LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# China's ICO Crackdown Clouds Efforts At Global Consistency

By **Tom Zanki**

*Law360, New York (September 12, 2017, 9:33 PM EDT)* -- Going against the more measured approaches taken by several other countries, China's ban on initial coin offerings is a stance that complicates the global regulatory landscape for these digital "token" sales, experts say.

The Chinese crackdown on ICOs, which has been followed by reports this week that Chinese authorities are also preparing to shut down all bitcoin exchanges in an effort to prevent capital from fleeing to digital currencies, stands apart from the positions many regulators around the world have taken on the burgeoning space.

Jurisdictions including the U.S. and even Hong Kong have taken the view that ICOs — which can resemble securities offerings — may fall under securities laws depending on the facts and circumstances of each case, and will be regulated accordingly. While the details vary by regulator, there had been hopes for some kind of regulatory consistency given the often global nature of the transactions.

But China's strict ruling dashes any such notions, at least for now.

"An announcement like the one from China makes people nervous because it was an initial outright ban versus, 'We are going to regulate it,'" said Skadden Arps Slate Meagher & Flom LLP partner James MacDonald, a corporate finance expert.

ICOs are a booming method of raising capital whereby startups sell digital tokens to investors to help fund certain projects, using digital currency facilitated by the same blockchain technology that powers bitcoin. The tokens themselves can represent various things, ranging from access to a company's products or services to an equity interest, thus falling into a regulatory gray area.

Moreover, the potential for these tokens to appreciate in value and become tradeable commodities is helping fuel the surge in ICOs. Digital currency news site CoinDesk reports that nearly $2 billion has been raised to date through ICOs, largely outside the realm of government oversight and without the investor protections and disclosure requirements that apply to traditional offerings.

Chinese authorities cited fraud concerns when they demanded all ICOs cease last week. They also ordered individuals who have already begun raising money from such offerings to provide refunds, and they banned exchanges from engaging in such transactions, among other things.

The action effectively halted a new and rapidly growing market in China, where about 65 ICOs raised nearly $400 million through the first seven months of 2017, according to the Beijing Internet Finance Association.

Despite this new development, some attorneys note that a global pattern is slowly beginning to emerge as more regulators state their view of these so-called token sales. Starting with the U.S. Securities and Exchange Commission, many agencies have issued guidance in recent months concluding that they will determine whether such offerings will be treated as actual securities transactions on a case-by-case basis.

“I see it as a trend towards legitimization, or at least acknowledgement of token sales,” said Josh Klayman, who leads Morrison & Foerster LLP's blockchain and smart contracts group.

The SEC issued its guidance in late July in the context of an investigative report into a group known as The Decentralized Autonomous Organization. The commission determined that The DAO ran afoul of securities laws when it failed to register tokens that raised about $150 million to fund investments for startup companies.

When issuing its report, the SEC did not categorize all digital tokens as securities, instead saying it will review examples case by case using the “Howey test,” principles established by a 1946 Supreme Court decision that determined what is considered an investment contract.

The Howey test stipulates that an investment contract can be considered as such if individuals invest money in a “common enterprise” with an expectation of profit derived mainly from the efforts of others. If a token-based offering fits that criteria, the SEC said, standard securities laws apply, meaning the issuer should register the offering or obtain an appropriate exemption.

Soon afterward, Singapore officials said some digital tokens could be considered securities and would be treated as such, while Canadian regulators issued guidance in late August containing many parallels with the U.S. statement.

“For example, if an individual purchases coins/tokens that allow him/her to play video games on a platform, it is possible that securities may not be involved,” the Canadian Securities Administrators wrote. “However, if an individual purchases coins/tokens whose value is tied to the future profits or success of a business, these will likely be considered securities.”

And around the same time China issued its ban, Hong Kong regulators issued a statement more in line with the SEC’s, saying they will determine whether ICOs are securities transactions depending on the facts and circumstances of each case.

And on Tuesday, the U.K.’s Financial Conduct Authority issued a warning about the risks of investing in ICOs, saying that it too will look at offerings on a case-by-case basis. That move echoed sentiments voiced to Law360 earlier this week by a European Union official, though the EU has yet to issue formal guidance on ICOs.

While different countries can be expected to draw different conclusions, attorneys say that some degree of international cohesion would help matters given that the technology behind cryptocurrency-based offerings lends itself to cross-border transactions.

“I have always found, and I think the marketplace has found, that having international regulations that operate harmoniously is great for the capital markets,” said Jones Day partner Stephen Obie, who advises multinational corporations and individuals on U.S. securities law compliance.

Skadden partner Stuart Levi, who specializes in intellectual property and technology, said: “If every country’s regulators adopt a different view of how to treat ICOs, it will be more challenging to conduct these offerings … than if a unified regulatory scheme emerges.”

Such a scheme is still very much a work in progress. In terms of China, it remains unclear whether the country’s crackdown on ICOs will be permanent.

Bitcoin news site CoinTelegraph reported Sunday that a researcher for China’s Institute of Finance and Banking, a government-supported academic research organization, told a state-run television network that the country’s ICO ban is only temporary until the government introduces a regulatory framework for ICO investors and projects.

Even apart from China, lawyers say many questions about ICO regulation remain unresolved. For one, it’s still unclear how exactly regulators will distinguish between what is and isn’t a security. Plus, there are questions as to how exchanges that list ICO tokens will be impacted.

Debevoise & Plimpton LLP counsel Lee Schneider points out that a digital token can represent a range of underlying assets, including a share in a company, a software license, health care records, or personally identifiable information. The latter two examples could affect health care regulations and privacy rules, adding layers of uncertainty yet to be ironed out.

“This idea that tokens should all be regulated the same way fails because its initial premise is not correct,” said Schneider, a blockchain expert. “By saying all tokens should be regulated the same way, you are saying all tokens are by and large the same kind of thing, and that’s just not the case.”

In terms of securities regulations, Obie said that if the SEC brings an enforcement action — the agency took no action following the DAO report — that could provide more clarity. He added that more thought needs to be given to differentiating between various kinds of tokens.

“Just getting the dialogue started will be helpful, because I think in the next six months, things will become even clearer,” Obie said.

--Additional reporting by Mark Taylor, Evan Weinberger and Jack Newsham. Editing by Mark Lebetkin and Aaron Pelc.

---