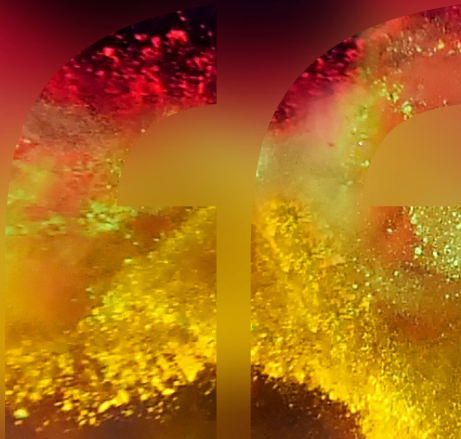
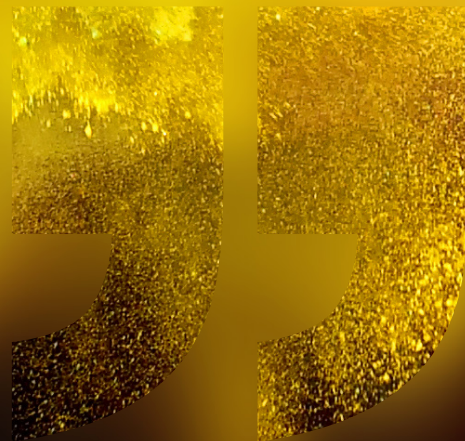


C L I F F O R D
C H A N C E



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



– THOUGHT LEADERSHIP

JULY 2017



INITIAL COIN OFFERINGS – ASKING THE RIGHT REGULATORY QUESTIONS

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

Terminology

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

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

- The right to a profit or asset (eg, distribution of actual profits or through repurchase and ‘burning’ repurchased tokens which theoretically reduces supply and thus increases the price of tokens).
- A right of use (eg, use of a system or particular service offered by the issuer).
- The right to vote (eg, voting right as a participant of a decentralised currency exchange operated by the issuer).

How does it work?

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

In the subscription process, the participant generally is required to transfer cryptocurrency to the issuer (to one or more designated addresses or wallets of the issuer). Subscriptions may be completed in minutes. A participant may also be rewarded with tokens by taking certain actions, such as marketing on cryptocurrency forums. Once the ICO is completed, the tokens will be distributed to the participants’ designated addresses or wallets. Issuers may have tokens listed on cryptocurrency exchanges

(eg, Poloniex or Bittrex) to trade against other cryptocurrencies to create liquidity and value.

What should you ask?

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

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

- What are the economics behind the tokens (eg, how can the participant expect to obtain a return, monetary or otherwise, if at all)?
- What are the underlying operations of the issuer (eg, is it a business venture or fintech solution) and how is it structured/managed/operated (eg, fully decentralised or through a legal vehicle)?
- Deposit
- Collective investment scheme/fund
- Insurance product
- Other regulated investment contract or product
- Could any circumstances arise that would trigger regulatory licensing/registration/authorisation requirements and/or other regulatory compliance requirements with respect to the nature of the tokens being offered under the ICO and the proposed role of each of the issuer and each service provider and participant under the ICO? Have relevant requirements, eg obligation to undertake anti-money laundering and know-your-client checks, been complied with? The following list of activities may trigger such requirements, although again this will vary depending on the jurisdiction and specific circumstances:

Regulatory analysis

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

- Think broadly about what could impact your position. For example, issuers should always consider the regulations of each potential participant's jurisdiction as they may affect how an issuer may market to or accept subscriptions from participants.
- Each party involved is likely to have a different perspective. For example issuers may be interested to know which jurisdiction is the most regulatory 'friendly' for it to perform the underlying operations or to host the ICO; a service provider may be interested to know whether the services it is providing are regulated services, and the participants would want to confirm that it is legal for them to participate in the ICO.
- What is the legal nature of the tokens being offered under the ICO in the relevant jurisdiction? For example, would it be categorised as any of the following and what are the regulatory implications? In many jurisdictions this is likely to vary depending on the exact terms of the tokens being issued.
 - Currency
 - Commodity
 - Security
 - Property
 - Structured product or derivative contract
 - Foreign exchange contract
 - Loan
 - Dealing/marketing/offering/advisory activities relating to securities or any other regulated contract or product
 - Money lending activities
 - Deposit taking activities
 - Operation of stored value facilities
 - Operation of securities, commodity or other regulated exchange
 - Management of collective investment scheme/fund
 - Remittance and/or money changing activities
 - Insurance brokerage activities
 - Business operation/establishment
 - Handling of personal data/privacy
 - Tax presence
 - Intellectual property
 - Gambling

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



WHAT ARE REGULATORS DOING?

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

FOCUS ON KEY JURISDICTIONS

Australia

In an interview in June 2017, the Australian Securities and Investments Commission (ASIC) Chairman Greg Medcraft broadly noted that the question of how ICOs are/should be regulated remains unsettled given that ICOs can lack characteristics associated with traditional securities. Medcraft noted that ICOs that meet the more traditional concept of a security would not be treated any differently to other financial instruments by ASIC. In particular, Medcraft mentioned he would take a technology neutral approach to such an ICO and focus instead on disclosure, both in respect of the issuer and the associated risks of the issuance. Medcraft stressed in his concluding remarks against undertaking any premature regulation of such offerings without first having a comprehensive understanding of the value proposition, underlying technology and the benefits and risks posed to both investors and the market generally.

Germany

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

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

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

Hong Kong

The regulators in Hong Kong have adopted a technology neutral regulatory approach and are seeking to develop and implement a regulatory framework and requirements based on intrinsic characteristics of the relevant activities or transactions and the risks arising from them. The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have not yet issued any formal publication on their views regarding the regulatory treatment of ICOs. In this respect the HKMA has previously reiterated that Bitcoin is not a legal tender but a virtual "commodity". While one may equate tokens with Bitcoin and thus assume that they should possess the same legal status as a virtual commodity, as discussed in this paper there are broader regulatory implications to consider with ICOs and tokens.

For now, ICOs will need to be analysed from a regulatory perspective as discussed in this paper under the existing local regulatory regime depending on the facts of the case.

Japan

Following amendments becoming effective in April 2017, cryptocurrencies are defined in Japan's Payment Services Act (PSA) as "Virtual Currencies". Sale and purchase of, and exchanging, Virtual Currencies (or acting as an intermediary in respect of such activities) are regulated and require a registration with the Financial Services Agency of Japan. Since no comprehensive rules or guidelines specifically regarding ICOs have yet been issued in Japan, it is advisable to consider carefully whether activities taken

in respect of any individual ICO could be categorised as regulated business under, among others, the PSA, traditional securities regulations and/or other financial regulations.

People's Republic of China

China has not developed a comprehensive regulatory regime for ICOs and cryptocurrencies. On 5 December 2013, the People's Bank of China (PBoC), the China Banking Regulatory Commission, the China Securities Regulatory Commission and other relevant Chinese regulators jointly issued the Circular on Guarding against the Risks of Bitcoin, which may inform the approach in respect of ICOs. According to the Circular, from a regulatory perspective, Bitcoin is not viewed as a type of currency but rather virtual goods in China. Chinese investors may engage in the trading of Bitcoin at their discretion but Chinese financial institutions and payment institutions may not engage in any activity or provide any services related to Bitcoin. Risks associated with the usage of Bitcoin (eg, money laundering, circumvention of foreign exchange restrictions) are also highly emphasised by the PRC regulators.

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

Poland

No law, regulation or guidance specific to ICOs has been implemented or issued in Poland. Recently, the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego, the KNF) and the National Bank of Poland (Narodowy Bank Polski, the NBP) issued a circular dedicated to virtual currencies. While the circular notes that dealing in virtual currencies does not breach Polish law, it warns against the risks associated with purchases of, and investing funds in, virtual currencies. The circular points out that holding virtual currencies involves risks not only for the users but also for financial institutions. The NBP and the KNF consider that the purchase, holding and sale of virtual currencies by institutions supervised by the KNF would carry a high risk and would not ensure stable and prudential management of a financial institution. Pursuant to the circular, financial institutions should exercise special caution when cooperating with entities trading in virtual currencies, in particular with regard to the risk of those entities being used to launder money and finance terrorism.

Russia

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

Singapore

MAS has not published any guidance on the regulatory treatment of ICOs and cryptocurrencies are currently not specifically regulated in Singapore. As such the regulatory treatment of any particular ICO and related tokens issued should be analysed carefully against existing regulation based on the terms of the ICO using the framework discussed above. In 2016 the MAS published a statement that it is currently working on proposed regulations to be introduced for virtual currency intermediaries operating in Singapore. MAS also announced in March 2014 that regulations will be applied to mitigate the money laundering and terrorist financing risks posed by virtual currency transactions which are facilitated by virtual currency intermediaries.

Spain

While the Bank of Spain has publicly stated the importance of providing an appropriate legal framework for virtual currencies, no comprehensive rules or guidelines regarding ICOs have yet been published. Accordingly, any ICO related activity in Spain requires careful consideration of payment services and anti-money laundering regulations (within the context of the EU Directives) as well as other general financial regulations.

United Arab Emirates

In the UAE, the leading sector for fintech innovation in the Middle East, ICOs are currently being undertaken without specific regulation but subject to certain licensing requirements where the units offer a right in an underlying commodity in which trading does require a license (gold being the example applied to date in the UAE). However, there has been some controversy regarding whether the UAE Central Bank intends to regulate "virtual currencies".

In January 2017, the Central Bank published a new licensing framework for stored value facilities offering certain digital payment services, due to be implemented by 1 January 2018. This framework states “All Virtual Currencies (and transactions thereof) are prohibited”. The definition of Virtual Currencies captures any type of digital unit used as a medium of exchange, a unit of account, or a form of stored value (expressly excluding loyalty or rewards programs).

Following confusion in the market, with several ICOs having already been publicised, the Governor of the Central Bank, issued a statement to the press in February 2017 regarding its regulations, including that they “do not cover Virtual Currency” and “do not apply to Bitcoin or other cryptocurrencies, currency exchanges, or underlying technology such as blockchain”. It was further noted that new regulations will be issued as appropriate. No action has been taken in respect of subsequent unlicensed ICOs.

It is now therefore expected that a more thorough regulation covering cryptocurrencies will be issued in the near future by the Central Bank, perhaps as part of the implementing measures for the 2017 licensing framework expected later this year. In addition, in November 2016, the Supreme Legislation Committee for the Government of Dubai announced discussions on future legislation related to cryptocurrencies in cooperation with the Dubai Electronic Security Center. This could result in regulations specific to the Emirate of Dubai, in addition those of the Central Bank (which would be at a Federal level across the UAE).

United Kingdom

The Financial Conduct Authority (FCA) has been uncharacteristically quiet on the topic of ICOs so far, given its reputation as one of the more technology-cognisant regulators. The only evidence that the FCA has ICOs on its radar is found in the FCA's consultation from April 2017 on the potential for the future development of distributed ledger technology in regulated markets. In this consultation, the FCA briefly noted in respect of ICOs that “depending on how they are structured, they may, therefore, fall into the regulatory perimeter”. On this, there are a number of regulated activities that issuers and participants in ICOs would need to consider and navigate, including deposit-taking and e-money issuance, CFDs and derivatives as well as the broad definition of what constitutes a collective investment scheme and applicable anti-money laundering regulations.

United States

In the United States, an ICO is potentially subject to numerous laws and regulations, depending on: (i) the location of the issuer, (ii) the entities or persons to whom it is marketed and (iii) the type of services provided or proposed to be provided. Generally, an offer and sale of tokens may be subject to U.S. securities laws if an investment of money is made with an expectation of profits arising from a common enterprise that depends solely on the efforts of a promoter or third party.

On July 25, 2017, the U.S. Securities and Exchange Commission (SEC) issued a report summarising its conclusion that tokens sold by The DAO were securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. If a token is a security, then its offer and sale must be registered or exempt from registration and the offer and sale may be subject to disclosure liability. The SEC in its report did not comment on the status of The DAO under the Investment Company Act of 1940, nor the status of the promoters of The DAO under the Investment Advisers Act of 1940, nor did it offer any guidance as to the securities offering safe harbours that would have been most applicable to The DAO ICO.

In addition, exchanges on which tokens classified as securities are traded may need to register with the SEC as alternative trading systems, and broker/dealers that engage in trading of security-tokens would likewise need to be registered with the SEC and other regulatory bodies. Other federal regulatory agencies, including the Commodity Futures Trading Commission, may respond to ICOs and other fintech innovations with new regulations.

A patchwork of state regulations can also apply to borderless ICOs, including investor suitability guidelines and financial services licensing requirements. The precise nature of a token can also have significant relevance under state corporate law: for example, if an ICO is deemed to be an offer and sale of general partnership units, participants might be surprised to find that they are liable for the actions of the issuer.

Terminology

The DAO was a decentralised autonomous organisation formed to facilitate an investor-directed venture capital fund that would operate automatically through a smart contract. The DAO hit the press in June 2016 when a user exploited a flaw in the code and siphoned off approximately one third of The DAO's funds. After much debate in the Ethereum community, the Ethereum blockchain was hard-forked, resulting in almost all funds being restored to their previous owners.

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