THE REGULATION OF INITIAL COIN OFFERINGS: A COMPARISON OF THE SOUTH AFRICAN INTERGOVERNMENTAL FINTECH WORKING GROUP POSITION PAPER AND THE EUROPEAN UNION EUROPEAN SECURITIES AND MARKETS AUTHORITY ADVICE ON INITIAL COIN OFFERINGS AND CRYPTO ASSETS

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Abstract

The advent of crypto assets has led to creative alternative ways of raising capital for emerging businesses through token sales, aptly termed Initial Coin Offerings or ICOs. The crypto asset market has experienced a period of high market growth in the past decade due to ICOs — a relatively new phenomenon in the financial markets — which has seen investors invest their hard-earned capital despite the information asymmetry and associated risks. The lack of regulation in ICOs and crypto assets, in general, has prompted regulators to take steps towards regulation. This submission explores how South Africa proposes to regulate ICOs and provides a comparison with the European Union's approach towards regulating ICOs by paying specific attention to the governmental papers published in the respective jurisdictions.

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1 Introduction

Cryptocurrencies or crypto assets have disrupted the way in which the world formerly transacted within the context of commerce.[1] From its origins as decentralised digital currency such as Bitcoin,[2] to products that serve multiple purposes within the financial and securities market such as smart contracts.[3] Initial Coin Offerings (ICOs) is another phenomenal aspect that has emerged as a result of innovation within the crypto assets landscape.[4] As is the case with emerging technologies, policymakers have taken up the task of creating laws governing ICOs. This article explores how ICOs are to be regulated in South Africa, and how it compares with the regulation of ICOs in the European Union (EU).

This article will begin with a rudimentary discussion on the concept of blockchain technology and crypto assets. An explanation of the intricacies of blockchain technology and its role in the decentralised nature of crypto assets will be proffered. Next, the concept of ICOs will be explored. The definition, as well as the process of ICOs will be discussed as a capital raising mechanism. The features and challenges of ICOs will be highlighted. In the third section of this article, the South African regulatory approach to ICOs will be explored through an analysis of the Crypto Assets Regulatory Working Group (CAR WG) position paper. Thereafter, a discussion of and analysis of the EU jurisdiction will be presented focusing mainly on the directives and regulations proposed by the European Securities and Markets Authority (ESMA Advice). In the final section, this article draws a comparison between the regulatory approach adopted by the EU with the recommendations presented by the CAR WG position paper in South Africa.

2 Blockchain and cryptocurrencies or crypto assets

Initial Coin Offerings (ICOs) are a novel way for businesses to raise capital. They offer expediency and efficiency in the process of generating investor capital for companies, usually start-ups.[5] This, of

1 E Reddy & V Lawack 'An overview of the regulatory developments in South Africa regarding the use of cryptocurrencies' 31(1) *Mercantile Law Journal* (2019) 5.
2 LP Nian & DLK Chuen *Handbook of digital currency* (2015) 11.
3 A Badari & A Chaudhurry 'An overview of Bitcoin and Ethereum white-papers, forks, and prices' 11 May 2021 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3841827 (accessed 20 October 2023).
4 R Robinxo 'The new digital wild west: Regulating the explosion of initial coin offerings' 85(4) *Tennessee Law Review* (2018) 924.
5 WA Kaal 'Initial Coin Offerings: The top 25 jurisdictions and their comparative regulatory responses' (2018) 1 *Stanford Journal of Blockchain Law & Policy* 41.

course, entails that the ICO process provides leverage due to requiring minimal cost, providing large sums of capital rapidly, and issuing investors with tokens instead of equity.[6] To fully understand what ICOs entail, their purpose, function and utility, and a basic understanding of cryptocurrencies or crypto assets and blockchain technology, it is necessary to explain the technology.

Blockchain technology encompasses a network of computers that supports a platform known as digital ledgers, where cryptocurrency transactions are recorded.[7] Blockchain platforms provide end-to-end encryption which is only accessible to users on a peer-to-peer scale, who have been granted access to the crypto assets available on the blockchain.[8] Blockchain technology is central to the creation of crypto assets. Some of the most notable crypto assets created through blockchain technology are Bitcoin and Ethereum.[9] Crypto assets can be classified as virtual or digital currencies that are transacted and validated on an encrypted peer-to-peer scale, known as cryptography.[10] These digital currencies operate and are recorded on a blockchain — a distributed ledger technology ('DTL').[11]

Blockchain technology is decentralised and this, in essence, means that the crypto assets issued are unregulated.[12] Unlike fiat currency, crypto assets are not minted or issued by an intermediary such as the central bank and consequently, do not enjoy the status of legal tender in varying jurisdictions.[13] Crypto assets were introduced as an innovative development meant to create a new decentralised digital currency that would function as a mode of exchange.[14] However, its decentralised characteristic suggests that it is extra-legal and may, therefore, be prone to illicit use.[15] The emergence of cryptocurrencies has been met with apprehension, with some

6 Kaal (n 5) 41-42.
7 BV Adrichem 'Howey should be distributing new cryptocurrencies: Applying the Howey Test to mining, airdropping, forking, and Initial Coin Offerings' (2018) 20(2) *Columbia Science and Technology Law Review* 391.
8 AV Maese & others 'Cryptocurrency: A primer' (2016) *The Banking Law Journal* at 468-469.
9 Ibero-American Institute for Law and Finance 'Working Paper Series 4/2018 The Law and Finance of Initial Coin Offerings' (2018) 2.
10 NJ Sherman 'A behavioral economics approach to regulating Initial Coin Offerings' (2018) Georgetown *Law Journal Online* 18.
11 As above.
12 JD Moran 'The impact of regulatory measures imposed on Initial Coin Offerings in the United States market economy' (2018) 26(2) *Catholic University Journal of Law and Technology* 217.
13 NH Hamukuaya 'The development of cryptocurrencies as a payment method in South Africa' (2021) 24 *Pioneer in Peer-Reviewed, Open Access Online Law Publications* 2.
14 C Gamble 'The legality and regulatory challenges of decentralised crypto-currency: A western perspective' (2017) 20 *International Trade and Business Law Review* 347.
15 F Ukwueze 'Cryptocurrency: Towards regulating the unruly enigma of Fintech in Nigeria and South Africa' (2021) *Pioneer in Peer-Reviewed, Open Access Online Law Publications* 2.

countries issuing outright bans, while other countries have kept an open mind and published governmental position papers in an attempt to integrate and regulate the crypto assets already circulating within their jurisdictions.[16] ICOs play a critical role in the crypto assets market and its overall impact on financial markets.

3 Initial coin offerings

3.1 Defining Initial Coin Offerings

An ICO can be described as a capital raising process, initiated by a start-up seeking capital, where new digital coins are generated and offered for sale to the general public.[17] The offering of tokens is facilitated on a blockchain platform.[18] Tokens are usually offered to investors in exchange for money or other crypto assets.[19] The ICO process emulates that of an Initial Public Offering ('IPO'), where a company issues equity in the form of shares to the public for a fraction of ownership of a company.[20] In the case of ICOs, token-holders own a fraction of the start-up's blockchain project, which offers investors or token-holders some benefits such as access to certain features on the blockchain project.[21] The types of tokens generated in ICOs can either be security tokens or utility tokens.[22] The former is synonymous with equity shares which confer upon token-holders ownership rights, and the latter refers to tokens which grant token-holders access to blockchain features as alluded to above.[23]

By far, one of the most successful ICOs is Ethereum's 2014 ICO. Ethereum sold Ether tokens to the value of $18 million,[24] and, as of 3 April 2023, possesses a market capitalisation of $221,62 billion.[25] Lockaby proffers an explanation of the ICO process using an analogy describing Ethereum as a virtual amusement park.[26] To enter the

16 The Law Library of Congress 'Regulation of cryptocurrency in selected jurisdictions: Argentina, Australia, Belarus, Brazil, Canada, China, France, Gibraltar, Iran, Israel, Japan, Jersey, Mexico, Switzerland' 2018.
17 Moran (n 12) 215.
18 As above.
19 F Steverding & A Zureck 'Initial Coin Offerings in Europe – the current legal framework and its consequences for investors and issuers' 7 April 2020 https://dx.doi.org/10.2139/ssrn.3536691 (accessed 26 February 2023).
20 J Draho *The IPO decision: Why and how companies go public* (2004) 1.
21 CD Lockaby 'The SEC rides into town: Defining an ICO Securities safe harbor in the cryptocurrency wild west' (2018) 53(1) *Georgia Law Review* 342.
22 Moran (n 12).
23 As above.
24 CoinDesk 'Sale of the century: The inside story of Ethereum's 2014 premine' https://www.coindesk.com/markets/2020/07/11/sale-of-the-century-the-inside-story-of-ethereums-2014-premine/ (accessed 3 April 2023).
25 YCHARTs 'Ethereum Market Cap (I:EMC)' https://ycharts.com/indicators/ethereum_market_cap#:~:text=Ethereum%20Market%20Cap%20is%20at,47.67%25%20from%20one%20year%20ago (accessed 3 April 2023).
26 Lockaby (n 21) 342.

Ethereum amusement park, you would have to purchase Ether tokens as an entry ticket.[27] However, to enjoy some of the rides — accessing applications provided on the platform — you have to acquire tokens specifically required for those particular rides, by exchanging the Ether tokens in your possession.[28]

IPOs require companies to conduct the capital raising process through an investment bank that serves as an intermediary, where a prospectus that is compliant under the securities or stock exchange listing requirements and company laws, is prepared for investors.[29] A prospectus provides disclosure of essential information that is related to the company 'going public'.[30] In contrast, ICOs do not require a prospectus to be issued. A white paper which details the uses and function of the tokens is instead provided. White papers serve a similar purpose as a prospectus in that they aim to persuade investors to invest in the company or the blockchain project.[31] However, it is not mandatory for companies to furnish a white paper to prospective token-holders.[32]

ICOs operate in an unsupervised and unregulated market, where issuers have carte blanche to raise large, unprecedented sums of capital while employing cost-efficient and uncomplicated methods.[33] The non-regulation of ICO is what makes its position precarious when it comes to protecting investors and the integrity of financial markets. It is common parlance that the absence of legal certainty means the absence of legal enforceability.[34] ICOs and crypto assets generally present a host of issues. These issues may range from market volatility, misrepresentation on white papers, fraud, hacking, and the impossibility to conduct proper due diligence.[35] Ways in which various governmental bodies across the globe attempt to regulate ICOs are further explored in this article.

3.2 The Initial Coin Offering Process

As stated above, ICOs entail an offering of crypto assets or digital tokens to the general public as an attempt to raise capital for an entity, which includes the issue of a white paper. As discussed, as

27 Lockaby (n 21) 345.
28 As above.
29 Ibero-American Institute for Law and Finance (n 9) 15-16.
30 CM Dailya et al 'Investment Bankers and IPO pricing: Does prospectus information matter?' (2005) 20 *Journal of Business Venturing* 94.
31 F Steverding & A Zureck (n 19).
32 As above.
33 As above.
34 J Hall 'Nulla poena sine lege' 47(2) *The Yale Law Journal* (1937) 165.
35 B Custers & L Overwater 'Regulating Initial Coin Offerings and cryptocurrencies: A comparison of different approaches in nine jurisdictions worldwide' (2019) 10(3) *European Journal of Law and Technology* 5.

opposed to a prospectus, which is subject to regulatory provisions, a white paper is not regulated by any legal prescriptions.

This contributes to the perilous state of misleading content often presented by token issuers in white papers.[36] Ideally, white papers are supposed to articulate well-formulated solutions to bridge information gaps regarding the operation of ICO projects to prospective investors.[37] Kasatkin provides the legal provisions that must be present in white papers as relating to compliance with particular legal prescriptions such as anti-money laundering legislation, arbitration, legal rights conferred on tokens (depending on their classification e.g. security tokens), contractual liability of issuers, terms of sale, and restrictions on participants.[38]

An essential feature of ICOs is the blockchain platform that is used to host the project. The initial step to launching an ICO project is selecting the blockchain platform the project will be facilitated on.[39] Entities will develop a blockchain platform on which they will launch their tokens, or they may elect to utilise an already established blockchain, such as the popular Ethereum, on which numerous ICOs have been launched.[40]

Using an already existing platform provides an advantage in that issuers will not be required to exert substantial effort in developing the blockchain as the infrastructure is readily available. The code in the blockchain is usually posted to the general public on a static hosting service website called Github, where coders are free to provide their input about the code.[41] This creates an opportunity to have the blockchain fixed and improved before it is launched. In essence, this may positively impact the capital raising of the ICO.[42] ICOs may conduct a pre-ICO capital raise, otherwise known as a pre-sale, where they sell tokens to a limited pool of investors at a lower cost before the official launch of the ICO.[43]

However, this opens the floodgates to investors pumping and dumping the token, in other words, investors acquire tokens cheaper at a pre-sale but as soon as the ICO launches and the tokens are tradable in secondary markets for a higher price, investors

36 M Ofir and I Sadeh 'ICO v IPO: Empirical findings' (2020) 53 (2) *Vanderbilt Journal of Transnational Law* at 547..
37 S Kasatkin 'The legal content of a white paper for an ICO (Initial Coins Offering)' (2022) *Information & Communications Technology Law* 82.
38 Kasatkin (n 37) 84.
39 MH Joo & others 'ICOs, the next generation of IPOs' www.emeraldinsight.com/0307-4358.htm (accessed 22 March 2023).
40 Ofir &Sadeh (n 36) 568.
41 VV Collao & V Winship 'The new ICO intermediaries' (2019) 5(2) *Italian Law Journal* 737-738.
42 J Campino, A Brochado & Á Rosa 'Initial Coin Offerings (ICOs): Why do they succeed?' 2022 https://doi.org/10.1186/s40854-021-00317-2 (accessed 20 October 2023).
43 Moran (n 12) 224.

immediately dump the tokens and make higher returns while the value of the tokens plummet.[44] In the final stage, an ICO will launch online or on a crypto asset exchange platform where investors can purchase tokens until the target threshold is met, after which the ICO issuer will distribute the tokens to their respective buyers through a blockchain-facilitated wallet, where ownership will be conferred upon such investors.[45]

4 How South Africa aims to regulate ICOs: Risks associated and recommendations

As things stand in South Africa, no formal legislation has been adopted to regulate crypto assets, and more specifically ICOs. However, the South African Reserve Bank in collaboration with National Treasury has taken initiative by publishing position papers on crypto assets through its governmental organisations, the Intergovernmental Fintech Working Group (IFWG) and Crypto Assets Regulatory Working Group (CAR WG). The latest of these position papers was published on 11 June 2021.[46]

What the position paper aims to achieve is to highlight the use case of crypto assets, the risks involved therein, and propose ways in which crypto assets can be regulated through crypto asset service providers (or CASPs).[47] The position paper also touches on ICO use cases, where issuers will be regulated as CASPs. CASPs are the same as Virtual Asset Service Providers (VASPs) which are defined by the Financial Action Task Force as entities that provide services concerning virtual assets for exchanging virtual assets with fiat currency and vice versa; the exchange between a variety of virtual assets; virtual wallet services, and others.[48] The CAR WG position paper has adopted a similar definition for CASPs. In essence, CASPs may also launch ICOs to attract investors and raise capital.[49]

44 ICO Watchlist 'What is an ICO pre-sale?' https://icowatchlist.com/presale/ (accessed 20 February 2023).
45 S Holoweiko 'What's an ICO? Defining a security on the Blockchain' (2019)87(6) *George Washington Law Review* 1481.
46 South African Reserve Bank 'Publication Details' https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2021/IFWG-CAR-Working-Group-position-paper-on-crypto-assets (accessed 5 August 2023).
47 The Intergovernmental Fintech Working Group Position Paper on Crypto Assets (2021) at 3 (IFWG Position Paper).
48 Financial Action Task Force Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Provider (2021) at 22.
49 IFWG Position Paper (n 47) 25.

4.1 Risks factors necessitating the need for ICO Regulation

The use case of ICOs as set out in the position paper, is similar to the description proffered above, which is: ICOs are essentially aimed at raising capital.[50] The first concern with ICOs is the risks related to money laundering and financing of terrorists. Entities, particularly crypto assets providers, ought to be regulated and compliant with anti-money laundering and counter-financing of terrorists (AML/CFT) provisions, due to their participation in financial services.[51]

An example of such a provision that can be used to ensure AML/CFT compliance is section 29 of the Financial Intelligence Centre Act 38 of 2001 (FIC Act), which compels an 'accountable institution' to verify the identity of clients, monitor transactions, and report suspicious transactions. A definition of 'accountable institution' is provided in Schedule 1 of the Act. The decentralised nature and anonymity attributed to crypto assets make them highly susceptible to money laundering activities.[52] Hence this predicament necessitates the enforcement of AML/CFT regulations.

The second concern is related to the speculative and limited exit opportunities risks associated with ICOs.[53] ICOs as investment vehicles are extremely speculative, and the volatile cryptocurrency market means that investors face the risk of losing their capital investment.[54] Projections stipulated in white papers are not guarantees that the target returns stated therein will be realised.[55] As stated earlier, issuers tend to provide misleading or fraudulent information in white papers. Introducing regulation will ebb speculative and duplicitous ICOs.[56] Exit opportunities regarding ICO investments are limited in that there may be instances where investors cannot liquidate their tokens by trading them in exchange for fiat currencies or exchange them for any other crypto assets.[57]

Third, a 'high risk of failure and the concomitant risk to investors' is inherent in ICOs as they tend to be initiated by newly established businesses that are in their infancy stage.[58] The tokens issued in an ICO usually possess no utility outside of the product or service that will potentially be offered by the issuer, with the hope that the

50 As above.
51 As above.
52 D Erasmus & S Bowden 'A critical analysis of South African anti-money laundering legislation with regard to cryptocurrency' (2020) *Obiter* 313.
53 IFWG Position Paper (n 47) 25.
54 As above.
55 As above.
56 C Bellavitis *et al* 'A comprehensive review of the global development of initial coin offerings (ICOs) and their regulation' (2021) 15 *Journal of Business Venturing Insights* 9.
57 IFWG Position Paper (n 47) 25.
58 IFWG Position Paper (n 47) 26.

product or service is successful.[59] Sherman provides the following statistics regarding ICO failure:

> … A recent study of ICOs sheds more light on how pure speculation is driving the ICO market: 59% of ICOs in 2017 are either confirmed failures or failures-in-the-making. Out of the roughly 900 ICOs in 2017, 142 failed at the funding stage, 276 failed after issuers stole the money or the project failed, and an additional 113 coins are considered 'semi-failed' either because the company's team has stopped communicating about the project or the community is so small signifying that the project is unlikely to succeed.[60]

The speculative nature of ICOs is a breeding ground for fraud, where issuers can defraud investors of their capital and crypto assets investment.[61]

Fourth, the 'risk of unclear legal frameworks and ICOs being prone to fraudulent activity' means that the absence of a regulatory framework that accommodates the different classes of ICO activities creates an opportunity for illicit conduct to thrive.[62] Criminals may exploit the non-existent or weakened position of regulation in various jurisdictions where no firm policy stance has been taken.[63] ICOs falling outside of the scope of regulation are susceptible to fraud and money laundering, as identified by the position paper.[64]

Fifth, the 'lack of a fiscal framework' provides that the Ministry of Finance along with tax authorities have a policy in place regarding the taxability of profits generated by ICOs.[65] Sixth, ICOs are laced with inherent 'cybersecurity risks' and the lack of regulatory oversight to ensure that the platforms ICOs are launched are vetted by professional developers and cybersecurity analysts, making them vulnerable to cyber-attacks from hackers.[66] Lastly, the 'risks related to incomplete and/or inaccurate disclosure' in white papers are what has led to numerous ICO failures as stated above. Issuers tend to only highlight the advantages and never the disadvantages.[67] In some cases, information in white papers is presented in technical terms that are difficult to understand.[68]

59 As above.
60 Sherman (n 10) 23.
61 Sherman (n 10) 34.
62 IFWG Position Paper (n 47).
63 As above.
64 As above.
65 As above.
66 As above.
67 As above.
68 S Samieifar & DG Baur 'Read me if you can! An analysis of ICO white papers' January 2021 https://doi.org/10.1016/j.frl.2020.101427 (accessed 19 October 2023).

4.2 Recommendations made in terms of the CAR WG Position Paper

The position paper provides a few recommendations which are pertinent in regulating CASPs, which also include token issuers in ICOs. However, there are only two recommendations that specifically relate to ICO within the position paper, recommendations 20 and 21. The former provides that National Treasury and the Financial Sector Conduct Authority (FSCA) should attempt to bring the regulation of ICO issuers within the scope of regulation of securities and over-the-counter (OTC) financial instruments issuers.[69] The position paper advises that tokens should be treated as securities subject to the Financial Markets Act 19 of 2012, conditional on consultation with the Companies and Intellectual Property Commission and in cooperation with the Companies Act 71 of 2008 'to the fullest extent possible and appropriate'.[70] The key authority in implementing this recommendation is the Financial Sector Conduct Authority and the legislation to facilitate it is the Financial Markets Act.[71]

Recommendation 21 provides that the issuing of payment or exchange and utility tokens should be governed subject to the licensing activities provisions of the Conduct of Financial Institutions Bill, 2020 (CoFi Bill) and as financial services, as stipulated in the Financial Sector Regulation Act 9 of 2017.[72] The position paper further provides that the provisions of the CoFi Bill on licensing requirements and specific conduct standards ought to be developed.[73] These standards will oblige ICOs issuers of payment and utility tokens to produce a well-crafted and detailed prospectus for the

> … specific requirements and details on disclosures about the company, a governance plan, any agreement(s) between the customers and ICO issuers, comprehensive independent audits, and specific reports (to be confirmed) to regulators.[74]

To provide context to recommendations 20 and 21, it is important to highlight the content of recommendations 9 and 10. Recommendation 9.1 states that crypto assets should be declared 'financial products' by the FSCA in the intermediary in terms of the Financial Advisory and Intermediary Services Act (FAIS Act).[75] This will, in the interim, bring crypto assets into the purview of the FSCA and crypto assets will be

69 IFWG Position Paper (n 47) 46.
70 As above.
71 Financial Markets Act 19 of 2012.
72 FWG Position Paper (n 47) 38.
73 As above.
74 As above.
75 IFWG Position Paper (n 47) 35-36.

regulated as financial products under the FAIS Act,[76] which is subject to repeal upon the enactment of the CoFi Bill.[77]

Recommendation 9.2 briefly provides that there should be the inclusion of specified services for crypto assets under licensing activities in the CoFi Bill.[78] Recommendation 9.3 succinctly provides that specified crypto asset services should be defined as 'financial services' in terms of the Financial Regulation Act.[79] These provisions essentially regulate ICO issuers within the broader context of crypto assets, more specifically crypto asset service providers. Recommendation 10 states that the FSCA should become the body responsible for providing licensing for the 'specified services' for crypto assets.[80] However, the position paper provides that recommendation 10 is dependent upon the proper implementation of recommendations 9.2 and 9.3.[81]

5 The EU's Regulatory Position

European authorities have been cautious to not implement excessive regulation of ICOs that will consequently stifle innovation, and have striven to maintain balance by having a policy — or directives — that encourage a free market that enjoys healthy legal protection.[82] To regulate ICOs, the European Union (EU) has opted to expand already existing regulations to accommodate crypto assets instead of enacting crypto asset or ICO-specific regulations.[83]

Before delving further into EU regulation it is important to consider the difference between directives and regulations in the EU context. Allaert explains that the former is a legislative act that sets out the purpose and objectives that Member States are obliged achieve, and the latter provides guidelines that should be followed for the purpose of implementation by Member States.[84] There are several regulations and directives issued by the EU, however, attention will only be given to the Advice on Initial Coin Offerings and Crypto Assets (herein referred to as the Advice) issued by the European Securities and Markets Authority (ESMA).

76 Financial Advisory and Intermediary Services Act 37 of 2002.
77 IFWG Position Paper (n 47) 36.
78 As above.
79 As above.
80 As above.
81 As above.
82 K Allaert 'ICO regulation in the US, EU and China: A comparative analysis' (Masters thesis, Universiteit Gent, 2022) 19.
83 As above.
84 Allaert (n 82) 20.

The Advice provides that crypto assets are not legally defined within the context of EU financial laws.[85] However, the legal position of crypto assets may be determined by considering whether they constitute 'financial instruments' in terms of existing regulations such as the Markets in Financial Instruments Directive (MiFID),[86] which provides a comprehensive regulatory framework for transactions involving financial instruments.[87]

The elements of the definition are that financial instruments constitute 'transferable securities', 'money market instruments', 'units in collective investment undertakings' and various derivative instruments.'[88] When crypto assets satisfy the definition of securities, they will, as a consequence, be subject to the provisions of the Prospectus Regulation.[89] The Prospectus Regulation stipulates in article 3 that a prospectus must be published before a public offering and sets out the guidelines on the information that should be included therein, for securities in markets of Member States.[90]

The Prospectus Regulation became effective on 19 June 2019.[91] The Prospectus Regulation does not state who is responsible for the drafting of the prospectus but provides that the author of the prospectus be made known.[92] The threshold size of the offering may determine whether a prospectus needs to be published, for instance, offers below one million Euros – or eight million Euros according to the national legislation of Member States – will be exempt from publishing a prospectus.[93] In the context of ICOs, the Prospectus Regulation will apply if the tokens offered meet the definition of 'securities', and are within the prescribed threshold size.[94] Issuers in ICOs will also have to provide information regarding ICO projects such as the terms and conditions, risks associated, and the rights of token-holders.[95]

The Transparency Directive will only enjoy application where tokens are considered financial instruments in terms of MiFID II.[96] This directive's objective is to ensure the accurate disclosure of information regarding securities that are being traded in regulated markets within the jurisdiction of Member States.[97] The information is required to be disclosed on a periodic and ongoing basis by issuers

85 European Securities and Markets Authority Advice Initial Coin Offerings and Crypto Assets (2019) 18 (ESMA Advice).
86 Markets in Financial Instruments Directive 2014 (2014/65/EU).
87 As above.
88 Markets in Financial Instruments Directive 2014 (2014/65/EU) art 4(1)(15).
89 Regulation (EU) 2017/1129.
90 Regulation (EU) 2017/1129 art 3(1).
91 Regulation (EU) 2017/1129.
92 Regulation (EU) 2017/1129 art 6(1).
93 Regulation (EU) 2017/1129 art 3(2)(b).
94 Regulation (EU) 2017/1129 art 2(a).
95 Regulation (EU) 2017/1129 art 6.
96 Directive 2014/65/EU art 5.
97 Directive 2014/65/EU art 1; See also ESMA Advice (2021) 24.

in the form of, inter alia, financial statements, bi-annual reports, annual reports, and changes in ownership of equity.[98]

MiFID II deals with governing investment firms that provide trading services with respect to financial instruments.[99] The MiFID II also consists of a regulation, the Markets in Financial Instruments Regulation (MiFIR).[100] The Advice stipulates that where crypto assets are deemed financial instruments, the crypto assets trading platforms or intermediaries are required to comply with the relevant requirements set out in MiFID II.[101]

These applicable requirements are concerning, namely: 'capital requirements' in terms of article 47(f) entail a firm satisfying the minimum capital requirements under the directives and regulations. However, traders trading on their account, or utilising a multilateral trading facility (MTF), or organised trading facility (OTF) must have a starting capital of 730 000 Euros. Additionally, the 'organisational requirements' stipulated in article 16 state that firms must ensure that they have policies in place concerning the governance of the firm to deal with, inter alia: conflicts of interest; risk management'; financial reports and; transparency regarding the rules, procedures and objectives of the firm. Under 'investor protection' firms must adhere to the provisions of the MiFID II which provide that they should avert conflicts of interest, conduct their business with integrity and professionalism, disclose accurate and non-misleading information, and initiate trades that are not detrimental to their clients.[102]

'Access to MTFs, OTFs and RMs' according to article 18(3) comprises policies that are not exclusionary and ensure transparency ought to be implemented to ensure the efficient utilisation of these facilities, while in terms of articles 3 to 11 'pre and post-trade transparency' require that the MiFIR makes provision for requirements multilateral systems utilised in firms which provide pre-trade transparency, waivers regarding pre-trade transparency and the limitations thereof, as well as post-trade transparency and 'deferred publication'. Under 'transaction reporting and obligations to maintain records' MiFIR compels firms to retain records of orders about financial instruments for five years.[103]

98 Directive 2014/65/EU art 16.
99 Directive 2014/65/EU art 1(1).
100 Regulation (EU) No 600/2014.
101 Directive 2014/65/EU art 1; See also ESMA Advice (2021) 24.
102 Directive 2014/65/EU 'Title II Authorisation and Operating Conditions for Investment Firms.
103 Directive 2014/65/EU art 25(1); Regulation (EU) No 600/2014 art 25(2); See also ESMA Advice (2021) 25-27.

The Market Abuse Regulation (MAR) deals with preventing the trading of insider information, unlawful disclosure of trade information, and market manipulation.[104] The instruments governed under this regulation are financial instruments exchanged on a regulated market; financial instruments traded via MTF or an OTF.[105] In essence, MAR finds application to crypto assets that are deemed financial instruments.[106] MAR places an obligation on trading platforms to implement policies that will help detect, report and combat market abuses.[107]

The conundrum confronting ESMA is that unprecedented forms of market manipulation and insider trading may arise and that the current regulatory framework may lack the necessary capacity to deal with these novel issues.[108] MAR may also have difficulties identifying the true identity of the market operator due to the anonymity that comes with the decentralised nature of crypto assets.[109] Crypto assets that do not constitute financial instruments fall outside the purview of MAR.[110] However, where crypto assets constitute financial instruments, they fall within the purview of the Short Selling Regulation in the instance that they would provide leverage by declining in value.[111]

The Directive on Investor-Compensation Schemes stipulates that compensation, that is limited to a certain amount, will be provided to investors in the case where an investment firm becomes insolvent.[112] This Directive applies to crypto assets that constitute financial instruments and investment firms that fall within the scope of the MiFID II.[113]

The European Banking Authority (EBA) initially made recommendations in 2014 that 'virtual currency-to-fiat exchanges' and virtual currency wallet services be brought into the remit of anti-money laundering and/or financing of terrorist regulations, by including provisions thereto in the fifth Anti-Money Laundering Directive.[114] However, crypto assets have morphed into new advancements where they are no longer only exchangeable for fiat currency but can be traded for other crypto assets.[115] This development urged the EBA to submit recommendations, along with

104 Regulation (EU) No 596/2014 art 14.
105 As above.
106 Regulation (EU) No 596/2014 art 16.
107 Regulation (EU) No 596/2014 arts 17-20.
108 ESMA Advice (2021) 29.
109 ESMA Advice (2021) 30.
110 As above.
111 Regulation (EU) No 236/2012 art 3.
112 Investor Compensation Schemes Directive (97/9/EC); See also ESMA Advice (2021) 36.
113 As above.
114 Regulation (EU) 648/2012; See also ESMA Advice (2021) 36.
115 As above.

those of the Financial Action Task Force, for the revision of the scope of Anti-Money Laundering Directive 5,[116] to include:

(i) providers of exchange services between crypto-assets and crypto assets; and
(ii) providers of financial services for ICOs

The Advice identifies 'potential gaps and issues' in the MiFID in the context where crypto assets constitute financial instruments. ESMA finds that the existing regulatory framework does not adequately accommodate the crypto assets and therefore, issues relating to the interpretation by Member States, regarding applicable provisions pose problems regarding uniformity which may result in regulatory arbitrage.[117] Some of the substantial gaps identified include inter alia, risks that are not adequately addressed or anticipated.[118] ESMA holds that issues can be addressed by providing clarity as to which crypto asset activities and services constitute services in terms of EU law and this can be effectively done by developing a DLT framework.[119] Conversely, ESMA has raised the concern that there may be variations of crypto assets that will not be classified as financial instruments due to their function and that will as a result not be governed by MiFID and other regulations applicable to financial instruments.[120] In essence, the regulatory framework is found wanting in this regard and leaves investors exposed to risk.[121]

6 Comparison of the South African approach and the European Union approach

It has now been established that in both the South African and European Union jurisdictions no comprehensive regulatory framework governing ICOs exists. A similarity that can be observed between the CAR WG position paper and the ESMA Advice, is that both aim to use existing legislation to accommodate crypto asset-related services and activities by bringing them within the scope of specific definitions in their respective financial legislative frameworks. For example, in the South African context, the CAR WG position paper recommends that tokens issued, in this instance during ICOs, should be treated as securities and that issuers of those tokens thereof should be governed by the Financial Markets Act 19 of 2012.

Similarly, in the EU the Advice provides that crypto assets which encompass tokens issued in ICOs, will be treated as financial

116 Directive (EU) 2015/849
117 ESMA Advice (2021) 37.
118 As above.
119 As above.
120 ESMA Advice (2021) 39-40.
121 As above.

instruments provided, they meet the specific requirements and be governed in terms of the MiFID II. The definition of financial instruments in MiFID II includes transferable securities. As securities, crypto assets in South Africa will be subject to provisions dealing with insider trading under the Financial Markets Act. Section 78 of the Financial Markets Act comprehensively covers the offence of insider trading. In the European markets, the Market Abuse Regulation is the legislation used to prevent insider trading with respect to financial instruments traded in regulated markets.[122]

When it comes to exchange and utility tokens the CAR WG position paper recommends that they should be regulated under the licensing activities provision of the CoFi Bill once it comes into effect, as well as be treated as financial services in terms of the Financial Sector Regulation Act.[123] The purpose of this would be to compel issuers to furnish prospectuses that satisfy the requirements on the governance, audit, disclosures, and pertinent details relating to the ICO project.[124]

In the EU financial instruments are broadly regulated by the Prospectus Regulation, which set out the requirements prospectuses must satisfy before a public offering can be initiated.[125] The implication is that crypto assets that constitute financial instruments will be governed by these Directives. However, what is unclear is whether tokens issued in an ICO constitute financial instruments. Perhaps this determination will be left to whether the tokens satisfy the criteria of financial instruments which are: 'transferable securities', 'money market instruments', 'units in collective investment undertakings' and various derivative instruments.[126]

In terms of AML and counter financing of terrorism with respect to crypto assets, the European Union's Anti-Money Laundering Directive finds application in 'virtual currency-to-fiat exchanges', but the European Banking Authority has made submissions that the provisions should be extended to crypto asset-to-crypto asset exchanges to stay on par with changing developments in the crypto market sphere. In South Africa, the Financial Intelligence Centre Amendment Act holds that 'accountable institutions' must be subject to provisions that ensure they employ preventative measures against money laundering and financing terrorists.[127] These institutions, which will include CASPs and other token issuers, are obliged to adhere to these

122 Regulation (EU) No 596/2014 art 14.
123 Act 9 of 2017.
124 Act 9 of 2017 Act 9 of 2017 sections 35, 127 & 248.
125 Regulation (EU) 2017/1129.
126 ESMA Advice (2021) 19.
127 Act 1 of 2017 sec 2(b) & (c).

measures — verifying the identities of users, monitoring transactions, and reporting suspicious transactions.[128]

7 Conclusion

This article sought to draw a comparison between the proposed regulatory regime of ICOs in South Africa as proposed by the IFWG position paper, and the regulatory position of the European Union as set out in the ESMA Advice. It is our observation that the IFWG position paper and the ESMA Advice are similar in material respects. Both policies demonstratively aim to ensure the protection of market participants by advising and recommending that ICOs be brought within the scope of regulation.

The IFWG and ESMA provide that tokens generated through ICOs be regulated through existing frameworks by expanding the definitions of financial instruments, securities, and services to include tokens and crypto assets. However, crypto assets, and consequently tokens, that emerge from ICO tend to become more nuanced as they advance and may fall outside of the scope of existing regulations.

In conclusion, it is evident that in the future, new legislation and legislative provisions that are specific to crypto assets and ICOs will have to be formulated to keep up with the developments in South Africa, the European Union, and other international jurisdictions.

128 Act 1 of 2017 sec 34.