In 2017, crypto-assets went from being a relatively fringe technological curiosity to a global, booming business. The rapid price appreciation of crypto-assets and the incredible growth of initial coin offerings (ICOs, or sometimes referred to as token generation events) has caught almost everybody off guard, including financial institutions, regulators and yes, even law firms. This booming market is creating both new opportunities and challenges as investor interest pushes the price of crypto-assets ever higher.

Crypto-assets, including crypto-currency and crypto-tokens, are cryptographically secured digital records stored and transacted on an immutable decentralized ledger, commonly referred to as a Blockchain. The “gold standard” crypto-asset is Bitcoin, which is often used as a store of value (not unlike physical gold), but which can also be used to transfer value over a peer-to-peer network without a trusted intermediary like a bank. The first Bitcoin was created in 2009, and except for temporary blips in 2011 and 2013, the price for one Bitcoin never exceeded US$1,000 before this year. In late 2017, however, the price for one Bitcoin soared past US$11,000, which put the total market capitalization of all Bitcoins significantly ahead of the total market capitalization of the Royal Bank of Canada, Canada’s largest public company. The price of Bitcoin is extremely volatile; it is not uncommon to observe swings of more than 10% in a matter of hours.

The second-most popular example of a crypto-asset is ether, which is used to pay for the computing power that runs applications on the Ethereum Blockchain. Ether was worth approximately US$8 in early January 2017. In late 2017, it traded at more than US$400, which puts the market capitalization of all ether at more than US$40 billion — more than the market capitalization of another major Canadian bank, the Canadian Imperial Bank of Commerce. Notably, Ethereum was primarily created by a group of Toronto-based developers, many of whom still play a leading role in the development of the Ethereum Blockchain protocol and many Ethereum-based decentralized applications, or “dapps.” While it is still in the early stages, it can be argued that Ethereum constitutes Canada’s greatest digital technology success.

It is difficult to pinpoint a single explanation for the rapid increase in the value of crypto-assets. Some would argue that we are in the midst of a classic market bubble: the combination of constrained supply of many crypto-assets and high demand from investors who expect that the price of the assets will never materially decline have caused valuations to skyrocket.

Another explanation is the proliferation of ICOs. Year to date, organizations have raised more than US$3.5 billion in ICOs, greatly outpacing traditional venture capital investment over the same time.
period. ICOs have become a popular tool for organizations to conduct what is essentially a global crowdfunding campaign, resulting in additional tailwinds that drive demand for crypto-assets. The structure of ICOs varies — some ICOs involve the sale of a token that has many of the attributes of equity, effectively ‘tokenized’ equity that grants the holder voting rights and rights to distributions or dividends. Other ICOs involve the sale of a crypto-asset that mimics the features and functionality of Bitcoin or ether, or that is designed to have a specific use within a Blockchain platform or application without any of the rights typically associated with an equity or debt security.

Total market capitalization of crypto-currencies hovers around $150 billion.

A third explanation is that crypto-assets reflect a much more significant (and difficult to articulate) technological and economic shift towards a “tokenized” open source sharing economy. In this new decentralized economy, crypto-assets can be used to both reward anyone that contributes to the value of a shared digital network and collect payment from anyone that derives value from using that network.

In the Canadian capital markets, there are two natural consequences of the rapid price appreciation and proliferation of crypto-assets. First, savvy investment managers have decided that the best way to rapidly grow their business is to create investment funds that invest in crypto-assets. And second, many growth-oriented technology companies have determined that an ICO is the best way to raise capital and transform their business models (or both).

Take Kik Interactive, which in 2015 completed a financing round that valued the privately held Waterloo technology company at more than US$1 billion. This September, Kik raised just less than $100 million in an ICO designed to introduce a new crypto-currency, Kin. The Kin token is designed as a general purpose crypto-currency for use in digital services such as chat, social media and payments within the Kin ecosystem; the Kik messaging application being the initial service in that ecosystem.

To date, few ICOs have been designed to comply with securities laws and, not surprisingly, financial regulators around the world have expressed significant concern over the rapid growth of ICOs and the use of crypto-asset sales as a fundraising mechanism. In August, the Canadian Securities Administrators issued CSA Staff Notice 46-307 – Cryptocurrency Offerings. The notice indicates that many offerings of crypto-assets, including crypto-assets that function more like a currency and that do not have the traditional attributes of a debt or equity security, involve sales of securities that are subject to Canadian securities laws, if Canadians are involved in the purchase or sale.

In an unconventional move, the Ontario Securities Commission provided further guidance on ICOs via social media in October to advise that it has established a team of executives to “respond quickly to cryptocurrency offerings.” Indeed, Canadian securities regulators have demonstrated a willingness to approve ICOs subject to narrow terms and conditions, as evidenced by exemptive relief granted to Impak Coin and TokenFunder.

It is unclear what will happen next in the crypto-asset space. It is possible that there will be significant market failures (and resultant class action lawsuits) and crypto-assets will lose their lustre. It is also possible that the crypto-asset market will become increasingly professionalized, stable and legally compliant. As institutional investors continue to move into these markets and regulators subject them to greater scrutiny, it is likely that there will be improvements to market liquidity, transparency and
reliability, more robust custody arrangements and an embrace of consistent global standards and best practices.


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