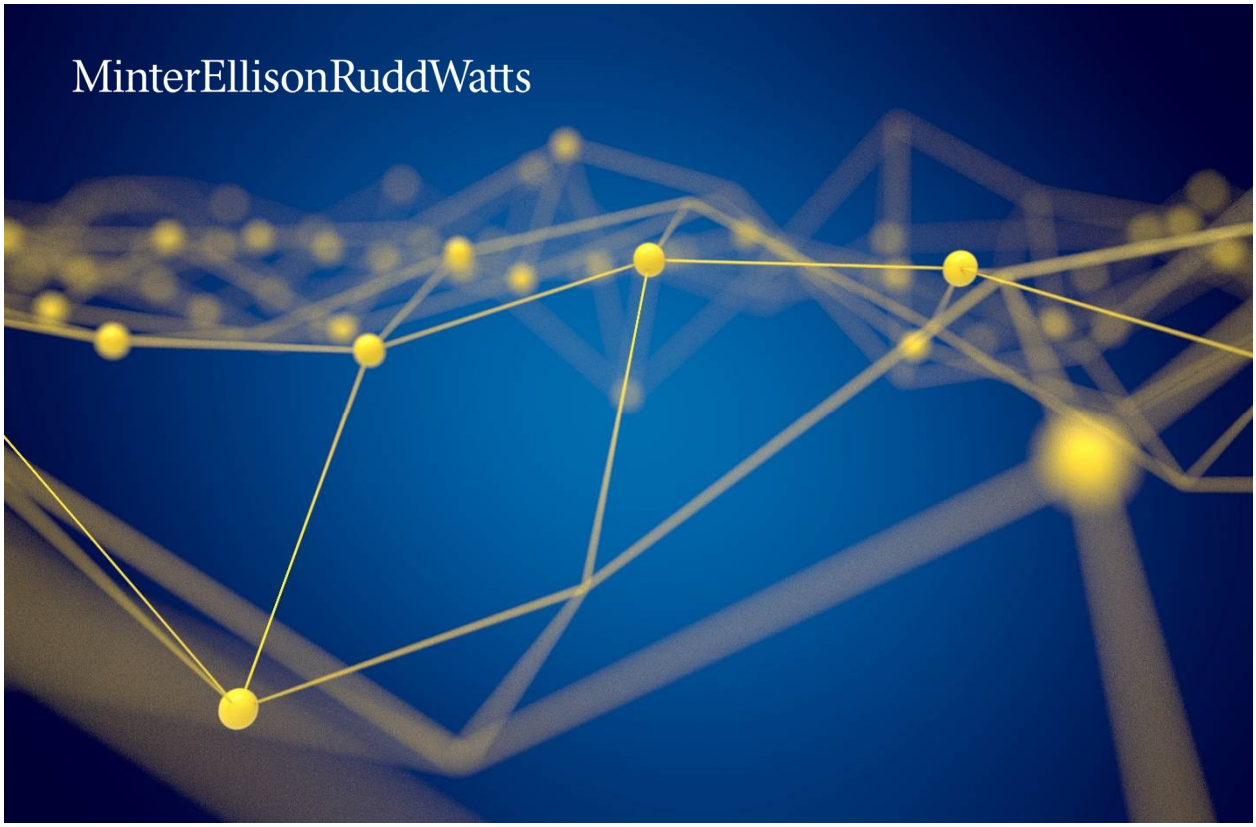

Tokens of our affection: An introduction to ICOs and digital tokens under New Zealand law

Authored by Jeremy Muir (Partner), Andrew Suggate (Senior Associate) and Jemimah Giblett (Solicitor) at MinterEllisonRuddWatts

Key points

- ICOs, or offers of digital tokens, have become big business. Consequently, regulators worldwide are taking a keen interest in them.
- It is critically important to those dealing with tokens in New Zealand to understand how the law will apply to them, but the regulatory treatment of ICOs is currently uncertain.
- To assist, in this article we break tokens down into **4 classes**: user tokens, asset backed tokens, intrinsic tokens and enterprise tokens and assess how New Zealand securities law will apply to these classes.
- The answers to the question in this paper are not just relevant to ICOs, but are critical considerations for financial services businesses as we move towards a fully digital future.

Introduction

Recently the trickle of capital raisings through Initial Coin Offerings (**ICOs**), or offers of digital tokens, has become a torrent. This year alone ICOs have raised staggering amounts e.g. Bancor (c.$153 million) and Tezos (c.$232 million). Some estimates place the total amount raised through ICOs to date in 2017 at over US$2 billion.[1] Not surprisingly, we have seen a surge of interest in New Zealand.

However, the status of these offers under securities law, both in New Zealand and overseas, is uncertain. Overseas, we have seen the US[2], UK[3], Singaporean[4], Malaysian[5], Hong Kong[6], Chinese[7] and Canadian[8] regulators express their view that certain classes of tokens may be securities, and therefore certain ICOs may be subject to securities law.

Of these, the Chinese authorities have gone the furthest, declaring ICOs illegal and requiring issuers to repay investors. No New Zealand regulator has published guidance on this issue, and their treatment under our securities legislation remains generally unclear. Likewise, the Australian regulators are yet to express their views.

Market comment in New Zealand makes the obvious point that some tokens may be financial products, depending on their terms.

This article goes further by providing a framework for participants in ICOs to consider in deciding whether New Zealand securities law may apply. We have done this by classifying tokens into **four broad classes** based on their terms, and then categorising these classes against the current New Zealand securities law framework.

Each individual token must be assessed on its particular terms. If you are unsure of the treatment of particular token, our experts are here to help.

What is an ICO?

ICOs take their name from, and share some common characteristics with, initial public offers (**IPOs**) of shares in a company. Like an IPO, an ICO is generally conducted through an offer that is open for a set amount of time, made to raise funds to finance a business, enterprise or project. However, rather than offering shares in a company, an ICO consists of an offer of digital tokens, sometimes called coins, to raise funds for a project - which can be anything from a new web browser[9] to creating a gaming platform.[10] ICOs are not necessarily conducted by a company (or even a legal entity), but can be carried out by a person, an unincorporated body or even a decentralised autonomous organisation.[11]

What is a digital token?

Participants in an ICO receive digital tokens (or “coins”), rather than shares in a company or units in a fund. A digital token is an intangible asset, representing a bundle of rights (and possibly liabilities) stored on and transferred through a distributed ledger (e.g. a blockchain).

The terms of a token are limited only by the imagination of the token’s creator, and are generally set out in the software code governing the token, as well as disclosed in offer documentation (often a relatively short white paper published on the Internet). A person controls or “owns” a token by having the ability to re-assign ownership to someone else. Tokens are therefore generally transferable on a secondary market.

How can we classify tokens?

Tokens can offer a range of benefits to holders, not all of which are financial. When characterised by the benefits they confer, most tokens arguably fit within one of the following four classes (although depending on its terms a token could include elements of more than one class):

- A **User Token** provides the holder with a right to access a new product or service that has been, or will be, created. For example, Brave's Basic Attention Token[12] or Golem Network Tokens.[13]

- An **Asset Backed Token** is the right to an underlying asset (such as a piece of land or gold) whereby the distributed ledger is used as a record of ownership. For example, the PTOs created for ATLANT[14] or OneGram's coin.[15]

- An **Enterprise Token** provides the holder with an ownership interest in a project, or an entity carrying out a project, which may include voting rights, and/or where the holder will be entitled to a financial return from the project/entity. For example, the DAO.[16]

- An **Intrinsic Token's** value is intrinsic because it is not backed by any asset and does not provide a right to access a new product or service, nor does it promise any return. Its value is dependent solely on what someone else will pay for it. Intrinsic Tokens include cryptocurrencies such as Bitcoin and Litecoin.

Other classifications have been developed, and there is room to develop this further.

Are ICOs regulated under New Zealand securities laws?

The principal piece of legislation that governs offers of securities within New Zealand is the Financial Markets Conduct Act 2013 (**FMC Act**). The offering provisions in the FMC Act apply to offers of "financial products", defined to mean:[17]

- **debt securities**;
- **equity securities**;
- **managed investment products**; and
- **derivatives**.

In addition, there is also a broad definition of "security" that covers other financial arrangements (this definition is discussed in more detail below). Securities are not themselves regulated. But the New Zealand securities regulator, the Financial Markets Authority (**FMA**), has the power to declare that a security is a financial product (although not retrospectively) and from that point the financial product is under the regime.

Under the FMC Act, the four types of financial product follow a hierarchy, from debt security at the top down to derivative. Each successive definition excludes things that are financial products under any of the preceding definitions. For example, if a token fell within both the definition of debt security and managed investment product because it exhibited elements of each token class, under the FMC Act it would be a debt security. See ***Summary of token classes vs financial product types*** below, for our thoughts on how to classify different types of tokens.

If a token offered through an ICO is a financial product, and the offer is received by a person in New Zealand, the FMC Act may apply. If the offer can be accepted by retail investors, this will mean that prescribed requirements will apply in respect of disclosure, governance, licensing and financial reporting obligations. These are onerous as the regimes have been designed from a consumer protection perspective, focussing on the requirements of prudent by non-expert retail customers.

If the offer is limited to certain types of qualifying (e.g. wholesale) investors only, obligations will be more basic, on the policy assumption the investors are more sophisticated and able to protect their own interests.

What about cross-border token offers?

Securities laws are inherently jurisdictional and many countries follow the same principles as New Zealand law i.e. they will apply their securities laws where an offer of securities/financial products is received and/or can be accepted by persons in that country. Some jurisdictions, e.g. the United States, seek to apply their laws extra-territorially, for example if an investor is a citizen or entitled to permanent residence wherever in the world they may receive the offer.

Therefore, in relation to ICOs, it is important to consider not only the jurisdiction where the issuer is located or creates the digital framework for the offer, but also each jurisdiction where the offer is open for investors. It may be necessary to explicitly exclude citizens or residents of some jurisdictions.

As more countries move to regulate token offers, we are starting to see offers which are limited to certain jurisdictions (or which exclude certain jurisdictions) and/or offers which are only open to qualifying investors in each country.

Summary of token classes vs financial products types

Back in New Zealand, the following table summarises our thinking as to how different classes of tokens can be classified under the FMC Act, with a tick meaning *likely*, a "P" meaning *possibly* and a cross meaning *unlikely*. Do not regard these as definitive as they will depend on the terms of each token.

We explore these further below.

	Intrinsic Token	Asset Backed Token	User Token	Enterprise Token
Debt Security	P	X	X	P
Equity Security	X	X	X	P
Managed Investment Product	X	P	P	✓
Derivative	X	P	P	P
Security	✓	✓	✓	✓

What terms of a token will make it a debt security?

A debt security means a right to be repaid money or paid interest on money that is, or is to be, deposited with, lent to, or otherwise owing by, any person.[18] Debt securities explicitly include debentures, bonds, notes, convertible notes and redeemable shares.

Central to whether a token is a debt security is whether "money" is given or received in respect of the token, and that it is repaid at some point. Case law in respect of the definition of debt security, under the previous Securities Act 1978, determined that "money" was a broad concept.[19] However, the definition of money under that legislation included "money's worth" (i.e. something valuable that isn't money).

Money's worth is expressly excluded from the FMC Act definition of money, as it relates to debt securities. This deliberate drafting change indicates that "money", in respect of debt securities, should be read more narrowly under the FMC Act. Money itself if not defined, but in the ordinary parlance it can mean a medium of exchange or store of value. It may include cash, sums standing to credit in a bank account or possibly even sums invested in securities. This narrower definition suggests that, in respect of the definition of debt security under the FMC Act, money would not include a token.

Where a token holder has not paid fiat (Government or central bank issued) currency, or had fiat currency contributed on their behalf, for a token, it is unlikely the token will be a debt security. An example may be where the token holder has paid by way of another token. In this case, because a token will likely not be "money" (see our discussion above), there will be no debt security.

Usually, User and Asset Backed Tokens do not give the holder a right to be repaid money, or to be paid interest on the contribution given to acquire the token. This means they are unlikely to be debt securities.

The same is typically the case for Intrinsic Tokens. However, in some cases an Intrinsic Token could be backed by a fiat currency or another token. An example of this could be a token that is pegged to the value of a fiat currency and whose terms promise the holder repayment of fiat currency upon request.[20] In this case, the token could be a debt security.

Similarly, an Enterprise Token, paid for in fiat currency, that promised repayment of and/or interest on the fiat currency contributed to acquire the token, will likely be a debt security. Interest is not defined in the FMC Act and it is possible that the Courts could consider this to be a wider concept than a monetary interest (for example, to include other consideration such as tokens). Issuers of Enterprise Tokens with any such terms will need to consider carefully whether the token could be characterised as a debt security.

What terms of a token will make it an equity security?

An equity security means a share in one of a company, an industrial and provident society or a building society, but does not include a debt security.[21] A share is issued by an entity by entering the name of the shareholder on the entity's share register, which will not typically be the case for tokens (note that a blockchain-based share register, would still be a share register for the purposes of the legislation). It is therefore unlikely that any tokens will be "shares" and therefore not equity securities.

An exception to this would be an Enterprise Token that gives the holder an option to acquire, by way of issue, an equity security.[22] We are not aware of any such tokens having been issued.

What terms of a token will make it a managed investment product?

A managed investment product means an interest in a "managed investment scheme" but does not include an equity security or a debt security. A "managed investment scheme" means a scheme to which each of the following applies:[23]

- the purpose or effect of the scheme is to enable persons taking part in the scheme to contribute money, or to have money contributed on their behalf, to the scheme as consideration to acquire interests in the scheme; and
- those interests are rights to participate in, or receive, financial benefits produced principally by the efforts of another person under the scheme (whether those rights are actual, prospective, or contingent, and whether they are enforceable or not); and
- the holders of those interests do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).

The first limb of the definition requires the contribution of money. Unlike in the definition of debt security, for managed investment schemes "money" is defined to include "money's worth". Case law under the previous Securities Act 1978 defined "money's worth" broadly, including a contractual commitment to purchase apartments.[24] Therefore, it is possible that the Courts may consider almost any valuable consideration, including other tokens, as "money" for the purpose of the managed investment scheme definition. Where this consideration is provided in exchange for tokens, it will likely be provided "to acquire interests in the scheme".

The second limb requires there to be a right to participate in, or receive, "financial benefits". "Financial benefits" means capital, earnings or other financial returns. Due to this limited definition of "financial benefits", in our view there should be a financial or monetary element to the benefit. Where tokens are purchased as financial investments, i.e. in the expectation of receiving something of financial value in return such as fiat currency or a valuable token, then it is likely that this element will be met.

Where there are financial benefits, these must be produced principally by the efforts of another "person". Attributing an issuance of a token to a "person" can be complicated as tokens can be issued by an entity, a group of associated persons or even a decentralised autonomous organisation.

This issue was considered in the recent Securities and Exchange Commission (**SEC**) report on its paper on the DAO, where the SEC found that the creators of the DAO could constitute a person for the purposes of US securities law.[25] "Person" is defined inclusively under the FMC Act and includes any entity, which in turn includes an unincorporated body. Given this broad definition, it seems likely that New Zealand law would similarly recognise the creators of decentralised autonomous organisations as "persons" under the FMC Act.

Token holders will generally not have day-to-day control over the operations of the enterprise as required by the third limb of the definition. For example, even if a token gives voting rights (e.g. as was the case for the DAO), this would not be considered to be day-to-day control.

User Tokens, Asset Backed Tokens and Intrinsic Tokens are unlikely to be managed investment products as it is not likely there will be a financial benefit provided principally by the efforts of another person. For User Tokens, it is unlikely that the user rights will be financial benefits (although this should be tested against the facts in each case). Amongst other reasons, Asset Backed Tokens and Intrinsic Tokens are unlikely to be financial products because there is no enterprise being managed by the token issuer that produces a financial benefit. Further, for Asset Backed Tokens with rights to require the delivery of property, previous case law indicates these would not be financial products.[26]

In contrast, many Enterprise Tokens will be managed investment products. The efforts of the creators and operators of the relevant enterprise/project will be engaged towards providing a financial return to token holders, who will have no day-to-day control over the enterprise. However, for certainty on this point the particular terms of an Enterprise Token will need to be reviewed.

What terms of a token will make it a derivative?

"Derivative" is defined comprehensively in the FMC Act. Essentially, for a derivative to exist there must be an agreement which requires a party to provide consideration at a future time and the consideration must be determined by reference to the amount of something else (for example, an asset, a rate, an index or a commodity). Derivatives do not include an agreement for the future provision of services or a debt security, equity security or a managed investment product.

The value of an Intrinsic Token does not typically change by reference to something else. Typically, Asset Backed Tokens will not include an agreement for the provision of consideration at a future time.

User Tokens will also not usually be derivatives, because:

- where a User Token gives the holder access to services, it will likely be an agreement for the future provision of services, and therefore excluded from the definition of derivative; and
- where a User Token gives the holder access to products, neither the amount of product (consideration) provided nor the value of the token are determined, derived from, or varied by reference to, the value or amount of something else.

Typically, Enterprise Tokens would not be derivatives because they do not provide for variable future consideration. However, this will need to be assessed against the terms of each Enterprise Token. For example, an Enterprise Token could provide for payment of royalties that vary depending upon the value of the project at a point in time. Provided that this token is not a managed investment product (which is higher in the FMC Act definitional hierarchy) then it could be a derivative.

Are tokens captured by the residual category of securities?

Under the FMC Act a "security" is an arrangement or a facility that has, or is intended to have, the effect of a person making an investment or managing a financial risk, and includes:

- a financial product;
- any interest or right to participate in any capital, assets, earnings, royalties or other property of any person;
- any interest in, or right to be paid, money that is, or is to be, deposited with, lent to, or otherwise owing by, any person (whether or not the interest or right is secured by charge over any property); and
- any renewal or variation of the terms and conditions of any existing security; but
- does not include any interest or right declared by regulations not to be a security for the purposes of the FMC Act (no tokens have yet been declared not to be securities).

Given the broad definition of security it is likely that **any of the four token classes** could, depending on their terms, fit within the definition. For example, a User Token could give the holder an interest or right to participate in the assets of a person. More broadly, tokens are clearly being marketed as an investment.

The effect of a token being a security is that the FMA can designate a particular security to be a financial product, which would bring that type of security within the requirements of the FMC Act (as discussed below).

What are the consequences of a token being a financial product?

If a person carries out an ICO of a token that is a financial product, and that token is offered to retail investors in New Zealand, the issuer must comply with the relatively onerous requirements for "regulated offers" in the FMC Act. These include, among a number of others:

- disclosure requirements such as providing a product disclosure statement and having in place a register entry on the Disclose website (operated by the Registrar of Financial Service Providers);
- if the token is a debt security or managed investment product, compliance with the governance requirements including appointing an independent supervisor and operating under a trust deed;
- if the token is a managed investment product, a derivative or a certain type of debt security, the need to obtain a licence for the issuer from the FMA or the Reserve Bank of New Zealand; and
- the need to comply with financial reporting requirements, that include registering publicly available audited accounts.

There are many difficulties in applying the current FMC Act regime to regulated token issues. For example:

- Tokens which are managed investment products must have an independent supervisor that must hold legal title to the tokens. However, it is uncertain whether supervisors are in a position to supervise token issuers effectively, or to hold title to tokens.
- Offers of tokens to retail investors will require a product disclosure statement, the contents of which are highly prescribed in regulations. It is unlikely that token offers could meet these requirements, without exemptions granted by the FMA.
- If a decentralised autonomous organisation is the "entity" issuing the tokens, it is not clear how the governance and financial reporting requirements would apply to the participants in the DAO, and who would obtain the licence required to be granted by the FMA.

If, however, the offer is limited to certain types of qualifying (e.g. wholesale) investors in New Zealand only, obligations will be limited to complying with the fair dealing requirements of Part 2 of the FMC Act (e.g. not to be misleading or deceptive, or make unsubstantiated representations).

What should the Regulator do?

One of the purposes of the FMC Act include the promotion of innovation and flexibility, and the confident and informed participation of businesses, investors and consumers, in the financial markets. We encourage the FMA to issue guidance on the treatment of ICOs and tokens, which will assist market participants to engage with these markets confidently and lawfully. We understand that the FMA is currently developing guidance both for offers and for investors, although this guidance is likely to be fairly limited in scope and detail at this stage.

We also believe that New Zealand (and the FMA) could consider innovative approaches such as:

- creating a new class of licensed intermediary, along with peer-to-peer lending platforms and equity securities, that covers licensed ICO markets. This would require new regulations, but would be a cost effective way to promote ICO regulation; and
- class or specific exemptions from the FMC Act to alter the disclosure, governance and other rules to suit ICOs. These could be limited by value of the offer, number of investors or other appropriate measures.

What else do I need to think about?

Brokers, exchanges and other intermediaries dealing with tokens within New Zealand need to understand whether the tokens they are dealing with are financial products, in order to determine whether they may be caught by other parts of the financial services regime, including:

- the broking rules under the Financial Advisers Act 2008;
- registration under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 and the requirement to be a member of an approved dispute resolution scheme;

- the Anti-Money Laundering and Countering Financing of Terrorism Act 2009; and
- the Non-bank Deposit Takers Act 2013.

Each of these Acts have rules around their territorial application (or are supplemented by guidance). They may apply differently, for example, to an ICO originated offshore but open to investors from New Zealand, versus a new business established in New Zealand to deal in tokens which originate offshore.

Understanding the tax treatment of gains and losses in relation to tokens here and overseas may also require professional advice. Currently, the New Zealand Inland Revenue Department is at an early stage of its consideration of cryptocurrencies such as Bitcoin only, and has not publically commented on their treatment (or in relation to tokens more broadly).

Conclusions

So why is this important? Only a small minority of businesses are likely to consider an ICO (at least for now) and it is still early days for tokens as an investable asset class. It's even possible that new regulation will change the shape and size of this market dramatically in the short term. In our view, however, ICOs represent a new and further step in moving towards a fully digital economy.

What is or is not a financial product? What are the rights of the parties involved? How do we balance investor protection with promoting new investment classes? How do we deal with jurisdictional issues in respect of cross-border investment flows? How do we regulate for new technologies in a way that does not stifle innovation?

We increasingly need to understand the legal issues raised by ICOs, in an environment where all financial services businesses, governments and regulators worldwide grapple with a financial system in which data is rapidly replacing paper.

If you would like to discuss any issues in respect of ICOs, tokens or cryptocurrencies, please contact one of our experts.

Our experts

Lloyd Kavanagh
Chair
+64 9 353 9976
lloyd.kavanagh@minterellison.co.nz

Jeremy Muir
Partner
+64 9 353 9819
jeremy.muir@minterellison.co.nz

Tom Maasland
Partner
+64 9 353 9875
tom.maasland@minterellison.co.nz

Andrew Ryan
Partner
+64 9 353 9950
andrew.ryan@minterellison.co.nz

Andrew Suggate
Senior Associate
+64 9 353 9890
andrew.suggate@minterellison.co.nz

Kara Daly
Chair
+64 4 498 5008
kara.daly@minterellison.co.nz

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[15] https://onegram.org/
[16] https://en.wikipedia.org/wiki/The_DAO_(organization)
[17] FMC Act, section 7.
[18] FMC Act, section 8(1).
[19] *Hickman v Turn and Wave Ltd* [2013] 1 NZLR 741.
[20] For example, if a token such as the Tui were to be launched. Each Tui would be exchangeable for one New Zealand dollar. See https://www.cio.co.nz/article/618961/case-tui-kiwi-cryptocurrency-other-uses-blockchain-technology/
[21] FMC Act, section 8(2).
[22] See FMC Act, section 8(5)(a)(iii).
[23] FMC Act, sections 8(3) and 9.
[24] *Hickman v Turn and Wave*, at [126].
[25] https://www.sec.gov/litigation/investreport/34-81207.pdf
[26] *R v Smith* [1991] 3 NZLR 740