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Regulatory Framework for Token Sales: An Overview of Relevant Laws and Regulations in Different Jurisdictions

Primavera de Filippi, Benedikt Schuppli, Constance Choi, Carla Reyes, Nikita Divissenko, Xavier Lavayssière, Francesco Dagnino, Marcus C Funke, Frank Bierwirth, Thomas Müller, et al.

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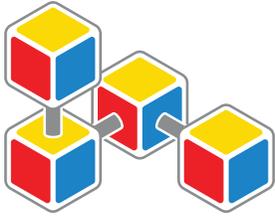
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COALITION OF AUTOMATED LEGAL APPLICATIONS

REGULATORY FRAMEWORK FOR TOKEN SALES

An Overview of Relevant Laws and Regulations in Different Jurisdictions

Primavera de Filippi, Benedikt Schuppli, Constance Choi, Carla Reyes, Nikita Divissenko, Xavier Lavayssière, Francesco Dagnino, Marcus C. Funke, Frank Bierwirth, Thomas Müller, Max von Cube, Axel Schiemann, Jiong Sheng, Gianna Abegg, Nathan Kaiser, and Jackie Yang

Coalition of Automated Legal Applications

April 2018





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Blockchain Research Institute, 2018

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Foreword

All fast-evolving technology presents a significant challenge to governments and regulatory bodies. Since the nature of legislation (at least, under traditional systems) is still slow, by the time that policymakers finish debating, drafting, discussing, redrafting, and enacting a law or regulation, it often ends up addressing an outdated version of the technology in question.

In the case of blockchain—since it represents such a transformational change in many sectors of society—stifling innovation simply to maintain control is not in the best interest of elected officials because it is not in the best interest of the electorate. Even authoritarian regimes can impair their ability to keep up with the free world. Exacerbating this situation is blockchain’s enforcement of privacy, which some circles have viewed (unfairly, in my opinion) as a tool of money launderers and other ne’er-do-wells.

This research project surveys the global landscape of regulatory frameworks and highlights the interesting decisions of various jurisdictions on the matter of blockchain-based token sales. It looks at initial coin offerings and explores how different regulators are categorizing these coins in their attempts to balance the protection of investors with the encouragement of innovators and entrepreneurs.

Such an ambitious project required a team of legal scholars to investigate the rules and regulations of more than a dozen countries. The team included Gianna Abegg, Frank Bierwirth, Constance Choi, Francesco Dagnino, Primavera De Filippi, Nikita Divissenko, Marcus Funke, Nathan Kaiser, Xavier Lavayssière, Thomas Müller, Carla Reyes, Axel Schiemann, Benedikt Schuppli, Jiong Sheng, Max von Cube, and Jackie Yang. Anyone interested in this dynamic map of the ICO world should find this research riveting indeed.



DON TAPSCOTT

*Co-Founder and Executive Chairman
Blockchain Research Institute*



Idea in brief

- » This research examines the current regulatory landscape and recent legal developments concerning the regulation of blockchain-based token sales, commonly referred to as *initial coin offerings* (ICOs).
- » This complex and constantly evolving regulatory landscape poses serious legal and operational challenges to practitioners and companies that desire to utilize the mechanism of an ICO for its perceived benefits: as a powerful new mechanism for alternative funding of blockchain-based networks or applications, and as an accessible tool for community building and global engagement.
- » The goal of the report is to orient the reader in the current legal treatment of ICOs across a variety of key jurisdictions in North America, Asia, and Europe.
- » Through a comparative analysis of existing regulations, this report underlines the critical need for international cooperation in the nascent blockchain ecosystem to produce healthy policy and market outcomes.

This research examines the current regulatory landscape and recent legal developments concerning the regulation of blockchain-based token sales, commonly referred to as initial coin offerings.

Introduction

The rapid development of emergent technologies presents ongoing challenges to legal oversight. Traditional procedures of lawmaking have been unable to keep up with today's pace of innovation, resulting in serious gaps between the state of technology and the state of regulation. This long-recognized problem of "regulatory lag" (also known as the "governance gap") has resulted in the destabilization of traditional mechanisms of adjudication and rule-making, and the erosion of public confidence in the "state of play"—that is, what is permissible and what is not.

The emergence of blockchain technology and the perceived multiplicity and diversity of its uses has exacerbated this long-standing problem. As a general-purpose technology, blockchain-based systems touch upon diverse policy domains. Given their public mandate to oversee technologies affecting markets and society more generally, governments have begun to act to regulate these nascent technologies, despite their limited understanding thereof.

With innovative and general-purpose technologies like blockchains, and the Internet before them, the stakes are high. It is, therefore, crucial to avoid ill-adapted laws that may be ineffective or carry unintended consequences and regulatory uncertainty that cripples the ability of innovators and regulated institutions to engage in and advance new technologies.



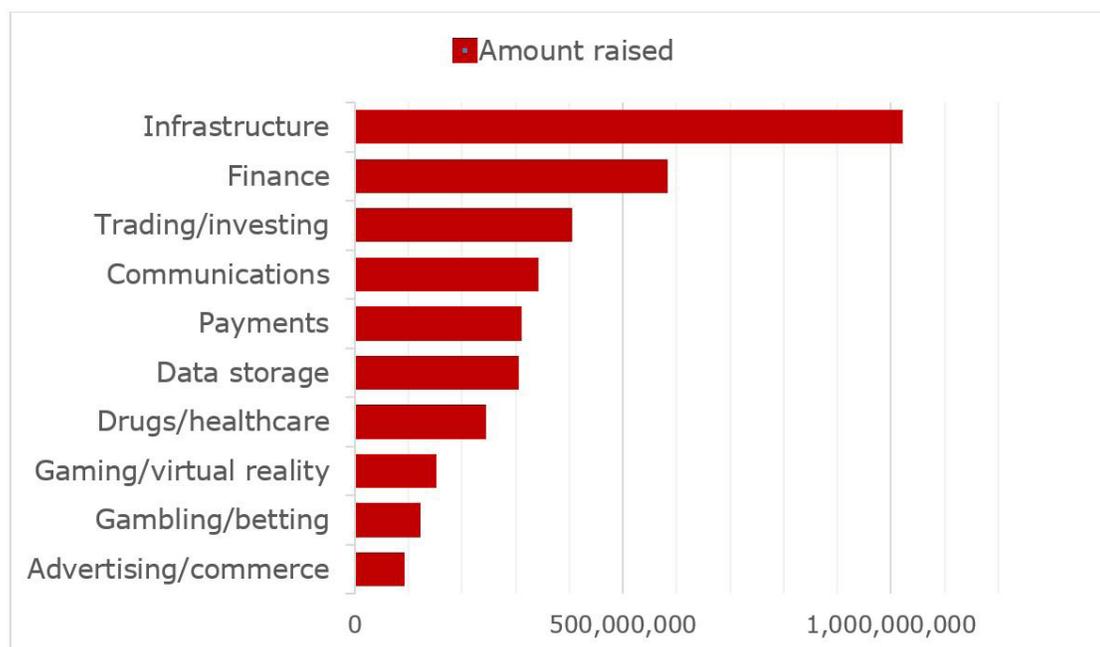
As is often the case, given the overlap between distinct but interdependent regulatory spheres, regulations in one sphere can impede or support other important policy domains. Until now, however, in the context of blockchain technology, regulation has been addressed ad hoc, within siloed regulatory agencies. Because blockchain technologies intersect key policy spheres, it is important to achieve:

Until now, in the context of blockchain technology, regulation has been addressed ad hoc, within siloed regulatory agencies.

- » Harmonization across the policy goals of existing legal frameworks;
- » Regulation that enables innovation and that can adapt to known and emergent usages of the technology.¹

In recent years, many blockchain-based projects or initiatives have experimented with new ways of raising funds through the issuance and sale of blockchain-based tokens. These so-called token sales or initial coin offerings are generally used to fund the development of digital platforms or software applications running on top of a blockchain.² Starting with Mastercoin's and Ethereum's crowdsales in 2014—which raised respectively \$500,000 and \$18 million worth of bitcoin at the time—followed by the Decentralized Autonomous Organization (DAO) in 2016, raising more than \$150 million in less than one month, the practice of raising funds through a blockchain-based token sales has become common practice.³ In 2017, token issuers raised an estimated \$3.7 billion globally through 235 total token sales, and the trend does not seem to be slowing down (Figure 1).⁴

Figure 1: Top 10 sectors raising funding through token sales in 2017



Source of data: Coinschedule.com, "ICOs by Category 2017."



Although ICOs may classify their tokens under different categories, rules and regulations in different jurisdictions may require token issuers to comply with specific restrictions or formalities.

Yet, most countries have no specific regulatory framework for ICOs. These new fundraising practices currently operate in a gray area of the law, and the legal qualification of blockchain-based tokens issued in token sales remains unclear, since different jurisdictions might construe them as different asset classes under different bodies of law. Besides, depending on the applications, these tokens can assume multiple functions:

- » They can be used to access a particular platform or benefit from a particular service.
- » They can be used to design sophisticated forms of participation, including new governance mechanisms.
- » They can sometimes enable token holders to obtain a share of the profits generated by these blockchain-based systems.

In almost all instances, owners of these tokens can resell them in a secondary market on virtual exchanges or other platforms, regardless of token issuers' intentions.

Although ICOs may classify their tokens under different categories (e.g., utility tokens, payment tokens, investment tokens), rules and regulations in different jurisdictions may require token issuers to comply with specific restrictions or formalities, depending on the token's technical attributes and functions. This legal uncertainty puts token issuers into a precarious situation, because, if they fail to comply with the appropriate rules and regulations, they might be held liable for violations of the law.

In particular, to the extent that ICOs are functionally equivalent to other (regulated) fundraising practices, the law may regard them as falling within a variety of existing regulatory frameworks. Indeed, securities regulations seem likely to apply at least to specific types of token sales, insofar as the law may regard the issued tokens as fully or partially assimilable to securities.

Token issuers could be held liable for infringement of consumer/investor protection regulations, should they fail to deliver on their promises.

Even if their activities do not fall within any existing regulatory framework, token issuers could nonetheless be held liable for infringement of consumer/investor protection regulations, should they fail to deliver on their promises or on other undelineated grounds. Besides, regardless of whether securities regulations apply to a given token sale, token issuers remain subject to potential forms of civil liability if they act fraudulently or enter into a breach of contract with their investors. The current state of regulation is fraught with operational and legal risks.

Organization of coverage

In this report, we investigate the legal qualification of blockchain-based tokens in light of a variety of laws and regulations, including securities laws, commodities laws, regulations around fraud and consumer protection, financial intermediaries and money



Given the notoriously long arm of US regulators and its leading role in the ICO market, we start with the laws and regulations governing token sales in the United States.

transfer laws, and other legal regimes that might apply in specific circumstances. We focus on a variety of jurisdictions that play a relevant or strategic role in the current ICO landscape. We illustrate the diversity and similarities of the policies and regulatory approaches of these different jurisdictions.

Given the notoriously long arm of US regulators and its leading role in the ICO market, we start with the laws and regulations governing token sales in the United States. We then move to other key jurisdictions such as Canada, Singapore, China, France, Germany, Italy, Estonia, Switzerland, Gibraltar, and Europe more generally.⁵

For each jurisdiction, we overview existing regulatory frameworks and the conditions under which a particular cryptographic token may fall under any existing laws and regulations (e.g., securities laws, regulations on money transmission and commodities trading, consumer protection laws).

We then look at the various statements and press releases of relevant regulatory authorities in that jurisdiction, as well as the decisions taken regarding specific ICOs or other related blockchain-based practices. Where applicable, we list noteworthy ICOs launched in that particular jurisdiction. We conclude with a critical assessment of the various regulatory frameworks applicable in the jurisdiction as well as a comparative analysis of the pros and cons of existing regulatory approaches.

Our comparative analysis reveals the significant lack of harmonization regarding the legal qualification of cryptographic tokens and a particular divergence between common law and civil law countries. Common law jurisdictions avail themselves of a more flexible regime, the scope of which can easily be extended to cover ICOs and other fundraising practices. However, because of the malleability of common law doctrines, these laws run the risk of expanding beyond their original scope, regulating practices that were not meant to be regulated when the rules were written. In other words, the common law approach offers greater flexibility but carries the risk of legal creep into unintended spheres, with new opportunities for selective enforcement.

We need a more harmonized regulatory framework at the international level.

In contrast, civil law jurisdictions, such as many European countries, have a much harder time regulating ICOs with existing laws and regulations because of their statutory provisions, which are more precise and formalized than their common law counterparts. Hence, although many token sales could potentially be assimilated as securities offerings, regulators in these jurisdictions need to rely on alternative bodies of law such as antitrust or consumer protection to regulate these activities.

We ultimately underscore the need for a more harmonized regulatory framework at the international level. Indeed, lack of a clear and harmonized regulatory framework may drive innovators and regulated institutions away from markets and jurisdictions with perceived high regulatory risks, which puts significant burden on all



Few tokens qualify as only one particular token type; most display the characteristics of several token types simultaneously.

stakeholders—token issuers and token holders alike—and ultimately impedes the development of a more robust ecosystem. In turn, an increasing number of actors might engage in forum shopping for launching an ICO.

Such jurisdictional arbitrage may very well enable a new wave of financial innovation, but it is also likely to hinder existing regulatory objectives, create significant asymmetries of information, and make it harder for domestic regulators to enforce laws concerning investor protection and market stability.

Limitation of scope

In this report, we focus only on the primary market of blockchain-based tokens—that is, the primary issuance, solicitation, and placement of these tokens on the open market. We do not analyze the legal implications of the secondary market, conducted via bilateral or multilateral exchanges or over-the-counter (OTC) transactions.

In our regulatory overview, we have not relied on any specific token classification system because most tokens—regardless of their functions—are obtained with the objective and expectation to make a profit.⁶ While this is obviously true in the case of investment tokens, it is also true for a large majority of cryptocurrencies and utility tokens.

People generally purchase these tokens during an ICO, not only because they want to use them to purchase specific goods or services or to access a particular platform, but also because they expect to sell them subsequently at a higher price on the secondary market. Therefore, few tokens qualify as only one particular token type; most display the characteristics of several token types simultaneously.

Furthermore, the decision not to rely on a general classification system can also be ascribed to the jurisdictional view that “substance trumps form,” often found in the context of US and Canadian securities laws, which—when it comes to determining whether a token qualifies as a security—will ultimately face the test developed in *Securities and Exchange Commission v. WJ Howey Co.* in 1946 (“the Howey test”).⁷

The view that “substance trumps form” rather than some general classification system has influenced the determination of whether a token qualifies as a security.

As highlighted both by the chairman of the Securities and Exchange Commission (SEC) in a recent statement and as established by the recent *Munchee* order of the SEC, simply naming a token a “utility token” or giving the token some form of a utility will not by itself reverse its qualification as a security under relevant regulations.⁸



Types of blockchain-based tokens

As an overview of market trends, here is a list of different token types and their properties:⁹

1. Cryptocurrency

Cryptocurrencies are integral to most public blockchains. Unlike government-issued fiat currencies, cryptocurrencies are generally created in a decentralized fashion, independently of any governments or central banks. Well-known examples include bitcoin and ether.

Cryptocurrencies are generally created in a decentralized fashion, independently of any governments or central banks.

2. Utility token

As opposed to cryptocurrencies, cryptographic tokens are issued on top of an existing blockchain infrastructure. Most of these tokens are created on the Ethereum blockchain via the ERC-20 protocol. With utility tokens, the investor purchases the right to access and/or use a blockchain-based *decentralized application* (Dapp) or other online platform. At times, these tokens are comparable to game credits or a software license. At other times, these tokens are a means of paying for goods and services from a particular application or from other participants in the platform. Finally, at times these tokens may enable token holders to participate in the governance or decision-making process of these platforms.

3. Equity token

Unlike utility tokens, which are used or spent within an online platform, equity tokens represent a share in a company, which is possible under Swiss stock corporation law, for instance, in the form of intermediated securities. Or they grant token holders the right to receive a share or other form of equity in a company, in which case, the tokens would include a derivative component. In some cases, equity tokens may include a governance component like that of utility tokens, granting token holders a right to participate in the decision-making process of a blockchain-based platform or organization, much as shares of stock grant such a right to traditional stockholders.

Essentially, profit-share tokens are a synthetic replication of a dividend payment on ordinary shares.

4. Profit-share token

Like equity tokens, profit-share tokens allow holders to participate in a company's success. Yet, unlike equity tokens, which confer the right to receive share capital or other forms of equity in the company, profit-share tokens confer the right to receive a payment only in the form of a dividend. Essentially, profit-share tokens are a synthetic replication of a dividend payment on ordinary shares. Thus, these tokens include a derivative component, in which the referential value is the dividend paid out on the underlying shares. However,



the fixed amount is never paid back, unlike traditional dividend certificates (i.e., debt securities).¹⁰

Other forms of profit-share tokens may confer the right to participate in a platform's revenue or profit. These tokens also include a derivative component, in which the referential value is the platform's revenue or profit, usually ascribed to the issuer's company.

Digitized physical asset tokens represent physical assets (e.g., a painting, a cask of wine, gold bars) or portion of such assets.

5. Digitized physical asset

These tokens represent physical assets (e.g., a painting, a cask of wine, gold bars) or portion of such assets. Issuers could legally structure such a token in several ways.

- › They could place the asset in a *special-purpose vehicle* (SPV) and create tokens representing shares of that SPV. the promise to deliver a physical asset (e.g., a unique bottle of wine) within the token and thereby ascribe to the token a derivative component.
- › They could structure the token in the form of an intermediated security representing a ware paper, itself representing possession of the ware—perhaps a gold bar.
- › Or they could represent the asset digitally to facilitate e-commerce by lowering transaction costs, in which case the asset would still have to change location to change ownership, since the token would be just a technical proxy that did not reflect on the legal nature of the asset.

Table 1: Types of blockchain-based tokens

Type	Characteristics	Examples
Cryptocurrency	Integral to most public blockchains, generally created in a decentralized fashion, independent of any governments or central banks	bitcoin, ether, zcash
Utility token	Issued on top of an existing blockchain infrastructure provides the right to access and/or use a blockchain-based decentralized application or other online platform	augur, filecoin, golum
Equity token	Represents a share in a company or the right to receive a share or other form of equity in a company	tzero, lykke
Profit-share token	Allows holders to participate in a company's success, confers the right to receive a payment only in the form of a dividend	Gifcoin, ETHlend's LEND
Digitized physical asset	Represents physical assets (e.g., a painting, a cask of wine, gold bars) or portion of such assets	Royal Mint Gold



NORTH AMERICA

United States of America

Carla Reyes

We expect ongoing enforcement activity from the various regulators to refine the law as it applies to token sales.

Token sales may be subject to a number of complex regulatory regimes in the United States, at both federal and state levels. Increasing that complexity is very little uniformity across states; token sale operators must develop a 50-state compliance strategy. At the federal level, at least four separate regulatory offices have jurisdiction over different aspects of token sales; and the treatment of token sales under each regime continues to emerge. In this section, we overview the law in its current implementation. We expect ongoing enforcement activity from the various regulators to refine the law as it applies to token sales.

Regulatory framework

This section discusses five substantive areas of US law—securities regulation, commodities regulation, money services business laws, consumer protection laws, and regulations overseen by the Office of Foreign Asset Control—that apply to token sales in the United States. Where appropriate, we examine both federal and state law.

Securities law

The Securities Act of 1933 and the Securities Exchange Act of 1934

Section 5 of the Securities Act of 1933 (the “Securities Act”) requires that all securities offered for sale be registered with the SEC unless an exemption applies.¹¹ Further, it requires “that the issuer disclose a variety of information to investors in connection with the registration requirement.”¹²

The registration, disclosure, and antifraud provisions apply only to the sale of instruments that qualify as a security.

The Securities Exchange Act of 1934 (the “Exchange Act”) imposes ongoing disclosure requirements.¹³ Further, both it and the Securities Act prohibit issuers from defrauding the public and impose liability for any misstatement or omission of material facts.¹⁴ These antifraud provisions are particularly broad. The registration, disclosure, and antifraud provisions apply only to the sale of instruments that qualify as a security. The analysis of tokens under US securities law thus begins with the definition of the term *security*.

Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act generally define *security* as any note, stock, bond, debenture, evidence of indebtedness, certificate of interest, or participation in any profit-sharing agreement, transferable share, investment contract, or instrument “commonly known as a security.”¹⁵ On its face, this definition is quite broad. In particular, the catch-all term *investment contract* could apply to any number of



instruments. Thus, the US Supreme Court uses the *Howey* test to consider the statutory definition of security as applied to “unusual instruments not easily characterized as securities.”¹⁶

Legal academics predicted that courts and regulators would use the *Howey* test to determine whether a token constituted a security.¹⁷ In July 2017, the SEC confirmed as much by releasing a report in which it used the *Howey* test to determine that a blockchain-based token qualified as a security and required registration under Section 5 of the Securities Act.¹⁸

Under the *Howey* test, an instrument is an investment contract and qualifies as a security if: (1) “individuals were led to invest money, (2) “in a common enterprise,” (3) “with the expectation that they would earn a profit,” (4) “solely through the efforts of the promoter or of someone other than themselves.”¹⁹

The *Howey* test is highly fact dependent and highly flexible, as determined in *SEC v. C.M. Joiner Leasing Corp*:

The reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing, which established their character in commerce as “investment contracts.”²⁰

In July 2017, the SEC released a report in which it used the Howey test to determine that a blockchain-based token qualified as a security and required registration under Section 5 of the Securities Act.

In the context of token sales, the first two prongs of the *Howey* test are commonly satisfied.²¹ To purchase a token, the purchaser invests money or something else of value that substitutes for money, (e.g., cryptocurrency).²² Similarly, many token sales will satisfy the “common enterprise” element of the test, since the price received for a token on resale is linked to the results of other token holders.²³ Therefore, many commentators believe that the last two elements of the *Howey* test are critical in the analysis of whether a token sale constitutes the sale of a security. Both of these elements—the “expectation of profits” and “solely from the efforts of others” elements—are intensely fact-dependent, meaning that the outcome for any given token sale may vary.²⁴

Recent SEC enforcement action bears out the fact dependence of the inquiry under the *Howey* test, and suggests that, for now at least, the SEC may be strongly preoccupied with its antifraud and investor-protection mandate. For example, when the SEC froze the assets of PlexCorps and RECoin in December 2017, the related press releases indicated that the presence of false promises of a 13-fold return on investment and false statements about the entity and staff operating the business weighed heavily in the enforcement decision.²⁵

Similarly, in the enforcement order against Munchee, the SEC found that those purchasing Munchee “MUN” tokens would have reasonably expected to profit from Munchee’s efforts to increase their value, because Munchee made statements in its token sale launch materials



The idea behind a simple agreement for future tokens (SAFT) is that the SAFT is a security that must comply with the registration, disclosure, and antifraud provisions of US securities laws, but the utility tokens generated and sold afterward are not.

regarding how “MUN tokens would increase in value, and the ability for MUN token holders to trade MUN tokens on secondary markets.”²⁶

Leading commentators in the United States have debated how to structure a token sale adequately so that the token does not constitute a security under the *Howey* test. In a white paper coauthored with Protocol Labs, the law firm Cooley LLP introduced the idea of a *simple agreement for future tokens* (SAFT).²⁷ The paper’s authors proposed a token sale structure in which token issuers first sell a SAFT to accredited investors.²⁸

Under the SAFT, the investors must immediately fund the token issuers, and the issuers must use those funds “to develop a genuinely functional network, with genuinely functional utility tokens, and then deliver those tokens to the investors once functional.”²⁹ The idea is that, although the SAFT is clearly a security that requires compliance with the registration, disclosure, and antifraud provisions of US securities laws, the utility tokens generated and sold after the SAFT are not.³⁰

Meanwhile, the Cardozo Blockchain Project argued that the SAFT approach relies on bright-line rules not present in the *Howey* analysis and that the *Howey* test demands more flexible and fact-intensive analysis.³¹ The SAFT approach has yet to be directly tested by an SEC enforcement action. SEC activity to date suggests that the regulator will apply the *Howey* test case by case; token sales whose issuers make statements about future profitability, efforts to improve profitability for purchasers, or any flat-out misstatements are likely to draw the SEC’s attention most quickly in this developing area of securities law.



US Capitol by Mark Fischer, 2013, used under CC BY-SA 2.0.

Token issuers may be subject to state securities laws and that state regulators have many of the same concerns as their federal counterparts.

State blue-sky laws

Every state maintains its own securities laws, known as “blue-sky laws” that generally work to protect investors from fraud. Like their federal counterparts, the state blue-sky laws typically require registration of a sale of securities to the public unless an exemption applies.³² Although most of the attention on the application of securities laws to token sales in the United States has been at the federal level, the State of Texas recently reminded everyone that token issuers should also consider state blue-sky laws.

On 4 January 2018, the Texas Securities Commissioner issued an emergency cease-and-desist order for BitConnect to stop offering any securities for sale in Texas until BitConnect registered with the Texas Securities Commissioner or received an exemption under the Texas Securities Act.³³ The Texas Securities Commissioner determined that BitConnect coins and investments in a BitConnect lending program each represented a security under the Texas Securities Act, and as such, BitConnect should have registered in Texas prior to selling such instruments to residents of Texas through its website.³⁴ The order also concluded that BitConnect failed to disclose material information related to its operations, the experience of its software developers, the riskiness associated with virtual currencies and investments in virtual currency-related business models, and the source of funds that it would use to pay investors the promised interest rate.³⁵

The Texas order reminds us that token issuers may be subject to state securities laws and that state regulators have many of the same concerns as their federal counterparts, including registration, adequate disclosure, and prevention of false and misleading public statements. Furthermore, since BitConnect was a British company with no physical US presence, the Texas order reminds token issuers of the long-arm approach of most US state and federal regulators to jurisdiction.

Commodities law

In 2015, the Commodity Futures Trading Commission (CFTC) determined that virtual currencies, including decentralized virtual currencies, fall within the definition of commodities and may therefore fall within the ambit of the CFTC’s regulatory oversight.³⁶ In particular, “the CFTC has regulatory oversight over futures, options, and derivatives contracts on virtual currencies or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.”³⁷ More specifically with regard to token sales,

The CFTC has exclusive jurisdiction over the marketplace for “retail commodity transactions,” arrangement that Section 2(c)(2)(D) of the [Commodities Exchange Act (the CEA)] describes as any agreement, contract, or transaction that is offered or entered into by a party: on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar



*basis; and to or with persons who do not qualify as either an eligible contract participant (ECP) or an eligible commercial entity (ECE).*³⁸

The CFTC regulates any virtual currency transactions conducted on a margined, leveraged, or financed basis as retail commodity transactions, unless an exception applies.

Thus, the CFTC regulates any virtual currency transactions conducted on a margined, leveraged, or financed basis as retail commodity transactions, unless an exception applies—if, for example, the contract of sale involved the leveraged, margined, or financed purchase or sale of a commodity that resulted in actual delivery within 28 days.³⁹ The CFTC issued a proposed interpretation of the term “actual delivery” in that exception on 15 December 2017.⁴⁰ According to Perkins Coie, actual delivery of a virtual currency would require that:

1. *There be a record on the relevant public distributed ledger network or blockchain of the transfer of the entire quantity of the virtual currency to the purchaser’s blockchain wallet*
2. *The purchaser be able to freely use the virtual currency (both within and away from any particular platform)*
3. *Neither the counterparty seller nor the platform retains any interest in or control over the transferred virtual currency*
4. *The counterparty seller has transferred title to the purchaser, which may be reflected by linking the purchaser with proof of ownership of the wallet into which the virtual currency is transferred.*⁴¹

The implications are that any transactions documented on intermediate, centralized, or internal exchange ledgers would not be considered actual delivery, and so the underlying transactions would be regulated as retail commodity transactions.⁴² If adopted, the proposed interpretation may have an impact on token sales.

Money services business laws

Regulation under the Federal Bank Secrecy Act

The Financial Crimes Enforcement Network of the US Department of the Treasury (FinCEN) enforces the Bank Secrecy Act (BSA) and its implementing regulations. The BSA and its regulations “subject financial institutions and *money services businesses* (MSBs) to a wide range of anti-money laundering obligations,” including registration, filing suspicious activity and currency transaction reports, and collecting and maintaining customer information and transaction records.⁴³ MSBs include those entities that provide money transmission services.

In March 2013, FinCEN issued guidance (“virtual currency guidance”) on the application of the provisions of the BSA and its regulations governing money transmission to “convertible virtual currencies,” including decentralized virtual currencies.⁴⁴ It concluded that, when an administrator or exchanger of convertible virtual currency “transmit[s] decentralized virtual currency or legal tender from one



user to another, or from one location to another,” such entities are money transmitters subject to the BSA and its regulations.⁴⁵

Under this virtual currency guidance, an administrator of a convertible virtual currency is the entity that has the power to issue (put into circulation) and withdraw (remove from circulation) a convertible virtual currency.⁴⁶ If an administrator of a convertible virtual currency allows transfers of value between persons or from one location to another, the administrator is, according to the guidance, engaging in regulated money transmission activity.⁴⁷

The guidance also considers entities to be exchangers of virtual currency and, therefore, money transmitters subject to BSA regulations when they accept real currency in exchange for virtual currency and when they resell or anonymize the sale of virtual currency by acting as an intermediary between the user and an administrator.⁴⁸

An entity can also qualify as an exchanger and money transmitter if the entity accepts decentralized virtual currency from one person or location and transmits it to another person or location as part of the acceptance and transfer of currency, funds, or other valuable substitute for currency.⁴⁹ Under this interpretation of BSA regulations, the words “or location” indicate that, even if a transfer of legal tender is between two bank accounts belonging to the same person or if a transfer of virtual currency is between two wallets belonging to the same person, that transfer nonetheless constitutes money transmission, and as such is governed by BSA regulations.

In a token sale, the token seller typically accepts virtual currency from one person (the purchaser) and transmits a token back to that same person. That the exchange involves only one person does not eliminate the possibility that the exchange could be regulated as money transmission under BSA regulations. Rather, whether the exchange constitutes money transmission may depend upon the design and implementation of the token sale. The more control the token seller retains over the token after its initial sale, the greater the risk that FinCEN will view the exchange as money transmission.

Most states also regulate the sale of virtual currency—potentially including tokens—as money transmission, the sale of stored value, or the sale of payment instruments.

Regulation under state money transmitter laws

Most states also regulate the sale of virtual currency—potentially including tokens—as money transmission, the sale of stored value, or the sale of payment instruments. Each state maintains a different statute, with different definitions of money transmission, stored value, and payment instruments.

We did not compile a 50-state catalog of statutes for this report. However, like the federal money transmission regulatory counterpart, analysis under the state statutes is highly fact-dependent; some token sales may conceivably constitute money transmission under the laws of one or more states. At least some state regulators are watching the ICO landscape carefully and issuing warnings to investors to “go beyond the headlines and hype to understand the risks associated with investments in cryptocurrencies.”⁵⁰



Consumer protection laws

Federal Trade Commission Act Section 5

Unfair practices include activity that is "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."

Section 5(a) of the Federal Trade Commission (FTC) Act prohibits "unfair or deceptive acts or practices in or affecting commerce."⁵¹ This prohibition extends to "such acts or practices involving foreign commerce that cause or are likely to cause reasonably foreseeable injury within the United States or involve material conduct occurring within the United States."⁵² Unfair practices include activity that is "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."⁵³ These prohibitions extend to endorsements of products by influential persons.

On 19 April 2017, the FTC issued letters to more than 90 influencers and marketers, warning them that they are required to "conspicuously disclose their relationships to brands when promoting or endorsing products through social media."⁵⁴ Although the FTC warning referred generically to any type of product endorsement, we see no reason to exclude token sale endorsements. In fact, when the SEC later issued a warning under its own antifraud statutory provisions, the SEC made clear that token sale endorsements absolutely fell within the ambit of potential regulation. The FTC has both civil and criminal enforcement authority.

State unfair and deceptive trade practices acts

Like the FTC, states also enforce their own unfair and deceptive trade practices acts to protect consumers from false, misleading, or deceptive misstatements or omissions of material facts in commercial transactions. Token sellers must be careful with the statements made in their white papers and in the promotion of their token sales. Misstatements or omissions of material facts under such circumstances could trigger enforcement actions by state attorneys general or private civil lawsuits.

Office of Foreign Asset Control Regulations

The Office of Foreign Asset Control (OFAC) of the US Department of the Treasury administers regulations intended to enforce economic and trade sanctions against specific countries and persons.⁵⁵ These OFAC regulations generally prohibit all US citizens and legal permanent residents regardless of their physical location, all companies organized in the United States, all foreign branches of US companies, and any person or entity located in the United States from conducting, being involved in, or in any way facilitating a transaction with certain specially designated persons and persons and entities located in or connected to sanctioned countries.⁵⁶ A token issuer who comes within the list of covered persons in one or more ways must be mindful of these OFAC regulatory obligations.



Regulatory statements

To give readers some evidence of the regulatory tone in the United States, we are listing select statements regarding token sales here (organized by regulatory agency, within each agency, by date, starting with the most recent), whether they affect the substantive legal regime or not. This list is not comprehensive; it is for reference: the endnotes contain links to source documents.

Securities Exchange Commission

SEC statement on cryptocurrencies and ICOs (11 Dec. 2017)

On 11 December 2017, SEC Chairman Jay Clayton issued a statement urging Main Street investors and market professionals to answer a series of questions before participating in ICOs and cryptocurrencies:

- » Is the ICO legal?
- » Is the offering legal?
- » Are the trading markets fair?
- » Are there substantial risks of theft or loss?⁵⁷

Chairman Clayton pointed out that, as of the date of his statement, no ICO had registered with the SEC, and the SEC had not approved the listing or trading of any exchange-traded products (such as exchange-traded funds) holding cryptocurrencies or other assets related to cryptocurrencies. (The statement does not mention notices of exemption such as Filecoin's on 23 May 2016 and 25 Aug. 2017.)⁵⁸ He also reminded Main Street investors that these markets span national borders, and the money invested might travel overseas.

For market professionals, Chairman Clayton suggested reading the 21(a) Report (cf. supra) and insisted that the interpretation of the securities law will focus on substance over form.⁵⁹ Not only does the "utility" of tokens not prevent the application of securities law, but any "marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under US law."⁶⁰

SEC Investors Bulletin: ICOs (25 July 2017)

SEC's Office of Investor Education and Advocacy intended its Investors Bulletin to alert investors of potential risks of participating in ICOs:⁶¹

- » Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens offered or sold may be securities. If they are securities, then the offer and sale of virtual coins or tokens must be registered with the SEC or performed pursuant to an exemption from registration. In the case of a security:

Any "marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under US law."



- › If an offering is registered, investors can find the information at SEC.gov through the EDGAR database (such as a registration statement or “Form S-1”)
 - › If a promoter states that an offering is exempt from registration, and the investor is not an accredited investor, then the promoter must first verify that the prospective investor meets net worth or income requirements.
 - › Although promoters sometimes describe ICOs as crowdfunding contracts, they may not be offering or selling the coins or tokens in compliance with the SEC requirements of “Regulation Crowdfunding” or with federal securities laws in general.⁶²
 - › Investment professionals and their firms who offer, transact in, or advise on investments must be licensed or registered. Registration status and background can be checked at investor.gov.
- » Investors should gather information on the project, business plan, code, the underlying blockchain, and whether there has been a security audit.
 - » Be aware of the potential of fraud, technical glitches, hacks, or malware, and the difficulty for law enforcement to trace money, freeze assets, and extend beyond its own jurisdiction.
 - » Warning signs of potential fraud include “guaranteed” high investment returns, unsolicited offers, pressure to invest immediately, unlicensed sellers, and no net worth or income requirements.

Warning signs of potential fraud include “guaranteed” high investment returns, unsolicited offers, pressure to invest immediately, unlicensed sellers, and no net worth or income requirements.

SEC report on the DAO (25 July 2017)

Facts

SEC’s release no. 81207 was titled, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO.”⁶³ The DAO was created by Slock.it and Slock.it’s co-founders, with the objective of operating as an investment fund. TheDAO token holders would be able to vote on investment opportunities and receive potential returns. From 30 April 2016 through 28 May 2016, the DAO offered and sold approximately 1.15 billion tokens in exchange for approximately 12 million ether, worth \$150 million at the time.

After TheDAO tokens were sold, an attacker used a flaw in the DAO’s code to steal approximately one-third of the DAO’s assets. After debate among the community, Ethereum major players, including Slock.it’s co-founders, responded by creating a fork on the Ethereum network, allowing TheDAO token holders to opt to have their investment returned to them.



Procedure

The SEC led an investigation on the DAO based on the Securities Act of 1933 and the Exchange Act of 1934. On 25 July 2017, the SEC published the aforementioned report on the DAO.⁶⁴

Discussion

In the report, the SEC applies the *Howey* test to assess whether DAO tokens are a security: an investment contract is (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others.⁶⁵

The novel digital form of DAO tokens as a form of investment contract does not contradict the existence of an investment contract with a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”⁶⁶

In analyzing whether something is a security, “form should be disregarded for substance,” “and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.”⁶⁷

1. “Money” does not necessarily take the form of cash.⁶⁸ “The ‘investment’ may take the form of ‘goods and services,’ or some other ‘exchange of value,’” thus including cryptocurrencies.
2. and 3. “Profits” include “dividends, other periodic payments, or the increased value of the investment.”⁶⁹ Slock.it’s documentation was clear on the DAO being a for-profit entity, and the common enterprise was to be lucrative for investors.
4. “Derived from the Managerial Efforts of Others” is the subtlest point of appreciation here: “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”⁷⁰ The SEC’s reasoning relies on:

In analyzing whether something is a security, “form should be disregarded for substance.”

- » The marketing efforts of the Slock.it team (its website, forum presence, etc.)
- » The presentation of the creators of the DAO as Ethereum experts
- » The choice of curators on their expertise and their significant role (the vetting of contractors, for example)
- » Slock.it announced it would propose profit-making contracts
- » The limited voting rights of investors



Because of the DAO token's qualification as a security, issuers should have registered their offer, unless a valid exemption would have applied. Moreover, their platform could qualify as an exchange (rule 3b-16a) and therefore should have been registered as a national securities exchange.

Decision

The commission determined not to pursue an enforcement action in the matter, implicitly as the project stopped and reimbursed investors after the hack. Nonetheless, this report has been widely presented and regarded as a statement on the SEC's position for further tokens, which later decisions confirmed.

The DAO report has been widely presented and regarded as a statement on the SEC's position for further tokens, which later decisions confirmed.

Other relevant statements from the SEC

- » Securities Exchange Act of 1934, release no. 34-82347 (18 Dec. 2017)⁷¹
- » "Company Halts ICO After SEC Raises Registration Concerns," press release, 2017-227 (11 Dec. 2017)⁷²
- » "SEC Emergency Action Halts ICO Scam," press release, 2017-219 (4 Dec. 2017)⁷³
- » "SEC Statement Urging Caution around Celebrity Backed ICOs," SEC Division of Enforcement and SEC Office of Compliance Inspections and Examinations, public statement (1 Nov. 2017)⁷⁴
- » "SEC Exposes Two Initial Coin Offering Purportedly Backed by Real Estate and Diamonds," press release, 2017-185 (29 Sept. 2017)⁷⁵
- » Laura Shin, "After Contact by SEC, Protostarr Token Shuts Down Post-ICO, Will refund Investors," *Forbes* (1 Sept. 2017)⁷⁶

Financial Industry Regulatory Authority

- » Investor Alerts: Don't Fall for Cryptocurrency-Related Stock Scams (21 Dec. 2017)⁷⁷

State securities regulators

- » In the Matter of Bitconnect, order no. ENF-18-CDO-1754, Emergency Cease and Desist Order, Texas State Securities Board (4 Jan. 2018)⁷⁸



Commodity Futures Trading Commission

Statement from CFTC chairman (4 Jan. 2018)

On 4 January 2018, CFTC Chairman J. Christopher Giancarlo issued a statement on virtual currencies, announcing a new meeting to consider the process of self-certification of new products and operational rules by *designated contract markets* under the CEA and CFTC regulations. The meeting took place one week after the 23 January 2018 meeting of the CFTC's technology advisory committee, sponsored by CFTC Commissioner Brian Quintenz, which considered the related challenges, opportunities, and market developments of virtual currencies.

The commissioner also declared, "One thing is certain: ignoring virtual currency trading will not make it go away. Nor is it a responsible regulatory strategy" and pointed out the risks of virtual currencies:

- » Early stage technology itself
- » Operational risks of unregulated and unsupervised trading platforms
- » Cybersecurity risks of hackable trading platforms and virtual currency wallets
- » Speculative risks of extremely volatile price moves
- » Fraud and manipulation risks through traditional market abuses of pump-and-dump schemes, insider trading, false disclosure, Ponzi schemes, and other forms of investor fraud and market manipulation.

"One thing is certain: ignoring virtual currency trading will not make it go away."

 J. CHRISTOPHER GIANCARLO
Chairman
Commodity Futures Trading
Commission

CFTC primer on virtual currencies (17 Oct. 2017)

LabCFTC, the branch of the Commodity Futures Trading Commission promoting responsible fintech innovation, issued a primer on virtual currencies in October 2017.⁷⁹ The document starts with the Internal Revenue Service's definition of virtual currency and then elaborates on virtual currencies as commodities.⁸⁰ Therefore, the CFTC's jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if fraud or manipulation involves a virtual currency traded in interstate commerce.

The document lists examples of authorized activities:

- » A registered swap execution facility listing a bitcoin swap (TeraExchange LLC)
- » A designated contract market listing binary options (NADEX Inc.)
- » A registered derivative-clearing organization listing digital currency options (LedgerX)



It also lists examples of unauthorized activities:

- » Price manipulation of a virtual currency traded
- » Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract
- » A virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC as a *swap execution facility* (SEF) or DCM.
- » Certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

Other relevant statements from the CFTC

- » "CFTC Launches Virtual Currency Resource Web Page," release no. 7665-17 (15 Dec. 2017)⁸¹
- » "CFTC Issues Proposed Interpretation on Virtual Currency 'Actual Delivery' in Retail Transactions," release no. 7664-17 (15 Dec. 2017)⁸²
- » "CFTC Charges Nicholas Gelfman and Gelfman Blueprint, Inc. with Fraudulent Solicitation, Misappropriation, and Issuing False Account Statements in Bitcoin Ponzi Scheme," release no. 7614-17 (21 Sept. 2017)⁸³

Examples of unauthorized activities include the price manipulation of a virtual currency being traded.

FinCEN

- » FinCEN, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," guidance FIN-2013-G001, Department of Treasury (18 March 2013)⁸⁴

State money transmitter regulators

- » Washington Department of Financial Institutions, "DFI Reminds Investors to Approach Cryptocurrency with Caution," alert (9 Jan. 2018)⁸⁵

Decisions

Protostarr

Protostarr was an ICO launched on 13 August 2017. The project was to create a web-based platform and Dapp where investors could fund YouTubers and Twitch streamers in return for a percentage of channel revenue via Ethereum smart contracts. Protostarr raised 119 ether on 24 August 2017 when the SEC contacted the company. Protostarr decided to stop the offering and reimburse participants.⁸⁶



SEC against REcoin Group Foundation, et al.

Facts

Since July 2017, Maksim Zaslavskiy, the sole owner of REcoin Group Foundation and DRC world, raised more than \$300,000 through an ICO. At the time of the complaint, the defendants were still soliciting the public.

The SEC presents that defendant Zaslavskiy made the following statements:⁸⁷

- » Investors were purchasing digital tokens
- » He raised \$2 million to \$4 million
- » REcoin had a team of lawyers and professionals
- » REcoin shut down because the US government had forced it to do so
- » Investors could expect to make returns from investments in real estate and diamonds

Procedure

Through emergency action before the Eastern District of New York US court, the SEC sought a temporary restraining order and a preliminary injunction prohibiting the defendants from future violations and conservation measures for the investigation.

Causes for action

1. Violations of Section 10(b) of the Exchange Act and Rule 10b-5(a)-(c)

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁸⁸

2. Violations of Securities Act Section 17(a)(1)-(3), fraudulent interstate transactions
3. Violations of Sections 5(a) and 5(c) of the Securities Act, unregistered offer and sell of securities
4. Aiding and abetting REcoin's and Diamond's violations of the Securities Act and the Exchange Act for Maksim Zaslavskiy

The SEC sought a temporary restraining order and a preliminary injunction prohibiting the defendants from future violations and conservation measures for the investigation.



Munchee ICO (Nov. 2017)

Facts

Munchee is a California business that was formed in 2015 and created and launched an iPhone application in 2017 for people to review restaurant meals.

Munchee is a California business that was formed in 2015 and created and launched an iPhone application in 2017 for people to review restaurant meals. In October and November 2017, Munchee offered and then sold digital tokens (called "MUN") issued on a blockchain or a distributed ledger. Munchee conducted the offering of MUN tokens to raise about \$15 million in capital so that it could improve its existing app and recruit users to buy advertisements, write reviews, sell food, and conduct other transactions using MUN. In connection with the offering, Munchee described how MUN tokens would increase in value because of Munchee's efforts and stated that MUN tokens would be traded on secondary markets.

Discussion

According to the SEC, the MUN tokens were securities for the following reasons:

- » Investors paid ether or bitcoin, constituting a contribution of value.
- » Purchasers had a reasonable expectation of obtaining a future profit from their common enterprise. For instance, in a blog post, Munchee stated that people should participate in the MUN sale because token value would increase with the number of users of the platform and the development of its ecosystem.⁸⁹
- » Profits could be expected from the Munchee team's efforts. The Munchee team highlighted the credentials, abilities, and management skills of its agents and employees.

Compared to its investigation of the DAO, the SEC looked carefully at Munchee's marketing material. More specifically, the SEC pointed out that, "even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security"; extending from case law, "form should be disregarded for substance" and "the emphasis should be on economic realities underlying a transaction."⁹⁰

Within hours of the contact from the SEC, the Munchee team decided to shut down its offering and return the proceeds.

Decision

Within hours of the contact from the commission staff, the Munchee team decided to shut down its offering and return the proceeds. On 11 December 2017, considering the company's cooperation, the commission issued an order instituting cease-and-desist proceedings pursuant to Section 8A of the Securities Act without sanctions under release no. 10445.⁹¹



Texas State Securities Board versus BitConnect (4 Jan. 2017)

The investment schemes should have been registered before the commission and BitConnect itself should have been registered for offering securities.

The Texas securities commissioner enacted an emergency cease and desist order to BitConnect operations. The commissioner considered that the investment schemes proposed by BitConnect were securities under the Texas Securities Act. Therefore, the investment schemes should have been registered before the commission and the company itself should have been registered for offering securities.

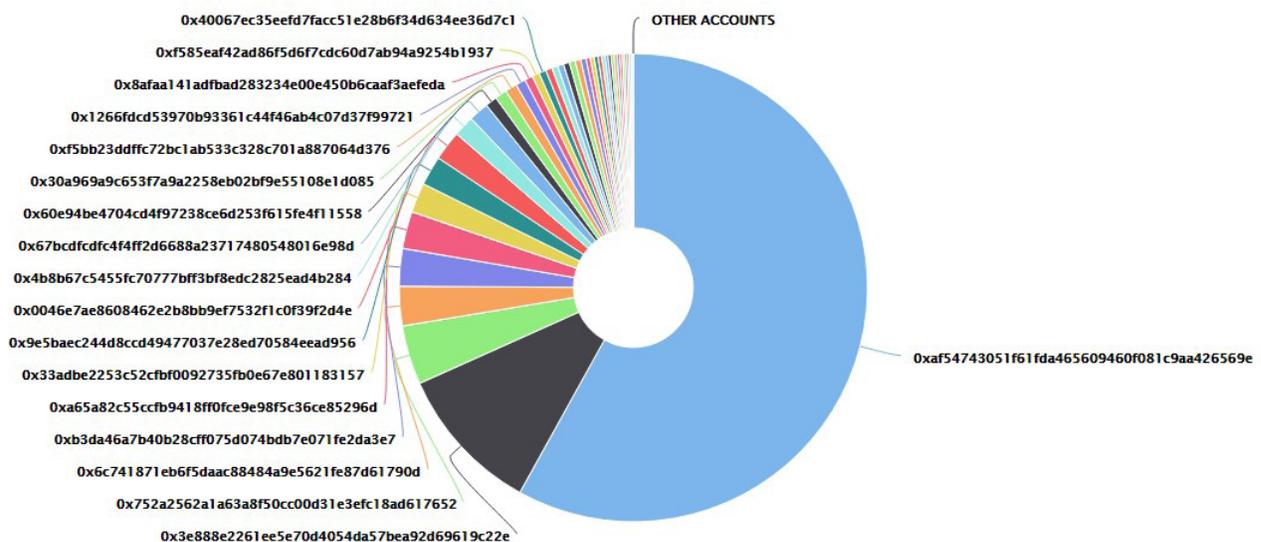
The company offers currently two investment programs. In the "BitConnect Lending Program," investors purchase BitConnect coins, which are provided to a "BitConnect Trading Bot" to generate returns as high as 40 percent a month. The BitConnect staking program offers a "safe" interest of up to 120 percent a year. Moreover, the company is planning a new ICO, BitConnectX, on 10 January 2018.

The commissioner also accused BitConnect of fraud by intentionally hiding critical information, for instance the obligation to pay investors who stake BitConnect coins. Claims such as representing the investment schemes as safe, disclaimers about the accuracy of the website, or the promise of the payment of commissions to individuals without mentioning the registrations requirements, are also considered misleading and deceptive.

While the company behind BitConnect coins, Bitconnect Ltd., is registered in England, the commissioner observed that the coins are offered to residents in Texas; therefore, the commission has jurisdiction over those operations.

Figure 2: Top Munchee token holders

Etherscan shows 41 accounts holding MUN tokens.



Source: Etherscan.io token tracker, Munchee token holders chart, 8 April 2018.



Other relevant decisions

- » *In the Matter of the Crypto Company*, File No. 500-1, Order of Suspension of Trading (18 Dec. 2017)⁹²
- » *In re BFXNA Inc., d/b/a Bitfinex*, CFTC No. 16-19 (2 June 2016)⁹³

Examples of ICOs

Determining the location of any given token sale is quite difficult. Nevertheless, some of the most discussed token sales in the United States include the Brave basic attention token (BAT) sale in May 2017. Brave raised \$36 million in roughly 30 seconds.⁹⁴ Storj, a distributed cloud storage service provider, also raised \$30 million through a token sale in May 2017.⁹⁵ According to some studies, the United States remains a leading country in number of token sales hosted, despite its complicated regulatory landscape.⁹⁶ For example, many token sale operators have apparently undertaken the process of registering with the SEC or filing for an exemption.

According to some studies, the United States remains a leading country in number of token sales hosted, despite its complicated regulatory landscape.

Critical thoughts and comparative analysis

The regulatory framework in the United States is complicated by both the separation of powers between the federal and state governments and by the diversity of regimes that can and have exercised jurisdiction over token sales. Furthermore, industry participants should expect further development token sale regulation in the

Figure 3: Storj price and trading volume

Etherscan.io shows 229,823 holders of Storj tokens as of 8 April 2018.



Source: CoinMarketCap.com, Storj chart, 1 July 2017–8 April 2018.



US regulators will take enforcement action against those believed to be defrauding or otherwise misleading consumers and the investing public.

United States. Regardless of which regime is under consideration, most of the analysis under US law is highly fact-dependent: regulators look at facts and circumstances or function over form. As a result, we may achieve clarity over time, through further enforcement activity and the issuance of other regulatory guidance.

What has become clear, in both the regulation of token sales specifically and virtual currency based-business activities in general, is that US regulators will take enforcement action against those believed to be defrauding or otherwise misleading consumers and the investing public.

The broad nature of the relevant statutory definitions and the general approach to the law through a common law system both contribute to the expectation that US law applies regardless of whether certain activity is taking place via new and emerging technologies. Furthermore, both state and federal government agencies have made clear that they intend to assert jurisdiction over activity that targets US consumers, investors, residents, or businesses, regardless of where the operator of the business is physically located, headquartered, or incorporated.

Canada

Xavier Lavayssière

Canada is a federal state composed of 10 provinces and three territories partly administered by the federal state. The Canadian regulatory framework exists both at the federal level and at the local or provincial level. It is particularly complex in that it combines both common-law and civil-law traditions (mostly in Quebec). The Supreme Court of Canada arbitrates disputes in all provinces. (All dollar amounts stated in this section are Canadian dollars.)

Regulatory framework

Securities laws

There are no federal regulations on securities in Canada.

There are no federal regulations on securities in Canada. Securities laws and their enforcement are organized at the provincial level. For example, in Ontario, the Ontario Securities Commission (OSC) is an independent crown corporation established by the Securities Act of 1990, whereas in Quebec, the rules are established by the Securities Act of 1982 and enforced by the Financials Market Authority (AMF).⁹⁷

While what constitutes a security differs in each province or territory, most jurisdictions (as well as the Supreme Court of Canada) have a wide interpretation, which likely covers a wide variety of token sales.



For instance, the Securities Act of Quebec applies to “any security recognized as such in the trade, more particularly, a share, bond, capital stock of an entity constituted as a legal person, or a subscription right or warrant” but also “a share in an investment club” and “an investment contract,” which is defined as

*a contract whereby a person, having been led to expect profits, undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture or without obtaining the right to participate directly in decisions concerning the carrying on of the venture.*⁹⁸

Provincial case law establishes that the Securities Act must have a broad and liberal interpretation to achieve its two objectives: to protect the public and to regulate the securities market.

Provincial case law establishes that the Securities Act must have a broad and liberal interpretation to achieve its two objectives: to protect the public and to regulate the securities market.⁹⁹

Similarly, in Alberta, a security is defined through a long enumeration in its Securities Act.¹⁰⁰ A recent decision of the Court of Appeal of Alberta adopted a broad definition:

*The Securities Act is very broadly worded legislation, designed to cover virtually every method by which money could be raised from the public. . . . Every sale of shares by a corporation to a member of the public is, at one level, a “private transaction.” The entire process of raising money from the general public is, however, regulated under the Act.*¹⁰¹

More generally, throughout the whole country, the Supreme Court of Canada’s decision in the Pacific Coast Coin case is the leading case for determining whether an investment contract exists. The Supreme



Ottawa Parliament Canada Government by festivio, 2013, used under CC0 1.0.



Court examined the *Howey* test and the capital risk approach of the Hawaii Supreme Court.¹⁰² The majority of the Supreme Court concluded on the basis of a two-part test:

- » Is there a common enterprise?
- » Are the efforts made by those other than the investor the undeniably significant ones?¹⁰³

However, the Supreme Court explains that, while it examined the facts in a manner similar to the *Howey* test and the Hawaii interpretation, regulators could take a broader approach to accomplish policy objectives such as customer protection.

Those analyses are broad enough to cover a large number of token sales, to the extent that people purchase tokens with an expectation of profit and that profits mostly derive from the work of a small team in charge of promoting and developing the project.

While every province implements a different set of regulations, provincial regulators coordinate their actions through the Canadian Securities Administrators (CSA) and intend to harmonize their regulations. In practice, unless exempted, a company that wishes to offer a security in Canada must register its prospectus with one of the authorities.

While every province implements a different set of regulations, provincial regulators coordinate their actions through the Canadian Securities Administrators.

For instance, the offering memorandum exemption, implemented in all provinces, relieves an issuer from registering a prospectus provided that it discloses specific information and obtains a signed risk acknowledgement from the purchaser with additional public filing, periodic disclosures, and investment limits in most provinces.¹⁰⁴ Similarly, a company or person who professionally trades securities in Canada must be registered as a dealer in each province or territory where such business and related activities are undertaken and where securities are marketed. Certain companies registered in a foreign country can register through a simplified procedure.

The CSA offers also a *principal regulator system* (a passport system) that allows a security or company registered in a province to operate in any other province or territory.¹⁰⁵ However, Ontario, the largest province, does not participate in this system. Participants in the passport system recognize a registration in Ontario, but not the other way around. Two self-regulatory organizations, the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association (MFDA), complement this action at the national level.

Payments and electronic money

Taking deposits during an ICO might be subject to various regulations and regulators. At the federal level, the Bank Act establishes payment rules, standards, and prudential oversight of financial institutions by the Office of the Superintendent of Financial Institutions (OSFI).¹⁰⁶ Additional rules exist at the provincial level.



In Ontario, for instance, under the Loan and Trust Corporations Act (LATCA), a business must register with the Superintendent of Financial Services to take deposits or hold funds for investments.¹⁰⁷

A company aiming to use cryptocurrency for payments will also have to comply with existing standards. The Canadian Payments Association (CPA), established in 1980 by the Canadian Payments Act, has the responsibility to establish and operate systems for clearing and settling payments and to facilitate the development of new payment technologies.¹⁰⁸ Under this mandate, the CPA operates the two national payment systems: the *large value transfer system* (LVTS) and the *automated clearing settlement system* (ACSS). On 25 April 2016, the CPA adopted the ISO 20022 standard. In 2017, the Department of Finance of Canada launched a public consultation to improve the current regulatory framework.¹⁰⁹

Anti-money laundering regulations

On 19 June 2014, Canada's Parliament approved a law (Bill C-31) amending the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA) to account for cryptocurrencies.¹¹⁰ The law applies to local or foreign entities that direct services to persons or entities in Canada. The law stipulates that any business "dealing in virtual currencies" is considered an MSB and subject to record keeping, verification procedures, and reporting obligations. A firm must register with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) and is subject of its anti-money laundering regulations.

Canadian law stipulates that any business "dealing in virtual currencies" is subject to record keeping, verification procedures, and reporting obligations.

FINTRAC is the service of the Ministry of Finance against money laundering and the financing of terrorist activities. Established by the PCMLTFA, the current regime requires financial institutions and intermediaries to identify clients and report to FINTRAC.¹¹¹ It also gives FINTRAC oversight and investigative power, assisted by specialized automated tools.

The regulations explicitly specify methods for identifying individuals and confirming the existence of entities such as the

- » *Government-issued photo identification method:* the checking of a government-issued photo ID to verify that the name and photograph match those of the person present.
- » *Credit file method:* the confirmation of a Canadian credit file in existence for at least three years and the verification of name, address, and date of birth of the person.¹¹²

Additional requirements apply for screening for foreign or domestic "politically exposed persons."¹¹³

Commodities

Commodities are regulated at the provincial or territorial level. In Ontario, the Commodity Futures Act (CFA) defines a *commodity*



When a party acquires a good or service using digital currency, the administration considers it as a barter transaction, and the Income Tax Act applies to the value of the transaction in Canadian dollars.

futures contract as a contract to make or take delivery of a specified quantity and quality, grade, or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange.¹¹⁴

The CFA also establishes the OSC as the primary regulator for commodity futures transactions. Exchanges must register with the OSC. Registered commodity futures exchanges and recognized self-regulatory organizations impose additional requirements. Similarly, a person who trades in a contract or acts as an adviser must register with the OSC. At this point, it is unclear whether and under what circumstances tokens issued during a token sale could be deemed regulated commodities under the laws of the different provinces of Canada.

Taxation

When a party acquires a good or service using digital currency, the administration considers it as a barter transaction, and the Income Tax Act applies to the value of the transaction in Canadian dollars.¹¹⁵ Parties can also buy or sell digital currency like a commodity. Any resulting gains or losses could be taxable income or capital.¹¹⁶ Finally, any taxes applicable to a transaction apply to transactions using digital currencies.

Main regulatory authorities

Financial Transactions and Reports Analysis Centre of Canada

FINTRAC was created in 2000 to facilitate the detection, prevention, and deterrence of money laundering and the financing of terrorist activities. In December 2001, Parliament expanded its mandate to provide information to intelligence services on terrorism financing.

Canadian Securities Administrators

The Canadian Securities Administrators (CSA) was formally established in 2003 to coordinate and harmonize the actions and rules of provincial and territorial securities organizations. Most notably, it developed the "passport system," which allows a company doing business across Canada (except Ontario) to deal with only one regulatory agency.

Office of the Superintendent of Financial Institutions

The OFSI is the independent agency regulating banks, insurance companies, trust companies, loan companies, and pension plans in Canada.

Main provincial securities organizations

- » Ontario Securities Commission (OSC)
- » Authority of Financial Markets in Quebec (AMF)



- » British Columbia Securities Commission
- » Alberta Securities Commission

Regulatory statements

CSA Notice 46-307 (24 Aug. 2017)

The CSA requires marketplaces to comply with the rules governing exchanges or alternative trading systems, including a registration or exemption from recognition.

On 24 August 2017, the CSA issued a notice to clarify the applicability of Canadian securities laws to ICOs, *initial token offerings* (ITO), and the sales of securities of cryptocurrency investment funds.¹¹⁷

The CSA requires marketplaces to comply with the rules governing exchanges or alternative trading systems, including a registration or exemption from recognition. The CSA points out that no cryptocurrency exchange has been recognized or exempted in Canada.

According to the CSA, the ICOs and ITOs that consulted the CSA were securities. The CSA invites businesses to conduct an extensive analysis. It advises companies to apply the four-pronged *Howey* test to determine whether an investment contract is a security: Is there (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?¹¹⁸

The CSA maintains that, if a token is a security, then the following regulations would apply, with slight variations in each province.

Prospectus requirement or exemption

While acknowledging that most ICOs and ITOs do provide a white paper with some information, the documents usually fail to provide all the required regulatory information, nor do they comply with the existing procedures.

ICOs not complying with the prospectus rules should sell coins only to accredited investors or fulfill all requirements of the offering memorandum prospectus exemption.

According to the CSA, ICOs not complying with the prospectus rules should sell coins only to accredited investors or fulfill all requirements of the offering memorandum prospectus exemption. Specifically, they must:

- » Meet the content requirements for the document (description, intended use, timeline)
- » Obtain a signed risk acknowledgement form from each investor
- » Comply with investor investment limits
- » Provide audited annual financial statements and ongoing disclosure to investors
- » Comply with resale restrictions, which will generally preclude coins/tokens from trading on cryptocurrency exchanges
- » File reports of exempt distribution with the securities regulatory authorities¹¹⁹



The CSA recognizes that existing regulatory framework might not be appropriate for new businesses and reminds businesses of the CSA regulatory sandbox which allows temporary exemptive relief for product testing.

Registration requirement or exemption

Businesses involved in the ICO might be considered as “trading in securities for a business purpose,” and therefore must obtain a dealer registration or an exemption. The “business purpose” classification is evaluated on such criteria as

- » Soliciting a broad base of investors
- » Using the Internet to reach a large number of potential investors
- » Attending public events to advertise the coin or token sale
- » Raising a significant amount of capital from a large number of investors¹²⁰

Besides the registration, those businesses must comply with additional obligations such as know-your-client procedures.

For businesses working on cryptocurrency investment funds, the CSA points out rules that might apply such as conducting due diligence on any cryptocurrency exchange used to add cryptocurrencies to the portfolio or any unique custodian used to hold cryptocurrencies.

Finally, the CSA recognizes that existing regulatory framework might not be appropriate for new businesses and reminds businesses of the CSA regulatory sandbox. Established in 2017, this program allows firms to register or obtain temporary exemptive relief from securities law requirements so that they can test their products, services, and applications throughout the Canadian market. Businesses must contact their provincial regulator to enter the sandbox.

Decisions

Plexcorps case

Facts

Dominic Lacroix founded DL Innov in 2012 and Gestio in 2013, and he administers several other financial services companies. In a decision on 13 June 2017, the Financial Markets Administrative Tribunal forbade Lacroix and his companies from engaging in any activity related to securities and to cease a suspicious ongoing investment scheme.¹²¹

On 3 July 2017, the entity PlexCoin opened the registration to an ICO, with the promise of immediate returns and exponential growth, using Facebook referral links among other techniques.¹²²

Decision ex parte (20 July 2017)

On 20 July 2017, the tribunal issued various ex parte orders against PlexCorps, PlexCoin, DL Innov, Gestio, and Lacroix regarding their activities relating to investment in the virtual currency PlexCoin.¹²³



The tribunal acted under Article 115.9 of the financial market authority law, which allows the tribunal to make such a decision under particular circumstances without prior hearing.¹²⁴

Motives

An investment contract is a contract whereby a person undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture.

According to Article 1 of the Securities Act, the law applies to an investment contract.¹²⁵ An investment contract is a contract whereby a person, having been led to expect profits, undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture or without obtaining the right to participate directly in decisions concerning the venture.¹²⁶

- » On the appreciation of those criteria, the tribunal quotes the US Supreme Court: "Form should be disregarded for substance and the emphasis should be on economic reality."¹²⁷
- » On the notion of investment contract: "It embodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."¹²⁸
- » On common enterprise: "The enterprise is the combination of the steps that constitute a plan, a complete investment program in common project or company."¹²⁹

Figure 4: PlexCoin flatlines



Source: CoinMarketCap, PlexCoin chart, 25 Nov. 2017–8 April 2018.



When there is a security, the operation must be registered or exempted. This obligation aims to protect the public, which the operation solicits via the Internet. "Sophisticated investors are not approached with investment opportunities through the Internet. Relatively unsophisticated retail investors are the target of solicitation through the Internet. The reach of the Internet is far and wide."¹³⁰

Decision

The tribunal orders Dominic Lacroix, Plexcorps, DL Innov, and Gestio to cease their activities, and orders Facebook Canada to close Plexcorps's and Plexcoin's accounts.

Decision ex parte (21 Sept. 2017)

On 21 September 2017, at the request of the AMF, and under Article 115.9 of the Securities Act, the Financial Markets Administrative Tribunal ordered Dominic Lacroix, DL Innov, and Sabrina Paradis-Royer to keep the funds, titles, and other goods in their possessions. The tribunal also ordered the Royal Bank of Canada, Shopify Inc., Shopify Payments Canada, and Wells Fargo Canada Corporation to keep all the funds they control for the defendants.¹³¹

When there is a security, the operation must be registered or exempted. This obligation aims to protect the public, which the operation solicits via the Internet.

SEC complaint (1 Dec. 2017)

Before the US District Court of the Eastern District of New York, the SEC estimates that the PlexCoin is a security sold over the Internet including in the United States, and therefore US courts have jurisdiction.¹³² The SEC points out that Lacroix is a persistent offender of securities law in Canada and that the ICO is obviously a "scam," as there is no team, no intention to use the funds to develop an activity, and therefore no reasonable expectation of financial returns.

Contempt of court and imprisonment (17 Oct. 2017)

The Superior Court of Quebec, after a plea from the AMF, declared Dominic Lacroix and DL Innov guilty of contempt of court for soliciting investors after the tribunal's 20 July 2017 order.¹³³ This charge led to a two-month jail sentence and \$110,000 in fines.

Elev3n versus Vanbex Group (29 Sept. 2017)

On 29 September 2017, Elev3n filed lawsuit in the United States District Court for the Eastern District of Pennsylvania.¹³⁴ Elev3n claimed that the Vanbex Group misused funds and copyrighted material to develop its own platform Etherparty. Elev3n had initially contracted with Vanbex to help it prepare an ICO and develop its platform.



TokenFunder: Exemptive relief application (17 Oct. 2017)

The OSC stated that this decision took into account the innovative nature of the TokenFunder project and might not apply to later applicants.

On 17 October 2017, the OSC admitted TokenFunder to the regulatory sandbox and allowed it to obtain exemptive relief from the securities law requirements for innovative projects.¹³⁵ The OSC allowed TokenFunder to sell its FNDR tokens as a private placement under the offering memorandum prospectus exemption for a 12-month period. The OSC stated that this decision took into account the innovative nature of the project and might not apply to later applicants. The OSC specified the rules under which the ICO could operate:

- » No participant could invest more than \$2,500 or its equivalent unless it provides additional evidence that it is an eligible or an accredited investor.
- » Holders of FNDR tokens will receive updates from TokenFunder management regarding development milestones and other material events concerning the business, including all disclosures required by law.
- » The issuer must conduct a know-your-customer and suitability review. Particularly, the issuer must include a survey to ensure that investors understand cryptocurrency and digital token offerings.
- » The issue may not list or trade tokens on any organized market, including cryptocurrency exchanges, without the OSC's prior approval.

Figure 5: Etherparty FUEL token price and trading volume



Source: CoinMarketCap.com, Etherparty chart, 30 Oct. 2017–8 April 2018.



- » “The smart contract established for purposes of the offering will not permit the filer to receive any ether proceeds from the offering if less than \$500,000 is raised in the offering, and it shall return such funds to the accounts provided by the subscribers for their digital currency (as applicable).”¹³⁶

Similarly, the AMF in Quebec admitted IMPAK Finance to the regulatory sandbox for the ICO of the token MPK on 15 August 2017.¹³⁷

Examples of ICOs

In October 2017, the Vanbex Group held an ICO of FUEL tokens to raise funds for the development of its Etherparty platform. FUEL is a utility token that developers need to create smart contracts through the Etherparty tool. Vanbex raised \$33 million with 4,611 contributors and an average purchase of over \$7,100. (See Figure 5, previous page.)

Critical thoughts and comparative analysis

The Canadian regulatory framework shares general regulatory principles with the United States, although its stronger federalism adds more complexity and flexibility. Avoiding qualifying as a security seems difficult, considering the various and broad interpretation of the term by the different jurisdictions. However, the CSA regulatory sandbox, the OSC Launchpad, and various regimes make Canada an interesting proxy to experiment with registered ICOs before entering the US market.¹³⁸ While regulatory authorities have thus far targeted particularly dubious projects, they have taken a much more flexible posture to innovative projects such as TokenFunder.

Several cryptocurrencies exchanges have grown in Canada, such as QuadrigaCX based in Vancouver and Coinsquare.io based in Toronto. Since 2014, these exchanges have operated under a relatively clear regulated regime. The recent OSC decision on TokenFunder shows that the regulator aims to provide a comprehensive framework for the whole ecosystem. Nonetheless, the current payment regulatory framework and market organization does not seem particularly favorable toward developing a large-scale payment solution based on blockchain protocols.

The Canadian regulatory framework shares general regulatory principles with the United States, although its stronger federalism adds more complexity and flexibility.

ASIA

Singapore

Benedikt Schuppli

Much like Switzerland, the city-state of Singapore has emerged as an undisputed hub for ICOs specifically and blockchain technology in



Singapore's domination of the ICO market has been ascribed to many factors, among them its rule-of-law reputation.

general. This is highlighted by the amount of investments flowing into Singapore-based ICOs since 2014—almost \$200 million, ranking third after the United States and Switzerland.¹³⁹

Singapore's domination of the ICO market has been ascribed to many factors, among them its rule-of-law reputation, its standing as a leading global financial center, and the Monetary Authority of Singapore's (MAS) pragmatic communication regarding ICOs. On 14 November 2017, MAS issued a statement:

Offers or issues of digital tokens may be regulated by MAS if the digital tokens are capital markets products under the SFA. Capital markets products include any securities, futures contracts and contracts or arrangements for purposes of leveraged foreign exchange trading.¹⁴⁰

Regulatory framework

In this section, we look at securities law (including collective investment schemes), money regulations (including both stored value facilities and anti-money-laundering regulations), commodities regulations, and consumer protections.

Capital markets law

Securities and collective investment schemes

In Singapore, the offer and sale of securities is collectively regulated in the Securities and Futures Act (SFA) (Cap. 289), its regulations, and related notices issued by MAS. Under the SFA, securities are included in the umbrella category of capital market products. A person issuing an instrument that qualifies as a security under the SFA must comply with the SFA's requirements and restrictions regarding the offer and sale of these securities.

If the digital tokens are capital markets products under the SFA, then the MAS may regulate the offer or issue of them.¹⁴¹ According to Section 2, *capital markets products* include any securities, futures contracts, and contracts or arrangements for purposes of leveraged foreign exchange trading. This overview emphasizes securities.

The SFA lists two almost congruent definitions of securities, a general definition in Section 2, and another in Section 239, which relates to offers of investments. Section 2 lists the following as securities:

- » Debentures or stocks issued or proposed to be issued by a government
- » Debentures, stocks, or shares issued or proposed to be issued by a corporation or unincorporated body
- » Any right, option or derivative in respect of any such debentures, stocks, or shares

Capital markets products include any securities, futures contracts, and contracts or arrangements for purposes of leveraged foreign exchange trading.



- » Any right under a contract for differences or under any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in
 - › The value or price of any such debentures, stocks, or shares
 - › The value or price of any group of any such debentures, stocks, or shares
 - › An index of any such debentures, stocks, or shares
- » Any unit in a collective investment scheme
- » Any unit in a business trust
- » Any derivative of a unit in a business trust
- » Such other product or class of products as the MAS may prescribe

Section 2 does not include:

- » Futures contracts traded on the futures market
- » Bills of exchange
- » Promissory notes
- » Certificates of deposit issued by a bank or finance company situated in Singapore or elsewhere
- » Such other product or class of products as the MAS may prescribe as not being securities

Section 2 does not include futures contracts traded on the futures market, bills of exchange, or promissory notes.



Istana (Singapore) by Elisa.rolle, 2012, used under CC BY-SA 4.0 via Wikipedia Commons.



Section 239 lists the following as securities:

- » Shares or units of shares of a corporation
- » Debentures or units of debentures of an entity
- » Interests in a limited partnership or limited liability partnership formed in Singapore or elsewhere
- » Such other product or class of products as the MAS may prescribe

Under Section 239, the MAS may also classify products or classes of products as not securities. Both definitions are substantially similar in terms of the types of interests or instruments considered securities under Singapore law.

For instance, shares and debentures are identified as securities in both Section 2 and Section 239. Units in collective investment schemes also are deemed securities by Section 2 of the SFA, but they are not mentioned in Section 239, which exclusively applies to the offerings of investments regarding shares and debentures.

As some tokens might be part of collective investment schemes regulated under Singapore law, this overview includes the latter asset type.

As some tokens might be part of collective investment schemes regulated under Singapore law, this overview includes the latter asset type. Section 2 of the SFA defines *collective investment schemes* as arrangements regarding any property under which:

- » Participants have no day-to-day control over management of the property. Instead, the property is managed as a whole by or on behalf of the scheme operator
- » Participants' contributions, as well as the profits or income of the scheme from which payments are to be made to the participants, are pooled
- » The purpose or effect of the arrangement is to enable its participants to participate in profits that arise from the scheme property

Tokens as securities or collective investment schemes

According to its guide to digital token offerings, MAS will examine the structure and characteristics of a digital token, including the rights attached to it, in determining whether the token is a capital markets product under the SFA.¹⁴² For instance, a digital token may constitute:

- » A share conferring or representing ownership interest in a corporation, a liability of the token holder in the corporation, and mutual covenants among token holders in the corporation



- » A debenture signifying indebtedness of the issuer of the digital token regarding any money that is or may be lent to the issuer by a token holder
- » A unit in a *collective investment scheme* (CIS), representing a right or interest in a CIS or an option to acquire a right or interest in a CIS

The MAS notes in its guide that these characteristics of a share or a debenture are not exhaustive.¹⁴³

Regulatory consequences

A person may only offer digital tokens that constitute securities or units in a CIS if the offer complies with the requirements under Part XIII of the SFA. This includes the requirement that the offer be made in or accompanied by a prospectus that is prepared in accordance with the SFA and is registered with MAS. An offer may nevertheless be exempt from the MAS's prospectus requirements if:

- » The offer is a small offer of securities of an entity, or units in a CIS, that does not exceed \$5 million (in Singapore dollars or equivalent in a foreign currency) within any 12-month period, subject to certain conditions
- » The offer is a private placement offer made to no more than 50 persons within any 12-month period, subject to certain conditions
- » The offer is made to institutional investors only, or
- » The offer is made to accredited investors only, subject to certain conditions¹⁴⁴

The exemptions for a small offer, a private placement offer, and an offer made to accredited investors are subject to certain conditions, including advertising restrictions. In addition, when someone makes an offer regarding units in a CIS, the CIS is subject to authorization or recognition requirements. An authorized or recognized CIS under the SFA must comply with investment restrictions and business conduct requirements.¹⁴⁵

Under Singapore money regulations, a token that has been issued and allows for payment within the issuer's system or platform to purchase goods and services on the platform may be regulated as a payment system.

Money regulations

Electronic money

Under Singapore money regulations, a token that has been issued and allows for payment within the issuer's system or platform to purchase goods and services on the platform may be regulated as a payment system under the Payment System (Oversight) Act or PS(O)A, specifically as a *stored value facility* (SVF).

Under Section 2 of the PS(O)A, a *payment system* is defined as a funds transfer system or other system that facilitates the circulation of money, and includes any instruments and procedures that relate



to the system. Payment systems that operate an SVF are regulated under the PS(O)A and its related regulations.¹⁴⁶ An SVF is a form of prepaid electronic cash or card that its holder can use within the system of the SVF issuer.¹⁴⁷

Under Section 2 of the PS(O)A, a *stored value facility* is defined as

(a) a facility (other than cash), whether in physical or electronic form, which is purchased or otherwise acquired by a person (the "user") to be used as a means of making payment for goods or services up to the amount of the stored value that is available for use under the terms and conditions applying to the facility, and payment for the goods or services is made by the holder of the stored value ("holder") in respect of the facility (rather than by the user), or (b) all the facilities referred to in (a) provided under the same terms and conditions.

Under Section 2 of the PS(O)A, *stored value* is defined as

the sum of money that (a) has been paid in advance for goods or services intended to be purchased through the use of the SVF, (b) is available for use from time to time for making payment under the terms and conditions applying to the SVF, and (c) is held by the holder of the SVF.

A SVF can be either single-purpose or multi-purpose. A single-purpose SVF is intended to be used only to purchase goods or services provided by the holder of that SVF. A multi-purpose SVF can be used to purchase goods or services provided by the SVF holder as well as third parties.¹⁴⁸

If the total stored value of a multi-purpose SVF exceeds S\$30 million, the SVF will be regarded as a "widely accepted stored value facility" (WA SVF).¹⁴⁹ Where the SVF is a WA SVF, the holder must be an "approved holder," and an "approved bank" must undertake to be fully liable for the stored value of the WA SVF.

Many tokens have surfaced that are not proprietary to their own blockchain but issued by a centralized counterparty such as a corporation that issues a token to be used on its proprietary platform.

Token as a stored value facility

In recent times, many tokens have surfaced that are not proprietary to their own blockchain but issued by a centralized counterparty such as a corporation that issues a token to be used on its proprietary platform. Token holders can often use them to purchase goods and services within that platform, from either the token issuer itself or third-party participants on the platform.

Such tokens could be an SVF in electronic form, as users purchase tokens to pay for goods or services up to the amount of the stored value (the sum of money that the user has paid in advance for goods or services intended to be purchased through the SVF). The token itself could be a single- or multi-purpose SVF.



Regulatory consequences

The MAS need not approve SVFs that are not WA SVFs. However, the holder of a non-WA SVF must mark, label, or accompany the SVF with the following statement:

Consumer advisory—<Name of holder>, the holder of <Name of SVF> stored value facility, does not require the approval of the Monetary Authority of Singapore. Consumers (users) are advised to read the terms and conditions carefully.¹⁵⁰

All holders of SVFs are subject to various ongoing requirements pursuant to the PS(O)A and its regulations and to notification requirements under paragraph 2A of MAS Notice PSOA-N02 on Prevention of Money Laundering and Countering the Financing of Terrorism—Holders of Stored Value Facilities.¹⁵¹ A holder of a SVF must notify the MAS at least 10 business days before the SVF begins operation. The SVF holder must also notify the MAS of any change in the particulars set forth in the original notification at least 10 days before the change takes place. Finally, the SVF holder must also complete and submit an annual form to the MAS.¹⁵²

To detect and deter the flow of illicit funds through Singapore's financial system, Singapore requires financial institutions to install robust controls such as identifying and knowing their customers.

Anti-money laundering regulations

Generally, to detect and deter the flow of illicit funds through Singapore's financial system, Singapore requires financial institutions to install robust controls such as identifying and knowing their customers (including beneficial owners), conducting regular account reviews, and monitoring and reporting suspicious transactions. MAS Notices on the Prevention of Money Laundering (AML) and Countering the Financing of Terrorism (CFT) cover the requirements for such financial institutions as capital markets intermediaries, financial advisers, and holders of SVFs.¹⁵³

In its guide on digital token offerings, MAS clearly emphasizes that these relevant AML/CFT requirements may apply if an issuer or trader of a token acts as a financial institution and falls within the scope of any of the above notices and guidelines.¹⁵⁴

In many cases, however, issuing a token—which itself is not within the scope of MAS regulatory purview—will not trigger the AML/CFT requirements. Therefore, we can conclude that, when someone issues a token that does not qualify as a capital market product, an SVF, a commodity, or any other regulated financial product or activity, the law does not require the identification of every investor as part of a KYC process. However, in its guide on digital token offerings, MAS emphasizes that tokens that may not fall within MAS' regulatory purview may be subject to other legislation for combating money laundering and terrorism financing:

- » Section 39 of the Corruption, Drug Trafficking, and Other Serious Crimes (Confiscation of Benefits) Act (Cap. 65A) obligates token issuers and traders to report suspicious transactions with the Suspicious Transaction Reporting Office, Commercial Affairs Department of the Singapore Police Force.



- » The Terrorism (Suppression of Financing) Act (Cap. 325) and various regulations giving effect to UN Security Council Resolutions prohibit token issuers and traders from dealing with or providing financial services to designated individuals and entities.¹⁵⁵

Given the regulatory void surrounding the issuance of digital tokens, MAS intends to publish a new payment services framework that will address money laundering and terrorism financing risks related to the dealing or exchange of virtual currencies for fiat or other virtual currencies. Requirements include conducting customer due diligence, monitoring transactions, screening, reporting suspicious transactions, and keeping adequate records.¹⁵⁶

Commodities

In the United States, commodities regulations might be applicable to the issuance and trading in cryptographic tokens under some preconditions and subject to supervision by the respective regulatory authority—that is, the CFTC. This section covers commodities regulation in Singapore and whether and how this regulation might apply to the issuance of and trading in cryptographic tokens.

Commodities Trading Act

Commodities in Singapore are regulated under the Commodities Trading Act (CTA). Under the CTA, a person is prohibited from acting as, or holding himself out as, a “spot commodity broker,” unless he holds a license authorizing him to act as such, or is exempted from the requirement to hold a license.¹⁵⁷ A *spot commodity broker* is defined as

*a person whether as principal or agent who carries on the business of soliciting or accepting orders, for the purchase or sale of any commodity by way of spot commodity trading, whether or not the business is part of, or is carried on in conjunction with, any other business, but does not include a commodity broker.*¹⁵⁸

Under the Commodities Trading Act, a person is prohibited from acting as, or holding himself out as, a “spot commodity broker,” unless he holds a license authorizing him to act as such.

A *commodity* is defined widely under the CTA to include “any produce, item, goods or article that is the subject of any:

- » Commodity forward contract
- » Leveraged commodity trading
- » Contract made pursuant to trading in differences
- » Spot commodity trading, and includes an index, a right or an interest in such commodity” (other than one that is the subject of a commodity futures contract).¹⁵⁹ For example, it includes gold and rights in gold.



A token that represents rights in a commodity—for example, the right to convert into or redeem for physical gold bars—could itself fall within the broad definition of a commodity under the Commodities Trading Act.

Tokens as commodities

Subsequently, a token that represents rights in a commodity—for example, the right to convert into or redeem for physical gold bars—could itself fall within the broad definition of a commodity under the CTA.

If the token in question qualifies as a commodity, the issuer could be regarded as “carrying on the business of soliciting or accepting orders, for the purchase or sale of such tokens by way of spot commodity trading,” and accordingly fall within the definition of “spot commodity broker.”

Depending on its specific terms, a token could also fall within the definition of “commodity contract” under the CTA. For instance, if the terms of the tokens are such that token holder will have a right to the difference in value of the good (e.g., a gold bar) linked to the token between the time at which the token was acquired and when it is sold, the tokens would be regarded as “commodity futures contracts.”

If the tokens are “commodity contracts,” the issuer could be regarded as soliciting or accepting orders for the purchase or sale of any commodity by way of or relating to any tokens, and accordingly fall within the definition of “commodity broker.”

Regulatory consequences

Whether as principal or agent, a person is prohibited from carrying on business or holding him- or herself out as a commodity broker unless this person holds a commodity broker’s license or is exempted from this requirement under Section 14A of the CTA.¹⁶⁰ If a person trades in commodity contracts only with accredited investors or is issuing or trading tokens characterized as “commodity contracts” under the CTA, then the person may be exempted (“CTA AI Exemption”).¹⁶¹

However, while a person may be exempted from holding a commodity broker’s license under the CTA AI exemption, such an exemption from the licensing requirement does not automatically exempt such person from the other requirements under the CTA and Commodity Trading Regulations that apply to commodity brokers.¹⁶²

Consumer protection

Consumer protection in Singapore is mostly regulated under the Consumer Protection (Fair Trading) Act (CPFTA), which took effect in 2004. The CPFTA lists specific unfair trade practices and empowers consumers to seek civil remedies. The business is responsible for proving that it did not act unfairly. However, businesses that commit unfair trade practices will not be subject to criminal sanction, as the CPFTA is not a criminal code. On 15 April 2009, the CPFTA was amended to cover financial products and services.¹⁶³ Issuers of



tokens are bound by CPFTA only to the extent where the claim does not exceed \$30,000.¹⁶⁴

The Second Schedule of the CPFTA specifies 20 prohibited unfair practices. For example, a supplier may not make false claims, nor do or say anything that might reasonably deceive or mislead a consumer, nor fail to do or say something that would have the same effect. A supplier may not exploit a consumer if the supplier knows or ought reasonably to know that the consumer cannot protect his or her own interests or understand the character, nature, language, or effect of the transaction or any matter related to the transaction. According to the Consumers Association of Singapore, consumers can approach the Financial Industry Disputes Resolution Centre for resolution of unfair practices of financial and insurance institutions.¹⁶⁵

Regulatory statements

MAS position on the offer of digital tokens (1 Aug. 2017)

On 1 August 2017, the MAS issued a press release clarifying the conditions under which digital tokens constitute products regulated under the SFA.¹⁶⁶

Virtual currencies *per se* are not regulated. The MAS points to a prior press release issued on 13 March 2014. However, intermediaries in virtual currencies would be regulated for risks of money laundering and the financing of terrorism.

Digital tokens may represent ownership or a security interest over an issuer's assets or property, and therefore may be considered an offer of shares or units in a collective investment scheme under the SFA.

Digital tokens may represent a debt owed by an issuer and be considered a debenture under the SFA. As a consequence of falling within the definition of securities in the SFA, three types of obligations apply to a particular token emission event:

- » Registration or exemption of a prospectus prior to the offer to the MAS
- » Licensing of issuers and intermediaries, unless exempted
- » AML/CFT requirements

In addition, MAS would need to approve or recognize any platform facilitating secondary trading of such tokens as an exchange or market operator.

Guide to digital token offerings (14 Nov. 2017)

On 14 November 2017, the MAS released a 13-page guide, not legally binding, about digital tokens and their regulatory framework in Singapore.¹⁶⁷ Offers or issues of digital tokens are regulated by

Consumers can approach the Financial Industry Disputes Resolution Centre for resolution of unfair practices of financial and insurance institutions.



MAS if the underlying assets are capital markets products. The MAS quotes the aforementioned three categories that a digital token might constitute.

Furthermore, a trading platform of digital tokens may constitute establishing or operating a market, and therefore must be approved by MAS as an exchange or recognized by MAS as a market operator under the SFA 26, unless otherwise exempted. Platforms operators, particularly if they engage any activity likely to persuade the public in Singapore, might be subject to Singapore regulation.

When an offer is not subject to MAS regulation, such AML/CFT requirements as reporting obligations, prohibition of activities, and mandatory due diligence and monitoring procedures to mitigate risks may still apply.

MAS on AML/CFT enforcement on virtual currency (8 Jan. 2018)

Answering a parliamentary question about the enforcement of AML/CFT to virtual currencies, Deputy Prime Minister Tharman Shanmugaratnam, minister in charge of MAS, pointed out, "Singapore's laws do not make any distinction between transactions effected using fiat currency, virtual currency or other novel ways of transmitting value."¹⁶⁸ There are three main actors in this policy:

- » MAS provides AML/CFT requirements
- » Commercial Affairs Department (CAD) investigates and prosecutes all manner of AML/CFT cases
- » Private businesses must report suspicious activities to the Suspicious Transaction Reporting Office in the CAD.

MAS is currently conducting public consultation on a proposed payment services bill to impose AML/CFT requirements on intermediaries and exchanges, acknowledging the difficulty of identifying parties and fraudulent transactions due to the architecture of cryptocurrencies.

Additionally, the MAS offers a regulatory sandbox to ease certain regulations for projects after they have done their due diligence, such as testing the proposed financial service in a laboratory environment and understanding the legal and regulatory requirements for deploying it.

Examples of ICOs

Blockchain Capital/BCAP

The venture capital firm Blockchain Capital provides one of the most prominent examples of an ICO from Singapore. Within just six hours on 10 April 2017, the issuer raised \$10 million in exchange for BCAP tokens. The BCAP tokens are an Ethereum-based smart-contract

"Singapore's laws do not make any distinction between transactions effected using fiat currency, virtual currency or other novel ways of transmitting value."

 THARMAN SHANMUGARATNAM
Deputy Prime Minister
Singapore



digital token representing an indirect fractional non-voting economic interest in Blockchain Capital III, Digital Liquid Venture Fund.¹⁶⁹

TenX/PAY

TenX, which is building a blockchain-based payment platform for blockchain-based assets, raised \$80 million in exchange for PAY tokens. PAY is a utility token for investors, a means of exchange within the TenX platform, and a profit-sharing right, receiving a share of the profit generated via incurred transaction fees within the TenX payment ecosystem.¹⁷⁰

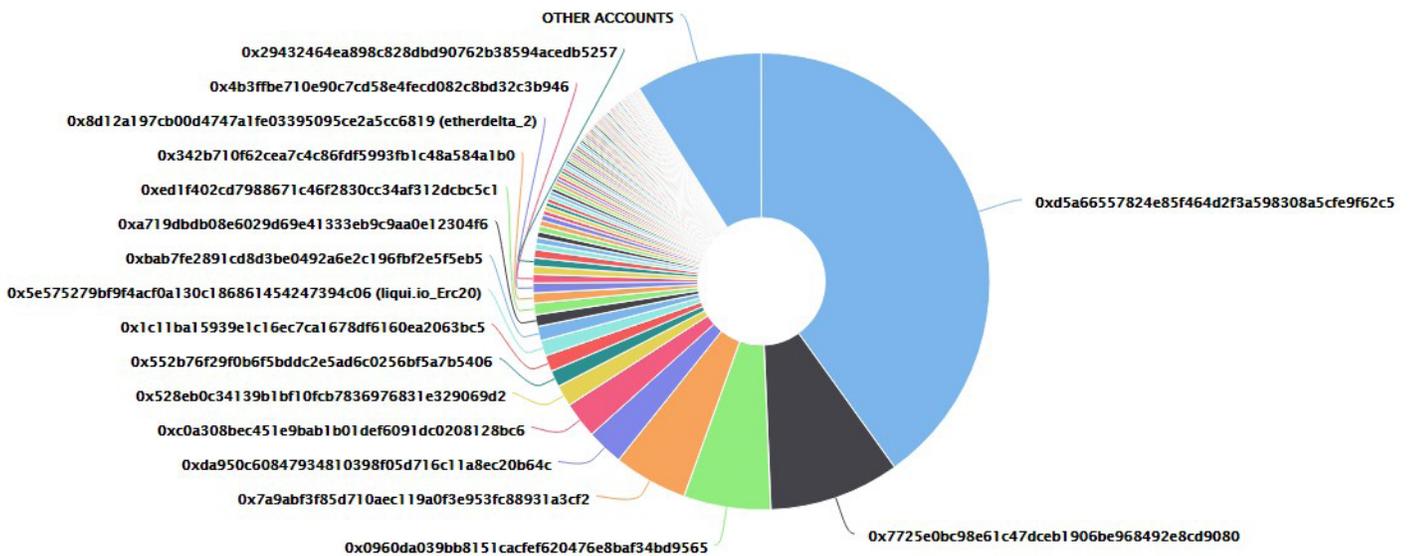
Singapore’s regulatory framework is closer to the code-based European approach than to the dynamic, flexible approach of the United States.

Critical thoughts and comparative analysis

Unlike the rather restrictive approach of nearby jurisdictions, Singapore’s regulatory framework is closer to the code-based European approach than to the dynamic, flexible approach of the United States. As Singapore is a common-law jurisdiction, case law will nevertheless influence future treatment of tokens, their fit in the existing regulatory framework, and any amendments to that framework.

With its comprehensive 14 November guideline, MAS has welcomed start-ups keen to use ICOs as a financing mechanism but will exert its regulatory authority in case of violations of the existing law. Furthermore, MAS has detected some loopholes in the existing financial market regulation, which it needs to amend to combat money laundering, for example.

Figure 6: Top holders of BCAP tokens



Source: Etherscan.io token tracker, BCAP token holders chart, 8 April 2018.



For these reasons, Singapore will most likely continue to be a hub for blockchain innovation in general and token sales specifically. The rather restrictive approach of nearby jurisdictions may reinforce Singapore as Asia's leading crypto hub.

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China (People's Republic of China)

Jiong Sheng, Gianna Abegg, Jackie Yang, and Nathan Kaiser

After the launch of the Bitcoin blockchain, China turned into a booming bitcoin market, with renminbi (CNY) accounting for 50 to 90 percent of global cryptocurrency trading by volume from 2014 through 2016.¹⁷¹ But it also clamped down on such trading and adopted a highly unfriendly policy toward cryptocurrencies. Since September 2017, all cryptocurrency trading platforms have shuttered and all ICOs, stopped.

Chinese cryptocurrency investors continue to trade and mine on the global market, but the Chinese government's position has always been clear and tough. Its legal structure and administrative system give regulatory bodies ample resources to crack down on this invention.

Regulatory framework

General framework

2013 notice and 2017 notice

Thus far, China's central bank—the People's Bank of China (PBC)—along with the banking, securities, and insurance regulatory commissions and the Ministry of Industry and Information Technology (MIIT) has issued two notices on cryptocurrencies and ICOs. Such notices are not laws or regulations *per se* but they have a restrictive effect on the entities under their supervision (e.g., banks, securities companies, and insurance companies); they reflect the government's policy position and carry administrative force but can be withdrawn or replaced.

The regulatory bodies defined the property of cryptocurrency in both notices. In the December 2013 notice, regulators did not recognize bitcoin as a type of currency because it was not issued by a monetary authority; instead, they considered bitcoin "as a type of virtual commodity" and allowed bitcoin trading on the Internet.¹⁷² Financial and payment institutions, however, were already forbidden from carrying out any bitcoin-related business, and PBC required all entities under its administration to "make efforts in preventing money laundering risks that may arise from bitcoin."¹⁷³

Since September 2017, all cryptocurrency trading platforms have shuttered and all ICOs have stopped in China.



In the September 2017 notice (sometimes called the “ICO Ban”), the regulators again ruled out cryptocurrencies as a type of legal currency, prohibiting their use or circulation in the market as such.¹⁷⁴ Cryptocurrencies are called “virtual currencies,” and ICOs are seen as activities bordering on “unapproved and illegal public fundraising,” “illegal sales of token notes,” “illegal securities issuance,” “financial fraud,” and “pyramid sales schemes,” and were immediately called to a stop. All cryptocurrency trading platforms were closed down, and financial and payment institutions were reminded of the redline preventing them from engaging in any relevant business.¹⁷⁵

Although such notices are not laws and subject to sudden changes when any policy adjustments happen, they still have huge administrative impact in China because the co-issuers of the two notices carry wide executive authority under the Chinese legal framework.

A closer look at the 2017 notice

The wording of the September 2017 notice is somewhat vague because Chinese authorities have a penchant for a minimum amount of uncertainty, which they use to their advantage: it gives them leeway to maneuver and decreases the need for short-term amendments, retractions, and extensions. This notice has a degree of uncertainty greater than what is generally the case with cryptotokens, in part, because the technology is so fast moving that regulators want to avoid using terminology already out of date. Such lack of rigor in wording allows for greater adaptability to the current state of the art.

In general, the various authorities who pronounced the ICO ban regulate the domestic Chinese market and its domestic participants. Therefore, the ban primarily affected Chinese companies and residents who wanted to carry out a “China-based” ICO as well as exchanges dealing with tokens. By extension, the ban affects not only Chinese-based distribution and marketing platforms that target local Chinese contributors for foreign-based ICOs but also foreign-based ICOs physically present in China. Under a wider interpretation, the ban may affect China-based but non-Chinese companies and individuals actively distributing and marketing foreign-based ICOs.

Not affected by the ban are exchanges located outside China (i.e., with no physical presence in China) as well as ICOs conducted through a non-Chinese entity (e.g., Swiss entity) with no distribution and marketing activities locally in China. Even assuming China-based distribution and marketing activities, the ban (and Chinese law in general) does not aspire to extraterritorial application, and the foreign entity is not subject to China law.

Money regulations

The law set down that “the legal tender of the People’s Republic of China is the renminbi (RMB),” and only the PBC could “issue renminbi and control its circulation.”¹⁷⁶ No one may use any other type of currency or tender as a medium of exchange for goods

In general, the various authorities who pronounced the ICO ban regulate the domestic Chinese market and its domestic participants.



or services within the territory of China (except, of course, in its special administrative regions). The 2013 notice stressed this legal interpretation.

On 14 October 2013, Baidu, one of China's largest Internet companies, had begun to accept bitcoin as an exchange medium for the services provided to its online customers. Following the 2013 notice, Baidu called that practice to a halt.¹⁷⁷

Not only are cryptocurrencies not legal tender in China, but they also "do not have the properties of a currency such as being legal and mandatory tender."

Not only are cryptocurrencies not legal tender in China, but they also "do not have the properties of a currency such as being legal and mandatory tender," that is, they are not foreign currencies either.¹⁷⁸ Instead, they are only a type of "virtual commodity."¹⁷⁹ That's why the regulatory body of foreign exchange, the State Administration of Foreign Exchange (SAFE) was not a co-signee of the two notices.

The consequence of such recognition is that cryptocurrencies therefore do not come under China's strict foreign exchange control system—which, all in all, sets an annual \$50,000 exchange limit on each individual, unless an individual can prove that any additional amount will not be used in investments abroad or an overseas transfer of assets.¹⁸⁰

Therefore, Chinese traders have always been able to trade bitcoins and other types of cryptocurrencies directly as commodities using RMB beyond the annual limit. Even after the 2017 notice, trade volume in RMB still accounts for about 14 percent of the world's total.¹⁸¹

Commodities

The 2013 notice defined bitcoins and possibly similar types of cryptocurrencies as virtual commodities. Regulatory control at the time was not so strict yet. The notice reminded bitcoin trading platforms to register at the MIIT as required by all Chinese websites. The 2017 notice went one step further: it forbade all transaction platforms from ICOs and clearly stated that MIIT could shut down any disobedient platform in accordance with the law. According to the Administrative Measures on Internet Information Services, the MIIT



Great Hall of the People at Night by Thomas.fanghaenel, 2007, used under CC BY-SA 3.0 via Wikipedia Commons.



does have such authority, especially toward “profit making” Internet information service providers that receive payments from their users—as those trading platforms do.¹⁸²

Apart from online trading, commodities are potentially tradable via futures or options contracts. For example, the CME Group, the world’s largest futures exchange, launched bitcoin futures in December 2017.¹⁸³ Yet China has never had a futures trading market for such virtual commodities because, according to Regulations for the Administration of Futures Trading, all futures trading must be carried out in China’s futures exchanges, not over the counter. Setting up a futures exchange requires approval from “State Council’s futures regulatory authority,” which is currently the SRC, as does establishing a futures company that intends to take up futures transactions.¹⁸⁴ These rules indicate the SRC’s reluctance to grant permission for cryptocurrency futures trading, and its unfriendly position shows little opportunity of the market’s opening up.

Securities laws

Chinese securities laws have large impact on ICOs. The 2017 notice focused on clamping down on ICOs suspected of constituting “illegal securities issuance and illegal fundraising.” Issuance and trades of securities, including shares, bonds, and the derivatives of such, are regulated under the PRC Securities Law, which states that any proposed issuance “must be submitted to [SRC] for examination and approval pursuant to the law. Without such examination and approval, no entities or individuals shall issue securities publicly.”¹⁸⁵ Issuers would have to return unapproved issuance, the funds raised, and any interest as well as pay fines, as would securities companies underwriting such issuance.¹⁸⁶ For clarification, to “issue securities publicly” means

- » Issuance to non-specific persons;
- » Issuance to more than 200 specific persons in aggregate, or;
- » Other legally forbidden issuances.¹⁸⁷

As we can see, China still has a highly regulated financial market; and any entity or person who wants to issue any type of security must have the prior approval from, not registration at, the SRC. If shares or bonds were to be issued in the form of ICOs, they would first require SRC approval; but the SRC will almost certainly not give its approval because the 2017 notice directed “all types of activities of financing by ICOs [to] cease immediately.” Furthermore, in April 2016, the SRC and other regulatory departments issued another joint-notice strictly forbidding “online share fundraising,” including crowdfunding or fundraising from unqualified investors.¹⁸⁸

The 2017 notice further defined ICOs as “in essence a form of unapproved and illegal public fundraising,” which could be in violation of Article 176 of the PRC Criminal Law. The Supreme People’s Court gave four conditions:

Chinese securities laws have large impact on ICOs. The 2017 notice focused on clamping down ICOs suspected of constituting “illegal securities issuance and illegal fundraising.”



1. Absorbing funds without approval from the relevant [government] department in accordance with the law or on the pretext of lawful operation;
2. Conducting public promotion through channels such as the media, conferences, leaflets, and mobile phone messages;
3. Undertaking to repay the principal and interest or a return in the form of currency, physical objects, or equity within a time limit; and
4. Absorbing such funds from the general public, that is, non-specific targets in the society.¹⁸⁹

Meeting all of them would be considered a criminal violation. Some have argued that, since cryptocurrencies are not currencies and therefore not “funds,” they could not constitute fundraising. Chinese law experts usually still consider ICOs as having met all of the above four conditions because “funds” do not just mean currency, but also the value of exchange; and the easy convertibility into legal tenders and market recognition of the cryptocurrencies’ worthiness have already given them the function of fundraising.¹⁹⁰ Those who violate Article 176 could face a maximum sentence of 10 years imprisonment and a fine of CN¥500,000.¹⁹¹

Any institutions which are set up without the PBC’s approval to engage in “illegal financial business activities,” such as the absorption of public funds, fundraising (including those “not in the name of taking deposits from the public, but where the obligations promised to be performed are the same nature”), purchase and sales of foreign exchanges, making trust investments, granting loans, and “other illegal financial business activities as determined by the People’s Bank of China,” are all considered as illegal financial institutions and will be banned and penalized by the PBC.¹⁹²

For legally established financial institutions, PBC has already clearly stated in both the 2013 and 2017 notices that they are not allowed to engage in “any bitcoin related business,” nor any ICO financing.

For legally established financial institutions, People’s Bank of China has already clearly stated in both the 2013 and 2017 notices that they are not allowed to engage in “any bitcoin related business,” nor any ICO financing.

Securitizations

Banks and other institutions regulated by the BRC often “securitize” foundational assets (e.g., converting mortgage loans into saleable securities to raise cash). Whether they could securitize cryptocurrencies or tokens issued through ICOs remains a question, and they would require BRC approval to initiate.¹⁹³ The Administrative Provisions on the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies laid down conditions for securities companies to engage in securitization trades.¹⁹⁴

For example, an entity would need to set up an SPV for each individual investment scheme, limit each scheme’s issuance to 200 “qualified investors,” set the value of each subscription to no less



than CN¥1 million, and file with China Asset Management Association and SRC within five working days of establishing an SPV.¹⁹⁵ Although the higher entry level into the securitization market could protect all investors with lower risk-taking capacity, entities would still need the BRC's approval. Unless BRC takes a softer position than PBC and SRC, which is unlikely as BRC is also a co-signee of the two notices, a Chinese securitizations market for cryptocurrencies is still unlikely.

One of the main concerns of cryptocurrency is always money laundering. Its anonymity and ease of transaction make it an easy medium for illegal transactions.

Other regulations

One of the main concerns of cryptocurrency is always money laundering. Its anonymity and ease of transaction make it an easy medium for illegal transactions. China's AML law gave the PBC the duty and power to monitor and prevent money laundering, and all financial institutions (such as banks, securities companies, etc.) must cooperate by establishing client identity databases and recognition systems, transaction records, and suspicious transaction report mechanisms; any information relating to money laundering must be passed on to the regulatory body or the police who will investigate.¹⁹⁶ In March 2017 (before the 2017 notice), the PBC was reported to have met with several bitcoin trading platforms, requesting them to also comply with the duties imposed on financial institutions under the law.¹⁹⁷

While domestic trading of cryptocurrencies has been closed down, no law forbids the holding of such commodity or the mining of it.

Figure 7: Huobi token price and trading volume outside China

Etherscan.io shows a total of 41,524 HT token holders as of 8 April 2018.



Source: CoinMarketCap.com, Huobi chart, 3 Feb.–8 April 2018.



Chinese traders can also bypass Chinese Internet control by making trades on overseas trading platforms. Chinese currency still accounts for a significant proportion of global trade, although it has suffered a plummet. But several sources report that the mining industry is getting wiped out—not directly, but through indirect policy pressure via electricity, tax, land, and environmental control.¹⁹⁸

To conclude, China currently does not have a complete, systematic set of laws on cryptocurrency. Instead, its regulation is primarily based on its two notices—the 2013 notice and the 2017 notice—which reflect the government’s current policy thinking. China’s legal structure empowers the issuing bodies of the notices, including PBC, SRC, BRC, MIIT, and several others, with full flexibility to restrict cryptocurrency development. Current policy has not shown any sign of softening. If cryptocurrency is in the future more widely accepted, then new notices may be issued and these policies may change.

Regulatory statements

2017 notice (“ICO ban”)

The September 2017 notice (a.k.a. “ICO Ban”) had the effect of prohibiting the use and circulation of cryptocurrencies as a type of legal currency and closing all cryptocurrency trading platforms.¹⁹⁹ For a full translation of People’s Republic China Announcement on Risk Prevention of ICOs, read Eiger’s memorandum of 4 September 2017.²⁰⁰

Current policy in China has not shown any sign of softening. If cryptocurrency is in the future more widely accepted, then new notices may be issued and these policies may change.

Closing of cryptoexchanges

According to various news reports in September 2017, the Office of Leading Group for Internet Financial Risk Special Rectification released the relevant Notice on Rectification for Initial Coin Offerings.²⁰¹ This notice included a list of ICOs subject to the PRC authorities’ attention in 2017.²⁰² According to the notice, all new China-based ICO projects were required to shut down. Based on this, China-based ICO platforms gradually refunded the currencies/tokens and stopped their exchange services last year. Here are a few:

- » **BTCCHINA:** All exchange services were stopped by 30 September 2017. Its exchange business completely shut down on 3 January 2018, and online withdrawals of funds are no longer allowed.²⁰³
- » **OKCoin:** Trading services were stopped by October 2017, and refunds were handled until 2 January 2018. OKCoin now works through new websites based outside mainland China (okex.com and okcoin.com for the overseas market, and bihang.com for China’s or the Chinese market).²⁰⁴
- » **Huobi:** All trading services were stopped by October 2017. Its HT tokens and digital exchange were moved to huobi.pro based outside mainland China.²⁰⁵



The court finally ruled that bitcoin was not only a specific virtual commodity, but that it also represents the victim's property, which should be protected by criminal law.

Without exception, all current ICOs with teams based in mainland China issue their tokens outside mainland China, mostly in Hong Kong.

Closing mining activities

Recently, Chinese authorities also seem to want to stop all mining activities. According to recent news reports, the PBC does not plan to issue a policy requiring the closure of bitcoin mining operations, but it does seem to intend to enforce local regulators to monitor and even restrict the power use of miners in certain regions of China.²⁰⁶ The local governments seem to have been asked to guide miners toward an exit from the business. To date no official statement has been published, but such steps would escalate the prohibition of crypto-related activities. At this stage news agencies still doubt whether those reports are accurate and consider them potentially fake.²⁰⁷

Decisions

A few court cases have involved cryptocurrency in China. To show the argumentation of the court, we want to point out two recent judgments:

In a larceny case heard by the Zhejiang Taizhou Court, the defendant stole the password of the victim's trading platform account, changed the account linked to the trading platform, and then transferred the resulting funds (70.96 bitcoins worth CN¥220,971) to his own bank account.²⁰⁸ The defendant argued that bitcoin was a virtual commodity and thus not subject to the criminal target of larceny. The court finally ruled that bitcoin was not only a specific virtual commodity, but that it also represents the victim's property, which should be protected by criminal law.

In a civil case heard by the Jiangsu Nanjing Court, the plaintiff instructed the defendant to invest an amount of CN¥53,040 to buy the equipment to go into mining.²⁰⁹ For various reasons, the plaintiff later could not exchange the DK coins from the defendant into fiat currency, and thus claimed that the defendant did not pay her debt. The court considered that

- » A debt in connection with coins is considered illegal and not protected by the law.
- » DK coin is considered a virtual currency and not a real currency.
- » DK coin as special virtual commodity does not have the same legal status as a legal currency and should thus not be used in the market.

Although citizens are free to invest or exchange DK coins or similar, such acts shall not be protected by the law. The court dismissed the case.

Examples of ICOs

Without exception, all current ICOs with teams based in mainland China, such as matrix.space, issue their tokens outside mainland China, mostly in Hong Kong.²¹⁰



To what extent the bans will dampen crypto and blockchain efforts in China over time is disputed.

NEO

NEO (formerly known as Antshares) is the PRC's first ever open-source blockchain.²¹¹ In October 2015, NEO held its ICO and raised \$550,000 (2,100 BTC valued at CN¥4,600,000).²¹² In September 2016, NEO held another crowdsale, in which it sold 24 million tokens and raised \$4.5 million (6,129 BTC, roughly CN¥25,000,000).²¹³ After the ICO ban, NEO fully refunded the money raised to participants who returned their NEO tokens.²¹⁴

Binance/BNB

Binance is a pure cryptocurrency exchange with a team located in the PRC.²¹⁵ Binance's ICO took place in Hong Kong on 1 July 2017 and raised \$15 million.²¹⁶

Critical thoughts and comparative analysis

The different bans issued in late 2017 have essentially stopped any ICO activity in mainland China. While competent teams remain active and present with new tokens, business models, and technical solutions, all ICO operations now take place outside China. To what extent the bans will dampen crypto and blockchain efforts in China over time is disputed.

Figure 8: Binance's BNB token price and trading volume

Etherscan.io shows some 297,203 accounts holding BNB tokens as of 9 April 2018.



Source: CoinMarketCap.com, Binance chart, 25 July 2017–9 April 2018.



In China, only time will tell.

Some point out that both the government and the Communist Party support innovation and blockchain-related efforts (e.g., for trade finance in the Belt and Road initiative). Others expect current restrictions eventually to be lifted, though a lift seems unlikely. One of the blockchain's main attributes is decentralization, implying a lack of (central) control and an inherent censorship resistance. Further, value-carrying tokens easily defeat national foreign exchange control regulations and limitations. These conditions appear to go against the current efforts of the Chinese leadership. Only time will tell.

EUROPE

European Union

Benedikt Schuppli

To date, the European Union has not passed any laws directly targeted at ICOs. Yet, some of the tokens issued via ICOs could fall within the existing regulatory framework. Here we identify the various directives and regulations that could potentially apply to token sales, especially those tokens that might qualify as transferable securities or other financial instruments.

We must note that financial regulation in the European Union is complex because a patchwork of legislation—at supranational (EU) and national (member state) levels—governs it. Different member states are implementing certain EU legislation at different speeds. As a result, some member states have ancillary legislation in force alongside EU rules and other member states don't.

Limitation of scope

In the European Union, token sales may be governed by EU-wide regulations on the supranational level as well as national legislations in individual EU member states implementing EU-directives.

Issuers conducting an ICO within an EU member state or to EU residents must always consider the various national laws, which may vary greatly in each member state.

Therefore, merely consulting the directives at the EU-level may not provide sufficient information to conduct such token sales in a compliant manner. Because of such dependence on national legislations, we have limited the scope of this section to cover the European Union briefly.

To date, the European Union has not passed any laws directly targeted at ICOs.



Regulatory framework

European Prospectus Regulation

Generally, if a token issued in an EEA member state qualifies as a security within the meaning of the European Prospectus Directive, then the issuer must publish and file a prospectus with a supervisory authority.

Generally, if a token issued in an EU member state qualifies as a security within the meaning of the European Prospectus Regulation that is, referencing the term “transferable security” pursuant to Article 4(44) of EU Directive 2014/65, the Markets in Financial Instruments Directive (MiFID II)—then the issuer must publish and file a prospectus with a supervisory authority.²¹⁷

To above rule, there are several notable exceptions:

Article 1(3) of the Prospectus Regulation carves out from its scope “an offer of securities to the public with a total consideration in the Union of less than €1 million, which shall be calculated over a period of 12 months.”

According to Article 3(2)(b) of the European Prospectus Regulation, member states are even empowered to except offerings of up to €8 million from the obligation to draft a prospectus.

At a national level, member states may incorporate other disclosure requirements for offers of securities that are exempt from the formal prospectus obligation. Such is the case in Germany, which has made use of the empowerment in Article 3(2)(b). However, issuers relying on this exemption must draft a so-called “securities information sheet” as a disclosure requirement nonetheless.

Other notable exceptions to the rule in Article 3(1) of the Prospectus Regulation include Article 1(4)(a) exempting qualified investors as well as Article 1(4)(b) exempting private placements from the



Building of the European Parliament in Brussels by Andrijko Z., 2014, used under CC BY-SA 4.0 via Wikipedia Commons.

prospectus obligation if the offer in question addresses fewer than 150 natural or legal persons per member state.

Issuers often misunderstand this latter exemption: they are *not compliant* if they accept fewer than 150 investors from each jurisdiction but publicly address a much larger group of people through their website and offering materials.

Independent of this uncertainty regarding European directives governing token sales, we provide a brief overview of the other important European regulations and their effect on token sales conducted within and to the European Union.

Markets in Financial Instruments Directive (MiFID II)

MiFID II, among other things, regulates the overall environment of capital markets. The general scope of MiFID II is to establish a comprehensive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used.

The degree to which EU member states have implemented MiFID II already varies significantly. Nevertheless, once fully implemented within EU member states, MiFID II will affect several aspects of token sales such as the offering of tokens to the public with the help of third parties (e.g., professional investment agents) and the use of specific platforms as trading venues for tokens.²¹⁸

Other relevant directives and regulations

If an issuer utilizes an ICO for crowdfunding or other financing or investment objectives, then the issuer must comply with overall directives and regulations governing such activities. For example, if the ICO qualifies as a collective investment in transferable securities, then the issuer must comply with the Undertakings of Investment in Transferable Securities (UCITS) directive.²¹⁹

If the token sale qualifies as a collective investment undertaking, then the issuer may be subject to the Alternative Investment Fund Managers (AIFM) directive, and the tokens themselves would correspondingly qualify as units in such an alternative investment fund.

If the contract governing the purchase of the token issued during an ICO is a financial contract linked to the fluctuation in the price of an underlying asset or a basket of assets, then a token may be a derivative. Common examples of assets upon which we can write a derivative contract are interest-rate instruments, equities, and commodities. An OTC derivative is one that is privately negotiated and not traded on an exchange.²²⁰ Any OTC trading of these types of tokens, which may be linked to a commodity (such as a right to receive a physical gold bar), may be subject to European Market Infrastructure Regulation (EMIR).

If an issuer utilizes an ICO for crowdfunding or other financing or investment objective, then the issuer must comply with overall directives and regulations governing such activities.



Token issuers must also consider the Fifth European Anti-Money-Laundering Directive (5AMLD). It is the first attempt to regulate cryptocurrency exchanges at an EU-level.²²¹

Under 5AMLD, wallet providers and cryptocurrency exchanges will be subject to, among other things, the requirements to carry out identity checks on customers, to obtain information regarding the assets' beneficial owner, and to monitor and report suspicious transactions.

Whether an ICO organizer might fall within the scope of the 5AMLD and its respective national implementations is currently under debate. ICO organizers might be deemed providers of exchange services when they issue tokens against contributions in fiat currencies, for example.

Generally, we can state that the understanding of the complex patchwork of legislation in the European Union is of utmost importance to token issuers and the like. Hacker and Thomale aptly express it in the following way:

We can state that the understanding of the complex patchwork of legislation in the European Union is of utmost importance to token issuers and the like.

While, just like MiFID II, these statutes do not directly target ICOs as such, they should be borne in mind for two reasons:

First, they may be part of the general legal environment of the enterprise behind an ICO and therefore can at least have an influence on the question, if, when, and how an ICO is the right business choice.

Second, from a legal governance perspective, the evolutionary nature of EU investment law allows [us] to project that sooner or later the phenomenon of ICOs will be subject to specific regulation designed to fill what will be perceived as "legal loopholes."

It is really up to market actors if they want to embrace rather than evade this fact and let their voices be heard in the legislative process.²²²

Regulatory statements

Given a rapid growth in ICOs globally and in Europe, the European Securities and Markets Authority (ESMA) has issued two ICO-related statements that have been relayed by national European authorities. One seeks to inform investors of the high risks they are taking when investing in ICOs. The other seeks to alert firms involved in ICOs to relevant applicable EU legislation with which they must comply.²²³

ESMA statement for investors (13 Nov. 2017)

In this statement directed to potential investors in tokens and ICOs, ESMA presents an extensive list of risks to which they might be exposed, where they could lose a portion or all of their invested capital:



ICOs are very risky and highly speculative investments, and investors may not be able to redeem their tokens for a prolonged period.

- » Depending on how they are structured, ICOs may fall outside of the scope of EU laws and regulations, in which case investors cannot benefit from the protection that these laws and regulations provide.
- » ICOs may be used for fraudulent or illicit activities, such as money laundering. Moreover, several recent ICOs have been identified as frauds themselves.
- » Most projects are in the early development phase.
- » Given the limited number of trading places and the low volume of exchange, investors have few or no redemption options for some projects.
- » ICOs are very risky and highly speculative investments, and investors may not be able to redeem their tokens for a prolonged period.
- » ICOs are often subject to extreme price volatility. These markets are often subject to price manipulation and related fraudulent activities, such as misinformation and insider trading.
- » The information made available to investors is often unaudited, incomplete, unbalanced, or even misleading (e.g., emphasizing the potential benefits but not the risks).
- » As several hacks or errors resulting in financial losses have shown, the code used to create, transfer, or store the coins or tokens may contain flaws.
- » More generally, the underlying blockchain technology may not function quickly and securely.

ESMA statement for firms (13 Nov. 2017)

In this statement, ESMA explains that, while some ICOs might not be regulated, firms involved in ICOs may still conduct regulated investment activities such as placing, dealing in, or advising on financial instruments, managing or marketing collective investment schemes, or being involved in offering transferable securities to the public. In all these cases, they must comply with the relevant legislation:

- » Prospectus Regulation (EU 2017/1129): Coins or tokens could fall within the definition of a transferable security, and thus necessitate the publication of a prospectus subject to approval by national authorities.
- » Markets in Financial Instruments Directive (2014/65/EU): If coins or tokens qualify as a financial instrument, then MiFID rules of conduct and transparency apply to such services and activities as placing, dealing in, or advising on financial instruments. The recent updated directive and its regulation increase reporting obligations and organizational rules.



Firms involved in ICOs should carefully consider whether their activities are regulated. Any failure to comply with the applicable rules will constitute a breach.

- » Alternative Investment Fund Managers Directive (2011/61/EU): ICOs may qualify as alternative investment funds, to the extent that they are raising capital to invest with a defined investment policy. Therefore, capital operational and organizational rules as well transparency requirements might apply.
- » Fourth Anti-Money Laundering Directive (2015/849): The directive requires firms to carry out customer due diligence, keep appropriate records, report suspicious activity, and cooperate with official investigations.

ESMA stresses that firms involved in ICOs should carefully consider whether their activities are regulated. Any failure to comply with the applicable rules will constitute a breach.

France

Xavier Lavayssière

As part of the European Union, France's regulatory framework complies with the prospectus directive as well as the MiFID II, AIFM, and AMDL4. As a civil law country with a strong culture of state intervention, France's complex regulatory framework and significant taxation on capital gains has, thus far, failed to attract a substantial number of foreign projects. However, its vibrant research and start-up ecosystem have brought some leading blockchain projects and ICOs to France.

France has several regulatory authorities in charge of establishing rules and regulations that might affect how people engage in a token sale:

- » *Ministry of the Finances and the Economy*. The current Minister of Finances, Bruno Lemaire, is eager to create new opportunities for a blockchain start-up ecosystem in France. However, public opinion leans toward limiting excessively speculative endeavors. The ministry consists of two services working on cryptocurrencies:
 - › The General Directorate of Public Finances (DGFIP) is in charge of taxation, clarified taxation on bitcoin and other cryptocurrencies for individuals.
 - › Tracfin (*Traitement du renseignement et action contre les circuits financiers clandestins*) is in charge of AML regulation and action against secret finance networks.
- » *Authority of Financial Markets (AMF)*. An independent administrative body, the AMF regulates markets and financial instruments so as to protect investors and allow the French ICO ecosystem to develop.

Its vibrant research and start-up ecosystem have brought some leading blockchain projects and ICOs to France.



- » *Prudential Supervision and Resolution Authority (ACPR)*. A department of the Bank of France, the ACPR supervises banks and insurance. While the Bank of France has experimented with blockchain through the implementation of some proofs of concept (e.g. using Ethereum for its register of participants in Single Euro Payments Area schemes), the ACPR maintains a more prudent position.

These regulatory authorities seek to clarify the potential application of existing laws and regulations on token sales, warn investors of the risks inherent in investing in cryptocurrencies, and foster a dialogue with start-ups so that the regulatory framework promotes innovation.

Regulatory framework

Securities law

In France, financial titles are defined through an explicit enumeration: shares, bonds, and units in collective investments.²²⁴ Unless tokens provide voting and financial rights to their holders (like a share or a bond on the issuer), they are unlikely to qualify as a financial title. Similarly, units in collective investments are precisely enumerated and only refer to investments in a fund, rather than in a particular project.²²⁵

Unless tokens provide voting and financial rights to their holders (like a share or a bond on the issuer), they are unlikely to qualify as a financial title.

However, token issuers might fall under the classification of *intermediaries in miscellaneous property*, which are defined as:

1. *Whoever, directly or indirectly, by means of advertising or direct marketing, regularly invites third parties to subscribe to life annuities or to acquire title to movable or immovable property where the acquirers do not perform the management thereof themselves or where the contract offers a buy-back or exchange option with revaluation of the capital invested.*
2. *Whoever collects funds to that end.*
3. *Any individual or legal entity responsible for the management of such property.*²²⁶

These intermediaries must register with the AMF and provide a document disclosing their operations.

A secondary status of intermediaries in miscellaneous property also applies to any party that proposes to one or several clients that they should acquire rights on one or several properties with the expectation of financial returns. In this broader sense, the AMF can control *a posteriori* the transparency and accuracy of relevant documents.

Those two classifications are likely to concern token issuers to the extent that a token sale consists of advertising the sale of digital rights that can be exchanged on a secondary market, with an expectation of return.



Money regulation

Electronic money

In France, *electronic money* is defined as a value stored in a digital form that represents a debt of the issuer and that is issued in exchange of money to be used for payment—transcribing the European directive on electronic money.²²⁷ Terms and conditions such as reimbursement should be defined by a contract. While this law is designed for electronic payment systems, some tokens could qualify as electronic money if they meet these criteria. The processing of electronic money generally requires a party to register as an electronic money establishment at the ACPR, as prescribed by the payment services directive and transcribed in French law.²²⁸

The term “electronic money” should not be confused with the broader notion of “virtual currency,” which refers to a unit of value with no legal status.²²⁹ Virtual currencies can be *closed* (currencies within online games), *unidirectional* (they can be bought with fiat currency but not redeemed for it), or *bidirectional* (most tokens and cryptocurrencies).

Payment services

In a 2014 position paper, ACPR estimated that receiving funds from the sale of bitcoin was regulated as a form of payment services—which requires the party to register at the ACPR as a payment institution.²³⁰ Alternatively, if a third-party provider handles the payments for the issuer, the party should consider registering at the ACPR as a banking and payment services intermediary.

The term “electronic money” should not be confused with the broader notion of “virtual currency,” which refers to a unit of value with no legal status.



Versailles Palace by Eric Pouhier, 2007, used under CC BY-SA 2.5 via Wikipedia Commons.



Anti-money laundering regulations

AML/CFT regulations concern most financial businesses.²³¹ Trading platforms and tokens issuers should comply with those rules. The main obligations are:

- » Vigilance through a risk evaluation policy
- » Identification of clients
- » Disclosure of suspicious movements of funds to Tracfin

Moreover, any individual or legal entity who, in the normal course of their business, executes, supervises, or recommends transactions that give rise to capital movements must declare any transactions they have knowledge of that involve sums which may come from a substantial crime.

In 2016, Tracfin received 178 reports of suspicious activity, primarily because a cryptocurrency was involved.²³² Tracfin has already put in place various cooperation and technical measures to detect suspicious patterns on public blockchains.

Consumer protection

Even if a token sale does not qualify as a security offering, and if a token issuer does not fall within the category of a payment processor, the sale and issuer might still be subject to the more general consumer protection laws.

Specifically, under French law, a professional who sells a product to a nonprofessional has the obligation of giving specific information, such as the essential characteristics of the product or service, the price, the date of delivery, the seller's identity, functionalities for a digital product, and legal information.²³³ Because an ICO could be considered the presale of a service, these rules are likely applicable.

Similarly, a platform operator who ranks products or services or offers a connection for the sale of a product, the delivery of a service, or the exchange or sharing of a content, service, or good, must provide information on:

- » General conditions of the service, including the referencing and ranking methods
- » The existence of a remuneration to promote a particular content, good, or service, if it influences its ranking
- » The rights and obligations of all parties

Many projects financed by ICOs are decentralized platforms. Those obligations would therefore apply and may raise questions on the responsibilities of the various stakeholders.

Even if a token sale does not qualify as a security offering, the sale and issuer might still be subject to the more general consumer protection laws.



Contractual clauses between a professional and nonprofessional can be declared abusive when the contract is substantially unbalanced.

Finally, contractual clauses between a professional and nonprofessional can be declared abusive when the contract is substantially unbalanced. For example, specific advertisements such as the designation of “digital vault” are regulated. As the act of buying a token in an ICO consists generally of an adhesion contract between a professional (the issuer) and nonprofessionals (the buyers), consumer protection law is therefore applicable to the terms and conditions of the sale.

Taxation

To date, there has been no clarification from the administration, the law, or a court on the taxation of an ICO, and several open questions remain regarding what constitutes a taxable event, valuation, and accounting in the context of a token sale.

Buying and selling bitcoin and other cryptocurrencies as a professional activity is interpreted as an industrial and commercial activity and is taxed as income or regarded as a noncommercial benefit, if the activity is occasional.²³⁴ The fact of buying and selling cryptocurrencies is exempted from *value-added taxes* (VAT), according to a decision of the European Court of Justice.²³⁵ Moreover, funds owned in cryptocurrencies are taken into account for the basis of the *solidarity tax on wealth* (ISF).

Regulatory statements

AMF discussion paper (22 Oct. 2017)

The AMF published a discussion paper regarding its analysis of the application of existing regulatory framework to ICOs and future regulatory options.²³⁶

Firms involved in ICOs are likely to fall within the scope of existing regulations on intermediaries in miscellaneous assets, as it relies on a loosely defined notion of assets as any resource having an economic value that can be appropriated.

Current framework

While most tokens present similarities with financial securities (equity or debt), they do not meet the required characteristics established in the financial markets code, and therefore should not be regulated as public offering of financial securities.²³⁷

As ICOs are generally not intended to manage a portfolio of financial instruments and deposits on behalf of investors, ICO token investors are not likely to be regarded as an UCITS. However, the AMF considers some ICOs to be alternative investment funds (AIF), to the extent that token issuers use the invested capital according to a predefined investment policy.

Firms involved in ICOs are likely to fall within the scope of existing regulations on intermediaries in miscellaneous assets, as it relies on a loosely defined notion of assets as any resource having an economic value that can be appropriated.²³⁸



Regulatory options

The AMF opened a public consultation, inviting people to discuss three separate options:

In December 2017, the French president signed a legislative order authorizing the use of a "shared digital registering device"—a formal designation for blockchain systems—for the transmission of financial titles.

1. To maintain the regulatory status quo and establish best practices. The current regulatory framework would not change. Depending on an ICO's structure and token characteristics, it might fall within existing regulations albeit rarely. The AMF could establish a set of best practices for new entrants on communicating, organizing, and conducting their token sales, but these would not be legally binding.²³⁹
2. To regulate ICOs using the existing legal framework for prospectuses. The European regulation on the prospectus for public offerings set the content and procedures for this document, but Europe would need to include ICOs in this legislation. Moreover, the "visa" procedure by which national authorities such as the AMF certify the document is particularly cumbersome.²⁴⁰
3. (a) To adopt a mandatory registration and authorization regime and apply it to all ICOs available to the public in France. This ad hoc procedure would be similar to the prospectus regulation, taking into account particularities of ICOs, such as the absence of a legal entity, community management of the project, the scientific and technical value of the project, and the high uncertainty of financial gains.²⁴¹

(b) To adopt an optional registration and authorization regime. ICOs could opt to register and obtain authorization similar to option 3 (a). Projects without the authorization would have to issue a warning to potential investors.²⁴²

Ordinance on the use of shared registers (8 Dec. 2017)

In December 2017, the French president signed a legislative order authorizing the use of a "shared digital registering device"—a formal designation for blockchain systems—for the transmission of financial titles.²⁴³ This legislative order was taken on the basis of a 2016 law and will require a law decree to be applicable.²⁴⁴ The decree must define the technical conditions under which financial titles can be transmitted and recorded via a "shared digital registering device." A similar provision was taken for a new category of treasury bonds called "minibonds."²⁴⁵ In both cases, no decree implementing the measures has been taken yet.

No decisions have been taken yet by any of the French regulatory authorities concerning ICOs.

Decisions

No decisions have been taken yet by any of the French regulatory authorities concerning ICOs.



Examples of ICOs

iExec/RLC

iExec now focuses on developing its platform while growing an ecosystem of start-ups that might use it at a later stage, similar to Amazon web services.

Based in Lyon, iExec aims to become a decentralized computing platform. The project is to allow Dapps to use its network external computing power safely. Led by two former researchers in distributed computing, the firm collected \$12 million during its RLC token ICO in six hours in April 2017, making it the fifth largest ICO at the time.²⁴⁶ The company now focuses on developing its platform while growing an ecosystem of start-ups that might use it at a later stage, similar to Amazon web services.²⁴⁷

Beyond the Void/Nexium

Also based in Lyon, the start-up B2Expand created Nexarium, a blockchain-based gaming ecosystem. B2Expand's multiplayer online battle arena (MOBA), *Beyond the Void*, is first native game on the Nexarium's distributed platform and combines games of role-playing, action, and strategy.²⁴⁸ For its first ICO in France in November 2016, B2Expand sold 30 million Nexiums for about \$300,000 worth of ether and BitCrystals, the tokens used in the BitCrystals gaming platform of Swiss-based Everdreamsoft SA and European Games Group AG.²⁴⁹

Figure 9: Nexium token price and trading volume

Etherscan.io found 678 holders of Nexium tokens as of 8 April 2018.



Source: CoinMarketCap.com, Nexium chart, 12 Dec. 2016–8 April 2018.



Critical thoughts and comparative analysis

Because of its high capital taxes and complex regulatory framework, France is currently not the most favorable country for launching an ICO. Other places in Europe are more attractive because of their simpler regulatory frameworks, lower taxation rates, and larger start-up ecosystems.

Because of its high capital taxes and complex regulatory framework, France is currently not the most favorable country for launching an ICO.

However, with a dozen Fields medalists (i.e., recipients of the International Medal for Outstanding Discoveries in Mathematics granted to mathematicians under the age of 40), substantial taxation credits for research, and a strong engineering tradition in mathematics and computer science, France is a flourishing place for R&D in the blockchain space. For instance, the National Institute of Research in Computer Science and Automation (INRIA, for *Institut National de Recherche en Informatique et en Automatique*), developed Caml, which evolved into the language used to program Tezos, a blockchain with static analysis capability for running smart contracts.²⁵⁰

Moreover, in a recent bid to relocate the European Banking Authority to Paris, French politicians showed an interest in being at the forefront of European finance.²⁵¹ Some administrations and regulatory authorities share this ambition, which might lead to significant clarification of the legal status of ICOs in the coming months. For instance, the AMF launched a digital-asset fundraising accompaniment and research program called “Unicorn” (Universal Node to ICO Research and Network) in addition to AMF’s public consultation on ICOs.²⁵²

Estonia

Nikita Divissenko

Estonia is considered one of the best places in the European Union (and the world) to start and run a business, and its innovation-oriented regulatory environment has been attractive to blockchain-based business.

Estonia is considered one of the best places in the European Union (and the world) to start and run a business, and its innovation-oriented regulatory environment has been attractive to blockchain-based business.²⁵³ Estonian financial regulation is based on EU financial law instruments (including the prospectus directive, MiFID II, EMIR, UCITS directive, AIFM directive and AMLD4), but has yet to put in place a definitive legislative framework regulating ICOs. So this section focuses on the existing legislation potentially applicable to ICOs and the current position of the regulator—the Estonian Financial Supervision Authority (EFSA)—regarding token offerings.

Regulatory framework

Securities law

Estonian securities law will apply to an ICO where the tokens issued give the investor a participation right in the issuing entity or a right



to (expect and) receive returns from the investment made when purchasing the tokens. Such tokens would qualify as transferable securities according to the Securities Market Act—the key piece of Estonian securities legislation.

The Securities Market Act defines security as a proprietary right or obligation or contract transferred (based on at least unilateral expression of will, even if no document is issued), which can be executed in the form of:

- » A share or other similar tradable right
- » A bond, convertible security, or other tradable debt obligation issued which is not a money market instrument
- » A subscription right or other tradable right granting the right to acquire either of the above (a share or a bond)
- » An investment fund unit and share
- » A money market instrument (i.e., a low-credit, unsecured, transferable, and marketable debt obligation issued for a term of up to one year, which is traded on the money market—including a treasury bond, commercial paper, certificate of deposit, or bill of exchange secured by a credit institution)
- » A derivative security or a derivative contract
- » A tradable depositary receipt
- » Unit of greenhouse gas emissions²⁵⁴

Therefore, barring other instruction, tokens are considered transferable securities, and the Securities Market Act shall apply to the ICOs conducted in Estonia (i.e., by an entity incorporated in Estonia) in which the tokens issued give the investor participation rights in the issuer (e.g., voting or other rights equal to those of shareholders) or rights to receive investment returns (interests, dividends, or any other type of returns).

In situations when the tokens qualify as transferable securities, regulators must assess whether the issue qualifies as a public offering and is subject to the prospectus requirement. The Securities Market Act provides a negative definition of the public offering, in which any offering is considered public, unless

- » The offering is addressed solely to qualified investors.
- » The offering is addressed to fewer than 150 persons per EU/EAA member state other than qualified investors.
- » The offering is addressed to investors who acquire securities for a total consideration of at least €100,000 per investor, for each separate offer.
- » The nominal value or book value is at least €100,000 per security (per token).

Tokens are considered transferable securities, and the Securities Market Act shall apply to the ICOs conducted in Estonia.



- » The total consideration of the offering is less than €2,500,000 per all the EU/EAA member states in total, calculated in a one-year period of the offering of the securities (tokens).²⁵⁵

When the ICO qualifies as a public offering of securities, the issuer must comply with the requirements of the prospectus directive transposed to the Estonian law in the Securities Market Act and register the prospectus with the EFSA.²⁵⁶

Issue of e-money is regulated under Estonian law by the Payment Institutions and E-money Institutions Act.

Money regulations

E-money

Issue of e-money is regulated under Estonian law by the Payment Institutions and E-money Institutions Act, which transposes the E-money Directive into Estonian legislation.²⁵⁷ According to the act, *e-money* is monetary value stored on an electronic medium (an e-money device) that expresses a monetary claim against the issuer and is

- » Issued at par value of the amount of the monetary payment received (i.e. the value of the tokens issued in exchange for a payment of €10 has to be equal to €10);
- » Used as a payment instrument to execute payment transactions; and
- » Accepted as a payment instrument by at least one person who is not the issuer of the same e-money.²⁵⁸



Kadriorg Palace by Eestl.pl, 2010, used under CC BY 2.0.

A payment token that can be "spent" as a means of payment would constitute e-money under Estonian law for as long as it is issued at par value and is accepted by at least one other person than the one which has issued the token.

The notion of payment transaction under Estonian law is enshrined in the Law of Obligations Act, which provides that "a payment transaction is an act initiated by the payer or on the payer's behalf or by the payee of placing, transferring or withdrawing funds, irrespective of any legal relationship between the payer and the payee constituting the basis thereof."²⁵⁹

Therefore, a payment token that can be "spent" as a means of payment in a payment transaction (e.g., to pay for a service) would constitute e-money under Estonian law for as long as it is issued at par value and is accepted by at least one other person than the one which has issued the token. Conversely, tokens that are used to pay for goods or services do not qualify as e-money if they are not issued at par value or if they are only accepted as a payment instrument by their issuer.

The most significant consequence of a token qualifying as e-money is that the issuer must comply with an authorization. Under Estonian law, e-money may be issued by

- » E-money institutions authorized under the Payment Institutions and E-money Institutions Act
- » Credit institutions as defined by the Credit Institutions Act (i.e., banks)
- » The European Central Bank and central banks of EU/EAA member states when not performing their duties as monetary authorities or other state agencies
- » EU/EAA member states or their regional or local governments when performing their duties.²⁶⁰

Tokens that qualify as e-money may be distributed or redeemed by either the e-money issuer or a person acting on behalf of the e-money issuer (an agent or a distributor). Upon use of such a distributor, the issuer has to notify the EFSA and comply with the specific due diligence requirements set out in the Payment Institutions and E-money Institutions Act and in the Money Laundering and Terrorist Financing Prevention Act including KYC requirements.

Tokens that qualify as e-money may be distributed or redeemed by either the e-money issuer or a person acting on behalf of the e-money issuer.

Virtual currencies

Enacted on 27 November 2017, the revised Money Laundering and Terrorist Financing Prevention Act defines virtual currencies as

A value represented in the digital form, which is digitally transferable, preservable, or tradable and which natural persons or legal persons accept as a payment instrument, but that is not the legal tender of any country or funds for the purposes of Article 4(25) of [Payment Services Directive (PSD2)] or a payment transaction for the purposes of points (k) and (l) of Article 3 of the same Directive.²⁶¹



Article 4(25) of PSD2 defines funds as banknotes and coins, scriptural money, or electronic money as defined in of Article 2(2) of Directive 2009/110/EC (E-money Directive), whereas Article 3(k)(I) defines payment instruments and transaction as:

- » *Services based on specific payment instruments that can be used only in a limited way, that meet one of the following conditions:*
 - › *Instruments allowing the holder to acquire goods or services only in the premises of the issuer or within a limited network of service providers under direct commercial agreement with a professional issuer;*
 - › *Instruments which can be used only to acquire a very limited range of goods or services;*
 - › *Instruments valid only in a single member state provided at the request of an undertaking or a public sector entity and regulated by a national or regional public authority for specific social or tax purposes to acquire specific goods or services from suppliers having a commercial agreement with the issuer.*
- » *Payment transactions by a provider of electronic communications networks or services provided in addition to electronic communications services for a subscriber to the network or service:*
 - › *For purchase of digital content and voice-based services, regardless of the device used for the purchase or consumption of the digital content and charged to the related bill; or*
 - › *Performed from or via an electronic device and charged to the related bill within the framework of a charitable activity or for the purchase of tickets.²⁶²*

Tokens, which are accepted as a payment instrument but qualify neither as e-money under the Payment Institutions and E-money Institutions Act nor as funds or payment instruments or transactions under PSD2, may qualify as “virtual currencies” under the Money Laundering and Terrorist Financing Prevention Act.²⁶³ The main consequences of such qualification are:

- » They must be authorized by the Financial Intelligence Unit (FIU), an independent structural unit of the Estonian Police and Border Guard Board, which is charged with the supervision of the entities subject to Money Laundering and Terrorist Financing Prevention Act²⁶⁴
- » The issuer must comply with the due diligence requirements as set out in the Money Laundering and Terrorist Financing Prevention Act (including KYC requirements).

Tokens may qualify as “virtual currencies” under the Money Laundering and Terrorist Financing Prevention Act in Estonia.



Although qualification as a “virtual currency” under Estonian law is obvious with respect to payment tokens such as bitcoin, other tokens that are used as payment instruments are not explicitly excluded. EFSA has voiced concerns about this, which suggests the importance of conducting a case-by-case assessment when organizing an ICO or purchasing tokens.²⁶⁵

Although qualification as a “virtual currency” under Estonian law is obvious with respect to payment tokens such as bitcoin, other tokens that are used as payment instruments are not explicitly excluded.

Payment services

The regulation of payment service providers may apply to token issuers in the context of operations with fiat currencies. The Payment Institutions and E-money Institutions Act provides a list of payment services that may be subject to regulation such as executing payment transactions and transferring funds to a payment account opened with a payment service provider.²⁶⁶

Insofar as token issuers offer payment accounts to token holders with the possibility of conducting payment transactions, the issuers may need to comply with the authorization requirements for payment institutions.²⁶⁷

Credit institution authorization

Token offerings that qualify as public offerings and are aimed at raising funds with the purpose of lending are reserved to authorized credit institutions (i.e., banks). In accordance with the EFSA notice of September 2015, all undertakings that use funds obtained from the public (via public offerings or any other kind of debt issue) to grant loans as a part of their business and commercial activities shall be authorized as credit institutions.²⁶⁸ Credit institutions receive authorization by meeting the conditions specified in the Credit Institutions Act.²⁶⁹ With respect to ICOs, the EFSA has reiterated this position and will consider tokens case by case as entities plan their ICOs.

Consumer protection

The Consumer Protection Act enshrines general consumer rights and regulates traders’ offering, sale, and marketing of goods or services to consumers. The act organizes and supervises consumer protection, determines liability for violations of the act, and outlines the procedure for alternative dispute resolution between consumers and traders, such as through the Consumer Disputes Committee.²⁷⁰

Specific rights and obligations, applicable depending on the type of token issued in an ICO, include the obligation to disclose information as laid down in Securities Market Act as well as the provisions of the Law of Obligation Act, which regulates the provision of information and fees related to the payment service contracts.²⁷¹

The Consumer Protection Act enshrines general consumer rights and regulates traders’ offering, sale, and marketing of goods or services to consumers.

Regulatory statements

In a statement, the EFSA has emphasized that tokens issued in an ICO, depending on their structure, might be considered securities



according to the definition set forth in the current Securities Market Act and Law of Obligations Act. Moreover, the EFSA stressed that in assessing whether securities laws apply to an ICO, entities should consider substance over form.²⁷²

Furthermore, the EFSA published statements adhering to the EU regulators' concerns about investors' lack of awareness of the high risks associated with investing in ICOs and the potential violation of applicable EU legislation by firms involved in ICOs.²⁷³

Decisions

Polybius: EFSA

The EFSA issued a notice indicating that Polybius Foundation holds no license to provide investment services, banking services, e-money services, or payment services, and therefore Polybius Foundation OÜ is not authorized to provide investment, banking, or payment services in Estonia. Polybius has not registered any public offer prospectus regarding the token offering conducted through its Web page.²⁷⁴

The EFSA published statements adhering to the EU regulators' concerns about investors' lack of awareness of the high risks associated with investing in ICOs.

Estonian Supreme Court on virtual currencies

Estonian Supreme Court (*Riigikohus*) has discussed trade in virtual currencies (namely bitcoins) in its 11 April 2016 decision.²⁷⁵ The court found that trading in virtual currencies amounts to trading in an alternative means of payment as defined by the Money Laundering and Terrorist Financing Prevention Act—a qualification replaced by the notion of “virtual currency” under the revised Money Laundering and Terrorist Financing Prevention Act, in which trading in virtual currencies amounts to a financial service subject to the act's authorization and the due diligence requirements (including KYC requirements).²⁷⁶

Examples of ICOs

Estcoin ICO: as yet unimplemented, Estcoin is a proposed e-Residency program (a network of the so-called e-residents having remote access to the online public services provided by Estonian government) run by the Estonian government that encompasses the creation of cryptotokens (coins) managed by the Republic of Estonia, but accessed by anyone in the world through its e-Residency program and launched through an ICO.²⁷⁷ Others include:

- » Robot Vera ICO²⁷⁸
- » Agrello (Delta token ICO)²⁷⁹
- » Mothership (MSP ICO)²⁸⁰
- » Polybius ICO²⁸¹



Critical thoughts and comparative analysis

Known as an innovation hub, Estonia has attracted numerous blockchain-based projects and ICOs. In line with its approach to innovation, the Estonian Financial Supervision Authority has expressed interest in the new developments and readiness to engage in the dialogue with market players—both issuers and investors.

The Estcoin initiative, if implemented, could result in creating a new standard for a “trusted ICO”.

Despite the EFSA’s openness, the regulatory framework has yet to embrace ICOs. While there have been some indications of the potential applicability of the existing rules to the new phenomenon of ICO and tokens in general, specific legislative initiatives are not expected. Insofar as Estonian legislation that may apply to different types of ICO (notably laws concerning securities, e-money, payments, and money laundering) is largely based on EU secondary legislation, ad hoc national laws will not likely be introduced to facilitate ICOs in the absence of an EU initiative or a wider European consensus. However, the Estcoin initiative, if implemented, could result in creating a new standard for a “trusted ICO” that could improve legal certainty and help establish a comprehensive regulatory framework for token offerings.

Figure 10: Polybius PLBT token price and trading volume

Etherscan.io found 24,379 PLBT token holders as of 8 April 2018.



Source: CoinMarketCap.com, Polybius chart, 6 July 2017–8 April 2018.



Germany

Dr. Marcus C. Funke, Axel Schiemann, Frank Bierwirth, and Max von Cube

The first German ICO took place in October 2017 with a volume of €25 million.

In Germany, companies active in the technology and digitization sectors, particularly start-ups lacking access to more traditional capital markets, are looking for financing through ICOs. The first German ICO took place in October 2017 with a volume of €25 million. The German Financial Services Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin) generally takes an approach to innovative products and services characterized as “technology-neutral”—that is, the existing regulatory framework applies without differentiating among technologies used for the creation, issuance, or offering of a particular product.

To that extent, BaFin has issued several regulatory statements to provide guidance to issuers and market participants. In one statement, BaFin classifies bitcoin and similar virtual currencies as financial instruments under the German Banking Act (*Kreditwesengesetz* or KWG). In addition to recent warnings to consumers on participation in ICOs, BaFin published guidance on the regulatory classification of ICOs. It stated that tokens may constitute financial instruments for purposes of the KWG and the German Securities Trading Act (*Wertpapierhandelsgesetz* or WpHG) and that, depending on the content and structure of the specific token, prospectus requirements as well as regulations of investment funds, insurance, and payment services may apply. This country section focuses on prospectus requirements, investment fund regulation, e-money regulation, AML regulation, and licensing requirements under the KWG.

Regulatory framework

Prospectus laws

Securities

The key criterion for a security in Germany is that it must be an instrument tradable on the capital market.

In Germany, the offering of securities to the public triggers the requirement to publish a prospectus under the German Securities Prospectus Act (*Wertpapierprospektgesetz* or WpPG) unless an exemption applies. The WpPG is the statute implementing the European Prospectus Directive into German law.²⁸²

An offering of digital tokens in Germany would be subject to prospectus requirements under the WpPG if the relevant digital token qualified as a security as defined by WpPG.²⁸³ The key criterion for a security is that it must be an instrument tradable on the capital market.

By its nature, a digital token is a dematerialized instrument, that is, an instrument that has no physical record or certificate. In general



Therefore, if digital tokens are instruments governed by German law, they will not qualify as a security.

terms, dematerialized instruments may constitute securities for purposes of the WpPG. However, the starting point for determining whether a dematerialized instrument constitutes a tradable security may be different, depending on the governing law of the token. Dematerialized instruments that have not traditionally qualified as securities under German law may still not qualify (except for German treasury bonds, which may be issued in dematerialized form). Therefore, if digital tokens are instruments governed by German law, they will not qualify as a security.

However, in its statement on ICOs, BaFin indicated that tokens could be securities under the WpPG, even though they were dematerialized instruments. It is debatable whether, under the WpPG, issuers of such instruments must prepare a physical prospectus. BaFin also stated that token exchanges may, in principle, qualify as capital markets. Therefore, tokens that “represent shareholder rights or contractual (schuldrechtliche) claims or similar rights or claims” may constitute securities under the WpPG and thus trigger a prospectus requirement under the WpPG.²⁸⁴

Some argue that the rights represented by a particular token must be comparable to those of traditional share or bond type instruments (i.e., they must relate to membership or financial rights). However, in its statement, BaFin did not promulgate such a restriction. Therefore, in certain cases, not only so-called “security tokens” but also so-called “utility tokens” will be regarded as securities, if they have characteristics of an investment and thus trigger a need for consumer and market protection, as is the case for traditional securities. In any event, considerable legal uncertainty remains. If the issuer has prepared a prospectus for the offering of a digital token, and if a competent authority has approved such a prospectus and notified the BaFin under the so-called “European passport” regime of the prospectus directive, then BaFin arguably must recognize such notification.

If a digital token in the form of a securities token is to be classified as a security for purposes of the WpPG, then its issuer may not offer it to the public in Germany unless the issuer has obtained the BaFin’s prior approval for a prospectus, or another competent authority has approved its prospectus, notified the BaFin under the prospectus directive, and such prospectus has been published, or an exemption applies.

Exemptions from the prospectus requirement under the WpPG are the same as under the prospectus directive, such as

- » Offerings only to qualified investors
- » Fewer than 150 (non-qualified) investors per EEA jurisdiction
- » Offerings requiring a minimum investment of €100,000
- » Offerings where the total sales price of all securities offered in the EEA does not exceed €100,000, calculated over 12 months.



The German Assets Investment Act regulates the prospectus requirements for public offerings of certain investment instruments that are not securities.

Member states may exempt offerings of securities from the application of the prospectus regime if the total sales price of all securities offered in the EEA, calculated for a period of 12 months, does not exceed €5 million. However, the German legislature has made use of this exemption in a rather restrictive fashion. Under the WpPG, this exemption is available only for securities issued by banks and companies whose securities are listed on a regulated market. In other EEA jurisdictions, this exemption may be available to all issuers of digital tokens.

Other investment instruments

The German Assets Investment Act (*Vermögensanlagegesetz* or *VermAnlG*) regulates the prospectus requirements for public offerings of certain investment instruments (*Vermögensanlagen*) that are not securities.

A prospectus requirement under the *VermAnlG* is triggered if the relevant investment instrument offered to the public falls within one of seven product categories, unless an exemption from the prospectus requirement applies. For such investment products and any related prospectus approved by BaFin, the European passport feature under the Prospectus Directive would not be available—that is, issuers would need to check whether, for each individual EEA member state, the offering triggers any prospectus requirements and, if so, what these requirements are.

Relevant instruments

The statutory list of product categories that are subject to a prospectus requirement under the *VermAnlG* if offered to the public includes the following instruments:

- » Shares/units that grant a participation in the result of a company



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Whether a digital token qualifies as one of these investment instruments depends on its terms and the rights granted under the token.

- » Shares/units that grant participation rights in trust assets (*Treuhandvermögen*)
- » Profit-participating loans (*partiarische Darlehen*)
- » Participation rights (*Genussrechte*)
- » Subordinated loans (*Nachrangdarlehen*)
- » Notes in registered form that are transferable by way of assignment (*Namensschuldverschreibungen*)
- » Other investment products that bear interest and are repayable or that provide for a cash compensation in exchange for making money available on a temporary basis (*Anlageinstrumente*).²⁸⁵

Whether a digital token qualifies as one of these investment instruments depends on its terms and the rights granted under the token; thus, an individual analysis of each relevant token is required. In our experience, digital tokens referred to as security tokens (and that do not qualify as a tradable security under their governing law) may frequently fall within one of these instrument categories.

By contrast, a so-called utility token that merely grants a right to receive certain services or goods (or an expectation to receive such services or goods) would typically fall outside the scope of the prospectus requirements under the VermAnIG (but may constitute a financial instrument for purposes of the German Banking Act, which regulates licensable banking activities and financial services).

However, under the VermAnIG, some degree of legal uncertainty remains. In particular, there is no unambiguous definition of participation rights (*Genussrechte*), which could include non-financial rights, such as rights to goods or services.

Exemptions from prospectus requirements

Section 2 of VermAnIG provides for various exemptions from the prospectus requirement, including, in particular, an exemption for

- » Offerings limited to professional investors
- » Offerings with a total sales price limited to €100,000, calculated over a period of 12 months
- » Offerings that provide for a minimum investment per investor of €200,000
- » Offerings limited to 20 units
- » Offerings that target only a restricted number of persons among others.

A so-called utility token that merely grants a right to receive certain services or goods would typically fall outside the scope of the prospectus requirements.



Furthermore, the prospectus requirements do not apply under the so-called "crowdfunding exemption" if

- » The total purchase price of all relevant investment instruments issued by the same issuer does not exceed €2.5 million and
- » The relevant investment instrument is sold through a regulated Internet services platform that checks as a matter of law that the investment by any single investor does not exceed
 - › €1,000
 - › €10,000 (if the total assets of such investor amounts to at least €100,000)
 - › 200 percent of the average monthly income of such investor, subject to a maximum investment amount of €10,000.²⁸⁶

This exemption is available only for the following, more debt-type investment instruments: profit-participating loans, subordinated loans, and other investment instruments. By contrast, more equity-type instruments, such as profit-participation rights or shares/units that grant a participation in the profits of a company, may not benefit from this crowdfunding exemption.

Like any other instrument, digital tokens may be subject to the regulatory requirements of the German Capital Investment Code.

Investment funds

Like any other instrument, digital tokens may be subject to the regulatory requirements of the German Capital Investment Code (*Kapitalanlagegesetzbuch*, or KAGB) if

- » There is a joint investment by at least two investors
- » Those investors contribute capital according to a specified investment strategy
- » The relevant issuer is an operating company outside of the financial sector

Whether a token meets these criteria for an investment fund depends on the terms and the structure of the individual token. For instance, if digital real estate tokens are to be issued and the proceeds are to be invested in one or more existing real estate assets, then a potential qualification as investment fund may be considered.

If the token is characterized as an investment fund, then the regulatory requirements set out in the KAGB for establishing a German fund or for the distribution of a foreign fund to German investors would apply.



Regulatory consequences

If a prospectus has not been published, or not properly or not fully been published, or if an investment fund has been distributed without complying with the provisions of the KAGB, the following regulatory consequence may apply:

Securities prospectuses

If a securities prospectus has not been published as required under the WpPG, then BaFin may impose a fine of up to €500,000. Furthermore, BaFin may take administrative measures such as enjoining the offering. In addition, the issuer and the offerer of the securities would be subject to a specific prospectus liability regime (in addition to any general contractual or tort liability) regarding investors.

In particular, investors are entitled to return the securities against repayment of the purchase price and reimbursement of its costs associated with the acquisition of the securities within six weeks following the first public offering of the securities. If the investor sold the securities, then the investor may alternatively claim the difference between the purchase price and the price at which the investor sold the securities, plus all costs associated with the acquisition and the sale of the securities.

If the issuer has its seat outside Germany and if the securities were offered outside Germany, then the specific prospectus liability would apply only if the purchase of the securities was concluded in Germany or if the investor acquired the securities on the basis of financial services performed in Germany.

Prospectuses for investment instruments

If a prospectus had to be published pursuant to the VermAnlG, and if such prospectus has not (or not properly or not fully) been published, BaFin may impose a fine of up to €500,000 and take administrative action such as enjoining the offering. In addition, the issuer and the offerer of the investment instruments would be subject to specific prospectus liability regarding investors, which in substance is the same as the securities prospectus liability, except that the period during which the investor may return the investment instruments against repayment of the purchase price is two years.

Investment fund

BaFin may take a broad range of regulatory measures, depending on whether the token is deemed to be a German fund or a foreign fund distributed to German investors, and depending on the relevant circumstances. Generally, BaFin may take administrative measures against the distribution of the investment fund and impose fines if the relevant investment fund may not be distributed to investors in Germany. Furthermore, if the business of an asset manager is operated without the necessary license or without prior registration, this may be sanctioned by imprisonment of up to five years or by a fine.

If a securities prospectus has not been published as required, then BaFin may impose a fine of up to €500,000.



Money regulations

Electronic money

Under German law, a token allowing users to make payments as a means of exchange to obtain goods and services among other things may be regulated as electronic money.

In the area of e-gaming and virtual sports, tokens have surfaced that are issued by a centralized counterparty to enable platform users to purchase digital goods and services on the issuer's platform, either from the issuer itself or third-party participants on the platform. Under German law, a token allowing users to make payments as a means of exchange to obtain goods and services among other things may be regulated as electronic money.

Electronic money means electronically stored monetary value represented by a claim on the issuer that is issued against receipt of funds for making payment transactions and is accepted by a natural or legal person other than the issuer.

The issuance of electronic money requires a license from the BaFin, which will grant the license only if the issuer meets certain prudential requirements relating to capitalization, risk management, and reliability and competence of its senior management. In addition, the issuer must comply with AML/CFT obligations. At any time, the holder may request that the issuer convert the electronic money back into fiat currency.

In practice, electronic money regulations often do not apply because the tokens do not represent a claim against the issuer, but serve only as a means of trading. In addition, in many cases, the issuers can avail themselves of certain exemptions, especially if token holders can use them only to acquire a limited range of goods or services.

Issuing electronic money without the necessary license is a criminal offense and may result in significant fines. In addition, BaFin may take administrative action such as imposing an administrative order on the issuer to wind down the electronic money business. Investors may also have claims for damages against the issuer and involved individuals.

Payment services regulations

Issuing electronic money without the necessary license is a criminal offense and may result in significant fines.

Third parties involved in transferring fiat currency between parties (e.g., as agents in token issuance or on cryptocurrency exchanges) may be subject to the licensing requirements of the German Payment Services Supervisory Act (ZAG). In this context, BaFin generally applies a wide interpretation of which types of activities constitute payment services.

Anti-money laundering regulations

German AML regulations primarily apply to regulated businesses, such as banks, investment firms, payment service providers, investment fund managers, and e-money issuers. In the context of ICOs, the AML obligations generally apply only if a regulated service provider (e.g., a licensed investment firm as placement agent) is involved in the ICO or if the issuer itself is a regulated business (e.g., an e-money issuer or a payment services provider).



Issuers in an ICO will face considerable difficulties when opening a bank account to pay in proceeds from an ICO conducted without performing due diligence on the respective investors.

Based on a broad interpretation of German AML provisions, issuers of so-called currency tokens could be subject to limited AML requirements as “commodity dealers.”

From a practical point of view, issuers in an ICO will face considerable difficulties when opening a bank account to pay in proceeds (converted into fiat currency) from an ICO conducted without performing due diligence on the respective investors.

AML obligations entail certain requirements to carry out due diligence on customers, certain systems, controls, and record-keeping requirements as well as obligations to report suspicious activity and to cooperate with any investigations by relevant authorities.

The European Union is in the process of adopting an amended AML directive (MLD5), which, among other things, brings virtual currency exchange platforms and custodian wallet providers directly within scope of AML requirements. Member states are expected to implement the directive into national law by the end of 2019.²⁸⁷

Requirements under the German Banking Act

Licensable activities under the KWG

Entities involved in the offering and placement of digital tokens may undertake activities licensable under the KWG. Such a license requirement may also apply to entities outside Germany, if the licensable activity is directed at the German market. If the token offering in substance means that money is accepted from the public and is to be repaid to investors, then this activity may constitute licensable deposit-taking business. Furthermore, if the token is a financial instrument as defined in the KWG, relevant licensable activities of an entity distributing such tokens may include the placement of financial instruments (*Platzierungsgeschäft*), brokerage activities where the relevant entity acts an agent/intermediary (*Anlage- oder Abschlussvermittlung*), or as principal for the account of the client (*Kommissionsgeschäft*). In certain circumstances, if there is secondary trading and market-making, then licensable financial services in the form of proprietary trading for third parties (*Eigenhandel für andere*) may be performed.

In many cases, security tokens would constitute financial instruments under the KWG.

Digital tokens as financial instruments

These activities would be licensable under the KWG if they relate to financial instruments. Financial instruments for purposes of the KWG include securities, investment instruments, and investment fund units. This means that, in many cases, security tokens would constitute financial instruments under the KWG.

Furthermore, BaFin has issued a statement that bitcoin and other virtual currencies constitute financial instruments in the form of units of account (*Rechnungseinheiten*) within the meaning of the KWG, which are treated in the same way as foreign exchange. As a consequence, digital tokens (including utility tokens used as



cryptocurrency) may qualify as a financial instrument for purposes of the KWG and may therefore trigger a licensing requirement for any person who undertakes any of the licensable activities described above. This includes cryptocurrency tokens used as a virtual currency functioning as a private currency or otherwise used as a replacement of fiat currency in multilateral settlement circles.

While no consumer protection rules apply specifically to digital tokens as such, the general German consumer protection law applicable to the relevant product or financial services does apply.

Regulatory consequences

If individuals conduct a licensable activity without first obtaining a license, then those individuals may be committing a criminal offense and may face a fine or imprisonment of up to five years. In addition, BaFin may take administrative measures enjoining such activities.

Consumer protection

While no consumer protection rules apply specifically to digital tokens as such, the general German consumer protection law applicable to the relevant product or financial services does apply. For instance, if the token is associated with financial services, then certain consumer information requirements may apply. Irrespective of the content of the digital token, the terms set out therein would be subject to the consumer protection rules relating to standard business terms—that is, terms that are not individually negotiated among the parties.

The rules contain rather restrictive requirements as to the clarity and transparency of the terms used in a contract, or other terms and conditions and comprehensive protection against unfair terms. The same rules also apply to contractual terms agreed among companies, although the level of protection of counterparties may be incrementally lower.

Regulatory statements

BaFin issued a regulatory statement that classifies bitcoin and similar virtual currencies as a financial instrument for purposes of the KWG. It also warned consumers of the following risks of investing in ICOs:²⁸⁸

- » Price fluctuation and the risk having no liquid secondary market or no secondary market at all
- » The experimental nature of the technology and business models
- » The difficulty for investors to grasp the technology and the risks of attacks and manipulation
- » Asymmetries of information among the investors and issuers, often relying on a “white paper”
- » The absence of guarantees on personal data
- » Systemic vulnerability to fraud, money laundering, and terrorist financing, and the related risk of law enforcement actions against operators²⁸⁹

The rules contain rather restrictive requirements as to the clarity and transparency of the terms used in a contract.



BaFin then published a related article published in its *BaFin Journal*.²⁹⁰ See the section on the “European Union” above for coverage of the ESMA’s similar warning to consumers regarding participation in ICOs as well as an alert to ICO issuers requiring compliance with applicable laws.²⁹¹

A token sale may be subject to prospectus and licensing requirements as well as trading regulations.

In its statement on the regulatory classification of ICOs, BaFin stressed that tokens are subject to the general financial regulatory rules if they qualify as a regulated financial instrument (i.e., there is no regulatory regime specific to token sales). BaFin noted that, depending on the classification as one of the instruments discussed above, a token sale may be subject to prospectus and licensing requirements as well as trading regulations. Also, third parties involved in transferring fiat currency between parties on cryptocurrency exchanges may be subject to the licensing requirements under ZAG.

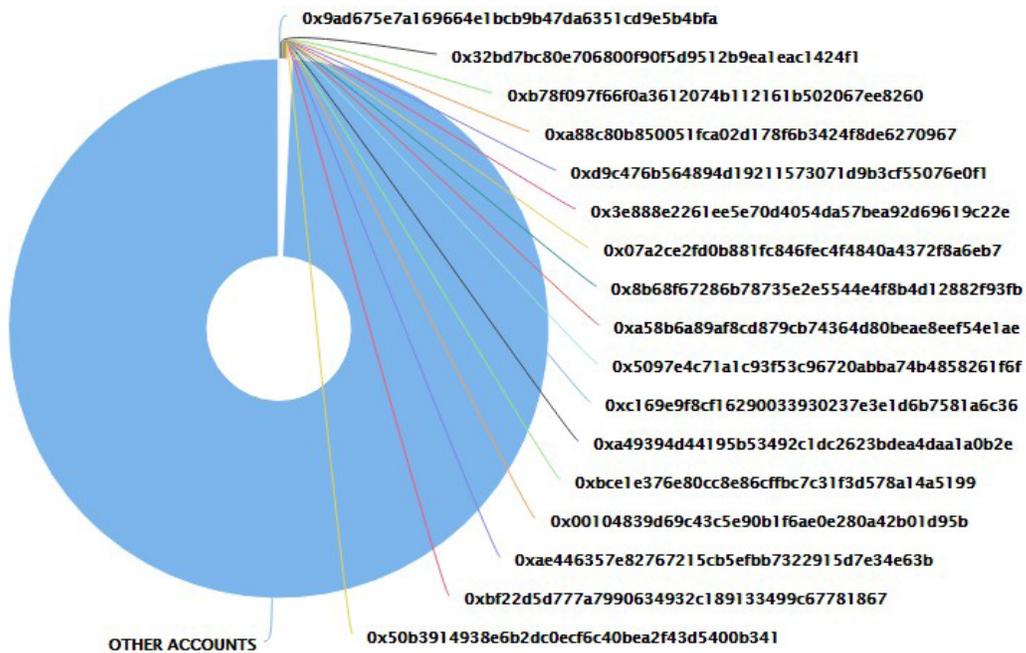
Examples of ICOs

Wysker/WYS

Dubbed Germany’s first ICO, wysker provides a framework for blockchain-based mobile shopping that addresses the problems with e-commerce over the Internet. Its founders believe that consumers should “own, control, and profit from their data,” which they expect to become increasingly valuable. In their view, today’s “digital

Figure 11: Top WYS token holders

Etherscan.io shows 825 holders of wysker’s tokens as of 8 April 2018.



Source: Etherscan.io token tracker, WYS token holders chart, 8 April 2018.



businesses claim all data as their own. . . . Wysker's mission is to change this imbalance and put consumers back in control."²⁹²

As of 15 January 2018, wysker raised more than 2,000 ether in exchange for WYS tokens. The company considers the WYS token "an integral part of the wysker app. It incentivizes early adopters as well as rewards app usage and advertised product views."²⁹³ Users can redeem earned tokens for discounts at select retailers.

Many cryptographic assets such as bitcoin and ether are regulated financial instruments under German law.

According to its founders,

This dynamic is fundamental to wysker's goal of returning control to users. In exchange for their time and attention, consumers receive something with real value and utility, that can be traded freely and will rise in value. That's why 10 percent of the total token supply is reserved to incentivize wysker app usage.²⁹⁴

Critical thoughts and comparative analysis

Compared to other European jurisdictions, German law has an additional type of financial instrument, the so-called "units of account." Therefore, many cryptographic assets such as bitcoin and ether, which are not regulated in other European jurisdictions, are regulated financial instruments under German law.

While these assets fall outside the scope of financial instruments in many of its neighboring countries, Germany's BaFin deems such cryptoassets to be units of account with many regulatory requirements concerning the consequent issuance of and trading in such cryptoassets. This might be why Europe's largest economy, an important financial center, has seen limited amounts of ICO funding flowing into its many crypto start-ups (despite, as some people argue, Berlin's being the undisputed European crypto-hub).

There remains considerable uncertainty around the classification of tokens.

There remains considerable uncertainty around the classification of tokens. For example, BaFin has clarified that bitcoin qualifies as "unit of account," but to what extent do utility tokens used as means of payment on the issuer's platform qualify as units of account? To what extent do tokens qualify as securities? Under German securities laws, dematerialized instruments could be classified as securities tradable on the capital markets only by exception. In contrast, instruments that could be transferred only by assignment (like other contractual rights) were not classified as securities tradable on the capital markets.

Thus, it is debatable whether new dematerialized instruments such as tokens, if issued in Germany and governed by German law, could qualify as securities. However, BaFin has applied a functionally equivalent perspective to token issuances, focusing on whether the relevant tokens are tradable on cryptocurrency trading platforms. This guidance is clear for securities tokens tradable on the capital markets, including token exchanges or trading platforms, but not for utility tokens, where the boundary remains uncertain.



Italy

Francesco Dagnino

To date, no specific laws or regulations in Italy directly address digital token sales.

Since it is a member state of the European Union, Italy's financial regulation framework is subject to EU directives and regulations, including key legislation such as the prospectus regulation, the MiFID II, the AIFM directive, and the AMLD4.

Italy's main financial supervisory authorities are the Bank of Italy, which supervises the sound and prudent management of financial intermediaries, and ensures their financial stability, and the Italian Companies and Exchange Commission (*Commissione Nazionale per le Società e la Borsa* or CONSOB), which is entrusted to protect investors and to ensure that financial intermediaries offer investment products in a fair and transparent manner.

To date, no specific laws or regulations in Italy directly address digital token sales, and neither the Bank of Italy nor CONSOB have issued any statement on them. Yet, pursuant to the principle of technological neutrality of the regulation, token sales may well fall within the scope of the existing legal framework regarding the offer of financial products. Instead, virtual coins have recently been defined and regulated by the Italian AML Code.

Regulatory framework

Securities law

The applicability to ICOs of the provisions set forth by the Italian Consolidated Law on Finance (TUF)—which include most of EU's regulatory framework on securities—must be assessed case by case.²⁹⁵ Regarding the requirements to publish a prospectus, the investigation should verify:

- » The qualification of digital tokens as "financial products," which includes both "financial instruments" (e.g., debentures, units of undertakings for collective investments, derivatives, etc.) and "any other investment having a financial nature" pursuant to TUF²⁹⁶
- » The existence of a communication by the issuer aimed to enhance the purchase or subscription of these financial products and, consequently, at least to represent the main features of the same
- » Whether the offer is directed to investors domiciled in Italy.

Virtual coins have recently been defined and regulated by the Italian AML Code.

If the offer meets all three of these requirements, a token sale should be treated as a public offer of financial products as defined in TUF, resulting in the obligation to publish a prospectus.²⁹⁷



In most cases, the qualification of tokens as financial products will essentially depend on whether tokens fall within the residual category of “any other investment having a financial nature.” According to CONSOB’s consolidated position, the notion of “investment having a financial nature” requires the coexistence of the following conditions:

The qualification of tokens as financial products will depend on whether tokens fall within the residual category of “any other investment having a financial nature.”

- » A capital investment
- » Expectation of a financial return
- » Assumption of a risk directly connected to the capital investment

From a broker perspective, the qualification of the token as a “public offer of financial products” may also result in the application of the provisions of TUF on

- » “Investment services and activities”
- » Collective asset management (in the case of upstream management of resources collected by third parties).



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Monetary laws

Italian AML Code

Virtual coins are defined as "the digital representation of a value, not issued by a Central Bank or Public Authority."

The Italian AML Code has introduced a definition of "virtual coins" and "exchangers" of virtual coins.²⁹⁸ In particular, *virtual coins* are defined as "the digital representation of a value, not issued by a Central Bank or Public Authority, . . . used as an exchange instrument for the purchase of goods and services and transferred, stored and negotiated electronically," while *exchangers* are defined as "persons providing . . . on a professional basis services relating to the use, exchange, and keeping of virtual coins and to their conversion into fiat currencies." Therefore, generally speaking, cryptocurrency exchange platforms shall comply with AML/KYC provisions.

Italian Consolidated Law on Banking (e-money)

Article 1, paragraph 1, letter H of the Italian Consolidated Law on Banking, implementing the E-money Directive, defines electronic money as

electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions . . . and which is accepted by a natural or legal person other than the electronic money issuer.²⁹⁹

However, the Bank of Italy has confirmed that cryptocurrencies do not fall within the scope of e-money regulations.

Italian Law on Payment Services

Payment services are regulated by Italian Legislative Decree no. 11/2010, as amended. Generally speaking, to the extent that cryptocurrencies (and/or tokens with "currency" nature) should not be considered as e-money according to the Bank of Italy position, they should not be subject to the regulatory framework on payments services.

The Bank of Italy has confirmed that cryptocurrencies do not fall within the scope of e-money regulations.

Commodities

In Italy, commodities are mainly considered by TUF in the context of the provisions on "derivatives on commodities." In this respect, there are no elements which appear to be particularly significant for the purposes of this paper, except that it is not possible to exclude that digital tokens may also present typical features of derivatives.

Consumer protection

The Italian Consumer Code contains provisions to protect "consumers" (i.e., any natural person acting for purposes which are outside his trade, business, craft or profession) when dealing



In January 2015, the Bank of Italy released a statement stating that virtual coins are not legal tenders and must not be confused with e-money.

with “professionals,” (i.e., persons who act for purposes relating to their trade, business, craft, or profession, and anyone acting in the name of or on behalf of a trader).³⁰⁰ In this respect, any promotional activity connected to an ICO when carried out between a professional and the generality of consumers must comply with such regulatory framework. In addition, if the token sale is carried out by distance, provisions on distance marketing of consumer financial services will apply if the tokens qualify as financial services (defined by the Italian Consumer Code as every service having a banking, credit, payment, investment, insurance, or social security nature).

Regulatory statements

Bank of Italy warning letter (30 Jan. 2015)

In January 2015, the Bank of Italy released a statement stating that virtual coins are “the digital representation of a value, not issued by a Central Bank or Public Authority, . . . used as an exchange instrument or held for investment, which may be transferred, stored and negotiated electronically,” and that “they are not legal tenders and must not be confused with e-money.”³⁰¹

Bank of Italy also discouraged Italian regulated intermediaries from entering into virtual coin transactions and clarified that virtual coin transactions may give rise to breaches of the applicable financial and banking laws and regulations (including those on licensing requirements).

CONSOB notice (4 Dec. 2017)

On 4 December 2017, CONSOB issued a warning summarizing the ESMA statements regarding investors and firms:

- » The speculative nature of ICOs with not easily perceived risks
- » The volatility of the values of virtual currencies
- » The potential difficulty for investors to redeem them
- » Risks related to the inapplicability of controls put in place by European regulations on financial investments
- » Potential illicit purposes, such as money laundering or fraud
- » The activity of firms may constitute a regulated activity that must be carried out according to regulations on financial investments (the prospectus directive, MiFID II, AIFMD, and AML4D)³⁰²

Bank of Italy discouraged Italian regulated intermediaries from entering into virtual coin transactions.

Decisions

CONSOB resolution no. 20207, Cryp Trade (6 Dec. 2017)

Cryp Trade Capital is a platform for trading and advising services about cryptocurrencies based in Alicante (Spain) and Glasgow (UK).



The platform was offering “cryptocurrencies’ extraction kits,” which involved a certain quantity of cryptocurrencies already included in the kits and a data mining service.

Investors were offered the right to resell the cryptocurrencies to the issuer periodically with a guaranteed profit. CONSOB qualified the offer as falling within the residual category of an “investment having a financial nature,” provided that the following requirements were met: capital investment, expectation of a financial return, and assumption of a risk directly connected to the capital investment. In this case, CONSOB held that the offer was addressed to Italian investors because it was promoted through a website that was also available in Italian language.

The CONSOB considered that Cryp Trade’s activity constituted an offer to the public in the meaning of the legislative decree no. 58 of 24 February 1998 (TUF).³⁰³ The criteria of TUF are:

- » A financial instrument or an investment of financial nature. The latter is constituted when there is use of capital with an expectation of financial return and the assumption of a risk directly connected with the use of capital
- » The existence of a communication aimed at making purchases or subscriptions
- » That this communication is addressed to the public residing in Italy

Consequently, Cryp Trade should have published a prospectus and notified CONSOB. Considering a prior 90-day suspension and the absence of counter-argumentation, the CONSOB prohibited activities of Cryp Trade in Italy, under the ground that, due to the specific conditions of the offer, it qualified as a public offer of “financial products,” requiring the prior publication of a prospectus.³⁰⁴

Italian Competition Authority resolutions: OneCoin

Through resolutions in December 2016 and August 2017, the Italian Competition Authority (*Autorità Garante della Concorrenza e del Mercato*, or “AGCM”)—empowered by the Italian Consumer Protection Code—suspended activities, and subsequently fined companies carrying out activities aimed at promoting the OneCoin cryptocurrency.³⁰⁵ These companies—One Life Network and One Network Services—were promoting, mainly via the Web, tokens to be converted into cryptocurrencies, with consequential expectation of profits for investors.

The AGCM ascertained that such activities constituted, among other things, a pyramid promotional scheme or a Ponzi scheme (i.e., one in which a consumer gives consideration for the opportunity to receive compensation primarily for introducing other consumers into the scheme, rather than from the sale or consumption of products), which is forbidden under the Italian Consumer Code.

The activities constituted a pyramid promotional scheme or a Ponzi scheme which is forbidden under the Italian Consumer Code.



In August 2017, the AGCM fined the two companies a total of €2,595,000 for violation of consumer protection rules because of to their engagement in a Ponzi scheme and misleading promotional methods.³⁰⁶

In August 2017, the AGCM fined the two companies a total of €2,595,000 for violation of consumer protection rules.

Court of Verona decision on bitcoin (24 Jan. 2017)

The Court of Verona stated:

The purchase of cryptocurrencies (i.e., bitcoins)—which should be classified as financial instruments—is a transaction that can be defined as highly risky for the investor, therefore obliging those who advertise the sale, on their own or on behalf of third parties, to inform the user in advance about the risks associated with the investment (so-called pre-contractual information), as established by articles 67 et seq. of the Consumer Code with regard to the distance marketing of consumer financial services; in particular, the promoter of the sales transaction is required to apply the stricter provisions of the sectoral legislation governing the offer of the concerned service or product.³⁰⁷

Italian Inland Revenue resolution (Sept. 2016)

The Italian Inland Revenue Agency (*Agenzia delle Entrate*), through resolution of September 2016, based on a judgment of the EU Court of Justice, stated that operations in cryptocurrencies in exchange for fiat currencies (and vice versa) qualify as “services with consideration” concerning currency, banknotes, and coins used as legal tender, which fall within the exemptions provided for by the Italian Code on VAT (and, conversely, they may be subject to corporate tax).³⁰⁸

However, the Court of Verona and the Italian Inland Revenue Agency have never used the expressions “initial coin offering,” “token sale,” or the like; and the cases they examined did not relate to a traditional sale of tokens issued in the context of an ICO.

Examples of ICOs

We have many examples of ICOs launched by Italian residents or publicized in Italy, but the vast majority of them were launched through foreign incorporated legal entities (e.g., Eidoo or AidCoin).³⁰⁹ CoinCrowd, an ICO incubator platform, launched through an Italian legal entity.³¹⁰

Critical thoughts and comparative analysis

Although there are no specific laws or regulations in Italy directly addressing digital token sales, token sales—pursuant to the principle of technological neutrality of the regulation—may well fall within the scope of the existing legal framework regarding the offer of financial products, resulting in the potential application of provisions



on prospectus, investments services, alternative investment fund managers, and more. However, there may be a high degree of uncertainty on many issues—including, for instance, whether and under which circumstances

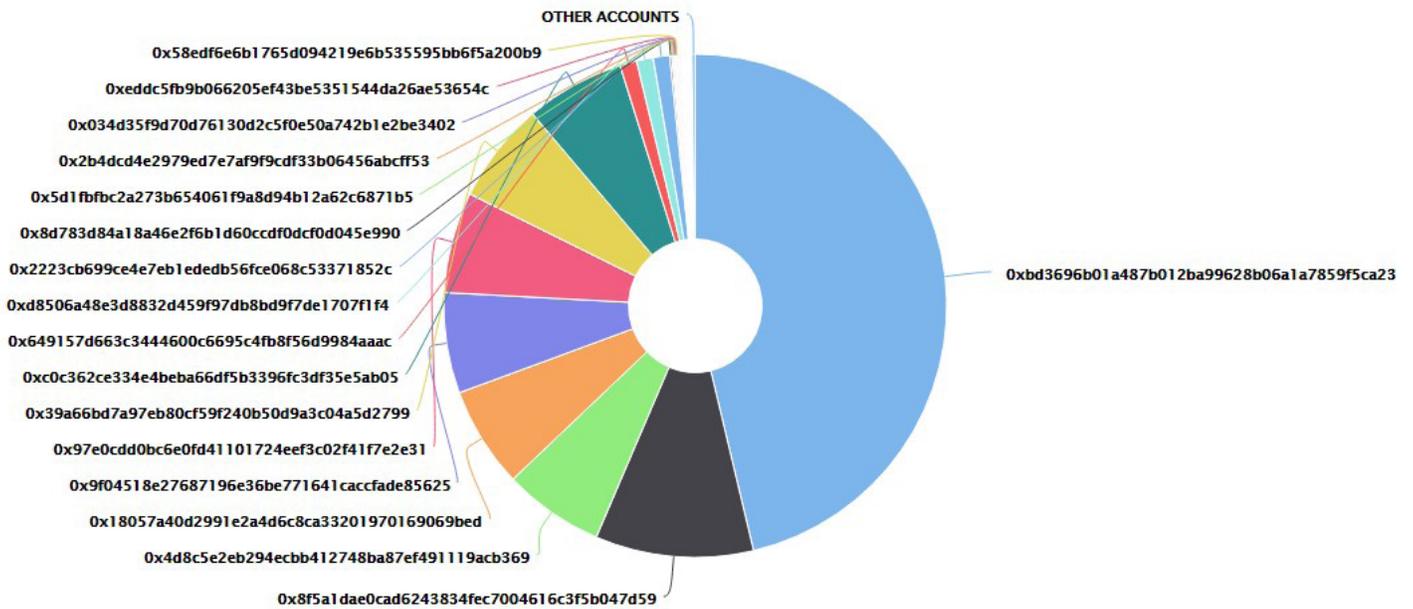
Existing Italian and EU regulations have not successfully captured the ICO phenomenon.

- » Utility tokens qualify as financial products
- » Investment tokens qualify as financial instruments or as financial products
- » Tokens that qualify as financial products are subject to all the provisions on investment services
- » “Reverse solicitation” exemptions apply to token exchange platforms. A statement from CONSOB or Bank of Italy addressing these issues is needed.

Existing Italian and EU regulations have not successfully captured the ICO phenomenon. “Regulation crypto,” introducing ad hoc rules for token sales, is probably necessary to adequately ensure investor protection and to give certainty to the issuers and intermediaries, kicking “cowboys” out of the market.

Figure 12: Top holders of CoinCrowd

Etherscan.io found 32,762 holders of CoinCrowd tokens as of 8 April 2018.



Source: Etherscan.io token tracker, CoinCrowd token holders chart, 8 April 2018.



Switzerland

Benedikt Schuppli and Thomas Müller

Switzerland has become an undisputed hub for ICOs, making up over \$600 million of the total ICO funding of \$3 billion obtained in 2017.

Switzerland has become an undisputed hub for ICOs, making up over \$600 million of the total ICO funding of \$3 billion obtained in 2017.³¹¹ Other sources put the number even higher, up to \$1 billion raised by ICO in Switzerland.³¹² We can ascribe this story of success to many factors, such as Switzerland's role as a global financial center as well as Switzerland's financial market supervisory authority (FINMA).

However, the most prominent reason for Switzerland's ascension as a crypto hub may relate more to the Ethereum Foundation's establishment there in 2014. Ethereum has become a role model for a number of crypto-endeavors in terms of its jurisdiction of choice and its legal structure.

Nevertheless, FINMA has proven its principles-based regulatory approach, its neutrality toward technologies in use, by clearly stating that ICOs are a legitimate way of financing commercial and noncommercial enterprises. Simultaneously, the Swiss regulator clearly communicated that ICOs are potentially subject to several financial market laws. Below is an overview over the Swiss regulatory framework governing token sales, the regulator's statements regarding ICOs, a summary of two ICOs conducted from Switzerland, and our critical thoughts and a comparative analysis.

Regulatory framework

In this overview, we focus on securities law, the law on collective investment schemes, and money regulations (including payment services as part of banking regulations and AML regulations).³¹³

Securities law

Securities

Securities in Switzerland are regulated in a number of acts, including the Federal Act on Securities and Stock Exchanges (SESTA) as well as the corresponding ordinance (SESTO). Furthermore, the Federal Act on Financial Market Infrastructures (FMIA) as well as the corresponding ordinance (FMIO) cover other functions of securities regulations, including the definition of securities, provisions regarding the secondary market, and criminal law provisions concerning insider trading and market abuse in relation to securities.³¹⁴

Under Swiss law, *securities* are defined as standardized certificated and uncertificated securities, derivatives, and intermediated securities that are publicly offered for sale in the same structure and denomination or are placed with more than 20 clients, provided that they have not been created especially for individual counterparties.³¹⁵

In this overview, we focus on securities law, the law on collective investment schemes, and money regulations.



Uncertified or certified securities are based on a common legal basis and issued under identical terms. According to Swiss law, uncertified securities are created with the entry in a physical or an electronic book and continue to exist only in accordance with such an entry. Swiss law does not require a specific form of the book; basically, any natural person or legal entity may create such book and, on this basis, issue uncertified securities.

Any transfer of the uncertified securities need not be registered in the book. However, the law requires written form for such a transfer. Various legal scholars have argued that this formal requirement serves only for documentation. As a consequence, a transfer of uncertified securities on the blockchain would comply with this requirement, because the transfer would be properly recorded on the blockchain. Certified securities are issued by a physical deed. This report will not consider certificated securities.

According to the Federal Act on Intermediated Securities (FISA), intermediated securities are personal and corporate rights of a fungible nature against an issuer that are credited to a securities account and may be disposed of by the account holder in accordance with FISA provisions.³¹⁶

Because the creation of intermediated securities requires the involvement of a regulated financial institution, tokens will hardly ever qualify as intermediated securities.

Intermediated securities are created, among other things, by a custodian that registers the uncertificated securities in its main register and credits the respective rights to one or more securities accounts.³¹⁷

The custodian needs to be a licensed bank, a licensed securities dealer, or a licensed asset manager for collective investment funds. The main register for intermediated securities may exist in electronic, dematerialized form. A distributed ledger may serve as the main register for intermediated securities.³¹⁸ Tokens, which represent equity or debts rights and were initially issued as uncertificated securities, may be represented and transferred on the blockchain, once they have been recorded in the main register of a custodian and subsequently credited to a securities account, thereby becoming intermediated securities.³¹⁹

Because the creation of intermediated securities requires the involvement of a regulated financial institution, tokens will hardly ever qualify as intermediated securities.

Derivatives are the remaining subcategory of securities. Under FMIA, derivatives are defined as financial contracts, the value of which depends on one or more underlying assets, and which are not spot transactions.³²⁰ Underlying assets include—but are not limited to—shares, bonds, commodities, and precious metals as well as reference values such as currencies, interest rates, and indices.³²¹ As a rule, if certain parameters are definable in a flexible manner, then the standardization and suitability will not be sufficient for purposes of mass trading.³²²



Derivatives exist in the form of bilateral contracts or as intermediated or uncertificated securities.³²³ As mentioned, a derivative will be deemed to exist only if it is not a spot transaction.³²⁴ Spot transactions, as outlined in FMIO, are transactions that are settled either immediately or, following expiry of the deferred settlement deadline, within two business days.³²⁵

Collective investment schemes

According to Article 7 of the Collective Investment Schemes Act, collective investment schemes are assets raised from investors for the purpose of collective investment and managed for the account of such investors. To fall within the definition, the investment requirements of the investors must be met on an equal basis.

Financial instruments

Swiss law provides only for the category of "financial instruments" as a regulated category of financial products peripherally, with little or no effect on the current regulatory landscape.

In current law, Swiss law provides only for the category of "financial instruments" as a regulated category of financial products peripherally, with little or no effect on the current regulatory landscape.³²⁶ However, the current law does not provide for a definition of *financial instruments*. The FMIA uses the term in relation to trading facilities only. The Financial Services Act (FinSA), likely to be set into force per 2020, defines financial instruments in accordance with MiFID II Appendix I.³²⁷ According to the draft FinSA, *financial instruments* include equity and debt rights, interests in collective investment schemes, structured products, derivatives, and certain structured deposits.³²⁸ As FinSA will presumably not be enacted until 2020, we will not analyze financial instruments further in this section.



Bundeshaus-253006 by Viola (violetta), 2012, used under CC0 1.0.



ICOs are currently not governed by any specific regulation in Switzerland.

Tokens as securities or collective investment schemes

ICOs are currently not governed by any specific regulation in Switzerland. The issuance of equity and debt rights on the primary market, the trading of securities on the secondary market, and deposit-taking are regulated by existing laws that protect creditors, depositors, and investors, and that ensure the proper functioning of financial markets. Swiss legislation on financial markets is principles-based; one such principle is technology neutrality.³²⁹

On 16 February 2018, FINMA issued comprehensive guidelines regarding the applicability of Swiss financial market laws to token sales. These guidelines did not impose new rules or regulation on ICOs and the qualification of tokens; rather, they confirmed the application of existing rules on ICOs.³³⁰

FINMA identifies three token categories in its guidelines:

- » *Payment tokens* (cryptocurrencies) are tokens “intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer. Cryptocurrencies give rise to no claims on their issuer.”
- » *Utility tokens* are those “intended to provide access digitally to an application or service by means of a blockchain based infrastructure.”
- » *Asset tokens* “represent assets such as a debt or equity claim on the issuer. Asset tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category.”³³¹

These categories reiterate more or less the nomenclature developed by legal scholars and practitioners. Unfortunately, the distinguishing criteria among the three categories remain somewhat vague. The definition of a payment token is very broad; it embraces all use cases where goods and services can be acquired by means of a token and where the debtor is not the issuer.

Utility tokens, on the other hand, are intended to provide access to an application or service. Utility tokens may also be a means of payment in consideration for a service, that is, for the functionality of the application. Hence, according to FINMA’s definition, each utility token used for accessing an application—where the counterparty is not the issuer—may at the same time be a payment token.

Since genuine blockchain-enabled applications are decentralized networks, this double dip will be accomplished in many scenarios. Rather than stating in the guidelines that “cryptocurrencies give rise to no claim on their issuer,” it should read, “the function of



cryptocurrencies is exhausted in their existence as a digital resource; they do not entail any claim on their issuer or another counterparty.”

On the other hand, the definition of an asset token representing a debt or equity claim on the issuer is remarkably clear. Unfortunately, the definition is beefed-up by inclusion of the category of tokens that “enable physical assets to be traded on the blockchain.” This latter category has nothing to do with a claim against the issuer and should not fall within the same category—it is unnecessary.

If a token merely enables a (tokenized) physical asset to be traded on a decentralized market place, it should be qualified as a utility and not as an asset token.

If an asset (e.g., precious metal or any other commodity) is tokenized by an issuer and can be redeemed by a token holder, then the token represents a claim against the issuer (or the holder of the respective assets) and is therefore an asset token. However, if a token merely enables a (tokenized) physical asset to be traded on a decentralized market place, it should be qualified as a utility and not as an asset token.

Consequently, some uncertainty remains regarding the qualification of utility tokens as securities. FINMA states in its guidelines that utility tokens shall “not be treated as securities, provided that their sole purpose is to confer digital access rights to an application or service and that the utility token can actually be used in this way at the point of issue.” If the utility token entailed an investment purpose component, then FINMA would treat such a token as a security.

In our view, FINMA’s approach that a utility token, which “additionally or only has an investment purpose at the point of issue,” will qualify as a security lacks legal basis. FINMA seems inspired by the notion of a security under US securities regulations (i.e., the Howey test), but the financing of a project—with the expectation that the token will gain value once the blockchain network is launched—does not in itself qualify it as a security under Swiss law.

In addition, FINMA’s approach has some awkward consequences on the secondary token market. Strictly applying the guideline, an exchange of utility tokens bearing an investment element in a professional capacity would require a securities dealer license. However, as soon as the utility token became fully functional, it would cease to be a security.

In our view, qualifying all utility tokens as securities would undermine the token categorization of the guidelines.

In most instances, a utility token is issued before the platform has reached full functionality. In many cases, the funds raised in the ICO will go (at least partially) toward development costs of the platform. In our view, qualifying all utility tokens as securities would undermine the token categorization of the guidelines.

Given the above, structuring a utility token may cause the most headaches around the potential application of the Swiss anti-money laundering regulation and securities law. The guidelines lack a criterion of clear demarcation between utility tokens and the other two token categories. An ICO organizer is, despite of the guidelines, left with either complying with both the securities and anti-money laundering regulation or discussing the token with FINMA prior to the ICO.



Finally, in its guidelines, FINMA has confirmed that the regulation on collective investment scheme would be relevant in an ICO, should the funds accepted in the context of the ICO be managed by third parties. This requirement may be triggered in the event the token holders have no right to decide on the investment policies but will receive a participation of the earning of the ICO entity. In the event the ICO entity is not an operational company but an investment vehicle only, the ICO and the rights of the token holders must be structured very carefully, not to be captured by the regulation of the collective investment schemes.

Regulatory consequences

Generally, a Swiss entity collecting funds for a third party while issuing securities triggers a licensing requirement as a securities dealer, acting specifically as an issuing house.³³² This is the case when the activity in question is conducted on a professional basis and the company is primarily active in the financial industry.³³³

A Swiss entity collecting funds for a third party while issuing securities triggers a licensing requirement as a securities dealer, acting specifically as an issuing house.

The same licensing requirement applies to situations where an entity is issuing tokens that qualify as derivatives on a professional basis, and the entity is active primarily in the financial industry. Furthermore, if the assets raised from investors during an ICO are used for the purpose of collective investments, and if such assets are managed for the account of such investors, and if the investors' investment requirements are met on an equal basis, then the provisions of the collective investment scheme legislation need to be considered (see above).

However, collecting funds for one's own account without a platform or issuing house acting as an intermediary (and without issuing derivatives in the fashion described above) is unregulated from a regulatory law perspective in cases where repayment is not obliged, payment instruments have not been issued, and no secondary market is maintained by the issuer or a third party.³³⁴ This is even the case for tokens that qualify as securities under Swiss law.

Apart from licensing requirements, the public issuance of a token that qualifies as either a debt or an equity security requires a prospectus, as does the placement of units in collective investment schemes.³³⁵ Furthermore, the issuance of certain derivatives—structured products—requires a simplified prospectus; and these structured products have to be issued, guaranteed, or secured by a regulated bank or securities dealer if they are not exclusively underwritten by qualified investors.³³⁶ This report does not deal with the scholarly dispute over whether the public issuance of a derivative, which does not qualify as a structured product, requires a prospectus. Generally, it is advisable for issuers of security tokens to draw up a prospectus.³³⁷

Until now, Swiss securities law does not require the filing of a prospectus for debt or equity securities with any governmental or supervisory authority, as is common practice in many other jurisdictions (e.g., the European Prospectus Directive).³³⁸ Such obligation regarding the primary market currently exists only in



regard to the collective investment scheme regulation, in which fund managers must submit the obligatory prospectus to FINMA.³³⁹ As such, the prospectus for equity and debt securities in Switzerland is a matter of private law, rather than regulatory law. Therefore, FINMA does not exert any supervision over debt or equity securities prospectuses.

Nevertheless, these provisions will be subject to change with the enactment of FinSA. Under FinSA, a prospectus will be required to be filed with a FINMA-authorized inspection body for securities that are publicly offered.³⁴⁰

Money regulations

Banking regulations/payment services

Under Swiss law, accepting deposits from the public qualifies as a banking activity that requires a license, unless one of the exemptions in the Banking Ordinance is applicable.³⁴¹

Four important exemptions from the said application of the Swiss Banking Act are noteworthy.

Under Swiss law, accepting deposits from the public qualifies as a banking activity that requires a license, unless one of the exemptions in the Banking Ordinance is applicable.

First, payments from investors based on a prospectus subject to Swiss law do not qualify as deposit under the Swiss Banking Act. Even though the disclosure requirements of a Swiss prospectus are currently rather low, the white papers used in ICOs do generally not cope with the legal requirements for a Swiss prospectus. However, it would take limited effort to amend a white paper in order to meet the prospectus requirements.

Second, payments to a charitable foundation would generally not be deemed as deposit. We believe that Swiss foundations engaging in an ICO do not have a charitable purpose and may therefore not benefit from this exception.

Third, accepting deposits from an unlimited number of third parties below the aggregate value of CHF one million would not trigger banking license requirements (regulatory sandbox).

Fourth, the acceptance of (virtual or fiat) money not exceeding a value of CHF 3,000 by a payment system for future services or goods fall out of scope of the term deposit (provided that no interest is being paid to the investor).³⁴² Even though the last two exceptions may be relied upon in an ICO, they would limit the acceptable ticket sizes and scale. Midsize and large investments would be excluded.³⁴³

FINMA stated that ICOs as a means to collect funds for one's own account in cases where, among others, repayment is not obliged and payment instruments have not been issued, do not fall within the scope of Swiss banking regulation.



In its guidelines, FINMA stated that the issuance of tokens would not generally be associated with claims for repayment on the ICO company, and such tokens would therefore not fall within the definition of a deposit. To this extent, token issuers would not be required to obtain a banking license. If, however, the tokens represent liabilities with debt character (e.g., promises to return capital with a guaranteed return) and the issuance of the tokens is not documented by a prospectus subject to Swiss law, then the funds raised may be treated as deposits and the ICO company would be subject to Swiss banking regulation (unless one of the aforementioned exceptions applied).³⁴⁴

Swiss AML regulations

The Swiss AML/CFT framework primarily consists of the following two separate pieces of legislation: the Anti-Money Laundering Act (AMLA) and the Criminal Code (CC).

The AMLA requires financial intermediaries to comply with the following statutory obligations: general duties of due diligence, including verification of the identity of the customer, establishment of the identity of the beneficial owner, and duty to keep records and to enact organizational measures.³⁴⁵

The Swiss AML/CFT framework primarily consists of the following two separate pieces of legislation: the Anti-Money Laundering Act (AMLA) and the Criminal Code (CC).

A person is subject to Swiss AML provisions if such person qualifies as a financial intermediary as defined in Article 2 of AMLA. Financial intermediaries include banks and securities dealers.³⁴⁶

Furthermore, financial intermediaries are also considered all natural and legal persons who accept, retain, or help transfer assets belonging to others on a professional basis. Examples of such activities include the offering of payment services, the issuance and management of means of payment and trading with money, foreign exchange, raw materials, securities, and precious metals.³⁴⁷

The use of virtual currencies as a means of payment for the acquisition or sale of goods and services does not constitute financial intermediation.

The trading in cryptographic tokens on a professional basis, and the operation of trading platforms where monies or cryptographic tokens from users of the platform are transferred to other users of the platform and the operator acts on a professional basis, fall under the AMLA.³⁴⁸

Regarding the applicability of the AMLA on activities in relation relating to cryptographic tokens, FINMA stated in its guidelines that the issuance of payment tokens would constitute the issuing of a means of payment, provided that the tokens may be transferred from one holder to another holder on a blockchain infrastructure. Anyone who provides payment services or who issues or manages a means of payment is deemed a financial intermediary subject to Swiss AML regulation.³⁴⁹



FINMA confirmed that payment tokens do not qualify as securities under Swiss law.

Regarding the application of the said AML requirements to ICO organizers, the guidelines foresee an important easement. According to FINMA, the ICO organizer would comply with the regulation if it accepted the funds via a third party service provider affiliated with a self-regulating organization (SRO) or subject to FINMA supervision. However, the ICO organizer would not have to affiliate with an SRO or be licensed directly by FINMA itself.

This analysis of FINMA is, albeit welcome, quite a liberal interpretation of the AMLA, which requires all financial intermediaries to affiliate with an SRO or be licensed by FINMA (whereas all other duties may be outsourced to a service provider).

No additional financial market regulation applies to payment tokens. FINMA confirmed that such tokens do not qualify as securities under Swiss law. Therefore, no prospectus requirements apply to the creation and issuance of payment tokens.

In 2015, FINMA confirmed that classical cryptocurrencies such as bitcoin and ether should be deemed virtual currency.³⁵⁰ Virtual currency must be treated like any other currency in regard to AML provisions:

[Accordingly,] the exchange of fiat money, bitcoin, ether into a newly issued token with a value itself in the course of an ICO would be qualified as currency exchange, which is regulated in the AMLO-FINMA. Any Swiss entity offering currency exchange has to comply with the Swiss AML rules in the event such entity is acting on a professional basis. In the course of any ICO, the required threshold to act on professional basis is being reached if the value of the accepted bitcoins or ethers in exchange of the issuance of new tokens exceeds CHF 2 million.³⁵¹

In such event, the Swiss entity issuing new virtual currency tokens has either to join a self-regulatory organization for AML purposes or submit itself to the respective supervision of FINMA. Any investor (whether foreign or Swiss) investing more than an equivalent of CHF 5,000 in the ICO is subject to the required know your customer due diligence of the Swiss entity conducting the offering.³⁵²

According to FINMA, a virtual currency is a digital representation of a value that is tradable on the Internet and takes on the function of money without being considered legal tender.

Others have argued that the issuance of an “intrinsic” token qualifies only as currency exchange if it is an actual virtual currency.³⁵³ According to FINMA, a virtual currency is a digital representation of a value that is tradable on the Internet and takes on the function of money without being considered legal tender. Virtual currencies can be used as a means of payment for goods and services.³⁵⁴ For a token issued during an ICO, usually no secondary market exists yet. Thus, the token is restricted in its tradability. Therefore, such a token potentially does not qualify as virtual currency, and the issuance cannot qualify as a currency exchange. This may even be the case for “intrinsic” tokens or “utility” tokens, provided that they do not qualify as a means of payment.



FINMA emphasizes that the exchange of a cryptocurrency into fiat money or another cryptocurrency would be subject to AML regulation.

Furthermore, at the time when the issued token may be listed on a secondary market and made tradable, the issuer itself may not be involved in creating the secondary market. Rather, independent and separate entities (e.g., crypto exchanges) will maintain and take care of the respective secondary market. That's why being subject to the AMLA via conducting a currency exchange will more likely affect the exchange rather than the original issuer (as long as the token is not being used within an electronic payment system maintained by the issuer, and the issuer is not involved in the creation of the secondary market). However, in light of the applicability of AMLA and the respective ordinances, how FINMA will treat the issuance of such tokens is unclear.

FINMA, on the other hand, emphasizes that the exchange of a cryptocurrency into fiat money or another cryptocurrency would be subject to AML regulation. The same would apply to entities providing token transfer services, if such service providers held the private key (e.g., a custody wallet provider). Intermediaries on the secondary market do not fall under the FMIA and do not require a securities dealer license.

Regulatory statements/Decisions

FINMA ICO guidelines (16 Feb. 2018)

On 16 February 2018, FINMA published its long-awaited guidelines on ICOs. FINMA picked up on some of the considerations made in its previous guidance (04/2017, below) but also make some novel interpretations.

Its main contributions are the introduction of a nomenclature to distinguish among token types, that is, payment tokens, utility tokens, asset tokens, and hybrid forms.

The guidelines marked a change in direction: FINMA took a tougher stance on the treatment of ICOs. FINMA subsumed any token that confers a right to the tokenholder under the definition of an uncertificated security. As uncertificated securities, the issuance and the exchange of the respective tokens come under the purview of FINMA as securities within the meaning of FMIA in connection with FMIO, in case they are issued in a standardized fashion and are suitable for mass-trading. As such, both the primary market issuance by a third party and the secondary market exchange may become regulated activities.³⁵⁵

FINMA recognizes the innovative potential of distributed ledger/ blockchain technology.

FINMA guidance on ICO regulations (29 Sept. 2017)

Background

In FINMA Guidance 04/2017 on the regulatory treatment of ICOs, FINMA recognizes the innovative potential of distributed ledger/ blockchain technology.³⁵⁶ It welcomes and supports all efforts to develop and implement blockchain solutions in the Swiss financial



center. Recently there has been a marked increase in ICOs, either conducted in or offered from Switzerland. ICOs are a digital form of raising funds from the public. They exclusively take place using distributed ledger or blockchain technology. “Token sale” or a “token-generating event” are other terms used.

Under the usual procedure for ICOs, financial backers will transfer a certain amount of cryptocurrency to a blockchain-generated address supplied by those organizing the ICO campaign. In return, financial backers receive blockchain-based coins or other tokens connected with a specific project or company run by the ICO organizers. How ICOs are structured from technical, functional, and business standpoints varies markedly from offering to offering. There is no catch-all definition.

Regulation

ICOs are currently not governed by any specific regulation, either globally or in Switzerland. Equity and debt capital-raising, deposit-taking, and the activities of financial intermediaries are controlled by existing laws that protect creditors, depositors, and investors, and which ensure that financial markets function properly.

Swiss legislation on financial markets is principles-based; one such principle is technology neutrality. Consequently, collecting funds for one’s own account without a platform or issuing house acting as an intermediary is unregulated from a supervisory standpoint in cases where repayment is not obliged, payment instruments have not been issued, and no secondary market exists. However, due to the underlying purpose and specific characteristics of ICOs, various links to current regulatory law may exist depending on the structure of the services provided. This concerns the following areas in particular:

ICOs are currently not governed by any specific regulation, either globally or in Switzerland.

- » Provisions on combating money laundering and terrorist financing: the AMLA applies where the creation of a token by an ICO vendor involves issuing a payment instrument. If this is the case, other supervisory issues may be effective for third parties, especially for professional cryptobrokers or trading platforms that carry out exchange transactions or transfers with tokens (secondary trading with tokens).
- » Banking law provisions: accepting public deposits, in which an obligation toward participants arises for the ICO operator because of the ICO, generally necessitates a banking license.
- » Provisions on securities trading: a licensing requirement to operate as a securities dealer may exist in which the tokens issued qualify as securities (e.g., derivatives).
- » Provisions set out in collective investment schemes legislation: potential links to collective investment schemes legislation may arise where the assets collected as part of the ICO are managed externally.



FINMA has closed down the unauthorized providers of the fake cryptocurrency "E-Coin."

Because of the close proximity in some areas of ICOs and token-generating events with transactions in conventional financial markets, the scope of application of at least one of the financial market laws may encompass certain types of ICOs as well as ICO activities that aim to circumvent those provisions. Given the wide variety in structure of ICO models, FINMA can carry out a conclusive regulatory assessment only in specific cases. Currently, FINMA is assessing several such cases. Where financial market legislation has been breached or circumvented, enforcement proceedings will be initiated.

FINMA does not carry out legal assessments of ICOs beyond the area of financial market legislation (e.g., the Swiss Code of Obligations and/or tax law).

FINMA closes down fake cryptocurrency E-Coin (19 Sept. 2017)

FINMA has closed down the unauthorized providers of the fake cryptocurrency "E-Coin."³⁵⁷ The developers of E-Coin had accepted some million Swiss francs in public deposits without holding the required banking license. FINMA has also launched bankruptcy proceedings against the legal entities involved.

For over a year since 2016, the Quid Pro Quo Association had been issuing so-called E-Coins, a fake cryptocurrency developed by the association itself. Working together with Digital Trading AG and Marcelco Group AG, the association gave interested parties access to an online platform on which E-Coins could be traded and transferred. Via this platform, these three legal entities accepted funds amounting to at least four million Swiss francs from several hundred users and operated virtual accounts for them in both legal tender and E-Coins. This activity is similar to the deposit-taking business of a bank and is illegal unless the company in question holds the relevant financial market license.

FINMA liquidates the companies

FINMA has taken action to protect creditors by launching enforcement proceedings against those involved. In its proceedings, FINMA found that the three legal entities had seriously breached supervisory law by failing to obtain the required authorization. As is usual in serious cases of unauthorized activity, FINMA has liquidated the association and the two companies. Since the three legal entities are insolvent, FINMA has also launched bankruptcy liquidation proceedings against them. FINMA has been able to seize and block assets to the value of approximately two million Swiss francs. The final amount of liquidation proceeds will not be known until bankruptcy liquidation proceedings have been concluded and all relevant liabilities have been identified.

FINMA found that the three legal entities had seriously breached supervisory law by failing to obtain the required authorization.

Not an actual cryptocurrency

Unlike real cryptocurrencies, which are stored on distributed networks and use blockchain technology, E-Coins were completely



under the providers' control and stored locally on their servers. The providers had suggested that E-Coins would be 80 percent backed by tangible assets, but the actual percentage was significantly lower. Moreover, substantial tranches of E-Coins were issued without sufficient asset backing, leading to a progressive dilution of the E-Coin system to the detriment of investors.

FINMA welcomes innovation, but when innovative business models are misused for unauthorized activities, FINMA intervenes.

FINMA warning about unscrupulous cryptocurrency providers

FINMA welcomes innovation, but when innovative business models are misused for unauthorized activities, FINMA intervenes. FINMA has evidence of attempts by unauthorized parties to persuade former E-Coin users to invest in two new, presumably fake, cryptocurrencies. FINMA has also placed the following companies on its warning list due to suspicious activity in the same field:

- » Suisse Finance GmbH in Liquidation
- » Euro Solution GmbH
- » Animax United LP

In addition, FINMA is conducting 11 investigations into other presumably unauthorized business models relating to such coins. As with any other investment opportunity, market participants should carefully weigh up the risks before they invest in instruments of this kind. FINMA publishes advice on its website suggesting ways in which market participants can protect themselves.

Examples of ICOs

Ethereum Foundation/ether

The Ethereum blockchain and the eponymous cryptoasset ether (which is proprietary to the Ethereum blockchain) barely needs an introduction: it is consistently ranked as the second or third cryptoasset after bitcoin, with a staggering market capitalization of \$126 billion.³⁵⁸ Ethereum is a decentralized platform on which smart contracts can be written and deployed to execute decentralized applications.

The Ethereum blockchain has become the unrivaled underlying network on top of which cryptographic tokens are issued.

In summer of 2014, the Switzerland-based Ethereum Foundation conducted a token sale in which approximately \$18.4 million was raised in exchange for 60 million ether.³⁵⁹

Ever since, the Ethereum blockchain has become the unrivaled underlying network on top of which cryptographic tokens are issued. Among tokens that were not issued as part of their own proprietary blockchain but on top of an existing blockchain, 18 of the top 20 by market capitalization were issued on the Ethereum blockchain.³⁶⁰

Under Swiss law, ether neither represents a participation and a claim in or against the issuer, nor does it derive its value from an underlying base value. Ether is a value in itself. Ether can therefore



also not take the form of uncertificated or intermediated securities. As such, ether is not a security and the trading in ether is not subject to regulation except for AML provisions and the Banking Act, in cases which deposits from the public are taken and no exemption can be relied upon.³⁶¹

Tezos Foundation/Tezzies (XTZ)

In July 2017, the Tezos Foundation conducted an ICO selling 607 million Tezzies (XTZ) in exchange for \$232 million worth of cryptographic assets, mainly ether and bitcoin.

Tezos is a blockchain-based, Dapps platform project. Within the Tezos blockchain, formal verification of smart contracts shall be facilitated. Furthermore, an on-chain governance mechanism shall be implemented.

Arthur and Kathleen Breitman cofounded Dynamic Ledger Solutions in 2015 to support the development and promotion of the platform, owning all the intellectual property of the project. To launch an ICO and handle the funds, they established a Swiss foundation known as the Tezos Foundation.

In July 2017, the Tezos Foundation conducted an ICO selling 607 million Tezzies (XTZ) in exchange for \$232 million worth of cryptographic assets, mainly ether and bitcoin. Tezzies gave various rights to participate in the upcoming Tezos network. XTZ's value would derive from the usefulness of the network—that is, the demand to use the network based on scarcity of access to the network.³⁶²

XTZ is a value in itself. XTZ neither represents a participation and a claim in or against the issuer, nor does it derive its value from an

Figure 13: Ether (ETH) token price and trading volume



Source: CoinMarketCap.com, Ethereum (ETH) chart, 5 Aug. 2015–8 April 2018.



underlying base value. XTZ can therefore also not take the form of uncertificated or intermediated securities. As such, XTZ is not a security and trading in XTZ is not subject to regulation except for AML provisions and the Banking Act, in cases which deposits from the public are taken and no exemption as described hereinabove can be relied upon.³⁶³

Switzerland's Crypto Valley has been a leading force in making Switzerland a global hub for token sales.

Critical thoughts and comparative analysis

Switzerland's Crypto Valley, a loosely organized cluster of blockchain start-ups, law firms, and government initiatives sprawled around the city of Zug, connected but not congruent with the eponymous Crypto Valley Association, has been a leading force in making Switzerland a global hub for token sales.

The Zug model, which includes setting up a Swiss foundation to distribute and issue the tokens while using the raised funds to ensure a proper development of the blockchain platforms or applications, has become the go-to model for many token sales conducted in Switzerland. Credit must certainly be given to the Ethereum Foundation established in Zug, which attracted a number of start-ups and companies already active in the development of distributed ledger technologies and helped Switzerland to become a crypto hub.

The foundation model chosen for the Ethereum blockchain ensures stable governance of the structure. But it neither provides nor benefits from the tax treatment of the fundraising by an ICO nor results in any regulatory easement. Payments from token holders to the issuing foundation or company is generally treated as income for accounting purposes at the level of the ICO promoter. This treatment would trigger corporate income taxes because Swiss tax law generally follows accounting law.

The company should, however, be allowed to record provisions in the same amount as the received funds, neutralizing the income from issuing the tokens. We see at least two conceivable justifications for such provisions. Therefore, we see a trend toward the issuance of income-sharing or royalty-sharing tokens by Swiss stock corporations or Swiss limited liability companies.

Innovators continue to select the foundation structure for open-source projects such as the Ethereum Foundation's Ethereum blockchain or Web3 Foundation's Polkadot protocol.

On the other hand, and different from such corporate structures, foundations may exist for decades and consistently provide funding for the development or maintenance of the envisioned platforms. the corresponding white paper. Therefore, these foundations can potentially exist for decades if not centuries, and consistently provide funding for the development or maintenance of the envisioned platforms.

That's why innovators continue to select the foundation structure for open-source projects such as the Ethereum Foundation's Ethereum blockchain or Web3 Foundation's Polkadot protocol. These kinds of initiatives would have a hard time raising money on the traditional capital markets, as they promote nonproprietary, open-source technology and have built (or aim to build) decentralized, nonproprietary networks.



The Swiss government has reaffirmed its overall positive approach to innovation in the field of distributed ledger technology.

We shall see whether the foundation model prevails as the go-to ICO model, as it has been co-opted by numerous initiatives for which the attributes “open source” and “nonproprietary” seem to be of lesser importance.

The hype and buzz around Switzerland as the go-to jurisdiction has slightly abated since FINMA has seemed to take a tougher stance on these novel forms of fundraising, disillusioning many entrepreneurs. Receiving a no-action letter from FINMA takes a long time and, thus, slows down often unrealistic timelines for conducting an ICOs. Firms are deciding to conduct ICOs in Liechtenstein or Malta instead.

Nevertheless, the Swiss government has reaffirmed its overall positive approach to innovation in the field of distributed ledger technology. The ministers of finance and education have initiated a blockchain taskforce to fortify Switzerland’s standing as a worldwide leader in the field.³⁶⁴

Furthermore, financing of start-ups through ICOs has recently exceeded financing through venture capital in Switzerland. It has also opened such investments to a large number of non-institutional investors. Despite some initial teething troubles, we believe that blockchain technology will play an important role in venture capital and probably in other kinds of corporate financing.

Gibraltar

Benedikt Schuppli

Gibraltar, a British overseas territory nestled on the southern coast of Spain, across from Morocco, is an offshore jurisdiction with more registered companies than households.³⁶⁵ Lately, Gibraltar has used its momentum around blockchain technologies to position itself as a crypto-friendly jurisdiction, leading many issuers of ICOs to consider conducting their token sale there, rather than setting up in other, less flexible European jurisdictions.

Gibraltar is an offshore jurisdiction with more registered companies than households.

With the Digital Ledger Technology (DLT) Regulatory Framework, Gibraltar has become the first jurisdiction to propose and outline a distinct legislative framework dealing explicitly and exclusively with blockchain technology in relation to financial services regulation. Below we assess the DLT Regulatory Framework. Furthermore, we analyze regulator statements and undertake a comparative analysis of Gibraltar’s approach to ICOs with that of other jurisdictions.³⁶⁶

Regulatory framework

The government of Gibraltar and the Gibraltar Financial Services Commission (GFSC) are currently working on implementing a legal and regulatory framework that will be aligned to the DLT Regulatory Framework for the sale, promotion, or distribution of tokens. As this



framework will govern initial coin offerings in the future, regular securities law, money regulations, consumer protection law, and commodities law will not be dealt with below.

In February 2018, Her Majesty's Government of Gibraltar announced its intention to proceed with token regulation.

As a British overseas territory, Gibraltar has a legal system quite independent from the United Kingdom. That has allowed it to develop its own government policies and economic priorities. Gibraltar has attracted financial companies and online sports betting and gaming businesses in its jurisdiction with corporate tax incentives and relaxed regulations unrivaled by others in the European Union.³⁶⁷

In December, the territory took a step forward in modernizing its financial services legislation with a newly proposed bill, articulated in a discussion paper to members of Gibraltar's Finance Centre. It paves the way for a comprehensive set of rules addressing challenges presented by cryptocurrencies and governing operations of companies in the sector.³⁶⁸

In February 2018, Her Majesty's Government of Gibraltar announced its intention to proceed with token regulation, as set forth in its white paper on token regulation.³⁶⁹

The proposed DLT regulations allow DLT providers based in or operating from Gibraltar to do business legally, once authorized by the GFSC. "DLT provider" refers to any person licensed to carry on the controlled activity of providing DLT services. Any firm carrying out business—in or from within Gibraltar—using DLT for storing or transmitting value belonging to others, must be authorized by the GFSC as a DLT provider. The draft bill introduces a regime of



Gibraltar Parliament at dusk by Certo Xornal, 2009, used under CC BY 2.0 via Wikipedia Commons.



“authorized sponsors.” The proposed regulation provides that, for every public ICO, a qualified authorized sponsor will need to be appointed, to be “responsible for ensuring compliance with disclosure and financial crime rules” and to remain directly accountable to the GFSC. Under this regulatory structure, the GFSC will establish and maintain a public register of authorized sponsors and their respective past and present codes of practices.³⁷⁰

The GFSC will establish and maintain a public register of authorized sponsors and their respective past and present codes of practices.

“Distributed ledger technology” means a database system in which (a) information is recorded and consensually shared and synchronized across a network of multiple nodes; and (b) all copies of the database are regarded as equally authentic. “Value” includes assets, holdings, and other forms of ownership, rights, or interests, with or without related information, such as agreements or transactions for the transfer of value or its payment, clearing, or settlement.³⁷¹

Before applying for a DLT provider’s license, a person or group of persons who intends to do so must submit an initial application assessment request to the GFSC.³⁷² The GFSC will then assess the nature and complexity of the requester’s proposed business model and of the products and services which the requester proposes to offer and provide the requester with an initial assessment notice informing them of any steps which they must take before applying for a DLT provider’s license.³⁷³

The GFSC will then issue the DLT provider a license if the application conforms with the requirements of the notice and the GFSC is satisfied that the applicant will at all times comply with the regulatory

Figure 14: Gibraltar Blockchain Exchange’s rock token (RKT)



Source: CoinMarketCap.com, Rock chart, 28 Feb.–8 April 2018.



The DLT Regulatory Framework sets out nine regulatory principles, which a DLT provider will be assessed on and continuously must comply with.

principles.³⁷⁴ The GFSC is committed to a three-month period for the assessment of an application for a DLT provider, and the end-to-end duration depends on many factors.³⁷⁵

The DLT Regulatory Framework sets out nine regulatory principles, which a DLT provider will be assessed on and continuously must comply with. Furthermore, a DLT provider must promptly inform the GFSC of any event which the DLT provider knows or reasonably suspects may affect its compliance with the regulatory principles. According to those principles, a DLT provider must

- » Conduct its business with honesty and integrity
- » Pay due regard to the interests and needs of each and all its customers and must communicate with them in a way that is fair, clear, and not misleading
- » Maintain adequate financial and non-financial resources
- » Manage and control its business effectively, and conduct its business with due skill, care, and diligence; including having proper regard to risks to its business and customers
- » Have effective arrangements in place for the protection of customer assets and money when it is responsible for them
- » Have effective corporate governance arrangements
- » Ensure that all its systems and security access protocols are maintained to appropriate high standards
- » Have systems in place to prevent, detect, and disclose financial crime risks such as money laundering and terrorism financing
- » Be resilient and have contingency arrangements for the orderly and solvent wind down of its business³⁷⁶

The GFSC addresses whether ICOs or token sales are covered by the DLT framework:

Generally, ICOs or token sales will not be caught under the DLT framework. However, there may be instances where, depending on what the token will be used for and how the token issue is structured, the token may fall within existing financial services legislation (for example, could be deemed as a collective investment scheme, alternative investment fund, etc.).

We would recommend that you seek independent legal advice to determine whether your ICO may be caught within existing financial services legislation. The Government of Gibraltar and the GFSC are working on developing a legal and regulatory framework, which will be aligned to the DLT framework, for the sale, promotion or distribution of tokens.³⁷⁷

Currently, as the DLT framework does not directly apply to the primary market issuance of tokens and the proposed legal framework



governing token sales has not yet been drafted, token sales in Gibraltar are treated the following way:

Tokens vary widely in design and purpose. In some cases, tokens represent securities, such as shares in a company, and their promotion and sale are regulated as such. More often, tokens serve some cryptocurrency or functional use that is unregulated, such as prepayment for access to a product or service that is to be developed using funds raised in the ICO.³⁷⁸

Regulatory statements

Proposals for a DLT regulatory framework (May 2017)

The Ministry of Commerce of HM Government of Gibraltar issued a public consultation regarding a proposed regulation for blockchain-related activities, with the objectives of fostering Gibraltar's economic development, while providing safeguards for consumers as well as protecting the reputation and integrity of the Gibraltar jurisdiction.³⁷⁹

The proposed regulation would amend the Financial Services (Investment and Fiduciary Services) Act of 1989 and empower the GFSC to authorize and supervise DLT firms. A license fee, kept minimal to attract new entrants, would finance the licensing regime.

Statement on ICOs (22 Sept. 2017)

The GFSC warned investors of potential risks and announced a fully operational regulatory framework by January 2018.³⁸⁰

Amendment to Financial Services Act (6 Dec. 2017)

On 6 December 2017, the legislature amended the Financial Services (Investment and Fiduciary Services) Act of 1989 to introduce new measures for the protection of investors, including in its scope "the customers of licensees carrying on controlled activities which are not investment services."³⁸¹ The purpose of this bill is to pave the way to provide regulatory certainty, according to Albert Isola, Minister for Commerce.

White paper on token regulation (9 March 2018)

In March 2018, HM Gibraltar issued its white paper, "Token Regulation: Proposals for the Regulation of Token Sales, Secondary Token Market Platforms, and Investment Services Relating to Tokens," which outlined Gibraltar's proposed regulatory framework for ICOs. It introduced a regime of "authorized sponsors" appointed for each public token sale and directly accountable to the GFSC for compliance. The white paper incorporated feedback on Version 1, circulated as a discussion paper to members of Gibraltar's Finance Centre in December 2017. In February 2018, HM Gibraltar announced

In March 2018, HM Gibraltar issued its white paper which outlined Gibraltar's proposed regulatory framework for ICOs which introduced a regime of "authorized sponsors" appointed for each public token sale and directly accountable to the GFSC for compliance.



its intention to implement its comprehensive regulatory framework for token sales, as outlined in this white paper.³⁸²

Examples of ICOs

On 11 February 2018, Globitex sold out of its tokens in 24 hours, reaching its presale and public sale hard capitalization of €10 million.

Gibraltar Blockchain Exchange (GBX), a subsidiary of the stock exchange operator, sold 210 million rock tokens (RXT) worth \$21 million in a private sale that concluded in December 2017. It offered another 60 million RXT in a public sale on 7 February 2018. According to the company's site, the tokens sold out in nine seconds, raising another \$6 million.³⁸³ GBX will use the funds to develop what may be the world's first licensed and regulated token sale platform and digital asset exchange in the European Union.

GBX plans to function as a trading venue and ICO Launchpad, with some 200 ICOs purportedly in the queue.³⁸⁴ According to Nick Cowan, Gibraltar's Minister of Finance and the CEO and founder of the Gibraltar Stock Exchange, the exchange promises to deliver "a strict due diligence and admissions process as well as a high-quality digital asset exchange." Parties will use rock tokens as the medium of exchange on GBX's yet-to-launch crypto exchange and as a method of payment for exchange fees."³⁸⁵

On 11 February 2018, Globitex sold out of its tokens in 24 hours, reaching its presale and public sale hard capitalization of €10 million.³⁸⁶

In addition, Covesting, a Gibraltar-based start-up aiming to bring copy trading (i.e., copying the positions of another trader) professional asset management to the cryptocurrency market, raised \$15 million in its token sale in December 2017.³⁸⁷

Critical thoughts and comparative analysis

Gibraltar has long been friendly to cryptocurrency and blockchain-based initiatives. The Gibraltar Stock Exchange hosted the launch of Europe's first regulated bitcoin product in mid-2016.

Given the conflation of business and government in Gibraltar, we cannot separate one from the other, and so we speak of Gibraltar as both the economic and business landscape as well as the government and its adherent administrative bodies. The aforementioned GBX programmatically states,

The Gibraltar Blockchain Exchange (GBX) aims to be a world-leading institutional-grade token sale platform and cryptocurrency exchange. Built upon principles of decentralization and community consensus, we seek to create a new era of trust, openness and global acceptance for the crypto industry, one quality token listing at a time.³⁸⁸

Gibraltar has been a leading offshore financial center for quite a while, and its move to position itself as a crypto hub is not that new. Gibraltar has long been friendly to cryptocurrency and blockchain-based initiatives. The Gibraltar Stock Exchange hosted the launch of Europe's first regulated bitcoin product in mid-2016.³⁸⁹



While the blockchain community undoubtedly welcomes the push for attracting crypto business to Gibraltar, whether and how Brexit will affect this development remains to be seen. Much uncertainty exists, including the future of Gibraltar, its access to the single market, and the potential loss of passporting.

With the advent of blockchain technology, anyone with an Internet connection and a limited amount of technical expertise can now invest in ICOs with the hope of receiving a quick return.

Conclusion

With more than \$3.2 billion raised in 2017 by more than 200 start-ups, ICOs have rapidly caught the eyes of regulators. Until recently, experienced investors have dominated venture capital in a highly regulated environment. With the advent of blockchain technology, anyone with an Internet connection and a limited amount of technical expertise can now invest in ICOs with the hope of receiving a quick return.

The issuers of many of these ICOs look to fund early-phase projects and initiatives, with little more than a white paper and a support team and no tangible product or even prototype. These projects generally view a token sale as a means to finance the development of a blockchain-based platform or Dapp, with the promise of a high return on investment from the appreciation in token value. The return on investment have been quite significant thus far, in large part because of the current hype surrounding the ICO landscape—but those are, for the most part, highly risky investments conducted in a largely unregulated market characterized by significant speculation and extreme market manipulation.

While the ICO model presents great opportunity for fundraising, in that it could democratize access to financial capital for both start-ups and established players, regulation is necessary to reduce the risks of fraud or scams. These have been recurrent in this emergent ecosystem, which is characterized by significant asymmetries of information, limited guidelines for investors, and no standard procedures for due diligence, as well as new opportunities for insider trading and market manipulation (e.g., “pumps and dumps”) from the side of token issuers and strategic investors.

One of the biggest struggles in regulating ICOs is their global scale.

One of the biggest struggles in regulating ICOs is their global scale. Generally, one legal entity incorporated into a particular jurisdiction is issuing the tokens, selling them via the Internet to whoever wants to buy them. An increasing number of ICOs are excluding buyers in certain countries—among them the United States, China, and South Korea—to avoid some of the regulatory burdens or prohibitions within these national boundaries.

If ICOs are global, then national laws are inherently local. The vast difference among regulatory frameworks within the United States or across member states of the European Union exemplifies the challenges of state and provincial legislators in governing an Internet-based, worldwide financial phenomenon such as an ICO.



Ultimately, just as people engage in forum shopping for favorable taxation, we might see blockchain entrepreneurs relocating their business to ICO-friendly jurisdictions.

Indeed, the lack of a harmonized regulatory framework for ICOs will likely drive entrepreneurs to specific jurisdictions such as Singapore or Gibraltar, which are strategically framing their laws to attract new digital entrepreneurs. These jurisdictions are particularly appealing for ICOs, not only because they provide a more favorable regulatory framework, but also because they come with a lower degree of regulatory uncertainty regarding the extent to which these new fundraising practices might or might not comply with existing laws and regulations.

Ultimately, just as people engage in forum shopping for favorable taxation, we might see blockchain entrepreneurs relocating their business to ICO-friendly jurisdictions. If one country's regulator introduces a strict regime for ICOs—as China and South Korea have done—the entrepreneurs behind token sales can easily move to set up their token sale in more lenient jurisdictions. With the difficulty of operating in an overly-regulated framework, many projects or initiatives have engaged in the expensive process of forum shopping, trying to incorporate in specific jurisdictions with more favorable regulation and barring investors from specific regions (the United States and China, in particular) from participating in the token sale.

This jurisdictional arbitrage might favor a new wave of financial innovation, but it might also impede the attainment of existing regulatory objectives: regulators may struggle more to enforce consumer protection laws and secure the proper functioning of financial markets worldwide. The result is asymmetric access to information about operational risks and a potential exit of entrepreneurs from markets with perceived high regulatory risks.

This asymmetry and flight of talent place significant burdens on token issuers and token holders alike, ultimately hindering the development of a more robust ecosystem. In particular, retail investors are unable to base their investments on informed decisions, insofar as they operate on secondary markets distorted by market abuse and large-scale insider-trading practices that maneuver outside of the scope of governmental regulation.

Clearly, we need international cooperation and harmonization of the regulation of these new fundraising practices.

Clearly, we need international cooperation and harmonization of the regulation of these new fundraising practices. Yet, looking at the current, still-evolving, regulatory landscape for ICOs, significant differences between jurisdictions remain. Beyond the countries that simply decided to ban ICOs, one of the most notable differences in regulatory approaches springs from the different legal systems governing civil law and common law jurisdictions.

The United States and other common law countries follow a more dynamic and flexible approach to determine whether any given token qualifies as a security. As highlighted by SEC Chairman Jay Clayton in his statement of 11 December 2017, substance supersedes form: merely calling a token a utility token or structuring it to provide some utility will not preclude its being a security. This emphasis on *substance over form* allows US securities laws to govern the issuance of cryptographic tokens through the application the *Howey test*—a



test developed in 1946, the same year as the Electronic Numerical Integrator and Computer (ENIAC), the first general-purpose digital computer.

In our view, this European emphasis of form over substance does not do justice to the economic realities of these token sales.

Conversely, in their attempts to determine the legal status of a blockchain-based token, European regulators are stuck with the application of static and strict statutory provisions that precisely stipulate the various features that a token must possess for it to qualify as a particular asset class such as a security. Under such strict regulations, cryptographic tokens simply cannot be deemed a security in some jurisdictions (e.g., German law does not contain a concept of uncertificated securities and thus cannot accommodate dematerialized securities).

In our view, this European emphasis of *form over substance* does not do justice to the economic realities of these token sales. Indeed, it has led to an inconsistent regulatory framework, whereby existing securities, which confer rights with a high degree of security for investors (through a process of securitization) are strictly regulated—and in many cases justifiably so—whereas cryptographic tokens, which confer no material rights to the investors (because they do not involve any form of securitization) are left largely unregulated.

While some industry standards are developing to reduce the degree of legal uncertainty surrounding ICOs—SAFT, for example, and the similar SAFTE (*simple agreement for future tokens or equity*)—regulators have a responsibility to intervene and cooperate so as to create a more coherent regulatory framework better able to accommodate these new fundraising practices. While regulating too early might stifle innovation and prevent solutions from being elaborated from the private sectors, the absence of regulation can also be problematic, in that it puts token issuers and investors in a precarious position, characterized by extensive risk and uncertainty.

Although international harmonization is required, legal reform is a long and complex process that might not keep pace with the evolution of these new fundraising practices.

Although international harmonization is required, legal reform is a long and complex process that might not keep pace with the evolution of these new fundraising practices. Other interim measures are available, however. With the advent of the Internet and digital technology, governments had to reform many laws and regulations to account for the specificities of these new technologies. Yet, to the extent that legislators have drafted laws to be technologically agnostic, regulators can apply them to a wholly new environment potentially without legislative reform.

With the emergence of e-commerce, for instance, countries opted not to update contract law, but merely to expand its scope to the digital world through the notion of “functional equivalence”—that is, emphasizing substance over form. When applied to ICOs, the principle of functional equivalence would be such that, insofar as cryptographic tokens are functionally equivalent to existing regulated financial instruments (e.g., securities), regulators could deem existing regulation applicable even if these tokens do not comply with all the formal requirements for an asset to qualify as a security. Such an approach would bring the jurisdictions of civil law countries closer to



those of common law countries and encourage people to experiment with new technologies and innovate with mechanisms that do not conflict with securities law.

Appendix

This appendix covers regulatory statements, causes of action, and decisions from other relevant jurisdictions.

United States

Tezos/Tezzies (XTZ)

Tezos is a decentralized applications platform project, facilitating formal verification of smart contracts, and including an on-chain governance mechanism.

Arthur and Kathleen Breitman cofounded Dynamic Ledger Solutions in 2015 to support the development and promotion of the platform and own all the intellectual property of the project. At a later stage, they added a third investor, Tim Draper, to the project. To launch an ICO and handle the funds, they formed the Tezos Foundation, a Swiss foundation with Johann Gevers as its president.

In July 2017, the defendants conducted an ICO selling 607 million Tezzies for \$232 million at the time in cryptocurrencies. Tezzies conferred upon token holders various rights to participate in the upcoming Tezos network. Their value would come from the usefulness of the network.

Class action by Andrew Baker (California, 25 Oct. 2017)

The class action pursuant to Section 382 of the California Code of Civil Procedure is brought before the San Francisco County Superior Court by Andrew Baker, represented by James Taylor Copeland, on behalf of all natural persons who purchased Tezzies during the ICO against Dynamic Ledger Solutions, the Tezos foundation, the Breitmans, Johann Gevers, and Strange Brew Strategies.

Statements

Strange Brew claimed that Tezos was recognized by industry giants such as Ernst and Young and Lexifi, which both denied it. The team exaggerated the advancement of the project, claiming in February 2017 that the testnet was operational, and the remaining work consisted mostly of security audits and improving the test coverage. In a blog posted dated March 2017, Strange Brew claimed it would launch in three to four months. The team misrepresented how the funds would be used—for instance, the hiring of several teams, sponsoring a computer science department, funding efforts to digitize



and map transaction logic from traditional legal prose to a Tezos language.

Causes of action

- » Unregistered offer and sale of securities [Sections 5(a) and 5(c) of the Securities Act]
- » Fraud in the offer or sale of securities [Sections 17(a)1] “to employ any device, scheme, or artifice to defraud,” referring to the false statements (cf. *supra*)
- » Fraud in the offer or sale of securities [Sections 17(a)2, 17(a)3]:
 - › *to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; or*
 - › *to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser*
- » Referring again to prior statements
- » False advertising (California Business and Professions Code §§17500 et seq.). Defendants knew or should have known “in the exercise of reasonable care” that the statements were misleading, and they resulted in injury to the plaintiffs property
- » Unfair competition (California Business and Professions Code §§17200 et seq.) for running an unregistered security sale and misstatements and omissions constituting unlawful business acts of practice
- » Alter ego liability, a Californian legal argument to make individuals responsible for corporate debts when generally there is an “unity of interest and ownership” between the owner and the company and it would be unfair otherwise to consider the actions of the company independently.

Class action by Alejandro Gaviria (Florida, 13 Nov. 2017)

In July 2017, Alejandro Gaviria invested 52 ether (worth \$14,153 at the time) as an investment in Tezos ICO. Action before the US District court, Middle District of Florida, pursuant to 28 USC § 1332.

The plaint presents the various statements and claims by Arthur and Kathleen Breitman during the ICO, the direct benefits for the projects promoters and apply the *Howey* test as the SEC did in its DAO report.



On jurisdiction, the plaintiff estimates that terms and conditions of the ICO restricting all disputes arising to the ordinary courts of Zug, Switzerland, therefore mandating the application of Swiss law and precluding class actions are all unenforceable. Here are the causes of action:

- » Unregistered offer and sale of securities [Sections 5(a) and 5(c) of the Securities Act]
- » Fraud in the offer or sale of securities [Sections 17(a)1 of the Securities Act]
- » Fraud in the offer or sale of securities [Sections 17(a)2 and 17(a)3 of the Securities Act]
- » Rescission of contract (returning the funds to the plaintiffs)
- » Alter ego liability
- » Unregistered offer and sale of securities (Fla. Stat. §§ 517.011 et seq.)
- » Fraud in the offer of sale of securities (Fla. Stat. §§ 515.011 et seq.)
- » Violation of Florida's Deceptive and Unfair Trade Practices Act (Ch. 501, § 211(1), Fla. Stat.)

Class action by GGCC (California, 26 Nov. 2017)

Action filed for security fraud (15:77) before the California Northern District Court by GGCC LLC, an Illinois company, for the following class of persons: "All US persons and entities who contributed bitcoin and/or [ether] to the Tezos initial coin offering from a computer within the United States."³⁹⁰ Here are the causes of action:

- » Violation of Sections 5 and 12(a)(1) of the 1933 Act: promotion, offer and selling of securities within the meaning of 15 USC § 77b(a)(1)
- » Violation of Sections 15 of the 1933 Act

This case was reassigned as it is related to the case *MacDonald v. Dynamic Ledger Solutions Inc.* (17-cv-07095-JSC) by decision of Judge Richard Seeborg on 14 December 2017 as the case of *Okusko v. Dynamic Ledger Solutions Inc. et al.* (17-cv-06829-RS).



Hong Kong

Securities and Future Commission Statement on ICOs (5 Sept. 2017)

The Securities and Future Commission of Hong Kong (SFC) released a statement on 5 September 2017 clarifying Hong Kong's law on ICO. While the SFC estimates digital tokens are virtual commodities, certain ICOs might qualify as securities, being shares, debentures, or interests in a CIS.

In those cases, parties are engaging in a regulated activity, and therefore required to be licensed by or registered with the SFC so long as the offering targets the Hong Kong public. The activity of offering securities is subject to registration or authorization requirements unless an exemption applies. Moreover, certain requirements relating to automated trading services and recognized exchange companies may be applicable to the business activities of cryptocurrency exchanges.

SFC circular on bitcoin futures contracts (11 Dec. 2017)

The Circular of Hong Kong's SFC on bitcoin futures contracts and cryptocurrency-related investment products is addressed to licensed corporations and registered institutions.

The SFC acknowledges that the United States have allowed bitcoin futures contracts. Those contracts meet the criteria of "futures contract" under the definition of the Securities and Futures Ordinance (SFO). Therefore, even though the underlying assets of bitcoin futures are not regulated under the SFO, bitcoin futures traded on and subject to the rules of those exchanges are regarded as "futures contracts" for its purposes.

Accordingly, parties carrying on a business in dealing in bitcoin futures are required to be licensed unless an exemption applies. Service providers, intermediaries, and marketing and advisory services might also be engaging in regulated activities.

Moreover, the SFC notices an increase in cryptocurrency-related investment products, such as cryptocurrency options, swaps, and contracts for differences. Depending on their terms and features, some cryptocurrency-related investment products may be regarded as "securities" as defined under the SFO, and therefore parties may be subject to the SFC's licensing, conduct, and authorization requirements. Otherwise, parties might be committing a criminal offence.



Taiwan

FSC warning on risks of virtual assets (19 Dec. 2017)

The Financial Supervisory Commission of Taiwan (FSC) issued a statement on four risks of investing in virtual assets such as bitcoin.

- » The FSC calls on the public for prudence, as the price of virtual assets fluctuates and is highly speculative.
- » It reminds the public that financial institutions may not participate in or provide virtual currency related services or transactions.
- » Tokens sold during an ICO might be securities regulated by the Securities and Exchange Act. In that case ICOs should be handled in accordance with the relevant provisions.
- » If the token issuer or seller is involved in fraudulent acts, such as fictitious currencies or unreasonably high remuneration claims, it may be prosecuted as a criminal case.

Financial Technology Innovative Experimentation Act (29 Dec. 2017)

On 5 May 2017, the Executive Yuan approved the draft act prepared by the FSC.³⁹¹ The legislation established a regulatory sandbox suspending criminal and administrative liabilities arising from engaging in certain regulated activities. Participants must apply to the sandbox program. The sandbox applies for an 18-month period, which can be extended to 36 months. This proposed sandbox has been voted into law on December 2017.

Malaysia

Media Statement on ICOs (7 Sept. 2017)

The Security Commission of Malaysia (SCM) issued a statement warning investors of the various risks posed by ICOs, and the high number of frauds that accompany them.³⁹² Because these practices are currently unregulated, the SCM warned investors about carrying out due diligence on the issuers and their operations.

Cease and desist order to CopyCashCoin (9 Jan. 2017)

In a press release, the SCM announced that it would investigate the CopyCashCoin ICO.³⁹³ The project was set to launch on 10 January 2018 by a Singapore registered foundation. The SCM noted that the ICO operator has organized various talks and seminars in Malaysia.

On 9 January, one day before the launch, the SCM sent cease and desist order to the CopyCash Foundation.³⁹⁴ The SCM estimates that the project will contravene relevant requirements under securities laws.



South Korea

Ban on ICOs (29 Sept. 2017)

On 29 September, South Korea's Financial Services Commission issued a statement following a meeting with other administrations to discuss countermeasures against the trend of virtual currencies.³⁹⁵

The statement observes that ICOs distribute revenues with various schemes, and states that the market is overheating due to a high level of speculative demand and there is an increased risk of frauds. Therefore, it establishes a policy of prohibiting all ICOs, regardless of technical terminology.

Moreover, the statement presents the results of law enforcement and upcoming legislation on cryptocurrencies under the Anti-Narcotics Act, user-verification provisions, AML obligations, and the establishment of a Joint Inspection System Operation.

Israel

ISA announcement of national committee (30 Aug. 2017)

On 30 August 2017, the Israel Securities Authority (ISA) announced the creation of a national committee to rule on whether tokens should be considered financial securities and to recommend a regulatory policy for ICOs.³⁹⁶ The committee will examine possible overlap with securities law, review current legislation in various countries, formulate recommendations, and examine enforceability of securities laws in this area. The committee is expected to deliver a report by the end of the year.

ISA on trading of cryptocurrencies (12 Dec. 2017)

ISA issued a statement on 12 December 2017 on trading of cryptocurrencies.³⁹⁷ Shmuel Hauser, the chairman of the ISA, is critical of bitcoin and its high volatility, suggesting that it is a bubble. The statement also explains that ICOs are being reviewed with the goal of providing regulatory certainty with the following cases:

- » Cases in which an ICO falls under securities law
- » Cases in which ICOs are not subject to securities law
- » Cases regarding "coin securities," a hybrid of a coin and a security. In those cases, an appropriate regulatory framework must be established, similar to the Regulation A exemption in the United States.
- » Cases that must be examined individually



Russia

Bank of Russia warning (Sept. 2017)

In September 2017, the Bank of Russia issued warnings about the risks posed by cryptocurrencies and ICOs. At the same time, the Russian Ministry of Finance is drafting a law that would provide a regulatory framework for cryptocurrencies, to be regulated as financial assets and possibly listed on the Moscow Stock Exchange (and potentially limiting them to qualified investors).

President's orders (21 Oct. 2017)

On October 2017, the president of Russia issued five orders related to cryptocurrencies and ICOs.³⁹⁸ The Government of the Russian Federation, in conjunction with the Bank of Russia, shall ensure that changes are made to the legislation of the Russian Federation providing for:

- » Determination of the status of digital technologies used in the financial sphere and their concepts (including such as "technology of distributed registries," "digital letters of credit," "digital mortgage," "cryptocurrency," "token," "smart contract"), providing that only the ruble has legal tender in the Russian Federation
- » Regulation on mining operations, including registration procedures and its taxation
- » Regulation of ICOs by analogy with the regulation of the initial placement of securities by July 2018
- » Proposals on the creation of a special regulatory platform ("sandbox") by 20 December 2017
- » Formation of a single payment space for the member states of the Eurasian Economic Union with the use of new financial technologies, including the technology of distributed registries

Australia

ASIC information sheet on ICOs (28 Sept. 2017)

On 28 September 2017, the Australian Securities and Investments Commission announced the release of Information Sheet 225 on ICOs.³⁹⁹ The sheet considers that the legal status of an ICO is dependent of the circumstances, such as how the ICO is structured and operated, and the rights attached to the token offered through the ICO. Applicable statuses include:

- » A managed investment scheme (MIS) as defined within the Corporations Act, when people are pooling assets to obtain an interest for a common enterprise with no control over



the scheme's operation except occasional voting rights. If an MIS is used, there is a range of disclosure, registration, and licensing obligations under the Corporations Act.

- » An offer of share when the token is issued to fund a company, or an undertaking that looks like a company. In that case, the law mandates a prospectus with all necessary information. Nevertheless, ASIC warns investors that in an initial public offering of stocks, investors can withdraw their money in case of incomplete, misleading, or deceptive statements, but no such protection exists for investors participating in an ICO.
- » An offer of a derivative
- » A trading on a financial market
- » Crowdsourced funding
- » Non-cash payment facility

Moreover, the ASIC warns issuers that Australian law prohibits misleading or deceptive conduct in a range of circumstances, including in trade or commerce, in connection with financial services, and in relation to a financial product.

New Zealand

FMA commentary on ICOs (25 Oct. 2017)

On 25 October, the Financial Markets Authority (FMA) announced the publication of notices on ICOs and cryptocurrency services alongside online resources for investors.⁴⁰⁰

The extent to which an ICO is regulated depends whether the token offered to the public is one of the four "financial products" set out by the Financial Markets Conduct Act of 2013 (FMC Act) debt securities, equity securities, managed investment products, and derivatives. In one of those cases, the issuer must comply with similar obligations: to register a product disclosure statement, to appoint a licensed supervisor, to have a trust deed that sets out investor rights and the supervisor's role, and to meet financial reporting and fair dealing obligations.

According to the FMA, businesses and individuals offering services such as cryptocurrency exchanges, wallets, and brokering:

- » Must be a member of a dispute resolution scheme
- » Must be on the financial services providers register
- » Must comply with fair-dealing provisions in the FMC Act



United Arab Emirates

FSRA Guidance on ICOs (9 Oct. 2017)

The Financial Services Regulatory Authority (FSRA) of the Abu Dhabi Global Market issued a guidance on its approach to ICOs and virtual currencies on 9 October 2017 under the Financial Services and Markets Regulations of 2015 (FSMR).⁴⁰¹

The FSRA notes that some tokens—a digital identity record, a voting right, or an access token—might not represent a financial asset. It also observes the rise of fundraising techniques in which the token represents a traditional regulated issuance. The FSRA states that its approach will be case by case and neutral to technology.

When a token represents a security, the token issuer is required to issue a prospectus. Exemption may apply if the offer is directed at professional clients, or fewer than 50 persons in any 12-month period, or if the payment by a person to acquire the security is at least \$100,000. Additionally, any party involved in the operations will have to be licensed or approved by FSRA.

Otherwise, while there will not be specific regulations under FSMR, regulated firms will have to demonstrate that they comply with their obligations when engaging in such activities.

Finally, derivatives of virtual currencies and securities tokens are regulated as specified investments under the FSMR. Market intermediaries and market operators dealing in such derivatives will need to be licensed or approved by FSRA.





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About the Blockchain Research Institute

Co-founded in 2017 by Don and Alex Tapscott, the Blockchain Research Institute is a knowledge network organized to help realize the new promise of the digital economy. It builds on their yearlong investigation of distributed ledger technology, which culminated in the publication of their critically acclaimed book, *Blockchain Revolution* (Portfolio|Penguin).

Our syndicated research program, which is funded by major corporations and government agencies, aims to fill a large gap in the global understanding of blockchain technology and its strategic implications for business, government, and society.

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Research areas include financial services, manufacturing, retail, energy and resources, technology, media, telecommunications, healthcare, and government as well as the management of organizations, the transformation of the corporation, and the regulation of innovation. We also explore blockchain's potential role in the Internet of Things, robotics and autonomous machines, artificial intelligence, and other emerging technologies.

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Notes

1. As a general rule, innovation requires a safe space for people to explore, test, launch, and iterate with new technologies. Hence, for innovation to occur, authorities must define and fairly administer this space and clearly communicate to all relevant stakeholders.
2. While we recognize that there are many kinds of token sales—many of which do not bear any resemblance to traditional IPOs or securities issuance—for the purpose of this report, we have chosen to refer to all practices and projects involving the issuance and sale of blockchain-based tokens to the public as “ICOs.”
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5. Note that we will look solely at the European Union in brief and in isolation because of the reasons highlighted in the respective report.
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9. Note that this is not an exhaustive list, and many other categories and subcategories may be defined. Further note that we will not pay attention to hybrid forms which combine elements from different main and subcategories. This is due to the limited length of this document and the difficulty in distinguishing these hybrid forms from the “pure” forms. This difficulty stems from the fact that all of these tokens have a payment utility to them and can be swapped in exchange for assets and services on exchange platforms, provided they are fungible enough. We will, therefore, focus on the defining characteristic of each token when subsuming them under one of the below categories. One could draw an analogy to the theory of absorption under contract law, which defines the governing contract type for innominate contracts (compound contracts to be exact) to be the one which governs the lion’s share—however quantifiable—of the legal relationship between two or more contracting parties.
10. With dividend certificates, the holder has a claim toward the issuer to receive a fixed amount; whereas, with profit share tokens, the token holder has no claim toward the issuer but rather receives consideration as part of the purchase agreement underlying the transfer, with no right to receive back the fixed amount.
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13. 15 USC § 78a *et seq.* See Rohr and Wright, "Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets," p. 43.
14. See 17 C.F.R. § 240.10b-5. Note that a material fact has been defined to include any fact that would be important to investors when deciding to buy or sell securities.
15. See Hansen and Reyes, "Legal Aspects of Smart Contract Applications." Note that the Securities Act includes short-term instruments with maturities of fewer than nine months in its definition of security, whereas the Exchange Act does not.
16. See *SEC v. WJ Howey Co.*, 328 US 293, 298(1946). See also *Landreth Timber Co. v. Landreth*, 471 US 681, 690 (9th Cir. 1985).
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18. Securities and Exchange Commission, *Securities Exchange Act of 1934: Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, release no. 81207, 25 July 2017. www.sec.gov/litigation/investreport/34-81207.pdf, accessed 24 March 2018. See also 15 USC § 77e.
19. *SEC v. WJ Howey Co.*, 328 US 293, 298 (1946).
20. *SEC v. C.M. Joiner Leasing Corp.*, 320 US 344, 351 (5th Cir. 1943). www.law.cornell.edu/supremecourt/text/320/344, accessed 2 April 2018.
21. Hansen and Reyes, "Legal Aspects of Smart Contract Applications."
22. Leading commentators concur that a token need not be purchased for fiat currency to satisfy the "investment of money" prong—any "good, service, promissory notes, and other exchanges of value" can satisfy the first element of the test. See Rohr and Wright, "Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets," p. 45 (citing *Uselton v. Commercial Lovelace Motor Freight, Inc.* 940 F.2d 564, 574-75 (10th Cir. 1991)). See also Reyes, Packin, and Edwards, "Distributed Governance," p. 29, wmlawreview.org/distributed-governance (citing Marco Santori, "AppcoinLaw: ICOs the Right Way," *CoinDesk*, 15 Oct. 2016, www.coindesk.com/appcoin-law-part-1-icos-the-right-way): "While the exchange of a cryptocurrency for a token would likely qualify as an investment of money, a contribution of computational power might not."
23. The common enterprise element has a "focus on the extent to which the success of the investor's interest rises and falls with others involved in the enterprise." Miriam R. Albert, "The Howey Test Turns 64: Are the Courts Grading This Test on a Curve?" *William & Mary Business Law Review* 2, no. 1, article 2 (2011): 16. scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1016&context=wmbblr. Since the Supreme Court never specifically defined "common enterprise," the lower courts were left to determine what it meant. At least three lower court tests have developed horizontal commonality, broad vertical commonality, and narrow or strict vertical commonality. Rohr and Wright, "Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets," p. 46. Although an exhaustive treatment of these tests lies beyond the scope of this discussion, generally speaking, "The horizontal commonality test requires multiple purchasers (more than one) who are all exposed to the risk of the enterprise" while the vertical commonality tests looks at the connection, in varying degrees, between the investor and the promoter. Rohr and Wright, "Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets," p. 47.
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32. Robert N. Rapp, "How to Apply Blue-Sky Laws to Securities Offerings," *Law360*, Portfolio Media Inc., 14 Nov. 2013. www.law360.com/articles/488533, accessed 24 March 2018.
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