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The tricky but necessary task of regulating Blockchain: the pragmatic approach of Gibraltar

SUMMARY: 1. Introduction. – 2. Regulatory issues raised by DLT. – 3. Why Gibraltar? – 4. The Financial Services (Distributed Ledger Technology) Regulations 2017. – 5. Conclusions: potentialities and shortages of the Gibraltar's solution.

1. *Introduction.*

In the past few months, Blockchain technology or, more correctly, distributed ledger technology (DLT) has captured the attention of business, media and regulators as well. Convinced by its deeply innovative features, both public and large private actors are venturing on DLT-based solutions in several crucial domains, including finance, supply chain man-

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agement and e-governance. At the same time, a growing number of retail investors are trying to financially benefit from the currently volatile DLT environment, often being exposed to risks they may not be able to prevent and manage. As it is usual with new, disruptive technologies, it emerges the question of whether - and to what extent - governments shall intervene to address risks and opportunities brought by emerging industries. This article looks at one of the first regulatory attempts made within the European territory to supervise and govern the growing DLT sector.

2. *Regulatory issues raised by DLT.*

The question of whether Distributed Ledger Technology needs to be specifically regulated has been the object of debate in many jurisdictions. Because of the evolving nature of the technology and of the applications that it is underpinning, it has been argued that it is premature to dictate hard regulation. This seems to be the opinion, among others, of European law-makers (specifically, the European Securities and Markets Authority - ESMA)[2] and it is the reason why some countries opted for soft tools such as regulatory sandboxes and non-binding opinions, paving the way for self-regulation.

This cautious approach on the part of regulators can be justified by two factors. On one hand, it is still difficult to identify the relevant issues and to extend or define new rules that can be effectively applied to various kind of blockchain-based applications and services. On the other, regulators understand that strict and hostile regulation would discourage entrepreneurs to further develop this promising industry.

Indeed, the ability of generating and transacting value directly via blockchain networks, with higher traceability and transparency, appears as an ideal opportunity for many inves-

[2] European Securities and Markets Authority (ESMA), Report «The Distributed Ledger Technology Applied to Securities Markets», 7 February 2017, available at: https://www.esma.europa.eu/sites/default/files/library/dlt_report_-_esma50-1121423017-285.pdf.

tors and entrepreneurs. Through DLT-based services, in fact, it is possible to bypass the mainstream financial sector,[3] perceived as opaque and overburden by regulations and fees. Unfortunately, however, the uncertain legal nature of digital assets and of new funding schemes – such as so called Initial Coin Offerings - make the industry unsafe, speculative and unstable. Digital ledger's technological features alone are not sufficient to prevent risks of abuses and fraudulent behaviours that can damage, first and foremost, unskilled retail investors. [4]

Initial Coin Offerings, simply known as "ICOs", are a new fundraising scheme consisting, in a nutshell, in the launch of a new digital token, or altcoin, on a blockchain. Start-ups are increasingly using it to early crowd-fund the realization of their projects, avoiding the traditional search for venture capitalists and equity partners. Investors can buy the tokens on an online exchange platform, with the result of funding the project while adding tokens in their personal "crypto wallet". Eventually, if the project is successful and the market is favourable, buyers will benefit from the increase of the token's value. In some ICOs, the structure resembles the issuing of an obligation, as the start-up promises to repay the total amount after a certain time.

Beside alleged risks of scams, tax evasion, and money laundering, users funding projects via ICOs must be aware of the high price volatility tokens are subjected to and of potential market manipulations - especially when the total market capitalization of the altcoin is not

[3] Gibraltar Financial Services Commission (GFSC), Statement on Initial Coin Offerings, 22 September 2017, available at http://www.gfsc.gi/news/statement-on-initial-coin-offerings-250.
[4] SolarCoin, «Enabling Prosumers to participate into the Energy Transition», European Utility Week, October 2017, available at: https://www.irena.org/-/media/Files/IRENA/Agency/Events/2017/Oct/EU-Utility-week/SolarCoin.pdf?la=en&hash=D3A2F7F0DE3E4CB42E5C6CC1FF23D250D4CB1FDC.
B. VITARIS, «SLVR: the First Digital Token Supported by Real Silver», 7 September 2017, available at: https://www.ccn.com/slvr-first-digital-token-supported-real-silver/.

announced. Given these threats tackling the stability of the industry as a whole, it is fundamental that regulators clarify the legal nature of altcoins and ICOs. This would make it easier to assess which sectorial rules shall apply to new blockchain-based forms of money, services and investment schemes.

The legal definition of tokens is not simple. They present different inherent features and purposes and, therefore, may fall under different sets of regulations. Some are similar to fidelity points or airmiles, as they are issued for every given unit of a physical asset. Others, instead, are closer to financial derivatives, as their value is linked to an underlying commodity (such as, for instance, silver[1] or power prices) fluctuations. In certain cases, tokens are only necessary for the functioning of the platform or for using the service they are linked to, without promising to pay dividends of the project's profit. In general, however, altcoins differ from traditional forms of investment and cannot be always assimilated to shares, as they do not automatically grant voting rights and the legal protections that are afforded for the latter.

The first official statement on the legal nature of altcoins and tokens appeared on July 2017, in a Report of the US Securities Exchange Commission (SEC) regarding the DAO (Decentralised Autonomous Organisation) – an online venture governed through a blockchain-based smart contract.[5] In the report, the SEC established that, unless specific features of the tokens prove otherwise, tokens must be treated as securities, bringing *de facto* the entire blockchain industry a step closer to the application of those rules designed for financial markets. European regulators, from their part, have been largely influenced by the SEC's posi-

[5] Securities And Exchange Commission, Securities Exchange Act of 1934, Release No. 81207, «Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO», 25 July 2017, available at: https://www.sec.gov/litigation/investreport/34-81207.pdf.

tion and followed this presumption. However, the higher complexity of EU's financial regulation, together with the uncertainty about the Brexit implementation process, are preventing a decisive EU's regulatory intervention.

Notwithstanding the "wait and see" approach of European law-makers, the Gibraltar Ministry of Finance published on the Gibraltar Gazette n. 4401 of October 12th, 2017 a set of Regulations which clarify whether and to what extent Distributed Ledger Providers shall be considered an investment or controlled activity subject to a licencing process under the Gibraltar Financial Services Commission. As one of the very first pieces of legislation providing a clear framework for the DLT industry, the new rules – in force from January 2018 – balance the need for a clearer legal framework with the openness and flexibility which are essential for such a new industry to keep growing. In the next passages, we will overview the key rules and legal solutions provided by this novel legislation.

3. *Why Gibraltar?*

For ages, this small yet strategic overseas British territory has been a crucial player for UK's financial and physical trading sector - in particular for freight shipping services. Due to its favourable corporate tax regime, Gibraltar attracts legal entities interested in scaling up, cutting costs and preserving liquidity. This is the cause of the high number of online gaming businesses registered here, which amount to the 60% of the world's gambling industry.[6] Similarly, given also the viability of blockchain-based solutions for cargo and supply chain traceability and the large number of Fintech start-ups hosted by UK, many blockchain-based ventures – involved in activities such as cryptocurrencies trading, asset-tokenisation and launch of coin offerings – are finding in Gibraltar a preferred destination.

[6] A. SANCHEZ, «Ruling sees Gibraltar gaming industry told to pay more taxes to UK», 14 June 2017, available at https://elpais.com/elpais/2017/06/14/inenglish/1497434012_762296.html.

Therefore, it is not surprising that Gibraltar is eager to address the main regulatory issues behind DLT and to gain the reputation of an experienced administration regarding the oversight of such innovative corporate entities. As stated in the Consultation Paper released by the Ministry of Commerce in May 2017, «*the main driver for proposing an innovative and bold regulatory framework for DLT activities is to encourage Gibraltar's economic development without threatening its reputation and integrity*».[7] Given that these online industries are often considered dodgy and purely speculative, Gibraltar's authorities are aware that boosting this new sector requires an effort (intensified by the new international regulatory requirements on enhanced transparency of financial markets) to protect Gibraltar's reputation.

4. *The Financial Services (Distributed Ledger Technology) Regulations 2017.*

The Regulations provided in the Legal Notice n. 204 of 2017 are the latest piece of legislation amending the Financial Services (Investment and Fiduciary Services) Act, according to Section 5, 7, 53 and 56. The Financial Services Act establishes restrictions, licensing criteria and conduct of business rules for investment businesses and other "controlled activities". Those entities that fall under the regulation must obtain a license based on the assessment of their general nature, specific attributes, organization, due diligence in record keeping and systems of control and «*any other factors which the Authority thinks it appropriate to consider*"(§9(e)).[8] The competent authority (i.e. The Gibraltar Financial Services Commission) holds broad and quite discretionary powers in granting, cancelling or suspending the license to carry out controlled activities, as well as in requiring relevant information and production of documents. Specific conditions can also be imposed on the license «*as appear to the Authority*

[7] HM Government of Gibraltar, «Proposals for a DLT Regulatory Framework», May 2017, available at: http://www.gibraltarfinance.gi/downloads/20170508-dlt-consultation-published-version.pdf?dc_%3D1494312876.
[8] Financial Services (Investment and Fiduciary Services) Act, Section 9(e).

to be necessary or desirable for the protection of investors, customers, the public or the reputation of Gibraltar as a financial centre» (§10(1)).

The declared intention of the concerned amendments is to reinforce Gibraltar's strategic role in the development of the DLT industry, positioning the country «*as a jurisdiction which facilitates innovation*» while ensuring the necessary regulatory outcomes. [9]

The law-makers' openness to the new promising area of business manifests itself in the choice of a «*flexible, adaptive*» principle-based approach «*rather than rigid rules*» that, in this context, could «*quickly become outdated and unfit for purpose*».[10] These principles (nine in total) are aimed at setting out standards and expectations for Distributed Ledger Providers to operate with integrity and due diligence, implementing appropriate safeguards for financial, operational and compliance risks. The broad framing of these principles is justified by the opportunity to adapt them to different characteristics, dimensions and scopes of emerging blockchain-based businesses and to adopt a case-by-case, risk-based and proportioned approach.

According to Samantha Barrass – GFSC CEO, «*The proposed framework will facilitate a progressive, well-regulated and safe environment for firms using DLT to grow, whilst also ensuring that this new regulatory environment protects both consumers and the good reputation of the jurisdiction*».[11] Notwithstanding the flexibility of these principles and the declared liberal intentions of the legislator, however, the new regulation qualifies DLT services as controlled activity, as such subject to licence and consequential duties.

[9] HM Government of Gibraltar, «Government confirms introduction of Government of Distributed Ledger Technology (DLT) Regulatory Framework in January 2018», Press Release No: 610/2017, 12 October 2017, available at: http://www.fsc.gi/uploads/GoGPR12102017.pdf.
[10] Gibraltar Financial Services Commission website: http://www.gfsc.gi/dlt.
[11] HM Government of Gibraltar, «Proposals for a DLT Regulatory Framework», May 2017, available at: http://www.gibraltarfinance.gi/downloads/20170508-dlt-consultation-published-version.pdf?dc_%3D1494312876.

In determining whether a principle is met, the GFSC «*will have regard to similarities in such matters as risk profile, use case, business model and product*».[12] The result of this approach is an authorisation process and a supervisory power from the part of the Gibraltar Financial Services Commission (GFSC) characterized by vagueness and, therefore, a great degree of discretion.

The vagueness concerns, first, the legal definitions and therefore the scope of application of the new amendments. DLT providers are, in fact, simply defined as «*carrying on by way of businesses, in or from Gibraltar, the use of distributed ledger technology for storing or transmitting value belonging to others*» (§10(1)).[13] The meanings of the terms «*distributed ledger technology*» and of «*value*», contained in the mentioned section, are therefore fundamental to draw the margins of applicability of the regulation. The first is defined as «*a database system in which information is recorded and consensually shared and synchronised across a network of multiple nodes, and all copies of the database are regarded as equally authentic*» (§10(2)(a)(b)). "Value", instead, consists in any form of ownership, including assets, holdings, rights or interests, «*with or without related information, such as agreements or transactions for the transfer of value or its payment, clearing, settlement*» (§10). This broad definition of "value" denotes that the Gibraltar's regulator has adopted a case-by-case approach in defining the legal nature of tokens and altcoins. In a nutshell, DLT providers fall under the legal notice regardless of the asset, holding, right or other form of ownership they store or transmit. This strategy is justified by the need of ensuring the broad applicability of the new regulation to the various and ever-changing blockchain-based solutions for value storage and transmission – something that would indeed be prevented by a univocal legal qualification of tokens and altcoins.

Moreover, the rules in object present ambiguity in relation to many aspects of the licensing process. Firstly, there is uncertainty about the maximum time it may take to conclude the licensing process. Secondly, the document lack of proper parameters to determine the appli-

[12] *Ibid.*
[13] Financial Services (Distributed Ledger Technology Providers) Regulations 2017, Section 10(1).

cation fee required for such process, which can vary from 8k to 28k. The prices are further puzzled by the provision of «*an additional fee of not more than £20,000, depending upon the complexity of regulating the DLT Provider*».[14] Finally, the unmentioned legal nature of the administrative act at stake - an "authorisation act that includes licence, registration, approval or other permission" - is likely to raise further confusion.

Remarkably, Section 5(1) of the amended Financial Service Act states that «*the Authority must publish guidance on its application of the regulatory principles, including […] any criteria to which it refers in determining whether a person will comply, is complying or has compelled with those principles*». The GFSC, therefore, has promptly published a Guidance Notice clarifying the meaning of the nine principles at stake; however, the mentioned and other – yet to emerge - shortages of the regulation are still unresolved.

5. *Conclusions: potentialities and shortages of the Gibraltar's solution.*

On 13th November 2017, the ESMA has published two warnings respectively directed to investors and to businesses involved in ICOs. Primarily worried about consumer protection, the European authority underlines ICOs vulnerability to fraud and money laundering and stresses that involved companies should be aware of the possible applicability of European financial regulation.

The attempt to warn consumers catches and important point. In fact, the sources from which users can gather information about tokens and start-ups are hardly ever accredited. Companies engage in heavy online marketing and often proceed to token sale after publishing nothing more than a white paper – something comparable to a brochure with no binding value, explaining the future intention of the team about the project. At the current state, no

[14] Financial Services (Distributed Ledger Technology Providers) Regulations 2017, Schedule 3 - Consequential Amendments, amending The Financial Services Commission (Fees) Regulations 2016, Schedule 1.

legal remedies are granted to investors when the promises of the token seller are not fulfilled; therefore, regulators that recognise the potentials of fundraising schemes such as ICOs are advised to focus on consumer protection.

Any upcoming regulatory effort could either result in new tailored regulation or in the mere specification of the sectorial norms - including liability schemes, compliance and authorization requirements – that apply to each DLT solution - first and foremost ICOs.[15] The second approach, together with the adoption of soft-law tools such as sandboxes, code of conducts or self-regulation, could be deployed to establish clear parameters of due diligence while fostering further growth of the industry.

The solution provided by Gibraltar has the merit of establishing a tailored legal framework for DLT providers, setting out a minimum financial barrier to entry the market and imposing the same professional and organisational standards that are required to businesses operating in the traditional financial sector. The described approach does not lead to an inversion of the burden of proof, as ICOs or token sales will not be caught under the DLT framework automatically. As stated by the GFSC, «*depending on what the token will be used for and how the token issue is structured, the token may fall within existing financial services legislation (for example, could be deemed as a Collective Investment Scheme, Alternative Investment Fund, etc.)*».[16] The case by case approach governing the evaluation of the businesses' license applications allows to adapt the provided principles to entities that largely differ among each other - not only in business models and organisational schemes, but also in the nature of the traded, transferred or stored "value". The cases taken in consideration by the Gibraltar gov-

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[15] European Securities and Markets Authority (ESMA), Statement «ESMA alerts investors to the high risks of Initial Coin Offerings (ICOs)», 13 November 2017, available at: https://www.esma.europa.eu/sites/default/files/library/esma50-157-829_ico_statement_investors.pdf; and Statement «ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements», 13 November 2017, available at: https://www.esma.europa.eu/sites/default/files/library/esma50-157-828_ico_statement_firms.pdf.

[16] R. J. VAN RENSBURG, «Overview of Gibraltar's Blockchain / Distributed Ledger Technology (DLT) Regulation», 12 December 2017, available at: https://medium.com/growthpains/overview-of-gibraltars-blockchain-distributed-ledger-technology-dlt-regulation-b899ece978c4.

ernment's advisory panel span indeed from securities custody to mortgage loan application, supply chain, insurance and asset tracking.[17] This demonstrates regulator's awareness about the scalability of the technology applications and the effort to move away from popular, simplistic views regarding crypto finance.

In the last analysis, the provided set of rules could successfully satisfy both the need for stability for the DLT industry and that of a flexible and open policy that can foster innovation. Undeniably, the proper implementation of the regulation largely depends on the discretion and efficiency of the GFSC. The danger, in fact, is that the authority's discretionary powers – likely coupled with a significant number of applications in the coming months – slow down or jeopardise the success of newly-created enterprises. The use of transitional agreements and the possibility, during the first months of 2018, to operate while the application determination is pending, is expected to ease the GFSC task, allowing an orderly and effective application of the principles.

The concerns raised by the beforementioned examples of vagueness should be an early-warning for those entrepreneurs establishing their DLT ventures in Gibraltar. However, it is reasonable to expect Gibraltar to become a centre of excellence in DLT, paving the way to a pragmatic and up-to-date administration of these promising services. To this aim, in assessing and judging the suitability of DLT providers to perform their activities, it is fundamental that the GFSC guarantees an adequate level of speed, consistency and certainty.

[17] HM Government of Gibraltar, «Proposals for a DLT Regulatory Framework», May 2017, available at: http://www.gibraltarfinance.gi/downloads/20170508-dlt-consultation-published-version.pdf?dc_%3D1494312876