

THE BRAVE NEW WORLD OF ICOS

Initial Coin Offerings (ICOs) are exploding in popularity, but both offerers and investors need to understand the regulatory landscape to avoid getting burned

by **BRIAN MEENAGH** and **EYAD LATIF**

Initial Coin Offerings (ICOs) involve issuers offering virtual coins or tokens that are typically created and disseminated using distributed ledger or blockchain technology. Holders of virtual coins or tokens may have additional rights over and above those of merely the medium of exchange, such as rights to access the platform, utilize certain services, use the software, or otherwise participate in the project. In some cases, holders may also have rights to a return on their investment, or rights to participate in a share of the returns provided by the project or by the company backing the project.

Post-issuance, holders may resell certain virtual coins or tokens in a secondary market on virtual currency exchanges or other platforms. ICOs are typically announced on cryptocurrency forums and websites through a white paper describing the project and key terms of the ICO, subscription details, timeline, etc. To date, hundreds of ICOs have raised more than US\$6 billion, with a plethora of prospective ICOs frequently reported in industry publications. In late 2017, ICO funding surpassed that of angel and early-stage VC funding combined. As companies, including both tech startups and century-old multinationals alike, increasingly turn to

ICOs as a funding mechanism and tool to revolutionize innovation and breakdown historic barriers to entry, regulatory scrutiny is intensifying. Financial services and securities regulators around the world, including the UK's Financial Conduct Authority (FCA), the European Securities and Markets Authority (ESMA),

the German Financial Supervisory Authority, and the US Securities and Exchange Commission (SEC), have made public statements reminding issuers and investors that coins or tokens issued via an ICO will fall within the full scope of securities law in those jurisdictions, if they meet the relevant characteristics for >>>

ENABLING INNOVATION

Mohammed Alsehli, founder and CEO, ArabianChain, on how potential ICOs can be realized in the Middle East



"ICOs enable you to raise funds without needing a middleman, and that raises an issue for investors, because if you don't know the person raising funds, they could be anyone, including terrorist organizations and so on. The other issue relates to entrepreneurs because they also don't have control over who the participants will be. Anyone can participate and, for example, if somebody wants to launder their money through these ICOs, they can do that. At the same time, it is a fantastic tool to enable innovation. So, how can you get that value without bearing that much risk?"

This is where governments should work with ICOs to enable them rather than ban them. For now, most of the regional regulators don't yet recognize ICOs as an official way of raising funds, but at the same time they don't prohibit it, so it's in a grey area right now. I think that they are waiting to see how it's going to evolve because the market is still very young in terms of ICOs, but we've witnessed more and more adoption.

In Switzerland, for example, they have already established something that serves as a regulatory sandbox. It's called Crypto Valley and it is the place where they work on these ICOs, but they have put some rules and regulations on top of it. So, since they already have these regulations put in place, they will get to benefit from these people because all the money raised in Switzerland is staying in Switzerland. That is the benefit of for the whole economy of Switzerland. I really urge all countries to establish these sandboxes for ICOs."



THE INVESTOR'S VIEWPOINT

GARY SHEYNKMAN
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What are the factors one should take into consideration when launching an ICO?

"It is important to realize that there are different types of tokens. There are core protocol tokens, such as Bitcoin and Ether (Ether are the tokens on the Ethereum Blockchain), and then you have tokens based on Ethereum which are basically a method to create something like loyalty points, or some sort of a mercantile mechanism inside of the application that you are building, or to fundraise for your business through untraditional means.

An ICO pre-sale is a promise to get a discount on an economic

unit within a new system, once it's built or if it's operating already. This is where it gets interesting from a securities law perspective, because if it's a 'once it's built' situation, then, at least the US government, considers it as a security. But, if it has a use case already on day one, then it is a utility and you are selling something else, a commodity. There are large companies, US\$300 million+ organizations, that are now issuing tokens for some useful things and those are honest utility tokens because they are launching a token that can participate in a company that is worth millions/billions of dollars. That is a worthwhile investment.

I would be extremely wary of anyone launching their utility token sale before they have a product. There are two definitions with the same name. >>>

IMAGE CREDIT: ARABIANCHAIN, SPICE VENTURE CAPITAL, VENTURE SOUQ, ABU DHABI GLOBAL MARKET | GARY SHEYNKMAN © STUART TRACT

“IN LATE 2017, ICO FUNDING SURPASSED THAT OF ANGEL AND EARLY-STAGE VC FUNDING COMBINED.”

a security, whether or not such coins or tokens are labelled as a “utility” coin or token. In addition, certain jurisdictions (most notably China) have moved to prohibit fundraising through ICOs and require funds raised through ICOs to be returned to investors.

In the US, the SEC has recently issued a cease and desist order with respect to the Munchee Inc. (Munchee) ICO that emphasizes the

fact that regulators will look to substance over form in determining whether an ICO token is a security. Munchee, a California-based company, was in the process of offering digital tokens (designated as “MUN” tokens) to investors through an ICO. The SEC determined that the ICO was an offering of securities without registration or an available exemption, notwithstanding that the digital tokens offered and sold in the ICO were intended to have a utility function. The Munchee order demonstrates that the relevant facts and circumstances reviewed by regulators in assessing whether a token is a security will not be limited to the rights and interests the tokens are pur-

ported to provide the holders themselves, which may be of a utility or consumptive nature, but will also include the manner of the offering, including how the tokens were marketed and whether the promoter touted a potential increase in token value

as well as any promise of secondary market trading.

In the United Arab Emirates, the Central Bank, the Securities and Commodities Authority (SCA), the DIFC Financial Services Authority (DFSA), and the ADGM Financial Services Regula-



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What is driving the rapid growth of the ICO market at the moment?

“It is driven by the appetite of founders on one side to bypass the traditional fundraising process with VCs and also avoid dilution, and on the other hand, by a lot of new investors looking to invest in new startups via a mechanism (issuing tokens) that has liquidity and using crypto. It is true that there is a lot of hype and noise, but there are also many legitimate projects that might become the new Amazon or Google. In terms of capital deployed into ICOs, US\$5 billion, it is still tiny. Yearly, there are more than \$600 billion of VC money being deployed, so ICOs hasn't even reached 1% yet.

Also, I think that the hype and growth of the ICO market, like any other market like this, has attracted a lot of bad actors trying to take advantage of the opportunity. However, regulators have started to step in to avoid the retail investor being harmed by some of these bad practices and I do not think that this will affect the disruptive potential that blockchain technology holds.

I think that outright banning ICOs or shutting down mining operations or exchanges is not the solution. Those companies just might move somewhere else. I think that regulators need to find the right balance between protection and freedom to introduce technological innovation. There has been a lot of abuse on the utility token side of things, particularly where companies are artificially creating utility tokens that make no sense for their business model but just to justify bypassing the existing regulations and selling them to retail customers. But the US Securities and Exchange Commission has already taken the lead saying that many utility tokens have features of securities. Going forward, what I believe that we will see is an increased adoption of security tokens as an improvement over the current crowdfunding model where you get much broader inclusivity, scalability to handle more investors and distribute money back to them via smart contracts as well as liquidity in the secondary market.”

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There are what I would consider security tokens, which is an organization that issues you a token in accordance with securities laws, you sign a subscription agreement, and have a contractual relationship that is represented by a token. So, you get a contract and you have a tradeable token at the end of that exchange. Then, there are companies that are issuing tokens which the governments would say are security tokens, but they are not following the regulations in terms of contract work. I think that a large portion of ICOs that are marketed to people on Facebook, Twitter, or Instagram are fraudulent either purposely or by accident, meaning that they are just not sophisticated enough to understand that they are committing securities fraud. It's probably mostly the latter, but when I see a pre-sale for things that are clearly not built yet and are

marketed on Facebook to you, that is by definition securities fraud. They are marketing something that does not exist yet and they are just fundraising for their company this way. They can call it whatever they want but that is not what it is in the eyes of the regulators. So, when it comes to security and utility tokens, my tip is: know the difference. But I'd rather not give investment advice because some people have a high tolerance for risk and then some traders take those weird tokens, just to get in and get out, make a couple of percentages, and do well. Just in the way that you play over-the-counter bulletin board type stocks that are not listed on any proper exchange, you do the same with tokens. That is a very different conversation than a large hedge fund coming in with millions of dollars into a token they plan to hold for several years.”



“CRYPTO AND ICOS ARE POTENTIALLY HIGHLY DISRUPTIVE TO THE VC INDUSTRY AND DIFFERENT VCS HAVE TAKEN DIFFERENT APPROACHES.”

tory Authority (FSRA) all potentially have jurisdiction over ICOs depending on the type of ICO and location where the ICO is issued or marketed. As of date of writing this article, the Central Bank and SCA have yet to issue any regulations or formal guidance on ICOs, but this should not be taken as guidance.

The DFSA issued a statement in September 2017 that “the DFSA would like to make it clear that it does not currently regulate these types of product offerings or license firms in the Dubai International Financial Centre (DIFC) to undertake such activities. Accordingly, before engaging with any persons promoting such offerings in the DIFC, or making any financial contribution toward such offerings,

the DFSA urges potential investors to exercise caution and undertake due diligence to understand the risks involved.” The FRSA issued guidance at the same time that “issuances of Securities (as defined in Section 258 of FSMR), whether through a DLT (Distributed Ledger Technology) platform or other means, will see no difference in their treatment under our regulatory framework. Those issuers/market actors who seek to raise funds in a regulated, robust and transparent manner using new business models or technologies such as DLT are encouraged to engage with us as early as possible in the fundraising process.”

It is clear that as interest in issuing, marketing and participating in ICOs in the UAE develops, the guidance that will be issued by the relevant regulators will also develop so as to protect investors in ICOs and maintain confidence in the UAE financial services and securities market as a whole.

In jurisdictions where ICOs are not prohibited, but are subject to local securities regulations, issuers should understand the questions that regulators are asking when determining whether a coin offering is considered



THE INVESTOR'S VIEWPOINT

SUNEEL GOKHALE
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How are traditional VCs, both globally and regionally, reacting to ICOs disrupting the world of investments?

“Crypto and ICOs are potentially highly disruptive to the VC industry and different VCs have taken different approaches. Some have stayed away, almost digging their heels in and continuing to take the position that ‘this is a bubble’. Others have gone all in and in some cases completely shifted away from traditional venture funding and moved almost 100% in crypto. For VentureSouq, we are somewhere in the middle— we have not gone headfirst into ICOs but rather have looked at investing in companies that are built around blockchain with clear use cases that address some of the existing friction points with respect to crypto. I think that we, along with all other investors

in the VC space, are likely to have the same thoughts— how we raise money and invest in early-stage technology companies is likely going to look different in the next 2-5 years. That could mean only raising money through ICOs in the future, which would be the most aggressive form of disruption, or something milder like using smart contracts to close investments and agree terms with our investors and then using blockchain to keep registers or KYC information. For now, there has been significant demand from our investors to see investment opportunities in crypto and blockchain, so much so that we have even had dedicated events and programming with respect to cryptocurrencies. At least a couple of times a week, we get a call from an investor asking us about the latest ICO or development in crypto. It’s been great as we love the high level of engagement from our investor base, and we don’t see this as a threat but rather an opportunity for our investors. The thing we often hear about early-stage and venture opportunities is the lack of liquidity and the longer hold periods. At the end of the day, if crypto and ICOs allow for enhanced liquidity earlier in the lifecycle of a technology company, that makes the venture capital space all the more appealing.”

to constitute a traditional security as opposed to a utility coin or token.

As a general rule of thumb, a token is likely to fall within the definition of a financial instrument if it does any of the following:

- Gives the holder a right to share in the capital or

participate in the profits of projects derived from the efforts of others.

- Creates a transferable debt instrument.

- Creates an instrument in favor of the holder, the value of which is based on an underlying index, commodity, currency, or other asset. >>>



THE INVESTOR'S VIEWPOINT

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How are regulatory bodies reacting to the financial disruption posed by ICOs?

"The market for ICOs is incredibly broad. We, at the FSRA of ADGM, are acutely aware that ICOs do not always fit neatly into existing regulatory classifications. Therefore, a one-size-fits-all approach is not appropriate. This was laid out in a Guidance which we released in October 2017. In our ADGM RegLab, we have one fintech firm that wants to use the ICO technology to facilitate offerings of securities and run a blockchain-powered stock exchange. We, at the FSRA, view this as a legitimate use of innovative technology and since it concerns a regulated product, the firm requires authorization from us. There are, of course, other ICOs that are offerings of products which are not regulated, such as utility tokens.

Additionally, we have classified cryptocurrencies as commodities; therefore, spot transactions in these are not regulated (although derivatives on cryptocurrencies are regulated products.) Besides exercising our supervisory powers (as the FSRA) in the regulated space, we also included a consumer warning in our Guidance regarding the volatility of cryptocurrencies and ICOs and the risk of fraud. The recent announcement from the UAE's Securities and Commodities Authority has voiced similar concerns that we have. ICOs and cryptocurrencies are an extremely high-risk market, so we, as a financial service regulator, have urged the market to exercise due caution when engaging in it.

On February 10, 2018, ADGM announced that we were reviewing and considering the developing of a regulatory framework to regulate and supervise activities of virtual currency exchanges and intermediaries. We are currently using our ADGM RegLab and broader industry engagement to enhance our knowledge of the token market and reviewing what additional amendments are needed in our regulatory framework to accommodate new risks and business models enabled by blockchain technology and cryptocurrencies. It is not our practice to predict what global regulators more broadly will do with cryptocurrencies—there have been divergent approaches. However, we participate in international regulator forums, such as the International Organization of Securities Commissions (IOSCO) and Basel, to actively engage in the regulatory dialogue, and ensure that the interests of the UAE are represented."

Crucially, any prospective ICO issuer must consider in advance the legal implications and structuring options of the ICO. Key structuring questions include:

1/ What is the issuer's target market/jurisdictions? How can the issuer ensure that its offering will only be made to that target market, to avoid triggering the securities laws of unintended jurisdictions? Determining in which jurisdictions an issuer is to make an offer may be difficult if an issuer publishes a public whitepaper over the internet, so password protection and IP address verification may become the norm.

2/ Does the issuer want the coin or token to fall outside the definition of a security, recognizing that this may limit the purpose of the coin or token?

3/ Alternatively, if the issuer wants the coin or token to have an investment purpose: a. Can the issuer rely on an exemption or combination of exemptions in the target jurisdictions to limit the im-

pact of the securities laws/requirements (e.g. through structuring the ICO as a private placement)?

b. Does the issuer want to make a public offer and comply with the full scope of securities laws/requirements?

4/ Are there other innovative structures that might achieve the issuer's aims?

While ICOs may be blazing a new path through traditional fundraising mechanisms such as venture capital and capital markets, some issuers and investors may get burned in testing out the new limits of the path. Carefully thinking through questions on the nature of the offering before the issuance can help protect both issuers and potential investors. ■

"ICOS ARE A GREAT WAY TO RAISE MONEY, TO AVOID DILUTION, AT LEAST PARTIALLY, AND TO REACH AN ENTIRELY NEW CLASS OF INVESTORS."

