

# Initial Coin Offering — A Quick Look

| by Brian Lye Mou-Yu |

## What are digital ‘tokens’?

A digital token is created and cryptographically secured through blockchain as part of a decentralised digital protocol. Each token is a unit representation of the token holder’s right to receive a benefit or due performance of a specific function.

There are many different types of tokens, each with varying characteristics and utility. One particular function of a token is currency, like Bitcoin and Ether. While these tokens can serve as a digital medium for transactions, the tokens may also represent a right to tangible assets like luxury goods, commodities or real property in the form of a smart contract.

Digital tokens may be offered through an initial coin offering (“ICO”), which is a fundraising mechanism akin to an initial public offering (“IPO”) and equity crowd funding, i.e. crowd-sourced funding.

## What is an ICO?

An ICO presents a means for an issuer to raise funds by selling its digital tokens (unique to the particular issuer) in exchange for other cryptocurrencies of immediate value (usually Bitcoin or Ether) or fiat currencies. The objective of an ICO exercise is to generate the necessary funding and user base to enable the issuers to further enhance the product’s underlying technology.

ICO tokens have recently attracted regulatory attention worldwide in light of the sheer amount of ICO exercises. As of 11 October 2017, ICO exercises have raised approximately US\$2.7 billion.

An ICO exercise will have an accompanying whitepaper which is akin to a prospectus in an IPO. The whitepaper sets out, among others, the nature of the project, the project’s utility, the underlying technology, the costs, the duration of the ICO campaign and the cryptocurrency accepted. However, unlike a prospectus, an ICO whitepaper is not subject to any legislation, structure, standard or best practice.

At the closing of the ICO campaign, investors may then elect to retain or trade their tokens on the secondary market.

## Are ICO tokens securities?

Due to the nature of ICOs, it occupies a grey area in the respective regulatory regimes. The sudden surge in ICOs has proved to be a novel and complex phenomenon for many jurisdictions alike. Regulators have conflicting views on the legal status of ICOs. Certain jurisdictions have adopted the position that ICO tokens will likely form a new class of assets and, as such, it must be conducted in a manner that promotes investor confidence. On the flipside, there have also been jurisdictions that declared ICOs illegal.

### *Useful sources and for further reading:*

<https://techcrunch.com/2017/05/23/wtf-is-an-ico/>

<http://www.investopedia.com/terms/i/initial-coin-offering-ico.asp>

<https://www.coinschedule.com>

## Regulators' views

### US

On 25 July 2017, the US Securities and Exchange Commission ("the SEC") issued a report of its investigation regarding the offering of digital tokens by the Decentralized Autonomous Organization ("the DAO"). The report stemmed from the SEC's inquiry into whether the DAO had violated federal securities laws with the sale of DAO tokens in exchange for Ether.

In applying the test formulated by the Supreme Court in the case of *SEC v WJ Howey*,<sup>1</sup> it was concluded that the DAO tokens constituted an investment contract. The tokens were sold for value, represented shared interests in a common enterprise, the investors had an expectation of profit from the efforts of the "Curators" of the DAO, and the tokens were distributed in a manner akin to a traditional securities offering.

The report also stated that federal securities laws apply to those who offer and sell securities in the US, regardless whether:

- (i) the issuing entity is a traditional company or a decentralised autonomous organisation;
- (ii) those securities are purchased using US dollars or virtual currencies; and
- (iii) they are distributed in certificated form or through distributed ledger technology.

#### Sources:

<https://www.sec.gov/news/press-release/2017-131>

<https://www.sec.gov/litigation/investreport/34-81207.pdf>

### Singapore

On 1 August 2017, the Monetary Authority of Singapore ("the MAS") stated that it would regulate any offering or issuance of tokens should they constitute regulated products under the Securities and Futures Act ("the SFA").

The MAS acknowledged that the types of tokens offered in the market vary widely, and that some may be subject to the SFA while others may not. Tokens that relate to or resemble ownership or a security interest over an issuer's asset or property may be considered to be an offer of shares or units in a collective investment scheme under the SFA. Likewise, if the token represents a debt owed by the issuer to the investor, it may be considered to be a debenture under the SFA.

Where such tokens fall within the definition of securities under the SFA, the issuers must lodge and register a prospectus with the MAS prior to the offer of such tokens, unless exempted. The issuers or intermediaries of such tokens would also be subject to the licensing requirements under the SFA and the Financial Advisers Act, unless exempted, and the applicable requirements pertaining to anti-money laundering and terrorism financing. In addition, platforms facilitating secondary trading of such tokens would also have to be approved or recognised by the MAS as an approved exchange or recognised market operator respectively under the SFA.

#### Sources:

<http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/Consumer-Advisory-on-Investment-Schemes-Involving-Digital-Tokens.aspx>

<http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx>

<sup>1</sup> *Securities and Exchange Commission v WJ Howey Co et al* 328 US 293 (1946)

## Canada

On 24 August 2017, the Canadian Securities Administrators (“the CSA”) released CSA Staff Notice 46-307 Cryptocurrency Offerings that set out its views on ICO, initial token offerings (“ITO”) and sales of securities of cryptocurrency investment funds.

The CSA acknowledged that many businesses market their tokens as software products, taking the position that the tokens are not subject to securities laws. However, in many cases, when the totality of the offering or arrangement is considered, the tokens would resemble a security nonetheless. Despite the involvement of novel technology and the tokens sold being marketed as API access keys rather than that of a traditional security, such tokens may well still fall within the definition of a security in Canada.

Consequently, such ICOs/ITOs will be subject to prospectus requirements, and ancillary or supporting businesses may similarly be subject to registration requirements, unless exempted. Furthermore, where a platform allows for the trade of tokens that constitute securities, it may be considered a “marketplace” or an “exchange” and further regulation may also apply. Likewise, ICOs/ITOs that resemble derivatives shall be subject to derivative laws.

In determining whether tokens issued constitute a security, Canadian regulators will apply the principles established in *Pacific Coast Coin Exchange v Ontario Securities Commission*<sup>2</sup> (“*Pacific Coast*”). The principles set out in *Pacific Coast* mirror those of the Howey Test:

- (i) an investment of money;
- (ii) in a common enterprise;
- (iii) with the expectation of profit; and
- (iv) to come significantly from the efforts of others.

**Source:**

[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20170824\\_cryptocurrency-offerings.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm)

## UK

On 12 September 2017, the Financial Conduct Authority (“the FCA”) issued a statement setting out its views on ICOs. The FCA indicated that whether an ICO should be treated as a regulated product could only be decided on a case-by-case basis, having analysed the particular ICO structure against the current UK regulatory regime.

The FCA conceded that many ICOs will fall outside the UK regulatory regime. However, depending on how they are structured, some ICOs may involve or resemble regulated investments and firms involved in the ICOs may be conducting regulated activities.

The FCA also stated that where an ICO structure resembles an IPO, private placement of securities, crowdfunding or collective schemes, or similar investment structures, such ICO may fall within the regulatory regime.

**Source:**

<https://www.fca.org.uk/news/statements/initial-coin-offerings>

2 [1978] 2 SCR 112

### Australia

In late September 2017, the Australian Security and Investment Commission (“the ASIC”) issued an information sheet (INFO 225) (“Info Sheet”) on ICOs. The Info Sheet offered insight into the legal status of ICOs made available to investors in Australia, regardless of whether the ICO is created and offered from within Australia or offshore.

The legal status of an ICO will be dependent of the circumstances of the ICO, such as how it is structured and operated, and the rights attached to the token offered through the ICO. In some cases, the ICO will only be subject to the general law and Australian consumer laws regarding the offer of services or products. Where the tokens issued resemble those of traditional financial products, then the ICO may be subject to the Corporations Act.

**Source:**

<http://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings/>

### China and South Korea

Unlike the aforementioned jurisdictions, on 5 September 2017, the People’s Bank of China declared ICOs illegal. Concurrent with the ban, Chinese authorities have called on individuals and organisations to refund Chinese investors for any amount raised through ICOs. South Korea followed suit — on 29 September 2017, its Financial Services Commission released a similar statement declaring ICOs illegal.

**Sources:**

<https://www.bloomberg.com/news/articles/2017-09-04/china-central-bank-says-initial-coin-offerings-are-illegal>

<https://www.cnn.com/2017/09/28/south-korea-bans-all-new-cryptocurrency-sales.html>

### Malaysia

Over the course of this year, several Malaysian-based ICOs have surfaced, including the controversial EcoBit, which was placed on Bank Negara Malaysia’s (“BNM”) financial consumer alert service as “companies and websites which are neither authorised nor approved under the relevant laws and regulations administered by Bank Negara”. Apart from EcoBit, the other notable ICOs conducted include HelloGold and PitisCoin.

Despite the regulatory uncertainty, there is a clear level of interest among Malaysians. On 19 September 2017, BNM governor Tan Sri Muhammad Ibrahim was quoted as saying:<sup>3</sup>

“We hope that by year-end, (we) will be able to come out with some guidelines on cryptocurrency, particularly those related to anti-money laundering and terrorist financing. We want to ensure there are clear guidelines for those who want to participate in this particular sector.”

At this juncture, it remains unclear how Malaysian regulators will approach this phenomenon. However, premised on the above statement and state of affairs, it would suggest that Malaysia is unlikely to declare ICOs illegal.

3 On the sidelines of the Global Symposium on Development Financial Institutions held in Kuala Lumpur

**Useful sources and for further reading:**

<http://www.theedgemarkets.com/article/sc-warns-investors-icos-following-chinas-ban>

<http://www.thestar.com.my/business/business-news/2017/08/07/fundraising-disrupter/>

[http://www.bnm.gov.my/index.php?ch=en\\_announcement&pg=en\\_announcement&ac=551](http://www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=551)

<http://www.thestar.com.my/business/business-news/2017/09/20/guidelines-on-cryptocurrencies/>

If, as anticipated, Malaysia adopts a pro-ICO position, the guidelines could touch on one or more of the following:

- (a) “Whitepaper” preparation best practices;
- (b) ICO platform operator;
- (c) Investor education;
- (d) E-Know-Your-Customer guidelines;
- (e) Appointment of escrow agents and the handling of funds.

Ascertaining the legal status of ICO tokens will be a difficult task due to the plethora of factors at play. Depending on the structure and features of the particular ICO, it may or may not be subject to regulation. It should not come as a

surprise that few countries have guidelines regarding this subject, and many regulators appear to be sitting on the fence, awaiting further development.

In order to determine the legality of ICOs, the common approach adopted by regulators appears to be one of “substance over form”. It is also likely that regulators will be guided by the four-pronged test proposed in *SEC v WJ Howey*. **LH-AG**

**About the author**



**Brian Lye Mou-Yu** (blm@lh-ag.com) is an associate with the Corporate Department, and is part of a team headed by **Tay Weng Hwee** (twh@lh-ag.com)

