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China Shuts Down ICO Market

For the past few months, issuers of token sales or "initial coin offerings" (ICOs) have known that they were, to some extent, sailing in unchartered waters. Those waters have just gotten a bit murkier with an announcement by Chinese regulators that token sales are "an unauthorized and illegal public financing activity, which involves financial crimes such as the illegal distribution of financial tokens, the illegal issuance of securities and illegal fundraising, financial fraud and pyramid scheme." This pronouncement, which we outline in further detail below, effectively shuts down the ICO market in China for at least the short term.

What Are ICOs?

ICOs have become an increasingly popular way for startups in the blockchain space to raise capital. According to CB Insights, these offerings have so far raised over $1.6 billion in 2017 alone. This capital is raised through the sale of "tokens," a form of cryptocurrency that typically runs on the Ethereum blockchain. Indeed, Ethereum created a protocol, ERC-20, that standardized these tokens. The key question that has been hanging over the ICO market is how these tokens should be classified. A number of ICOs have taken the position that the buyer is simply purchasing a token that will, in the future, be needed to access the blockchain platform or application that the startup will be building with the proceeds from the ICO. These ICOs have typically been launched with a white paper describing the venture and opened the token sale to all buyers. In reality, however, certain of these "access" token sales seemed very much like the sale of a security, since the white paper or other promotional materials touted the investment potential of the token and the possibility that the tokens would appreciate in value, allowing the buyer to sell their token at a substantial profit. A few more recent ICOs have acknowledged this classification and have instead launched ICOs as a sale of securities, limiting, for example, U.S. sales to accredited investors.

Last month, the Securities and Exchange Commission (SEC) provided some much needed guidance in this market when it released a Section 21(a) Report of Investigation on its findings regarding the token sale by The DAO in May 2016. In finding that The DAO had improperly offered and sold securities, the SEC categorized DAO tokens under the "investment contract" test initially adopted by the Supreme Court in *SEC v. W.J. Howey Co.*, where the Court defined "investment contract" as a contract, transaction or scheme in which (1) a person invests money in a common enterprise; (2) with a reasonable expectation of profits; (3) to be derived from the entrepreneurial or managerial efforts of others. Although many ICOs would ostensibly meet this definition, the SEC did not go so far as to categorize all tokens as securities and therefore subject all ICO issuers and the related exchanges to the applicable registration requirements. Instead, it noted that the determination depends on the particular facts, circumstances and economic realities of the transaction.

Canadian regulators have taken a similar approach. A staff notice on "Cryptocurrency Offerings" from the Canada Securities Administrators (CSA) issued at the end of August stated, "[W]e have in many instances found that the coins/tokens in question constitute securities for the purposes of securities laws, including because they are investment contracts." The UK's Financial Conduct Authority also announced that it was looking closely at ICOs, on September 6.

Pronouncement by Chinese Regulators

Some assumed that the SEC investigative report, although reigning in the somewhat free-wheeling ICO market, would introduce a period of relative stability to this space by providing some formal guidance on how ICOs would be analyzed under U.S. law. These hopes for stability were dashed when a group of Chinese financial regulators, including the People's Bank of China, the Ministry of Industry and Information Technology, the China Banking Regulatory Commission and the China Securities Regulatory Commission announced on September 4 that token sales in China constituted "unauthorized and illegal public financing activity," and that all token sales must cease. China also directed any entity or individual who had already completed a token sale to make appropriate arrangements to protect its investors' rights, including refunding crypto assets. In its pronouncement, the Chinese regulators defined token sales very broadly as "a process where fundraisers distribute digital tokens to investors who make financial contributions in the form of cryptocurrencies such as bitcoin and ether."

With respect to enforcement, the regulators directed Chinese law enforcement representatives to investigate and severely punish those who refuse to halt token sales in China as well as those whose completed sales violate Chinese law or regulation.

The pronouncement also extended to token exchanges operating in China. Such exchanges are a critical component of the ICO ecosystem, since they provide a platform for token liquidity. Although the SEC has not yet brought an action against such exchanges in the U.S., it made clear in its investigative report that exchanges that trade tokens that can be characterized as securities should be registered or avail themselves of a valid exemption. China took a more direct view, stating that — effective immediately — no exchange can: (1) offer exchange services between fiat currency and tokens or between cryptocurrencies and tokens; or (2) act as a central party facilitating the trading of tokens for cryptocurrencies. Exchanges that violate these prohibitions will have their websites shut down and their mobile applications shut down and delisted from app stores. The State Administration for Industry and Commerce can also void the exchange's business license.

In order to further cut off the ICO market in China, financial institutions and nonbanking payment institutions are prohibited from operating any businesses that deal with token sales, including by providing account opening, registration, trading, clearing and settlement services, or insurance for tokens and cryptocurrencies.

In conclusion, Chinese regulators noted that token sales present numerous risks, such as the offering of fraudulent assets and the potential for failure of the business for which the token sale is raising money. They cautioned the public to be vigilant against any financing activity using a "coin," and to report violations to the authorities.

Analysis

After the release of the investigative report on The DAO, many asserted that the impact on the global ICO market would be negligible given the prominence of the Chinese market in this space. Indeed, according to a report from the National Internet Finance Association of China, during the first half of 2017, 65 China-based ICOs raised approximately $400 million. With China requiring, at least for the time being, the shutdown of all token sales in China, the future of the ICO market is unknown. As opposed to the SEC approach, which provided a regulatory framework under which legitimate ICOs could proceed, China has opted simply to shut down the entire market. Whether it provides a regulatory framework under which certain ICOs could proceed in China remains to be seen.

One reason that China might remain opposed to the ICO market is that the blockchain ventures these token sales finance are decentralized offerings that the state cannot control. Because China may not be able to control the adoption of blockchain solutions, it may feel that prohibiting or controlling how capital is raised for these ventures is essential.

It is noteworthy that shortly after the China pronouncement, Hong Kong regulators issued a statement that was more in line with the cautionary view of the SEC than the outright China ban. The Hong Kong Securities and Futures Commission (SFC) stated that "depending on the facts and circumstances of an ICO, digital tokens that are offered or sold may be 'securities' as defined in the Securities and Futures Ordinance, and accordingly subject to the securities laws of Hong Kong."

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