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## Blockchain, cryptocurrencies and ICOs



corporate

### Introduction

Recent months have seen an increased awareness amongst investors and market observers of major blockchain-based cryptocurrencies, such as Bitcoin and Ether, in part due to the spectacular gains for holders of those cryptocurrencies. While prone to significant volatility, Bitcoin and Ether have hit all time high valuations, with Bitcoin being up over 500% YoY and Ether up over 2,200% YoY.

### What is a blockchain?

A blockchain is an open, distributed ledger system. The records are grouped into blocks and are “hashed” using cryptography, and that “hash” forms the basis for the next block. In such a way, the successive blocks are built on the preceding blocks, and therefore information stored in a preceding block cannot be altered or deleted without affecting the subsequent blocks. Consequently, the blockchain contains a cryptographically verifiable record of every single transaction made. Blockchain technology can therefore provide a permanent and transparent record of transactions which users can access, without needing to trust an independent authority.

### What are the applications?

Cryptocurrencies, including Bitcoin and Ether, are built on a blockchain. Ethereum (the blockchain on which Ether is located) also brings to the fore smart contracts and the ability to pre-define the actions and responses of a

given situation. Blockchain as a technology, and the developments made prominent by Ethereum, have the potential to bring huge efficiencies and increased security in a diverse range of applications and to a variety of industries. It is therefore of little surprise that the technology is being looked at and actively implemented by a growing number of established companies. For example, TUI has transferred its hotel inventory to a blockchain and the R3 consortium is seeking to build a new operating system for financial markets based on its distributed ledger platform “Corda”.

However, it is not only established companies with large systems to maintain that are seeing the potential benefit of the technology. Start-ups and established but early stage businesses looking for their next round of capital are increasingly turning to the technology as an efficient mechanism to raise funds to make their concepts a reality.

## **Initial Coin Offerings, or ICOs**

This is where the ICO (initial coin offering) or “digital token sale” comes in (each coin or token representing a new cryptocurrency). Start-ups are using online crowdfunding to bypass the traditional venture capital financing process, by issuing digital coins or tokens. This method of financing has seen a huge increase over recent months, with over \$2bn being raised so far this year for a range of businesses – a faster pace than any other early-stage venture capital funding. Globally, there were 46 ICOs in 2016 and 140 this year up to mid-September. Significant sums have been raised: about half of the money raised in ICOs has gone to the 10 largest ventures. Filecoin, a data storage network, raised US\$257m, while Tezos, which has developed its own secure blockchain infrastructure, raised US\$232m. Many of these offerings have been sold out in minutes, if not seconds.

The structure of a typical coin or token is that it is intended to be used as a means of purchase or exchange for the goods or services to be provided by the platform being developed by the start-up – a so-called “utility token”. Such tokens, generally issued in limited numbers to create scarcity, may be bought and sold on a cryptocurrency exchange, or retained for future capital growth should demand for the platform for which they are the “currency” take off.

## **Regulatory issues – UK and overseas**

Globally, the key issue exercising regulators is whether the digital tokens represent securities, and hence whether the detailed disclosure requirements and protections afforded by securities laws would (or should) apply to ICOs (including whether the offeror or issuer, or intermediaries, should be registered with the financial authorities as conducting regulated business).

In July 2017, the US Securities and Exchange Commission (SEC) issued a report focussing on the particular case of the 2016 US\$150m token sale by The DAO (which was hacked to the tune of US\$50m). The particular features of The DAO tokens led the SEC to conclude that they were in fact securities and, since they had not been registered in accordance with SEC requirements, their issue breached US securities laws. The SEC took the opportunity in the report to remind market participants of the legal tests for establishing whether or not a cryptocurrency might also constitute a security, and this report (and subsequent notices) make it clear that the SEC is closely monitoring the ICO space.

Following the SEC’s lead, the financial regulators in Singapore, Malaysia, Canada, Hong Kong and Australia have issued similar statements to put market participants and potential issuers on notice that a digital token may be classified as a security, depending on its specific features and structure. Most significantly, on 4 September 2017, China’s central bank

declared ICOs illegal in China and required an immediate halt to all ongoing ICO activity, a refund of all money previously raised by way of ICO and a halt to the trading of cryptocurrencies on Chinese exchanges (this ban was followed by a similar move in late September 2017 by the South Korean financial regulator). The Chinese ban caused an immediate drop in the value of Bitcoin and Ether (a position that has since been largely reversed), and the position taken by certain regulators may well result in future ICOs excluding certain jurisdictions from the offering or adopting a private placement structure (i.e. restricting the offering to accredited, sophisticated or high net worth investors) in accordance with traditional securities laws in the relevant jurisdictions.

However while regulators, other than in China and South Korea, have been cautious, the market continues apace. Smaller jurisdictions, such as Zug in Switzerland, which has become known as Crypto Valley, and Gibraltar, where not only was the first regulated bitcoin product launched, but also where the Gibraltar Stock Exchange is planning a blockchain powered trading system, continue to innovate and promote the technology. In the last few weeks a number of ICOs have completed and raised substantial sums, for example, Substratum (US\$13.8m), Power Ledger (US\$17m), Rivetz (US\$19.71m) and Kick Coin (US\$22.34m).

In the UK, the Financial Conduct Authority (FCA) issued a consultation paper in April 2017 on the potential for the future development of distributed ledger technology in regulated markets. In this consultation, the FCA briefly noted in respect of ICOs that “depending on how they are structured, they may...fall into the regulatory perimeter”. In response to the recent flurry of announcements from overseas regulators and the Chinese blanket ban, on 7 September 2017 the FCA essentially repeated this statement to the market and, on 12 September 2017, issued a further statement warning consumers about the potential risks of ICOs, noting that “many ICOs will fall outside the regulated space”, and that “...depending on how they are structured, some ICOs may involve regulated investments and firms involved in an ICO may be conducting regulated activities.” On this, there are a number of regulated activities that issuers and participants in ICOs would need to consider and navigate, including deposit-taking and e-money issuance, as well as the broad definition of what constitutes a collective investment scheme and applicable anti-money laundering regulations.

### **What next?**

Building on the undoubted potential of blockchain technology to bring significant changes and efficiencies to a number of industries and applications, both in the financial and non-financial sectors, ICOs as a method of financing the development of a platform or application are likely to continue apace. This will require a response from traditional financiers, such as banks, brokers and venture capital firms. It is likely that we will see the establishment of further hedge funds or investment managers focussed on investments in cryptocurrencies and ICOs following Polychain Capital in the US and First Block Capital in Canada, which was approved by the British Columbia Securities Commission in early September.

There will be developments in the levels of sophistication regarding the rights attaching to tokens (for example, participation in profits), which can be encoded in the smart contracts. Derivative financial products will be developed and cryptocurrency holdings may become eligible as collateral for personal borrowings. And, as is clear from developments in the last few months alone, the regulatory landscape is changing rapidly, so it is probably inevitable that regulators will step into a space which has been described by some as a “wild, wild west” and impose investor protections, including establishing regulated exchanges. ■

## The Fladgate team

Advising on ICOs, and fintech more generally, requires a multi-disciplinary team including specialists in capital markets, regulatory matters and intellectual property. Fladgate is committed to a leading position in this sector and is already advising technology entrepreneurs on a number of ICOs and related regulatory and structuring issues. For further information, please contact:



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Paul is a corporate and equity capital markets lawyer.

Paul has acted for corporations and financial institutions on a wide range of UK and international corporate finance and M&A transactions including: public and private acquisitions and asset transactions; joint ventures; IPOs on the London Stock Exchange's Main Market (Premium and Standard segments of the Official List) and AIM market (including dual listings), UK and international secondary fundraisings and other transactions for listed companies; UK financings for overseas companies; and share buybacks and other corporate reorganisations.



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Charles is a very experienced banking and finance lawyer who has worked both in London and the Far East. His wide-ranging background includes acquisition finance, real estate finance, trade finance and associated areas. He has also completed Shari'ah-compliant transactions for large scale transactions in the London investment property market.

Charles has been heavily involved in issues that have arisen in the wake of the financial crisis, with an increased focus on regulatory developments and the resolution of bank-to-bank disputes.

In addition to his practice, Charles has written extensively on banking and financial issues. In particular, he has published five textbooks, most recently *The Law and Practice of International Banking*, a 1,000 page text published by Oxford University Press in March 2015. He is also a recognised expert in the sphere of monetary law and is the author of the Seventh Edition of *Mann on the Legal Aspect of Money* (Oxford University Press, 2012).



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Eddie is an intellectual property, technology and commercial law specialist and advises clients across a broad spectrum of legal issues.

Eddie has considerable experience in handling a wide variety of commercial issues and disputes involving all kinds of IP. He regularly advises on transactions ranging from exploitation through licensing or transfers to complex corporate or financing projects where IP is a key business asset. Eddie combines this with practical experience in enforcing IP rights and defending IP claims. He has considerable experience in advising content providers and publishers in this area.

He advises on commercial transactions such as licensing, distribution, franchising, agency and manufacturing arrangements, and technology projects such as IT procurement, supply and development. He regularly deals with e-business issues for clients across a range of industries. Eddie is also a member of our hotels and leisure team, advising hotel owners and operators on hotel management and franchise contracts. Eddie also has considerable experience in data protection and privacy legal issues. He routinely advises clients on risk management methods, such as contract terms and policies, as well as day-to-day compliance steps.



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Katherine is a financial services regulatory lawyer who advises a wide variety of financial services clients, including banks, insurers and investment managers.

She has extensive experience of advising on UK and EU financial services rules and legislation including in respect of conduct of business, client money and assets, investment funds, authorisation and passporting, outsourcing, change of control and payment services. She has also advised clients on the implications of Brexit.

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David has experience of advising clients from owner managed businesses to investee companies backed by private equity on a range of corporate matters including general corporate advisory, private mergers and acquisitions and group reorganisations.

He has also advised companies on their admission to AIM, reverse take overs and on placings.

David has acted for clients in a number of sectors, among them the natural resources, media & technology (including a blockchain consultancy and incubator) and recruitment sectors.