Freak Out?

Just like that dance craze so vividly brought to life by the 70s disco-funk band Chic, all things crypto-currency continue to generate excitement as the New Year begins. The Chicago Board Options Exchange believes that "big fun will be had by everyone" if it can list and trade shares of bitcoin-based ETFs. Meanwhile, regulators aplenty are warning about the risks of initial coin offerings (ICOs), and digital currencies' plunging market values are making heads spin all around. Find out more in this month's edition of the Bulletin.

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1. Bitcoin ETFs – Ready to List?

In 2017, we provided updates with respect to Blockchain technology, Bitcoin, coin and token offerings, and crypto-currencies/assets. Recently, the United States Securities and Exchange Commission (SEC) published for comment proposed rule changes by the Cboe BZX Exchange, Inc. (the Exchange) that, if approved, could lead to the public listing and trading of Bitcoin-based exchange traded funds (ETFs) in the U.S. While some Canadian regulators have tacitly approved private funds based on Bitcoin and related technology (by granting registration to investment fund managers wishing to offer such funds), the example of publicly traded, Bitcoin-based ETFs in the U.S. could be of interest to firms or exchanges wishing to bring a similar innovation to Canada.

In Brief

IOSCO and other regulators express concern about ICOs

It seems like you can't open an industry e-newsletter these days without reading about another regulator expressing concern about crypto-currency based investments. As the Board of the International Organization of Securities Commissions (IOSCO) noted in a media release published on January 18, initial coin offerings (ICOs) aren't standardized and their legal and regulatory status is likely to depend on the specific circumstances of the ICO. IOSCO also noted that, although some operators are providing legitimate investment opportunities to fund projects or businesses, the increased targeting of ICOs to retail investors through online distribution channels by parties

In connection with its proposal to list and trade shares of several Bitcoin-based ETFs, the Exchange has sought the SEC's approval to, in effect, exempt these particular ETFs from the application of certain of the Exchange's listing requirements designed to prevent market manipulation. The SEC published the Exchange's proposed rule changes for public comment on December 28, 2017 and January 2, 2018, respectively (collectively, the Requests for Comment).

The Exchange believes that the rule exemptions are appropriate because there will be other factors mitigating the risk of market manipulation, including expected liquidity levels in the market for listed Bitcoin derivatives and surveillance procedures applicable to the Bitcoin futures contracts and the Bitcoin-based ETF shares. As well, the Exchange believes that "the nature of the bitcoin ecosystem" makes manipulation of bitcoin difficult.

The Exchange also submitted that investors will benefit from the listing and trading of these ETFs. According to the Exchange, the shares will provide an inexpensive and simple vehicle for investors to gain long or short exposure to bitcoin in a "secure and easily accessible product that is familiar and transparent to investors" and enhance the security afford to investors as compared with a direct investment in bitcoin.

Although the proposed rule changes are quite technical, the anticipated commentary on the Requests for Comment and the SEC's response to that commentary may offer insight into the potential for a public market in Bitcoin-based ETFs. AUM Law will continue to follow these developments and is happy to discuss with you any plans that you may have in the Blockchain, Bitcoin, coin and token offerings, and crypto-currency space.

2. The Initial Coin Offering (ICO) Process Compared to the Initial Public Offer (IPO) Process

Initial coin offerings (ICOs) typically involve the creation of digital tokens, using distributed ledger technology, and their sale to investors in return for a crypto-currency. In light of recent market interest in such offerings, we think this comparison between the traditional IPO process and a typical ICO process might be helpful.

IPO Process	ICO Process
Step 1: Assemble IPO Team – Retain legal counsel, an auditor and underwriters for the offering.	**Step 1: Idea Generation** – Develop an idea for a decentralized blockchain application.
Step 2: Evaluate the Business – Decide if a business is ready for an IPO including answering questions such as: • Does the business have a well-developed business plan and financial assets and/or revenues (or path to revenues) that can support the operational costs of running a public company? • Does the business have an appropriate management team/board of directors to lead the business through an IPO	**Step 2: Team and Research** – Recruit a management and operations team to make decisions on: • The technology required and how it can be applied to the blockchain application; • The business approach (marketing, financial, logistics and staffing); • The governance considerations (legal and tax structuring, securities compliance questions); and

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often outside the investor's home jurisdiction raises investor protection concerns. The IOSCO Board has established an ICO Consultation Network through which IOSCO members can discuss their experiences and bring their concerns to the attention of fellow regulators. It has also published a sample of regulators' media releases here. We can expect to hear more from regulators on this topic, and AUM Law will keep on an eye on developments that affect Canadian markets and market participants.

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IIROC and FINRA outline their compliance priorities for 2018

Earlier this month, each of the Investment Industry Regulatory Organization of Canada (IIROC) and its U.S. counterpart the Financial Industry Regulatory Authority (FINRA) disclosed their compliance and examination priorities for the firms they supervise. Although these reports are of most relevance to firms directly supervised by these regulators, these supervisory trends may also be of interest to other Canadian registrants as well.

IIROC's Compliance Priorities Report indicates an emphasis on areas such as: pro-active management of cyber-related risks (which may involve table-top simulations of cyber-incident scenarios as well as self-assessment exercises); reviews of dealers' accounting systems for compliance with CRM2 reporting requirements; service arrangements between portfolio managers and dealers; trading compliance (including best execution, fair pricing, electronic trading

IPO Process	ICO Process
and then manage a public company? • Does the business have adequate formal governance, internal reporting and control structures so that a CEO or CFO can complete with confidence quarterly certifications post-closing? • Has the firm formalized key arrangements with current customers and suppliers? • Has your IPO team conducted extensive operational, financial and legal due diligence to ensure that the business can provide accurate disclosure in the IPO? (The underwriters may want to do their own, independent due diligence.)	• Whether an ICO is required to support the above functions. If you decide to go ahead with an ICO – additional questions include: ○ which token platform or blockchain will be used; ○ what will the structure of the sale will look like; and ○ how the sale will be priced.
Step 4: Regulatory Review – File a preliminary prospectus and then work with your counsel to respond to regulators' comments on it. This process usually takes 4-5 weeks but can vary depending on the offering.	**Step 4: White Paper/Disclosure Document** – Author a white paper that explains: the vision of your concept, the technology used, the team you will employ, business plan, ICO process and other legal disclosure.
Step 5: Marketing – This step traditionally is done concurrently with Step 4 above. The business's management and underwriting team typically will conduct a "road show" involving presentations to brokers and institutional investors.	**Step 5: Consultation** – Describe the ICO to a select audience of early investors, industry insiders and technical advisers to obtain feedback and iterate on your concept. These individuals may become proponents of your concept and spread your idea through their network.
Step 6: Final Receipt – Obtain clearance from the securities regulators and prepare a final prospectus.	**Step 6: Pre-Sale (Optional)** - Consider doing a limited capital raise to help support the operational, legal and development costs required in preparation for the full ICO.
Step 7: Sale – The IPO occurs and the securities qualified under the prospectus are distributed to purchasers.	**Step 7: General Marketing** – Start marketing to your target investors through traditional and technological mediums (as permitted by securities laws).
	Step 8: Sale – The ICO occurs and tokens are distributed to purchasers.

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controls, and supervision of over-the-counter debt trading); dealer compensation-related conflicts of interest; automated/online advice service offerings; CRM2 (especially KYC information regarding clients' investment time horizons and pre-trade disclosure of charges); and registration filings (including concerns about notices of termination, filings relating to outside business activities, and late or incomplete disclosures with respect to regulatory, civil, criminal and financial disclosure items).

FINRA's 2018 Annual Regulatory and Examinations Priority Letter indicates an emphasis on areas such as: microcap fraud schemes including schemes that target senior investors; registered representatives who raise funds from investors they serve away from their firms; business continuity planning; customer protection and verification of assets and liabilities; technology governance; cyber-security; anti-money laundering programs; liquidity planning; procedures for monitoring rates charged to customers for short sales; controls to meet suitability obligations; initial coin offerings and crypto-currencies; firms' disclosure and supervisory practices related to margin loans; market manipulation; best execution where firms provide price improvement when routing customer orders for execution or executing internalized customer orders; fixed income data integrity; front running in correlated options products; and market access.

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3. Up in Smoke?

As we reported in our October 2017 bulletin, the Canadian Securities Administrators (CSA) published Staff Notice 51-352, which outlined a disclosure-based approach to highlight risks facing issuers with marijuana-related activities in the United States. The CSA notice took into account the existence of a U.S. federal government forbearance approach (outlined in the Cole Memorandum) to the enforcement of federal laws relating to marijuana.

On January 4, 2018, the U.S. Attorney General rescinded all previous guidance specific to federal law enforcement relating to marijuana. In response to this change in enforcement approach, the CSA announced on January 12, 2018 that it is considering whether its disclosure-based approach for issuers with U.S. marijuana-related activities remains appropriate. The CSA said that it will provide an update on its position shortly.

This is also a good time to remind TSX-listed issuers (and those investing in TSX-listed issuers) with marijuana-related activities that the TSX believes that issuers with ongoing business activities that violate U.S. federal laws regarding marijuana are not complying with the TSX Company Manual. Read more in our October 2017 bulletin.

4. Court of Appeal Upholds OSC's Interpretation of "Special Relationship" in Tipping Case

The OSC regards insider tipping as conduct just as serious as insider trading because tipping undermines confidence in the marketplace. It can be challenging, however, to determine whether a person down the line from a reporting issuer in a chain of communications containing material non-public information (MNPI) is in a "special relationship" with that issuer, such that he or she is subject to the prohibitions on insider trading and tipping in the Securities Act. In 2015, the OSC's decision in *Finkelstein v. Ontario Securities Commission* outlined an approach and list of factors to be considered in deciding such cases. On January 25, 2018, the Ontario Court of Appeal upheld the OSC's Reasons for Decision and confirmed that the factors developed by the OSC panel in assessing whether a person is "in a special relationship" are a reasonable guideline in making such a determination.

The OSC's original Reasons and the Court of Appeal decision are of particular interest to registrants and other professional market participants, since several of the factors applied by the OSC (and accepted by the Court of Appeal) take into account the tipper's and tippee's professional qualifications and relationship to each other. For example, the OSC considered such factors as:

- Whether the tipper's professional qualifications and standing put him in a milieu where transactions are discussed;
- Whether the tippee's profession or position put him in a position to know that he cannot take advantage of confidential information and therefore a higher standard of alertness is expected of him than from a member of the general public; and
- The relationship between tipper and tippee (e.g., whether they are close friends, whether they also have a professional relationship and whether the tippee knows of the tipper's trading patterns, successes and failures).

In its reasons, the Court of Appeal set out a hypothetical fact pattern involving a tipper and tippee who have worked together for some time and are registrants in securities markets. The Court of Appeal noted:

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OSC Finalizes Rule 72-503 Distributions outside Canada

Further to our bulletin of October 2017, the Ontario Securities Commission has finalized OSC Rule 72-503 *Distributions outside Canada* (the "Rule") and its accompanying companion policy. If the Minister of Finance approves the Rule (or does not take any further action by March 5, 2018), the Rule and companion policy will come into effect on March 31, 2018.

The Rule, once in force, will provide clarification to issuers and dealers involved in cross border activities. The companion policy provides guidance with respect to when a distribution of securities can be said to occur outside of Canada, and thus no prospectus or exemption from the prospectus requirement would be needed. If a distribution of securities does occur in Ontario (or the analysis is not made), the Rule itself provides various prospectus exemptions. For example, a prospectus exemption will be available to non-reporting issuers for a distribution by the issuer to a person outside Canada, if that issuer has materially complied with the disclosure requirements of the securities law requirements of the foreign jurisdiction (or if the distribution is exempt from such requirements).

Registration, of course, generally is required if registrable activities are provided to Ontario investors or are otherwise conducted in Ontario. Under the Rule,

> "Such facts could constitute evidence logically relevant not only to the nature of the information conveyed by the tipper – non-public material information – but to the likelihood that the tipper's source of the information was linked to or related in some fashion with the issuer – i.e. that the market registrant tippee ought reasonably to have known the market participant tipper operated in a confidential information loop and was passing on material, non-public information likely sourced from another person in a special relationship."

AUM Law can assist you in developing policies and procedures to prevent, deter and detect illegal insider trading and tipping, and we can provide customized training to your staff to illustrate and reinforce those policies and procedures. Please contact your usual AUM lawyer to discuss how we can help you.

5. To Wrap or Not to Wrap: Providing Offering Documents to Canadian Resident Investors

Historically, many foreign issuers used a "Canadian wrapper" – a document that "wraps" around the foreign offering document to add required Canadian disclosure, instead of altering their existing offering documents to comply with Canadian securities laws. In September 2015, however, Canadian securities regulators adopted several amendments to reduce the disclosure burden on foreign issuers privately placing securities in Canada. The intent of the amendments was to end the need for Canadian wrappers and allow foreign issuers to access the Canadian private placement market more quickly and cost effectively.

Two years on, we decided to consider whether the Canadian wrapper is facing extinction. Unfortunately, we don't think so. Although Canadian wrappers certainly are less prevalent today than they were before September 2015, they may still be required or remain the most cost-effective solution in certain situations.

First, the Canadian wrapper "exemption" is not an automatic exemption. To conclude that a Canadian wrapper is not required, a substantive analysis of the specific facts needs to bear that out. For example, it will need to be confirmed that all prospective, Canadian-resident investors qualify as "permitted clients" under Canadian securities laws and not just as "accredited investors" (the threshold otherwise typically required in order to issue securities on a Canadian, prospectus-exempt basis). Also, if there is a potential conflict of interest between the issuer and the dealer engaged to effect the distribution (which will often be the case for investment funds that use dealers that are affiliated with the issuer), then it must be confirmed that:

- there will be a concurrent distribution of the securities to U.S. investors (which will not always be the case);
- the foreign offering document to be delivered to Canadian-resident investors contains the same disclosure as provided to investors in the U.S.; and
- if applicable, the disclosure complies with FINRA rule 5121 (which again will not always be the case).

These determinations typically require the advice of both foreign and Canadian counsel.

From the above, you will note that counsel is often needed to determine whether a Canadian wrapper is required in the context of a specific offering. Also, if counsel is not careful they may burn unneeded time and money in trying to conclude that a Canadian wrapper is not required, only to then determine that a Canadian wrapper is in fact required or is the most practical path forward. In that instance, time and money have been spent and the issuer is back to square one – having counsel prepare a Canadian wrapper.

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registration exemptions are provided for foreign dealers and Ontario issuers (subject to a number of conditions) in connection with their activities in Ontario for distributions made to investors outside of Canada in the specified jurisdictions. One rationale behind the new Rule is that investors would generally expect to rely on the protections of the securities law of the foreign jurisdiction in which the investor is located. The Rule provides some much needed updates and clarity for these distributions of securities.

Accordingly, we continue to stress the importance of engaging experienced, Canadian counsel when undertaking a cross-border private placement. In addition to efficiently answering the question of "to wrap or not to wrap", Canadian counsel will need to provide practical guidance on various other issues, including: the availability or not of various prospectus exemptions, dealer and investment fund manager registration requirements and exemptions that may be relied on, the applicability of Canadian anti-money laundering (AML) legislation, and Canadian post-trade reporting obligations, as well as the documentation to be provided even when the wrapper exemption applies. The Canadian-wrapper exemption notwithstanding, none of these considerations have disappeared or become less layered over the past two years. AUM Law's value-add proposition is that with knowledgeable, pragmatic Canadian counsel, none of these issues should deter an issuer from raising money in Canada.

We are confident that our team can provide you with the cost-effective solutions you are looking for in this space.

6. Is Your Firm Paying for Insurance Coverage It's not Required to Have?

With the adoption of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) in 2009, the securities registration regime across Canada experienced a major overhaul. Before then, regulators in some provinces including Alberta, Manitoba and Saskatchewan required firms seeking to be registered in certain categories to obtain insurance coverage in the form of a surety bond in addition to a Financial Institution Bond. With the adoption of NI 31-103, these province-specific surety bond requirements were eliminated.

Although this regulatory change occurred quite some time ago, it may be valuable for registrants to review their current insurance coverage to determine whether their firm is adequately insured and/or whether it is paying insurance premiums for coverage it no longer requires. AUM Law would be pleased to assist you in comparing your existing insurance coverage to that required by Canadian securities regulators. Please reach out to your usual AUM lawyer.

AUM Law: We Have the Knowledge, Experience and Bench Strength to Meet Your Needs

AUM Law serves the asset management sector in the areas of regulatory compliance, investment funds and corporate law. Our team of legal professionals offers deep knowledge, experience, skills and bench strength to provide you practical and forward-thinking advice. Our business model is geared to efficiency, responsiveness and client service excellence, with a focus on fixed fees.

As we start the new year, we thought you would find it helpful to have a snapshot of who's who among our legal professionals. Find out more about us by clicking on the links in their names.

Kevin Cohen
Chief Executive Officer

Erez Blumberger
President

Kimberly Poster
Chief Legal Counsel
and Senior Vice President

Janet Holmes
Director of Knowledge Management and Communications, Special Counsel

David Coultice
Senior Legal Counsel

Chris von Boetticher
Senior Legal Counsel

Stacey Hoisak
Senior Legal Counsel

Jason Streicher
Senior Legal Counsel

Stacey Long
Senior Legal Counsel

Sandy Psarras
Senior Legal Counsel

Richard Roskies
Legal Counsel

Christopher Tooley
Legal Counsel

Jennifer Jeffrey
Legal Counsel

Florind Polo
Legal Counsel

Gordana Beric
Senior Law Clerk

Rose Haggarty
Senior Law Clerk

Amy Doyle
Senior Law Clerk

Millie Yang
Senior Law Clerk

AUM Law primarily serves the asset management sector, with specific expertise in the regulatory and investment fund space. We strive to provide the most practical, forward-thinking advice and services, using a business model geared to efficiency, responsiveness and client service excellence. We are pleased to send you this summary of recent developments that may affect your business.

This bulletin is an overview only and it does not constitute legal advice. It is not intended to be a complete statement of the law or an opinion on any matter. No one should act upon the information in this bulletin without a thorough examination of the law as applied to the facts of a specific situation.