

Update on the Status of Initial Coin Offerings in Europe

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With crypto-currencies on the rise and technological developments providing great opportunities in the financial services sector, Initial Coin Offerings (“ICO”) provide an innovative way of raising capital. They are particularly interesting for start-up companies as an alternative to venture capital financing. Equally, ICOs could become a novel path of financing for small and medium-sized enterprises (“SME”) – an important objective of the European capital markets union. Regulators in a variety of countries have been making an effort to communicate regulatory guidance to issuers and investors and the common perception that the ICO market is unregulated no longer holds true.

What is an ICO?

ICOs are an increasingly popular method of start-ups and other companies to raise capital. Investors participate in the fundraising by transferring fiat currencies, such as US dollar (“USD”), Euro or Renminbi, or crypto-currencies, such as Bitcoin or Ether, to the issuer in exchange for digital tokens (“Tokens”). Tokens represent a holder’s right of benefit or performance vis-à-vis the issuer. Tokens may also be used (exclusively) for payment to the issuing company for its services or products. Contrary to a traditional initial public offering (“IPO”), most Tokens typically do not represent an ownership interest or dividend right in the issuer’s entity. ICO investors seek to directly benefit from the issuing company’s future business, while investors in IPOs tend to pursue a long-term interest in the value-creation of the IPO entity.

The underlying technology of the Tokens is based on blockchain (an electronic distributed and therefore generally fraud-resistant ledger, in which transactions are protocolled in a documented and reproducible way without a central authority (also referred to as distributed ledger technology - “DLT”) which is maintained by a network of participants and computers. Utilizing cryptography to record transactions, blockchains process, verify and track the trade of the relevant virtual currency (Bitcoin or Ether) securely across independent network components.

Similarly to IPOs, the issuer can use the proceeds of the ICO to finance its business operations and future growth. In the event that Tokens are exchanged for other crypto-currencies, the issuing company can exchange them for fiat currencies, as required. As the features of Tokens issued in ICOs can vary widely, every Token has to be assessed individually. Tokens are typically tradable on virtual currency exchanges, creating a secondary Token market, which makes them fungible in the same way as shares.

To market an ICO, it is currently market practice that the issuing company publishes a whitepaper (“Whitepaper”) on its website and certain virtual platforms (see further below under “Documentation Requirements and Liability Issues”).

The international ICO market is developing rapidly. In 2016, approximately USD 94 million were raised through ICOs globally.¹ In 2017, ICOs yielded an estimated USD 6.6 billion, exceeding USD 1.7 billion in December 2017 alone.² Despite rising regulatory pressure, approximately USD 21.5 billion were raised in 2018.³ Although the second half of 2018 saw a light decline, 2019 already realised a total of USD 126.3 million through ICOs.⁴ This significant market growth and the fact that ICOs offer limited investor protection with many recorded fraudulent activities in the past have caught the attention of regulators all over the world. Many jurisdictions still rely on applying existing securities and financial market regulations to ICOs. However, efforts towards providing regulatory guidance to issuers, investors and financial markets as a whole are becoming more tangible.

To comply with regulatory requirements, potential ICO issuers should seek qualified securities' counsel advice to conclusively analyse the applicable legal framework.

Types of Tokens

Although there is no established classification of Tokens, the categorisation introduced by the Swiss Financial Market Supervisory Authority ("FINMA") based on the economic functions of the Tokens proved to be widely accepted.⁵

- Utility Tokens: are intended to provide access to a specific application or service but are not accepted as a means of payment for other applications. The value of the service or product depends on the perception of the investor, making him comparable to a purchaser of a product or service;
- Asset Tokens (or Security Tokens): represent assets such as a debt or equity claim against the issuer as they promise the owner a share in the future profits or capital flows of the underlying company (sale of the tokens, dividends, interest). They resemble bonds, financial instruments or derivatives; and
- Payment Tokens (or Currency Tokens): represent a means of payment for goods and services and are true virtual currencies with the most prominent example being Bitcoin. The holder has no claim against the issuer.

Tokens combining several features of these different token categories are referred to as Hybrid Tokens.

Financial Regulation of ICOs and Legal Classification of Crypto-Currencies and Tokens

Applicable regulations are not necessarily limited to those of the jurisdiction governing the ICO. When marketed to investors residing or domiciled in another jurisdiction, financial regulatory rules of such jurisdiction may equally apply to the ICO. A governing law clause does not dispense the ICO issuer from compliance with such financial regulation. Publishing the Whitepaper in a certain language may already be presumed as marketing of an ICO and consequently cause regulatory exposure. For example, a Whitepaper in German is likely to be considered as targeting investors in Germany, regardless of the issuer's residence, and would consequently subject the ICO to the complete scope of German regulation. Existing investor-targeting regulation, for example in relation to market sounding, should be considered to reduce the risk of incompliance until further guidance becomes available.

Issuers of ICOs will be required to limit accessibility of ICO information and documentation to those residents of those jurisdictions that were pre-determined prior to launching the ICO based on a regulatory feasibility analysis. Failure to do so is likely to increase regulatory scrutiny by competent regulators.

Further, the regulatory status of crypto-currencies, including Tokens, largely depends on the jurisdiction of the issuance and the rights associated with the crypto-currency. The purchase of Tokens issued in connection with an ICO can be qualified as a purchase of commodities, a purchase of rights or a purchase of securities, which may ultimately subject ICOs and Whitepapers to prospectus or other disclosure requirements.

¹ <https://www.coinschedule.com/stats.html?year=2016>

² <https://www.coinschedule.com/stats.html?year=2017>

³ <https://www.coinschedule.com/stats.html?year=2018>

⁴ <https://www.coinschedule.com/stats.html?year=2019>

⁵ See SMSG Advice to ESMA, Own Initiative Report on Initial Coin Offerings and Crypto-Assets, 19 October 2018, available at: https://www.esma.europa.eu/sites/default/files/library/esma22-106-1338_smsg_advice_-_report_on_icos_and_crypto-assets.pdf

The following outlines the current regulatory environment for certain jurisdictions.

European Union

On 9 January 2019, the European Banking Authority (“EBA”)⁶ and the European Securities and Markets Authority (“ESMA”)⁷ published two reports providing advice on crypto-assets for the European Commission (“EC”), and ESMA further to the EU Parliament and Council. These respond to the EC’s 2018 FinTech action plan⁸ request for the European Supervisory Authorities (“ESAs”) to assess the suitability of the current EU regulatory framework. The definition of crypto-assets provided by EBA and ESMA includes crypto-currencies and Tokens.

ESMA’s report contains the outcome of its 2018 survey, which summarises the EEA Member States’ views on the qualification of a sample set of crypto-assets as financial instruments under the respective national transposition of the Markets in Financial Instruments Directive II (“MiFID II”). Where crypto-assets qualify as transferable securities, the legal framework for the regulation and supervision of financial instruments applies to crypto-assets: the Prospectus Directive, the Transparency Directive, MiFID II, the Market Abuse Directive, the Short Selling Regulation, the Central Securities Depositories Regulation and the Settlement Finality Directive. Nevertheless, ESMA recognises the existence of gaps and issues in the current regulatory framework vis-à-vis crypto-assets. Where a specific crypto-asset does not qualify as a financial instrument, no financial regulation or supervisory rules will apply leaving investors exposed to substantial risks. However, according to ESMA, all crypto-assets and related activities should be subject to Anti-Money-Laundering (“AML”) provisions.⁹

In May 2018, the European Parliament approved the fifth Anti-Money Laundering Directive (“MLD5”) making an initial step for a regulatory framework. The MLD5 amends the previous Anti-Money Laundering Directive (“MLD4”), *inter alia*, by providing a legal definition for “virtual currencies”. The Member States are obliged to implement MLD5 into national law within 18 months. The MLD5 further extends the scope of application of the MLD4 to (i) “providers engaged in exchange services between virtual currencies and fiat currencies” and (ii) “custodian wallet providers”. Therefore, service providers are subject to the same regulatory framework, which applies for banks and other financial institutions under this directive.

In a report by the Securities and Markets Stakeholder Group (“SMSG”) dated 19 October 2018¹⁰, the SMSG advised ESMA that Payment/Currency Tokens should be viewed as financial instruments under MiFID II as they can be considered as investment objects. Utility Tokens, however, should only be added to the list of financial instruments if they are transferable. The report made different suggestions for Security or Asset Tokens depending on whether they are financial instruments under MiFID II and the Market Abuse Regulation and transferable security under the Prospectus Regulation. Further, the SMSG urged ESMA to clarify the definition of “commodity” in level 3 guidelines and to define the conditions when Security Tokens giving right to a commodity are to be considered MiFID II financial instruments. Lastly, the SMSG was asking ESMA to provide guidelines setting out minimum criteria for national authorities operating or wanting to operate a sandbox or innovation hub.

The EBA report provides an overview of the ambit of EU financial services law, in particular if crypto-assets qualify as financial instruments, electronic money or neither and the implications thereof. It also focusses on the secondary market (e.g. crypto exchanges). Generally, EBA’s and ESMA’s report concur.

Germany

In Germany, the Bundesanstalt für Finanzdienstleistungsaufsicht (“BaFin”) will determine the applicability of certain national legislation including the German Banking Act (*Kreditwesengesetz*, “KWG”), the German Securities Prospectus Act (*Wertpapierprospektgesetz*, “WpPG”), the German Capital Investment Code (*Kapitalanlagegesetzbuch*), the German Capital Investment Act (*Vermögensanlagegesetz*, “VermAnlG”) and

⁶ <https://eba.europa.eu/documents/10180/2545547/EBA+Report+on+crypto+assets.pdf>

⁷ https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf

⁸ https://ec.europa.eu/info/publications/180308-action-plan-fintech_en

⁹ For a more detailed analysis of the EBA and ESMA reports, see the White & Case Client Alert: Cryptoassets and ICOs: EU Regulators Show their Hand, available at: <https://www.whitecase.com/sites/whitecase/files/files/download/publications/cryptoassets-icos-eu-regulators.pdf>

¹⁰ SMSG Advice to ESMA, Own Initiative Report on Initial Coin Offerings and Crypto-Assets, 19 October 2018, available at: https://www.esma.europa.eu/sites/default/files/library/esma22-106-1338_smsg_advice_-_report_on_icos_and_crypto-assets.pdf

the Payment Services Supervisory Act (*Zahlungsdiensteaufsichtsgesetz*) on an individual case-by-case basis. The application of such legislation will depend on the contractual arrangements of each ICO. Market participants providing services related to Tokens, dealing with Tokens or publicly offering Tokens must consider whether the Tokens constitute a regulated instrument under the applicable rules and legislation.¹¹

Security Tokens may, under German law, qualify as securities under the German Securities Trading Act (*Wertpapierhandelsgesetz*, “WpHG”) and the WpPG. If the rights represented by the Tokens are comparable to shares, bonds etc., they can be considered a transferable security which is one of the characteristic features for a security. They could equally represent a capital investment under the VermAnlG, which includes “*other investments*” as it can be assumed that a Token promises a dividend or other kind of interest payment. Under the WpPG and the VermAnlG, the offering of both securities and capital investments requires the publication of a prospectus approved by the BaFin.¹²

By contrast, pure Utility Tokens are not regulated as financial instruments. The BaFin will first ascertain whether a token actually qualifies as a payment token or as an equity token. If the assessment is negative, BaFin classifies the token as a pure utility token and no regulatory consequences apply.

With regard to Currency Tokens such as Bitcoin, the legal classification has, until recently, been controversial in Germany as the BaFin was of the opinion that Bitcoin qualified as financial instruments within the meaning of the KWG. The categorisation of Bitcoin as a financial instrument results in additional regulatory obligations, in particular licensing requirements as Bitcoin trading is deemed to involve the conduct of banking transactions and/or the provision of financial services. If the required BaFin licence has not been obtained, this may result in a statutory offense under the KWG, which provides for fines or imprisonment for up to five years.

In its ruling of 25 September 2018, the Berlin Court of Appeal renounced this categorisation and decided that Bitcoins do not constitute financial instruments within the meaning of the KWG, and, in particular, not units of account. Due to this fact alone, the KWG was not generally applicable here.

Switzerland

In a guideline published in February 2018, FINMA outlines its approach for enquiries regarding the applicability of financial market regulation to ICOs¹³ and complements FINMA’s Guidance 04/2017 published in September 2017.¹⁴ FINMA will determine the applicability of regulatory law on an individual basis, distinguishing between Payment Tokens, Utility Tokens, Asset Tokens and Hybrid Tokens depending on the underlying economic function of the token. FINMA further considers if Tokens can be classified as securities and concludes that (i) Payment Tokens/crypto-currencies will not be treated as securities; (ii) Utility Tokens will not be treated as securities if their sole purpose is to confer digital access rights to an application or service and if the Utility Token can actually be used in this way at the point of issue. However, FINMA will treat Utility Tokens as securities if they additionally or only have an investment purpose at the point of issue; and (iii) Asset Tokens are treated as securities. If FINMA classifies ICO tokens as securities, they fall under the securities regulation with all the legal consequences this entails (e.g. possible prospectus requirement).

In a report dated 14 December 2018 by the Swiss Federal Council on the legal framework for distributed ledger technology and blockchain in Switzerland, the Federal Council concludes, *inter alia*, that the Swiss legal framework is already suitable for dealing with business models based on DLT and blockchain and provides further advice to create the best possible framework conditions.¹⁵

¹¹ BaFin: “Hinweisschreiben, WA 11-QB 4100-2017/0010”, 20 February 2018, available at:

https://www.bafin.de/SharedDocs/Downloads/DE/Merkblatt/WA/dl_hinweisschreiben_einordnung_ICOs.html

¹² As recently confirmed in the reply by the German Government to an official inquiry (Drucksache 19/6975, 14 January 2019), available at: <http://dip21.bundestag.de/dip21/btd/19/069/1906975.pdf>

¹³ Swiss Financial Market Supervisory Authority: “Guidelines for enquiries regarding the regulatory framework for initial coin offering (ICOs)”, 16 February 2018, available at <https://www.finma.ch/de/news/2018/02/20180216-mm-ico-wegleitung/>

¹⁴ Swiss Financial Market Supervisory Authority: “Guidance 04/2017: Regulatory Treatment of Initial Coin Offerings”, 29 September 2017, available at: <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/4dokumentation/finma-aufsichtsmittelungen/20170929-finma-aufsichtsmittelung-04-2017.pdf>

¹⁵ <https://www.news.admin.ch/news/message/attachments/55153.pdf>

United Kingdom

On 23 January 2019, the UK Financial Conduct Authority (“FCA”) launched a consultation (CP19/3) on Guidance¹⁶ for market participants on the classification of crypto-assets within the regulatory perimeters, in particular the Regulated Activities Order, MiFID II, the E-Money Regulations and the Payment Services Regulations. The FCA makes suggestions regarding the categorisation of, *inter alia*, Exchange Tokens (no “specified investment”), Utility Tokens (no “specified investment”) and Security Tokens (possibly a “specified investment” and therefore within the regulatory perimeter). The Guidance also provides model Q&A on common related questions.¹⁷

In October 2018, the UK Crypto-assets Taskforce (comprising HM Treasury (“Treasury”), the FCA and the Bank of England) already published a final report on crypto-assets and their underlying technology assessing the associated risks and potential benefits, and setting out a new path for the regulation of crypto-assets in the UK.¹⁸ The Taskforce classifies crypto-assets by reference to three broad types: (i) Exchange Tokens (crypto-currencies, e.g. Bitcoin); (ii) Security Tokens (crypto-assets falling within the definition of an existing regulated investment in the UK); and (iii) Utility Tokens. The Taskforce emphasises that each crypto-asset must be assessed on a case-by-case basis to determine whether or not its features can bring it within the scope of existing financial regulation. However, the report contains no proposals to regulate Utility Tokens or Exchange Tokens in the UK (currently unregulated). The report also reaffirms the current regulatory position in the UK that crypto-assets are not considered to be a currency or money.

France

On 12 September 2018, the French Parliament passed a new ICO legislation creating a legal framework for ICOs in France. This regulation, which has yet to be ratified by the government (and is expected to come into force around summer 2019), provides, *inter alia*, (i) a legal definition for Tokens and crypto-assets; (ii) an optional approval from the Autorité des Marchés Financiers (AMF) for ‘utility’ ICOs; (iii) a legal framework for crypto-asset intermediaries (exchange platforms, custodians, investment advisors, etc.); and (iv) an ad hoc tax regime for investors and ICO issuers. It also establishes the accounting rules applicable to ICO issuers, ICO investors, and more generally any company holding any kind of crypto-currency or crypto-asset. This regulation, however, will not apply to Security Tokens as under French law, these are considered to be regular financial instruments and therefore may not benefit from any provision of this regulation. These token offerings will have to comply with the regulations applicable to public offerings of securities.

Documentation Requirements and Liability Issues

Generally, transaction documentation must include all necessary information to permit an average investor to make a reasonable investment decision. The documentation must be accurate and not misleading, comprehensive and transparent. It should include a description of the issuer’s business, potential risk factors as well as a description of the characteristics of the Tokens. Statements on future developments must be reasonable and the use of proceeds be disclosed. If qualified as general terms and conditions, the terms of the sales documentation must comply with specific local requirements. While initially most ICOs were marketed globally, more and more ICOs are more restrictive and are only marketed to investors in certain jurisdictions or exclude investors in certain jurisdictions.¹⁹

In addition to the laws relating to the regulation of transferable securities or capital investments (depending on the classification of the Tokens), other aspects that have to be considered in connection with an ICO and the choice of the Token include anti-money laundering and financial crime requirements (as set out in the MLD5), privacy and data protection issues (as recently introduced by the General Data Protection Regulation in the EU) as well as accounting and taxation aspects.

Whitepapers relating to many previous ICOs may not always have complied with the above standards. Transparency and comprehensiveness of a Whitepaper are currently often not examined by regulatory

¹⁶ FCA Guidance on Cryptoassets, available at: <https://www.fca.org.uk/publication/consultation/cp19-03.pdf>

¹⁷ For more information on the Guidance, see the White & Case Client Alert: ICOs and Security Tokens: FCA Consults on Crypto Guidance available at: <https://www.whitecase.com/publications/alert/icos-and-security-tokens-fca-consults-crypto-guidance>

¹⁸ Cryptoassets Taskforce: final report, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

¹⁹ An overview is available online at: <https://www.smithandcrown.com/icos/>

authorities. Risk factors, if included at all, are frequently limited to vaguely standardised descriptions of potential conflicts. It is also doubtful to what extent a reasonable investment decision can be made in the absence of (audited) historic financial information, but conversely, ICOs commonly occur in the early stages of launching a business.

Unfortunately, at present there is no established case law available in respect of inaccurate, incomplete or misleading ICO documentation. This may change as a result of recent investigations or when investors are seeking damages for ICO investment losses. In April 2019, a first landmark decision on fraudulent ICOs is expected in the US after the ruling of a district court applying US securities law to the ICO in question.

Under German law, any shortcomings in the documentation of an ICO may result in the potential prospectus liability pursuant to § 311 German Civil Code.

ICOs for SME Financing

According to Eurostat, SME are referred to as the backbone of the European economy, providing a potential source for jobs and economic growth. In 2017, SME in the EU-28 non-financial business sector accounted for almost all EU-28 non-financial business sector enterprises (99.8 %), two-thirds of total EU-28 employment (66.4 %) and slightly less than three-fifths (56.8 %) of the value added generated by the non-financial business sector.²⁰

However, due to the increase of borrowing costs caused by Basel III and the lack of transparency, this form of financing has become increasingly less attractive. At the same time, it is often not viable for SME to access the debt capital market at economically justifiable conditions, as the entry costs and continuing costs are relatively high compared to the (sometimes) little capital raised.

ICOs may offer a range of benefits, which are particularly attractive for SME²¹:

- Low cost by efficiency savings: absence of intermediation and efficiency gains from the use of blockchains and automation and lower regulatory requirements.
- Flexibility, speed and liquidity: possibility to invest in fractions of Tokens only, speed of execution thanks to the use of blockchain and DLT and almost immediate liquidity as Tokens issued can be traded instantaneously.
- Unlimited investor pool: even small retail investors may invest, thereby providing greater diversity and heterogeneity of investors.
- No risk of dilution: an ICO issuer does not share equity ownership or control in their company.

Unfortunately, these important benefits of ICOs are facing several disadvantages:

- Regulatory uncertainty and arbitrage: differing regulatory frameworks depending on the jurisdiction(s) involved and possible absence of supervision, which may be exploited.
- Absence of disclosure requirements: information asymmetries due to the absence of or differing disclosure requirements.
- Lack of consumer and investor protection: risks associated with ICOs difficult to gauge for retail investors and legal uncertainty around compensation rights.
- High fraud risk.

In order to become a sustainable alternative to traditional bank lending for SME financing purpose, it seems vital to create a robust regulatory and supervisory framework.

²⁰ Annual Report on European SMEs 2017/2018, available at: https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_en#annual-report

²¹ As set out in OECD report on Initial Coin Offerings (ICOs) for SME Financing, published on 15 January 2019, available at: <http://www.oecd.org/finance/ICOs-for-SME-Financing.pdf>

Regulatory Sandboxes and Innovation Hubs

In response to the criticism towards legislators and regulators for not keeping pace with industry practices and initiatives, regulators in several countries have opted to create “innovation facilitators” in the form of regulatory sandboxes and innovation hubs enabling potential providers to develop their business models and testing the boundaries of the law in a supervised environment.

Regulatory sandboxes and innovation hubs differ in their scope. An innovation hub is likely to be integrated within the supervisory authority responding to enquiries made by potential operators to what extent potential new products or services meet regulatory requirements and consumer protection expectations. Regulatory sandboxes go further and allow operators to offer a new product or service to actual consumers by ensuring compliance with consumer protection rules.

On 7 January 2019, the Joint Committee of ESAs published a report on sandboxes and innovation hubs.²² In the report, the ESAs analyse the innovation facilitators established to date within the EU. The ESAs also set out ‘best practices’ regarding the design and operation of innovation facilitators, informed by the results of their analysis and the experiences of the national competent authorities in running them. Further, options for future EU-level work on innovation facilitators are being discussed.

Conclusion and Outlook

ICOs offer an attractive alternative to raise capital, in particular for SME as faster financing at lower costs with a more diverse investor base is possible. Although the majority of countries still have no specific ICO regulation in place, blockchain technology does not release users from the need to comply with the existing regulatory framework. However, recent developments indicate that the assumption of some market participants that ICOs were entirely unregulated is misleading. Some countries are acting as pioneers for the implementation of ICO regulations pathing the way to a more regulated approach to this new financing technique, e.g. Malta, Liechtenstein and France where legislation regarding ICO regulation is under way. With the global nature of ICO issues, the co-operation at international level to prevent regulatory arbitrage and to provide sufficient investor protection is vital in the elaboration of a legal framework.

A “new coin on the block”?

There may, however, be a safer trend in sight. The “new coin on the block” are stablecoins. Stablecoins are crypto-assets whose prices are linked to a stable value like fiat currencies (e.g. USD, EUR) or commodities (e.g. gold). To avoid the volatility of most crypto-currencies, their value is fixed in relation to their underlying asset while thereby offering many of the transactional benefits of digital assets with enhanced stability. In this way, stablecoins offer a bridge between the traditional financial markets and the emerging opportunities offered by crypto-currency technologies. Despite its potential attractiveness, the question about legal certainty remains the same.

An interesting time lies ahead. Regulators and legislators now have to collaborate closely to establish a framework, which allows both for the creation of new forms of financing methods, particularly for SME, without at the same time neglecting consumer protection issues. Initiatives such as the recent ESMA, EBA and ESA reports as well as recommendations by the Financial Action Task Force are important stepping stones towards a sound legal framework regulating ICOs and crypto-assets.

²² Fintech: Regulatory Sandboxes and Innovation Hubs, available at: <https://eba.europa.eu/documents/10180/2545547/JC+2018+74+Joint+Report+on+Regulatory+Sandboxes+and+Innovation+Hubs.pdf>

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