

UK Regulator Examines Scope of Securities Laws, Warns of Initial Coin Offering Risks

IN SHORT

The Situation: The UK Financial Conduct Authority has released a statement on initial coin offerings. It focuses the circumstances in which an ICO might fall within the scope of the FCA's current regulatory boundaries as well as the potential risks to consumers of participating in ICOs.

The Result: The FCA has confirmed that many ICOs will fall outside the scope of current UK financial services regulation. However, where the ICO structure has parallels with initial public offerings, private placement of securities or similar investment structures, the businesses involved may be carrying out regulated activities or may need to be authorised by the FCA. The FCA also has warned of the potential risks to consumers.

Looking Ahead: Those involved in ICOs connected to the United Kingdom should focus on the FCA's guidance on structure and interaction with current UK regulation. A further update on distributed ledger technology is expected from the FCA at the end of 2017, and this may have a further impact on ICOs.

The UK Financial Conduct Authority's ("FCA") announcement is one of a number of country regulator statements in 2017 following a global increase in initial coin (or digital token) offerings ("ICOs") as a means of raising funds for new tech ventures. See our recent *Commentaries*, "[SEC's Investigative Report Raises Difficult Questions for ICO Issuers](#)" and "[Announcement Clarifies Regulatory Position on Digital Token Offerings in Singapore](#)".

The FCA describes an ICO as a digital way of raising funds from the public using a virtual currency, which is exchanged for a proprietary "coin" or "token" that is related to a specific firm or project investment opportunity. The announcement notes that ICOs vary widely in design and that often ICO projects are in a very early stage of development.

Are ICOs Regulated by the FCA?

The FCA has indicated that whether an ICO should be treated as regulated can be decided only on a case-by-case basis, having analysed the particular ICO structure against the current UK regulatory regime. The announcement acknowledges that ICOs can fall outside the scope of regulation in the United Kingdom; indeed, "many ICOs will fall outside the regulated space".

The FCA's guidance is that where an ICO structure has parallels with initial public offerings, private placement of securities or similar investment structures, the businesses involved may be carrying out regulated activities or may need to be authorised by the FCA. This could include digital currency exchanges, if they facilitate the exchange of tokens as part of an ICO.



ICO investments are aimed at experienced investors with a good knowledge of the underlying project who can afford to put their entire investment at risk.



The FCA notes that certain types of ICO may also fall within the United Kingdom's Prospectus Rules. Broadly, these rules require a formal prospectus to be published for any offer of transferable securities to the public, unless an exemption applies. We note that the ongoing introduction of the new European Prospectus Regulation—due to come fully into force in 2019—may have an impact on this analysis.

The FCA statement warns those involved in ICOs connected to the United Kingdom to consider carefully what activities they are undertaking, and particularly whether they are arranging, dealing, promoting or advising on regulated financial investments.

Impact on Consumers

The FCA also focuses on the risks of investing in ICOs for consumers, emphasising that ICO investments are aimed at experienced investors with a good knowledge of the underlying project who can afford to put their entire investment at risk. It identifies six key consumer risks:

- **Unregulated space:** Most ICOs are not regulated by the FCA, and many are based overseas.
- **No investor protection:** Consumers are extremely unlikely to have access to UK regulatory protections like the Financial Services Compensation Scheme or the Financial Ombudsman Service.
- **Price volatility:** Like cryptocurrencies in general, the value of a token may be extremely volatile and vulnerable to dramatic changes.
- **Potential for fraud:** Some issuers might not have the intention to use the funds raised in the way set out when the project was marketed.
- **Inadequate documentation:** Instead of a regulated prospectus, ICOs usually only provide a "white paper". An ICO white paper might be unbalanced, incomplete or misleading. A sophisticated technical understanding is needed to fully understand the tokens' characteristics and risks.
- **Early-stage projects:** Typically ICO projects are in a very early stage of development and their business models are experimental. There is a good chance of consumers losing their whole stake.

The FCA's approach to ICOs is consistent with two of its key statutory objectives, ensuring that relevant markets function well and that consumers are protected. At the same time, the FCA has a strong track record in promoting fintech in the interests of consumers, including developing proportionate regulatory regimes which promote innovation in the United Kingdom, such as its peer-to-peer consumer lending regime.

The FCA has not indicated that it considers any changes to existing regulation are necessary to either protect consumers or ensure that regulated activities (including by way of ICO) are carried out in an appropriate way. However, it is still considering the responses to its April 2017 discussion paper on distributed ledger technology, and a further publication is expected from the FCA at the end of 2017.

TWO KEY TAKEAWAYS

1. Those involved in ICOs connected to the United Kingdom should consider their proposed structure carefully and assess whether any aspect can be said to parallel an existing regulated activity in the United Kingdom, such as the issue of securities to the public.
2. Look out for the FCA's further publication on distributed ledger technology which the FCA has confirmed they will seek to publish at the end of 2017.

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