



**Gibraltar Finance**

HM Government of Gibraltar

## Token Regulation

Proposals for the regulation of token sales, secondary token market platforms, and investment services relating to tokens

# Introduction

## Purpose of this document

This document explains the background to so-called initial coin offerings (**ICOs**), highlights some of the problems and key issues associated with ICOs, and sets out the proposed regulatory response for Gibraltar.

In December 2017, version 1 of this document was circulated as a discussion paper to members of Gibraltar's Finance Centre Council. Feedback received from FCC and other stakeholders has been incorporated in this revised version. In February 2018, HM Government of Gibraltar announced its intention to proceed with token regulation, as now set out in this policy document.

## Background

An ICO is a means of raising finance by, typically, early stage startups. Most often, ICOs involve the sale of tokens or (virtual) coins created using Distributed Ledger Technology (**DLT**). As with other forms of crowd funding, raising finance by means of an ICO is unregulated in Gibraltar, and in many other jurisdictions. The initial sale of such tokens in the primary market is also undertaken using terms such as token sale, initial token offering, token generating event, and the like.

The use of tokens for crowd financing proliferated during 2017 with, at the time of writing, over \$3.5bn having been raised to date; exceeding the amount raised by traditional venture capital funding during the same period.

In common with governments and regulators around the world, HM Government of Gibraltar (**HMGoG**) and the Gibraltar Financial Services Commission (**GFSC**) have observed the rapidly rising use of ICOs as a means of crowd financing. Since announcement of the DLT regulatory framework in May 2017, Gibraltar has become, and is expected to remain, an attractive jurisdiction from which to conduct unregulated ICOs.

On 22 September 2017, GFSC issued a public statement on ICOs<sup>1</sup> pointing out:

- that new ventures are highly-speculative and risky;
- that early-stage financing is best undertaken by experienced investors; and
- matters that ought to be considered by anyone thinking of investing in tokens.

The statement explained that:

*ICOs are an unregulated means of raising finance in a venture or project, usually at an early-stage and often one whose products and services have not yet been significantly designed, built or tested, let alone made operational or generating revenue. Such forms of crowdfunding are often used by start-ups to bypass the rigorous and regulated capital-raising process required by venture capitalists or financial institutions. In an ICO, tokens are sold to early supporters of a project in exchange for cash or cryptocurrency, such as bitcoin or ether.*

*Tokens vary widely in design and purpose. In some cases, tokens represent securities, such as shares in a company, and their promotion and sale are regulated as such. More often, tokens serve some cryptocurrency or functional use that is unregulated, such as prepayment for access to a product or service that is to be developed using funds raised in the ICO.*

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<sup>1</sup> <http://www.fsc.gi/news/statement-on-initial-coin-offerings-250>

## Defining the problem

### Lack of regulation

Unless structured as a security (e.g. with an equity interest or right to distributions of, say, profits or in the event of winding up) or as a debt instrument, tokens do not constitute any form of regulated financial instrument, either in Gibraltar or, generally, elsewhere in the EU. Consequently, they (and their sale) are unregulated.

Tokens have proved popular as a means of participating in early-stage ventures and projects. There are risks to the general public and to inexperienced investors, in particular, in subscribing for unregulated crowd financing instruments. Such risks are heightened where underlying products and services have yet to be built, tested and deployed, or market demand established.

### Definition of security

Most often, tokens do not qualify as securities under Gibraltar or EU legislation. In many cases, they represent the advance sale of products that entitle holders to access future networks or consume future services. They are akin to mobile phone companies pre-selling airtime in networks they plan to build using the proceeds of those airtime sales. As such, these tokens represent commercial products (albeit reliant on future availability and utility) and are not caught by existing securities regulation in Gibraltar.

Tokens are sometimes created with the characteristics of a virtual currency, serving principally as a medium of exchange within an ecosystem (or marketplace) of consumers and service providers. In some cases (e.g. where a centralised virtual currency is involved), the organiser of the DLT system may fall within scope of the DLT Regulations<sup>2</sup> but the token sale, secondary market conduct and investment services relating to tokens remain unregulated.

The driver for purchasing tokens in an ICO is typically the expectation of making a return by selling them at a profit once the project is successfully completed and its products or services become popular and in demand. This is similar to early acquisition and holding of commodities with a view to trading them later at a higher price.

### Tokens: distinct from underlying object

Tokens are digital representations of something else, whether tangible or intangible. As such, they are distinct from any underlying object. Much like derivatives, trading tokens is not necessarily the same activity as trading its underlying asset (where one exists). So, for example, sale of a token representing a physical asset is not the same as selling that physical asset.

## Proposed regulatory response

New legislation is proposed to regulate the following activities conducted in or from Gibraltar:

- the promotion, sale and distribution of tokens;
- operating secondary market platforms trading in tokens; and
- providing investment and ancillary services relating to tokens.

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<sup>2</sup> Financial Services (Distributed Ledger Technology Providers) Regulations 2017, <http://gibraltarlaws.gov.gi/articles/2017s204.pdf>

# Goals

Desired outcomes are to protect customers, to protect Gibraltar's reputation, and to support the safe use of token-based crowd financing.

## Protect consumers

Token-based crowd financing exposes the public to both unscrupulous and naïve entrepreneurs. Similarly, there are market conduct risks to users of secondary market platforms used for trading tokens. Those being offered investment and ancillary services relating to tokens also run the risk of poor professional or conduct standards.

It is therefore desirable to establish a regulatory regime that mitigates such risks and provides appropriate and adequate safeguards by:

- requiring full and accurate disclosure of information;
- imposing rules for the orderly and proper conduct of secondary market platforms; and
- requiring competent professional investment services.

## Protect Gibraltar's reputation

Gibraltar is committed to being a safe and sound place in which to do business. It is therefore desirable to provide regulatory certainty and establish a regulatory regime that mitigates the risk of fraud and financial crime, and protects Gibraltar's reputation and integrity.

## Support the safe use of tokens as a means of crowd financing

Well-funded businesses help Gibraltar's economic development. Raising finance is vital to every business, especially to startups and small and medium-sized enterprises. Crowd financing is a perfectly legitimate method of raising finance as is seeking public subscription for new ventures. It is therefore desirable to establish a regulatory regime that helps firms in Gibraltar to develop new products and services and maintain competitiveness whilst, at the same time, protecting consumers and Gibraltar's reputation.

# Proposals

## Outline and scope

It is proposed that new legislation will regulate the following activities conducted in or from Gibraltar:

- the promotion, sale and distribution of tokens;
- the operation of secondary market platforms trading in tokens; and
- the provision of investment and ancillary services relating to tokens.

It is proposed that GFSC will regulate:

- authorised sponsors of public token offerings;
- secondary token market operators; and
- token investment and ancillary service providers.

It will not regulate:

- technology;
- tokens, smart contracts or their functioning;
- individual public token offerings; or
- persons involved in the promotion, sale and distribution of tokens.

It is also proposed to make undertakings that receive proceeds from the sale of tokens subject to anti-money laundering (**AML**) and countering financing of terrorism (**CFT**) legislation, and to designate GFSC as their relevant supervisory authority for AML/CFT purposes.

The provisions of the Financial Services (Distributed Ledger Technology Providers) Regulations 2017 (**DLT Regulations**) will, where applicable, still apply to firms caught by the new token regulations.

## Promotion, sale and distribution of tokens to the public

### Public offering of tokens

The public offering of tokens that constitute securities are already adequately caught by existing securities legislation and do not require further regulation.

The public offering of tokens that are not securities and that do not constitute outright gifts or donations are, typically, offers of commercial products and services (which, at the time of sale, may or may not yet exist). Such tokens are sometimes referred to as utility or access tokens and the like. In circumstances where a token constitutes a product or service that does not yet exist (or is not, at the time of sale, substantially functional), it represents, in effect, no more than a hope or ambition to deliver that product or service in the future. In such cases, purchasers risk that the product or service might never be delivered and often waive any right to the return of the price paid. Purchasers may well be prepared to take that risk but it is appropriate that they be presented, in advance, with all relevant information to enable them to make an informed decision.

The first limb of the proposed token regulations is intended to regulate primary market promotion, sale and distribution of tokens, that are neither securities nor outright gifts or donation, conducted in or from Gibraltar. Tokens that function solely as decentralised virtual currency<sup>3</sup> (e.g. Bitcoin) or as central bank-issued digital currency will be excluded from this limb of the regulations. However, it is possible for tokens to have an underlying economic function that is both virtual currency and something else. Such hybrid tokens will be caught by this limb of the regulations.

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<sup>3</sup> *Virtual Currencies: Key Definitions and Potential AML/CFT Risks*, Financial Action Task Force, June 2014, <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>

## In or from Gibraltar

The first limb of the regulations will apply to activities carried out in or from Gibraltar and are intended to include activities:

- which purport to be or imply that they are made from Gibraltar;
- are intended to come to the attention of or be accessed by any person in Gibraltar;
- are conducted by overseas subsidiaries of Gibraltar-registered legal persons (in such cases, the Gibraltar person will be liable); or
- are conducted by overseas agents and proxies acting on behalf of Gibraltar-registered legal persons, or on behalf of natural persons ordinarily resident in Gibraltar (in such cases, the Gibraltar person will be liable).

## Disclosure rules

The proposed regulations on the promotion, sale and distribution of tokens will require adequate, accurate and balanced disclosure of information to enable anyone considering purchasing tokens in the primary market to make an informed decision. The regulations may prescribe what, as a minimum, constitutes adequate disclosure, and in what form disclosures are made (e.g. in a key facts document not exceeding 2 pages). From time to time, guidance on disclosure rules may be published by GFSC.

## Financial crime provisions

Undertakings that receive, whether on their own account or on behalf of another person, proceeds in any form from the sale of tokens will be brought into scope of the Proceeds of Crimes Act 2015 (**POCA**) and will need to comply with its AML and CFT provisions. GFSC will be their AML/CFT supervisor. These changes will be implemented by a separate Regulation and notification under POCA.

## Authorised sponsors

The proposed regulations will establish a regime for the authorisation and supervision of token sale sponsors (**authorised sponsors**) possessing appropriate relevant knowledge and experience who will be responsible for compliance with this limb of the regulations. An authorised sponsor will need to be appointed in respect of every public token offering promoted, sold or distributed in or from Gibraltar.

Authorised sponsors may be appointed by the Gibraltar promoter or by organisers of the offering, wherever located. Authorised sponsors will be required to have mind and management in Gibraltar.

Authorised sponsors may provide additional services to sponsorship clients, over and above those of assuring compliance with this limb of the regulations (e.g. acting as custodian of the proceeds of the token sale and/or supervising their release according to sale conditions).

Authorised sponsors may delegate or outsource some of their work to others, including to persons located overseas, but will remain directly accountable to GFSC for the actions of their delegates.

## Codes of practice

Authorised sponsors will be required to have in place one or more codes of practice relating to offerings they sponsor. This is seen as a crucial step in establishing best practice for token sales conducted in or from Gibraltar. Authorised sponsors are considered to be in the best position to determine best practice for the offerings they sponsor and will be free to apply different codes to different categories of tokens and offerings. Codes of practice may set out such matters as the method for applying and distributing sale proceeds.

A code of practice must be incorporated into the authorised sponsor's agreement with each of their sponsorship clients. The submission of codes of practice will form part of an authorised sponsor's licence application, and amendments thereof must be reported, in advance, to GFSC and will be treated in the same way as any other major business change.

It is intended that the regulations should specify principles governing the content of codes of practice. Authorised sponsors will be free, subject to approval, to set their own methodologies for implementing the principles.

## Registers of authorised sponsors, codes of practice, sponsors' clients and tokens

GFSC will establish and maintain a public register of authorised sponsors and their respective past and present codes of practice.

Authorised sponsors will register details with GFSC of public offerings for which they are engaged and, in respect of each of them, details of:

- the client(s) for whom they act;
- the token(s) included in the offering;
- the code of practice applicable to the offering; and
- any interest they, and connected persons, have in the tokens offered.

GFSC will add the offering details to the public register within 5 business days of receipt from an authorised sponsor.

The regulations may set out grounds upon which GFSC may refuse to add, or may remove, offering details on the register. The promotion, sale and distribution of a public token offering may only be conducted in or from Gibraltar once, and while, the offering appears on the register.

## New controlled activity and offence

The proposed legislation will add:

- the controlled activity of being an authorised sponsor; and
- an offence of promoting, selling or distributing tokens without complying with:
  1. the requirement for an authorised sponsor;
  2. the requirement for a current entry on the public register;
  3. specified disclosure obligations; and
  4. relevant provisions of POCA, where applicable.

## Secondary market activities

### Secondary markets in tokens and their derivatives

Apart from relevant provisions of the DLT Regulations, operating a secondary market platform for trading tokens is not currently regulated in Gibraltar. It is proposed to regulate the conduct of secondary market platforms, operated in or from Gibraltar, that are used for trading tokens and, to the extent not covered by other regulations, their derivatives. The aim is to ensure such markets are fair, transparent and efficient.

The proposed regulations are intended to:

- ensure organised trading takes place only on regulated platforms;
- establish transparency and oversight of secondary token markets;
- enhance investor protection;
- impose conduct of business rules; and
- encourage competition.

The proposed regulations will set out requirements for:

- disclosure to the public of data on trading activity;
- disclosure of transaction data to GFSC; and
- specific supervisory actions concerning tokens and positions on token derivatives.

The scope of this limb of the proposed regulations will cover secondary market trading of all tokenised digital assets including virtual currencies.

This limb of the regulations will be modelled, so far as is appropriate, proportionate and relevant, on market platform provisions under MiFID 2 and MiFIR. Guidance may be issued by GFSC, from time to time, as appropriate.

## Authorised secondary token markets

It is proposed that GFSC will authorise and supervise secondary token market operators, and establish and maintain a public register of such operators.

## New controlled activity

The proposed legislation will add the controlled activity of operating a secondary market platform used for trading tokens and their derivatives.

## Investment and ancillary services relating to tokens

### Regulated token investment service

Providing investment and ancillary services relating to tokens is not currently regulated in Gibraltar. It is proposed to regulate the provision of investment and ancillary services in or from Gibraltar and, to the extent not otherwise caught by regulations, their derivatives. The aim is to ensure such services are provided fairly, transparently and professionally.

This limb of the regulations is intended to cover, *inter alia*, advice on investments in tokens, virtual currencies and central bank-issued digital currencies, including :

- generic advice (setting out fairly and in a neutral manner the facts relating to token investments and services);
- product-related advice (setting out in a selective and judgemental manner the advantages and disadvantages of a particular token investment and service); and
- personal recommendation (based on the particular needs and circumstances of the individual investor).

This limb of the regulations will be modelled, so far as is appropriate, proportionate and relevant, on similar provisions under MiFID 2. Guidance may be issued by GFSC, from time to time, as appropriate.

### Authorised token investment services

It is proposed that GFSC will authorise and supervise token investment service providers, and establish and maintain a public register of such providers.

### New controlled activity

The proposed legislation will add the controlled activity of providing investment and ancillary services relating to tokens.

# Implementation

## Legislation

Implementing these token regulation proposals will require primary legislation. Given the high degree of alignment with the Financial Services (Investment and Fiduciary Services) Act (**1989 Act**), implementation can be achieved by means of a limited Bill amending the 1989 Act, supplemented by new Regulations covering each of the three limbs.

A draft Bill is expected to be ready by the end of March 2018. Draft Regulations for the promotion, sale and distribution of tokens should be ready in May 2018. The last of the three Regulations should be completed by the end of October 2018.

A limited Regulation amending POCA, and designation of GFSC as the relevant supervisory authority are expected in March 2018.

## Ancillary matters

A review of the current investment funds regime is currently underway and consideration is being given, within that work, to the impact of the inclusion of tokenised assets within investment funds.

Separately, consideration is being given to a review of protected cell companies and their application to DLT-related undertakings.