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The New Digital Era: blockchain, cryptocurrency, and ICOs
PART 3

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THE LEGAL AND REGULATORY ASPECTS OF BLOCKCHAIN AND ICOS

After reading Parts 1 and 2 you should have a basic understanding of how blockchain works, and the purpose it serves in recording and facilitating peer-to-peer (P2P) transactions for a multitude of online transactions. As with any trade or service, these blockchain platforms, and the Initial Coin Offerings (ICOs) used to fund their development, do not exist in a legal vacuum.

It is important to really look at the features of the coin or token you are interested in releasing or buying into, as this will determine the level of regulatory scrutiny it will be subject to.

REGULATION IN AUSTRALIA AND INTERNATIONALLY

The increasing prevalence of legitimate uses of cryptocurrencies and tokens in the corporate world, particularly ICOs, has attracted the attention of regulatory bodies across the globe.

In Australia, ASIC released new guidance in September 2017 reminding issuers of existing areas of the law which may apply to their ICO. But ASIC didn't introduce any new policy as such. Compared to the SEC in America, which has come out declaring the sale of digital tokens is "subject to the requirements of the federal securities law", Australia's regulator has taken a very supportive position. At the other end of the spectrum, earlier in 2017 China and South Korea both banned ICOs completely. That said there is speculation that China banned them in the short term, because they want to be able to fully regulate ICOs in the future. And South Korea has since changed decided regulation is key, rather than banning.

KEY LEGAL CONCEPTS APPLYING TO ICOS AND TOKENS IN AUSTRALIA

Depending on how the ICO is structured and the rights attached to the tokens, this will effect the legal obligations of the company offering the tokens. If the token is just a product or service then the general consumer laws will apply to the sale. Alternatively, if it is a "tokenised security" then under Australian law it is considered a financial product, and subject to the *Corporations Act 2001* (Cth).

If any of the following categories apply and the ICO is a financial product, then the company will have extra costs of licencing and disclosure requirements. Also, the penalties for false or misleading statements about financial products are significant. And even if the company isn't operating under Australian law, ASIC's guidelines are still useful for understanding the nature of the tokens on offer.

(a) **Managed investment schemes**
An issuer conducting an ICO may in fact be operating a managed investment scheme where:

(i) someone contributes assets, including cryptocurrency, to get an interest in the scheme;

(ii) they do not have day-to-day control of the scheme but may have voting rights; and

(iii) assets are pooled with other contributors to produce financial benefits or interests in property.

It is the pooling of assets which tends to give away that the issuer is running a managed investment scheme. If you are, the Corporations Act will apply and you will need an Australian Financial Services Licence.

(b) **Shares**
If the ICO was created to fund a company and the tokens have rights attached to them such as equity ownership, voting rights, or rights to dividends, they are likely to be shares (even if you call them a token and they exist only on the blockchain).

If the ICO is in reality an offer of shares in the form of tokens, then a formal prospectus will have to be issued, rather than the simpler white paper.

(c) **Derivatives**
As ASIC so eloquently says it in its guidance: a derivative is a product that derives its value from another 'thing', which is commonly referred to as the 'underlying instrument' or 'reference asset'. The underlying instrument may be, among other things, a share, a share price index, a pair of currencies or a commodity (including a cryptocurrency).

Therefore a token whose value is derived from a reference asset is likely to be a derivative. But what is interesting here is that at the time most ICOs are conducted the business or platform of the issuer has not even been built. Therefore, in the case of a utility token which can only be used on the issuer's to-be-built platform, at the time of the ICO the token may not be a derivative. The token only becomes a derivative once the platform has been built and the token takes on all of its full derivative characteristics. When the token becomes a formal derivative the necessary licenses can be obtained and disclosures given at that time.

NON-CASH PAYMENT FACILITIES

Certain non-cash payment facilities (NCP facilities) may fall into the category of financial products which are exempted from the Corporations Act. ASIC has indicated that it is unlikely tokens and ICOs will be considered NCP facilities. However ASIC does recognise the need to be flexible to cater for new technologies and methods of payment. Blockchain is becoming more advanced and increasing in popularity, so it is prudent to consider whether the token you are interested in releasing or participating in could be a NCP facility.

ICOs may fall under the NCP facility category of loyalty schemes. We all know how they work: if you spend money on the goods or services of a company, they will reward you will credits to use either with themselves or a third party.

Arguably, a token offeror may be running a loyalty program in two ways:

(a) Where the ICO is accompanied by a "bounty campaign", people are encouraged to buy into and promote the ICO. They will earn points for each type and number of posts they do on social media, blogs and so on, and be rewarded with bonus tokens. Once the issuer's product or service has been built users might be rewarded for engaging with the service – like earning Flybuys when you shop at certain stores.

(b) Blockchain platforms require some participants to actively authenticate and record transactions. In return they are generally rewarded with tokens in that platform which can then be traded.

Alternatively, a token offeror that accepts fiat currencies in its ICO may be considered a NCP facility that requires an Australian financial services licence to operate. While many ICOs only accept popular cryptocurrencies such as Bitcoin or Ether as payment to bypass these types of regulatory hurdles, some ICOs will also accept fiat currencies in order to boost their target audience or restore confidence in certain investors. US-based Filecoin managed to raise $257 million through its ICO in September 2017. This success is due in no small part to the fact that Filecoin included fiat currencies as a payment method in its ICO. If this was in Australia, it probably would have been captured as a NCP Facility, and therefore be subject to regulation.

AML REGULATIONS

Know Your Client (KYC) and Anti-Money Laundering (AML) regulations exist in Australia to protect against fraudulent investments and money laundering. In December 2017 the *Anti-Money Laundering and Counter-Terrorism Financing Amendment Act 2017* (Cth) was passed, coming into effect on 1 April 2018, with changes relevant to ICOs and blockchain companies.

One of the amendments replaces the definition of “e-currency” with definition of “digital currency”. This new definition effects whether your company is considered a “registrable digital currency exchange”, and subsequently obliged to comply with the KYC provisions of the Act. The new term is in fact very specific, which will mean that many companies holding an ICO will not have to register with AUSTRAC under the amended Act.

Even though it’s not strictly required, some companies like CanYa, are voluntarily doing KYC on applicants for their tokens.

HOW DO I START PARTICIPATING IN THIS WORLD OF COINS AND TOKENS?

(a) Open an account with a reputable coin exchange such as Coinbase or BTC Markets, from which you can by Bitcoin, Ethereum and Litecoin, etc.

(b) At the same time you will need to create a digital wallet, of which there are many to choose from. If you are investing significant amounts of money in ICOs, many cryptocurrency enthusiasts recommend getting a hardware wallet to more securely store your coins and tokens.

(c) Transfer your chosen crypto currency, such as Ethereum, to your wallet.

(d) From your wallet you can then buy tokens and participate in upcoming ICOs.

It’s that simple. If you don’t own any cryptocurrency we highly recommend investing even $20 in some Ethereum or Bitcoin so you can see how simple it is. You will almost forget that in doing so you have just participated in your first blockchain transaction. Seeing is believing.

If you want to keep up with current trends in cryptocurrency and ICOs there are plenty of people who enthusiastically share their insights and tips with large followings on social media. Take a look at Bob Voulgaris, Peter Brandt and Tone Vays, to name a few. CoinDesk.com is also a great source of information and articles about cryptocurrency trends.

SO WHAT DOES ALL THIS MEAN?

Is it just theory, out of our reach, something only for future generations to embrace? Not at all. There is an explosion in popularity of blockchain as a means of digitally facilitating all sorts of global trades and agreements. This uptake in ICOs by blockchain companies requires a change in the way we view raising capital.

Ordinarily shares and equity were the key terms used in relation to investors in startups and businesses in their growth stages. Now, it seems a solid understanding of blockchain, the differences between coins and tokens, and the differences between ICOs and IPOs are all becoming pre-requisite knowledge in the world of investment.

Not all countries have been keen to integrate ICOs and cryptocurrency into their legal systems, but some have embraced this technology. It is encouraging that in Australia, ASIC is confident our laws on securities and financial products need no amendment with the advent of ICOs, coins and tokens. ASIC’s position seems to support cautious investment, rather than total avoidance.

If you are thinking an ICO is a good way for you to raise capital, stop, pause and think: is my business compatible with tokens and the blockchain? If not, then an ICO might not be for you as the fundamentals for a successful ICO are missing.

Now is not the time to simply let other people ride this wave. So get a digital wallet, find out which ICOs are launching, read the white papers, and get involved in the discussion. There will undoubtedly be something that interests you. And even if you feel buying into an ICO is not appropriate for your portfolio, it is better to know what other investors are getting involved in, rather than live in ignorance or denial.

After all, no one wants to be the next Kodak.

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