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Cryptocurrencies and ICOS: an introductory Q&A

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What is an ICO?

When a company wants to raise money it may issue shares or debt, both being bought by investors with the relevant currency, for example GBP, Euro or USD. Issues of shares and debt in the UK are regulated by the Financial Conduct Authority (the "FCA").

Similarly, a fund manager may issue shares to raise money to invest in a fund which trades a particular investment strategy, for example equity, managed futures, fixed income, credit or private equity. Again, this activity falls under the jurisdiction of the FCA but this time with additional regulations relating to funds likely to apply as well.

But what if, instead of issuing a share which is not represented by a certificate but held electronically on behalf of the shareholder, the company issues something similar – a token or coin (in this note called a token) which has been created by that company and, at the point of issue, relates to the value of that company and can be traded to create liquidity and a variance in value from the company? That token may not be regulated by the FCA and money may be raised with fewer regulatory concerns.

The structuring of tokens can be various, both in the required type of subscription which may be a fiat currency or a cryptocurrency, and in the goods or services to which the value of the token is attached. Its value may also vary according to the market in buying and selling the tokens, the exchanges on which they can be traded and the ability to convert them into a fiat currency.

An ICO, or initial coin offering, is therefore one way in which a company can raise funds with fewer regulatory concerns. From that starting point, many possibilities arise and ICOs can take a number of forms. ESMA itself noted the varying features and purpose of tokens in a statement made in November 2017, citing that that tokens can be used to provide access to or the purchase of a service of product and/or provide voting rights or a share in revenues.

What is a cryptocurrency?

A cryptocurrency is a currency which is created virtually and held securely by means of cryptography and recorded in immutable form using blockchain technology. Two points are key to tokens: firstly there is no centralised system or government involvement and secondly, is that there may be a limit to the number of cryptocurrency tokens available.

Are tokens or cryptocurrencies regulated by the FCA?

The FCA regulates certain investments which it refers to in legislation as specified investments. These do not include tokens or cryptocurrencies. However, derivatives are specified investments and so are regulated by the FCA when dealt with in a manner which legislation defines as a specified activity, for example investment advice, investment management, dealing and arranging deals in investments.

This freedom does not, however, mean that digital assets have escaped the attention of the regulators and in November 2017 BaFIN, ESMA and the FCA published statements on tokens and cryptocurrencies.

BaFIN, the German regulator, noted the highly speculative nature of ICO investment and the lack of regulatory protections, as well as issuing a consumer protection warning on this topic.

ESMA also issued two statements, one concerning the risks of ICOs for investors and the second warning firms that the structures used for ICOs may subject them to regulation.

The FCA issued a consumer warning about the risks of investing in cryptocurrency contracts for differences. It should be noted that this publication is about a derivative on cryptocurrency and not the cryptocurrency itself.

Please see *"What are the dangers?"* below for more details.

How are tokens subscribed for in a fund offering?

In the fiat world, a fund will issue shares in return for cash and use the cash to deploy a particular investment strategy.

Where a fund is issuing tokens it may ask for the tokens to be subscribed for in cash, or it may require a cryptocurrency to be used for subscription. In return for subscription, whether in a fiat currency or a cryptocurrency, the fund will issue subscribers with a token which has certain rights attached to it. The value of the token will vary over time according to the rights attached to the token, and it may also vary according to the secondary market for the tokens. Specialist exchanges provide a secondary market for the trading of tokens and the trading price may not match the value of the token.

The rights of a token can be, and are, many and various and this is being taken up in the mainstream corporate world with companies issuing tokens rather than shares. The reasons for this vary but often focus on the speed and lack of regulation in offering tokens to raise cash rather than going through a share issue or IPO.

Details on the issue of a new token can be set out in a white paper or an offering memorandum.

How are tokens held?

Tokens are held in electronic form, in a digital wallet. A digital wallet can be used to store the token, connect to the network, and purchase or sell, own, transfer, or receive tokens.

Each digital wallet has a unique address and verification system, consists of a "public key" and a "private key" which are linked mathematically to each other. A public key serves as an address for the digital wallet, which is similar to a bank account number. A user must provide its public key to the party initiating the transfer while the private key is a secret piece of data which proves that the user is authorized to spend the token from a specific wallet. Rather like a personal pin number for a bank account, it can be used to authorise access to and transfer of, the funds to and from the digital wallet by other users.

Private key(s) can be stored in a number of ways, the most common being on a user's computer or on remote servers. If a user fails to secure or make a backup of the public and private key relating to a digital wallet, or loses its private key, or if the digital wallet containing the keys is deleted or hacked into, the user permanently loses access to the tokens in the digital wallet and has no right of recourse or help to any centralised group or agency.

How are tokens converted into a fiat currency?

There are a number of ways in which a token might be converted into a fiat currency. One is for the token to be sold or redeemed for cash, potentially by the issuer of the token or by trading on an exchange.

Conversion on an exchange can happen in a number of ways, the most common being either for the token holder to enter into a trade either with another person or with an intermediary or via an online exchange, where the token is traded with the exchange rather than another individual.

Other methods of conversion are coming into play though, an example being the growth in peer-to-peer marketplaces which enable tokenholders to use their tokens to buy goods from suppliers who do not accept tokens and match these tokenholders with individuals who want to buy tokens with credit or debit cards. The peer-to-peer marketplaces introduce both parties to each other and enable the tokenholder to sell its token to a buyer in return for goods at a reduced cost.

Another option is for the token to create rights to an asset which is, at a certain point, paid for in a fiat currency.

What parts of an ICO do the FCA regulate?

The FCA regulates those who carry out specified activities in relation to specific investments. Thus, it is a two-limbed test which needs both limbs to be met for the FCA to require, or a firm to desire, regulation in the United Kingdom by the FCA. As tokens are not a specified investment the two-limb test will not be met and activities in them will not be regulated, even if the activities involved are specified activities. As set out above, it is important to remember that derivatives on tokens will be regulated as derivatives are a specified activity regardless of their underlying asset.

However, if the token is offered via a fund or collective investment scheme, FCA regulation will be relevant as the FCA regulates the activities of managers and other functionaries to funds and collective investment schemes. This brings in the need to consider fund legislation which may be domestic UK laws, for example authorisations and rules on collective investment schemes, and regimes with a European Union genesis such as the Prospectus Directive, AIFMD and MiFID II. Both full and small scope AIFMs will need to be considered and it may also be possible to make use of the small registered AIFM regime if certain criteria are met.

Please see *"Are tokens or cryptocurrencies regulated by the FCA?"* above for more details.

What are the dangers?

While being unregulated may be seen as an advantage, and the transparent and immutable nature of blockchain as a self-policing advantage which is built into the structure of tokens, many people take the view that the unregulated nature of tokens and the large sums of money which have been invested into them pose a danger to economic structures and free ticket money laundering. This can mean that the appetite for tokens may be reduced as a whole, or reduced to a smaller investment arena that is enjoyed by mainstream, regulated assets.

One such perception is the lack of the ability for an investor to have access to regulatory sanctions or protections such as the UK's Financial Services Compensation Scheme and Financial Ombudsman Service. A counter argument could be made that certain categories of investors do not have such regulatory benefits anyway and that any risk of losing regulatory protection can be balanced by only selling tokens to investors who have sufficient understanding, access to advice or wealth.

In November, BaFIN made the point that ICOs are highly speculative investments which are not subject to regulation and therefore have none of the protections or benefits which may come with regulated investments. It added that since essential features of a share issue, such as voting rights, control rights and the right to information are not part of an ICO (unless the issuer makes them such), the issuer can have unfettered rights and decide entirely itself on what rights to give, or not give, to investors. BaFIN went on to highlight risks such as fluctuation of price, limits on trading tokens, loss or theft of private keys and the total loss of investment and issued a separate consumer protection warning the same month.

ESMA also issued two statements on ICOs. One focussed on the risks of ICOs for investors and commented on the high risk of losing all of invested capital, describing ICOs as very risky and highly speculative investments and noting the extremely volatile and potential illiquidity of token prices.

Other dangers include technology flaws, inadequate documentation and a lack of valuable and meaningful information on which investors can rely. Lack of testing and the relatively new and untested nature of the digital asset market which, inevitably, means that sufficient information to analyse whether current and or past levels of performance are sustainable and/or how the digital asset market will react in the short or long-term is not available.

What are the potential benefits?

Whilst also included in the lists of as a danger, the fact that most ICOs are not regulated by the FCA is also a potential benefit as the issuers of token are not obliged to go through the time-consuming process of obtaining authorisation before launch.

This means that ICOs can provide a quick, easy and efficient fundraising opportunity. Almost anyone can set up an ICO and sell the tokens directly or by using an exchange. The costs associated with marketing ICOs and the contribution settlement are considerably lower than some of the other popular mechanisms used for fundraising, for example initial offerings in shares or debt issues.

A significant advantage of an ICO for investors is that it is open to everyone. Traditional venture financing tends to be geographically limited to financial hubs such as London or New York. However, an ICO removes this limitation and opens up opportunities for anyone anywhere, essentially allowing anyone to invest. Liquidity does not need to be limited by time zones as cryptocurrencies can be traded around-the-clock with participants able to trade at-will on exchanges that never close, unlike traditional markets which offer limited trading hours.

The transparency of the blockchain also makes it an attractive investment vehicle. The audit trail of blockchain technologies is public and available for everyone to view. This transparency, plus its inherent immutability, potentially reduces the risk of errors and can eliminate disputes.

Summary

Digital assets and blockchain technology look set to continue their rise for the time being, whether regulated or not. Those within this investment area see almost boundless room for potential which will not be merely a disruptive event, but an all-out revolution.

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