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Blockchain, Cryptocurrencies and ICOs: An Offshore Lawyer's Perspective

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Chris Page and Peter Ch'ng of Conyers Dill & Pearman Hong Kong discuss the brave new world of blockchain, cryptocurrencies and ICOs: the opportunities and challenges they present, and the benefits of establishing issuers offshore.

What is an ICO?

CP: We're all familiar with initial public offerings (IPOs) of shares by listed companies – well an initial coin offering is just another corporate finance fund raising tool, but with a twist. We live in an age where technology enables direct interfaces, and traditional forms of middlemen are being phased out: think of Uber or Airbnb, where consumers and suppliers deal with one another directly online. ICOs have provided blockchain entrepreneurs with a means to raise funds, not by traditional routes, but directly online; instead of selling shares or securities, ICO issuers offer digital "coins" or "tokens".

PC: It's no wonder that lawyers and regulators are equating ICOs and IPOs; many jurisdictions are still grappling with distinguishing the concepts of "coins" and "securities". The way things are heading, as the market morphs from a free-for-all to become more tightly regulated, there might soon be little distinction between the two.

How do digital coins or tokens work?

CP: A coin or token is an intangible, digital unit that has certain rights attached to it within the platform or blockchain project set up by the issuer. Some have certain inherent value or utility, and most of them can also be traded on a digital exchange at a market value that goes up and down. Often the proceeds of the ICO are used to fund the development of a platform related to a start-up blockchain venture and the coin is used to participate in the underlying product or service offered on the platform. Purchasers of the coins on the secondary market are betting on the popularity of the platform.

PC: Imagine gaming tokens issued by an amusement park, which you can use to pay for rides and food within the park. Now imagine that the tokens are limited in numbers but can be traded with anybody. Now let the walls and fences fall away and replace that with a virtual world with no geographical confines where tokens are accepted everywhere, you might get a sense of the infinite possibilities of a tokenized world.

What are cryptocurrencies?

CP: A cryptocurrency is a unique form of coin that is intended to be used as digital currency. Bitcoin was the first, created in 2009. It is basically money that is an alternative to sovereign currency accepted as a medium of exchange by an increasing number of establishments – you can use Bitcoin to subscribe and pay for your Netflix subscription, for example. People also use Bitcoin to buy tokens issued in ICOs.

PC: Ether is another well-known cryptocurrency, generated by Ethereum, which is the world's leading smart-contract blockchain platform. It allows users to create smart contract applications for a variety of commercial purposes which traditionally require middlemen or intermediate verification. For example, if you want to buy a vintage camera online from a seller in another country, Bitcoin doesn't solve the trust issue: if you send your Bitcoin before receiving delivery of the camera, you are risking your Bitcoins. Ethereum allows the condition of delivery to be written into the payment. In the

Ethereum-based platform, both buyer and seller can see that money (in the form of Ether) has been paid into the e-wallet where it is held in escrow pending electronic acknowledgment of the parcel delivery by the courier, when the money will be released. So both the buyer and seller are comfortable parting with their Ether and the camera.

Where does blockchain fit in?

CP: Blockchain is the technology that underpins ICOs and cryptocurrencies. It is basically a digital database or ledger for transactions that can be easily accessed, managed and updated. It is also tamper-proof and can replace middlemen and back-office functions by ensuring data incorruptibility.

PC: Conventional databases are centralized; there is a single central authority that keeps a master-copy and any changes to the database can only be made on the master-copy. However, blockchain is de-centralized and importantly, is "distributed", meaning that every participating computer or server in the blockchain network holds a complete copy of the database. Any user can amend or update the database but it only takes effect if the data input is verified by other users. Any false data or any attempt to alter the historical record of the chain of transactions will not pass verification by the users and will be automatically rejected.

Blockchain technology enables "smart contracts"– these are self-enforcing pieces of blockchain software (a bit like "apps" on your mobile) that allow creators to define and impose conditions that will execute multiple online transactions in myriad industries, such as splitting royalty payments for downloaded songs on music streaming services. Another example would be the filing of insurance claims with an insurer who is part of a private blockchain consortium with other insurers, where blockchain technology can instantaneously identify fraudulent double claims without sacrificing client privacy.

Why are ICOs so popular?

CP: ICOs are simply an easy way for a company or business to raise money. It's a less rigorous alternative to getting a bank loan or a venture capitalist investor to give you funding, and you don't need to give up ownership or operational control of your company to outside investors. The whole world becomes your potential investor pool. In the age of crowdfunding or crowd sales, this is an entirely logical development. It's certainly the mindset of the young and brave FinTech entrepreneur.

PC: Coinbase raised US$100m in 2017 through venture capital funding five years after it was founded. Contrast this with the Filecoin ICO, which on the day that the Coinbase funding was announced, raised over US$200m within the first hour of its launch.

According to CoinSchedule there were over 40 ICOs in 2016 raising around US$95 million and over 200 ICOs the following year raising around US$3.8 billion. Through the end of July 2018 there have been around 700 ICOs raising US$17.5 billion. The largest was EOS, which concluded its yearlong token sale in June 2018 having raised US$4.1 billion. These numbers speak for themselves. However it must be recognized that there is a high failure rate and research has estimated that the survival rate for start-ups after 120 days is only around 44%.

The top five sectors for ICOs are communications, finance, trading & investing, governance, and gaming & virtual reality. These are the low hanging fruit, but it is logical that in time blockchain 'consultants' will turn their minds to other sectors e.g. healthcare, insurance, data storage, energy and others – so the potential of fundraising through ICOs is vast.

What's the typical process for setting up an ICO?

CP: An entrepreneur with a business idea using blockchain technology needs to raise funds to cover operating costs, rent, programmer salaries and the developmental costs of the platform. As the founder, he starts by forming a company to be the token issuer/developer, creates a website and issues a "White Paper". This is a document describing the technology of his blockchain project, with a detailed description of the system architecture and its interaction with users, current market data and growth anticipations, and requirements for the issue and use of the tokens. In addition, it should include a list of project team members, investors and advisors.

PC: Without a competently drafted white paper it would be difficult for a project team to perform a successful ICO: few people would be willing to invest in a project lacking proper information. We have been sent many White Papers and it usually doesn't take long to weed out weaker ICOs from a quick review of this and the related website; basic decipherability can often be a good test!

What's the best way to structure an ICO?

CP: While some tech entrepreneurs might consider all they need is a laptop and a website to issue tokens, I would advise such founders to think about ring-fencing their personal exposure and liabilities by setting up a limited liability company to issue tokens, maybe even separating the token issuer, the developer and the holder of intellectual property rights into different companies. From a business standpoint, valuable intellectual property rights and patents should be registered to a corporate vehicle to encapsulate the ownership rights and contributions and responsibilities of the respective founders, so that shareholders' agreements can be prepared and different shares and stock option incentives awarded to their programmers. A sensible corporate structure will better regulate the interests of the various stakeholders, facilitate corporate funding and prepare it for acquisition or IPO once they achieve success.

PC: Some founders might also consider setting up a foundation company or even an offshore orphan or bankruptcy-remote structure, where the relevant companies are owned by a commercial purpose trust. You can also set up a separate Cayman STAR trust to hold the ICO proceeds and have the developer named as a beneficiary - the Cayman trust deed will regulate the use of the ICO proceeds and could appoint a board of trustees to enforce the terms of the trust or to audit the trust.

What kind of legal challenges do ICOs present?

PC: AML/CTF is the first issue. It's very difficult to perform KYC on the ICO buyers; even more so on the secondary market – all the issuer may see is an electronic address and perhaps the source of funds coming from the electronic wallet. Few jurisdictions have regulations around this at present, so it is a grey area. An AML policy is definitely recommended and even mandated in some countries, but it is not easy to determine what standard to adopt, or how it can be implemented in practice.

CP: Another big question is whether or not a token issued by an ICO is deemed to be a 'security' as currently defined in the laws of most jurisdictions. Typically, regulators recognize a rough distinction between utility tokens and equity tokens. Utility tokens are tokens which enable you to take part in a service or experience on the issuer's platform: think of tokens to play video games in a virtual arcade or air miles accrued for redemption in an airline program. These would generally not be regulated as a securities offering, especially where business is already in operation when the offering is made. However, tokens that entitle the holder to a share of the business or profits, especially where platform has yet to be built, may be problematic.

PC: This uncertainty has led to very different approaches. China and South Korea have both banned ICOs and certain cryptocurrencies for now, while Singapore, Taiwan and Hong Kong are trying to develop legal frameworks around them. Japan has embraced cryptocurrencies and amended their banking laws to recognise them as a method of payment.

The US SEC has indicated that it could have the authority to apply federal securities law to ICOs. I would advise anyone to read the DAO Report issued by the US SEC in July 2017. It analysed an ICO by a virtual organisation called the DAO and found the tokens were in fact securities under US law. The analysis in the report is insightful and regulators around the world are taking many of their cues from it. In June 2018, Jay Clayton, Chairman of the SEC stated in a CNBC interview that he considers tokens that act as digital assets to be securities.

What are the benefits of establishing an ICO issuer offshore?

PC: Many ICOs favour the use of offshore corporate vehicles as the token issuer – Bermuda, the Cayman Islands and the BVI have each seen their fair share of ICOs. Basically, tech entrepreneurs go offshore for same reasons that international businesses go offshore: it offers a tax neutral platform for international cross-border transactions. Any pooling of capital in an offshore financial centre will not levy additional tax to the venture by that fact alone, and whether the company or their owners will incur tax in the jurisdictions in which they reside or operate is driven by their own activities and business plans. That's what's meant by tax neutrality.

CP: Just as important, offshore centres offer flexible, business-friendly regimes and are well regulated, transparent and exhibit a high degree of corporate governance. Bermuda, BVI and the Cayman Islands are all UK self-governing territories with sophisticated legal systems, and their commercial courts run on English common law with a final appeal to the UK Privy Council. These jurisdictions have experienced professional advisory and support service personnel - international business is the most important pillar of their economies and they are eager to accommodate.

How do different offshore jurisdictions view ICOs?

CP: Our offshore jurisdictions are all open for business when it comes to ICOs, but they are taking different approaches. Cayman and BVI have adopted a "wait and see" approach, while Bermuda is being much more proactive with a declared intention of becoming a leading global blockchain and ICO centre. It has amended its Companies Act to define and regulate "digital assets", which includes all categories of digital coins and tokens which are being issued as ICOs. Before an ICO can take place, the issuer must be approved by a FinTech Advisory Committee and produce an offering document (likely to consist of the issuer's whitepaper), which includes the type of disclosure and information that you would be familiar with from a more traditional securities offering circular.

Bermuda has also recently passed the Digital Asset Business Act (DABA), which is concerned with regulating virtual currencies and digital asset/currency exchanges. The DABA licensing regime consists of two classes: a full virtual currency licence and a sandbox licence, which is designed to allow for novelty start-ups looking to test new products or services for a defined period of time under the supervision of the Bermuda Monetary Authority.

PC: Cayman and BVI have not, as yet, taken the same route as Bermuda to introduce specific legislation to regulate these activities as, presumably, their governments are of the view that their existing laws and regulations are sufficient to address ICOs. We are not advocating one approach over the other - they simply reflect different philosophies. The important thing is to appreciate that these jurisdictions provide a range of options. Which one a client chooses will simply reflect the type of business they wish to engage in and their appetite for regulation.

ICOs, cryptocurrencies, blockchain… is this a temporary bubble or do these innovations offer real, long-term business opportunities?

CP: That's the question we've been asking ourselves for the last year or so. There has been a gold rush mentality and to some extent it feels like the early days of the dot.com era; however, it has calmed down a bit after the frenzy of enquiries we received in 2017. Blockchain technology offers real innovation, driving efficiencies in markets and has the ability to disrupt traditional business sectors. Whilst logistical, regulatory and other challenges exist, with careful selection there are some very real opportunities.

PC: Blockchain is an exciting, new technology that is here to stay and will have lots of applications, not just for digital currencies, but for smart contracts and many other purposes. ICOs and cryptocurrencies will likely become more regulated - much to the chagrin of the early pioneers who envisioned a free market, unhindered by the tenets of traditional business and economies. Once the smoke clears and the concerns around the possibilities of fraud and other AML issues become better controlled, the survivors could offer serious opportunities in a legitimate, re-minted growth space.

How is this space likely to evolve?

CP: Given the potential of blockchain technology and the opportunities that this offers for entrepreneurs, I don't see ICOs as being a passing phase – already they are becoming mainstream. However, as regulators get to grips with this area, the days of seeing an ICO as a way of raising quick, easy money are numbered as issuers become more aware of the potential consequences of falling foul of the securities regimes in various jurisdictions.

Beyond acting as ICO issuers, we have seen offshore vehicles being used as holding vehicles, whether for IP interests or operating subsidiaries; as joint venture vehicles, so that founders can organize their affairs and bring in more traditional types of funding, be it debt or equity. In addition, we are getting more enquires about setting up funds so investors can pool their interests which can then be invested by a manager with expertise in identifying potential winners amongst the ICO offerings and tokens being offered on the secondary market.

PC: This is such an incredibly fast changing space that legislation and lawyers will forever be playing catch-up to the tech innovators. For our part, we believe that our offshore jurisdictions will continue to do what they have always done, which is to work with referring lawyers, advisers and business experts to provide business friendly, appropriately regulated, tax neutral structures that allow people to get on with their business.

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