

## Initial Coin Offerings (ICOs) - digital corporate financing on the blockchain

ICOs are increasingly attracting interest as an alternative form of corporate financing. Young (technology) companies raise record amounts in funding. Investors seek high profits. Regulatory authorities point out risks of loss. This article discusses selected regulatory and private law issues arising in the context of ICOs.

### I. Introduction

ICOs are becoming increasingly popular as an innovative form of corporate financing. Even though the term ICOs is similar to an initial public offering (IPO), ICOs differ significantly from raising capital on a stock exchange. Numerous, partly new, legal questions arise. This brief article examines selected regulatory and civil law issues that arise in the context of an ICO. Tax issues are not dealt with in this article.

#### a) Issuance process

The raising of capital and the issue of so-called tokens – in simplified terms – takes place in the following steps:

The company seeking capital issues so-called tokens, which are acquired by the token purchasers or investors in consideration of a predetermined nominal value in fiat or crypto currencies. The tokens embody the token owner's rights in digital form. Tokens can be equipped with different features, which are embedded in a smart contract. Tokens can have an equity-like structure and grant the holder profit-sharing and voting rights (*security token*), assign usage rights to the token holder (*utility token*) or have the character of a means of payment (*currency token*).

The "subscription" of the tokens usually takes place in two or more successive phases; the private sale (also called Pre-ICO) followed by a public sale, which is comparable to a public offer.

#### b) ICO documentation

The company seeking capital presents its entrepreneurial project to be financed in a so-called whitepaper to potential token acquirers. The white paper, which contains explanations of the technology and the respective market as well as information on the issuer, the project team and the advisory board, is comparable to an (non-standardised) information memorandum.

The "Terms of Issuance" are set out in the terms and conditions of an issuance agreement. Token issuance and any trading on trading platforms comparable to secondary markets takes place via blockchain technology.

Numerous other contracts are concluded with transaction participants and service providers.

### II. Regulatory classification and consequences

Under supervisory law, the question often arises as to whether banking business (section 1 para. 1 sentence 1 German Banking Act – "KWG") subject to authorisation, financial services (section 1 para. 1a sentence 1 KWG) or payment services (section 1 para. 1 sentence 2 Payment Services Act – "ZAG") are provided in connection with an ICO. This must be assessed on a case-by-case basis. Payment processing in the context of token issuance might be considered as a payment service.

Furthermore, the question arises whether the preparation of a prospectus according to the Securities Prospectus Act – "WpPG" or the Investment Products Act – "VermAnlG" is required under supervisory law. The nexus for the prospectus requirement under the WpPG is the existence of a security (section 3 para. 1 WpPG). Depending on the structure, the respective token may be a (stock-like) security within the meaning of section 2 No. 1 a WpPG.

If the token is to be qualified as a security and thus as a financial instrument within the meaning of section 2 para. 4 Securities Trading Act – “WpHG”, the organization and conduct of business duties of the WpHG have to be adhered to.

Even if the ICO issuer is domiciled outside Germany, the ICO must (also) be assessed in accordance with German law and may give rise to regulatory obligations if the tokens are also sold on the domestic market, i.e. offered to investors in Germany. The question whether an ICO/token, which is largely unregulated in an EU/EEA home country, is subject to stricter supervisory rules in Germany or whether equal treatment on the basis of the EU passport regime appears to be necessary, is dogmatically interesting and not yet finally clarified.

### **III. Civil Law Issues**

Many civil law issues also arise in connection with ICOs. With regard to the "issuance vehicle", German law does not require a certain legal form. The choice of corporate form is often driven by tax considerations.

The transfer of tokens and their ownership under civil law are also relevant. If the tokens are "backed" with company shares, the fungibility of the shares must be assessed separately (see, for example, section 15 para. 3 Limited Company Act – “GmbHG”).

In case of doubt, the content of the contractual performance promised to the token holder laid down in the white paper shall be determined in accordance with the general principles of interpretation of sections 133, 157 German Civil Code – “BGB”. The whitepaper must be assessed also in the light of the principles of civil prospectus liability if the special prospectus liability regime does not apply. Incorrect information can trigger liability on the part of the initiators and the "backers" of the ICO.

The terms and conditions of an ICO are subject to the content control of (unfair) terms according to sections 305, 307 et seq. BGB. Provisions that are intransparent or severely restrict the rights of the token holder may result in the ineffectiveness of the respective clause. If the contract of issuance contains a choice of law clause stating that foreign law is applicable, mandatory consumer protection provisions of German law remain unaffected (see Article 6 para. 2 of the Rome I Regulation).

In individual cases, it should also be examined whether consumers are entitled to a legal right of withdrawal when purchasing the token.

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