



## DIGITAL TOKENS

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# The Singaporean perspective on initial coin and digital token offerings

In its ruling on 25 July 2017, the United States Securities Exchange Commission ('SEC') stated that US securities laws may apply to offers, sales, and trading of interests in virtual organisations and applied the test set out in *SEC v. W.J. Howey Co.* (the 'Howey Test') to determine whether a digital token issued by a virtual organisation named The DAO constituted a security under US securities laws (it found that it did) (the 'SEC Ruling'). On 1 August 2017, in the wake of a recent surge in the number of initial coin (or digital token) offerings ('ICOs') held out of Singapore as a means of raising funds, the Monetary Authority of Singapore ('MAS') followed the example of the SEC by making an announcement (the 'MAS Announcement') on its position with respect to digital tokens and offerings thereof in Singapore, as Jeffrey Maddox, Ben Witherall and Nicholas Dimitriou of Jones Day, explain.

The MAS Announcement made the following points explicitly clear:

- As with many jurisdictions around the world, the MAS does not regulate virtual currencies;
- Digital tokens are not, by virtue of their digital, decentralised or cryptographically secured nature (or otherwise) excluded from being able to fall within the definition of a 'security' under the Securities and Futures Act (Cap. 289) ('SFA');
- Where a digital token or type of digital token falls within the SFA's definition of a 'security,' issuers of such digital tokens ('Tokenised Securities') would, unless exempted, be required to lodge and register a prospectus with the MAS prior to the offer of such Tokenised Securities;
- Issuers and intermediaries of such Tokenised Securities would, unless exempted, also be required to be licensed under the

SFA and the Financial Advisers Act (Cap. 110) ('FAA'); and

- Any platform facilitating secondary trading of such Tokenised Securities would have to be a MAS approved exchange or a MAS recognised market operator.

A Consumer Advisory on Investment Schemes Involving Digital Tokens from the MAS and the Commercial Affairs Department ('CAD') followed the MAS Announcement highlighting what the MAS and the CAD see as inherent risks in investments into digital tokens and provided guidance as to what they consider to be a responsible approach to such investments.

Despite the risks involved, ICO participants have collectively invested close to \$2 billion through ICOs up to August 2017. With exponential growth in interest (including from mainstream companies) in virtual

(or crypto) currencies, blockchain technology and ICOs, consideration is required as to the interplay between innovation, the inherent risks of schemes involving digital tokens and the current regulatory landscape in Singapore.

### What is an ICO?

Simply put, an ICO is a fundraising method used by a project, venture or decentralised application (or 'dApp') whereby digital tokens are issued to ICO participants typically in exchange for other digital tokens such as bitcoin or Ethereum's ether. ICOs are comparable to both initial public offerings on a stock exchange and crowdfunding initiatives in that they raise funds from the public, albeit that in ICOs, investors receive digital tokens as opposed to equity shares or rewards.

### What are digital tokens?

In the MAS Announcement, the MAS broadly described digital tokens

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as “a cryptographically-secured representation of a tokenholder’s rights to receive a benefit or to perform specified functions.”

From a technological standpoint, as the MAS acknowledged, “the function of digital tokens has evolved beyond just being a virtual currency” and digital tokens can therefore be categorised into certain types that have differing functions and utilities.

#### *Virtual currencies*

A virtual currency can be broadly defined as a cryptographically secured digital currency built on a decentralised peer-to-peer network. While blockchain based virtual currencies may each have their own different characteristics, as described by the MAS in the MAS Announcement, they all “typically [function] as a medium of exchange, a unit of account or a store of value.”

#### *Protocol tokens*

The term ‘protocol,’ in the context of blockchain technology, typically refers to the set of ‘cryptoeconomic’ rules used to maintain consensus across an individual blockchain (or peer-to-peer network). There is generally one native token per protocol with the primary purpose of such tokens being to facilitate participation in the activities of the network in respect of which they have been issued, for example mining or voting on development.

#### *Application tokens (or AppCoins)*

Decentralised applications usually do not require a native token to function and instead draw value from charging (via the sale and purchase of a scarce access-token (an AppCoin)) for access or use of the protocols. An AppCoin can resemble a type of ‘digital share,’ sold to investors in exchange for a portion of future profits, where the payout is governed by either a ‘smart contract’ or a legally binding written agreement (or both).

#### *Asset backed tokens*

Asset backed tokens are digital tokens that actually represent some or all of an underlying asset, essentially acting as a cryptographically secured IOU for the underlying asset. Some asset based tokens are designed to be permanently pegged to and are 1-to-1 backed by a traditional currency, while others are backed by a minimum

amount of the underlying asset (e.g. gold), but are designed with the intention of increasing in value over time.

Notwithstanding the different characteristics described above, digital tokens can possess a number of different utilities depending on the user. Taking the native token used on the Ethereum network, Ether, as an example, for those that actually execute smart contracts on the Ethereum network, Ether’s utility is primarily that of a virtual currency and/or a protocol token as it is used as ‘gas’ to execute a smart contract. Conversely, there are those that purchase Ether but do not intend on actually using the Ethereum network, instead speculating on future appreciation in value. In this regard, ownership of Ether could be seen as ownership of a stake in the total number of Ether tokens issued on the Ethereum blockchain, resembling traditional share ownership in a company, for example.

#### **Are digital tokens securities?**

From a regulatory and legal standpoint, the key determination for digital tokens appears to be whether or not such token’s characteristics and utility cause it to fall within the definition of ‘securities’ in the SFA.

The MAS Announcement did not provide detailed guidance on the application of the definition of ‘securities’ under the SFA to digital tokens, other than to state that (i) if the use of a digital token relates to ownership of, or a security interest over, an issuer’s assets or property, it could be considered to be an offer of shares or units in a collective investment scheme under the SFA, or (ii) if a digital token represents a debt owed by an issuer, it may be considered a debenture under the SFA, in each case being ‘securities’ for the purposes of the SFA.

Therefore, while it appears that the MAS is following the stance taken by the SEC (the application of the Howey Test), the MAS has stopped short of considering any specific ICO or digital token, or the characteristics thereof, to confirm whether or not it constitutes a ‘security’ under the SFA.

Unlike the Howey Test, which takes a subjective ‘case-by-case’ approach to determining whether or not something is a security, the definition of ‘securities’

under the SFA refers to traditional common law forms of security interests (such as debentures, shares, collective investment schemes and business trusts). A digital token, therefore, would need to fall within the definition of an existing type of ‘security’ like a debenture or a share. Determining this may be difficult where a digital token has certain characteristics, for example as one of a limited number of tokens that together form the value of an enterprise (appearing to be more like a security), and at the same time usable only to purchase services in such enterprise and not exchangeable for ‘fiat currencies’ e.g. USD or SGD.

In the SEC Ruling, the SEC stated that any digital token that passes the Howey Test would be considered as a security, and this has therefore provided a starting point for those intending to deal in digital tokens from which to assess their legal standing.

Conversely, the MAS’ approach leaves those who have previously conducted or participated in ICOs or facilitated secondary digital token markets (or those contemplating any such activity) without guidance or any detailed indications of any potential safe harbours. It also (and perhaps more importantly) provides the MAS with sufficient flexibility to both consider industry practices as they develop and determine how digital tokens should be treated on a case-by-case basis, pending any regulatory changes that the MAS considers appropriate to deal with digital token issuances.

#### **Consequences of being a ‘security’; what exceptions might apply**

If a digital token does fall within the definition of ‘security’ under the SFA, unless applicable exemptions apply, any offer of such digital tokens would be required to be accompanied by a prospectus lodged and registered with the MAS, with the issuer and/or intermediaries of such digital tokens subject to licensing requirements under the SFA and the FAA, as a holder of a capital markets services licence and/or a financial adviser’s licence.

The SFA provides a number of exemptions from the prospectus requirements, most of which appear unsuited to ICO practices (for example,



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small offers under SGD 5 million within a 12 month period or offers made to fewer than 50 persons within any 12 month period). Perhaps the exemption more likely to be available would be for offers made to 'accredited investors,' whereby digital tokens could be offered to investors fulfilling the requirements of the foregoing definition in the SFA (primarily by reference to income (currently SGD 300,000 or more in the preceding 12 months) and net worth (currently in excess of SGD 2,000,000) thresholds), accompanied by an information memorandum purporting to describe the digital tokens being offered and the enterprise involved, that is prepared to assist accredited investors in making an investment decision in respect of the digital tokens being offered.

Any such offering purporting to be exempt by virtue of only being to 'accredited investors' and therefore SFA 'compliant,' would however need to (a) provide for safeguards to ensure that investors satisfy the requisite requirements of the definition of 'accredited investor,' (b) be undertaken by a suitably licensed or exempt issuer or intermediary, and (c) restrict offers and sales into jurisdictions where such offers and sales would fall foul of local securities laws (for example, offerings into the United States).

In the US, a number of issuers are purporting to undertake 'compliant' ICOs. FileCoin, a cryptocurrency issued to power a proposed decentralised storage network, has undertaken an ICO on CoinList, a platform designed to host US securities law-compliant ICOs through the use of a 'Simple Agreement for Future Tokens.' Only accredited investors were able to participate in the FileCoin ICO (which raised a record aggregate amount of more than US\$250 million), with CoinList (through its founder partner AngelList) undertaking investor Know Your Customer ('KYC') checks to ensure compliance with required income and net worth thresholds under applicable securities laws.

While this has not been confirmed as compliant by the SEC, an SEC approved digital token 'security' or ICO process would represent a potential safeguard for issuers and investors to participate in this market without falling outside of applicable regulatory regimes.

If the SEC provides guidance on such a platform, it may be that the MAS follows suit to legitimise 'compliant' ICOs as a new fundraising tool for issuers.

Notwithstanding whether analysis has been undertaken as to whether an issuer's digital tokens represent 'securities' under the SFA or not, issuers

on many recent ICOs have attempted to steer clear of the application of securities laws by expressly stating that the digital tokens being offered are not and should not be treated as a form of security. It has not yet been addressed whether such express statement will exonerate such issuers from the application of securities laws or whether the MAS will instead look at the actual utility of each individual digital token to an investor to make a determination.

### Conclusion

The vast majority of ICOs up until now have typically involved fundraising for blockchain related technology in which the concept of ownership or profit sharing, for example, and therefore the 'security' nature of tokens, is not always clear. However, with increasing interest globally, it is possible that ICOs may become a prominent method of raising funds for issuers in any type of industry. Accordingly, it has become increasingly apparent that regulatory bodies around the world, including the MAS, will need to understand the implications of digital token offerings under existing regulatory regimes, and adapt such regulatory regimes quickly enough to ensure that adequate protections exist for investors and ICO participants, while simultaneously supporting innovation in a sector with significant potential to shape future economics and finance.