Token Issuance in Europe

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Introduction: Token Issuance in Europe

This Client Briefing provides a high level overview of the issues to be considered by anyone wishing to raise capital in the form of 'tokens' or 'coins' from European investors.

Issuers need to consider:

- The optimal domicile for the issuer
- The legal form of the issuer – typically a 'corporation', 'foundation', or an 'association';
- Whether the tokens' or 'coins' are 'investments' under local legislation and therefore any marketing is regulated
- Whether any local Operating Company (OpCo) needs to be regulated – e.g. as a 'distributor', professional trader or 'arranger' of investment transactions
- Whether the t tokens' or 'coins' could be considered units in a 'collective investment scheme' or 'alternative investment fund' under domestic laws
- Compliance with data protection laws
- Compliance with consumer protection laws

Choosing the Optimal Domicile for the Issuer

The major considerations here are:

- Onshore or Offshore?
- Regulated and Unregulated Domiciles
- Availability of suitable ‘decentralised’ structures – Foundations and Associations
- Taxation – exemption from income and corporation taxes and sales and value added taxes

Choosing the Optimal Domicile for the Issuer

Onshore or Offshore; Regulated and Unregulated Domiciles?

- Choose a crypto/token friendly jurisdiction to avoid unexpected future regulation and or taxation
- China, Russia, Vietnam, Thailand, Taiwan for example ban the sale of Bitcoin; and some Middle eastern jurisdictions view crypto as akin to gambling and therefore unsuitable for Islamic investors
- The Cayman Islands, the Isle of Man, Malta, Gibraltar and Switzerland are crypto friendly with the Isle of Man, Malta and Gibraltar having licensing regimes designed to regulate the issuers and other participants
- It is critical to consider whether the issuer and any party involved in fund raising or trading will the issuer will be carrying on 'investment business', issuing 'securities' or other 'investments' ; or could even be deemed a 'fund' under the EU Alternative investment Fund Manager Directive. Note this analysis needs to be undertaken in respect of both the country of domicile of the issuer and the jurisdictions where any fund raising or trading will take place
- Most issuers prefer to be unregulated and to market their tokens as broadly as possible. Some EU jurisdictions which have brought in licensing regimes which, whilst they may give some investors and counterparties the comfort of having a degree of regulatory oversight this will likely also impose costs and restrictions which may considered quite burdensome.

Choosing the Optimal Domicile for the Issuer

Onshore or Offshore; Regulated and Unregulated Domiciles?

- Will the offering of tokens constitute a ‘public offer’ of ‘securities’ – if so consider compliance with the EU Prospectus Directive which allows public marketing to retail investors and, although it requires issuance of a compliant prospectus and filing with the local regulator, is relatively easy to comply with compared to, say, the US which involves more detailed approval by the SEC and compliance with ongoing reporting requirements .

- Although some of the exemptions under EU rules involve annual fund raising limits which are lower than those permitted under, for example, Reg A/Reg A+ in the US, there are other exemptions under EU rules which impose no financial limits where the number of investors in any one EU country is below 150 persons for example

- Would investors value the issuer being ’regulated – e.g. having its blockchain verified by approved/licensed local service providers; being required to engage local regulated administrators/auditors/other service providers?

- Would being in a regulated environment improve access to banks/ability to open and operate bank accounts, especially if accepting or offering crypto currencies?

Choosing the Optimal Domicile for the Issuer

Taxation

- If any 'trade or business' is being conducted or if the token issuer will receive income or gains you ideally want the issuer to be exempt from taxation which means it either has to be an onshore tax exempt entity (e.g. a charity, foundation or some other tax exempt onshore vehicle) or formed in an offshore tax haven or tax free zone etc.

- And you need to analyse whether any value added or sales taxes (e.g. EU VAT) applies to the issuer – e.g. if it is providing goods or services). This a potential 'trap' for issuers of utility or hybrid tokens which offer some form of service to token holders

• ‘Decentralised’ structures – Foundations and Associations

How ‘decentralised’ is the token issuer?

- Companies laws envisage certain ‘fundamental’ matters be determined by the ‘shareholders’ and day to day decisions are undertaken by a ‘board of directors’. In other words, there is no true ‘decentralisation’ of decision taking with corporations

- Even if smart contracts allow for certain decision making by token holders overall management lies with the shareholders and the directors and making token holders shareholders or director with consequent fiduciary and other duties is unworkable

- Foundations are typically tax exempt if set up as not for profit organisations and they need have no shareholders

- BUT rules regarding operations of foundations vary:

  - Swiss Foundations are under the supervisory power of an ‘administrator’ and a board of trustees who must ensure the Foundation’s assets are used for the declared purpose. The latest thinking is that this legal rigidity may be unsuitable for blockchain based entities as the technology is fast evolving and if issuers of ICOs are unable to deliver their promised products within the promised framework it will be difficult or impossible to amend the framework.

• ‘Decentralised’ structures – Foundations and Associations

- The founders of the Swiss Tezos Foundation are in legal dispute with the Foundation’s trustees over control and use of the funds in the Foundation, for example.

- Also, the not for profit requirement in some countries means Foundations may be unsuitable for ICOs which involve an investment or profit making objective. Indeed, one of the law firms which was instrumental in setting up Swiss foundations for ICOs now believe that Foundations are often “…not the most adequate legal structure to conduct ICOs.”

- Associations having legal personality are another option.

- Swiss Associations are required to have two corporate bodies: (i) a General Assembly and (ii) a Board of Directors. The general assembly is the supreme governing body of the association. It decides on the admission and expulsion of members, appoints the board of directors and resolves all matters not assigned to other persons in the articles of association.

- Again, to avoid taxation, like Swiss Foundations, Swiss Associations must be not-for-profit organisations and obtain Swiss tax approval as such. So again they are not appropriate for ICOs involving a profit motive.

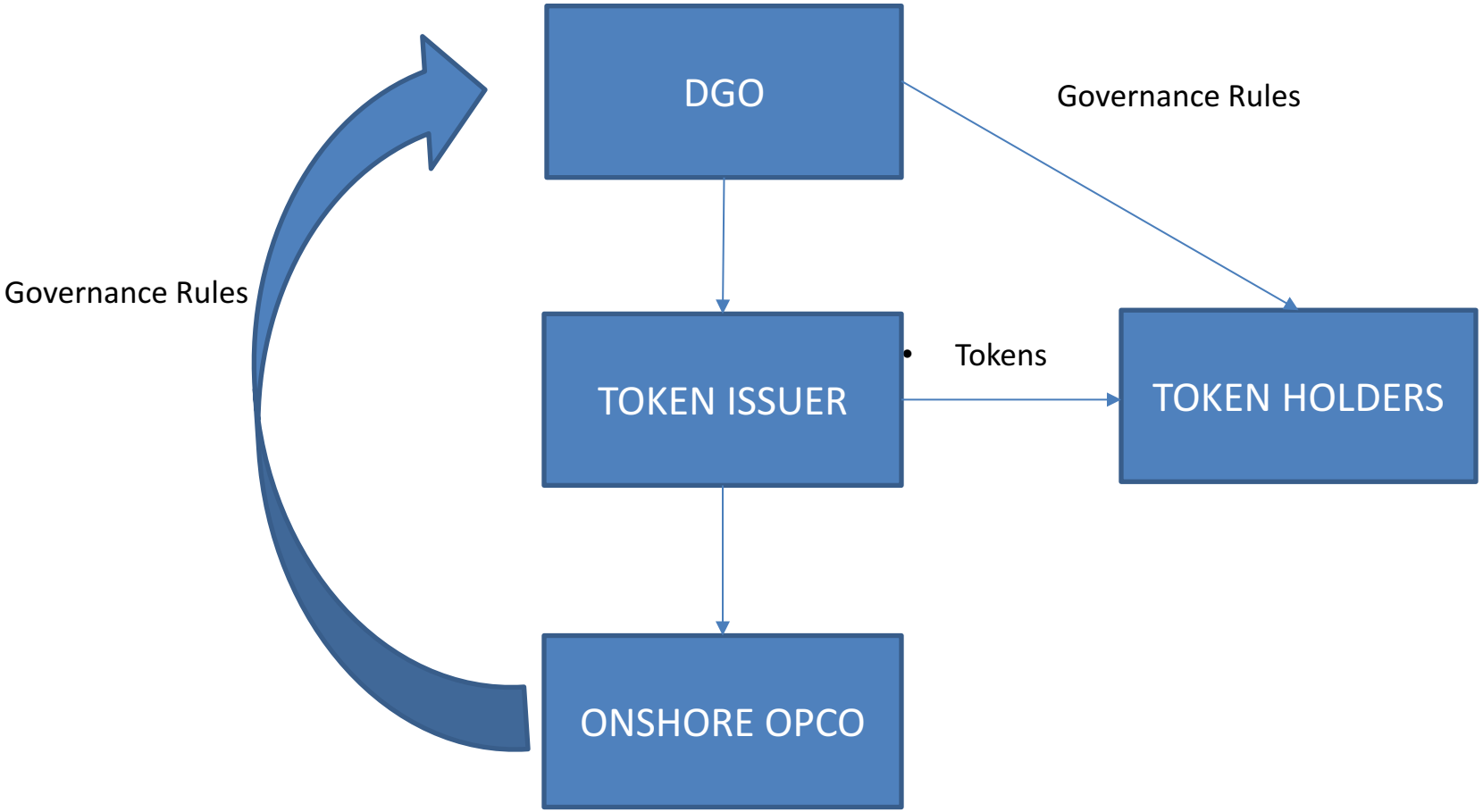
• ‘Decentralised’ Structures – Foundations and Associations

- The solution to the issue of Foundations and Associations issuing tokens may be to limit their role to governance.

- This allows such entities to operate as “Decentralised Governance Organisations” (DGOs) meaning they act as the oversight body with responsibility for ensuring that a separate token issuing entity operates in accordance with prescribed constitutional terms and in accordance with an agreement between such DGO and the token issuing entity and or the blockchain development company which may also be owned and controlled by the DGO.

- The following Structure Diagram shows how a DGO and STO Issuer might be structured with an onshore Operating Company with responsibility for developing the blockchain and fund raising etc.

- **Availability of suitable 'decentralised' structures – Foundations and Associations**



• Are Tokens "Investments" under EU Regulations

- In order to determine the regulatory status of an ICO/STO it is necessary to determine whether the token is an "investment' under relevant laws

- In the EU the issue should be considered at (i) the EU level and (ii) under each Member State's domestic laws as relevant EU Directives do not preclude individual member States from having additional local laws as long as they do not conflict with EU laws. So the UK FCA, for example, has its own set of 'financial promotions' rules which supplement rules applicable under the EU Directives.

- The relevant EU Directives are (i) the Markets in Financial Instruments Directive (MiFID) and (ii) the EU Prospectus Directive.

- MiFID imposes obligations on both EU and non-EU persons undertaking relevant activities in the EU in relation to 'investments' which are defined as, inter alia:

  - Transferable securities
  - Units in collective investment undertakings
  - Financial contracts for differences
  - Options, futures, swaps, forward rate agreements and any other derivative contracts …relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF.

- It is necessary to consider each of the above terms in detail – for example, what is understood by "securities" and what "transferable" means in the context of tokens, in particular will they be traded on an "exchange", a "regulated market" an "OTF" and or an "MTF".

• Are Tokens "Investments" under EU Regulations

- The definition of what constitutes a "transferable security" is particularly important as not only does that determine whether a token could be an investment under MiFID but also whether the EU Prospectus Directive is triggered and which mandates the issuance of a compliant prospectus unless an offer is conducted in compliance with specified exemptions.

- Companies raising money through ICOs frequently use Telegram and other social media venues to advise potential investors of their offering. Whilst this may be perfectly legitimate for non-securities/non-investment based ICOs (commonly referred to as 'Utility Token Offerings') these methods in no way by-pass existing laws and regulations where they constitute an offer of securities or other investments, as the SEC has made clear in a number of cases it has brought in the U.S.

- There is, however, an important difference between U.S. and EU regulations in this area. In the U.S. 'securities' are defined much more broadly to cover any 'investment contract' as defined in the seminal case in this area – known as the 'Howey Test' in the U.S. 'securities' are defined as broadly equivalent to 'investments' in the EU whereas 'securities' are defined more narrowly and form a sub-set of 'investments under EU legislation.

- As mentioned above, one critical consequence is that only if an ICO involves 'transferable securities' is the EU Prospectus Directive brought into play and which is broadly equivalent to the U.S. Securities Acts being invoked, both potentially triggering the production and filing/approval of a complaint prospectus and various ongoing reporting obligations.

• Are Tokens "Investments" under EU Regulations

- Many ICOs which would trigger US prospectus obligations. under U.S. Securities Acts will therefore not trigger the production of a compliant prospectus under EU prospectus Directive requirements – i.e. because although they constitute 'investment contracts' and therefore 'securities' under U.S. laws they will not be considered 'securities' under EU laws, even though they may be investments under such laws.

- Of course, some ICOs will involve securities under both sets of rules and in both jurisdictions there are so-called 'private placement' exemptions from the requirement to produce a compliant prospectus. In the EU the most common exemptions are:

  Offers to no more than 150 persons in any one EU Member State
  Offers which in aggregate raise no more than up to Euro 8m in any 12 month period – but NB offers above Euro 1m are subject to local limitations which may be between Euro 1-8m

  SME's meeting two of the following requirements:

  an average number of employees during the financial year of less than 250,
  a total balance sheet not exceeding €43 million, and/or
  an annual net turnover not exceeding €50 million;

  or

  an average market capitalisation of less than €200 million on the basis of end-year quotes for the previous three calendar years.

• Are Tokens "Investments" under EU Regulations

- Even if an ICO does not trigger prospectus obligations because no securities are being offered or because private placement exemptions are applicable, it is nevertheless necessary to consider whether MiFID applies.
- Persons based in the EU being remunerated for fund raising may need to be regulated on the basis that they are involved in 'acceptance and transmission of orders' for tokens or 'placing' tokens.
- In the UK such persons may also be deemed to be 'arranging' transactions if involved in fund raising and this concept includes making introductions.
- Anyone giving investment advice in relation to such offerings would also likely need to be regulated.
- Non-EU persons not having a place of business in the EU may be able to avoid being regulated under MiFID or operating through an onshore regulated entity if approaching only 'professional investors' but generally speaking approach 'retail investors' will require marketing to be undertaken by an EU regulated person. This is very similar to the concept that marketing of securities in the U.S. must be undertaken by an SEC registered broker-dealer. 'Professional investors' are defined very narrowly under MiFID and precludes approaching most individuals unless experienced investors in securities tokens or persons working for regulated financial institutions. So fund raising via Telegram or other social media likely to breach EU rules and professional advice should be taken.

• Could the Issuer Be A ‘Fund” under EU Regulations

- Although a token issuer may not be structured in a traditional fund format it should be noted the definitions of what constitutes an ‘alternative investment fund’ (AIF) under the EU Alternative Investment Fund Manager Directive (AIFMD) or a ‘collective investment scheme’ and under UK domestic laws is extremely broad.

- In particular, ‘closed end’ investment companies not offering redeemable shares or other buy back rights can fall within the basic definitions and it is usually necessary to find one or more exemptions in order to avoid being an AIF and/or a CIS.

- Companies established to carry out ‘commercial activities’ as opposed to ‘investment activities’ are typically exempted exempted.

- And fully decentralised structures where investment decisions are determined by the token holders through appropriate voting systems may also be exempted. But where companies have a board of directors who make such decisions they may be considered a ‘;self –managed’ fund – i.e. it is not necessary that the entity has a separate fund manager or general partner to be considered an AIF or CIS for these purposes.

- The importance of this analysis is that even non-EU AIFs/CISs are subject to separate (and more restrictive) rules even if promoted from outside the EU. In particular such marketing may trigger local filing obligations before marketing can be commenced; and marketing is again restricted to ‘professional investors’ only, subject to any local exemptions from this requirement.

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• EU General Data Protection Regulation (GDPR), Consumer Protection Laws and Taxation

- It should be noted that EU Data Protections laws are very strict and breaches can result in very significant fines of up to 20 million Euros or 4 percent of annual global (note global!) turnover, whichever is the higher.

- Under GDPR the collection and use or personal data is highly regulated and applies to companies established outside the EU offering goods or services (paid or for free) or monitoring the behaviour of individuals in the EU. Thus it applies to issuers offering utility and well as securities tokens. And such non-EU persons are required to appoint an EU 'representative'

- Many issuers of tokens have argued they are outside the scope of MiFID and the Prospectus Directive as they are issuing utility as opposed to securities tokens. This may indeed be the case where there is no investment element but the position of hybrid tokens is far from clear; and issuers should not forget that utility tokens by definition (and hybrid token by implication) involve the offering of goods and or services.

- As such, issuers based in the EU may be subject to consumer protection laws applicable to the offering of such goods or services (e.g. cancellation rights) and must also consider the applicability of EU Value Added Tax (VAT) to such goods and services. Failure to properly account for VAT could mean, for example, any payments made are deemed VAT inclusive and the =issuer would need to account for 20% of amounts received to the tax authorities

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Conclusion

- Choosing the optimal domicile and structure for an ICO requires consideration of multiple issues
- Very few jurisdictions have come out with definitive regulations with regard to crypto currencies, blockchain and or ICOs and those which have within the EU are potentially subject to ESMA coming out with more restrictive regulations in due course
- Issuers wishing to establish truly decentralised organisation need to consider non-corporate forms of entities such as Foundations and Associations
- EU rules applicable to issuers of so-called 'securities tokens' are less onerous than those applicable in the U.S - i.e. many tokens which would trigger US Securities Act compliance will not trigger equivalent EU Prospectus Directive obligations as such tokens will not be 'transferable securities' for these purposes; and even if there are they can be sold under more generous 'private placement' exemptions which remove the obligation to file a prospectus and ongoing filing requirements
- EU persons involved with fund raising on a professional basis (e.g. paid – whether involving fiat or crypto or other non-monetary benefits) may nevertheless be subject to rules applicable to offering regulated 'investments' – e.g. as persons 'accepting and transmitting orders', 'placing' tokens and or 'arranging' token transactions (whether in the primary or secondary markets)
- Non-EU persons may also be required to comply with local 'marketing rules' such as the UK's 'Financial Promotions' regime and which effectively ban the marketing of investments to private individuals (subject to applicable exemptions); and to equivalent EU MiFID rules which often require marketing to be conducted by EU regulated MiFID firm.

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Martin is widely recognised as a leading fund management and financial services regulatory lawyer with over 25 years experience.

Martin's practice encompasses all forms of alternative investment funds and acts for both managers and investors as well as proprietary traders, brokers and dealers.

Martin was previously a partner at a leading U.K. 'silver circle' law firm, partner in charge of fund management at two US/Global law firms and European Legal Director of an international investment bank.

His recent deals and accomplishments include:

- Co-Founder of and legal adviser to a tokenised VC Platform
- Advising on the establishment of a Cayman ICO and crypto investment fund
- Advising on the establishment of Isle of Man, Gibraltar and Malta crypto funds
- Launch of 'seed capital/accelerator' Luxembourg hedge fund Advising on establishment of a Luxembourg carbon emissions investment fund
- Advising on the establishment of a novel platform solution to marketing alternative investment funds in the EU/EEA under the Alternative Investment Fund Manager Directive
- Advising LPs in numerous private equity, real estate and hedge funds including negotiation of terms and side letters.