INITIAL COIN OFFERINGS
THE GOOD, THE BAD, AND THE UGLY

Guy Morgan and Chris Finney of Fox Williams LLP explain the new fundraising model of initial coin offerings and consider how they fit into the existing system of regulation.

According to the digital currency news site CoinDesk, more than $2 billion was raised by way of initial coin offering (ICO) in 2017. But while believers see the development of ICOs as an example of technology being used to disrupt traditional venture and equity capital markets funding models, sceptics see baseless hype and another financial scandal around the corner.

This article examines the current trend for ICOs, the regulatory framework surrounding ICOs and the risks associated with ICOs.

WHAT IS AN ICO?

An ICO is a low-cost and time-efficient type of crowdfunding which is facilitated through the use of distributed ledger technology (*see box "Distributed ledger technology"*).

In much the same way that an initial public offering (IPO) involves the issue of securities to investors in exchange for fiat currency, an ICO involves the issue of transferable tokens to investors typically in exchange for cryptocurrency such as Bitcoin or Ether.

Advantages and disadvantages

The rights attaching to tokens vary widely. Some tokens may resemble traditional securities such as shares or debt securities, while others may represent a right to access or receive future services, typically on preferential terms. A key appeal of ICOs is that tokens are easily tradeable. This means that investors can, assuming sufficient liquidity, buy and sell tokens on cryptocurrency exchanges, unlike more traditional venture capital investments, which may not be easily traded.

Other benefits of ICOs compared to more traditional fundraising models are seen to include:

- The ease and speed with which tokens can be issued and funds raised, in many cases without the use of intermediaries.
- Low transaction and settlement costs.
- A perceived lack of regulatory barriers.
- For many issuers, the formation or augmentation of a wide and motivated user base of the underlying product or service.

Commonly cited disadvantages of ICOs when compared to traditional fundraising models include:

- The price volatility of the most popular cryptocurrencies. ICO issuers will commonly seek to exchange cryptocurrencies subscribed by investors into fiat currency following the ICO, therefore incurring substantial exchange rate risk. It may be prohibitively expensive or difficult to hedge this risk effectively.

- A lack of clarity regarding numerous legal issues relating to the underlying distributed ledger technology, including the enforceability of code-based smart contracts.

- An uncertain and evolving regulatory position globally. Combined with the absence of any industry standardisation, this increases the advisory costs and slows the speed at which a compliant ICO may be carried out.

- Cyber security risks, compounded by the irreversibility of many cryptocurrency transactions.

- Reputational issues.

What ICOs are being used for?

The earliest ICOs were used to launch new cryptocurrencies but increasingly they have been used by early stage companies to fund the development of other projects or services and, in particular, the development of decentralised software applications that run on existing blockchain platforms, such as Ethereum (*see box "Decentralised applications"*).

However, an ICO can be executed by any company looking to issue tradeable rights to investors in exchange for capital, regardless of the sector in which it operates or the product that it wishes to develop (*see box "KodakCoin"*).

In September 2017, Kik, an established social media platform, raised approximately $98 million through an ICO of "Kin" tokens to support the development of its existing messaging ecosystem.

It remains to be seen whether other non blockchain-centric businesses will use ICOs as a means of raising funds.

LAUNCHING AN ICO

To launch an ICO, an issuer will typically produce a white paper, which is analogous to the prospectus or admission document that a company is required to produce in connection with the admission of securities to trading on the Main Market of the London Stock Exchange or AIM.

The white paper will set out the nature of the service or product, what resources are required and the amount of funds that are required to raise to develop the service or product. It will also typically set out the minimum and maximum number of tokens the issuer intends to issue and what rights each token gives to the tokenholder. However, unlike a prospectus or admission document, there are no content requirements or minimum standards for white papers and this can contribute to the common misconception that all ICOs are completely unregulated (*see "The UK regulatory position" below*).

Token issuers frequently seek to disclaim liability in their terms and conditions, unlike a prospectus where the company and directors are required as a matter of law to take responsibility for the information contained in the document.

A subscriber will typically subscribe for tokens by transferring consideration to a specified account, and in doing so it is deemed to have accepted the terms and conditions applicable to that ICO.

The tokens themselves are typically created, allocated and distributed through a pre-existing blockchain platform, such as Ethereum, in each case without requiring an intermediary.

Types of token

There is no market standard as to what rights each token gives to a tokenholder, which vary widely in design. Similar to reward-based crowdfunding, where each issuer decides what it gives the investor in return for their subscription, in an ICO the issuer has complete discretion as regards the rights to which the tokenholder is entitled.

The earliest ICOs were used to launch new cryptocurrencies, where the subscriber received a new cryptocurrency in exchange for the payment of an existing cryptocurrency. More commonly, the rights attaching, and value attributable, to a token fall into either or both of the following two categories:

Security tokens. Security tokens have rights akin to those of a traditional security, such as a share or debt security. These rights may include voting rights or the right to participate in profits. They may also include rights in a particular asset.

A pure security token will not have any additional use.

Utility tokens. There are also tokens that give the holder the right to "buy" a product or service, perhaps on preferential terms, such as a discounted rate or exclusive access. These tokens are commonly referred to as utility tokens. A useful analogy used to explain the purpose of utility tokens is that of a fairground or a food fair. On entry to the fair, visitors have to buy a number of tokens for cash. Once inside the fair, visitors can use the tokens to go on various different rides, to buy food or drink or to play the arcades. Each transaction is settled using the tokens and within the fair visitors do not use any other currency.

The most common form of utility token allows the user to access and use a specific software

Distributed ledger technology

The concept of a distributed ledger is that there is a shared database which is replicated and synchronised across all of its users over an online peer-to-peer network. There is no central administrator or centralised data storage centre or node.

The most famous use of distributed ledger technology is Bitcoin. Bitcoin transactions are recorded on a distributed ledger called the blockchain. As with all distributed ledgers, no one person owns or controls the blockchain. Thousands of computers around the world work together to process Bitcoin transactions.

The growth in initial coin offerings (ICOs) has been particularly facilitated by the development of blockchain platforms such as Ethereum, an open-source programmable platform which lets anyone create secondary digital tokens, in exchange for the primary platform currency Ether. The platform has a built-in crowd sale function enabling issuers to carry out ICOs.

Decentralised applications

Blockchain is a type of distributed ledger. However, the use of distributed ledger technology for the Bitcoin payment ledger is only one particular use of distributed ledger technology.

Historically, programmes and applications have been centralised. In this context, centralised means that the relevant programme or application is stored on, and controlled by, a central server. A decentralised application or "DApp" relies on a decentralised network to move functions, powers and processing away from a central server to a peer-to-peer network. Conceptually, a decentralised application cannot be changed without the consensus of the majority of its users.

Twitter is an example of a centralised application. Twitter Inc has the power to delete or censor messages. If Twitter were a decentralised application, then Twitter Inc would not be able to delete or censor any messages.

platform, such as a decentralised application. This software platform may not exist at the time of the ICO, if the funds raised are to be used to develop it. However, there is no reason why the rights attaching to a utility token must necessarily relate to blockchain or software.

The concept of investors being granted rights to receive services or a product in some preferential manner, in lieu of a purely financial return, is not new. Reward-based crowdfunding, popularised by Kickstarter and equivalent platforms is based on the concept of patrons receiving tangible rewards or experiences for their pledges.

Similarly, mini-bond issues can often involve the investor being offered a mixture of financial and other goods and services by way of returns. As an example, retailer Hotel Chocolat funded its expansion in part by the issue of £4.2 million of unsecured bonds whose coupon was payable annually in the form of chocolate or gift cards.

However, in both cases, the ability to trade the relevant rights is restricted. Where ICOs differ is that, by the use of existing distributed ledger infrastructure, an issuer has the capability to easily create and autonomously manage digital tokens relating to those rights. Those tokens can be allocated to investors and easily traded, all without using trusted intermediaries.

THE UK REGULATORY POSITION

A lack of regulatory barriers is seen by some participants as one of the primary attractions of carrying out ICOs. However, while there is no regulatory framework in the UK which is specific to ICOs, or which refers to the specific technology or terminology used in ICOs, it is a common misconception to say that all ICOs are unregulated. Indeed in September 2017, in its consumer warning about the risks of ICOs, the Financial Conduct Authority (FCA) identified that some ICOs feature parallels with IPOs, private placements of securities, crowdfunding or even collective investment schemes, all of which are subject to an existing legislative regime (*www.fca.org.uk/news/statements/initial-coin-offerings*).

Issuers and their advisers must therefore consider carefully the applicability and effect of the full range of relevant legislation including, among others, legislation that relates to the carrying on of regulated activities, the publication of a prospectus and the making of financial promotions.

In addition, because blockchain platforms such as Ethereum operate without geographical borders, issuers must carefully structure ICOs to be compliant with regulations in relevant overseas jurisdictions. This may include taking steps to ensure that an investor is not investing from a jurisdiction that does not permit ICOs. The Chinese government declared ICOs illegal in September 2017, and a similar approach has been taken in South Korea (*see box "Overseas regulatory position"*).

Regulated activities

Under the general prohibition in section 19 of the Financial Services and Markets Act 2000 (FSMA), a person may not carry on a regulated activity in the UK, or purport to do so, unless they are either an authorised person or an exempt person.

It is a criminal offence for a person to carry on activities in breach of the general prohibition in FSMA, punishable by up to two years in prison or a fine. In addition, agreements may be rendered unenforceable if they are entered into by persons without the relevant permission(s), which could potentially require compensatory payments to be made to investors who acquired tokens.

Whether a promotor of an ICO requires authorisation will depend, generally, on whether it will be carrying out regulated activities, such as dealing, arranging

KodakCoin

On 9 January 2018, Kodak made headlines as it became the latest firm to seek to raise capital from an initial coin offering (ICO) to facilitate the creation of an image rights management platform, KodakOne, providing a digital ledger of rights ownership for photographers to register both new and archive work that they can then license within the platform.

Kodak claims that the platform will provide immutable proof of ownership of registered images and each licence of an image will be recorded as a smart contract on the blockchain. The platform will also monitor the internet for unlicensed use of those images. Payments in royalties will be in KodakCoin, the cryptocurrency that is the subject of the ICO.

The ICO was delayed at the end of January 2018 on account of delays in verifying the identity of investors as accredited investors, as required under an exemption from registration under the US Securities Act of 1933.

Overseas regulatory position

There is no consistent global approach to the regulation of initial coin offerings (ICOs). Different countries have different approaches but, as a generalisation, these can be categorised in one of three ways:

Technology neutral	The first approach, typically taken by regulators in those developed economies where there is a strong existing regulatory framework, is one of technology neutrality where the local regulator simply applies existing regulation to new technologies or innovations such as ICOs. This is the broad approach taken by regulators in the UK, the US, Australia and Switzerland, among others.
Restrictive or prohibitive	The second approach is restrictive or prohibitive. In September 2017, The People's Republic of China became the first country to declare ICOs illegal and ordered them to cease immediately. It remains to be seen whether this is a temporary or a permanent ban. Similarly, at the end of September 2017, South Korea's Financial Services Commission stated that it would ban raising money through all forms of virtual currencies.
Permissive	The final approach is permissive. Many offshore centres have adopted a relatively permissive or supportive approach towards ICOs, although in the majority of cases within the existing regulatory regime or subject to further regulatory review. Jurisdictions falling within this category include the Cayman Islands, Mauritius, the Isle of Man and Guernsey.

transactions or advising, by way of business in the UK in relation to specified investments. The categories of regulated activities and specified investments are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*).

Below are some of the most likely specified investments that a token could constitute and the regulated activities which might be undertaken in respect of them.

Collective investment schemes. Collective investment schemes (CISs) are specified investments and are defined in section 235 of FSMA as any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of those profits or income.

The definition of CISs is widely drawn and covers a broad range of investment arrangements. As such, it is possible for a CIS to arise inadvertently and token issuers must therefore carefully consider whether tokens bought through an ICO constitute units in a CIS. If an ICO does meet the CIS test, then the person responsible for it may be engaged in the regulated activity of establishing or operating a collective scheme for which authorisation or an exemption is required.

Alternative investment fund. An alternative investment fund (AIF) is a collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

Depending on the facts, a token issuer may be deemed to have established and be managing an AIF, which is a regulated activity for the purposes of FSMA.

Electronic money. Tokens issued under an ICO may constitute electronic money, being electronically (including magnetically) stored monetary value as represented by a claim on the issuer which is both:

- Issued on receipt of funds for the purpose of making payment transactions.
- Accepted by a natural or legal person other than the token issuer.

Issuing electronic money is a regulated activity for the purposes of FSMA. Utility tokens can satisfy this definition although, if the token is issued in return for a cryptocurrency payment, that result is arguably avoided.

Requirement for a prospectus

Under section 85 of FSMA, a prospectus approved by the relevant competent authority is required in order for an issuer to offer transferable securities to the public in the UK. Breach of section 85 of FSMA is a criminal offence. As the publication of a prospectus can be time-consuming and expensive, issuers will typically wish to structure an ICO so as to avoid the need to publish a prospectus.

Given that one of the fundamental attractions of ICOs is that they involve the offer of transferable tokens to the public, the key question therefore is typically whether a token typically constitutes a security as defined in the recast Markets in Financial Instruments Directive (*2014/65/EC*) (MiFID II Directive). This must be assessed by reference to the nature of rights attaching to a token on a case-by-case basis. It is likely that tokens that provide equivalent rights to shares in companies, or depositary receipts in respect of shares, will be deemed to be securities. It is less clear whether utility tokens will be deemed to be securities but, in most cases, this seems very unlikely.

Even if a token does constitute a security, there are a number of exclusions and exemptions from the requirement to publish a prospectus. An offer of fully transferable tokens that is treated as an offer of securities addressed to fewer than 150 persons, or to qualified investors only, is exempt. Other potential exemptions may apply where the quantum of securities being offered is below a minimum threshold.

It should be noted that the new Prospectus Regulation (*2017/1129/EU*) that will repeal and replace the existing Prospectus Directive (*2003/71/EC*) and the Prospectus Regulation (*809/2004/EC*) is anticipated to come fully into force in 2019 (*see feature article "New Prospectus Regulation: an evolving regime", www.practicallaw.com/w-008-4813*).

Marketing an ICO

Issuers also need to consider the restrictions on marketing an ICO.

Financial promotions. A further consideration relates to the method of promotion of an ICO. Section 21 of FSMA (section 21) provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless the promotion has been made or approved by an authorised person or it is directed at a person who falls into one of the exempt categories of recipient and meets a series of tests. Investment activity includes dealing in securities and contract-based investments, which is likely to catch a security token that carries rights equivalent to those of a share or debt security. It is less clear whether utility tokens will also be caught, and that point would need to be assessed on a case-by-case basis.

Agreements entered into by a person as a customer as a result of an unlawful financial promotion are unenforceable against that customer (*section 30, FSMA*). In addition, it is a criminal offence for an unauthorised person to communicate a financial promotion in breach of the section 21 financial promotion restriction. As the criminal offence is committed by the person communicating a financial promotion, this offence can be committed by persons other than just the issuer. The practice of issuers paying bounties in the form of additional tokens or other rewards to those investors that have conducted a social media campaign or other online marketing activity promoting the issue needs to be considered with this in mind.

Misleading statements and impressions. If the token is a specified investment, section 89 (misleading statements) and section 90 (misleading impressions) of the Financial Services Act 2012 (2012 Act) will also apply, including to the white paper issued and any other marketing material published by an issuer.

Related information

This article is at practicallaw.com/w-013-2485

Other links from uk.practicallaw.com/

Topics

Information technology	topic/5-103-2074
Securities, Markets and Investments	topic/2-541-9505
Prospectus and Marketing	topic/7-103-1380
Equity Capital Markets	topic/8-103-1351
Initial Public Offerings	topic/3-103-1377

Practice notes

When is a prospectus required?	5-352-2952
Preparing a prospectus	6-506-4734
Proposed new Prospectus Regulation	6-619-3947
Blockchain technology and its regulation: introduction	w-003-1213
Demystifying IT for lawyers	4-619-6070
Trends in information technology law: looking ahead to 2017	w-005-0084
Misleading statements	1-591-4129
Misleading impressions	2-592-4825

Previous articles

New Prospectus Regulation: an evolving regime (2017)	w-008-4813
Blockchain and IP: crystal ball-gazing or real opportunity? (2017)	w-010-1622
Crowdfunding: an alternative source of financing (2016)	3-633-1200
Blockchain technology: emerging from the shadows (2016)	4-634-8506
Cryptocurrencies and mobile payments: all change (2015)	4-616-6092
Virtual currencies: the other side of the coin (2013)	9-542-5225

For subscription enquiries to Practical Law web materials please call +44 0345 600 9355

Under section 89 of the 2012 Act, a token issuer will commit a criminal offence if it knowingly or recklessly makes a materially false or misleading statement, or dishonestly conceals any material facts, with the intention of inducing, or it is reckless as to whether it might induce, another person to enter into, or to refrain from entering into a relevant agreement, for example, an agreement to subscribe for tokens.

A similar offence exists under section 90 of the 2012 Act, whereby a token issuer will commit an offence if, among other things, it creates a false or misleading impression as to the market in, or the price or value of, a relevant investment in order to induce another person to acquire or subscribe for investments such as tokens.

Even if a token does not constitute a specified investment, an issuer must be mindful of common law liabilities. Civil liability may arise in respect of untrue or misleading statements in, or omissions from, the prospectus or other marketing documents or other publicly available materials, for example, on grounds of negligent misstatement and deceit. Criminal, as well as civil, liability may also arise in relation to misleading statements, deception or false representation.

On a traditional IPO involving the issue of equity securities, the lawyers to the company will typically carry out an exhaustive verification exercise, in which all directors participate, to reduce the likelihood of any director being held to be reckless as to the nature of information contained in the prospectus or as to any omission from it. A similar verification process is advisable on ICOs in respect of the information contained in the white paper or other marketing materials.

Money laundering

Token issuers will also need to consider whether the UK's new Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations

2017 (*SI 2017/692*) (2017 Regulations) will apply to them (*see Briefing "New anti-money laundering regulations: a risk-based approach", www.practicallaw.com/w-009-3383*).

If the 2017 Regulations do apply, the issuer must carry out compliant due diligence on customers, implement systems and controls to address money laundering and terrorist financing risks, and report any suspicious activity to the authorities. In conducting their activities, token issuers should also bear in mind the core money laundering offences under sections 327 and 328 of the Proceeds of Crime Act 2002.

A LOOK TO THE FUTURE

While it is certainly true that many ICOs are speculative, high risk and, in some cases, fraudulent, it is a common misconception to say, in the UK at least, that all ICOs are unregulated or that is inevitable that new regulation will be introduced to cater for the growth of ICOs and the underlying distributed ledger technology. The existing regulatory framework in the UK is intentionally "technology-neutral" and focuses on the underlying activity, rather than the specific technology by which this activity occurs. Accordingly, the FCA has explicitly stated that it does not see a clear need to consider changes to its regulatory framework in light of the development of distributed ledger technology.

Either way, given the intense public attention currently focused on ICOs and cryptocurrencies more generally, it seems inevitable that the FCA will soon move beyond warning about the risks of ICOs, and instead turn its attention to enforcement.

Guy Morgan and Chris Finney are partners at Fox Williams LLP.