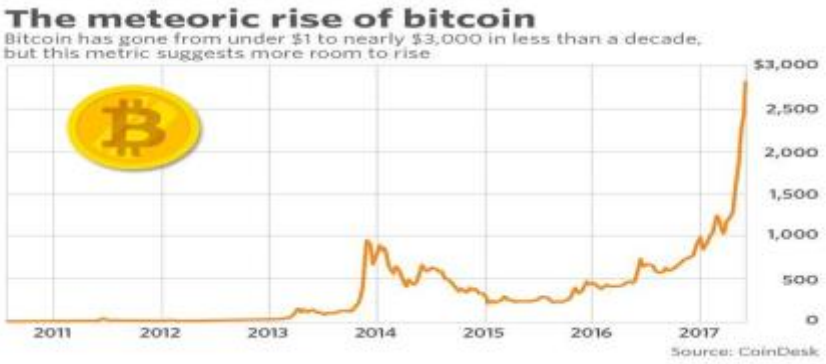
MAKING AN (INITIAL COIN) OFFER YOU CAN'T REFUSE: AN OVERVIEW OF RECENT REGULATORY RESPONSES

"You can resist an invading army; you cannot resist an idea whose time has come"
– Victor Hugo

THE STORY SO FAR

In the short space of less than two months, the regulatory status for digital tokens (or "crypto-coins", as they are sometimes affectionately called), has attracted much attention, particularly from regulators themselves. The U.S. Securities and Exchange Commission ("**SEC**") was first off the blocks with its press release on 25 July, issuing an investigative report cautioning market participants that offer and sales of digital assets by "virtual" organizations would be subject to the requirements of federal securities laws. The press release by the Monetary Authority of Singapore ("**MAS**") on 1 August 2017[1] clarified that the offer or issue of digital tokens in Singapore would be regulated if such digital tokens constituted products regulated under the Securities and Futures Act of Singapore.

More recently, the great bombshell (by not one, but seven official agencies of the People's Republic of China ("**PRC**") that the PRC was banning initial coin offerings ("**ICOs**"), has caused some consternation in the crypto-world, with the price of Bitcoin (BTC) tumbling after it reached an all-time high of around USD4,700. The sudden flurry of responses and activities by financial services regulators all over the world is reminiscent of the price of Bitcoin itself, the most popular digital coin of them all. While volatile, the price of Bitcoin from its first major crash in 2014 (following the closing of the ill-fated Mt. Gox exchange) to the end of last year, had remained below its all-time high at that time, only to form a classic "cup and handle" pattern and shooting up in a manner that can only be described by traders as parabolic. In the same vein, the regulatory responses, though far from muted since 2014, have been measured and largely reactive. This has now changed.



(*All links in this article were last accessed on 12 September 2017*)

[1] Press release titled "MAS clarifies regulatory position on the offer of digital tokens in Singapore" dated 1 August 2017 http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx

Nothing in either the MAS or the SEC press releases should be of any surprise. It has always been the legal position that if an instrument, whether digital or otherwise, can be classified as a security, it will come within the ambit of the securities laws of the jurisdiction in which it is offered or if it is offered to the residents of that jurisdiction. What is different this time is the shift in the stance of the regulators – arguably now more pro-actively scrambling to issue statements of caution, compared to adopting a more relaxed wait-and-see approach.

The event that sent shockwaves through the blockchain community and anyone proposing to launch an ICO was the fate of an ICO launched on 13 August 2017 by Protostarr, a DApp (decentralised application) start-up. As quoted in Forbes[2]:

> "*[The SEC investigators] called and asked for me to volunteer a bunch of information about the company. They gave me a quick little brief: They're both federal investigators, anything I say has to be truthful or honest, I could be prosecuted for providing false information -- a bunch of stuff like that, so immediately, I said, I would like to be open with you guys but this is sounding like an 'I should get a lawyer' kind of conversation." (The SEC declined to comment.)*
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> *"We're just a couple guys who are tech nerds in our basement," said Gilson [Note: Gilson is Joshua Gilson, the chief executive of Protostarr]. "It didn't occur to us that the model everyone else in the world is using would have any specific laws here that would apply to us. We just weren't aware. In the month leading up to it, we were going full bore, working till 2am every night on the ICO, so we didn't even see the DAO ruling when it came out until someone brought it to our attention." By then it was August 15 -- three weeks after the report had come out, and two days after they'd launched their sale.*
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> *"I thought the DAO was selling portions of itself with voting rights and ownership of the company essentially, so I saw it as a stock or a security, and I thought, well, we aren't structured that way, so we should be fine,"* said Gilson.

The news headlines by other media outlets were dramatic, with most of them worded along the lines of "SEC shuts down ICO with one phone call". It is not entirely clear if the SEC was indeed going to take any action against Protostarr, but the chilling effect of the phone call is instructive for anyone seeking to raise funds through an ICO. ICOs are no longer under the radar of the regulators; in fact, they are very much in their front sights.

The clearest illustration of trenchant government action is the ban by the PRC on all ICOs and secondary trading of digital tokens, announced during the Labor Day long weekend in the United States. The joint statement by the seven official agencies, including the People's Bank of China, is peppered with words like "illegal" and "against regulations".[3] The posturing of the PRC government is clear – ICOs and trading of digital tokens will be banned - until they are (able to be?) regulated. This was followed by (at the time of writing) unconfirmed reports from Caixin that a ban on Chinese crypo-exchanges is next in the pipeline.[4] This sent the price of Bitcoin, yet to recover fully from the ICO ban, plummeting to below US$4, 200.

Almost immediately after the ICO ban in the PRC, the financial regulators of South Korea[5] and Hong Kong

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[2] News article titled "After Contact By SEC, Protostarr Token Shuts Down Post-ICO, Will Refund Investors" dated 1 September 2017, obtained from https://www.forbes.com/sites/laurashin/2017

[3] Joint statement (in Chinese) dated 4 September 2017, obtained from http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3374222/index.html

[4] News article (in Chinese) titled "虚拟货币交易所时代结束" dated 8 September 2017, obtained from http://finance.caixin.com/2017-09-08/101142797.html

[5] News article titled "Regulating Bitcoin Trading Financial Authorities to Strengthen Regulations on Digital Currency Trading" dated 4 September 2017, obtained from http://www.businesskorea.co.kr/english/news/money/19180-regulating-bitcoin- trading-financial-authorities-strengthen-regulations-digital

released their own statements on their intention to increase their scrutiny of ICOs. In this respect, the statement by the Hong Kong Securities and Futures Commission is similar to the MAS press release of 1 August 2017. The Commission, like MAS, cautioned that tokens that confer rights in a corporation, dividend rights, or rights under a debenture will all be regarded as a security and be subject to securities laws. Likewise, a startup that raises cash through an ICO that pools the funds to "invest in projects with an aim to enable token holders to participate in a share of the returns provided by the project," will also be regarded as a collective investment scheme. Not to be left out, the Securities Commission of Malaysia issued its own terse regulatory statement on 7 September to caution investors about the risks of ICOs[6].

IS REGULATION NIGH?

To paraphrase the villain in the James Bond flick, Goldfinger: once is happenstance, twice is coincidence, and thrice is concerted regulatory action - or at least copycat action. None of these statements or reports could have been issued in a vacuum. If the regulators had not had a meeting of minds and coordinated their public pronouncements, they were at least watching one another. The timing of the issuance of the consumer advisory by MAS and the Commercial Affairs Department days after MAS' own statement on its regulatory position is telling. Taken together with the statements of the regulators of the US, and of certain major economies in Asia, there is a now an unmistakable message for ICO issuers. The position of the PRC regulators is clear and unequivocal but the subtleties of the other regulators – with the disclaimer that every ICO must be examined on its own facts and economic realities – do not hide the uncomfortable truth that the spotlight is finally on ICOs, and also the trading of digital tokens. The passive wait-and-see approach has now morphed into a wait-to-pounce readiness to act.

The silver lining in the midst of this regulator backlash is the response of the Canadian financial regulators. While deeming the token to be issued by start-up Impak Finance as a security, Quebec's Autorite des Marches Financiers (AMF) will be accepting the project into its regulatory sandbox, as reported by Coin Telegraph.[7]

On 24 August 2017, the Canadian Securities Administrators published a staff notice on "Cryptocurrency Offerings", with an assuring statement that "we welcome digital innovation and we recognize that new fintech businesses may not fit neatly into the existing securities law framework.[8]"

Canada's response is a clarion call for all regulators to temper the knee-jerk reaction to over-regulate. In the brave new world of disruptive technology, none will discombobulate more than blockchain technology. Blockchain technology has the potential to threaten not only payment systems but the legitimacy or role of entire governments and states. It is not surprising that central banks and financial regulators have been cautious in their approach to blockchain, crypto-currencies and digital tokens.

But at least one central bank, the Bank of Finland, has been in the news for its progressive and pragmatic views on Bitcoin. The Bank of Finland recently published an excellent research paper, calling Bitcoin "revolutionary" and a "marvelous structure".[9] The paper contains both technical expositions and

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[6] News article titled "Media Statement on Initial Coin Offerings" dated 7 September 2017, obtained from https://www.sc.com.my/post_archive/media-statement-on-initial-coin-offerings/

[7] News article titled "While China is Getting Tough With ICOs, Canada Voices Support For Token Sale" dated 6 September 2017, obtained from https://cointelegraph.com/news/while-china-is-getting-tough-with-icos-canada-voices-support-for-token-sale

[8] Press release titled "CSA Staff Notice 46-307 Cryptocurrency Offerings" dated 24 August 2017, obtained from http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm

[9] Research paper titled ""Monopoly without a Monopolist: An Economic Analysis of the Bitcoin Payment System" dated 30 August 2017, obtained from https://helda.helsinki.fi/bof/bitstream/handle/123456789/14912/BoF_DP_1727.pdf;jsessionid=2F1E2EDBF1180739B5C13906CA99260E?sequence=1

comprehensive descriptions of Bitcoin as good as any in commercially published guide books. More importantly, the paper concludes with a bold statement that "[Bitcoin] cannot be regulated. There is no need to regulate it …" There is the usual disclaimer that "The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland." While not an official and ringing endorsement of Bitcoin, the publication of the paper on the Bank of Finland's website is noteworthy.

MAKING SENSE OF IT ALL

The cynical among us may suspect regulators and central banks of orchestrating the regulatory crackdown, and indeed, the fiercest advocates of blockchain technology - libertarians who distrust governments - are probably convinced that Big Brother is out to snuff out the emerging forces behind the peer-to-peer networks. Leaving aside conspiracy theories, let's examine what the regulators have actually said publicly. There are two common themes in every statement published by all the regulators, even in the forward-thinking statement by the Canadian Securities Administrators:

a) Protection of investors; and
b) Concerns about money laundering

Neither of these concerns presents insurmountable problems, and it would be a pity if these are indeed the reason inhibiting the regulators from actively tailoring the legislative framework to accept or accommodate blockchain technology, including for ICOs. It is not difficult for a regulator to provide administrative guidance, pending legislative amendments or a judicial decision, on crowdfunding activities that do not confer equity or debenture rights on funders, including guidelines restricting the funding to certain classes of persons only. Only fraudulent scammers seeking to make a quick buck from the retail public will eschew such guidance, while genuine ICO issuers will appreciate it. The SEC's DAO report and the staff notice by the Canadian Securities Administrators, and to a lesser extent, the notice by the Hong Kong Securities and Futures Commission, are admirable examples of administrative guidance providing much-needed clarity to the industry.

As for money-laundering concerns, this issue has been trumpeted every time a regulator mentions crypto-currencies and ICOs, often as an unconscious mantra that does not seem to have been re-evaluated and critically examined. There is no denying that crypto-currencies and blockchains present unique challenges for compliance with anti-money laundering and countering of financing of terrorism (AML/CFT) regulations. Using Bitcoin as an example, the oft-cited though inaccurate charge against Bitcoin is that they are anonymous and that the bad guys can move funds around without anyone being able to trace them. This is incorrect. Bitcoin transactions, like many other transactions based on blockchain technology, are *pseudonymous*. A sender and a receiver of Bitcoins are only identified by their public keys (or rather public addresses) but this does not mean that their real identities can never be verified or discovered. The Bitcoin blockchain is a chain of transactions in the public domain for all to see. Unlike cash, which can be moved anonymously with the right mules and disappear once out of the banking system, each flow of Bitcoin is immutably linked to all earlier flows before it, and would have been verified by miners before being added to the blockchain. Just as law enforcers can follow a transaction from person A to person B, and count the number of Bitcoins that has passed hands, it is technically possible to trace the genesis of the Bitcoins used for any series of transactions. In this connection, regulations mandating KYC checks at crypto-exchanges or brokers when fiat currencies are first converted into Bitcoin or altcoins will be helpful to track the identities of BTC owners when money in the physical world crosses over to the virtual world of crypto-currencies.

FINAL THOUGHTS

In the immortal words of Victor Hugo, no one can resist an idea whose time has come. If blockchain technology has the potential to dramatically impact our lives as we know it, it is pointless to resist it. Like BTC, which is reaping the fruits of its first-mover advantage, the regulator and country that first embraces blockchain, will stand to benefit immensely. On the flip side, any regulator that seeks to stifle this promising nascent technology with burdensome regulatory oversight, will be forced to follow the lead set by innovator governments.[10] The race to the top of the blockchain food chain has begun!

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[10] See, for example, the commentary titled "Hong Kong must join China to lead the bitcoin revolution, or be left in the dust" dated 4 September 2017, obtained from http://www.scmp.com/comment/insight-opinion/article/2109361/hong-kong-must- join-

china-lead-bitcoin-revolution-or-be-left