Offerings of Cryptocurrencies:

Some considerations for the securities sector

Further to the issuance of the first cryptocurrency[1] ('Bitcoin') in 2009, the number of cryptocurrencies in existence has grown to 6,500 cryptocurrencies as at September 16, 2021[2].

Amidst the rise in the growth of cryptocurrencies, there is still much debate among regulatory bodies and governments as to the classification and formulation of appropriate frameworks to govern not only the existence of cryptocurrencies, but that of the Exchanges/Networks on which they are traded.

These debates are complicated by the fact that cryptocurrencies combine the properties of electronic payment systems, currencies, commodities[3] and/or securities. A commodity here refers to a basic good used in commerce that is interchangeable with other goods of the same type. When they are traded on an exchange, commodities must also meet specified minimum standards.[4] Further, the transnational and virtual nature of transacting in cryptocurrencies create opportunities for regulatory arbitrage and limit law enforcement actions where coordinated policy decisions have not been made.

For the purposes of this article, the Trinidad and Tobago Securities and Exchange Commission (TTSEC) seeks to highlight some of the considerations persons should be cognisant of, if they are interested in operating in the cryptocurrency space. These considerations entail the relationship between cryptocurrencies and the securities sector (by virtue of its classification) and some of the risks inherent to cryptocurrencies.

Classification as a security

[1] Cryptocurrency refers to a math-based, decentralized convertible virtual currency that is protected by cryptography. Source: FATF (2014) - Report: Virtual Currencies Key Definitions and Potential AML/CFT Risks.
[2] www.coinmarketcap.com "Cryptocurrencies." Accessed September 16, 2021.

[3] IMF Discussion Note (January 2016) pg. 7
[4] https://www.investopedia.com/terms/c/commodity.asp

Units of cryptocurrencies (usually referenced as coins, tokens or utility tokens) are created and disseminated using distributed ledger technologies. They are generally marketed by way of a “White Paper” and in more recent times they have been initially issued by way of Initial Coin Offerings (ICOs) or Initial Token Offerings (ITOs).

Depending on the characteristics of an ICO/ITO, units of a stated cryptocurrency may be classified as a security and therefore subject to securities laws and regulations. This is because virtual organizations and/or capital raising entities making use of distributed ledger technology are not exempted from the fundamental principles of securities laws[5].

In that regard, Section 4 of the Securities Act, Chapter 83:02, (SA)states, inter alia, that a “security” includes a share, stock, unit certificate, participation certificate, share certificate, investment contract or other interest or any derivative. Further, the same section of the SA defines “derivative” and “investment contract” in the following manner:

> *“derivative” means an option, swap, futures contract, forward contract, or other financial or commodity contract or instrument whose market price , value, delivery obligations, payment obligations or settlement obligations are derived from reference to or based on an underlying interest (including a value, price, rate, variable, index, event, probability or thing), but does not include any contract or instrument that is prescribed not to be a derivative or that by reason of Bye-law under section 148(1)(t t) is not a derivative”.*

> *“investment contract” includes any contract, transaction, plan, scheme, instrument or writing, whereby a person invests money or other property in a common enterprise with the expectation of profit or gain based on the expertise, management or effort of others, and such money or other property is subject to the risks of the common enterprise”.*

While the above definitions may be subject to legal interpretation depending on the facts surrounding the coin and ICO/ITO, they provide the key characteristics to be assessed when determining whether any specific cryptocurrency issued via an ICO/ITO may be considered to be security.

When making such an assessment, securities regulators will look at whether the tenets of an investment contract has been met and also the bundle of rights attached to a unit of a cryptocurrency. More specifically, as it pertains to the latter point, where the rights attached to such units (whether referred to as tokens or otherwise) are similar to the rights commonly attached to a share or stock, there exists a possibility that the units could also fall into the definition of a security. In a similar vein, derivative products whose underlying value is based on cryptocurrencies may also be captured.

Thus, any person who is proposing to raise capital through an offering/distribution of cryptocurrencies, should give consideration as to whether such an offering involves the distribution of a security and therefore falls within the realm of securities laws.

[5] USSEC Release No. 81207/ July 25, 2017

Money Laundering Risks

Cryptocurrencies are susceptible to heightened money laundering risks for numerous reasons. Based on guidance from the Financial Action Task Force on Money Laundering (FATF) these include, but are not limited to, the following factors:

Anonymity - Cryptocurrency transactions via the internet are generally characterized by non-face-to-face relationships and allow for greater anonymity than traditional cash payment mechanisms. By design, some protocols such as the Bitcoin software do not require or provide identification and verification of participants or generate historical records of transactions that are usually associated with real-world transactions[6]. Accordingly, financial institutions that participate in the cryptocurrency space are challenged in verifying the identities behind various funding sources.

Anti-Money Laundering (AML) monitoring systems have not kept pace with these financial developments – There is no monitoring software currently available to monitor and identify suspicious transaction patterns, and there is an absence of a central regulatory authority with oversight for cryptocurrency transactions. Accordingly, financial institutions who participate in the cryptocurrency space are challenged in their identification of suspicious transactions.

Limited law enforcement actions – Cryptocurrencies can be used to make purchases, transfer funds and even make payments within their associated exchange (systems). The said exchanges operate via the internet (including mobile applications) and the transactions involve the use of various participants who may be widely dispersed across various jurisdictions. As such, the parties charged with the responsibilities for AML supervision and enforcement are in most cases unclear. Further local law enforcement agencies may be inhibited from sanctioning any central location and/or entity for investigative or asset seizure purposes.

Other Risks Potential Investors should consider in relation to ICOs/ITOs and transacting in cryptocurrencies

Heightened potential for fraud – Recall, ICOs/ITOs are usually issued by way of a disclosure document called a "White Paper". While these documents seek to provide potential investors with information about the business model for the specific cryptocurrency, in some cases, these documents are very technical in nature and do not contain the level of financial detail investors may come to expect from a 'Prospectus'. Accordingly, investors may not fully understand the rights, interests in and/or the associated risks and returns applicable to an investment in cryptocurrencies.

This lack of complete information upon which to make an informed investment decision is compounded by the fact that cryptocurrency transactions and cryptocurrency issuers, in some instances, are not subject to regulation and that the internet technologies, upon which cryptocurrency transactions take place, are susceptible to hacks and other cyber security

[6] Source FATF (2014) - Report : Virtual Currencies Key Definitions and Potential AML/CFT Risks

risks. These factors increase the probability that investors in cryptocurrencies may become victims of fraud.

Cross-border distribution risks – As the issuer may also be operating the ICO from outside the investor's jurisdiction, following the money in the event of a collapse of the ICO, as well as recovering invested funds, may prove extremely difficult in practice.

Liquidity risks – The pricing mechanisms of non-regulated cryptocurrency exchanges are opaque and the prices of a given cryptocurrency usually exhibits a volatile pattern. Some analysts in the cryptocurrency space have also noted that there is insufficient liquidity to support reliable trading and market-making activities. These factors leave investors susceptible to dramatic price changes and the possibility that they may not be able to liquidate their holdings.

Additionally, in some instances there may not be a secondary market to sell or exchange your cryptocurrencies subsequent to the ICO and in others, cryptocurrencies cannot be exchanged for other commodities. In such cases, there are usually claims that the capital obtained through the sale of the ICO will be used to develop a propriety network for the trading of the said coins or tokens and/or merchant networks at a future time.

In light of the foregoing considerations, the TTSEC wishes to emphasise that cryptocurrencies and derivative products whose underlying values are based on cryptocurrencies, are high-risk products with an unproven track record and high price volatility. Notwithstanding same, the TTSEC is also cognizant of its role to foster development of the securities market and towards this end has taken a consultative approach in relation to cryptocurrencies, while remaining cautious in our assessments of developments in the cryptocurrency space and financial technologies (Fintechs) in general.

More specifically, the TTSEC has developed a FinTech Policy and has partnered with the Central Bank of Trinidad and Tobago and the Financial Intelligence Unit of Trinidad and Tobago to establish a Joint Fintech Steering Committee, as a mechanism for collaborative discussions on matters that span all three regulators. Further, the three aforementioned regulators are collaborating on a Joint Innovation Hub and Regulatory Sandbox whereby potential issuers and other persons, who are seeking to provide services within the cryptocurrency arena within Trinidad and Tobago can contact the said regulators, to initiate an exchange of information and obtain guidance pertaining to requirements to operate in the financial environment.

Potential investors are urged to note the foregoing considerations prior to making an investment decision with respect to offerings in cryptocurrencies. Similarly, persons wishing to raise capital through the issuance of cryptocurrency ICOs/ITOs and/or operate cryptocurrency platforms within Trinidad and Tobago are encouraged to participate in open dialogue with regulators through the Joint Innovation Hub, in order to ensure that they do not run afoul of financial sector laws.

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