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Security Tokens – Legal Aspects

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Introduction.

With over six billion US dollars raised through token sales since the beginning of 2018[1], the popularity of the ICO model for fundraising has surged while regulators around the world have been closely monitoring the phenomenon.

The term ICO is used to describe a digital representation of value and/or underlying rights that are issued or generated in exchange for fiat currency or cryptocurrencies. Coins issued, also known as tokens, may represent rights to an asset, payment or benefit, or can be exchanged for goods and services. As such, the term "token sale" is more accurate to describe this mechanism than initial coin offering that is derived from the concept of "initial public offering".

Different classifications have emerged in different jurisdictions. For example, the United States has been proactive in doing so and the Swiss Financial Market Supervisory Authority (FINMA) has published guidance on its classification based on the underlying economic function of the token[2].

Depending on the qualification retained for the tokens, several legal fields may be involved and one must acknowledge the current legal uncertainty surrounding the recent ICOs phenomena. This also applies to Luxembourg where the Luxembourg Supervisory Authority for the Financial Sector (CSSF) only recently issued a warning on ICOs and tokens[3] (ICO Warning) and another, which is closely related, on virtual currencies[4] (VC Warning). On the EU level, the European Securities and Markets Authority (ESMA) issued an Advice on ICOs and Crypto-Assets in January 2019.[5]

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[1] According to the ICO rating website, www.ICOdata.io/stats/2018 (website last accessed on 31 August 2018)
[2] FINMA, Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), 16 February 2018, https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?la=en
[3] CSSF, Warning on initial coin offerings ("ICOs") and tokens, 14 March 2018, http://www.cssf.lu/fileadmin/files/Protection_consommateurs/Avertissements/W_ICOS_140318_eng.pdf
[4] CSSF, Warning on virtual currencies, 14 March 2018, http://www.cssf.lu/fileadmin/files/Protection_consommateurs/Avertissements/W_ICOS_140318_eng.pdf
[5] ESMA Advice, Initial Coin Offerings and Crypto-Assets, 9 January 2019, https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection

The purpose of this paper is to give an overview about the possible classification of tokens and the possible legal issues relating to an ICO.

1. Possible token classification.

1.1. Payment tokens

Payment tokens are virtual or cryptocurrencies (this is, for instance, the case of Bitcoin or Ripple), i.e. tokens intended to be used, now or in the future, as means of payment for acquiring goods or services or as means of money or value transfer[6][7]. Payment tokens are not related to a particular asset or service. Token holders have no right to claim against the issuer of the token. In fact, there is no issuer of token in the common sense because cryptocurrencies are based on decentralised control as opposed to centralised electronic money and central banking systems.

Payment tokens are not legal tender as they are not issued by any central bank. Central banks have the exclusive authority to issue legal tender. Legal tender means that a payment extinguishes a financial obligation without specific agreement by the creditor. In itself a payment token has no discharge effect (or *force libératoire* in French).

Cryptocurrency transactions are agreements between two parties to comply with their obligations and to accept the exchange of a cryptocurrency against a good or service deemed of equivalent value. It is not binding against third parties and the difference with legal tender relies on the concept of acceptance. It can be assimilated to a means of exchange, as gold used to be.

1.2. Asset tokens

Asset tokens represent assets such as a debt or an equity claim on their issuer. They promise a share of future earnings of a company or future capital flows. They are analogous to equities, bonds, or derivatives and therefore generally treated as a security. According to FINMA, tokens which enable trading of physical assets on the blockchain also fall within this category[8].

When assessing whether a token is a security or not, attention should be given to the fact that it is a *substance over form* analysis that will prevail. If a token has features commonly found in securities, such as dividend rights, rights to future profits, political rights such as voting rights,

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[6] FINMA, Roundtable on ICOs, March 2018

[7] Note that on 19 June 2018, Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (commonly referred to as AMLD V) was published in the Official Journal of the European Union (OJ L 156, 19.6.2018, p. 43–74). It contains the following definition of virtual currencies: "*virtual currencies" means a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically.*

[8] FINMA, Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), 16 February 2018

or rights to claims in bankruptcy as a creditor, then it is likely it will be deemed a security. Units of collective investment schemes are also securities, even if they are tokenised.

Under Luxembourg law, there is no single definition of a security. Under Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MiFID II)[9], securities (*valeurs mobilières*) are defined as classes of securities which are negotiable on the capital markets (with the exception of instruments of payment) such as:

(i) shares in companies and all other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
(ii) bonds or other forms of securitised debt, including depositary receipts in respect of such securities; and
(iii) any other securities giving the right to acquire or sell any such securities or giving rise to a cash settlement determined by reference to securities, a currency, an interest rate or yield, commodities or other indices or measurements.

Luxembourg courts and legal writings, on the other hand, tend to agree that securities have two main features: they are (i) negotiable and (ii) fungible.

FINMA treats asset tokens as securities if the tokens are standardised and suitable for mass standardised trading[10]. As a result, in the absence of a single definition of a security, different elements must be taken into account when issuing an asset token or defining its features or to assess whether a specific token may fall outside this classification. If a token qualifies as a security, the token itself and/or its issuer must comply with the laws and regulations applicable to the issuance of securities.

1.3. Utility tokens

Utility tokens are not treated as securities if their sole purpose is to confer digital access rights to an application or service and if the utility token can be used in this way at the point of issue. Here, the typical feature of securities – that is the connection with the capital markets – is missing since the underlying function is to grant access rights.

Regulators have reclassified a number of tokens as securities, often times because token issuers did not comply with the condition that their utility be available at the point of issue. Several so-called utility tokens were issued to finance the development of the application or service that would only be made available in the future. At the same time the token was marketed as tradable, sometimes as an investment with a promise that it would increase in value in the future.

In a nutshell, if a utility token additionally or only has an investment purpose at the point of issue, it should be treated as a security according to FINMA. If the only purpose of a token is to provide

[9] As implemented into Luxembourg law by the law of 20 May 2018 relating to markets in financial instruments, Journal Officiel du Grand-Duché de Luxembourg, Mémorial A, N° 446, 30 May 2018
[10] FINMA, Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), 16 February 2018

digital access to an application or service by means of a blockchain-based infrastructure, then they can be considered as falling outside securities law.

Finally, token classifications are not mutually exclusive and tokens can be hybrid, such as a utility token or an asset token. In other words, they can be a payment token at the same time. So-called pre-sales of tokens, which entitle holders to acquire other tokens at a later date, are also another permutation of tokens.

Assessments by regulators tend to vary. In the United-States, the U.S. Commodity Futures Trading Commission (**CFTC**) regulates virtual currencies and considered that they are commodities[11]. In Luxembourg, the CSSF acknowledged in the ICO Warning that there is a lack of specific regulations applying to ICOs and declared that it will not hesitate to review token sales by extending the analysis to the objectives pursued to determine whether there has been an intention to circumvent applicable laws, in particular the prospectus law or the financial sector regulations. FINMA has the same approach and clarified that it will base its assessment on the underlying economic purpose of an ICO, especially when there are indications of an attempt to circumvent regulation.

Furthermore, the ICO Warning provides that the CSSF will not hesitate to assess fundraising activities. In the VC Warning, the CSSF has invited all persons who carry out activities using virtual currencies and tokens to contact the CSSF beforehand to determine whether the intended transaction is permitted under the current legal framework and if it requires any specific license of authorisation from the CSSF.

In any case, to avoid any unwanted consequences, drawing up an offer document, in addition to a whitepaper, to fully disclose possible risks and set out investor protections (in a way that is comparable to that required by regulations relating to securities or regulated financial services activities) is recommended[12].

2. Possible legal issues relating to an ICO.

2.1. Prospectus aspects

If tokens were to be considered as securities, then an ICO would have to comply with the Luxembourg law of 10 July 2005 on prospectuses for securities, as amended (**Prospectus Law**)[13],

[11] CFTC: *An introduction to Virtual Currency*, https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_aivc0218.pdf

[12] Initial coin offerings: innovating in a changing market, Allen & Overy LLP, 10 April 2018, http://www.allenovery.com/SiteCollectionDocuments/Initial Coin Offerings 2018.pdf

[13] Note that Regulation 2017/1129/EU of the European Parliament and of the Council of 14 June 2017, on the prospectus to be published when securities are offered to the public, or admitted to trading on a regulated market, and repealing Directive 2003/71/EC will be fully applicable from 21 July 2019 on and supersede the national prospectus laws such as the Prospectus Law.

including the prohibition provided of any offer of securities made to the public within the territory of the Grand Duchy of Luxembourg without prior publication of a prospectus compliant with the Prospectus Law. Whether an ICO can be considered as being made in Luxembourg would need to be determined, *inter alia* in the light of the relevant criteria such as the place of the offer, the place of the public's residence, and the location of the target market.

White papers that are frequently provided in the context of ICOs would likely not meet the requirements for a prospectus, so a separate document would have to be drafted and submitted for approval to the CSSF. However, upon the approval of the prospectus, the issuer of the tokens would benefit from the European passport rules and would thus be able to offer its tokens throughout the European Union.

2.2. Investment funds analysis

The ICO Warning clarifies that direct and indirect investments in virtual currency by Luxembourg UCITS[14], Part II UCIs,[15] and other investment funds with non-professional investors or pension funds are not permitted under the current rules. Investments in tokens as a class of assets could be allowed for Luxembourg funds other than the aforementioned investment vehicles, such as SIFs[16], SICARs[17], RAIFs[18], or unregulated partnerships under the form of common limited partnerships (SCS) or special limited partnerships (SCSp). Note that the SCS and SCSP are both subject to specific rules, such as diversification of assets, investment objectives, investment strategies, or investment policies.

The qualification as "units" in collective investment undertakings could apply where the tokens have similar characteristics to the ordinary shares/units/interests of such entities. In theory, any type of investment fund, whether regulated (Part II UCI, UCITS, SIF SICAR) or unregulated (RAIF or unregulated partnership), could issue shares/units/interests in the form of tokens. However, the compatibility of such issuances with the current Luxembourg UCITS regulatory regime is doubtful and in any event would require a prior consultation with the CSSF. As regards Luxembourg investment funds other than UCITS, an ICO may fall within the scope of the Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers (the AIFMD) (with the potential requirement to appoint an alternative investment fund manager (AIFM) or to obtain a license as AIFM).

2.3. Consumer law aspects

[14] UCITS means undertaking for collective investment in transferable security subject to the 2010 Law
[15] Part II UCI means an undertaking for collective investment subject to part II of the Luxembourg law of 17 December 2010 on UCIs, as amended (2010 Law)
[16] SIF means specialised investment fund subject to the Luxembourg law of 13 February 2007 on SIFs as amended
[17] SICAR means an investment company in risk capital subject to the Luxembourg law of 15 June 2004 on SICARs as amended
[18] RAIF means reserved alternative investment fund subject to the Luxembourg law of 23 July 2016 on RAIFs

Separate legal concerns, applicable to all types of tokens would arise in respect of ICOs opened to the general public and specifically individuals (which is often the case for ICOs), in which case Luxembourg consumer law would apply.

Indeed, the issuer would be subject to the obligation provided under article L. 111-1 of the Luxembourg consumer code (*Code de la Consommation*) (**Consumer Code**) requiring from professionals to clearly inform consumers by making all the necessary information to ascertain the essential characteristics of the service/good offered available to them. In addition, the issuer would be prohibited from using unfair and misleading commercial practices under article L. 122-2 of the Consumer Code, and the purchasers of the tokens would also be protected from any abusive clauses contained in the ICO documentation pursuant to article L. 211-2 of the Consumer Code. If operated via the internet, ICOs could qualify as "distance sales", resulting in the application of the information obligations provided under article L. 222-1 of the Consumer Code to the issuer of the tokens and the right for purchasers to withdraw from the transaction within the legally specified period.

2.4. Licensing aspects

Although the parties involved in an ICO vary, some common key players can be identified, such as the issuer, the token exchange, the manager and the advisor. The possible licensing requirements for each of these participants would depend on the initial qualification to be given to the relevant tokens, particularly from the perspective of the activities that are regulated under the Prospectus Law and the Luxembourg law of 5 April 1993 on the financial sector, as amended.

As regards the issuer, no specific license would be required for the issuer if the tokens are considered securities. If the tokens have similar features to fund shares/units/interests and the vehicle issuing such tokens qualifies as an AIF under the Luxembourg law of 12 July 2013 on AIFMs, as amended, an AIFM will be required.

If the tokens constitute financial instruments, the exchange could meet the criteria for being considered either a multilateral trading facility (**MTF**) or organised trading facility, both of which require a prior authorisation from the CSSF.

A licence of payment service institution under the Luxembourg law of 10 November 2009 on payment services, as amended, may be required if the tokens traded on the exchange function as virtual currencies. If the tokens were considered financial instruments, the ICO manager, may be required to apply for a licence of underwriter or broker, depending on its exact role within the transaction.

More generally, as reminded in the VC Warning, any provision of financial sector services (irrespective of their exact form) requires an authorisation by the Luxembourg Minister of Finance.

2.5. Anti-money laundering and counter-terrorism measures

Because of its intrinsic and technical features, the use of tokens is made through virtual technology and thus via decentralised connections. One cannot exclude the possibility that this technological advance might be used to facilitate fraud/money laundering and/or terrorist financing.

Within the context of the consolidation of the existing regulations with a goal to be more transparent, the CSSF recommends that anti-money laundering and terrorist financing procedures be put in place for any fundraisings pursuant to an ICO (therefore regardless of the type of token issued).

2.6. Tax Aspects – Luxembourg Tax Circular on Virtual Currencies

The Circular issued by the Luxembourg tax authorities in summer 2018 ("the Circular") establishes how virtual currencies will be treated in the Grand Duchy from a tax perspective. [19]The Circular notes that virtual currencies (such as bitcoin) are not considered a currency because they do not have legal tender. Accordingly, for Luxembourg tax purposes, assets and liabilities (as well as income and expenses) that are denominated in a virtual currency should be reported in Euro or in a currency for which the European Central Bank prepares and publishes the exchange rate of the Euro. For corporate taxpayers, Luxembourg corporate income tax, municipal business tax, and net wealth tax should be due on income derived from such cryptocurrencies, which are characterized as intangible assets. For individual taxpayers, income derived from cryptocurrencies will either constitute:

(i) business income; or
(ii) other income,

depending on whether the activity with such cryptocurrencies constitutes a "commercial activity." Individuals also benefit from a *de minimis* threshold in the cases where the income is characterized as "other income." A separate circular was also issued to clarify that transactions on virtual currencies are VAT exempt provided that the virtual currencies have no other purpose than being a means of payment and that they are accepted for that purpose by certain operators.[20]

[19] Circular LIR n ° 14/5 - 99/3 - 99 *bis* / 3 of July 26, 2018.
[20] Circular n ° 787 pf 11 June 2018.