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ESMA Highlights EU Regulatory Rules Applicable to ICOs

ESMA has published two statements highlighting ICO risks for investors and EU regulatory rules applicable to issuers and advisors involved with ICOs.

The European Securities and Markets Authority (ESMA) published two statements on Initial Coin Offerings (ICOs) on 13 November 2017. The first statement is a warning to firms involved in ICOs that tokens issued via ICOs may be financial instruments, depending on how those tokens are structured. If that is the case, ICOs may involve firms carrying out regulated activities in the EU. The second statement highlights the speculative nature of ICOs, and the risks that some ICOs may pose to investors.

ESMA is not alone in issuing cautionary statements; some national regulators have recently published similar warnings about the risks of ICOs (*e.g.*, the German Financial Supervisory Authority and the UK Financial Conduct Authority).

ICOs involve issuers offering virtual coins or tokens that are created and disseminated using distributed ledger or blockchain technology (DLT). The capital raised from the offer will fund the development of a digital platform, software, or any other project. Holders of virtual tokens may have additional rights over and above those of a cryptocurrency, such as rights to access the platform, 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.

Warning for Firms

ESMA is concerned that firms involved in ICOs may be conducting their activities without complying with relevant EU legislation. ESMA has, therefore, released a statement reminding firms involved in ICOs that they must give careful consideration as to whether their activities constitute regulated activities in the EU and, if so, comply with applicable EU laws and regulations.

All firms involved in ICOs should take notice of ESMA's statement, including issuers, corporate finance advisors, firms dealing in tokens, firms providing custody and wallet services, and firms providing secondary market trading facilities (*e.g.*, cryptocurrency exchanges).

While stressing that ICOs may involve the issuance of tokens that qualify as financial instruments (depending on the structure), ESMA does not provide any details of the characteristics that would lead to a token falling within the definition of a financial instrument.

Financial instruments are defined in the Markets in Financial Instruments Directive (MiFID) to include transferable securities, money-market instruments, units in collective investment undertakings, a broad range of derivatives (including futures, swaps and options) and certain recognised emission allowances. Tokenised financial instruments will fall within the scope of EU regulation in the same way as traditional financial instruments.

Whether a token falls within the scope of the definition of a particular financial instrument can involve a complex analysis, and a number of exemptions may be available for certain structures. However, as a general rule of thumb, a token is likely to fall within the definition of a financial instrument if it:

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

Tokenised financial instruments may fall within a range of EU regulatory regimes and ESMA identifies the Alternative Investment Fund Managers Directive (AIFMD), the Fourth Anti-Money Laundering Directive (MLD4), MiFID, and the Prospectus Directive as examples. The table below sets out (broadly) the types of firms that may be subject to the requirements of these regulatory regimes, if they are involved in an ICO in which a token is structured as a security. The table also sets out a high-level summary of the key requirements of those regimes.

Tokenised Financial Instruments: Applicable EU Regulations

EU regulatory regime	Applicable to (among others)	Key requirements
Prospectus Directive	Issuers/offerors of transferable securities	Publication of an approved prospectus when securities are offered to the public, unless relying on an exemption Exemptions include: • Offers solely to qualified investors • Offers to less than 150 non-qualified investors per European Economic Area (EEA) member state • High-denomination securities (denominations of at least €100,000) • A floor on minimum investment (of at least €100,000 per investor) • A ceiling on the total size of the volume offered to investors (aggregate consideration payable for all securities that are subject to the offer in the EEA amounting to less than €100,000)

MiFID and MiFID II	• Broker-dealers • Corporate finance advisors • Placing agents and underwriters • Trading platforms • Custodians • Investment advisors • Portfolio managers	• Regulatory licensing regime in home EEA member state • Conduct of business requirements and requirements to manage/prevent conflicts of interests • Requirements for adequate systems and controls • Pre- and post-trade transparency requirements • Requirements for custodians safeguarding cash and/or assets on behalf of customers • Organisational requirements for trading platforms • Training and competency requirements • Obligations on firms engaging in algorithmic and/or high-frequency trading
AIFMD	Managers of Alternative Investment Funds	• Regulatory licensing/registration regime in home EEA member state • Conduct of business and transparency requirements • The mandatory appointment of depositaries and custodians • Restrictions on delegation of portfolio management and risk management • Restrictions on marketing of Alternative Investment Funds • Restrictions on the use of leverage • Prospectus / disclosure requirements
MLD4	• Credit institutions • Financial institutions (MiFID firms) • Payment services institutions • E-money issuers	• Requirement to carry out due diligence on customers, and to conduct ongoing monitoring of customer relationships • Systems and controls and record-keeping requirements • Obligations to report suspicious activity and to co-operate with any investigations by relevant public authorities

Other considerations not mentioned by ESMA, but which firms involved in ICOs should turn their minds to include:

- The ultimate decision as to whether a token qualifies as a financial instrument is within the responsibility of the national regulators of the individual EU member states and experience has shown that the national supervisors take different approaches in this regard, *i.e.*, they may come to different results when making their assessment.

- In some EU member states, the regulatory regime captures a broader range of financial products than just financial instruments in terms of MiFID (*e.g.*, *Vermögensanlagen* in terms of the German *Vermögensanlagengesetz*).

- The issuance of tokens that are redeemable may be qualified as deposit-taking business, which requires a banking licence.

- The requirement for regulated firms to maintain adequate regulatory capital under the Capital Requirements Directive and Capital Requirements Regulations.

- Whether the activities of firms involved in ICOs could fall under the scope of the current EU Payment Services Directive (PSD), the new PSD2 (which comes into force on 13 January 2018), or the E-money Directive (this will be particularly relevant to wallet providers and exchanges).

- The application of financial promotion regimes of individual EEA member states, which may impose restrictions and content requirements on marketing materials in relation to the issuance or sale of financial instruments.

- The application of consumer rights law, which may impose obligations on ICO issuers in respect of any retail investors (*e.g.*, the UK Consumer Rights Act 2015).

In addition, it should be noted that in July 2016 the European Commission published proposals for amendments to MLD4, dubbed "MLD5", among which is a proposal to bring virtual currency exchange platforms and custodian wallet providers directly within scope of the EU money laundering requirements. It was expected that the MLD5 proposals would be adopted by the end of 2017, however, that timetable may be set to slip. It is not yet clear what the timeline will be for implementation of the proposals.

Risks for Investors

ESMA has observed a rapid growth in ICOs and is concerned that investors may not realise the high risks that they are taking when investing in ICOs. ESMA stresses that ICOs are extremely risky and highly speculative investments and identifies the following risks for investors when investing in ICOs:

- ICOs may not be captured by existing EU regulatory rules and may fall outside of the regulated space, meaning that investors cannot benefit from the protections imposed by those regulations. In addition, ICOs may involve fraudulent or illicit activities, including money laundering.

- There is a high risk that investors will lose all of their invested capital. This is because ICOs are often launched by very early-stage ventures that have an inherently high risk of failure and many tokens issued using ICOs have no intrinsic value other than the possibility of using the token to access a platform or service that may not be successfully developed.

- There may be a lack of exit options for investors because not all tokens are traded on virtual currency exchanges and when they are, like virtual currencies, their price may be extremely volatile.

- Information provided to investors in ICO whitepapers may be "unaudited, incomplete, unbalanced or even misleading".

- DLT is still largely untested and there may be flaws in the code or programs that are used to create, transfer or store the coins or tokens.

What Does This Mean for ICOs?

ESMA is the latest in a string of regulators to speak out about the potential risks of ICOs. ICOs have even been banned in some jurisdictions. Their prominence in the regulatory spotlight means that all parties involved in ICOs need to consider their regulatory obligations carefully, and ensure they comply with relevant regulation. This can be challenging, particularly for parties not familiar with applicable regulatory frameworks who may not be aware of when or how regulations could bite. It is also a challenge because often the regulators themselves are as yet not fully familiar with ICOs, and are unsure how to categorise them.

However, given the growing scrutiny of ICOs amidst a backdrop of unclear regulatory obligations and shifting regulator expectations, it is imperative that firms involved in ICOs conduct a proper analysis of the facts and adhere to applicable rules.

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