CONSOB approach on Initial Coin Offerings (ICOs): how to make the most out of the status quo when dealing with a new legal issue

ICOs and the relevant legal issues

On the wave of the significant growth of blockchain technology and relevant market awareness of this phenomenon, initial coin offerings (**ICOs**) had a tremendous boost in the last year, proving to be an alternative way of funding for many small entrepreneurial projects.

It is well known that an ICO consists in the offering of a token (or coin) to the public through a digital platform by a company (generally a small enterprise or start-up) in exchange for either traditional currencies or cryptocurrency. The token offered by the company is a digital piece of information registered in a digital public distributed ledger (a blockchain) which, depending on the type of services rendered by the company promoting the ICO, gives certain rights to its owner.

Considering their features, ICOs have immediately posed many legal issues worldwide. Indeed, it is undisputed that this kind of transaction might entail a number of risks for the purchasers of tokens. In particular, in November 2017, the European Securities and Market Authority (**ESMA**) warned investors of the potential risk of losing their money in ICOs, given the highly speculative nature of an investment in tokens, the high volatility of the price of tokens and the high risk of fraud[1].

In this context, one of the most significant challenges for the supervising authorities of the EU Member States has been and continues to be, the answer to the following question: is the traditional EU legal framework granting transparency and symmetry of information to investors applicable to ICOs?

To answer this question, it is necessary to verify whether a token can be legally qualified as a transferable security as defined by Directive 2014/65/EU (**MiFID II**) - i.e. a "*security which is negotiable on the capital market*" - such definition being the cornerstone of the applicability, inter alia, of Directive 2003/71/EC (**Prospectus Directive**) and MiFID II.

Given the different nature of tokens offered in the market, this assessment is not straightforward and the supervising authorities of the EU Member States have adopted slightly different approaches.

The approach of the Italian supervising authority

In 2018, the Italian supervising authority (**CONSOB**), suspended many ICOs carried out in Italy in accordance with the provisions of Legislative Decree no. 58 of 24 February, 1998 (**Italian Consolidated Financial Act**) regarding the offering of securities to the public. In particular, instead of trying to legally qualify tokens as transferable securities, CONSOB chose to use the broader domestic category of "financial product".

Indeed, according to article 1, paragraph 1, letter "u" of the Italian Consolidated Financial Act a "*financial product*" is not only a "*financial instrument*" (a definition including the category of transferable securities) but also "*any other financial investment*".

CONSOB used this category many times in the context of its supervising activity, therefore, creating a consolidated interpretation on this matter. In particular, according to CONSOB, in order for a product or a contractual scheme to be considered a "financial investment", such product or scheme shall have the following three features:

a) require the payment of a sum of money by the investor;

b) entail an expectation of return; and

c) entail a risk directly associated with the payment of the sum of money.

1 Please see https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms

Accordingly, should a token have all of the above features, its offering would be subject to the provisions of article 94 of the Italian Consolidated Financial Act regulating the offer to the public of securities requiring the publication of a prospectus approved by CONSOB. However, the same token would not be considered a transferable security, thus the provisions implementing MiFID II in Italy would not apply. Therefore, the activities carried out in respect of this token (e.g. placing or management) would not be qualified as financial services and the entities carrying out these activities would not need to be investment firms[2].

One of the latest CONSOB resolutions[3] on this topic involved the offering of a token named "token TGA" carried out by Togacoin Ltd. In this case, on its website, the company (i) presented its ICO as a "sure investment" linked to the "Toga project", concerning the "creation of a data centre focused on cryptocurrencies mining", (ii) gave to the users the possibility of calculating their potential return, and (iii) set out the nominal value of a token and the relevant minimum amount of tokens to be purchased in order to participate in the ICO. Considering the above, CONSOB was of the opinion that the contractual scheme embedded in the tokens offered by Togacoin Ltd (i) required the payment of a sum of money, (ii) expressly promised a return on the tokens, and (iii) entailed a financial risk directly associated with the investment of money. Accordingly, the authority qualified the "token TGA" as a financial product pursuant to the Italian Consolidate Financial Act and suspended its offering due to the lack of publication of the relevant approved prospectus.

2 Please note that neither CONSOB nor the other Italian competent authorities expressed a formal position on whether a token could or could not be deemed a transferable security, therefore triggering, inter alia, the application of the MiFID II provisions. It is worth noting that some Italian scholars maintain that – depending on its features – a token could be considered a transferable security thus triggering the application of MiFID II provisions. In addition, some scholars are of the opinion that ICO could be also qualified as a specific type of equity crowdfunding.

3 Please refer to CONSOB resolution no. 20660 of 31 October 2018.

Given the lack of a specific regulation on tokens and the relevant ICO, CONSOB decided to use the above "financial investment" test on a case by case basis in order to prevent at least the offering of products entailing a high degree of risks without proper disclosure. However, this approach does not grant full and certain protection of investors which, as specified above, could not benefit, *inter alia*, from the provision of MiFID II.

Final thoughts

Even though the case by case approach adopted by CONSOB might ensure a certain level of protection during this phase, a legislative intervention of the EU providing for a clear regulation of ICOs seems to be the best way not only to grant effective protection to investors but also to promote this alternative way of funding.

In this respect, it should be noted that in 2018 ESMA conducted a survey assessing the approaches regarding the legal qualification of tokens and ICOs adopted by the supervising authorities of the EU Member States. Following this survey, on 9 January, 2019, ESMA published advice[4] showing that these approaches are different and therefore highlighting the need for general harmonization on this matter.

The hope is that the EU might draft a tailor made regulation which grants legal certainty and protection on the one hand and does not limit the great possibility of alternative funding offered by ICOs on the other hand.

For a discussion of the applicable framework for crypotcurrencies in the United States please see this article from our Summer 2018 Global Insights Brochure: Cryptocurrencies: What is the applicable regulatory framework in the United States?

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4. Please see https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection