

ATOZ ALERT



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ICOs in the spotlight – ESMA issues a first statement on regulated risks of ICOs

Based on its initial observations of the rapid growth of the market, on 13 November the European Securities and Markets Authority (ESMA) issued two statements on the associated risks to which firms and investors are subject in relation to their involvement with ICO offering or investments, echoing recent positions on the ICOs taken by other regulators.

These papers broadly draw the EU market attention on the fact that (i) on one hand, firms involved in ICOs must give careful considerations as to whether their activities constitute a regulated activity subject to relevant EU rules and (ii) on the other hand, investors must pay attention to their risk exposure with regards to their investments in ICOs, in particular if these ICOs do not benefit from a regulatory protection.

What are ICOs?

ICOs, standing for initial coin/token offering or coin/token sale, are an innovative way of raising money from the public, using coins or tokens, and have recently witnessed an increase in use. According to the ICO tracker of the coindesk, more than USD 3.5 billion had been raised through ICOs continuing a skyrocketing growth since mid-2016. Virtually any business or individual can issue coins or tokens and make them available for sale on the Internet and social media platforms in exchange for virtual currencies (Bitcoin, Ether) or traditional currencies (Euro, USD). The creation and dissemination of the coins/tokens is made through distributed ledger technology, more commonly known as blockchain technology (DLT). At the opposite end, virtually anyone with access to the Internet can acquire coins/tokens.

What are these coins/tokens?

The industry defines the token as “a cryptographically secured digital representation of a set of rights”. Some coins or tokens don’t grant any rights, while others may give redemption rights against currencies, products or services, redemption rights based on the value of underlying investments or, less often, voting rights or rights to receive a share of the future earnings. Coins/ tokens are very volatile and their value may be based on either underlying rights or on mere speculation. Depending on how they are structured, coins/ tokens may qualify as financial instruments or they may completely fall outside of the regulated space.

How are these coins/tokens used?

There is no single use or uniform feature of the coins/ tokens. They can be used:

- to access a network or purchase a service or product to be developed in the future by the issuer using the proceeds of the ICO,
- to purchase voting rights or rights to a portion in the future revenues of the issuer (which could also be a fund),
- to further trade and/or exchange them for traditional or virtual currencies on secondary markets, on coin/token special exchanges.

ICOs in the regulatory spotlight

ESMA puts all firms involved in ICOs on notice, asking them to consider whether they are involved in regulated activities. In summary, when tokens qualify as financial instruments, all persons involved in placing, dealing, advising in coins/tokens, or managing or marketing funds or offering coins/tokens to the public need to be regulated and are subject to a wide range of European and national regulations, including the Prospectus Directive (if tokens qualifying as transferable securities are offered to the public), MiFID (as far as placing agents, advisors or exchanges are concerned), the AIFMD (should an ICO scheme qualify as an AIF), and the Fourth AML Directive (generally applicable to financial institutions). Any failure to comply with the authorisation, disclosure, transparency and reporting obligations deriving from the relevant regulations may trigger considerable sanctions.

ESMA qualifies coins/tokens as “extremely risky and highly speculative investments”. ESMA warns all (future) investors that ICOs bear a number of risks and leave investors exposed to: (i) fraudulent or illicit activities, including money laundering risks; (ii) a potential loss of a part or all of their invested capital, especially when the relevant ICOs’ issuer is at a very early stage in term of development and therefore such ICO has no or only a very limited intrinsic value; (iii) high volatility, lack of exit options or market manipulation, considering that the exchanges are unregulated and that all coins or tokens are not convertible in traditional currencies; (iv) inadequate, incomplete or unaudited information, especially with respect to the potential risks imbedded in the coins/tokens; and/or (iv) flaws, hacks or inefficiencies in the technologies used to create, distribute and store coins and tokens.

ESMA hasn’t taken a position on the qualification of the coins/tokens, but reminds firms involved in ICOs that it is their responsibility to assess on a case-by-case basis whether they fall within the regulatory framework or not.

Can we help? Do you have further questions?



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