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Initial Coin Offering

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ABSTRACT: Financings via Initial Coin Offerings (ICO) or Initial Token Sales (ITS) have recently come into the spotlight for their ability to raise large amounts of funds in a short period of time from purchasers all over the globe. However, their negative aspects are also becoming apparent as authorities in several countries, including Japan, have recently announced warnings that such financings may violate their financial regulations and may constitute investment fraud and scams.

This newsletter briefly explains the outline and specific methods of ICOs and ITSs and the classification of the tokens issued and analyzes the application of Japanese laws as well as trends of overseas authorities.

1. Outline

Financing via Initial Coin Offerings or Initial Token Sales (hereinafter collectively referred to as “ICO”) have recently come into the spotlight. An ICO is a fund-raising method by which a company or an organization that issues unique tokens (hereinafter referred to as “Tokens”) on the Blockchain (hereinafter referred to as “Token Issuers”) sells Tokens on the Internet in exchange for payments by virtual currency such as Ethereum or Bitcoin or legal tender.¹

ICOs are different from conventional crowdfunding in that (1) the procurement funds are intended to be used mainly for the development and operation of a project that utilizes the Blockchain, and, in many cases, Tokens to be sold are closely tied to such project, (2) accepting virtual currency upon fund-raising makes it possible to instantly raise funds from domestic and foreign purchasers with low remittance charges, and (3) token purchasers may independently trade the issued Tokens on the Internet, and in case the Tokens are traded at overseas virtual currency exchanges, they may trade the Tokens with unspecified persons, which generates liquidity of the Tokens. Based on these

¹ We previously issued a newsletter in Japanese concerning the same topic in September 2017, which is posted on our website (see below link). However, this newsletter reflects more recent developments (as of October 27, 2017) and is not an English translation of the above newsletter and the contents are not necessarily the same.

http://www.amt-law.com/pdf/bulletins2_pdf/170915.pdf

characteristics, it can be said that fund-raising by ICO, in contrast to conventional crowdfunding, makes it possible to raise large amounts of funds in a short period of time.

Although news outlets report different figures for the amount of funds raised by ICOs, according to CoinDesk, a news website concerning virtual currency, among the ICOs that have completed offerings in 2017, the accumulated total amount of procured funds as of the end of July 2017 was approximately 1,411,040,000 dollars.² Considering the fact that, based on the same statistics, the accumulated total amount of procured funds by the ICOs that completed offering in 2016 was approximately 256,400,000 dollars (excluding the amount of procured funds by the DAO stated below of 152,000,000 dollars, approximately 104,400,000 dollars), the market for ICOs has rapidly developed this year.

Until August 2017, ICOs had been mainly conducted by overseas Blockchain-related companies, and there was no case of large-scale financing using ICO in Japan. However, since September 2017, several ICOs in large scale were completed or announced in Japan. Also, several Japanese companies, including financial institutions, have made public announcements of establishing ICO platforms. Therefore, it is likely that ICOs will be increasingly more active in Japan as well.

2. Specific method of ICOs

In typical ICOs, Token Issuers provide information through their own websites, including summaries of more detailed information such as technical descriptions in the form of white papers. Information generally disclosed upon implementation of ICOs includes the following items.

- Commencement date and closing date of the ICO
- Outline of a specific project utilizing Blockchain technology developed and operated by the procured funds
- Relevance and technical explanations of the project with the Tokens
- Characteristics and features of the Token and advantages of purchasing Tokens
- Total amount and allocation of Tokens to be issued
- Minimum and maximum amount of funds to be raised by the ICO
- Roadmap for the project development
- Explanation of legal nature and risks of the Token, and disclaimers

These particulars are distributed on the Token Issuer's website as well as information websites specialized in ICOs, SNSs, and the like, and token purchasers consider such information when deciding whether to buy the Tokens. Those who wish to purchase Tokens agree to terms and conditions on the Token Issuer's website and send compensation for the Tokens to the Token Issuer's address (typically in virtual currency such as Bitcoin or Tokens called "Ether" on Ethereum), and after verifying the receipt of the compensation on the Blockchain, the Token Issuer sends Tokens to the

² <https://www.coindesk.com/ico-tracker/>

purchaser's wallet. Whether identity verification or other customary KYC review is required depends upon the ICO.

3. Classification of Tokens issued in ICOs and application of Japanese laws

There are various types of Tokens issued by ICOs, and this section classifies them based on their features and discusses them in terms of applications of Japanese laws.

(1) "Virtual Currency type" Tokens

These include Tokens that are intended to be used as means of settlement and payment such as Bitcoin. Token Issuers often emphasize the advantages of their "Virtual Currency type" Tokens such as the enhanced convenience as a means of settlement including its ability to swiftly transfer funds and ensure anonymity in comparison to Bitcoin.

However, even if they are used as a means of settlement, Tokens whose property values are recorded and that can be used only as a compensation for goods or services provided by the Token Issuers are likely to be classified as "prepaid card type," as described in (3) below.

Under Japanese law, this type of Tokens could be deemed to correspond to "Virtual Currency" under the Payment Services Act (hereinafter referred to as the "PSA") (Article 2 (5) (i) or (ii) of the PSA). It should be noted that, in case the Token corresponds to Virtual Currency, engaging in trades or exchanges, or intermediary, brokerage or agency for trades or exchange of the Tokens as a business corresponds to "Virtual Currency Exchange Service", and only persons who have been registered with the Financial Services Agency (the "FSA") are permitted to provide such services (Article 2 (7), Article 63-2 of the PSA).³

(2) "Membership type" Tokens

This is where the Token Issuer or its partner (hereinafter collectively referred to as "Token Issuer") provides preferential treatment with respect to its services such as discount of service prices to those who prove that they own a certain amount of the Tokens. Further, there could also be Tokens of this type that, in combination with the "Virtual Currency type" Tokens of (1) above or the "Prepaid Card type" Tokens of (3) below, provide greater discounts if the Tokens are used to make a settlement of the services provided by Token Issuer compared with the cases the settlement is made in legal tender or other types of Virtual Currency.

³ For the definition of Virtual Currency and Virtual Currency Exchange Services as well as the outline of the regulation, please see our Banking & Finance newsletters.

"Development of Legal Framework for Virtual Currencies in Japan - Bill Submitted to the Diet"
https://www.amt-law.com/en/pdf/bulletins2_pdf/160425.pdf

"Publication of the Draft of Cabinet Office Ordinance concerning Virtual Currency Exchange Service Providers"
https://www.amt-law.com/en/pdf/bulletins2_pdf/170207.pdf

Under Japanese law, this type of Token is not likely to fall under the definitions of “Securities” under the Financial Instruments and Exchange Act (the “FIEA”). However, when this type of Token also has a settlement function, whether or not it falls under Virtual Currency or “Prepaid Payment Instruments” under the PSA depends upon the characteristics of the Token. For example, Tokens that are mutually exchangeable with “Type 1 Virtual Currency”⁴ such as Bitcoin in relation to other unidentified parties could fall under “Virtual Currency” under the PSA. In this case, in order to engage in trades or intermediary for trades of the Tokens as a business, a registration as a Virtual Currency Exchange Service Provider is required.

(3) “Prepaid Payment Instruments type” Tokens

Tokens that could be used as consideration for goods or services provided by Token Issuers fall under this type.

It should be noted that this type of Token may fall under Prepaid Payment Instruments under the PSA. Prepaid Payment Instruments would be classified as Prepaid Payment Instruments for Own Business if the Prepaid Payment Instruments can be used only by the Token Issuer (including persons who have close relationship with the said issuer; the same shall apply hereinafter), and as Prepaid Payment Instruments for Third-Party Business if the Prepaid Payment Instruments can be used also by third parties (e.g., member shops) other than the Token Issuer.

For example, in case the Token falls under Prepaid Payment Instruments for Own Business, and if the unused balance of the Token exceeds 10 million yen as of the reference date (specified as the end of March and September every year by the PSA), notification must be made to that effect to the Director-General of a Local Finance Bureau (Article 5 of the PSA). Further, after such notification, a person who made such notification is required, as an Issuer of Prepaid Payment Instruments for Own Business, to make security deposits in an amount equal to at least half of the amount of the unused balance as of the reference date (in principle, the unused balance as of the end of March and September every year) and for submitting business reports as of each reference date under the regulation.

Like a Prepaid Payment Instruments for Own Business, a Prepaid Payment Instruments for Third-Party Business is required to make security deposits. In addition, it is also required to register with the Director-General of a Local Finance Bureau (in lieu of simple notification), which could be relatively burdensome (Article 7 of the PSA).

According to the FSA’s response to the public comments dated March 24, 2017 (concerning the PSA (virtual currencies) No. 37), in case that a payment method falls under the Prepaid Payment Instruments under the PSA, it does not fall under the Virtual Currency under the same act⁵. Therefore, it

⁴ This refers to Virtual Currency set forth in Article 2 (5) (i) of the PSA.

⁵ <http://www.fsa.go.jp/news/28/ginkou/20170324-1/01.pdf>

is not likely that a Token becomes subject to regulations on Prepaid Payment Instruments and regulations on Virtual Currency at the same time.

(4) “Fund-equity type” Tokens

These are Tokens where any distributions paid to holders are based on the profits of the businesses conducted by the Token Issuer and are calculated based on a given holder's ownership ratio of the Tokens.

Financial authorities of multiple countries including the U.S. Securities and Exchange Commission (hereinafter referred to as “SEC”) and the Monetary Authority of Singapore (hereinafter referred to as “MAS”) have announced that they might regulate “Fund-equity type” Tokens as Securities, as will be discussed in 4 below. It should also be noted that, under Japanese laws, this type of Token may fall under the interest in a collective investment scheme among the “Paragraph (2) Securities” under the FIEA (Article 2(2)(v) of the FIEA). FSA has also responded at the House of Councilors’ Committee on Financial Affairs on June 8, 2017 that the “Fund-equity type” Token Issuers may be subject to the rules for Financial Instruments Businesses under the FIEA. Furthermore, as described in the next section, the FSA made an announcement on ICOs on October 27, 2017 stating, among other things, that if an ICO has the characteristics of an investment and the purchase of a token by a virtual currency is practically deemed equivalent of that by a legal tender, the ICO becomes subject to regulations under the FIEA.

(5) “Application Platform type” Tokens

These are Tokens that are required to use application platforms on computer networks.

For example, Ethereum, which is reported to have the second largest aggregate market value and transaction volume after Bitcoin, falls under this type. To be precise, Ethereum is the name of an application platform that utilizes Blockchain, and the Token called “Ether” is the currency used to pay the platform usage fees. On the Ethereum network, every processing could be written, and Ether is required for uploading the application also known as “Smart Contract” onto the network, utilizing the application or merely for making remittance processing. It is also possible to issue new Tokens on the Ethereum network, and Tokens have recently been issued on the Ethereum network in recent ICOs⁶.

This type of Token is required to upload applications on the network or use them. However, in the case that the Token is not used for exercise of the rights in relation to Token Issuer, it is not considered to fall under Prepaid Payment Instruments under the PSA.

Further, as stated in 2 above, Ether is also used in exchange for other types of Tokens in the ICOs that offer such Tokens, and can be used as means of settlement or payment. This type of Token that is available as means of settlement and payment like Ether is considered to fall under (1) “Virtual-Currency type” Tokens as well.

⁶ It is also said that it is possible to issue other kinds of Tokens on the Bitcoin network as well.

4. Announcement on ICOs by the FSA

On October 27, 2017, the FSA made an announcement on ICOs warning about the risks of ICOs⁷, warning both users (Token purchasers) and business (Token Issuers and related entities).

The announcement warns Token purchasers about the high risk nature of a Token, including the high volatility of a Token price and potential risk of fraud and says that “you should transact in tokens at your own risk only after sufficiently understanding both the risks noted above and the other relevant details of the ICO. You should also pay careful attention to suspicious solicitation on ICOs.”

The announcement warns businesses (Token Issuers and related entities) that ICOs may fall within the scope of the PSA and/or the FIEA depending on how they are structured. It also warns businesses involved in an ICO to adequately fulfil their duties required by related laws and regulations (such as making the relevant registrations when their services are regulated by those acts) and that delivering such services without registration is subject to criminal penalties.

5. Trends of overseas authorities

(1) SEC report

The SEC announced on July 25, 2017 that, with respect to “The DAO Token” sold from April to May 2016 by a Decentralized Autonomous Organization called “The DAO” in which Slock.it, a German company, was involved, the DAO Token falls under Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934, and registration with the SEC will be required in order to offer or sell them unless falling under the exemption clause of these acts⁸.

(2) Press release of the Monetary Authority of Singapore

The MAS published a press release concerning ICOs on August 1, 2017⁹. In the press release, MAS says that digital Tokens that represent ownership or a security interest in the Token Issuers’ assets may be regulated as shares or units in a collective investment scheme, and the digital Tokens that represent the Token Issuers’ liabilities may be regulated as debentures under the Securities and Futures Act.

(3) Public Notice of Chinese authorities

Chinese authorities, including People’s Bank of China, issued a public notice to ban ICOs on September 4, 2017 (English version was issued on September 8, 2017)¹⁰.

(4) Statement by Securities & Futures Commission of Hong Kong

The Securities & Futures Commission of Hong Kong (hereinafter referred to as “SFC”) published a

⁷ http://www.fsa.go.jp/policy/virtual_currency/07.pdf

⁸ <https://www.sec.gov/litigation/investreport/34-81207.pdf>

⁹ <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx>

¹⁰ <http://www.pbc.gov.cn/english/130721/3377816/index.html>

statement on ICOs on September 5, 2017¹¹. In the statement, SFC explains that the digital Tokens provided in typical ICOs are normally considered as virtual commodities and do not fall under Securities, but in recent ICOs there are some representations and characteristics that may fall under Securities.

(5) Warning by U.K. Financial Conduct Authority

The U.K. Financial Conduct Authority (hereinafter referred to as “FCA”) issued a warning about risks of ICOs to consumers on September 12, 2017¹².

(6) Press release by Korean authorities

A joint task force comprised of South Korean regulatory authorities relevant to cryptocurrency issued a press release on September 29, 2017 that includes, among others, a ban of ICOs. Although the regulators’ initial position was to penalize ICOs in the form of securities issuance, their new policy is to ban all types of ICOs (including those in the form of securities issuance).

6. Concluding Remarks

ICOs enable Token Issuers to raise large amounts of funds in a short period of time from all over the globe, without giving up their ownership in their companies to shareholders and without bearing the considerable administrative workload or expenses of a typical stock listing. However, they present a number of issues for participants. For example, purchasers should note that the details and feasibility of the projects have not been made very clear in the white papers of the past ICOs, and any purchase of Tokens involves considerable risks. From a legal viewpoint, there are a number of issues that are unresolved for which there is no controlling authority, such as determining the person against whom an investor would have recourse in the event of a Token Issuer’s bankruptcy.

Further, as ICOs invite purchasers across national borders via the Internet, they may be subject to regulations of different countries, and authorities of some countries including the U.S. are beginning to issue warnings on the possibility of violation of their financial regulations. Considering these facts, in case Japanese companies intend to carry out ICOs, a scheme for ICO trades needs to be carefully deliberated in light of Japanese laws as well as other countries’ regulations.

¹¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR118>

¹² <https://www.fca.org.uk/news/statements/initial-coin-offerings>

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