

Initial Coin Offerings

REGULATORY LANDSCAPE IN GERMANY AND THE EUROPEAN UNION AND GOOD PRACTICE PRINCIPLES

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1. Introduction

Recent statements by various regulators around the world demonstrate an increased scrutiny of initial coin offerings ("**ICOs**"). In order to create a well-functioning global market for ICO fundraisings, a professionalization of the ICO process is urgently needed.

In this article, we analyse the German and European regulatory landscape possibly applicable to ICOs and endeavour to formulate good practice principles for ICO issuers from a regulatory and corporate governance perspective.

The good practice principles set out below aim to strike a fair balance between the sometimes conflicting needs of ICO market participants. Compliance with these principles should enable ICO issuers to provide a higher standard of consumer protection and help stabilising the ICO market. The aim should be a fair disclosure by ICO issuers in order to empower investors to make better investment decisions and to use ICOs as an alternative way of raising funds for high quality companies. ICO issuers could use the good practice principles in order to differentiate themselves from ICOs with lower quality and standards of disclosure and to mitigate their risk of liability in connection with the issuance.

2. Regulatory landscape

Under the laws of many jurisdictions, in particular Germany, United Kingdom and the United States, tokens issued in an ICO process have no official status at present. Some tokens, particularly those granting rights against either the token issuer or a third party, have features similar to securities. Other tokens, particularly those without underlying assets or extensive rights against the issuer or a third party, have features resembling fiat currency. Nearly all regulators who have commented on ICOs thus far have noted that the status and treatment of tokens issued in an ICO process must be considered on a case-by-case basis.

2.1 Germany

The German Federal Financial Supervisory Authority ("**BaFin**") has recently published a warning regarding the potential risks associated with ICOs¹, but has not yet officially commented on the exact regulatory regime applicable to ICOs.

The following is an overview of the existing regulatory guidance and legal interpretation under German law relating to public offerings of tokens by means of an ICO in Germany, subject to the developing BaFin practice.

2.1.1 Financial instruments

Under German law, certain activities relating to financial instruments constitute regulated activities. The definition of "financial instruments" (*Finanzinstrumente*) is very broad and includes not only securities and derivatives but also for example "units of calculation" (*Rechnungseinheiten*) that operate similarly to a currency but are not an official currency.

For example, BaFin takes the view² that Bitcoins qualify as "units of calculation" (for exchange into money) (*Rechnungseinheiten*) and, therefore, as a financial instrument for regulatory purposes within the scope of in particular the German Banking Act (*Kreditwesengesetz* – "**KWG**"), regardless of what software or encryption technologies have been used. As a consequence, while the use and mining of Bitcoins does not constitute a regulated activity, certain other activities, such as trading or market making in Bitcoins, other cryptocurrencies, such as ether, or in tokens issued in an ICO process, may fall within the scope of a regulated activity. Such activity may, depending on the case, be qualified as providing brokerage services, investment and contract broking services, other financial services or services as a Multilateral Trading System (MTF) and may thus require a license. Offering such services without a license is punishable under KWG by imprisonment of up to five years.

2.1.2 Securities

German securities laws impose certain restrictions and obligations on issuers of securities. This includes in particular certain disclosure obligations in case of public offerings. Whether tokens are subject to securities laws needs to be assessed on a case by case basis depending on the features of the token.

Under section 2, para. 1 of the German Securities Prospectus Act (*Wertpapierprospektgesetz* – "**WpPG**"), "securities" are transferable securities which can be traded on a market, in particular:

- a) shares and other securities equivalent to shares or units in limited companies (*Kapitalgesellschaften*) or other legal entities, and certificates representing shares;
- b) debt securities, in particular bonds and certificates representing securities other than those mentioned in a);
- c) any other securities granting the right to acquire or sell such securities or to receive a cash amount determined by reference to transferable securities, currencies, interest rates or payments, commodities or other indices or measures;

with the exception of money market instruments having a maturity of less than 12 months.

¹ See https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2017/meldung_171109_ICOs_en.html
https://www.bafin.de/SharedDocs/Downloads/DE/BaFinJournal/2017/bj_1711.pdf?__blob=publicationFile&v=3.

² See https://www.bafin.de/DE/Aufsicht/FinTech/VirtualCurrency/virtual_currency_node.html
https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2014/fa_bj_1401_bitcoins.html.

Whether the German securities laws apply to tokens depends on the assets backing the token and/or the rights granted by the token. There are good arguments that tokens similar to the existing cryptocurrencies such as Bitcoin, which carry only a right to the coin itself and no right against a counterparty, do not qualify as securities under German law.

On the other hand, tokens granting rights similar to those attached to securities described in section 2, para 1 WpPG against either the token issuer or a third party may be classified as securities, in particular if they have further essential features of securities under German law, namely fungibility (*Fungibilität*) and fitness for circulation (*Umlauffähigkeit*)³, which is in particular the case of blockchain based tokens.

Under German law, good arguments can be made that tokens carrying the following features **do not qualify** as securities:

- a) Rights to program, develop or create features for a system;
- b) Rights to access or license a system;
- c) Rights to contribute labor or effort to a system;
- d) Rights to use a system or its output;
- e) Rights to use a system against a fee or with a discount.

On the other hand, good arguments can be made that tokens carrying the following features **may qualify as securities** under German law:

- a) Dividend or dividend equivalent rights;
- b) Profit and/or loss participation rights or duties similar to equities;
- c) Voting and participation rights;
- d) Repayment obligations from the legal entity of the ICO issuer;
- e) Derivative elements linked to securities or commodities.

2.1.2.1. Tokens qualifying as securities

Public offerings of tokens which qualify as securities under German law will generally require the publication of a prospectus approved by BaFin, unless specific exemptions under WpPG apply.

The existing exemptions, such as those for offerings to qualified investors or offerings to less than 150 persons in the European Economic Area, are unlikely to apply in a standard ICO (crowdfunding) scenario. For example, an individual would only be regarded as a qualified investor if he or she applied to be treated as qualified investor and at least two of the following criteria are satisfied: (i) he or she carried out transactions of significant size on the relevant market at an average frequency of 10 per calendar quarter over the previous four calendar quarters, (ii) the size of his or her portfolio is in excess of EUR 500,000, or (iii) he or she has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged. Nevertheless, an ICO that is directed at qualified investors only and managed accordingly (e.g. access to documentation on the website only after positive approval of a qualified investor status) would be possible outside of the strict WpPG disclosure regime for securities.

³ Berrar/Meyer/Müller/Schnorbus/Singhof/Wolf, § 2 WpPG Rn. 4.

The mandatory content of the prospectus pursuant will need to be assessed based on the Commission regulation (EC) No 809/2004 implementing Directive 2003/71/EC ("**Prospectus Regulation**") depending on the features of the token. In particular, in order to determine mandatory annexes of the Prospectus Regulation and the applicable building blocks (see Annex XVII of the Prospectus Regulation) it is necessary to assess if the token is structured similarly to shares, bonds or whether it has derivative features.

As most token issuers will likely be in an very early stage of establishing a business, the guidance of the European Securities and Markets Authority ("**ESMA**") on start-up companies⁴ should be applied. Pursuant to the ESMA guidance, a start-up company shall discuss in the prospectus its business plan, strategic objectives and shall provide the key assumptions upon which such plan is based. Further, the prospectus shall contain information on dependence on key personnel, current and expected market competitors, dependence on a limited number of customers or suppliers and specify any assets necessary for the business which are not owned by the issuer. A valuation report prepared by an independent expert on the services/products of the issuer may be voluntarily included in the prospectus.

Investors in the ICO would generally be entitled to prospectus liability claims pursuant to section 21 WpPG based on an approved prospectus.

2.1.2.2. Tokens qualifying as asset investment

Section 1, para. 2 of the German Law on Asset Investments (*Vermögensanlagengesetz* – "**VermAnlG**") defines asset investments as investments which e.g. grant a participation in the profit of a company, qualified subordinated loans or participation rights and which do not qualify as securities. General purpose of the VermAnlG is to provide a regulatory regime for asset investments which are not subject to the German securities regime. Due to the fact that most tokens will typically have the standard features of securities, such as being fungible and fit for circulation, the VermAnlG will only apply in specific circumstances, where tokens are not qualified as securities. If the VermAnlG applies to tokens issued in an ICO, the crowdfunding exemption for certain obligations under VermAnlG pursuant to section 2a VermAnlG may be relied upon, provided that in particular the following conditions are fulfilled: (i) an investment restriction of not more than EUR 1,000 per individual investor or EUR 10,000 if a know your customer (KYC) procedure was conducted and (ii) an overall limit for the proceeds of not more than EUR 2.5 million. However, due to those restrictions, most recent ICOs would not have been able to rely upon such exemption.

2.1.2.3. Liability outside mandatory disclosure regimes

Even if no mandatory disclosure regime, such as the regime of the WpPG or VermAnlG, applies, ICO issuers may still be subject to the general liability regime under German civil law in case of material omissions or misstatements.

In practice, ICO issuers typically publish "white papers" which set out the details of the project and the terms of the ICO. Even if the specific prospectus liability regime pursuant to section 21 WpPG does not apply, white papers should be drafted with due diligence due to the fact that, under German law, liability claims may also be based on documents similar to a securities prospectus if such document contains any untrue or misleading statement of a material fact or omits to state a material fact necessary for the investment decision.

⁴ No 135 – 139 of ESMA update of the CESR recommendations dated 20 March 2013 (ESMA/2013/319) <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-319.pdf>; However, the ESMA recommendation only directly apply to the issuance of shares. Nevertheless, the same principles could as well be applied to debt a debt issuance.

The general prospectus liability under German law is based on a case law of the Federal Court of Justice ("**BGH**")⁵ which closes a legal loophole concerning the "grey" capital market. This liability is not codified, but based on the continued development of the *culpa in contrahendo* principle. According to the case law, a prospectus is a market-related written statement that contains or gives the impression that it contains all relevant information upon which the investor is able or believes to be able to assess the offering. The written statement must create the impression that it is a comprehensive description of the investment. These requirements are already fulfilled if the statement contains a detailed product information. Even an advertising material can be classified as a prospectus, if it contains a comprehensive, but not necessarily complete, description of the investment. From an average investor's point of view, the information is comprehensive, if it is sufficient enough to form the basis of his or her investment decision, without the necessity to gather further, more complex or in-depth information on the investment.

The standard white papers currently used in ICOs may well qualify as prospectuses within the meaning of the BGH case law. In many cases, they constitute a comprehensive guide for investors in the ICO and investors will most likely base their investment decision predominantly on the information contained in the white paper. Thus, it is possible that a German court would apply case law-based prospectus liability principles in order to establish a liability claim against an ICO issuer.

Further, the management of an ICO issuer and the experts involved in the ICO process may be held directly liable under German civil law. German case law generally provides for a liability of board members of a German stock corporation as well as of experts participating in the marketing of an investment product⁶ based on the *culpa in contrahendo* principle. According to the BGH⁷, a board member of a capital seeking German stock corporation may be held liable for incorrect or incomplete information if he or she personally provides potential investors with information material for the investment decision. Personal liability applies in particular in cases in which a board member has a private economic interest in a transaction.⁸ In an ICO such a private economic interest may exist if the ICO provides for a material allocation of tokens to the management. In such a case, the management of the ICO issuer has a private interest in the success of the ICO in order for their personally held tokens to be of value. Similar principles would also apply to an expert involved in the marketing of the ICO.

2.2 European Union

In relation to offerings in the European Union, ESMA has published statements⁹ reiterating that certain EU legislation should be taken into consideration by ICO issuers and advisors when conducting, advising or facilitating a token offering in the European Union. This includes, for example:

- a) The Prospectus Directive ("**Prospectus Directive**") if tokens qualify as securities. The Prospectus Directive aims at ensuring that adequate information is provided to investors by companies raising capital in the EU and, in particular, requires the publication of a prospectus, unless certain exclusions and exemptions apply.
- b) The Markets in Financial Instruments Directive ("**MiFID**") if the tokens qualify as financial instruments. MiFID sets out certain organisational requirements, conduct of business rules and transparency requirements rules for certain activities and services, such as placing, dealing in or advising on financial instruments.

⁵ BGHZ 71, 284; 72, 382; 79, 337; 83, 222; 84, 141.

⁶ BGH, III ZR 103/10, NJW 2012, 758.

⁷ BGH, NZG 2008, 661.

⁸ BGHZ 56, 81, 83 = WM 1971, 592; 159, 94, 102 = ZIP 2004, 1662, BGH ZIP 1981, 1076; NJW 1986, 586, 587.

⁹ See <https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms>

- c) The Alternative Investment Fund Managers Directive ("**AIFMD**") if the ICO scheme qualifies as an alternative investment fund (AIF) in the European Union. AIFMD lays down the rules for the authorisation, ongoing operation and transparency of the managers of alternative investment funds. In particular, AIFMD provides for capital, operational and organisational rules and transparency requirements.
- d) The Fourth Anti-Money Laundering Directive ("**AMLD**"), if the ICO issuer qualifies as obliged entity, in particular in case it qualifies as MiFID investment firm and therefore as a financial institution. The AMLD requires obliged entities to carry out due diligence on beneficial owners and to have in place appropriate record-keeping and other internal procedures. Obligated entities have an obligation to report any suspicious activity and to co-operate in any investigations by relevant public authorities.

2.3 Other jurisdictions

Over the recent months, various regulatory authorities worldwide have issued statements on their respective national regulatory treatment of ICOs. The regulatory authorities in China and Korea have banned ICOs outright.¹⁰ The US SEC, Singapore's MAS, Canada's CSA, the UK's FCA, Japan's FSA, Hong Kong's SFC, Australia's ASIC, Abu Dhabi's FSRA, Germany's BaFin and EU's ESMA have confirmed their respective views that tokens issued in ICOs may qualify as securities and have issued warnings for investors to be cognizant of the risks of participating in ICOs.¹¹ Singapore's MAS¹² has been more definitive by issuing a guide to digital token offerings including various case studies indicating which tokens would qualify as securities under Singaporean law and which not. In the United States, an ICO has become subject of the first class action lawsuit¹³.

¹⁰ See <http://www.circ.gov.cn/web/site0/tab6554/info4080736.htm>;
http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&menu=7210100&no=32085.

¹¹ See https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings; <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx>;
http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm; See
<https://www.fca.org.uk/news/statements/initial-coin-offerings>; http://www.fsa.go.jp/policy/virtual_currency/07.pdf;
<http://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-initial-coin-offerings.html>; <http://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings>;
<https://www.adgm.com/media/192772/20171009-fsra-guidance-for-icos-and-virtual-currencies.pdf>;
https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2017/meldung_171109_ICOs_en.html;
<https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms>.

¹² See
<http://www.mas.gov.sg/~media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/Regulations%20Guidance%20and%20Licensing/Guidelines/A%20Guide%20to%20Digital%20Token%20Offerings%20%202014%20Nov%202017.pdf>

¹³ See <http://www.almcms.com/contrib/content/uploads/documents/403/4319/tezos-sfo-complaint.pdf>.

3. ICO good practice principles

The proposed ICO good practice principles are directed at ICO issuers and comprise (i) general principles, (ii) preparatory principles, (iii) disclosure principles, and (iv) post transaction principles.

The good practice principles contain **recommendations** and **suggestions**.

Recommendations are indicated by using the word "**shall**". It is also proposed that if ICO issuers depart from any of the recommendations, they shall disclose and explain to potential investors any departures from the recommendations (i.e. the comply or explain principle approach).

In addition, we have also included **suggestions** which we consider beneficial for the ICO process and as a general standard for ICO issuers.

3.1 General principles

The ICO issuer **shall**:

1. Manage and control its business effectively, and conduct its business with due skill, care, honesty, integrity and diligence; including having proper regard to risks to its business and customers.
2. Pay due regard to the interests and needs of its customers and communicate with its customers in a way which is fair, clear and not misleading. This includes:
 - protecting customers' interests equally to their own, and dedicate sufficient resources necessary to protect customers;
 - use best efforts to mitigate the risks associated with investing in the ICO;
 - provide appropriate disclosure regarding the material information for the ICO participants including all risks associated therewith;
 - correct and update incorrect, partial or misleading information promptly; and
 - disclose any conflicts of interest.
3. Maintain good standing. This includes:
 - adequate financial and non-financial resources;
 - sustainable business model;
 - maintenance and retention of books and records; and
 - compliance with audit and reporting standards.
4. Have effective arrangements in place for the protection of client's assets and money (if fiduciary duty applies).
5. Have effective corporate governance arrangements in place. This includes:
 - setting up a board structure, including composition of the board which ensures that there is a good balance and mix of skills and experience to complement the business;
 - clearly allocating responsibilities within the management team and setting-up rules of procedure;
 - leading and managing employees with responsibility, dedication and commitment; and
 - applying an adequate four eyes principle.
6. Ensure that all systems and security access protocols are maintained to appropriate high standards. This includes:
 - skilled and experienced staffing;

- risk assessment of applications, underlying technology, and cybersecurity;
 - continuous vulnerability and threat analysis and assessment;
 - continuous monitoring and response provisions;
 - policies, procedures and controls to ensure the delivery of this principle; and
 - independent compliance audit and reporting.
7. Have systems in place to prevent, detect and disclose financial crime risks such as money laundering and terrorist financing.

3.2 Preparatory principles

Prior to launching the ICO process, the ICO issuer **shall**:

1. Prepare material information for potential investors. Unless mandatory securities laws apply, ICO issuers are free to choose the way of disclosing such information to potential investors prior to the investment decision, e.g. by way of a white paper, business plan or terms and conditions for the ICO.
2. Seek legal and commercial advice by independent third party advisors.
3. Seek early contact with relevant regulators.
4. Specifically target the markets in which tokens are offered.

Further, we suggest that the ICO issuer should:

5. Mandate an independent expert to render a valuation report on the business model and/or services in order to substantiate the ICO.
6. Request its management team to invest its own money in the ICO in order to emphasize its strong commitment.
7. Implement an advisory and/or supervisory board with an adequate experience.
8. Limit the amount of tokens offered based on the actual financial needs of the token issuer or based on a valuation of the token issuer or project.

3.3 Disclosure principles

Irrespective of the applicability of securities laws, any disclosure by the ICO issuer during the ICO process shall be in line with the general principles set out above and the ICO issuer **shall** in particular disclose to potential investors the following:

1. Risk disclosure
 - Risks relating to the technology, including protocol-related risks, storage and access of private key related risks.
 - Regulatory risks.
 - Business related risks, including market and counterparty risks.
2. Information on issuer and business
 - Information on the issuer, including history, seat and legal status.
 - Audited financial statements for the last two years.
 - Viable business model by presenting either a proof of concept (existing products, services, customers) or a business plan including strategic objectives and the key assumptions upon which such plan is based as well as milestones to be achieved.

- Information on current and expected market competitors.
 - Specific dependencies, in particular on a limited number of customers or suppliers, specific assets or key personnel.
 - Conflicts of interest.
 - Information on post ICO communication principles, including communication on material events and financials.
3. Technical description of the token issued
- Summary of the token features, including utility, benefits and rewards.
 - Detailed technical specifications of the token and system, including technological challenge and solution.
 - Information on other existing tokens with similar features.
 - IP and trademark ownership.
4. Description of the offering
- Detailed technical description of the token offering, including way of acquisition, payment and other material terms.
 - Information on the amount of tokens offered (capped or uncapped) and purchase price.
 - In case of a pre-sale of tokens, the basic information on such pre-sale including the material terms and discounts.
 - Information on the trading facility for and liquidity of the token, including any lockups.
 - Information on the legal nature of the offering, including applicable law to the tokens and the offering as well as applicable selling restrictions.
5. Use of proceeds
- Expected amount of proceeds (cryptocurrency or fiat currency).
 - Detailed statement on the use of proceeds, if possible linked to the agreed milestones or how proceeds will be released, as well as on the escrow principles applied.
 - Mechanism to refund the proceeds in case of business failure or if the target amount is not reached.
 - Fees and costs of the ICO process.

3.4 Post transaction principles

Following completion of the ICO, the ICO issuer shall adhere to the post ICO communication principles as announced during the ICO process. Further, we suggest that ICO issuers update investors quarterly on business developments within 30 days after close of the calendar quarter and publish annual financial statements within 180 days after the close of the financial year.

4. Contacts



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