



Cryptocurrency pre-ICO funding – a regulatory overview

Overview^{1,2}

Launching a cryptocurrency typically involves an initial fundraising process followed by a public sale process, by way of initial coin offering or token sale (“ICO”). In addition to providing the means to the issuer to pursue initial development, offset development costs and fund future projects, an ICO allows a large pool of interested parties to buy (and subsequently trade) the new cryptocurrency. Creation of a diversified and sufficiently large pool of cryptocurrency holders is key to creating an interest and market for the newly launched cryptocurrency. However, in order to reach the ICO, pre-ICO fundraising may also be required. This is where proceeds of pre-ICO fundraising will be used to pay for the final development steps and for it to operate successfully on a cryptocurrency exchange. Pre-ICO fundraising should also help ascertain (and generate) interest prior to the ICO.

The UK Financial Conduct Authority (the “FCA”) does not regulate cryptocurrencies in their pure (coin) form³. On 12 September 2017, the FCA issued a warning to the public about investing in ICOs in which it stated that most ICOs will not be regulated by the FCA⁴. This article explains how cryptocurrency generally falls outside the remit of the FCA and considers what, if any, regulatory and legal oversight applies to pre-ICO fundraising.

Cryptocurrency landscape

A cryptocurrency is a digital asset designed to work as a medium of exchange. They use cryptography to secure transactions, to control the creation of additional units and to verify the transfer of assets between users. Cryptocurrencies seek to operate on a decentralised basis, independent of a central bank. The decentralised control of each cryptocurrency works through a blockchain. This is a public transaction database, functioning as a distributed ledger. Generally, cryptocurrencies are designed to gradually decrease production of coins, placing an ultimate cap on the total amount of any given cryptocurrency that will ever be in circulation, mimicking precious metals and rendering certain central bank functions (such as printing more money or fractional reserve banking) impossible.

Cryptocurrencies are used primarily outside existing banking and governmental institutions and are usually exchanged over the internet. Exact numbers are difficult to ascertain, but recently published data suggested that as of December 2017 total market capitalisation of cryptocurrencies exceeded USD 600 billion, with record daily trading volume exceeding USD 500 billion. It is estimated that there are over 1,800 digital currencies in existence, and growing. In spite of the rapidly increasing and volatile nature of the cryptocurrency market, its disruptive effect and decentralised construction render it an attractive proposition for many stakeholders.

Any comments or queries?

James Kaufmann
Legal Director

+44 20 3060 6465

james.kaufmann@rpc.co.uk

1. Whilst every reasonable effort has been taken by the author of this article to ensure that its contents represent an accurate and not misleading portrayal of the applicable legal and regulatory issues considered herein at the date of writing, many of the topics considered in this memorandum (particularly blockchain and cryptocurrency) are subject to current political, regulatory and legal debate, and risk. As such there is much uncertainty in many aspects surrounding the matters discussed. Accordingly, there can be no guarantee that the contents of this article, and any statements set out in it, will not be challenged, corrected, overruled or contradicted in the future by the author or as a result of any external factors.
2. A legal analysis of an ICO itself is beyond the scope of this article.
3. See [here](#), which is a letter from Andrew Bailey, dated 30 January 2018 to Nicky Morgan, Chair of the Parliamentary Treasury Select Committee.
4. See [here](#).

Cryptocurrencies (as the term is generally accepted) do not constitute a “currency” or money in the traditional sense. Units of an issued cryptocurrency may be divided in to two categories – “coins” and “tokens”. Coins are a “pure” form of cryptocurrency, issued and operating on their own native blockchain. Whilst the blockchain on which such a coin has been issued may possess the technology to attach functionality to the coin, thereby giving it a specific utility, the issuer has decided that these coins will only have one utility – to act as stores of value with no other functionality represented or manifested through a variety of dynamic functions. Tokens, however, are a representation of a particular asset or utility. Tokens can represent any assets that are fungible and tradeable, from commodities to loyalty points to other cryptocurrencies. Tokens achieve this frequently through attaching smart contracts⁵ to a coin.

Regulation of cryptocurrencies in the UK

In the UK, individuals and firms need to be authorised and regulated by the FCA if they carry out “regulated activities”. Section 19 of the Financial Services and Markets Act 2000 (“FSMA”) provides that: “no person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is an authorised person or an exempt person”.

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (the “RAO”) sets out what constitute regulated activities under FSMA. The list of investments to which regulated activities may apply is an exhaustive one, and is also set out in the RAO. Cryptocurrency, generally, is not a specified investment listed in the RAO. If cryptocurrency is not an “investment” for these purposes, activities relating to it are unlikely to constitute regulated activities and so will fall outside the general prohibition.

Section 21 of FSMA states “a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity” unless an authorised person has signed-off or approved the content and communication. An invitation or inducement to engage in investment activity is referred to as financial promotion. “Engaging in investment activity” involves entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity, or exercising any rights conferred by a controlled investment to acquire, dispose of, underwrite or convert a controlled investment.

The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529) sets out an exhaustive list of what constitute controlled activities and investments under FSMA. Similarly to regulated activities, cryptocurrency coins are unlikely to fall within any of the controlled investments for these purposes and accordingly communications relating to such coins should not constitute financial promotions.

However, it is possible that a token could fall inside the definition of an investment under English law depending on the nature of the application for which it is intended. For example, a token might be considered a forward contract if it entitled the holder to purchase a particular asset at a particular time in the future at a particular price. Equally, a contract for difference with a cryptocurrency as the underlying would still be subject to the regulatory oversight of the FCA since the determining factor here is the CFD element of the instrument and not the underlying⁶. Accordingly, the nature of a specific cryptocurrency and any utility it may possess will be key to determining whether it is subject to the FCA’s regulatory oversight.

5. A “smart contract” is a computer protocol which allows performance of transactions automatically. They are self-executing, trackable and irreversible contracts, with the terms of the agreement being written in to lines of code.
6. Statement of the FCA “Consumer warning about the risks of investing in cryptocurrency CFDs”, 14 November 2017.

Pre-ICO fundraising

If the relevant coin is not considered an investment or security and if the fundraising is not conducted in a way which attracts financial regulation, pre-ICO fundraising within the UK to UK targets should not be subject to the regulatory aegis of the FCA.

Pre-ICO fundraising involves seeking funding from backers in order to seek to develop and ultimately launch a product. Pre-ICO fundraising can, therefore, be characterised as reward crowdfunding whereby many direct investments in a project are aggregated (crowdfunding) in return for the promise of some type of return on investment (reward)⁷.

The FCA expressly does not regulate reward-based crowdfunding⁸. However, UK consumer protection rules will apply. Such rules impose a duty on the issuer to permit backers to seek a full refund on their investment for up to 14 days after delivery⁹, provided the backer is classified as a “consumer”. A prerequisite to be a consumer is to be an individual¹⁰. Accordingly, any funder in the pre-ICO phase who is a company or other body corporate (rather than a person) will not be considered a consumer and not be entitled to such protections.

In addition, even if no other regulations or regulatory oversight applies, where funds in excess of EUR 10,000 are being received from third parties, anti-money laundering provisions will apply¹¹ and where personal information is being received from third parties, data protection provisions will apply¹².

Conclusion

In conclusion, cryptocurrency (generally) does not currently constitute an investment which would fall under the jurisdiction of the FCA and pre-ICO fundraising should not currently be subject to the oversight or regulation of the FCA. To the extent that funders in the pre-ICO phase are individuals, the provisions of consumer protection rules, anti-money laundering regulations and data protection regime under English law will apply to such activities. However, if no funders in the pre-ICO phase are individuals (but are companies or other body corporates with their own legal personality), consumer protection rules will not apply.

7. European Corporate Governance Institute, “The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts”, John Armour & Luca Enriques, September 2017.
8. Paragraph 2.4 of FCA Consultation Paper 13/13, “The FCA’s regulatory approach to crowdfunding (and similar activities)”, October 2013.
9. The unconditional right to cancel under the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 (the “CCRs”), which implement the EU’s Consumer Rights Directive.
10. Defined in the Consumer Rights Act 2015, “a consumer is an individual acting for purposes which are wholly or mainly outside that individual’s trade, business, craft or profession”. Under this definition, a legal person, such as a company or a limited liability partnership, cannot be a consumer.
11. The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017.
12. The EU General Data Protection Regulation (GDPR) will apply from 25 May 2018, when it supersedes the UK Data Protection Act 1998.

About RPC

RPC is a modern, progressive and commercially focused City law firm. We have 83 partners and over 600 employees based in London, Hong Kong, Singapore and Bristol.

“... the client-centred modern City legal services business.”

At RPC we put our clients and our people at the heart of what we do:

- Best Legal Adviser status every year since 2009
- Best Legal Employer status every year since 2009
- Shortlisted for Law Firm of the Year for two consecutive years
- Top 30 Most Innovative Law Firms in Europe

We have also been shortlisted and won a number of industry awards, including:

- Winner – Overall Best Legal Adviser – Legal Week Best Legal Adviser 2016-17
- Winner – Law Firm of the Year – The British Legal Awards 2015
- Winner – Competition and Regulatory Team of the Year – The British Legal Awards 2015
- Winner – Law Firm of the Year – The Lawyer Awards 2014
- Winner – Law Firm of the Year – Halsbury Legal Awards 2014
- Winner – Commercial Team of the Year – The British Legal Awards 2014
- Winner – Competition Team of the Year – Legal Business Awards 2014

Areas of expertise

- | | | |
|------------------------------|---------------------------|------------------------------|
| • Competition | • Employment | • Projects & Outsourcing |
| • Construction & Engineering | • Finance | • Real Estate |
| • Corporate/M&A/ECM/PE/Funds | • Insurance & Reinsurance | • Regulatory |
| • Corporate Insurance | • IP | • Restructuring & Insolvency |
| • Dispute Resolution | • Media | • Tax |
| | • Pensions | • Technology |
| | • Professional Negligence | |

