

HOW ISRAELI REGULATORS ARE MEETING ICO CHALLENGES

A recent report proposes a balanced approach to ICOs that could add new vigour to the country's vibrant blockchain sector

In July 2016 Rich Daly, the long-serving CEO of Broadridge Financial Services, wrote in Forbes Magazine: "Blockchain is the most game-changing technology advance since the internet". And as with the last technology revolution, Israel and Israelis are punching well above their weight. In 2017 Israel-based initial coin offerings (ICOs, or token sales) raised almost \$500m, a remarkable slice of the total ICO cake that year. Israeli entrepreneurs are among the dominant forces in the world of blockchain protocols and cryptocurrencies.

Like elsewhere, the Israeli regulators have been busy. In February the Israel Tax Authority published its taxation guidelines in respect of cryptocurrencies, and in March the Israel Securities Authority (ISA) published its interim report on ICOs. With 188 pages of definitions, descriptions, economic analysis, comparative law research and legal (interim) conclusions, the report is forward-thinking. In its introductory paragraphs it discusses how the final regulations will have to strike a balance between ensuring safeguards are in place to protect the investor community and not stifling wealth creation.

The ISA identifies three categories of cryptocurrencies: Currency Tokens, intended to be used as a method of payment; Security Tokens, conferring a right of ownership, membership or participation; and Utility Tokens that confer a right to access or use a service or product. The ISA proposes that the determination of whether or not a token is a Security Token and therefore needs to be regulated under the Israeli Securities Law, depends on the nature of the transaction. According to the ISA, the determining factor in the classification of a token as a security is the rights it grants to those who hold it. In other words, that a token conferring similar rights to those conferred by 'traditional' securities including the right to profits or income, or to receive payments, whether by the distribution of additional tokens or cashing tokens into fiat currency, as well as ownership or participation rights in enterprises whose purpose is to yield financial profit will likely be deemed a Security Token.

Conversely, the report says that an investment in the acquisition of a product or service, the purchase of tokens for consumer-related purposes or the fact that a token is transferable will not necessarily result in it being considered a security.

However, the ISA proposes a more nuanced approach to determining if something which, on the face of it, is

not a security would still qualify as one. It proposes that when determining whether or not a token is a security the following considerations should apply: (1) the purpose for which the purchasers of the token acquired it; (2) the level of the token's functionality, ie to what degree can purchasers use it for the purpose for which it was created; and (3) representations and warranties made by the offeror, including a promise to yield profits and create or work towards creating a secondary market for the tokens.

When looking at the foregoing factors, consideration should also be given to whether any change in the nature of the service or product, the right to which is conferred by the token, is caused by the coin offering (in other words whether, as a result of the ICO, the token transitions from being a product or service into an asset). As a result of these considerations, the ISA notes that what appears to be a Utility (or hybrid) Token could in fact be determined to be a Security Token.

The proposals

The ISA has suggested a number of measures it believes will strike the right balance between protecting investors and encouraging innovation in crypto: (i) a channel for ICOs of limited size, similar to the Reg A+ regime in the US; (ii) applying to ICOs the recently enacted Israeli equity crowdfunding rules for public offerings; (iii) a 'regulatory sandbox' environment tailored to the needs of fintech companies that will work together with the authorities on 'pilot' ICOs with scaled back regulations and allow both regulators and companies to better understand the mechanics of the rules, then scale up accordingly; (iv) apply to ICOs the 'dual listing' regulations for companies traded on foreign exchanges to list with minimal additional requirements on the Tel Aviv Stock Exchange; and (v) institute for ICOs in general a more tailored disclosure regime.

The interim report thus takes an approach combining caution and flexibility that could enhance the already vibrant Israeli blockchain/cryptocurrency market.



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