

INITIAL COIN OFFERINGS

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Introduction

In this second article of a three-part series, we introduce initial coin offerings (“ICO”) – including the components of an ICO, a brief overview of the ICO process, the risks typically involved in an ICO and some regulatory aspects of an ICO.

Components of an ICO

An ICO is an alternative means of fundraising outside of the traditional fundraising methods such as initial public offerings, crowdfunding, venture capital funding and angel funding. Consequent on the ever-developing progress of blockchain technology, ICOs are increasingly used by blockchain-based start-ups to raise funds for new ventures. The market for ICOs has boomed to approximately \$1.3 billion so far this year. Such projects include:

1. development of a new cryptocurrency – e.g. Lisk; or
2. creating a new product – e.g. TenX.

ICOs are conducted between the **issuer** on the one hand and the **investors** on the other. Each investor sends either existing cryptocurrencies (e.g. Bitcoin or Ether) or legal tender to the issuer, receiving digital tokens in exchange. Once the issuer's project is successfully launched, the investor will use the digital token to gain access to the assets or the project underlying such token.

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The ICO process

Broadly speaking, there are three main stages of an ICO, namely, (1) pre-announcement; (2) ICO launch funding; and (3) end of ICO.

(1) Pre-announcement

At the pre-announcement stage, the issuer typically prepares a white paper, road map, and terms and conditions (“T&Cs”) of the ICO.

- The white paper sets out key aspects of the underlying project, such as the technical aspects of the product, the problems the product intends to solve and how it is going to solve them.
- The road map outlines defined and realistically achievable goals of the project, and the intended timeframes.
- The T&Cs of the ICO would cover risk factors, representations and warranties and other key legal terms.

These documents are published and prospective investors may actively discuss the merits of the project through platforms such as Reddit, Bitcointalk, Slack and Telegram.

(2) ICO launch

At the launch stage, an interested investor sends existing cryptocurrencies or legal tender to the issuer, in exchange for digital tokens.

Fundraising minimum requirements met?

- If the minimum funds requirements are met within the specified timeframe, the money raised is used to either initiate the new project or to complete it.
- However, if the money raised does not meet the minimum required by the issuer, the money is returned to the investors and the ICO is deemed to be unsuccessful.

The duration of the fundraising stage may vary from hours to days to even months and may be divided into different phases. Typically, however, the launch stage would last for hours before the funding requirements of the issuer are met or surpassed.

(3) End of ICO

Upon successful fundraising, digital tokens will be distributed to the investor. The tokens give the investor access to the assets or the project underlying such tokens.

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Risks involved

General: Jurisdiction and applicable law

Blockchains are by its inherent technological nature, carried out in a decentralised system. This means that the servers are located across the globe and are not situated in one single location. As such, this creates conflicts of law issues and related issues – what is the applicable law that would govern an ICOs?

While the ICOs are carried out on the servers and the servers would be located in different places and quite often, simultaneously in different countries, it is impossible to pinpoint a specific country where an ICO is being offered. Hence, investors, issuers and regulators would be faced with the dilemma as to which country's laws should apply. Consequently, it would be difficult to impose, much less enforce any specific country's laws and regulations on an ICO. Additionally, another issue would be for investors or issuers who have a claim against the other, to decide which country's laws would apply and also, in what forum should the claim be filed in?

There have been developments in the market, attempting to provide or attribute a legal home for an ICO, thereby placing the entire process of the ICO to the laws of the country in which it is located. Otonomos is a Singapore company known to help companies incorporate online on the blockchain. They are currently planning to offer a service to provide ICOs with a legal home.

The risk to issuers: Security or asset?

As it stands, the legal character of cryptocurrency is still uncertain. The classification of whether cryptocurrencies are a security or asset would determine the type of laws and regulations as well as the tax(es) which ICOs may be subject to. In some jurisdictions, cryptocurrencies are regarded as securities, with the exception of Singapore and Switzerland which currently treat cryptocurrencies as assets.

Being categorised as securities would potentially oblige an ICO issuer to comply with requirements for an offering of securities under various securities laws in the relevant jurisdiction. For example, under the Securities and Futures Act (Cap. 289) of Singapore ("**SFA**"), a prospectus is required for any offer of securities that is not an excluded or exempted offer under the SFA. A breach of this prospectus requirement may lead to both civil and criminal sanctions. In this regard, issuers may not be equipped with the legal knowhow to structure the ICO and ensure that the ICO is legally compliant with the laws of the relevant country in which the ICO may be considered to be homed.

The Risk to investors: (1) Lack of information and disclosures

Many investors participating in ICOs are people with little or no expertise on the blockchain, cryptocurrencies or how ICOs operate. Along with the upward trend of ICOs, many investors are simply jumping on the bandwagon, hoping to make good investment returns and quite often make decisions to participate in an ICO based on inadequate and possibly inaccurate information.

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Moreover, some offerings are posted on unsupervised platforms with insufficient information and disclosures. The lack of a prospectus requirement (or equivalent regulation) under Singapore law in relation to ICOs gives rise to this information asymmetry which acts adversely against investors. Thus, investors should be careful when deciding whether or not to participate in an ICO.

The risk to investors: (2) Uncertain rights and onerous terms

Along with the inherent difficulties in determining the relevant jurisdiction and applicable law of an ICO and on top of the potential risk of insufficient information and disclosures, potential investors may not be aware of their legal rights and whether is any recourse available to them should any dispute arise between the investor and the issuer.

Also, due to the inequality in bargaining power between the issuer and the investors, there could be particularly disadvantageous or onerous terms in the T&Cs of the ICO such as a complete exclusion of liability (although the enforceability of such a term is subject to the applicable law of the ICO).

Regulatory aspects of an ICO

Along with its increased popularity, ICOs are now being heavily scrutinised by various government organisations. Cryptocurrency contributes to a significant proportion of the current investment market and for something generating so much value, there are currently little to no regulations on ICOs in most jurisdictions where ICOs have been launched

However, there has been a movement toward regulating the cryptocurrency market. For example, the U.S. Commodity Futures Trading Commission has expressed intentions to regulate virtual currency. More recently, the U.S. Securities and Exchange Commission ("**SEC**") decided that the largest sale of cryptocurrency tokens last year, reminiscent of an initial public offering of shares, was to be regarded as a sale of securities and requiring it to have complied with United States laws governing the process and protecting investors. However, in that case, the SEC apparently chose not to go after the blockchain experts who were behind the Decentralized Autonomous Organization (also known as "**DAO**"), which raised \$150 million in either, the digital currency of the Ethereum platform. But the Wall Street watchdog's report, released on 25th July 2017 sounds a warning signal to the ICO market and may deflate or at least slowdown what appears to have become a potential bubble.

Therefore, whilst ICOs are presently conducted in many countries with relative ease due to the paucity of laws and regulations, it will not be long before countries start putting in place legislation and regulations. However, given the nature of the decentralised system of an ICO and taking into account, the aforementioned issues with regard to applicable law, it would not be easy for any single government or government authority to police and enforce such laws and regulations even when put into place.

In Singapore, the Monetary Authority of Singapore ("**MAS**") has expressed its concern over the risks in the cryptocurrency industry. Regulators are attempting to strike a balance between promoting innovation and

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risk management with regard to the Fintech sector. It has been noted that cryptocurrencies thrive in this mostly unregulated sphere and regulators in some jurisdictions may have some concerns that imposing overly restrictive laws and regulations might stifle such growth by driving them away to other jurisdictions without such laws and regulations.

As ICOs operate in multiple ways, there is often difficulty in classifying the cryptocurrencies being marketed, and what laws or regulations would apply.

- For example, some ICOs work like reward-based crowdfunding, an activity currently unregulated in Singapore.
- If, however, an ICO operates like an offering of securities, it may be potentially subject to prevailing laws and regulations under Singapore law governing the offering of securities.
- If an ICO is marketed as a sale of a fund, it may also fall within the ambit of funds offerings and be subject to applicable laws and regulations.

The Singapore position was stated as follows:

"If these things become big enough, then we will find powers to do something ... it was all about proportionality, and if the bitcoin providers were small-scale and not engaging in conduct that was fundamentally fraudulent – with any risks made known to investors from the outset – their behaviour should be treated as acceptable under normal circumstances." – a MAS officer at the Blockchain for Finance Conference Asia Pacific, Singapore, held on 20 and 21 June 2017. On 1 August 2017, the MAS clarified its position in relation to ICOs arising from the increasing number of ICOs launched here. The MAS said that digital tokens may be viewed as an offer of shares or of units in a collective investment scheme falling under the SFA. Additionally, digital tokens may also be regarded as debts from an issuer of an ICO and thus regarded as a debenture under the SFA. The effect of the latest MAS statement is that issuers in ICOs which in substance offer investors any forms of securities (equity or debt) will be legally obliged to comply with the requirements of the SFA, including issuing a prospectus when the digital tokens are offered. The exemptions and exclusions under the SFA (mentioned above) will avail and these include private placements and offers made to accredited investors or institutional investors.

What remains to be seen in the near future, with the proliferation of ICOs in this part of the world, would be whether there will be any additional laws or regulations promulgated by the relevant authorities in Singapore and in countries where ICOs are launched to specifically govern the issue of cryptocurrencies and ICOs based on the ephemeral form of cryptocurrencies inherent in their nature and also to guard against the ever-present risk of cryptocurrency issues and ICOs being used for money laundering and financing terrorism.

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