

International ICOs – legal challenges and implications

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WHITE & CASE

Agenda - Initial Coin Offerings (ICOs)

1. White & Case & ICOs
2. Significance, Description and Key Features of ICOs
3. Benefits and Risks
4. Securities Laws and other Regulation of ICOs
5. International Differences in ICO Regulation
6. ICOs and Corporates
7. Outlook on Regulation

1. White & Case and ICOs

Why White & Case?

White & Case has a leading, global Financial Institutions Advisory group, that focuses on advising corporations, governments, investors, and financial institutions in connection with all aspects of the FinTech and Blockchain ecosystems.

- **Forward-looking Lawyering.** Rapidly developing advances in FinTech and changing consumer behaviors are driving fundamental changes to the way financial institutions deliver products and services to their clients. Blockchain ledger technology (Blockchain), and the cryptocurrencies (crypto) enabled by Blockchain, play a key role in the latest wave of FinTech innovation. While these innovations are potentially significant sources of revenue enhancement and cost reduction for our clients, the legal and regulatory issues presented by application of Blockchain technologies are oftentimes novel, complex, and multi-jurisdictional in nature.
- **Dedicated, Accomplished Team.** To help our clients navigate the rise of these FinTech technologies, White & Case offers a team of committed senior-level lawyers to cover the latest developments and market trends in the FinTech and Blockchain ecosystems. Our lawyers are often at the forefront of these advances and pioneer first-of-their-kind transactions and solutions in the space, and they include several former financial regulators in the US and abroad, former in-house lawyers and executives at global financial institutions, and leaders in the private financial services and FinTech bars.
- **Comprehensive Solutions.** We advise on a range of carefully crafted pilot programs, on the one hand, to fundamental enterprise-wide digital transformations, on the other. Our FinTech team spans the globe, and we have critical bench strength in the key financial and technology centers throughout the world among our 43 global offices. We, thus, are able to deliver comprehensive FinTech solutions to our clients along regulatory, transactional, enforcement, and public policy practice areas.
- **Ready to Help.** The pages that follow highlight our representative matters in this space. We would be happy to share further details of our global capabilities and global team members that would be able to serve your FinTech needs.

Awards & Rankings

“White & Case has an extensive roster of large banking and technology clients, and a strong practice in respect of a range of legal issues in the FinTech space, including blockchain and AI.”

“They have excellent expertise in financial regulation as applicable to FinTech, and they are very responsive, which makes them great partners for lengthy negotiations taking place in several countries.”

***Chambers Professional Advisers:
FinTech 2018***

“ Regularly advises clients in various fields, such as technology... and financial services on outsourcing matters, and has experience in protecting clients' technology and data assets.”

Chambers Global 2017

“highlighted for... representation of financial institutions in technology and outsourcing transactions, drawing on significant experience in fintech developments.”

Chambers USA 2017

Dedicated Global White & Case Team



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Offices

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Countries

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Continents



White & Case
at a glance

Americas

Boston	Miami
Chicago	New York
Houston	São Paulo
Los Angeles	Silicon Valley
Mexico City	Washington, DC

Europe, Middle East and Africa

Abu Dhabi	Dubai	Johannesburg	Riyadh*
Astana	Düsseldorf	London	Stockholm
Berlin	Frankfurt	Madrid	Tashkent
Bratislava	Geneva	Milan	Warsaw
Brussels	Hamburg	Moscow	
Cairo	Helsinki	Paris	
Doha	Istanbul	Prague	

Asia-Pacific

Beijing	Shanghai
Hong Kong	Singapore
Jakarta*	Sydney
Melbourne	Tokyo
Seoul	

* Associated firm

2. Significance, Description and Key Features of ICOs

Illustrative Process; Success Factors

Illustrative Process

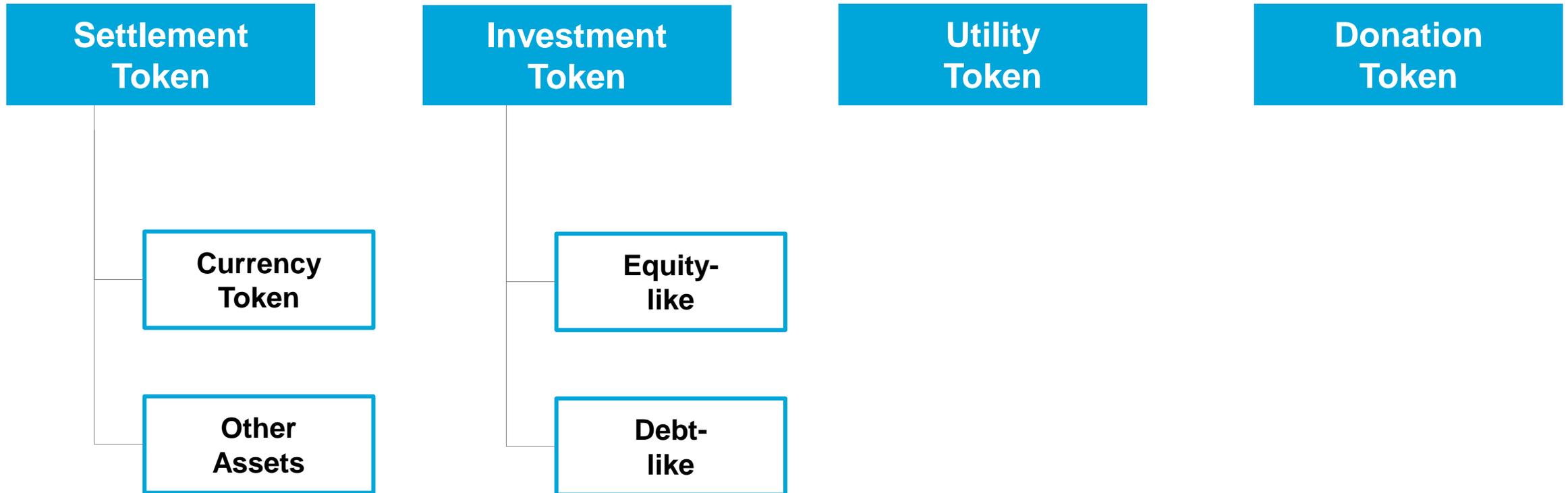
- Preparation
 - White Paper
 - Investment Agreement
- Private Presale
- Public Presale
- Main Sale
- Post ICO-Management

Success Factors

- Structured Approach
- Business Plan
- Marketing (Reddit, Twitter, Social Media)
- Community Management
- Incentives to Generate Network Effects
- Time to Market
- Legal Analysis

Note: What may be desirable in one jurisdiction may be highly problematic in another

Various forms of tokens



3. Benefits and Risks

Select Benefits

Issuers

- May be a faster and easier fundraising method
- Due to the online nature of ICO marketing and settlement, costs are significantly lower
- May avoid equity dilution
- Can isolate economics in one asset or product line via cryptonomic design

Investors

- ICOs offer the opportunity to see gains more quickly and to take profits out more easily (high-risk, high-reward market)
- Cryptocurrencies can appreciate quickly in value (Bitcoin was worth USD 100 in 2013 and in December 2017 it was trading just under USD 20,000; Monero and NEM both saw increases in value up to 2,000%)
- May be able to reach a broader investor base (democratization) depending on regulatory restrictions

Select Risks

- **ICOs are Early Stage Products.** Many start-ups work with experimental business models that come with high price volatility and a high risk of total investment default or loss
- **Manipulation.** Vulnerability of technology opens doors for manipulation
- **Accountability and Transparency.** The lack of a formal process to audit an ICO organization leads to legal and technological uncertainty
- **Fraud:** There have been cases of fraudulent use of ICOs to raise funds to be used in ways which were not originally marketed to investors
- **Inadequate Information/Disclosure:** Whitepapers may not specifically be regulated and consequently may be incomplete or misleading in comparison to regulated prospectuses
- **Investor Unsophistication:** Many investors lack knowledge of the investment they are making and regulators may be reluctant to attempt to regulate the technology which they may not fully understand
- **Legal and Regulatory Risk:** Jurisdictions treat ICOs differently, sometimes regulating them as securities (which are subject to comprehensive regulatory frameworks in each country)

4. Regulation of ICOs: Securities and Other Relevant Laws

Applicable Law – EU Law

- Prospectus Regulation
 - Extended exceptions from the obligation to publish a prospectus, streamlining of the prospectus, prospectus approval procedure is rationalized and simplified
- Markets in Financial Instruments Directive, as amended
 - Licensing requirements, product governance rules, pre- and post-trading transparency requirements, requirements for adequate systems and controls, organizational requirements for trading platforms, requirements for companies active in algorithmic and/or high frequency trading
- Alternative Investment Fund Manager Directive
 - Licensing requirements, conduct of business and transparency requirements, prospectus and disclosure requirements, mandatory appointment of depositories and custodians, restrictions on the use of leverage
- 4th/5th Anti-Money Laundering Directive
 - Due diligence on customers and ongoing monitoring of customer relationships, requirements regarding systems and controls and record-keeping, reporting on suspicious activities and co-operation with any investigations by relevant public authorities
- Market Abuse Regulation
- Electronic Money-Directive (EMD2) and PSD2
- E-Commerce Directive, Consumer Rights Directive, Distance Selling Directive

When does a token constitute a financial instrument, a security, a share in an investment fund or a capital investment?

- Case-by-case decision
- Financial Instrument pursuant to Annex I, Section C MiFID2
- Security pursuant to Art. 3 (1) MAR
 - Transferable (+)
 - Effectively negotiable on financial and capital markets (+ / -)
 - Standardized / Embodiment of rights (+)
 - No payment instrument (+ / -)
 - Functionally comparable with other debt or equity instruments in Art. 4 (1) Nr. 44 MiFID II (+ / -)
- Share in an investment fund
 - Tokens constitute shares in an investment fund if they are based on a share of an undertaking for collective investments
- Specific national laws: Example: capital investment pursuant to Sec. 1 (2) German Assets Investment Act (VermAnlG)
 - Neither a security nor a share in an investment fund
 - The acceptance of money does not constitute a deposit business (Sec. 1 (1) Sentence 2 Nr. 1 KWG)

Regulation of ICOs in the United States

Jurisdiction

- A company, even a non-US company outside the US, that offers securities to US investors, is subject to US securities regulation

- US securities regulation has two parts:
 - **Federal law:** Securities and Exchange Commission (SEC) regulation
 - **State law:** regulated by each of the 50 states

Regulation of ICOs in the United States

Jurisdiction

- Key question: Is the company offering a security?
 - SEC uses the *Howey* Test for “investment contracts,” a type of security under US law:
 - Investment of money
 - In a common enterprise
 - With the expectation of profits
 - Derived from the efforts of others
- Most token offerings intended to raise capital will be treated as a security offering for US purposes; these are generally investment contracts under federal law
- The states have similar (but not identical) tests

Regulation of ICOs in the United States

Difference between “utility” tokens and “security” token

- US law does not make a distinction between the two terms; these are market terms
- Just because something has utility, does not mean it is not a security: many tokens that are securities also have utility
- Example: Simple Agreement for Future Tokens (SAFT)
 - Once platform is built and functional, these tokens will be delivered and useable
- Bottom line: whether a token is described as a utility or security token, the *Howey* Test will still determine whether it is a security

Regulation of ICOs in the United States

What rights and responsibilities does a token provide? Purchase agreement is key

	Equity	Debt	Token
Investor rights	<ul style="list-style-type: none"> <input type="checkbox"/> State law (e.g., Delaware corporate law) <input type="checkbox"/> Purchase agreement <input type="checkbox"/> Bankruptcy law (equity owners are paid after debtholders) 	<ul style="list-style-type: none"> <input type="checkbox"/> State law (usury, licensing, etc.) <input type="checkbox"/> Purchase agreement <input type="checkbox"/> Bankruptcy law (higher priority than equity) 	<ul style="list-style-type: none"> <input type="checkbox"/> Generally no state law rights (starting to change, e.g., New York) <input type="checkbox"/> All rights specified in the purchase agreement <input type="checkbox"/> Bankruptcy law (unclear how tokens are treated; token holders have less defined recourse)
Is it clear what the investor receives?	<ul style="list-style-type: none"> <input type="checkbox"/> Yes 	<ul style="list-style-type: none"> <input type="checkbox"/> Yes 	<ul style="list-style-type: none"> <input type="checkbox"/> No standardization: largely dependent on the purchase agreement (tokenomics)

Regulation of ICOs in the United States

Assuming a token offering that is a security—what are the implications?

- Notably, various market participants are regulated under federal law:
 - **Issuer:** the company itself can offer tokens via an ICO (no licensing necessary) subject to SEC regulations
 - **Broker-dealers:** i.e., third parties that help make a market in securities by finding buyers – must be registered with FINRA to conduct such activities
 - **Consultants:** if designing the ICO's tokenomics, consultants must refrain from market making and securities advising

Regulation of ICOs in the United States

Assuming a token offering that is a security—what are the implications?

- All other federal and applicable state securities laws will apply, for instance:
 - Investment advisers must be registered with the SEC
 - Investment Company Act can be implicated (e.g., asset tokenization business model)
 - To trade securities in the secondary market, there are various considerations:
 - Holding periods (depending on offering type)

Regulation of ICOs in the United States

Assuming a token offering that is a security—what are the implications?

- Platform considerations for trading in the secondary market:
 - Registered exchange (e.g., NYSE)
 - OTC trading
 - Broker-Dealer alternative trading system (ATS)
 - Decentralized platforms (regulatory treatment still unclear)

Common US Offering Types

Potential Advantages/Disadvantages by Offering Type

	Substantial SEC Engagement	Governance Requirements	Regulatory Review (Timing)	Holding Period	Relative Expense
Public Offering	<input type="checkbox"/> Yes, file a registration statement	<input type="checkbox"/> Public yearly reporting <input type="checkbox"/> Board committees <input type="checkbox"/> Independent audit (among others)	<input type="checkbox"/> Longer	<input type="checkbox"/> None	<input type="checkbox"/> Highest
Regulation A/A+ (Mini IPO)	<input type="checkbox"/> Yes, file a lighter form registration statement	<input type="checkbox"/> Some, but not as onerous as public offering	<input type="checkbox"/> Moderate	<input type="checkbox"/> None	
Regulation D (Private Placement)	<input type="checkbox"/> No, just submit a Form D	<input type="checkbox"/> No	<input type="checkbox"/> None	<input type="checkbox"/> 12 months (Generally)	
Regulation S (US Issuer Selling to Non-US Investors)	<input type="checkbox"/> No	<input type="checkbox"/> No	<input type="checkbox"/> None	<input type="checkbox"/> Fact-specific	
				<input type="checkbox"/> Lowest	

Regulation of ICOs in the United States

What if an ICO isn't a security offering?

□ Tokens are commodities

- Although not regulated as a security, commodities are regulated at the federal (Commodity Futures Trading Commission (CFTC)) and state levels (state AGs, commodities regulators)
- Although there is no comprehensive regulation for spot market transactions for commodities, the CFTC does enforce market fraud and manipulation in the futures and spot markets
- Just like there is market infrastructure enforcement regulation for securities, there are analogous concepts for commodities (e.g., CTAs, CPOs, derivative exchanges)

5. International Differences in ICO-Regulation

Regulatory Approaches to ICOs

- W&C has performed a study on ICO regulation in 39 countries.
- (Most) Tokens as securities or other financial instruments
 - US, Canada, Australia, Germany
- Ban on ICOs
 - South Korea and China
 - Rationale: potential harm to investors and public outweighs the benefits
- Specific ICO Regulation
 - To date, no jurisdiction (except Gibraltar) has enacted specific ICO laws
 - Under consideration in UK, Israel, Singapore, Malta and others

6. ICOs and Corporates

ICOs and Corporates

- Exposure to ICOs is not limited to start-ups
- Corporates are seeking opportunities, but are doing so cautiously
 - Financial investments
 - Strategic investments
 - Joint venture model
 - Vendor relationships
- Generally will need a blockchain champion to socialize and oversee adoption

7. Outlook on Regulation

Outlook of Crypto-Securities Regulation

- G20 welcomes new standards to be proposed by the Financial Action Task Force
- ECB is looking to regulate virtual currencies, virtual currency exchanges, wallet-providers and brokers, financial market infrastructures and banks
- Clarification of classification of tokens as financial instruments, securities, goods by adjustment of MiFID, PSD and the Prospectus Regulation (with specific disclosure rules)
- Code due diligence
- Rise of crypto-friendly jurisdictions (but only a home jurisdiction solution)

Questions

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