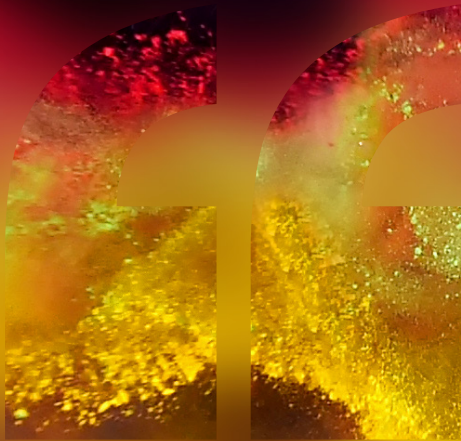
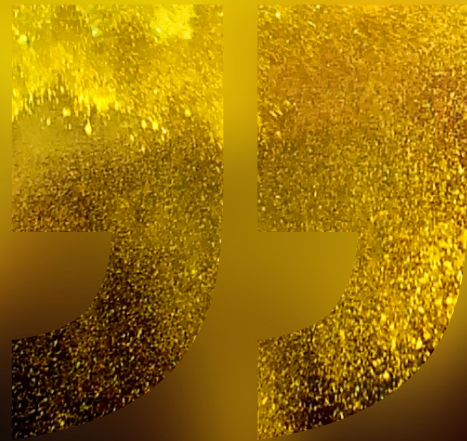


C L I F F O R D
C H A N C E



**INITIAL COIN
OFFERINGS –**
ASKING THE
RIGHT REGULATORY
QUESTIONS



– THOUGHT LEADERSHIP

MAY 2018



INITIAL COIN OFFERINGS – ASKING THE RIGHT REGULATORY QUESTIONS

Initial coin offerings or ICOs are growing rapidly. Essentially a method of crowdfunding facilitated through blockchain and cryptocurrency technologies, ICOs are reported to have raised almost \$1.3 billion globally from the start of 2017 despite being denounced by some commentators as Ponzi schemes. Companies and financial institutions are keen to explore the possibilities of ICOs – whether as a fundraising method or to cash in by acting as advisers or arrangers – but what are the risks, how are ICOs regulated and how might this change?

Terminology

- An ICO is a fundraising event in which an issuer/operator offers tokens to participants in return for consideration (funds, or as a reward for marketing or referral efforts).
- ICOs are also known as initial public coin offerings, initial token offerings, token launches and token sales, typically due to regulatory differences or marketing or technical distinctions. The terms 'cryptocurrency', 'crypto-token', 'blockchain token' and/or 'token' are sometimes used instead of 'coin'.
- Generally, coins and cryptocurrency are separate blockchains (or decentralised distributed ledgers) which store value or transaction information (eg, Bitcoin, Ethereum, Waves or Digibyte). Tokens are commonly generated by a smart contract system (which often has multi-functionality) that is based on an existing cryptocurrency (for example, Golem which is Ethereum-based and Mobilego which is based on both Ethereum and Waves).
- For simplicity, the term 'token' in this briefing is to be taken as also including coin and cryptocurrency.

The tokens under an ICO will typically entitle holders to a right derived from the underlying asset or business arrangement, for example:

- The right to a profit or asset (such as the distribution of actual profits or through the repurchase and the virtual destruction (termed 'burning') of repurchased tokens which theoretically reduces supply, so increasing the token price).
- A right of use (say of a system or particular service offered by the issuer).
- Voting rights (for example, as a participant of a decentralised currency exchange operated by the issuer).

How does it work?

ICOs are typically announced through online channels such as cryptocurrency forums and websites. Most issuers will provide access online to a white paper describing the project and key terms of the ICO (its economic terms, subscription details, timeline, for example), and providing information on the status of the project as well as the key team members involved.

In the subscription process, the participant generally is required to transfer cryptocurrency to the issuer – typically to one or more designated addresses (an online reference for cryptocurrencies similar to an account number) or online wallets of the issuer. Subscriptions may be completed in minutes. A participant may also be rewarded with tokens by taking certain actions, such as marketing on cryptocurrency forums. Once the ICO is completed, the tokens will be distributed to the participants' designated addresses or online wallets. Issuers may

have tokens listed on cryptocurrency exchanges (eg, Poloniex or Bittrex) to trade against other cryptocurrencies to create liquidity and value.

What should you ask?

Here are some questions to consider before deciding whether to participate in an ICO; the regulatory implications are much broader than simply considering whether the tokens issued are regarded as 'currency' or 'securities'. Because blockchain platforms such as Ethereum operate without borders, issuers/operators must carefully structure ICOs to be compliant with regulations across multiple jurisdictions. Similarly, participants and service providers must be mindful of the regulations applicable to their own jurisdictions, including those by virtue of extra-territorial effect.

- Who is the issuer and in which jurisdiction(s) will it operate?
- Who are the service providers, what are the services being provided, and where will they perform their service operations?
- Who are the participants of the ICO and in which jurisdiction(s) are they based?
- How and by what means could participants acquire the tokens? For example, by crowd sale with subscription through payment of other cryptocurrency, or by performance of certain actions?
- What is the asset or business arrangement underlying the tokens? What rights does the participant acquire from holding the tokens, for example, a right to profit, right to use or voting rights?
- What are the economics behind the tokens (for example, how can the

participant expect to obtain a return, monetary or otherwise, if at all)?

- What are the underlying operations of the issuer (for example, is it a business venture or new technology solution) and how is it structured/managed/operated (for example, fully decentralised with no formal legal structure or through a legal vehicle)?

Regulatory analysis

Taking into account the answers to the questions above and any other relevant circumstances, a regulatory analysis can then be undertaken for each of the relevant jurisdictions (ie, those of the issuer, the service providers and the participants). Some points to note:

- Think broadly about what could impact your position. For example, issuers should always consider the regulations of each potential participant's jurisdiction as they may affect how an issuer may market to or accept subscriptions from participants.
- Each party involved is likely to have a different perspective. For example issuers may be interested to know which jurisdiction is the most regulatory 'friendly' for it to perform the underlying operations or to host the ICO; a service provider may be interested to know whether the services it is providing are regulated services, and the participants would want to confirm that it is legal for them to participate in the ICO.
- What is the legal nature of the tokens being offered under the ICO in the relevant jurisdiction? For example, would it be categorised as any of the following in accordance with the laws of each relevant jurisdiction and what are the regulatory implications? In many jurisdictions this is likely to vary depending on the exact terms of the tokens being issued and the nature of the treatment of these legal concepts in that jurisdiction.
 - Currency
 - Commodity
 - Security
 - Property
 - Structured product or derivative contract
 - Foreign exchange contract

- Loan
 - Deposit
 - Collective investment scheme/fund
 - Insurance product
 - Other regulated investment contract or product
- Could any circumstances arise that would trigger regulatory licensing/registration/authorisation requirements and/or other regulatory compliance requirements with respect to the nature of the tokens being offered under the ICO and the proposed role of each of the issuer and each service provider and participant under the ICO? Have relevant requirements, such as the obligation to undertake anti-money laundering and know-your-client checks, been complied with? The following (non-exhaustive) list of activities may trigger such requirements, although again this will vary depending on the jurisdiction and specific circumstances:
 - Dealing/marketing/offering/advisory activities relating to securities or any other regulated contract or product
 - Money lending activities
 - Deposit taking activities
 - Operation of stored value facilities
 - Operation of securities, commodity or other regulated exchange
 - Management of a collective investment scheme/fund
 - Remittance and/or money changing activities
 - Insurance brokerage activities
 - Business operation/establishment
 - Handling of personal data/privacy
 - Tax presence
 - Intellectual property
 - Gambling

There is no one-size-fits-all solution for designing a regulatory analysis framework for ICOs and the regulatory analysis we have outlined is by no means exhaustive. The regulatory analysis will be affected by the laws and regulations of the relevant jurisdictions, the nature of the crypto-world and its ongoing evolution, the usage and meaning of the term ICO, and the fact that the structure and nature of ICOs may change or evolve very quickly.



WHAT ARE REGULATORS DOING?

While no jurisdiction has yet implemented a regulatory framework specific to ICOs and/or tokens, regulators globally are increasingly focused on them and a number have issued announcements, guidance or comments. The general regulatory theme is that activities around ICOs and/or tokens may constitute regulated activities in the relevant jurisdiction under the existing local regulatory regime depending on the facts of the case, and regulators are closely watching this space. Some highlights of the international regulatory framework and some recent examples of regulator engagement globally are set out below.

FOCUS ON KEY JURISDICTIONS

Australia

In light of increasing ICO activity in Australia, the Australian Securities and Investments Commission (ASIC) released an information sheet on ICOs in September 2017 designed to give guidance about the potential application of the Australian Corporations Act to businesses that are considering raising funds through an ICO. This confirms that the legal status of an ICO in Australia will depend on how the ICO is structured and operated and the rights attached to the coin / token being offered. If the ICO has characteristics typically associated with a security under the Australian Corporations Act then it will most likely be regulated as such. If the ICO has no connection to the elements of a security under the Australian Corporations Act then while the ICO may be outside of the regulatory umbrella of the Australian Corporations Act, it will still be subject to general law and Australian consumer law relating to the offer of services or products.

ASIC's information sheet is useful in helping to more formally delineate the key areas of consideration that, at a minimum, potential issuers of ICOs should have on their radar. For example, whether their ICO has the characteristics of a managed investment scheme, an offer of shares or a derivative. For those providing the platform on which such coins / tokens are trading (assuming the ICO in question is a financial product) consideration also needs to be given as to whether a financial market is being operated by the platform.

This reflects our experience of the questions issuers are considering. Either looking to ensure that the ICO will be outside of the regulatory sphere of the Australian Corporations Act or acknowledging the nature of the proposed ICO will put it under the purview of the Australian Corporations Act and thus looking to ensure that the Australia Corporations Act requirements are understood and complied with.

More widely, following a review by the Australian Government of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act) and its associated rules and regulations (together, the AML/CTF Regime), the AML/CTF Act was amended with the purpose of minimising the perceived money laundering and terrorist financing risks associated with the growing use of digital currencies in the Australian economy. The focus of the amendments to the AML/CTF Act was to bring digital currency 'exchange providers' within the regulated population of Australia's AML/CTF Regulator, AUSTRAC. The effect of the amendments to the ICO process is uncertain with the precise interpretation of 'exchange provider' yet to be clarified. Arguably, the concept of an exchange provider is wide enough to capture issuers of a digital currencies. If this is the practical implication of the amendments, digital currency issuers would need to register with AUSTRAC as exchange providers and would be subject to the entire ambit of the AML/CTF Regime as it applies to digital currencies. The amended AML/CTF Regime is expected to come into effect in April 2018.

France

In February 2018, the French Autorité des marchés financiers (AMF) published a summary of the responses it collated from market participants and other stakeholders in the context of its public consultation on the possible regulatory frameworks applicable to ICOs in France.

The AMF presented three possible supervisory options for ICOs:

- Promote a best practice guide without changing existing legislation (option 1).
- Extend the scope of existing texts to treat ICOs as public offerings of securities (option 2).
- Propose an *ad hoc* legislation adapted to ICOs (option 3).

Respondents largely favoured option 3, that of an ICO-specific regulation, and unanimously considered that an information document (whitepaper) is necessary to inform buyers of tokens and that it should include, as a minimum requirement, information on:

- The project related to the ICO and its advancement.
- The rights conferred by the tokens.
- The accounting treatment of funds raised during the ICO.

For almost all respondents, this document should also allow for the identification of the legal entity responsible for the offer, its managers and founders, and their competences. The vast majority of respondents also supported the establishment of rules making it possible to ensure the escrow of funds raised, and the setting up of a mechanism to prevent money laundering and terrorist financing. Finally, respondents suggested that ICO whitepapers could be subject to an optional visa (or some other kind of approval) to be delivered by the AMF that would be in charge of verifying the information provided by the ICO initiator. The AMF College has decided to continue to work on the definition of a specific legal framework for ICOs providing for the appropriate guarantees, particularly in terms of information, which will be necessary for this new type of offer. This work would be carried out in coordination with the other public authorities concerned.

Germany

The German Federal Financial Supervisory Authority (BaFin) has published a guidance note on virtual currencies on its website. BaFin qualifies virtual currencies as units of account (Rechnungseinheiten), which generally qualify as financial instruments within the scope of the German Banking Act, regardless of what software or encryption technologies have been used. Tokens issued under an ICO are likely to be classified as virtual currencies for this purpose.

In BaFin's view, virtual currencies are not legal tender and so are neither currencies nor foreign notes or coins. Virtual currencies also do not usually qualify as e-money within the meaning of the German Payment Services Supervision Act (Zahlungsdiensteaufsichtsgesetz) – in BaFin's view they do not represent any claims on an issuer, as in most cases there is no issuer of coins. However, BaFin takes a different view for digital payments with virtual currencies which are backed by a central entity that issues and manages the units, which may be the case with certain ICO issuances.

The simple use of virtual currencies as a substitute for cash or deposit money, to participate in exchange transactions as part of the economic cycle does not in BaFin's view trigger a licencing requirement in Germany. The "mining", purchase or sale of virtual currencies would also not trigger a licencing requirement. However, in certain additional circumstances, commercial handling of virtual currencies may trigger a licencing requirement under the German Banking Act. In this respect, every ICO would need to be assessed on a case by case basis.

In November 2017 BaFin also published a consumer warning regarding the risks associated with ICOs. This warning does not have any regulatory impact and does not provide further information on the regulatory status of ICOs in Germany. However, it shows that BaFin has ICOs on its radar and closely monitors any negative developments. In particular BaFin addresses the insufficient information provided compared to regulated prospectuses and the systemic vulnerability of ICOs to fraud, money laundering and terrorist financing.

Hong Kong

The regulators in Hong Kong have adopted a technology-neutral regulatory approach and are seeking to develop and implement a regulatory framework and requirements based on the intrinsic characteristics of the relevant activities or transactions and the risks arising from them.

The general stance of the Hong Kong Securities and Futures Commission (SFC) with respect to ICOs is that while digital tokens offered in typical ICOs are usually characterised as a "virtual commodity" (which is consistent with the position of the Hong Kong Monetary Authority (HKMA) which has previously reiterated that Bitcoin is not a legal tender but a virtual "commodity"), depending on the terms and features (e.g. whether the ICO provides equity or debt features, or the token proceeds are managed collectively for returns by scheme operators), such tokens may be considered "securities" and accordingly will be subject to the securities laws of Hong Kong.

In this respect, where the digital tokens involved in an ICO fall under the definition of "securities", dealing in or advising on such tokens, managing or marketing a fund investing in such tokens or operating a cryptocurrency exchange involving trading of such tokens may be considered a "regulated activity" and may potentially trigger Hong Kong licensing / product authorisation requirements. The SFC issued press releases in February and March 2018 providing updates on its regulatory actions against cryptocurrency exchanges and ICO issuers where 'securities' tokens are involved. This demonstrates that the SFC is actively surveilling activities around securities tokens to ensure regulatory compliance by issuers and operators.

Japan

Following amendments becoming effective in April 2017, cryptocurrencies are defined in Japan's Payment Services Act (PSA) as "Virtual Currencies". Sale and purchase of, and exchanging, Virtual Currencies (or acting as an intermediary in respect of such activities) are regulated as a Virtual Currencies Business Operator and require registration with the Financial Services Agency of Japan (JFSA). JFSA has not issued any guidelines concerning ICOs other than the PSA. It is not a negative signal for ICOs in Japan. However, it is advisable to consider carefully, based upon actual facts and details of relevant ICOs, (i) whether an issuer or other service providers could be categorised as a Virtual Currencies Business Operator (when the subscription price of the ICO digital token would be paid in cryptocurrencies, "exchanging" of cryptocurrencies could be at issue), (ii) whether the digital tokens issued in the ICO would be categorised as "Virtual Currencies" under the PSA and (iii) whether such digital tokens would be categorised as conventional securities under the existing securities regulations in Japan, especially where such tokens grant equity type rights to subscribers. If the digital tokens are considered to be

conventional securities, traditional securities regulations would apply to the ICO. JFSA will monitor markets of Virtual Currencies and ICO activities to consider whether any regulatory actions would be required or appropriate.

People's Republic of China

In September 2017 a cross-agency working committee led by the People's Bank of China issued a Circular on Preventing Risks related to Initial Coin Offerings, categorising ICOs as an unauthorised and illegal public fundraising activity. This is the first time that Chinese regulators have set out their stance in respect of ICOs in China. The circular stated that ICOs may constitute a number of crimes such as illegal quasi-currency instruments offering, illegal securities offering, illegal fundraising, financial fraud and pyramid selling schemes. The

digital tokens used in ICOs are not currencies issued by competent authorities and may not be circulated or used as currency on the market. The circular stated that all ICOs in China should be halted immediately, and issuers that have completed ICOs should provide refunds to investors. Digital token financing/trading platforms (including websites and APPs) may be closed or barred from operating, and the business licenses of entities running such platforms may be revoked. Financial institutions and non-banking payment institutions are prohibited from directly or indirectly providing any ICOs-related services.

Recently, the relevant Chinese regulators (in particular, PBoC) have taken a number of regulatory actions related to Bitcoin usage including conducting on-site inspections of domestic Bitcoin trading platforms, summoning the senior management in charge of the relevant trading platforms for meetings, and urging these platforms to arrange self-surveys and take rectifying measures accordingly. These demonstrate the Chinese regulators' stance of increased supervision and oversight in this area.

Poland

In November 2017, the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego, KNF) issued a communiqué on Initial Token Offerings (ITOs) and Initial Coin Offerings (ICOs). In the communiqué the KNF stated that making investments in tokens, under ICOs, is highly risky. The KNF noted that actions in the scope of ICOs may potentially be subject to a number of legal requirements, including those pertaining to the preparation of an issue prospectus and public offering, the creation and managing of alternative investment funds and protection of investors, although they must be assessed on a case-by-case basis. In the communiqué the KNF drew the attention of potential investors and entities interested in implementing projects of this kind to the specific and significant risks related with ICOs. The KNF noted that potential buyers should be aware, in particular, of the possibility of losing their entire invested capital and possible lack of legal protection. The KNF explained that investors who are contemplating investing in ICOs are exposed to, in particular, the following risks: unregulated area susceptible to fraud and other irregularities; high risk of the loss of all or a portion of the funds invested; lack of information, inadequate documentation; lack of the possibility of "exiting" from the investment and very high fluctuations of value; defects of the technology used.

Russia

While the initial attitude of the Russian Government to cryptocurrencies was fairly cautious (with some officials even suggesting it would be a criminal offence to use cryptocurrencies), over the last 18 months there has been a considerable shift in mindset. Although Russia has not issued any specific regulations on cryptocurrencies yet, the issue is widely debated both by the Government and in the business community, with more and more businesses expressing interest in ICOs and a willingness to accept payments in cryptocurrencies. Accordingly, in June 2017 the Central Bank of Russia has together with the Ministry of Finance announced that draft legislation is being developed to define the legal and tax status of cryptocurrencies, and although limited information is available at this stage, it appears that the intention is to treat cryptocurrencies as "quasi-commodities".

Singapore

In the wake of an increase in the number of ICO offerings in Singapore, MAS issued a clarification on the regulatory position on digital token offerings on 1 August 2017, as well as a joint consumer advisory (with the Commercial Affairs Department of the Singapore Police Force) on investment schemes involving digital tokens and virtual currencies on 10 August 2017. On 14 November 2017, MAS published a further guide on the application of Singapore securities laws to offers or issues of digital tokens in Singapore.

MAS stated in the guide that the offer/issue of digital tokens in Singapore may be regulated if the digital tokens constitute capital markets products under the Securities and Futures Act (SFA). This would include securities, futures contracts, and contracts or arrangements for the purposes of foreign exchange trading or leveraged foreign exchange trading. Intermediaries who facilitate offers or issues of digital tokens, such as operators of platforms on which offerors of digital tokens may make primary offers or issues of digital tokens, operators of platforms on which digital tokens are traded, and persons who provide financial advice in respect of digital tokens, may be required to hold a licence to carry on such activities.

ESMA highlights ICO risks

On 13 November 2017 the European Securities and Markets Authority (ESMA) alerted investors and firms involved in ICOs to the risks involved. ESMA is concerned that investors may not be aware of the high risks they are taking such as the volatility of the price of the coins or tokens and that they may not benefit from the protection of EU laws and regulations where ICOs fall outside their scope. It urges firms involved in ICOs to give careful consideration to whether their activities constitute regulated activities as any failure to comply with the applicable laws will constitute a breach.

MAS had previously stated in March 2014 (and this was recently repeated in a media release published in December 2017) that virtual currencies are not regulated. However, MAS has clarified that they view a virtual currency (functioning as a medium of exchange, a unit of account or a store of value) as only one particular type of digital token. Where digital tokens represent ownership or a 'security' interest over an issuer's assets or property, for example, such tokens may be considered an offer of shares or units in a collective investment scheme under the SFA. Digital tokens may also represent a debt owed by an issuer and so be considered a debenture under the SFA. As such, the regulatory treatment of any token and, if applicable, the related ICO offering would need to be analysed carefully against existing regulations based on the terms of the token and the ICO and the activities and role of the various players using the framework discussed above.

The consumer advisory advised the public to exercise due diligence to understand the risks associated with ICOs and investment schemes involving digital tokens and virtual currencies, and also set out a non-exhaustive list of such risks. It further went on to advise the public to report any suspected cases of fraudulent investment schemes involving digital tokens to the police. This was reiterated by MAS in the December 2017 media release, in which it cautioned members of the public who are considering investing in cryptocurrencies.

MAS had stated in March 2014 (and it was recently repeated in a February 2018 parliamentary response) that intermediaries in virtual currencies would be regulated for money laundering and terrorist financing risks. The proposed anti-money laundering and countering the financing of terrorism framework for virtual currency intermediaries, as well as a new licensing regime for payment services (including virtual currency services), was consulted on as part of a public consultation (that closed on 8 January 2018) on the proposed changes to the payments regulatory framework under a new Payments Services Bill.

The requirements under the Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act (Cap. 65A), the Terrorism (Suppression of Financing) Act (Cap. 325) and the various regulations giving effect to United Nations Security Council Resolutions apply whether or not digital tokens perform functions within MAS' regulatory purview, as do suspicious transaction reporting requirements.

Spain

Spain's Stock Exchange Commission (CNMV) and the Bank of Spain, issued a communication in February warning of the risks associated with cryptocurrencies and ICOs. Accordingly, any ICO related activity in Spain requires careful consideration of payment services and anti-money laundering regulations (within the context of the EU Directives) as well as other general financial regulations.

United Arab Emirates

Overall, the UAE, like many other jurisdictions is not specifically regulating ICOs and other crypto-currency related activities unless the activity pertains, in substance, to other regulated activities, such as the offering of shares or trading in gold (where the relevant tokens purport to represent interests in such securities). However, each of the UAE Central Bank, the UAE Securities and Commodities Authority (SCA) and the financial free zone regulators in the Dubai International Financial Centre (DIFC) and Abu Dhabi Global Market (ADGM) have all issued warnings regarding subscriptions in ICOs and trading crypto-currencies generally and specific regulations are expected in the near future. Caution should therefore be adopted in marketing ICOs and other crypto-business to UAE investors.

There is, however, one form of crypto-business recently licensed in the UAE; a principal/proprietary trader in crypto-currencies in the Dubai Multi-Commodities Centre (DMCC). The DMCC, a free zone for certain corporations within the jurisdiction of Dubai, had created a licensing category for principal/proprietary trading in crypto-currencies, but such license was expressly limited to this – brokerage, exchange business and related payment services were excluded. The DMCC, which is not a financial services regulator, is currently limiting access to this licensing category, we understand, to avoid permitting activities for which a UAE Central Bank or SCA license is required.

UAE Central Bank

It remains unclear whether the UAE Central Bank intends to regulate "virtual currencies". In January 2017, the Central Bank published a new licensing framework for stored value facilities offering certain digital payment services, due to be implemented by 1 January 2018. This framework states "All Virtual Currencies (and transactions thereof) are prohibited". Following some confusion in the market, the Governor of the Central Bank, issued a statement in February 2017 that the regulations "*do not cover Virtual Currency*" and "*do not apply to Bitcoin or other cryptocurrencies, currency exchanges, or underlying technology such as blockchain*". No action has yet been taken, so far as we are aware, in respect of subsequent unlicensed ICOs offered in the UAE.

In October 2017, the Governor of the UAE Central Bank was reported in the press to have said the Central Bank considers digital currencies to pose high risks to investors and present money laundering risks. The comments may have sought to clarify that the Central Bank is not regulating a number of digital currency exchanges and ICOs marketed in the UAE.

We expect engagement between the SCA and Central Bank (along with the free zone regulators) as each develops its policies (see below).

SCA

The SCA issued its warning statement in February 2018 relating to ICOs, wishing to caution investors in respect of ICO schemes, being highly speculative with high volatility and low liquidity. The SCA highlighted a number of risks including (i) that ICOs are not regulated and may be subject to fraud risk (ii) unclear foreign laws apply and recovery of funds may be extremely difficult and (iii) the risk/return profile may be difficult to understand and there are no required standards/audits for information provided to investors. It was confirmed that the SCA does not presently regulate or recognize ICOs and no legal protection is offered to investors.

It is also yet to be determined whether certain types of crypto-currency business (such as exchanges or brokerage) will fall within future regulations for fintech being developed by the SCA. In February 2018, it was announced that the SCA has entered into an agreement with PWC to develop a regulatory framework for financial and regulatory technology in the UAE capital markets. The process will involve benchmarking international practices, the development of a regulatory sandbox to work with key stakeholders and devising a model and an operation plan. Reference was made to engagement with the UAE Central Bank as a part of the process.

Financial Free Zones

The Dubai Financial Services Authority (DFSA) issued a warning statement to investors in September 2017 that crypto currency investments should be treated as high risk and with unique risks which may be difficult to identify. The DFSA clarified that it does not regulate ICOs and also that it would not currently license firms undertaking such activities. Interest from firms engaging in crypto-currency business to become licensed in the financial free zones remains high and we understand the DFSA is currently internally considering its position and potential licensing regime, which may cover ICO activities in some form as part of a broader move towards licensing crypto-currencies as an investment loss. We expect further updates later this year.

Following this trend, the Financial Services Regulatory Authority (FSRA) in the ADGM has gone further and issued regulatory guidance to clarify for investors that whilst ICOs (or crypto currencies) would not be regulated in themselves, elements of certain ICO offerings, which can include activities of operating an exchange, offering securities or units in a fund and dealing in derivatives, can fall within the regulatory perimeter. In such case, the activities would be regulated in the usual way. The FSRA also confirmed that many aspects of ICOs, including spot transactions in virtual currencies, may not be regulated activities and investors must be aware of the lack of regulatory oversight.

The FSRA also made a formal announcement in February 2018 about its intentions to review and consider the development of a robust, risk-appropriate regulatory framework to regulate and supervise activities of virtual currency exchanges and intermediaries. We understand the FSRA is currently engaging with stake-holders and international counterparts to identify the scope of its proposed regulations and the key areas where this business presents unique risks requiring a specific regulatory approach. We expect further updates in the near future. However, at the present time, we do not expect its regulations to cover ICOs specifically, based on the published scope of exchange and brokerage.

United Kingdom

The United Kingdom Financial Conduct Authority (FCA) has issued a consumer warning about the risks of ICOs. It says "ICOs are very high-risk, speculative investments." It adds that whether an ICO falls within the FCA's regulatory boundaries or not can only be decided case by case and states: "Businesses involved in an ICO should carefully consider if their activities could mean they are arranging, dealing or advising on regulated financial investments. Each promoter needs to consider whether their activities amount to regulated activities under the relevant law. In addition, digital currency exchanges that facilitate the exchange of certain tokens should consider if they need to be authorised by the FCA to be able to deliver their services." The FCA had previously noted in its April consultation on the potential for the future development of distributed ledger technology in regulated markets, that "depending on how they are structured, they may, therefore, fall into the regulatory perimeter". As the FCA has indicated, there are a number of regulated activities that issuers and participants in ICOs would need to consider and navigate, including deposit-taking and e-money issuance, CFDs and derivatives as well as the broad definition of what constitutes a collective investment scheme and applicable anti-money laundering regulations.

United States

In the United States, most offers and sales of tokens in ICOs are subject to the U.S. securities laws and to the jurisdiction of the U.S. Securities and Exchange Commission (SEC) or state securities regulatory agencies, requiring such offerings to be conducted on a registered basis or to qualify for exemptions from registration. A “security” is generally considered to be an “investment contract”, defined as an investment of money made with an expectation of profits arising from a common enterprise that depends largely on the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

In July 2017, the SEC first issued an investigative report (The DAO Report) on whether the digital tokens sold in an ICO by The DAO, a virtual decentralized autonomous organization built on Ethereum’s blockchain and functioning by means of smart contracts technology, were in fact securities under the federal securities laws. Here, the proceeds of tokens sold by The DAO were pooled and invested in various “projects” to be undertaken by independent contractors to develop products or services. Token holders would receive a share of profits from the projects as a return on their token investment. The SEC determined that the tokens issued by The DAO were securities, subjecting The DAO to its jurisdiction. The SEC was careful to note, however, that the analysis as to whether a token or other digital asset is a security depends on a careful examination of the particular facts and circumstances, including the economic realities of the transaction, implying that it does not consider all tokens to be securities. Subsequently the SEC has made clear that it does not consider Bitcoin, for instance, to be a security, meaning offers and sales of Bitcoin itself do not have to comply with the U.S. securities regulatory framework. Trading in Bitcoin itself is subject to a different federal regulatory regime presided over by the Commodity Futures Trading Commission.

Since The DAO Report, the SEC has pursued a number of enforcement actions against ICO issuers and released public statements warning intermediaries facilitating trading of ICO tokens, such as virtual currency exchanges, of their obligation to register and be regulated as securities exchanges. So far, the SEC has brought fraud and registration charges against promoters of ICOs involving: (1) purportedly diamond- and real estate-backed tokens that were in fact backed by nothing (RECoin and Diamond Reserve Club), (2) a cryptocurrency, the proceeds of whose sale would purportedly be used by the issuer’s management team (including multiple recidivist securities law violators) to develop a proprietary global payment network and credit card, but which were instead misappropriated by them to pay for personal expenses (Plexcoin), (3) a cryptocurrency issued by the “world’s first decentralized bank” and its purportedly fully-licensed subsidiaries whose deposit accounts were FDIC-insured, which would supposedly be convertible into hundreds of other cryptocurrencies and spendable using a proprietary credit card, but instead turned out to be an elaborate fraud which neglected to disclose the felony robbery and felony theft convictions of its top management (AriseCoin/ AriseBank), (4) Bitcoin-denominated shares of virtual currency enterprises, marketed and traded over an unregistered securities exchange, whose operator misappropriated customer funds for personal expenses and fraudulently failed to disclose a separate theft of customer Bitcoin caused by a cyber hack (BitFunder) and (5) tokens, endorsed by popular celebrities like boxer Floyd Mayweather and musician DJ Khaled, the proceeds of whose sale were purportedly to be used to develop a cryptocurrency debit card that, because of partnerships with Visa and Mastercard, could be used to spend cryptocurrency at any real-world merchant using those card networks, but was in fact a complete scam (Centra Coin).

As the foregoing demonstrates, most of the SEC’s ICO enforcement activity to date has been focused on cases involving fraud. However, the SEC has also brought at least one case against an issuer of “utility tokens” where only registration violations, and not fraud, were alleged. Unlike securities, so-called “utility tokens” confer the right to use goods or services, rather than representing an ownership interest in an issuer. Some market observers have argued that utility tokens are not securities because holders are motivated primarily by a desire to *use* or *consume* them, rather than by a desire to hold them as passive investments like securities. Therefore, any expectation of profits from owning utility tokens would not derive from the managerial or entrepreneurial efforts of others (*i.e.* the issuer or promoter), but instead arises from commodity-like market supply and demand or the token holder’s *own* efforts in using the token, thereby apparently escaping the application of the *Howey* test. However, the SEC’s enforcement action against Munchee, Inc., which planned to use utility tokens in its restaurant-review smartphone app, appears to have rejected this theory.

The SEC argued that, even if Munchee’s tokens were utility tokens, the expectation of profits harboured by potential investors likely would have stemmed from the “efforts of others”, *i.e.* the *issuer’s* managerial and entrepreneurial efforts, given that the issuer would hire the persons who would set up the network and write the software code, as well as attract and retain the necessary ecosystem participants – restaurants, advertisers, reviewers, and of course ordinary consumers – through promotional and marketing efforts targeting them, and also make the tokens more attractive to own by creating a secondary market that would provide token investors with liquidity. Once the Munchee software network was operational, the issuer would be responsible for maintaining it on an ongoing basis, given it was not open-source. For all these reasons, even if Munchee’s tokens

were true utility tokens, the SEC determined that the expectation of profits would have derived from the efforts of the issuer, making Munchee's utility tokens securities. The SEC also questioned why the issuer would market its tokens by touting their financial performance relative to other cryptocurrency investments and target advertising towards financial investors using social media and message boards dedicated to Bitcoin and cryptocurrency investment, if it were intending to sell true utility tokens rather than securities.

Issuers like Munchee, Inc. have not been the only targets of the SEC's attention. In the Bitfunder case mentioned above, the SEC charged the online platform over which Bitcoin-denominated securities were traded with operating as an exchange without registering with the SEC or qualifying for an exemption from registration. Shortly afterward the SEC's Divisions of Enforcement and Trading and Markets released a Public Statement reminding operators of online trading platforms which operate as exchanges of the need to register as such with, or seek an exemption from, the SEC. An "exchange" is generally defined as an organization, association, or group of persons providing a market place or facilities for bringing together the orders for securities of multiple buyers and sellers, using established, non-discretionary methods (such as an electronic trade matching engine) under which orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. Furthermore, even if they do not meet the criteria for an "exchange", online platforms offering digital wallet services may trigger other categories of registration requirements under the federal securities laws, including those for broker-dealers, transfer agents, or clearing agencies.

Apart from the SEC, state securities regulators have been active as well in taking action against ICOs for both fraud as well as registration violations. A case brought by the Massachusetts securities regulator is particularly notable, because the issuer tried to limit the sale of the tokens in the ICO solely to persons outside the U.S., in order to avoid triggering either federal or state securities registration requirements. The issuer hired a third party vendor to supply software that would screen out U.S. persons based on their IP addresses. Potential purchasers with U.S. IP addresses identified by the software were required to upload government-issued photo identification, which would be reviewed manually by the ICO issuer's personnel and, if necessary, prohibited from participating in the ICO. However, the Massachusetts securities regulator found that these precautions were not enough, based on the fact that they were easy to circumvent and did not actually prevent the sale of tokens in the ICO to Massachusetts investors. As evidence of this, the Massachusetts securities regulator cited the fact that at least two U.S. investors, including one of its Massachusetts-based employees, were approved to participate in the ICO.

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