it has a concern that the rise of virtual currencies is allowing fraudsters to facilitate Ponzi and other schemes, or engage in fabricated investments or transactions, specifically noting a recent case it prosecuted in which an alleged Ponzi scheme was advertised as a Bitcoin "investment opportunity"^[2]. The SEC has taken enforcement action against such schemes, and issued several investor alerts over the past number of years.

More recently, the analysis provided by the SEC appears to contemplate the treatment of coins or tokens sold pursuant to Initial Coin Offerings or Initial Token Offerings as a security^[3]. Among other items, the most recent



investor bulletin related to Initial Coin Offerings outlines that the offer and sale of such coins may need to be registered with the SEC or be performed pursuant to an exemption, and further that investment professionals and the firms that transact, offer, or advise on investments of cryptocurrency, may be required to be licensed or registered, if such cryptocurrency constitutes a security^[4].

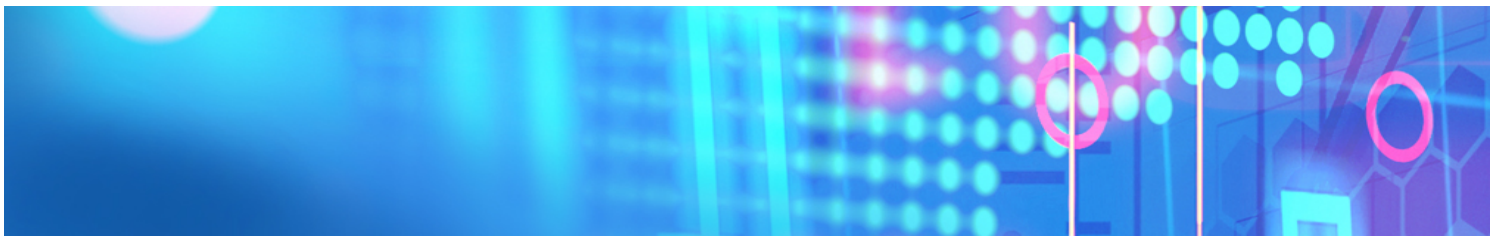
The SEC's investigation of the DAO provides a valuable case study in how the SEC approaches the issue of cryptocurrency offerings within its regulatory system.

The DAO Investigation

The DAO was created as a for-profit entity that creates and holds assets through the sale of DAO Tokens to investors, and those assets would then be used to fund the projects undertaken by DAO. The holders of the DAO Tokens were anticipated to receive earnings from the projects, and had the right to vote on those projects on the basis of their DAO Token holdings. Further, the holders of DAO Tokens could sell their DAO Tokens on various online platforms that supported this trading. The DAO Tokens were sold to investors in exchange for approximately 12 million Ether, which is another virtual currency used on the Ethereum blockchain, which the SEC indicated had a value of approximately US\$150 million.

Similarly to the approach taken by the CSA, the SEC had sought to establish whether the DAO Tokens were a security on the basis of whether they could be characterized as an investment contract^[5]. The test for investment contracts in the United States was adopted by the U.S. Supreme Court in *SEC v WJ Howey Co.*^[6], which was considered by the Supreme Court of Canada in *Pacific Coin*, leading to the two tests being very similar. The test articulated in *Howey* is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Ultimately, the SEC found that the test articulated above was satisfied. The concept of money does not need to be cash, and the SEC determined that the sale of DAO Tokens for Ether met the first stage of the test, namely that an investment was made. The SEC's analysis further included investors who were purchasing the DAO tokens were investing in a common enterprise and they expected to earn profits from that enterprise, which could include both dividends or other periodic payments and also an increase in the value of their investment. This profit was further to be derived from the managerial efforts of others, including those who managed the DAO and put forward project proposals that could generate profits for the DAO's investors. Additional evidence of reliance that was specifically mentioned by the SEC was the marketing efforts put forward by the managers of the DAO, and specifically with how they held themselves out to be experts in Ethereum, which was the blockchain protocol upon which the DAO operated. The persons who selected the projects that would be voted on were held out to investors to be experts in the area, which further indicated to the SEC that DAO Token holders were acting in reliance on such persons. Finally, the SEC found that the limited voting rights



afforded to the DAO Token holders were not enough to vitiate the reliance on third parties. The DAO was therefore obligated to register the offer and sale of the DAO Tokens under the Securities Act of 1933, unless a valid exemption applied.

The Chinese Approach

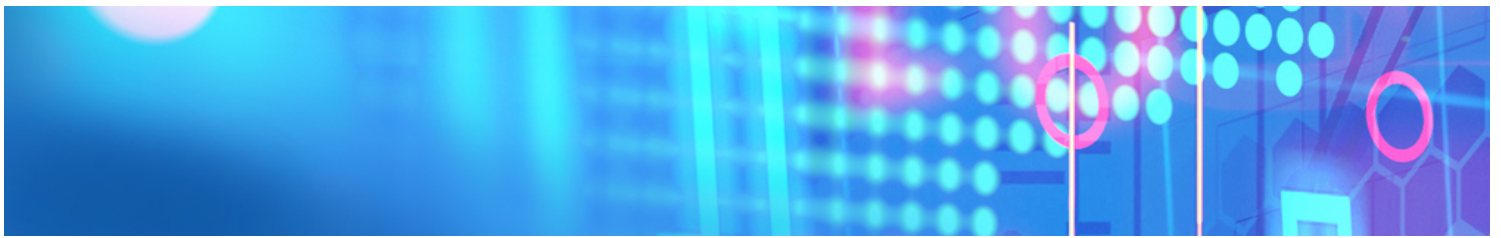
On September 4, 2017, reports emerged that China was banning the practice of capital raising through the sale of cryptocurrency. China in particular has been a jurisdiction in which a significant number of Initial Coin Offerings have been conducted, particularly recently, as data emerging from a government organization that monitors such activity stated that between January and July of 2017, there had been 65 Initial Coin Offerings raising a combined 2.62 billion yuan (estimated to be approximately US\$394.6 million) from 105,000 individuals^[7]. Some reports drew conclusions related to the fall of value of Bitcoin and Ethereum, two of the most popular cryptocurrencies available, after the news of China's ban emerged^[8].

Comparison of Regulatory Approaches

Each of the SEC and the CSA did not categorize all cryptocurrency as being a security, but rather outlined the tests that apply to the determination of whether something is a security, and specifically whether it is an investment contract. The SEC specifically stated in the DAO investigation report “[w]hether or not a particular transaction involves the offer and sale of a security – regardless of the terminology used – will depend on the facts and circumstances, including the economic realities of the transaction.^[9]” The result of such an approach is that there could be cryptocurrencies that on the facts may not be considered a security, and so the regulatory system in place would presumably not apply, however the exact set of facts that would need to exist to eliminate one or more of the factors in the *Howey* test or the Pacific Coin test is not readily apparent at this time.

China has taken a different approach, opting not to allow investors to engage with cryptocurrency. It is uncertain whether such restrictions will prove to be permanent or will be loosened over time, however there is significant disparity with this approach in comparison to that adopted by Canada and the United States, which does serve to impact the global community of investors in cryptocurrency as well as the issuers offering such virtual currency.

South Korea initially appeared to be taking a different approach from China, as reports emerged that it will seek to strengthen regulations related to the offer, sale, and trade of virtual currencies, and will punish Initial Coin Offerings conducted in violation of the capital markets legislation in the jurisdiction. The regulations were anticipated to be in the form of strengthening user authentication procedures and banks' suspicious transactions reports, monitoring overseas transactions of service providers who use digital currencies to transfer money, and introducing new regulations related to domestic trading of virtual currencies^[10]. In



September 2017, the Financial Services Commission in South Korea released a statement that ICOs were banned as a fundraising tool, and that penalties would be issued on financial institutions or any other parties involved in issuing cryptocurrency through an ICO^[11].

Conclusion

At present, there is no unified global approach to the regulation of cryptocurrency, and while some of the jurisdictions such as Canada and the United States may have minor differentiations in their approaches, other jurisdictions such as China can significantly diverge. As each jurisdiction decides on its approach, it is clear that governments and regulatory authorities are aware of the growing popularity and use of cryptocurrency as a capital raising mechanism, and that such attention by the authorities will mean enforcement of regulation and at times perhaps even the introduction of new regulations that issuers, investors, and virtual currency exchanges, will have to contend with.

[1] [1978] 2 SCR 112, [1977] 2 ACWS 1063 (SCC) [Pacific Coin].

[2] US, US Securities and Exchange Commission, Investor Alert: Ponzi Schemes Using Virtual Currencies (Sec Pub No 153-7/3) (July 23, 2013), online: <https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf>.

[3] US, US Securities and Exchange Commission, Investor Bulletin: Initial Coin Offerings (July 25, 2017), online: <https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings>.

[4] Ibid.

[5] US, US Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Release No 81207) (July 25, 2017) at 11, online: <<https://www.sec.gov/litigation/investreport/34-81207.pdf>> [DAO Investigation].

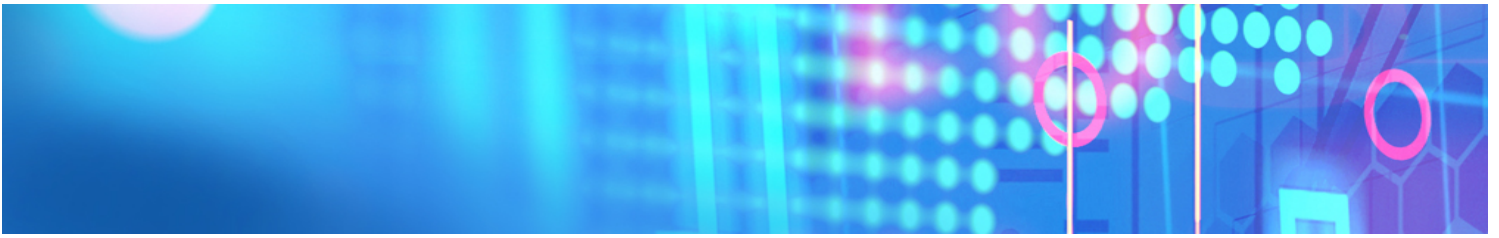
[6] 328 US 293 (1946) [Howey].

[7] John Ruwitch & Jemima Kelly, "China hits booming cryptocurrency market with coin fundraising ban" (September 4, 2017), Reuters, online: <<https://www.reuters.com/article/us-china-finance-digital/china-hits-booming-cryptocurrency-market-with-coin-fundraising-ban-idUSKCN1BF0R7>>.

[8] "China just banned initial coin offerings, calling them illegal fundraising" (September 4, 2017), Business Insider, online: <<http://www.businessinsider.com/r-china-bans-initial-coin-offerings-as-illegal-fundraising-2017-9>>.

[9] DAO Investigation supra note 5 at 17-18.

[10] Yoon Yung Sil, "Regulating Bitcoin Trading: Financial Authorities to Strengthen Regulations on Digital



Currency Trading” (September 4, 2017), Business Korea, online:

<<http://www.businesskorea.co.kr/english/news/money/19180-regulating-bitcoin-trading-financial-authorities-strengthen-regulations-digital>>.

[11] “South Korea bans all new cryptocurrency sales” (September 28, 2017), CNBC, online: <<https://www.cnbc.com/2017/09/28/south-korea-bans-all-new-cryptocurrency-sales.html>>.

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CSA REINFORCES POSITION THAT SECURITIES LAWS APPLY TO CRYPTOCURRENCY OFFERINGS, CONFIRMS REGULATORY SCRUTINY FOR INDUSTRY PARTICIPANTS

Posted on July 19, 2018

by Raj Dewan, Jeffrey Gebert, Alex Bruvels and Joseph Osborne

Introduction

On June 11, 2018, the Canadian Securities Administrators (the “**CSA**”) published CSA Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens* (the “**Staff Notice**”) providing regulatory guidance on token and coin offerings.

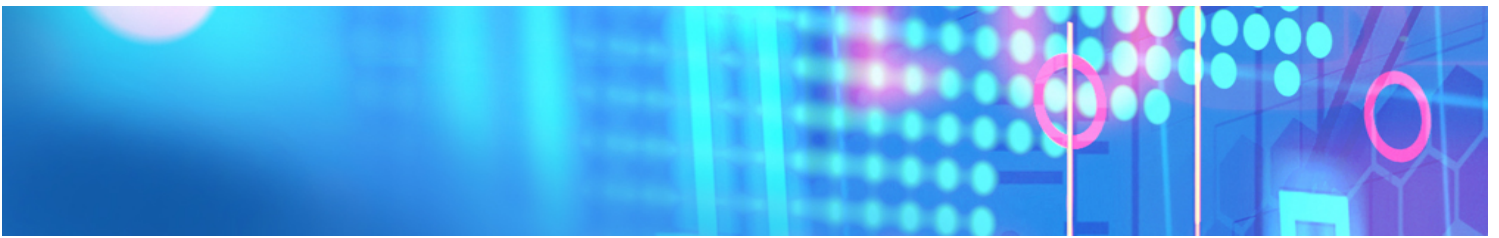
The Staff Notice builds on CSA Staff Notice 46-307 – *Cryptocurrency Offerings* (“**SN 46-307**”). In SN 46-307, the CSA stated its view that cryptocurrency offerings, including initial coin offerings (“**ICO**”) and initial token offerings (“**ITO**”), may involve an offering of securities and therefore may trigger prospectus or registration requirements under applicable securities laws. However, SN 46-307 did not provide much practical guidance to businesses that were contemplating completing an ICO/ITO on when such offerings would constitute the sale of securities. In particular, SN 46-307 did not directly address the concept of “utility tokens”, an industry term commonly used to describe a sub-set of tokens which have one or more specific functions, such as allowing its holder to access or purchase services or assets based on blockchain technology.

The Staff Notice offers some practical guidance on two primary issues relating to crypto-offerings: (i) when an ICO/ITO may constitute an offering of securities and therefore, trigger the application of securities laws; and (ii) ICOs/ITOs structured in multiple steps.

When an ICO/ITO may involve an offering of securities

An ICO/ITO may involve the distribution of securities if: (i) it involves the offering of “investment contracts”; and/or (ii) the tokens that are offered are otherwise considered securities under the broad definition of a “security”. A token may constitute an “investment contract” (and accordingly, a security) by virtue of the presence of the following elements:

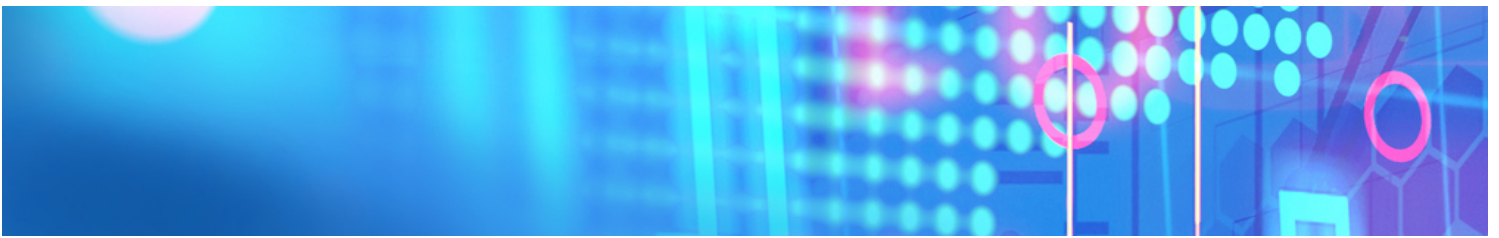
- an investment of money;
- in a common enterprise;



- with an expectation of profit;
- coming significantly from the efforts of others.^[1]

To determine whether an offering of tokens involves an offering of investment contracts, the CSA will focus on not only the technical characteristics of the token, but the economic realities of the offering as a whole, with focus on substance over form. The Staff Notice provides non-exhaustive examples of situations that may indicate the presence of one or more elements of an investment contract including^[2]:

- *tokens are not immediately delivered to purchasers*: Purchasers may not be purchasing tokens because of their immediate utility but because of profit expectations. Additionally, a “common enterprise” may be present because of the purchaser’s reliance on management to deliver the tokens;
- *the stated purpose of the offering is to raise capital to be used to perform key actions related to supporting the value of the token, the issuer’s business, or the platform’s usability*: These statements may indicate an expectation of profit and the presence of common enterprise;
- *the issuer suggests that the tokens will be used as a currency or have utility beyond the issuer’s platform but the issuer is not currently able to demonstrate the wide use or acceptance of the token*: A “common enterprise” may be present because of the purchaser’s reliance on management to deliver the tokens;
- *the issuer’s management representing expertise that will increase the token’s value*: These statements may indicate common enterprise via reliance on management and an expectation of profit derived from that expertise;
- *a finite number of tokens*: may indicate an expectation of profit as token value may rise if demand increases in relation to the fixed supply;
- *tokens are sold at a value disproportionate to their purported utility*: may indicate that the tokens’ real value is in the expectation of profit from resale;
- *marketing of the offering is targeted to persons who would not reasonably be expected to use the issuer’s product, service, or app*: indicating the motivation of purchase is profit and not usage of the product, service, or app;
- *statements of management suggesting that the tokens will appreciate in value or comparing them to other cryptocurrencies that have increased in value*: indicative of an investment thereby creating an expectation of profit. In contrast, to the extent management clearly promotes the utility of the token and not its investment value, the implication that purchasers have an expectation of profit may be reduced; and
- *tokens are reasonably expected or marketed to trade on one or more cryptoasset trading platforms including decentralized or “peer-to-peer” trading platforms or to otherwise be freely tradable in the secondary market*: the CSA states that to determine whether tokens are reasonably expected to be



subject to secondary trading, they consider all representations made formally and informally by the issuer including through social media. Considerations are also given to representations by third parties that are endorsed by the issuer.

Offerings of tokens structured in multiple steps

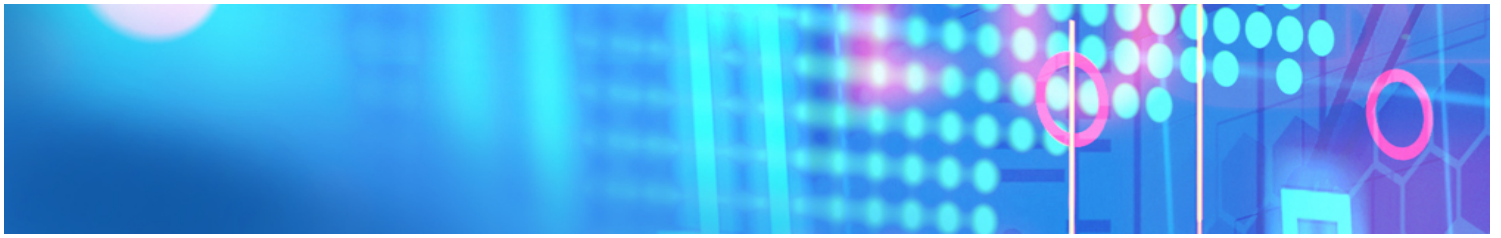
The CSA also acknowledges consistent with their focus on substance over form that the occurrence of ICOs/ITOs occurring in multiple steps may trigger the applicability of securities laws. Specifically, where the offering has been structured on the following basis: (i) the purchaser agrees to contribute money in exchange for a right to receive tokens at a future date and the tokens are not delivered at the time of purchase (often completed via a “simple agreement for future tokens” or “**SAFT**”); and (ii) the token is delivered later than the time of purchase. At the time of delivery, the token issuer typically represents that the software, online platform or app is built, that services are now available or that the tokens are now functional. In relation to such offerings, the CSA states:

- the token delivered at a second or later step may be a security and will be subject to further assessment, including a consideration of the elements set out above;
- the distribution of the security is subject to prospectus or exemption requirements;
- a person or company in the business of trading securities is subject to the dealer registration requirements;
- if the distribution at the first step is made without compliance with securities law, the issuer remains in default of securities law despite the occurrence of subsequent steps; and
- the CSA has concerns where a multiple step transaction structured to attempt to avoid securities legislation.

Compliance and enforcement

Businesses should note that the CSA is conducting active surveillance of coin and token offerings and intend to continue to take enforcement action against non-compliant businesses. To ensure regulatory compliance, the CSA encourages businesses with proposed ICOs/ITOs to consult legal counsel and to contact their local securities regulatory authority to discuss their project. Finally, the CSA promotes the “Regulatory Sandbox”, its initiative supporting fintech businesses seeking to offer innovative products, services, and apps by allowing firms to register and/or obtain exemptive relief from securities laws under a faster and more flexible process than the standard application. Applications are analyzed on a case by case basis. A list of firms that have been authorized in the CSA Regulatory Sandbox is available on the [CSA website](#).

Conclusion



The Staff Notice makes it clear that utility tokens may constitute “investment contracts” depending on the economic realities of the offering as a whole. Accordingly, businesses should complete a meaningful analysis of any proposed ICO/ITO to ensure that the business goals of such offering are achieved in compliance with applicable securities laws.

Please contact a member of McMillan's Capital Markets Group if you have any questions, are seeking assistance with an ICO/ITO, or wish to seek exemptive relief in relation to an offering via the CSA Regulatory Sandbox.

[1] See, for example: *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*, [1978] 2 SCR 112.

[2] Refer to the Staff Notice for the complete list of situations outlined by the CSA that may be indicative of the existence of one or more elements of an investment contract and associated implications.

A Cautionary Note

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CRYPTOCURRENCY SECURITIES LAW UPDATE – PLATFORM FRAMEWORK AND SERVICE PROVIDERS

Posted on August 6, 2019

by Adam Chisholm, Michael Burns

Cryptocurrency is not necessarily a “security” under Canadian securities law. Nonetheless, Canadian regulators have sought to extend their reach over cryptocurrency in various ways. This bulletin advises of recent developments in the Canadian securities regulatory space particularly in the area of cryptocurrency platforms and other service providers.

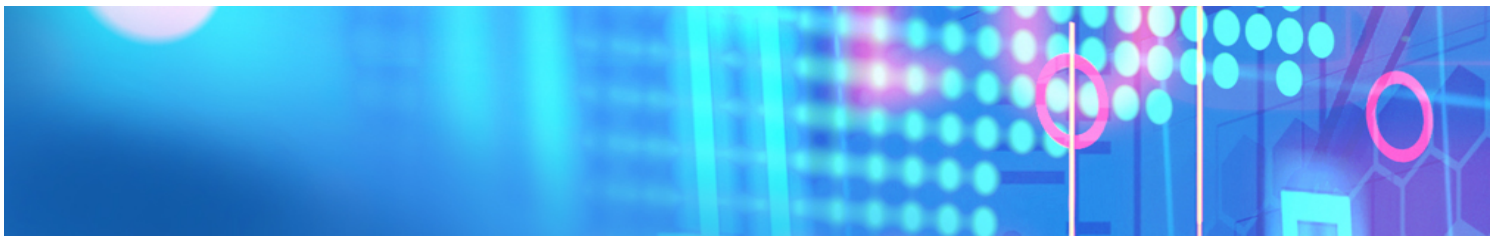
As of the date of this bulletin, there are no cryptocurrency trading platforms recognized under Canadian securities laws as an exchange or authorized to act as a marketplace or dealer in Canada.

The Canadian Securities Administrators and Investment Industry Regulatory Organization of Canada recently issued Consultation Paper 21-402, *Proposed Framework for Crypt-Asset Trading Platforms*.^[1] The paper contains Canadian regulatory commentary on: the nature of crypto assets and application of securities legislation; risks related to platforms; regulatory approaches in other jurisdictions, and the proposed platform framework.

Comments from the public were solicited in writing until May 15, 2019. Materials filed in the course of the consultation have not yet been publicized or responded to by the CSA or IIROC.

It is apparent that the CSA and IIROC are of the view that various Canadian registration requirements apply to cryptocurrency platforms in Canada. *The Proposed Framework*, among other things, contemplates that cryptocurrency platforms will become registered as investment dealers and IIROC dealer and marketplace members. It also suggests that they may be recognized as exchanges under provincial securities regulation.

It is often the case that documents such as the *Proposed Framework* are used by regulators to purport to provide jurisdiction over according subject matter in their dealings with the public. Particularly with the *Proposed Framework* at the consultation stage, it is not clear that any exercise of purported regulatory authority derived from the document is necessarily valid. That said, entities contacted by securities regulators will want to consider what level of cooperation with those regulators is appropriate, whether the inquiries should be answered regardless of the *Proposed Framework* and what the attendant consequences could be by failing to engage.



While the status of cryptocurrency as a “security” may be disputed^[2], some products which leverage cryptocurrency are undeniably “securities” under Canadian securities laws. Several settlements have been reached with provincial securities regulators across Canada regarding trading platforms that have been alleged to offer Canadian customers access to cryptocurrency derivatives. The outcome of the settlements has depended greatly on the offerings of the platform, the conduct of the operators of the platform once they were aware that Canadian regulators viewed the offering of such derivatives as contrary to law and other facts which are described in the settlement agreements.^[3]

Platform operators and parties transacting in cryptocurrency assets are not the only parties receiving regulatory attention. Other forms of service providers are attracting scrutiny. As the result of a recent settlement, a Canadian company was fined and banned from certain market conduct for five years. The company’s CEO and director also gave personal undertakings about positions he would hold in the future. These consequences flowed from an agreement that certain conduct in marketing cryptocurrency tokens constituted acting in furtherance of trading of those tokens.^[4]

All this attention on cryptocurrency platforms and other services may seem unnecessary, particularly for those foreign to the Canadian market. There is relevant Canadian context, however. A prominent Canadian online cryptocurrency exchange, QuadrigaCX, suddenly ceased operations and declared bankruptcy this year. It has been estimated that up to CAD\$250 million was held in QuadrigaCX investor accounts. This background may make the attention on cryptocurrency platforms and services more understandable: securities regulators wish to demonstrate to the public that they are active in protecting the public interest.

McMillan’s securities and litigation lawyers have advised clients in relation to the application of the *Proposed Framework*, the application of Canadian securities laws to cryptocurrency and cryptocurrency platforms and have represented parties in matters resolved on both “no contest” and admitted liability bases in matters involving enforcement staff at Canada’s securities regulators.

[1] OSC - Consultation Paper 21-402.

[2] There have been recent instances of Canadian securities regulators finding that a particular cryptocurrency is a security: see *Autorité des marchés financiers c. PlexCorps*, 2018 QCTMF 91.

[3] See e.g. *eToro (Europe) Limited*, 2018 ONSEC 49 and *Ava Trade Ltd. (Re)*, 2019 ONSEC 2.

[4] *CoinLaunch Corp. (Re)*, 2019 ONSEC 26.

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CANADIAN REGULATORY DIRECTION AND PRESSURE FOR CRYPTOCURRENCY PLATFORMS

Posted on July 7, 2021

by Matthew DeAmorim, Adam Chisholm and Raj Dewan

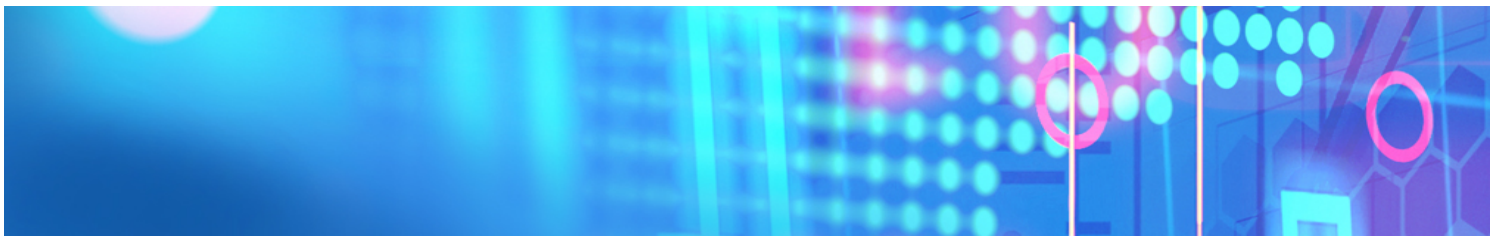
On March 29, 2021, the Canadian Securities Administrators (the “**CSA**”) and the Investment Industry Regulatory Organization of Canada (“**IIROC**” and together with the CSA, the “**Regulators**”) issued Staff Notice 21-329 (the “**Notice**”). The Notice provides a firm statement of the Regulator’s intent to apply Canadian securities laws to ‘crypto asset trading platforms’ (“**CTPs**”), and the regulatory hurdles they will be required to jump if they are to operate in Canada. This Notice also reinforces that the regulation of CTPs has become a regulatory priority of Canadian securities regulation given the recent popularity of these assets amongst investors.

The Notice comes during a period of extended growth in the crypto space. The direct listing of the largest cryptocurrency exchange in the U.S. (by trading volume), Coinbase, was one of the most highly anticipated public offerings of 2021, and the cryptocurrency market cap recently surpassed \$2 trillion USD after doubling this year.^[1]

Since issuing the Notice, the Regulators’ enforcement response has involved a combination of public warnings and commencement of proceedings against CTPs who have not sought registration. The parent entities behind the Kucoin crypto exchange,^[2] and Poloniex,^[3] another crypto exchange, have been the latest subjects of the Ontario Securities Commission’s (the “**OSC**”) enforcement initiative. Similar regulatory responses have been initiated in other jurisdictions, including by the SEC in the United States and the Financial Conduct Authority in the United Kingdom.

Prior to issuing the Notice, the OSC enforced regulations over CTPs on a more ad-hoc basis. McMillan LLP (“**McMillan**”) was a first-mover in providing legal advice on such issues. McMillan lawyers negotiated the first regulatory settlements involving CTPs in Canada.^[4] In addition, our team have had discussions with the OSC LaunchPad on behalf of some of our fintech clients who are exploring innovative business models dealing with crypto assets.

For discussion on previous developments in the Canadian securities regulatory space in respect of CTPs, please see [Cryptocurrency Securities law Update – Platform Framework and Service Providers](#).



CTPs, Dealer Platforms and Marketplace Platforms

The purpose of the Notice is an attempt to reach regulatory consensus and consistency with respect to the treatment of CTPs. In past cases, the legal question at issue was whether cryptocurrency, itself, is a security or not. Without landing on a reliable position on that issue, much of the regulatory resolution of issues related to CTPs concerned whether the Crypto Contracts exchanged on CTPs fell within the definition of derivative contracts under Canadian law. This issue avoided the more complicated question of whether any particular cryptocurrency constituted a “security” under Canadian law. The treatment of crypto contracts as derivatives found more easy approval by the decision-making branches of the Regulators, such as the OSC’s tribunal.

The Notice defines a CTP as a platform that facilitates the trading of: (a) crypto assets that are securities (“**Security Tokens**”); or (b) instruments or contracts involving crypto assets (“**Crypto Contracts**”).^[5]

The Notice illustrates that the regulatory requirements applicable to a CTP will depend on whether the CTP operates as a ‘Dealer Platform’ or a ‘Marketplace Platform’.

Key Activities of Dealers:

The two most common activities undertaken by a CTP operating as a Dealer Platform are:

- exclusively facilitating the primary distribution of Security Tokens; and
- acting as the counterparty to each trade of Security Tokens and/or Crypto Contracts, and users do not trade with one another on the CTP.

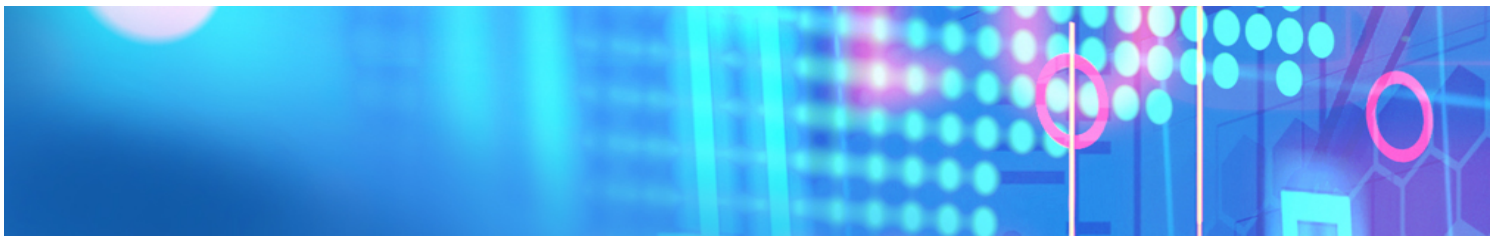
Key Features of Marketplaces

In contrast to a Dealer Platform, the Regulators’ position is that a CTP operates as a Marketplace Platform if it:

- constitutes, maintains or provides a market or facility for bringing together buyers and sellers or parties to trade in Security Tokens and/or Crypto Contracts;
- brings together orders of Security Tokens and/or Crypto Contracts of buyers and sellers or parties of the contracts; and
- uses established, non-discretionary methods under which orders for Security Tokens and/or Crypto Contracts interact with each other and the buyers and sellers or parties entering the orders agree to the terms of a trade.

Regulatory Requirements

According to the nature of the CTP’s activities, Dealer Platforms are required to register under the appropriate category of dealer registration. A Dealer Platform, that does not offer margin or leverage, and solely facilitates



the distribution of Security Tokens pursuant to prospectus exemptions, will generally be required to register as an exempt market dealer, or a restricted market dealer, as appropriate. A Dealer Platform offering margin or leverage for Security Tokens must register as an investment dealer and obtain IIROC membership. The Notice also outlines that Dealer Platforms trading Crypto Contracts are required to register under an appropriate dealer category. Furthermore, where these platforms trade or solicit trades for retail investors that are individuals, they will generally be required to be registered as an investment dealer and obtain IIROC membership.

Existing registered firms introducing crypto asset products and/or services are required to report a change in their business activities.

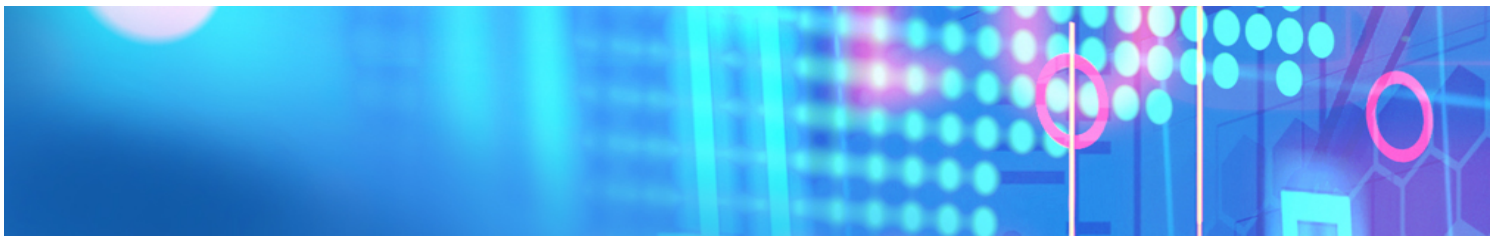
In respect to Marketplace Platforms, the Notice states that the provisions relevant to marketplaces under the existing instrument framework will apply. Trading activity on Marketplace Platforms will likely be subject to market integrity requirements, and Marketplace Platforms will operate under the oversight of the CSA and IIROC. Additionally, the regulations applicable to exchanges may also apply to Marketplace Platforms. If a Marketplace Platform trades Security Tokens and regulates issuers of those Security Tokens, or if it regulates and disciplines its trading participants, other than by denying them access to the platform, the Marketplace Platform will likely be viewed as carrying on business as an exchange. Marketplace Platforms carrying on exchange activities are required to seek recognition as an exchange, or an exemption from such recognition.

The Notice additionally makes it clear that Marketplace Platforms and Dealer Platforms are not mutually exclusive categories. Marketplace platforms conducting activities similar to those of Dealer Platforms are subject to the applicable dealer requirements, and visa-versa.

Importantly, the Notice reminds CTPs operating from jurisdictions outside Canada that have Canadian clients that they are required to comply with Canadian securities legislation.

Regulatory Tailoring and Interim Approach

Although the Notice serves as a firm statement that the Regulators expect CTPs to comply with Canadian securities legislation, in order to foster innovation and provide flexibility, the Regulators have provided for an interim period in recognition of: (a) the time it takes to prepare for, and obtain, required registrations and IIROC membership; and (b) those CTPs looking to test a novel business idea in a rapidly developing industry. Accordingly, a CTP that does not offer leverage, margin trading or operate as an exchange, will likely be required to register as a restricted dealer, or exempt market dealer, and consider future registration as an investment dealer. This interim period will allow the CTP to operate under terms and conditions tailored to the CTP's business model. For those Marketplace Platforms operating an exchange function, the Regulator's appear open to considering if recognition as an exchange or an exemption is required during the interim



period in order to tailor the regulatory requirements to the specific business model of businesses impacted by this Notice.

Enforcement and Effect

In past and current enforcement matters involving CTPs, the OSC has requested a plethora of corrective and punitive actions for allegedly failing to comply with securities legislation. In the matter involving Poloniex, the order the OSC is seeking includes that Poloniex:

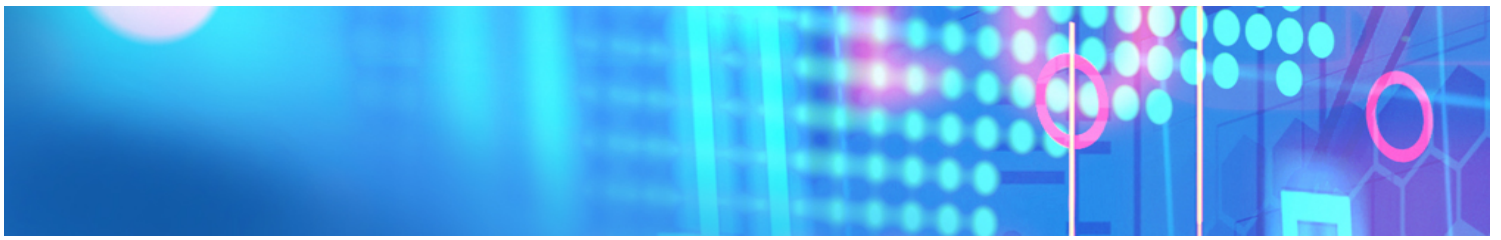
- cease trading in any securities or derivatives permanently or temporarily;
- be prohibited from acquiring any securities permanently or temporarily;
- be reprimanded;
- be permanently prohibited from acting as a registrant, investment fund manager or promoter under securities regulations;
- disgorge to the OSC any amounts obtained from Ontario based users; and
- pay costs and additional penalties.^[6]

In the future, CTPs are likely to simply discontinue such offerings to avoid regulatory risk in Canada, given the relative size of the Canadian market. The nuance, cost, and inconvenience arising from seeking registration in Canada (assuming it is even available to them) is leading CTPs to simply not offer products to Canadians. It is impractical to think that CTPs that offer services around the world, in dozens or hundreds of countries, will make significant changes to their businesses to satisfy the Regulators when those other countries do not have similar requirements. It is not a coincidence that on June 25, 2021, Binance, the world's largest crypto exchange (by trading volume), announced it would no longer provide service to Ontario-based users.^[7] However, it is welcome that the Regulators, in issuing the Notice and making the interim period available for seeking registration, have sought to use tools other than those arising from enforcement.

There are good questions surrounding whether the Notice adequately takes into consideration the impact of technology with respect to CTPs. Does the process set out in the Notice, and related enforcement actions which have followed, truly benefit Canadians who, if they wish to trade Crypto Contracts or Security Tokens, are likely to find off-shore ways to do so? As these technologies serve to decentralize currency itself, are efforts to fit cryptocurrency into existing securities regulatory regimes an appropriate or adequate methodology – even if there can be no doubt that is the approach currently applied in Canada? What we do know is that CTPs will have to continue to navigate matters with the Regulators until a different approach is available.

[1] See [*Crypto Market Cap Surpasses \\$2 Trillion After Doubling This Year*](#)

[2] See [*Statement of Allegations: In the Matter of Mek Global Limited and PhoenixFin*](#)



Pte. Ltd.

[3]See [Statement of Allegations: In the Matter of Polo Digital Assets, Ltd.](#)

[4]See e.g. *eToro (Europe) Limited*, 2018 ONSEC 49 (eToro), and *International Capital Markets Pty. Ltd. (Re)*, 2019 ONSEC 28.

[5]CTPs that facilitate the trading of Crypto Contracts includes those platforms that allow users to buy and sell crypto assets, but only grant the user a contractual right or claim to the underlying crypto asset and the platform provider is not required to immediately deliver the crypto asset to the user. See CSA Staff Notice 21-327.

[6]*Supra*, note 3.

[7]See [Binance Terms of Use Review \(2021-06-25\)](#)

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NFTS AND IMPLICATIONS UNDER CANADIAN SECURITIES LAW

Posted on August 16, 2021

by Adam Chisholm, Raj Dewan, Jeffrey Gebert and Sam Kelley, Summer Law Student

Non-fungible tokens (“**NFTs**”) are a type of digital asset that uses blockchain technology to provide real world objects with unique identification codes and metadata.

Non-fungible means that NFTs are unique and distinct. Each NFT has its own identifying code that certifies its uniqueness and authenticity. As a result, NFTs are not interchangeable. An NFT’s distinctiveness is what differentiates it from other cryptocurrencies such as Bitcoin, which are identical and can be easily exchanged.

Currently, most NFTs are created using the Ethereum blockchain but the number of blockchains that support NFTs is growing. Creators can also mint the tokens to allow the issuer to receive a share of the proceeds every time it is sold in the future.

Different Uses of NFTs

NFTs can have an abundance of different uses. To date the biggest market for NFTs has been collectibles such as digital artwork, sports highlights and video game skins. NFTs can also certify the ownership of physical assets (such as limited edition sneakers, real estate and automobiles).

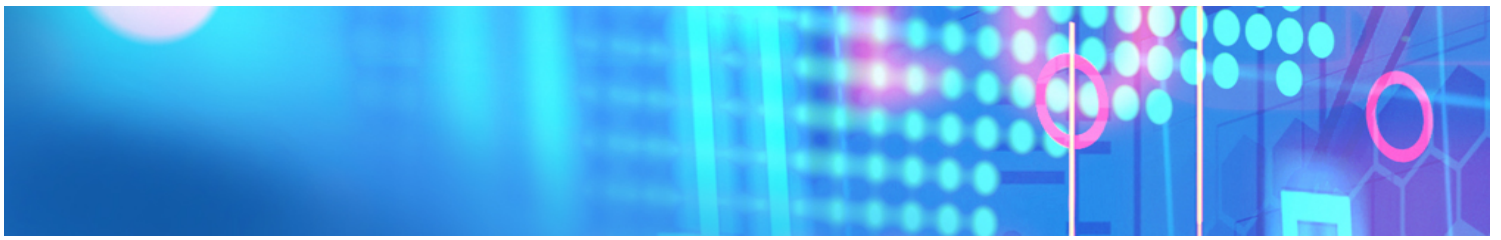
More recently, there has been a growing trend to issue fractionalized NFTs. Fractionalizing NFTs allows buyers to purchase a percentage of the full NFT. It also allows owners of NFTs to receive some liquidity from the token without having to sell it in its entirety.^[1] Several NFT trading platforms have emerged to help facilitate the creation, sale and trade of NFT fractions.

Regulation of NFTs in the United States

At the time of this publication, we have been unable to locate any decision which considers the regulation of NFTs in Canada or the United States.^[2] Before considering the landscape in Canada, we first offer a Canadian (and thus simplified view) of the United States securities framework that may apply to NFTs.

The *Securities Act of 1933* and the *Securities Exchange Act of 1934* have broad definitions for “security”. Those definitions include a number of popular instruments such as stocks, bonds and investment contracts.

The “Howey Test” arises from the 1946 Supreme Court of the United States decision in *Securities and Exchange Commission v. W. J. Howey Co.*^[3] This test is commonly applied to determine whether a transaction



constitutes an “investment contract” and is therefore regulated as a security under the *Securities Act* and the *Securities Exchange Act*. The framework known as the Howey Test considers:

1. Has there been an investment of money or assets?
2. Does the investment of money or assets involve a common enterprise?
3. Is there a reasonable expectation of profit?
4. Does any profit come from the efforts of a promoter or third party?[4]

The United States courts may also consider the “family resemblance” test established by the United States Supreme Court in *Reves v. Ernst & Young*. [5] The family resemblance test asks whether an instrument resembles a security based on four factors:

1. whether there is motivation to profit;
2. whether the plan of distribution resembles common trading for speculation or investment;
3. whether the investing public reasonably expects that the instrument is a security; and
4. whether there is another regulatory scheme that protects the investor.

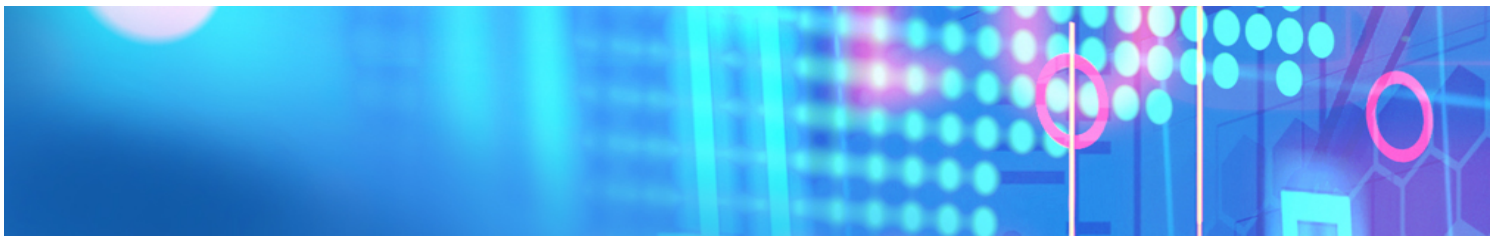
Due to the lack of direct guidelines relating to NFTs, a registered broker-dealer sent a petition to the SEC in April 2021 requesting that the SEC publish a concept release on the regulation of NFTs and propose rules to address when NFTs are securities. The petition differentiated between collectible and fractionalized NFTs, suggesting the latter was more likely to qualify as a security. [6]

The petition echoed unofficial comments made by the SEC’s Commissioner Hester Pierce who warned people to be cautious selling fractionalized NFTs. She pointed out that the main concept of NFTs is that they are non-fungible and therefore less likely to be a security. However, she added that whether NFTs qualify as securities would largely depend on their use. The SEC’s view appears to be that since NFTs lose their uniqueness when they are fractioned, they are more likely to qualify as “securities”. [7]

Possible Treatment of NFTs in Canada

American securities jurisprudence may be a useful source of persuasive authority in some cases. Ontario’s Court of Appeal has recently held, however, that it is not necessary or advisable to import the family resemblance test into the definition of security in the Ontario context. [8]

The Ontario *Securities Act* is a “catch and exclude” scheme whereby it defines key terms very broadly, and thereby captures broad conduct and then provides for many exemptions. As such, it is unlikely that the American general interpretive laws above will alone provide sufficient legal guidance to dictate the degree to which NFTs will be regulated as securities in Ontario or indeed other Canadian provinces.



In 2018, the Canadian Securities Administrators (“**CSA**”) issued Staff Notice 46-308: Securities Law Implications for Offering Tokens. The Staff Notice provided insight into when an offering of tokens may constitute a distribution of securities. The CSA stated that when offering tokens, businesses should consider whether the tokens constitute investment contracts by considering whether the offering of tokens involves:

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^[9]

These factors were applied by the Supreme Court of Canada many years ago in *Pacific Coast Coin Exchange*^[10] in determining whether a transaction was an investment contract. That case concerned selling bags of silver coins on margin, which the courts held in those circumstances involved commodity account agreements that were investment contracts. Among other things, the Supreme Court considered the Howey Test.

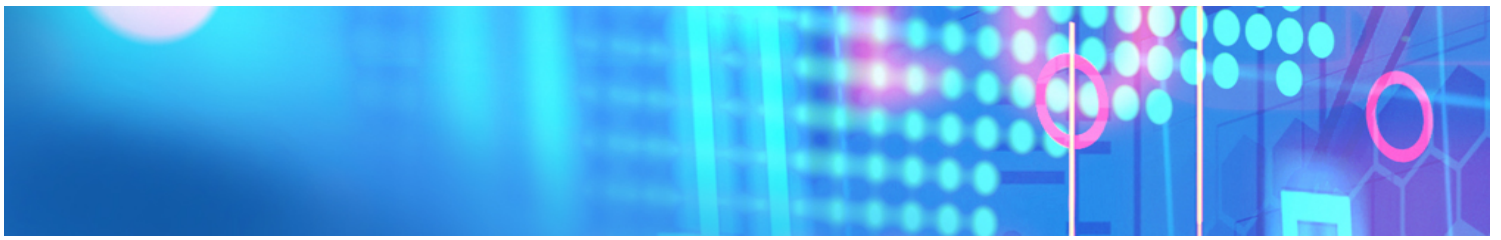
In the Staff Notice, the CSA claimed that NFTs are unlikely to be interpreted as investment contracts since they fail to meet the second (common enterprise) and fourth (efforts of others) branches of the test. However, the CSA highlighted that its views should not be interpreted as determinative.

That was then and this is now. The CSA Staff Notice does not include consideration of the fractionalization or recently high-profile nature of some NFT sales. This leads to interesting and unresolved questions under Canadian law. Would fractionalization impact whether NFTs are held to be securities, as the SEC’s Commissioner suggests? Do certain market activities impact whether creators are in a common enterprise or dictate that NFTs involve profit from the efforts of others?

Recent enforcement action taken by the Ontario Securities Commission (“Commission”) in the blockchain and digital asset space has focused on cryptocurrency asset trading platforms. The most recent proceeding commenced at the Commission concerns a Seychelles-based cryptocurrency trading platform which allegedly focuses on the availability of instruments or contracts related to cryptocurrency assets and crypto asset futures.^[11] These actions tell us little about the Commission’s views or intentions with respect to enforcement in relation to NFTs.

A Jurisdictional Issue?

There are other issues with enforcement regarding NFTs, aside from the issue of whether or not they meet the definition of “security”. Another challenge that any Canadian regulator may have concerning any NFT-related enforcement action would be that of jurisdiction. The Commission’s proceedings commenced in relation to



cryptocurrency trading platforms, for example, purport to be jurisdictionally anchored through sales to Ontario investors. These are instances with established businesses trading in significant volumes in one jurisdiction.

But what of small-scale NFT transfers? Of ten editions of a piece of digital art? Even if Canadian regulators were to take an affirmative view that NFTs are securities, what is the value of enforcement in relation to one foreign-based transaction? Or ten? It would not appear that most investor protection goals would be furthered by such narrow enforcement steps. That said, is there a point at which NFT activity will result in regulators feeling compelled to act as a warning signal, regardless of legal certainty, perhaps after a high-profile investor loss?

McMillan has been a market leader in resolving Ontario cryptocurrency-related enforcement actions in Canada. It has acted for a number of entities in digital asset regulatory and enforcement matters, including disputes resolved without the commencement of contested proceedings. As may be inferred from the above, the application of Canadian securities law to blockchain technology and digital assets will not necessarily mirror that in other nations. Our team has the experience and expertise to explore with technology clients how the Canadian legal landscape may apply to their business.

[1]For example, some musicians have started using fractionalized NFTs to sell a [percentage of their songs' copyright royalties](#).

[2]There have been a number of other SEC [proceedings](#) and [investigations](#) regarding digital assets and initial coin offerings but none on NFTs in particular.

[3]*Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946).

[4]U.S Securities and Exchange Commission, "[Framework For "Investment Contract" Analysis of Digital Assets](#)" (3 April 2019). SEC v W.J. Howey Co, (1946) 328 US 293. (Howey Test)

[5]*Reves v. Ernst & Young*, 494 U.S. 56 (U.S. Ark. S.C. 1990).

[6]Vicent R Molinari, "[Rulemaking Regarding Non-Fungible Tokens](#)" (12 April 2021).

[7]Sophie Kiderlin, "[The SEC's 'Crypto Mom' Hester Peirce says selling fractionalized NFTs could be illegal](#)" (26 March 2021).

[8]*Ontario Securities Commission v. Tiffin*, 2020 ONCA 217.

[9]Canadian Securities Administrators, "[Staff Notice 46-308: Security Law Implications for Offering Tokens](#)" (11 June 2018).

[10]*Pacific Coast Coin Exchange v Ontario (Securities Commission)*, [1978] 2 SCR 112.

[11]*In The Matter Of Polo Digital Assets, Ltd.*, File No. 2021-17.

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NFTS AND CANADIAN COPYRIGHT LAW

Posted on August 31, 2021

by Kaleigh Zimmerman, Peter Giddens and Sezen Izer (Articling Student)

Non-Fungible Tokens, or “NFTs”, have garnered significant media attention, due largely to the high price tag attached to many NFT sales. Famously, an NFT of Beeple’s digital artwork was auctioned off for \$69 million USD through Christie’s Auction House.^[1] NFTs are now being sold by artists, musicians, sports leagues, fashion designers, and more. In spite of their increase in popularity, some confusion still surrounds the intellectual property rights associated with the purchase of an NFT.

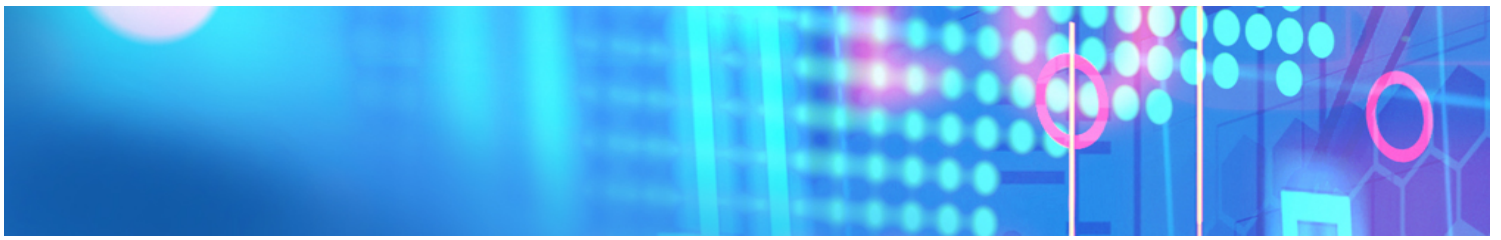
To read more about the potential securities law considerations of NFTs, please see our firm’s bulletin on that topic, found [here](#).

What is an NFT?

An NFT is a digital certificate of certain rights associated with an asset. An NFT is composed of (1) a base that consists of cryptocurrency transformed into a non-currency token, (2) a digital file and (3) a series of smart contracts^[2] governing the rights associated with the NFT. When these three components are combined, or “minted”, the result is a unique digital file that can be bought, sold and traded. Each sale of an NFT is recorded on a blockchain (most usually the Ethereum blockchain), thereby creating an indisputable and verifiable ledger of the owner of each NFT.

What do you get when you buy an NFT?

The buyer of an NFT that includes a piece of art receives the same rights as would a buyer of a physical version of that art. When buying an NFT, the purchaser does not acquire the copyright to the underlying work, unless there is an agreement to the contrary. As the copyright remains with the original copyright owner, the purchaser of the NFT is granted ownership only over that specific version of the digital work underlying the NFT, and the details of ownership are dictated by the terms of the smart contracts underlying the NFT. Further, under Canadian copyright law, the author of the artistic work associated with the NFT enjoys moral rights in respect of that work, whether the or not the author is the copyright owner. Moral rights inuring to an author upon creation of a work in which copyright subsists include the right to the integrity of the work and the right, where reasonable in the circumstances, to be associated with the work as its author by name or under a pseudonym and the right to remain anonymous.^[3] Moral rights may not be assigned, but may be waived in



whole or in part.^[4]

The smart contracts accompanying each NFT can vary which proprietary rights are transferred to the purchaser. For instance, an NFT may include restrictions on the ability of an owner of an NFT to alter, modify, or commercialize the digital file.^[5] Further, creators of NFTs can prepare certain terms in a smart contract to ensure the payment of royalties to the creator upon each subsequent sale of the NFT or payment to a third party (for example, a charitable organization).

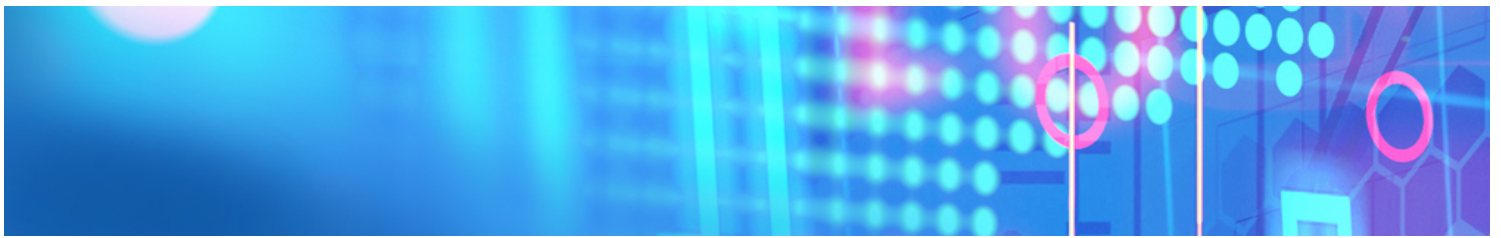
An NFT that comprises an artistic work (i.e. paintings, drawings, maps, charts, plans, photographs and compilations of artistic works) is afforded the same copyright protection that a physical artistic work would be entitled. For that reason, the Canadian *Copyright Act* governs a number of the intellectual property issues that surround NFTs.

Since the copyright does not transfer to the purchaser of an NFT, without an agreement to the contrary between the creator of the NFT and a subsequent owner, the original copyright owner retains the right to mint new NFTs using the same underlying work. Since NFTs derive their value in large part based on their rarity, for a copyright owner to mint new, highly similar NFTs can significantly alter an NFT's value after it is purchased.

To mint an NFT, one must be the copyright holder with sufficient rights to tokenize the work into an NFT. As such, in order to avoid a potential copyright infringement, anyone without full and complete copyright ownership, such as a copyright licensee, must evaluate whether their rights extend to the ability to mint an NFT. For instance, in the U.S., artist Jay-Z recently filed a lawsuit against Damon Dash, the co-founder of his record label, for attempting to mint and auction off an NFT of the copyright to one of Jay-Z's albums. The complaint alleges that Dash's status as minority shareholder of the record label does not give Dash sufficient rights to mint an NFT of Jay-Z's work.^[6] While this case is still ongoing, it highlights the risks one faces when minting NFT's based on copyrighted work that they do not fully and completely own.

Conclusion

It may come as a surprise to some purchasers that the rights associated with their NFT do not include the intellectual property rights to the underlying work. It is important to scrutinize the smart contracts associated with each NFT to understand which rights the purchaser is truly acquiring. When investing in physical artwork, future profitability is typically based upon the value of each specific piece as art, rather than upon any scheme to modify or reproduce the artwork or to commercialize the copyright in the artistic work. Similarly, for individuals or investment funds purchasing NFTs with an intent to monetize them, profitability from such investments is typically based on the specific edition purchased rather than any opportunity to exploit the underlying work (akin to the value of first print versus the final print of a limited edition release of piece of artwork, i.e. 1/100 versus 100/100).^[7] Lastly, in negotiating future copyright licenses, it is now relevant to



explicitly account for the ability to mint an NFT using the copyrighted work. It is always a best practice to work with an expert in intellectual property law when drafting and negotiating intellectual property licenses. For assistance with your intellectual property licensing needs, please [contact one of our practitioners](#).

[1] Michaela Moscufo, "[Digital artwork sells for record \\$69 million at Christie's first NFT auction](#)" (2021) NBC news, online.

[2] A smart contract is a self-executing contract whereby the terms of the agreement between buyer and seller are directly written into lines of code. The code and the agreements contained therein exist across a distributed, decentralized blockchain network. The code controls the execution, and transactions are trackable and irreversible. For more information on smart contracts click [here](#).

[3] *Copyright Act*, RSC 1985, c C-42, s 14.1(1), 14.2.

[4] *Copyright Act*, RSC 1985, c C-42, s 14.1(2)

[5] National Basketball Association, "[Terms of Use](#)."

[6] *Roc-A-Fella Records, Inc. v. Damon Dash* (18 June, 2021), [Complaint, No. 1:21-cv-5411](#).

[7] The conventions for numbering artistic prints are well-established, a limited edition is normally hand signed and numbered by the artist, typically in pencil, in the form (e.g.): 14/100. The first number is the number of the print itself. The second number is the number of overall prints the artist will print of that image. The lower the second number is, the more valuable and collectible the limited editions are likely to be, within their price range. Other marks may indicate that a print has been made in addition to the numbered prints of an edition. For more click [here](#).

A Cautionary Note

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CRYPTOCURRENCIES AND DIGITAL ASSETS: BACK TO SCHOOL UPDATE ON RECENT DEVELOPMENTS IN CANADA

Posted on September 7, 2021

by Jennie Baek

It may be hard to imagine a world without cryptocurrencies, yet Bitcoin was first launched only a little over a decade ago. Since then, blockchain, digital assets, cryptocurrencies, and related technologies have developed at explosive rates and continue to pervade more and more of our everyday life - from El Salvador becoming the first sovereign nation to adopt Bitcoin as legal tender – to the landmark sale in March, 2021 by Christie’s auction house of an entirely digital artwork in a US\$69 million transaction in Ether, a cryptocurrency.

As summer vacation comes to an end, this bulletin provides a “back to school” refresher on recent highlights and developments in Canada in this fast-paced and innovative industry.

Bitcoin ETFs

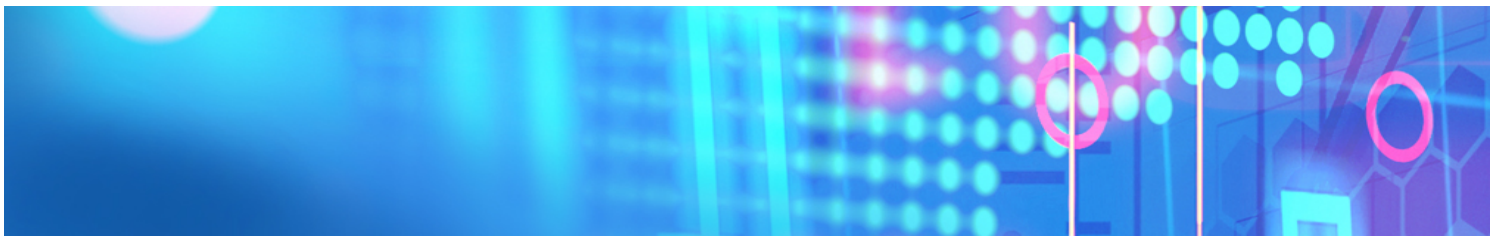
Canada has continued to keep up with the innovative trends in the cryptocurrency industry. Earlier this year, the world’s first Bitcoin exchange-traded fund (ETF) began trading on the Toronto Stock Exchange: the Purpose Bitcoin ETF, soon followed by the Evolve Bitcoin ETF. Although there are retail-level Bitcoin exchange-traded products available in Europe, this was the first vehicle of its kind in North America, and the first globally to be designated as an “ETF”.

Securities Regulatory Developments

Cryptocurrencies and digital assets are a key focus for the Canadian securities regulators, and the Canadian Securities Administrators (CSA) have in place a three year business plan to modernize the regulatory regime for crypto trading and crypto assets in Canada.

On March 11, 2021, the CSA published Staff Notice 51-363 – *Observations on Disclosure by Crypto Assets Reporting Issuers*, summarizing the regulators’ observations and recommendations with respect to disclosures by reporting issuers (excluding investment funds) that are materially engaged in the business of holding, trading, or mining cryptocurrencies and other digital assets.

On March 29, 2021, the CSA and the Investment Industry Regulatory Organization of Canada (IIROC) published Staff Notice 21-329 – *Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements*,



which sets out how securities legislation applies to crypto asset trading platforms that facilitate the trading of crypto assets that are securities and instruments or contracts involving crypto assets. For more details, please see our separate bulletins [on this Staff Notice](#) and on [previous developments in the Canadian securities regulatory space in respect of crypto asset trading platforms](#).

The Ontario Securities Commission (OSC) concurrently issued a press release notifying all crypto asset trading platforms that they must bring their operations into compliance with Ontario securities laws, with a deadline of April 19, 2021 to contact OSC staff to initiate compliance discussions. The OSC's threat of potential regulatory enforcement was followed with swift action, with statements of allegations published against Polo Digital Assets, Ltd. (Poloniex), Mek Global Limited and PhoenixFin Pte. Ltd. (KuCoin), Bybit Fintech Limited (ByBit), and Aux Cayes Fintech Co. Ltd. (Aux Cayes). As of June, 2021, over 70 platforms had initiated compliance discussions with the Canadian securities regulators, with almost one quarter of them based outside of Canada. McMillan has acted in both publicly disclosed and non-publicly-known settlements with the OSC involving a range of client-focused outcomes. Indeed, McMillan represented clients in the very first public settlement with the OSC regarding such platforms.

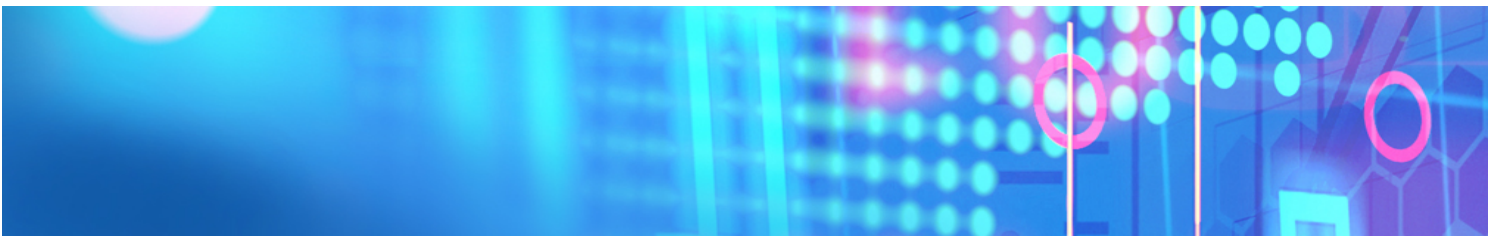
On August 10, 2021, the OSC published OSC Staff Notice 33-752 – *Summary Report for Dealers, Advisers and Investment Fund Managers*. This Staff Notice noted that compliance review activity of the OSC will prioritize “Registration as the First Compliance Review” for crypto asset trading platforms.

Consistent with this focus, the OSC released its 2021 – 2022 Statement of Priorities for the fiscal year ending March 31, 2022, which includes strengthening oversight of crypto asset trading platforms and other dealers as a component of its goal to promote confidence in Ontario's capital markets.

Other Regulatory Developments

In addition to securities regulatory developments, other recent regulatory developments in Canada include:

- [Office of the Superintendent of Financial Institutions \(OSFI\)](#): A public consultation paper on the prudential treatment of crypto asset exposures was released by the Basel Committee on Banking Supervision on June 10, 2021. This was followed by a letter published by OSFI on July 5, 2021 requesting feedback from Canadian federally regulated financial institutions on the consultation questions raised in the paper. In addition, earlier this May, the Bank of Canada noted that volatility in cryptocurrency assets is an emerging vulnerability to the country's financial system, noting that although crypto markets are not yet of systemic importance as an asset class or method of payment, this could change if a large technology firm (or “Big Tech”) with a sizeable user base decided to issue a cryptocurrency that became widely accepted as a means of payment.
- [Financial Transactions and Reports Analysis Centre of Canada \(FINTRAC\)](#): Updates to the *Proceeds of*



Crime (Money Laundering) and Terrorist Financing Act and associated regulations took effect June 1, 2021 and extended various compliance obligations with respect to transfers exceeding C\$10,000 and know-your-client recordkeeping to “virtual currencies”.

- Canada Revenue Agency (CRA): In March, 2021, the Federal Court authorized the CRA to issue an “unnamed persons requirement” (UPR) to Coinsquare Ltd. for information and documentation relating to users of Coinsquare, a cryptocurrency exchange operating in Canada. This is part of an ongoing CRA project, led by the CRA’s specialized “Cryptocurrency Section” of the CRA’s Digital Compliance and Audit Support Division, which focuses on taxpayers who have failed to properly report income from cryptocurrency transactions.

Crypto and ESG

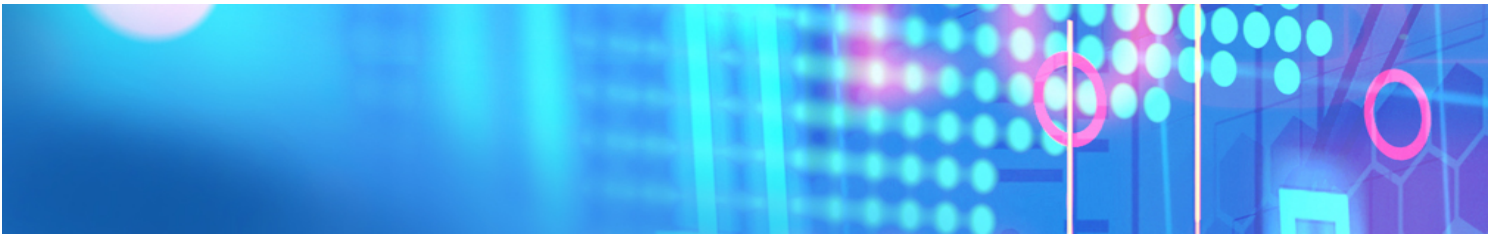
A significant issue facing cryptocurrencies with respect to ESG (environmental, social, and governance) is the concern with respect to the energy consumption required to fuel certain cryptocurrency activities, such as mining certain cryptocurrencies. Famously, the annual energy consumption of Bitcoin has been cited as rivaling or exceeding the annual energy consumption of entire countries, such as the Netherlands or Argentina. The price of Bitcoin crashed by more than fifty percent during one week in May, arguably fueled by a tweet from Elon Musk citing concerns around the fossil fuel energy consumption of Bitcoin.

Some claim that the benefits of cryptocurrencies could outweigh this problem, or point to other cryptocurrencies that use different technologies that arguably use less energy. For example, some argue that cryptocurrencies present social advantages (the “S” in ESG) by democratizing financial markets by removing intermediaries or by reducing the cost of remittance corridors between richer and poorer countries through which, for example, migrant workers can send funds home to their families.

The industry continues to grapple with this issue, including the launch of new products that aim to address this concern, such as through the purchase of emission offsets or wrapping cryptocurrencies with carbon credits that trade together as a single asset. Government action may also affect how this area develops. For instance, in March, 2021, the provincial government of Inner Mongolia, where a large amount of cryptocurrency mining was conducted, announced that it would ban all cryptocurrency mining operations in a bid to achieve carbon-reduction targets set by the central government. As both ESG and cryptocurrencies develop, it will be interesting to see how the market responds to these concerns.

The Rest of 2021 and Beyond

As the cryptocurrency and digital assets industry marches forward, it will continue to grapple with existing and new issues, including bridging the gap between crypto securities and crypto commodities, the potential development of central bank digital currencies (CBDCs), and how jurisdictional matters for an intangible



product without borders can or should be addressed. It is clear that this industry is and will continue to be a key priority for the regulators, and that addressing the unique issues raised will continue well beyond 2021.

McMillan has been a market leader in the cryptocurrency and digital asset space and our team has the experience and expertise to explore with technology clients how the Canadian legal landscape may apply to their business.

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Representative Experience

- Acted for CryptoStar in connection with its reverse takeover of Aumento Capital VI Corporation and offering of \$20 million of common shares.
- Acted for CryptoStar in connection with its offering of \$25 million of common shares, led by H.C. Wainwright & Co.
- Acted for a private Canadian cryptocurrency exchange operator in connection with its capital raises and restructuring.
- Acted for a syndicate of investment dealers led by Stifel GMP and Canaccord Genuity in connection with the offering by Tokens.com Inc. of approximately \$20 million of subscription receipts.
- Acted for eToro (Europe) Ltd. in connection with allegations made by the Ontario Securities Commission.
- Acted for Impak Finance Inc. in connection with the first Initial Coin Offering (ICO) to be granted exemptive relief by a securities regulatory authority in Canada.
- Acted for BCM Capital LP, a private Quebec-based investment fund investing in Bitcoin and other cryptocurrencies, in connection with structuring matters.
- Acted for GraphBlock Chain Ltd. in connection with a Series B private placement and listing on the Canadian Stock Exchange.
- Acted for Datametrex AI Limited in connection with its acquisition of Ronin Blockchain Corp.
- Acted for Ronin Blockchain Corp. in connection with a reverse takeover with Cluny Capital Corp on the TSX-V.
- Acted for Nubeva Inc. in connection with a reverse takeover and concurrent financing on the TSX-V.
- Acted for a Canadian ICO service provider in connection with its listing on the TSX-V and concurrent \$10 million subscription receipt financing.
- Acted for a US-based technology company in connection with the structuring of its ICO offering as a SAFT (Simple Agreement for Future Token) offering under US and Canadian securities laws.
- Acted for a Canadian cryptocurrency mining company in connection with its listing on the TSX-V and concurrent \$21.5 million common share financing.
- Acted for Fogchain Inc. in connection with a reverse takeover and concurrent financing on the Canadian Stock Exchange.
- Acted for GMP Securities LP in connection with a \$38 million private placement of common shares by Hut 8 Mining Corp.
- Acted for Koreconx in connection with a potential token offering in Canada.
- Acted for WCX Canada Limited (a wholly owned subsidiary of World Cryptocurrency Exchange Ltd.) in connection with a proposed restructuring.



McMillan is a leading business law firm serving public, private and not-for-profit clients across key industries in Canada, the United States and internationally. With recognized expertise and acknowledged leadership in major business sectors, we provide solutions-oriented legal advice through our offices in Vancouver, Calgary, Toronto, Ottawa, Montréal and Hong Kong.

Our firm values – respect, teamwork, commitment, client service and professional excellence – are at the heart of McMillan’s commitment to serve our clients, our local communities and the legal profession.

For more information, please visit our website at www.mcmillan.ca



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Jennie Baek has a broad capital markets and securities law practice with an emphasis on the investment funds and asset management industry, assisting clients in all sectors, including technology issuers. Jennie also advises clients on securities registration and compliance matters.

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Michael Burns provides advice on all facets of capital markets and securities law with an emphasis on alternative investment funds, alternative and conventional mutual funds and structured product. Michael also provides advice to clients on the securities law aspects of OSC Enforcement matters relating to the offering of crypto-based securities in Canada via online platforms.

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Adam Chisholm is a partner in the firm's Toronto office. Adam is recognized as a leading technology lawyer and is ranked by Chambers, Best Lawyers, Lexpert and Benchmark Litigation. He was lead counsel on the first securities enforcement matters involving cryptocurrency derivatives and frequently authors on blockchain-related topics.

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Rajeev (Raj) Dewan is a leading business lawyer with a thriving capital markets and securities practice. He regularly acts on behalf of high-growth companies in the eSports, health-care / life sciences, mining and technology sectors. Raj is recognized as a leading lawyer in the areas of Technology and Corporate Mid-Market by Lexpert Magazine. Raj is also an appointee to the TSX Venture Exchange's Listing Advisory Committee (Ontario).

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Jeff is an experienced capital markets and M&A lawyer, with expertise in advising companies and investment banks in the crypto space. He has advised in multiple go-public transactions for companies in the crypto space and is also called on to provide trusted commercial and regulatory advice for crypto issuers.

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Leo Raffin is a highly respected lawyer with a capital markets and securities law practice that focuses on mergers and acquisitions. He has extensive experience acting for technology, industrial and mining issuers. Leo also advises clients on cryptocurrency and blockchain matters, including coin or token offerings (ICOs and ITOs), blockchain-based platforms, cryptocurrency exchanges, and CSA Sandbox Applications.

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Kaleigh is an intellectual property associate with McMillan. She has written and advised clients on the intellectual property ownership rights of NFTs, including with respect to copyright considerations for artists in tokenized design works and for the sale and use of NFTs by consumers.

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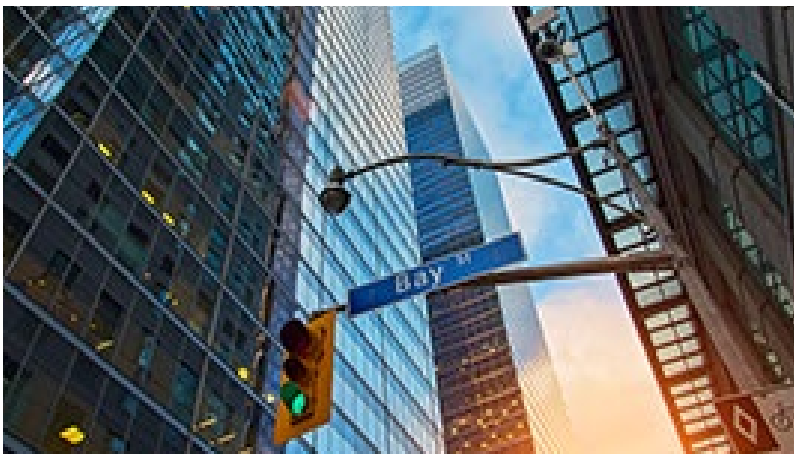




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