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Initial Coin Offerings in the United Arab Emirates

Background

Against the backdrop of the increasing prominence of cryptocurrencies globally, initial coin offerings or ICOs are becoming commensurately popular as a capital raising method. ICOs, essentially a method of crowdfunding undertaken through the use of blockchain technology, helped reportedly raise US\$4.5 billion in 2017, nearly 20 times more than in 2016. Whilst a common criticism directed towards ICOs has been the lack of regulation, regulators in numerous jurisdictions have thus far been making an effort to communicate guidance to market participants. Moreover, regulators have, in some instances, clarified the application of existing regulation to ICOs, or have expressed an intention to create new or broaden existing regulatory frameworks to apply to ICOs. In particular, a number of regulators (particularly in the US) have begun to seek enforcement against ICOs that do not comply with securities laws, undermining some of the early ICO exuberance that perhaps “utility tokens” would escape regulation as securities. In addition, regulators of exchanges around the world ranging from commodities exchanges to currency exchanges have begun assessing what rules should apply to the trading of coins or tokens, creating additional uncertainty about regulatory status and whether the exchange regulators and securities regulators will come to consistent conclusions about how to treat ICOs.

At the same time that many countries have reacted with a stated or implicit desire to curb ICOs, a number of countries have embraced the potential of blockchain and sought to develop regimes that will address some of the core concerns about ICOs but also foster the appropriate growth of their use.

In this context, we examine the approach taken thus far by relevant authorities in the United Arab Emirates (the UAE) to ICOs.

What is an ICO?

ICOs, also referred to as initial token offerings, initial public coin offerings, token launches and token sales, are a method through which start-ups and other companies can raise capital. In an ICO, investors participating in the offering receive digital tokens (**Tokens**) in exchange for fiat currencies (required to be transferred to an “online wallet” of the issuer) or cryptocurrencies (required to be transferred to one or more designated

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addresses (an online reference for cryptocurrencies similar to an account number)). Tokens can be designed to represent any right that the issuer defines; some tokens are targeted to be “utilities” such as passes to access services, while others represent the holder’s right of benefit or performance with respect to the issuer; for example, pursuant to its terms, a Token could represent the right to a profit or payment upon the issuer achieving certain business milestones (much like the dividend on a security) or a right of use (of, for example, a particular service offered by the issuer or a loyalty rewards program, which is similar to a gift card program). In contrast to shares offered in a traditional initial public offering (**IPO**), Tokens do not typically represent an ownership interest in the issuer.

ICOs are typically launched or announced through cryptocurrency forums, websites or through other online channels, though with increasing securities enforcement public advertising may scale back at least in the near term. Through the relevant channel(s), the issuer will typically provide access online to a whitepaper (the **Whitepaper**) describing the business or project, the key terms of the ICO (i.e. the structure and key features of the Tokens offered, economic terms, subscription details, etc.), and providing information on the status of the project and key team members involved. In addition to the Whitepaper, the ICO documentation may also include a Token purchase agreement, which will set out the terms and conditions applicable to the Tokens. On completion of the ICO, the Tokens will be distributed to the participating investors’ designated addresses or online wallets.

The underlying technology of the Tokens is based on blockchain (an electronic distributed ledger, in which transactions are protocolled in a documented and reproducible way without a central authority) which is maintained by a network of participants and computers. Similar to shares offered in an IPO, Tokens are typically tradable on virtual currency exchanges, creating a secondary Token market.

Regulatory considerations – an international perspective

Bearing in mind that blockchain platforms such as Ethereum operate without borders, for an ICO, and applicable participants, to be in compliance with applicable regulatory requirements, it may be necessary to structure ICOs to be compliant with regulations across multiple jurisdictions.

At the time of writing, the general regulatory theme in most jurisdictions has been that ICOs may fall within the scope of existing regulatory regimes, and that regulators are watching this space closely. In jurisdictions with established regulatory and securities laws such as the United States, the Securities and Exchange Commission has signaled an increasing concern with ICOs, and has taken enforcement action against a number of ICO issuers, stating in a recent case that an ICO was an offering of securities without registration or available exemption, notwithstanding that the relevant Tokens sold in the concerned ICO were designed to have a utility function. Since then, the US SEC has made numerous public comments and brought a series of actions to demonstrate its commitment to applying securities laws to tokens and discounting the utility role of a token that more broadly has the appearance of a utility. In addition, SEC action chills the ability of issuers to promote the expected availability of independent public trading. Thus, while private placements of tokens to wealthy “accredited” investors is possible, the path to broad trading or liquidity is now obscure. In the UK, the Financial Conduct Authority has issued a consumer warning on ICOs, has asked for feedback from market participants on the legal and regulatory risks associated with ICOs and has commented that depending on how they are structured, ICOs may fall within the existing regulatory regime.

ICOs in the United Arab Emirates

UAE (onshore)

In the UAE, there is currently no specific regulation applicable to ICOs, albeit that there are certain licensing requirements which apply where a right in an underlying commodity in which trading does require a license is offered (such as, for example, gold) and certain regulators have issued guidance with respect to ICOs.

There was however some uncertainty regarding the status of virtual currencies when the UAE Central Bank (the **Central Bank**) published a new licensing framework for stored value facilities offering certain in January 2017, which stated “*All Virtual Currencies (and transactions thereof) are prohibited*”. The Central Bank later confirmed that the regulations “do not cover Virtual Currency” and “do not apply to Bitcoin or other cryptocurrencies, currency exchanges, or underlying technology such as blockchain”. It was, however, noted that new regulations will follow, and so it is expected that specific regulation will be issued in this area by the Central Bank in the near future.

On 4 February 2018, the Emirates Securities and Commodities Authority (the **SCA**), which regulates the conduct of securities business in the UAE, for the first time offering guidance related to cryptocurrencies and ICOs. SCA issued a circular highlighting for potential investors certain risks associated “digital, token-based fundraising activities or investment schemes” covering ICOs, token presales and token crowdsales including that:

- Some ICOs are not regulated and thus may be subject to fraud risks;
- ICOs may be issued abroad, and therefore are subject to foreign laws and regulations that can be difficult to verify. Tracking and recovering funds in case of ICO collapse may prove to be extremely difficult in practice;
- ICO trading on the secondary market is subject to opaque, volatile pricing and insufficient liquidity;
- Many investors, especially retail, may not be able to comprehend the risks, costs, and expected returns arising from ICO investments; and
- ICO information made available to investors may be unaudited or incomplete and may present a given investment case in an unbalanced and misleading manner.

The SCA circular reiterated, however, that it does not recognize, regulate, or supervise any ICO presently and that ICO investments are not offered legal or regulatory protection. It said that investors involved in ICO investments are doing so at their own risk.

In November 2016, the Supreme Legislation Committee for the Government of Dubai, in cooperation with the Dubai Electronic Security Center, announced discussions on future legislation related to cryptocurrencies. As a result, specific regulations concerning the Emirate of Dubai could also be issued.

In the absence of specific regulation and official guidance, other than the SCA circular and a statement reportedly made by the Governor of the Central Bank on the high risks to investors and money laundering risks posed by cryptocurrencies, it is difficult to ascertain with any degree of certainty the extent to which ICOs could fall within the scope of the existing regulatory regime in the UAE. For example, it is possible that the Promoting and Arranging Regulations (the **PIRs**), published by SCA on 10 January 2017, apply to the promotion of Tokens in the UAE. Under the PIRs, unless an exemption applies, the promotion of financial products to persons in the UAE requires an SCA licence for which an onshore UAE business presence is required. Whilst exemptions include promoting to institutional

investors, licensed financial institutions and promotions on a reverse solicitation basis, no such exemption exists for retail or high net worth individuals. Furthermore, “financial products” is broadly defined to include securities, commodity contracts, derivatives or structured products.

Dubai International Financial Centre

In the Dubai International Financial Centre, the Dubai Financial Services Authority (**DFSA**) has issued a warning statement to investors that cryptocurrency investments should be treated as high risk. The DFSA also clarified that it does not regulate ICOs and would not license firms undertaking such activities.

Abu Dhabi Global Market

In the Abu Dhabi Global Market (ADGM), the Financial Services Regulatory Authority (**FSRA**) issued guidance in October 2017 on ICOs and cryptocurrencies which clarifies that, whilst ICOs and cryptocurrencies would not be regulated in and of themselves, the FSRA will take a substance over form approach, such that certain components of an ICO may fall within existing regulation, such as operating an exchange, offering securities or units in a fund. The FSRA also confirmed that many aspects of ICOs may not be regulated activities, and urged caution by investors.

On 11 February 2018, FSRA announced that is reviewing and considering the development of a robust, risk-appropriate regulatory framework to regulate and supervise activities of virtual currency exchanges and intermediaries.

Conclusion

Whilst ICOs represent a significant and innovative new frontier for capital raisings, participants should exercise caution. In the UAE, as in many other jurisdictions, whilst no specific ICO regulation is in place, elements of ICOs could certainly fall within the existing regulatory perimeter. As such, a detailed analysis of the regulatory framework is necessary to ensure compliance, particularly in the context of a cross border ICO. Moreover, irrespective of the ICO and Token structure and components, the issuing company should in all circumstances ensure that it provides investors with sufficient and accurate information to enable it to make an informed investment decision.

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