

Regulatory Hotline

March 08, 2018

INITIAL COIN OFFERINGS (ICOS): NEW SWISS AND GERMAN ICO GUIDELINES RELEASED; ANALYSIS VIS-A-VIS INDIAN LAW

- Swiss FINMA and German BaFin have both issued Initial Coin Offering (ICO) statements
- The statements do not act as new law but rather a guide to interpretation
- FINMA classifies tokens as payment tokens, utility tokens, and asset tokens
- BaFin says tokens may be securities, asset investments, units in investment funds, underlyings of derivatives contracts, or units of account

BACKGROUND

As Initial Coin Offerings (ICOs) begin to gain mainstream acceptance as a mode of fundraising, the German and Swiss financial regulators have recently issued statements detailing their outlook on ICOs. The German Federal Financial Supervisory Authority (BaFin) on February 20, 2018, published a note on the regulatory treatment of ICOs from a securities law perspective.¹ The Swiss Financial Market Supervisory Authority FINMA has issued guidelines which detail its position on ICOs. The "Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)"² ("Guidelines") were published by FINMA on February 16, 2018, and act as a follow-up to a briefer guidance that was issued by FINMA in September 2017.³ This Hotline primarily focuses on the Guidelines by FINMA since the note by BaFin is not yet available in English and we have relied on a secondary source for our information.⁴

The Guidelines are important since Switzerland – particularly, Zug, known as "crypto valley" – has become a popular destination for cryptocurrency businesses and ICOs. Notable players in the industry like Ethereum, ShapeShift and Xapo are based out of Switzerland.

The Guidelines follow similar advisories issued by regulators in Canada,⁵ Estonia,⁶ E.U.,⁷ Hong Kong,⁸ Singapore,⁹ U.K.,¹⁰ and U.S.,¹¹ among others, over the past year.

We have analyzed the Guidelines below, with comparative notes on the Indian regime where relevant.

WHAT IS AN ICO?

For the uninitiated, an ICO is a cryptocurrency-driven mode of fundraising. The entity wishing to raise capital – the issuer – makes its own cryptocurrency available for purchase by the public, in exchange for commonly traded cryptocurrency (like Bitcoin or Ether) or fiat currency. The ICO tokens exist either on a proprietary blockchain or through a smart contract on a pre-existing blockchain. Usually, issuers release a white paper describing their project, the characteristics of the token, and the profile of their team. Some issuers also do a pre-sale where high-value investors get a beneficial price.

Under Swiss law, currently there is no ICO-specific regulatory framework; depending on the nature of an ICO, compliance with existing regulatory requirements may be attracted. To deal with enquiries from proposed issuers in terms of applicability of financial market regulation, FINMA has issued the two guidance notes so far.

While the September 2017 guidance was high-level and noted that ICOs need to comply with the requirements set out in the relevant financial market laws, the recent Guidelines provide a much more detailed perspective on how FINMA is likely to consider the different types of ICO activity under Swiss regulations. In an Appendix, the Guidelines also specify the minimum information requirements for ICO enquiries to be submitted to FINMA. FINMA will assess the proposed ICO on a case-by-case basis in light of the Guidelines.

India

In India, there are no specific regulations surrounding ICOs yet. Entities wishing to carry out ICOs hence need to be mindful of a variety of generally applicable laws, including those on the acceptance of deposits, setting up of Collective Investment Schemes, and issuance of securities.

We understand that the Securities and Exchange Board of India (SEBI) is in the process of considering a regime to govern ICOs.

Also, the Cabinet recently approved the introduction of the Banning of Unregulated Deposit Schemes Bill, 2018, in Parliament (further discussed below).¹²

BaFin statement

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The BaFin statement too does not create a regulatory regime specific to ICOs, but reiterates that they would be subject to financial regulations depending on their characteristics. BaFin states that tokens may in particular be securities, asset investments, units in investment funds, underlyings of derivatives contracts, or units of account.

CLASSIFICATION OF TOKENS

The Guidelines set out a tripartite classification of tokens based on the *underlying economic function and purpose of the token*. The classifications are as follows:

- i. **Payment tokens:** These tokens are intended to be used as a means of payment for trading goods or services, as a form of money/value. They do not give rise to claims against their issuer.
- ii. **Utility tokens:** Utility tokens are intended to be used as form of access to the underlying technology application or service of the company issuing them. They are thus a type of access code to the company's services and do not have any intrinsic financial value.
- iii. **Asset tokens:** These tokens are a form of debt or equity claim against the issuer. They closely resemble securities issued in a traditional initial public offering (IPO). They are thus analogous to traditional equities, bonds, or derivatives, as they promise certain future returns. Tokens enabling the trade of physical assets on the blockchain also classify as asset tokens.

It must be noted that these classifications are not mutually exclusive, i.e., a given token may be any one or even all three types of the aforementioned classes of tokens. These tokens are referred to as *hybrid tokens*. The regulations governing these tokens are cumulative, viz. they may be regulated as both a type of security as well as a means of payment.

Another type of token issue may be issued where investors or subscribers receive tokens which entitle them to acquire a different token at a later date. This type of ICO is called a *pre-sale* or *pre-financing*.

The classification into these distinct token types, with legal implications flowing accordingly, differs from the approach followed by most regulatory advisories worldwide, which have generally only analyzed whether a token would be a 'security' or not. From the perspective of regulatory clarity, this is a welcome approach; however, if tokens are structured such that they do not clearly fit into these categories, that will present ambiguity.

IMPLICATIONS UNDER SECURITIES LAWS

FINMA has examined the applicability of Swiss securities regulations to these various types of tokens.

- i. **Payment tokens:** Since these are primarily used as a means of payment and are not analogous to traditional securities, FINMA will not treat them as securities.

From an Indian law perspective, if the blockchain relating to the ICO token forms a "payment system" requiring authorization under the Payment and Settlement Systems Act, 2007, the entity that commences or operates such a system may be required to be authorized by the Reserve Bank of India (RBI).

- ii. **Utility tokens:** FINMA will not regulate utility tokens as securities if they only confer digital access rights to an application or service and if the utility token can actually be used in this way *at the point of issue*. However, the Guidelines state that if a utility token has an investment purpose at the point of issue, FINMA will treat such tokens as securities.

Under Indian law, such tokens can be seen as acknowledgements issued in return for advance paid for services to be rendered in the future. As noted below, if the amounts accepted for these tokens are appropriated against the supply of goods or services within a period of three hundred and sixty five days, legal and regulatory compliance in relation to the acceptance of 'deposits' should not be attracted.

- iii. **Asset tokens:** These are treated as securities by FINMA. The Guidelines also clarify that if an asset tokens represents a derivative, it will be treated as a security.

And,

- iv. **Pre-sale tokens:** If these tokens confer claims to acquire tokens in the future, these claims – like asset tokens - will also be treated as securities.

If ICO tokens are classified as securities, corresponding securities obligations under Swiss law will become applicable, though not all issuances or sales of securities are specifically regulated.

Under Indian law, if the 'security' test under the Securities Contracts (Regulation) Act, 1956 ("**SCRA**"), is met, implications under the SCRA (e.g., securities can only be listed on recognized stock exchanges), and possibly the Companies Act, 2013 and Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 (e.g., as regards the issuance of securities), arise.

BaFin has stated that depending on the classification of the token as securities, asset investments, units in investment funds, underlyings of derivatives contracts, or units of account, an ICO would be potentially subject to prospectus requirements (such as under the Securities Prospectus Act), licensing requirements (such as under the Banking Act and Payment Services Supervisory Act), and trading regulations (such as the Securities Trading Act).

Broadly, all three regimes discussed above follow the principles that there is no ICO-specific legal regime, and that once a token is classified as a particular type of legal instrument, the regulatory implications would follow in ordinary course.

ANTI-MONEY-LAUNDERING (AML) REQUIREMENTS

According to the Guidelines, the issuing of payment tokens would constitute the issuing of a means of payment which would be subject to Swiss AML regulation if the tokens can be transferred on the blockchain infrastructure.

For utility tokens, the Guidelines clarify that AML regulation is not applicable if the main reason for issuing the tokens

is to "provide access rights to a non-financial application to blockchain technology".

In India, AML regulations are applicable only to certain regulated entities (e.g., banks, NBFCs and various intermediaries regulated by SEBI). However, if an ICO token were to constitute a "payment system" or other regulated activity, the issuer would need payment system authorization from the RBI under the Payment and Settlement Systems Act, 2007, and would become a regulated entity. It would hence need to follow KYC / AML norms. Separately, it is likely, based on government press comments, that many cryptocurrency businesses may come under the scope of a new regulation and have to follow KYC / AML norms.

DEPOSITS REGULATIONS

The Guidelines explore whether the acceptance of value in exchange for the ICO token issuance would constitute a 'deposit' subject to banking regulation, and hence need the procurement of a banking license. However, since tokens are not generally associated with claims for repayment on the ICO issuer, FINMA takes the view that such tokens do not fall within the definition of a deposit. However, tokens which have a debt capital character e.g., act as promises to return capital with a guaranteed return, the funds raised through the ICO would be seen as deposits, and a banking license may need to be obtained.

In India, as mentioned above, the Banning of Unregulated Deposit Schemes Bill, 2018, is due to be introduced in Parliament. While the text of this Bill does not appear to be publicly available yet, the accompanying press release indicates that the term "deposit" is defined such that "*deposit takers are restricted from camouflaging public deposits as receipts, and at the same time [the definition does not] curb or hinder acceptance of money by an establishment in the ordinary course of its business.*" According to a 2016 draft of the Bill, 'deposit' means the "*receipt of money, by way of advance or loan or in any other form, to be returned, ... with or without any benefit in the form of interest, bonus, profit or in any other form.*" The draft Bill provides a schedule of Regulated Deposit Schemes, and all Unregulated Deposit Schemes are prohibited. Hence it would appear that if the Bill is passed in its draft form, ICO issuers would need to ensure that any money received should not be liable to be returned in order to be outside the purview of this Bill.

Further, the regulations under the Companies Act, 2013, and the Companies (Acceptance of Deposits) Rules, 2014, specify when the receipt of money by way of deposit or loan or in any other form, by a company would be termed a 'deposit' and also provides certain exemptions from its applicability. For example, any amount received in the course of business as an advance for the supply of goods or services would not be a 'deposit' if such advance is appropriated against supply of such goods or services within a period of three hundred and sixty five days. If a company is deemed to be accepting 'deposits', a variety of compliances under the Companies Act and its rules, along with RBI regulations, would be triggered.

COLLECTIVE INVESTMENT SCHEMES REGULATIONS

The Guidelines clarify that these regulations would be relevant if the funds accepted in the context of an ICO are managed by third parties.

In India, Collective Investment Schemes (CIS) can only be operated by entities registered with SEBI for this purpose. Among other criteria, a CIS is likely to be formed if contributions or payments by investors are pooled and utilized for the purposes of the scheme; the contributions or payments are made with a view to receive profits, income, or property; the scheme corpus is managed on behalf of the investors; and the investors do not have day-to-day control over the management and operation of the scheme.

TAKEAWAYS

As leading global economies (and in Switzerland's case, a leading jurisdiction for cryptocurrency businesses and ICOs), Germany's and Switzerland's moves to have a balanced outlook on ICOs can be seen as a positive. The statements achieve the purposes of bringing about clarity in the regulators' interpretation, protecting investors, and not unnecessarily impeding innovative activity. The statements have also stuck to a technology-neutral approach and not an overtly narrow one. In the case of the Guidelines, they would also serve as precedent to many offshore financial centers competing to attract fintech businesses.

In terms of India where we have seen increased interest in the cryptocurrency industry and ICO activity, the Guidelines may also attract Indian entrepreneurs to headquarter ICO-driven projects in Switzerland, which is already attractive due to a favourable tax, regulatory, and blockchain industry climate. However, if this route is pursued, Indian laws on exchange control and securities will have to be closely analyzed.

At the same time, the statements set a good precedent that the Indian financial sector regulators can look to for guidance. ICOs present an innovative means of fundraising and their embrace by Indian regulators can help the government's goals of promoting innovation and start-ups. A negative outlook by regulators or a continuing lack of clarity may result in Indian entrepreneurs choosing foreign jurisdictions for ICOs and related fintech innovations. In this connection, it is worth noting that the (Indian) Ministry of Finance has just constituted a Steering Committee to promote fintech innovation in the country.¹³ It remains to be seen if the Ministry of Finance or a sectoral regulator like SEBI will issue any statement on their outlook on ICOs.

— Jaideep Reddy, Ruchi Biyani & Vaibhav Parikh

You can direct your queries or comments to the authors

¹ https://www.bafin.de/SharedDocs/Downloads/DE/Merkblatt/WA/dl_hinweisschreiben_einordnung_ICOs.pdf?__blob=publicationFile&v=2, last accessed March 8, 2018.

² <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?la=en>, last accessed February 20, 2018.

³ <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/4dokumentation/finma-aufsichtsmittelungen/20170929-finma-aufsichtsmittelung-04-2017.pdf?la=en&hash=9DCC5C1FF8F61C9AA9412FAD2D7C70533F341EF2>, last accessed February 20, 2018.

⁴ <https://www.lw.com/thoughtLeadership/bafin-publishes-statement-on-ico-and-token-regulation>, last accessed March 8, 2018.

⁵ http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm, last accessed February 20, 2018.

⁶ <https://www.fi.ee/index.php?id=21662&year=2017>, last accessed February 20, 2018.

- ⁷ https://www.esma.europa.eu/sites/default/files/library/esma50-157-828_ico_statement_firms.pdf, https://www.esma.europa.eu/sites/default/files/library/esma50-157-828_ico_statement_firms.pdf, last accessed February 20, 2018.
- ⁸ <http://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-initial-coin-offerings.html>, last accessed February 20, 2018.
- ⁹ <http://www.mas.gov.sg/.../JA%20Guide%20to%20Digital%20Token%20Offerings%20%2014%20Nov%202017.pdf>, last accessed February 20, 2018.
- ¹⁰ <https://www.fca.org.uk/news/statements/initial-coin-offerings>, last accessed February 20, 2018.
- ¹¹ <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>, last accessed February 20, 2018.
- ¹² <http://pib.nic.in/newsite/PrintRelease.aspx?relid=176666>, last accessed March 8, 2018.
- ¹³ <http://www.pib.nic.in/PressReleaseIframePage.aspx?PRID=1522473>, last accessed March 8, 2018.
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