



UNIVERSITY *of* NICOSIA

Session 10

Capital and Financial Markets

BLOC 513: Law and Regulation in Blockchain

Session objectives

- To navigate students through the heavily regulated financial and capital markets, their centralized mode of governance.
- To examine the key characteristics of the financial and capital markets, the strict licensing requirements subject to constant supervisory oversight.
 - In particular, to understand:
 - The importance of the classification of crypto assets as financial instruments or securities;
 - The enforcement of enhanced due diligence and AML compliance checks across the crypto industry;
 - The various and multilevel actions and reactions by Financial and Capital Markets Regulators towards cryptocurrencies;
 - The regulated framework of operation for crypto asset service providers.

Session outline

1. Initial Coin Offerings (ICOs)
2. Utility or Security
3. Security Token Offerings (STOs)
4. Focusing on Crypto Asset Service Providers
5. Required reading
6. Further reading

Initial Coin Offerings (ICOs)

Initial Coin Offerings

What is an ICO?

A form of crowdfunding that trades future crypto coins or tokens for cryptocurrencies or fiat currencies.

Depending on its concept, an ICO sells blockchain-based “coins” or “tokens” that may be exchanged for products and/or services.

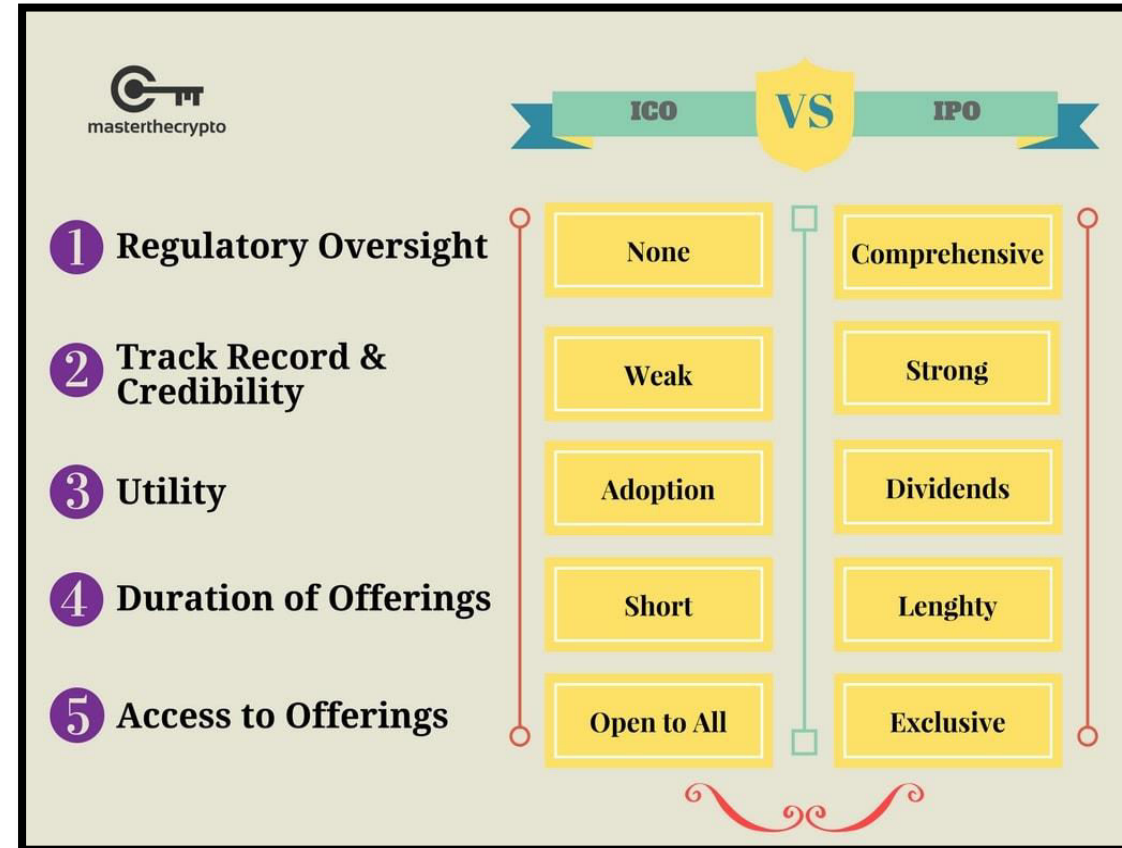


ICO or TOKEN SALE

Initial Coin Offerings

ICOs are preferred over IPOs because the issuer doesn't give away (or at least does not wish to give away) parts of the business, while tokens don't include any voting or economic rights.

IPOs is a well-established process set up by a private company in order to expand and become publicly traded. It involves some formalities in the duration of the process. IPO refers to the public sale of the shares of a company, with the goal of collecting funds for development after the company has had a profitable cycle.



Initial Coin Offerings

- Virtual coins or tokens are created and disseminated using distributed ledger or blockchain technology, using a '**smart contract**'. They form a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account, or store of value.
- Purchasers may use **crypto or even fiat** currencies to buy these virtual coins or tokens.
- The sale of coins or tokens is always linked to an **innovative project**, which the seller presents to the prospective purchasers in the 'whitepaper' displayed on the ICO website, explaining how the capital raised will be used to fund the gradual development of the project.
- After they are issued, the virtual coins or tokens may be resold to others in a **secondary market** on virtual currency exchanges or other platforms.

Initial Coin Offerings

SELLER

- Website
- Whitepaper (project & token distribution)
- Token price
- Token sale & pre-sales (Soft & Hard cap)
- Roadmap
- Team & Advisors

Marketing Strategy

Online trading platforms / Virtual Currency Exchanges
<https://coinmarketcap.com/ico-calendar/>



e.g. SAVVIDES TOKEN (SAV)

BUYERS

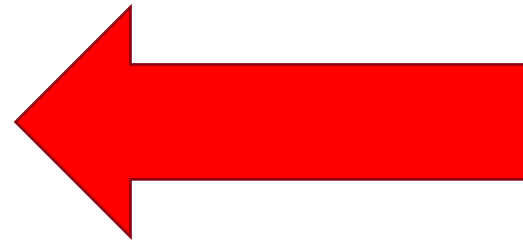
Anyone worldwide who has a digital wallet and he/she is interested in buying the offered tokens.



BITCOIN



ETHEREUM



DOLLAR



EURO

Initial Coin Offerings

Seller

Home

Stats ▾

Exchanges

News

ICO ▾

Tools ▾

Watchlist

Portfolio

Dark mode

USD ▾

Search cryptocurrency

Login / Register

#	Name	Ticker	Last price	%	24 high	24 low	Price Charts 7d	24 volume	# Coins	Market cap
1	Bitcoin	BTC	\$ 9,306.935	+0.71%	\$ 9,512.225	\$ 9,123.962		\$ 3.68B	16.79M	\$ 156.28B
2	Ethereum	ETH	\$ 726.19081	+0.19%	\$ 746.21986	\$ 718.85766		\$ 1.16B	96.87M	\$ 70.34B
3	Litecoin	LTC	\$ 184.51034	-0.90%	\$ 194.97828	\$ 183.47319		\$ 709.58M	55.56M	\$ 10.25B
4	Ripple	XRP	\$ 0.81156475	-1.25%	\$ 0.84027017	\$ 0.80131731		\$ 517.69M	38.59B	\$ 31.32B
5	Eos	EOS	\$ 6.0197932	+0.18%	\$ 6.4273925	\$ 5.9158953		\$ 302.08M	1.00B	\$ 6.01B
6	Ethereumclassic	ETC	\$ 21.839331	-0.99%	\$ 22.734411	\$ 21.645436		\$ 293.69M	93.44M	\$ 2.04B
7	Bitcoincash	BCH	\$ 1,064.324	+0.43%	\$ 1,079.232	\$ 1,028.513		\$ 252.32M	16.67M	\$ 17.74B
8	Tron	TRX	\$ 0.03685545	-0.29%	\$ 0.03829345	\$ 0.03647417		\$ 239.30M	65.74B	\$ 2.42B
9	Neo	NEO	\$ 91.388492	-0.49%	\$ 93.980384	\$ 89.863886		\$ 140.25M	65.00M	\$ 5.94B
SAV			\$ 91.388492	-0.49%	\$ 93.980384	\$ 89.863886		\$ 140.25M	65.00M	\$ 5.94B

Buyers



Initial Coin Offerings

The Growth...

An easier method for start-up and other companies to raise capital

- No need for bank loans

The massive increase in the value of cryptocurrencies

- The market capitalization of all cryptocurrencies has risen from \$6,5 billion in January 2016 to around \$800 billion in January 2018, and to \$2.7 trillion in October 2021.
- Cryptocurrency holders are enabled to diversify their holdings using the cryptocurrency itself rather than taking their money out into fiat currency.

The power (momentum?) of blockchain, tokenization and decentralization

- Tokenization is a process of transformation of asset accounting and management to represent each asset by a digital token. It's expected to reduce costs and frictions to trade.

Incredible returns, particularly to early buyers

Initial Coin Offerings

The Risks...

Volatility of Cryptocurrencies

- No significant source of utility value.
- Significant speculative value.
- Trade on a variety of fragmented markets with poor regulatory oversight.
- Manipulation.

Fraud, technical glitches, hacks or malware

- Unlicensed sellers inside an unregulated space.
- Sophisticated corporate structures make it difficult to follow the flow of money.
- Almost impossible to recover funds invested in fraudulent schemes.

Too good to be true

- There is no 'investment' with little or no risk; the higher the return the more the risk.
- Funding a start-up is by default a high-risk investment

Utility or Security?

The Utility or Security Debate

Back in 2016 and especially in 2017, many ICOs attempted to evade the SEC's scrutiny by self-labeling their products as utility tokens.

If they could prove their tokens were built to serve a function rather than exist as an investment vehicle, then they could avoid a securities classification and continue their sale without registering with the SEC.

- **The SEC, though, later confirmed the distinction.**

Securities Act of 1933

Section 2(a)(1)

April 3, 2019

Response of the Division of Corporation Finance

Re:

TurnKey Jet, Inc.
Incoming letter dated
April 2, 2019

The Utility or Security Debate

- A token is a **Utility Token** and thus no restriction may apply if all the below are met.
 - TKJ will not use any funds from Token sales to develop the TKJ Platform, Network, or App, and each of these will be fully developed and operational at the time any Tokens are sold;
 - the Tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
 - TKJ will restrict transfers of Tokens to TKJ Wallets only, and not to wallets external to the Platform;
 - TKJ will sell Tokens at a price of one USD per Token throughout the life of the Program, and each Token will represent a TKJ obligation to supply air charter services at a value of one USD per Token;
 - If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens (one USD per Token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the Tokens; and
 - The Token is marketed in a manner that emphasizes the functionality of the Token, and not the potential for the increase in the market value of the Token.

The Utility or Security Debate

- The token may entitle its holders to certain rights related to a venture underlying the ICO, such as rights to profits, shares of assets, or voting rights.
- In Howey (1946), the US Supreme Court held that an investment contract is a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. This means a three-part test:
 - (1) Investment of money
 - (2) In a common enterprise
 - (3) With an expectation of profits, produced by the efforts of others
- A token that provides rights to dividends from a business operated by the ICO sponsor would clearly be a security, whereas a token that only allows network participants to **access a service** may, under the right circumstances, not be a security.

Kaye Scholar's - a law firm's - view

The Howey Test is that the asset, interest, enterprise, instrument or arrangement must involve:

- ▮ an investment of money;
- ▮ in a common enterprise; and
- ▮ the expectation of profits coming solely for the efforts of others.

While an acquisition of Bitcoins may involve an investment of money, it appears in the view of law firm Kaye Scholer, to fail both the 2nd and 3rd factors of the Howey test.

The Utility or Security Debate

European Securities and Markets Authority (ESMA)

In January 2019, [ESMA published an Advice](#) on Initial Coin Offerings and Crypto-Assets in light, as explained, of the rapid development of the capitalization of crypto-assets and their high price volatility, and the speculative and unregulated environment.

Apart from raising concerns for *investor protection* and *market integrity*, ESMA addressed in its Advice the legal qualification of crypto-assets under EU financial securities laws.

Importantly, ESMA underscores that the qualification of all crypto-assets as financial instruments has unwanted collateral effects, because:

- the existing regulations were not drafted having these instruments in mind;
- acknowledging them as financial instruments would grant them potentially unwanted legitimacy;
- the needed supervisory tools and resources may not be in place.

The Utility or Security Debate

Utility Tokens

- These are tokens issued by a particular platform that may be used as a means of payment on that platform but carry no rights to any payouts and cannot be redeemed.
- They function very much like air miles or loyalty points, but with the key difference that it is possible to trade them with others and thereby potentially sell them on at a profit without ever making use of the offered utility!
- A token granting access to a fully operational blockchain protocol is less likely to be considered a security token than one issued in order to raise funds for the development of a new blockchain protocol.
- In the “SAVVIDES TOKEN” example (see slides 9 and 10) the listing of the token on an exchange is decisive for its classification as security token.

Security Token Offerings (STOs)

Security Token Offerings (STOs)

- STOs are securities as their name suggests. They are digital assets that are subject to security regulations and Financial Market Regulations in general.
 - Thus, there is a need to be compliant with any registration and/or authorization requirements before being issued.
- Private and public offerings of security tokens enable access to a pool of investors, under the same protection and compliance rules as in traditional conditions.
- The best expression of security tokens is the tokenization of assets that embody a value/asset.
 - Tokenised Shares (tokens representing the ordinary share capital of a company and carry the rights to voting and dividends that one would normally associate with shares).
 - Tokenised Equity Interests (tokens which do not function like ordinary shares, they have no voting rights, but carry rights to equity style payouts).
 - Tokenised Debt Securities (tokens functioning like ordinary bonds, structured products or derivatives, but are settled using a blockchain infrastructure).
 - Tokenised Funds (these are essentially investment units in an Alternative Investment Fund).

Security Token Offerings (STOs)

Examples...

- **Firm AB** issues tokens that provide token holder with a share of the company's profits to be paid annually. The tokens also provide the holder with voting rights. The tokens are structured so they can be easily transferred between two individuals and a change of ownership can be recorded. The tokens can also be traded on crypto-asset exchanges.
 - This token confers right similar to those given by shares and is likely to be considered a financial instrument. The negotiability suggests that the token will also be considered a transferable security.
- **Firm CD** incorporated in the UK, has created a social trading platform, called the CD Platform, for users to easily exchange fiat currencies for exchange tokens. The firm issues "CD Tokens" which are exchanged for fiat funds and these tokens are used to purchase other exchange tokens.
 - This alone is not enough to categorize the CD Tokens as security tokens. However, if they also confer on the holder a right of ownership of the CD Platform, proportionate to the number of CD Tokens held, and a right to participate in the profits of CD Platform, to be paid annually in the form of a dividend, then it might be classified as security.

Security Token Offerings (STOs)

Examples...

- **Firm EF** issues a token that it is described in its whitepaper document as a pure utility token. The token allows the holder to access a product the firm is still developing. The token also allows the holder to share in profits in line with their holdings, once the product launches. The developers have been careful to make sure that the token will not be able to be traded on the capital markets.
 - Despite the token being described as a utility token in the whitepaper, its lack of tradability and the fact that it offers access to a future product, it would still be considered a financial instrument given it confers on the holder rights similar to financial instruments i.e. conferring on the holding the right to share in profits in line with their holdings.

Security Token Offerings (STOs)

ESMA 2019 Advice

- ***“Crypto-assets” are both cryptocurrencies or virtual currencies and tokens, so it is the broadest term. Moreover, they differentiate in 4 categories. Namely,***
 - Those with profit rights
 - Those with governance rights
 - Those that provide consumption value and
 - Those that are meant to be used as a means of exchange.
- ***“Financial instruments” are defined in Article 4(1)(15) of MiFID II***
 - “an asset or evidence of the ownership of an asset, or a contractual agreement between two parties to receive or deliver another financial instrument”

These are inter alia:

- ‘transferable securities’,
- ‘money market instruments’,
- ‘units in collective investment undertakings’ and
- various derivative instruments (options, forwards, futures, swaps).

“Transferable securities” under Article 4(1)(44) of MiFID II,
“Those classes of securities which are negotiable on the capital market, with the exception of instruments of payment”.

“Security”

“A fungible, negotiable financial instrument that holds some type of monetary value. It represents an ownership position in a publicly-traded corporation (via stock), a creditor relationship with a governmental body or a corporation (represented by owning that entity's bond), or rights to ownership as represented by an option”.

Focusing on Crypto Asset Service Providers

Focusing on Crypto Asset Service Providers

- The EU Commission proposed in July 2016 the revision of the 4th EU Anti-Money Laundering Directive (AMLD) as part of its enhanced Action Plan against terrorism which was announced in February 2016.
- *The AMLD 5 was published on the 19th of June 2018 and all EU Member States were obliged to transpose the modified regulations into national law by the latest January 20th 2020.*

Particularly the AMLD 5

- grants access to the general public to beneficial ownership information of EU based companies;
- makes it an obligation to consult the beneficial ownership register when performing AML due diligence;
- obliges member states to create a list of national public offices and functions that qualify as politically exposed (PEP);
- introduces strict enhanced due diligence measures for financial flows from high-risk third countries;
- ends the anonymity of bank and savings accounts, as well as safe deposit boxes and creates central access mechanisms to bank account and safe deposit boxes holder information throughout the EU;
- makes information on real estate holders centrally available to public authorities;
- lowers thresholds for identifying purchasers of prepaid cards and for the use of e-money;
- facilitates cooperation and information exchange among national authorities;
- extends the scope to **virtual currency platforms and wallet providers**

Focusing on Crypto Asset Service Providers

According to the AMLD 5:

- **“Virtual Currencies”**, means “a digital representation of value that is neither issued nor guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored, and traded electronically.
- **“Custodian wallet provider”** means an entity that provides services to safeguard private cryptographic keys on behalf of its customers, to hold, store and transfer virtual currencies.

Member States shall ensure that providers of exchange services between virtual currencies and fiat currencies, and custodian wallet providers, are registered and become obliged entities.

For the purposes of anti-money laundering and countering the financing of terrorism (AML/CFT), competent authorities should be able, through obliged entities, to monitor the use of virtual currencies. Such monitoring would provide a balanced and proportional approach, safeguarding technical advances and the high degree of transparency attained in the field of alternative finance and social entrepreneurship.

The anonymity of virtual currencies allows their potential misuse for criminal purposes. The inclusion of providers engaged in exchange services between virtual currencies and fiat currencies and custodian wallet providers will not entirely address the issue of anonymity attached to virtual currency transactions, as a large part of the virtual currency environment will remain anonymous because users can also transact without such providers.

Focusing on Crypto Asset Service Providers

Is it enough to include only custodian wallet providers and virtual currency exchanges in the list of obliged entities?

- The market participants are the users, miners, cryptocurrency exchanges, trading platforms, Wallet providers, coin inventors and offerors.
 - Custodian wallet providers are entities that provide services to safeguard private cryptographic keys on behalf of their customers, to hold, store and transfer virtual currencies.
 - Virtual currency exchanges are providers engaged in exchange services between virtual currencies and fiat currencies.
- There are **relevant market participants that are not caught by AMLD 5** (software wallet providers and pure cryptocurrency exchanges that are not custodian wallet providers, trading platforms, miners, hardware wallet providers and coin offerors).

Focusing on Crypto Asset Service Providers

Proposal for EU Regulation on Markets in Crypto-Assets ([Sept. 2020](#))

Crypto-assets issued by central banks acting in their monetary authority capacity or by other public authorities should not be subject to the Union framework covering crypto-assets, and neither should services related to crypto-assets that are provided by such central banks or other public authorities.

This Regulation lays down uniform rules for the following:

- (a) transparency and disclosure requirements for the issuance and admission to trading of crypto-assets;
- (b) the authorisation and supervision of crypto-asset service providers and issuers of asset-referenced tokens and issuers of electronic money tokens;
- (c) the operation, organisation and governance of issuers of asset-referenced tokens, issuers of electronic money tokens and crypto-asset service providers;
- (d) consumer protection rules for the issuance, trading, exchange and custody of crypto-assets;
- (e) measures to prevent market abuse to ensure the integrity of crypto-asset markets.

Focusing on Crypto Asset Service Providers

Proposal for EU Regulation on information accompanying transfers of funds and certain crypto-assets ([July 2021](#))

Nature of the new obligations on crypto-asset service providers

The crypto-asset service provider of the originator must ensure that transfers of crypto-assets are accompanied by the name of the originator, the originator's account number, where such an account exists and is used to process the transaction; and the originator's address, official personal document number, customer identification number or date and place of birth; the crypto-asset service provider of the originator must also ensure that transfers of crypto-assets are accompanied by the name of the beneficiary and the beneficiary's account number, where such an account exists and is used to process the transaction.

The crypto-asset service provider of the beneficiary must implement effective procedures to detect whether the information on the originator is included in, or follows, the transfer of crypto-assets. The crypto-asset service provider of the beneficiary must also implement effective procedures, including, where appropriate, ex-post monitoring or real-time monitoring, in order to detect whether the required information on the originator or the beneficiary is missing.

Required Reading

Required Reading

Valeria Ferrari, “The regulation of crypto-assets in the EU – investment and payment tokens under the radar” (2020)

Alireza Bariklou et. al., “Analyzing Cryptocurrencies as Capital” (2020)

Giancarlo Giudici et. al., “Cryptocurrencies: market analysis and perspectives” (2020)

Diego Zuluaga, “Should cryptocurrencies be regulated like securities?” (2018)

Further reading

Further reading

European Parliament, **Cryptocurrencies and blockchain** (2018)

Marco Schletz et. al., “**Blockchain and Tokenized Securities: The potential for Green Finance**” (2020)

Thomas Lambert et. al., “**Security Token Offerings**” (2020)

A Can Inci, Rachel Lagasse, “**Cryptocurrencies: applications and investment opportunities**” (2019)

Andrea Flori, “**Cryptocurrencies in Finance: Review and Applications**” (2019)

Niamh Moloney. “**The European Union in International Financial Governance.**” (2017)

Flamée, Michel, and Paul Windels. “**Restructuring Financial Sector Supervision: Creating a Level Playing Field.**” (2009)



UNIVERSITY *of* NICOSIA

Questions?

Contact Us:

Twitter: **@mscdigital**

Course Support: digitalcurrency@unic.ac.cy

IT & Live Session Support: dl.it@unic.ac.cy