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Capital Raising and Digital Tokens: Using crypto to fund your business



Date of publication: 3 November 2021

Related Expertise: Cryptocurrency / Crypto Assets, Financial Markets & Capital Raising

Whether you are a start-up, or a small-to-medium enterprise wanting to scale, an understanding of the capital raising landscape is crucial. As the Covid-19 crisis deepens, and balance sheets and cashflow become increasingly strained, businesses need to fully assess all possible sources of capital.

A host of capital raising options exists, each with its own unique set of features, benefits and drawbacks, depending on your funding needs.

There are the traditional avenues of debt funding (from banks or financial institutions) and equity funding, whereby in exchange for investment, shares in a company may be offered to the likes of angel investors, venture capital funds, private equity firms and, in some cases, crowdfunding participants on platforms like Snowball Effect and PledgeMe.

Naturally, there are limitations with the above. The process can be, and often is, drawn out, costly and complicated, and institutions that provide funding are typically highly risk averse, which means, in many cases, without a fundamentally sound investment proposition, your business might not get the capital it needs.

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However, with the advent of blockchain technology, the world has witnessed something of a fintech revolution – there exists a novel, cryptocurrency-based, capital raising alternative you might want to consider, in order to fund business growth and development: it involves raising capital by selling digital tokens to investors.

In this article we take a quick look at some of the key aspects, and legal implications, of this alternative form of capital raising.

Types of digital token

In essence, a digital token (referred to in this article as a token) is a computer-generated, digital representation of value or a specific right in, or to, something. It is a form of 'cryptocurrency' or 'cryptoasset'.

Businesses needn't operate in the tech space, nor be associated with blockchain, in order to sell tokens to investors, however there may be natural synergies and efficiencies if they do.

A token will typically serve one of the following four functions:

1. **Payment token/coin:** It facilitates a means of payment or exchange.
2. **Utility token:** It grants the holder the right to obtain a product or service, or generally transact with the business, once the business's capital raising goal is met (for example, tokens offering loyalty-style discounts or membership benefits).
3. **Security token:** It grants the holder an ownership right in an asset (for example, shares in a company, bonds, commodities, real estate, personal property etc).
4. **Non-fungible token:** It grants the holder ownership rights in authentic and unique digital media (i.e. an 'NFT').


Why sell tokens?

There are numerous benefits of selling tokens to investors, the most common of which tend to include:

1. **Lower barriers to entry:** The initial, upfront business-costs of selling tokens are relatively lower compared to other traditional forms of capital raising and there are (generally) few geographic barriers to investor involvement. (This obviously depends on the type of token being offered and the rules around their issue.) Token sales also help democratise finance by allowing small investors, potentially with lower risk appetites, to participate in what are traditionally 'closed shop' arrangements for qualified investors only.
2. **Liquidity:** Many secondary markets exist and operate on a 'round-the-clock' basis to facilitate token trading directly between investors (i.e. peer-to-peer), without regulation from intermediaries or a central authority.



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3. Greater flexibility: Asset-backed tokens support fractionalised ownership, across multiple owners, and enable businesses to monetise what have historically been regarded as 'illiquid' assets. Businesses have the option of distributing a percentage of revenues instead of profits, and investors have the opportunity to invest in a more diversified portfolio than traditional investment structures otherwise permit.
 4. Targeted fundraising: A token sale allows a business to raise funds for a specific project or business division, whereas traditional forms of equity fundraising do not tend to differentiate this way as investors are effectively being asked to back the entire business.

Tokens v Equity

The important distinction between traditional forms of equity capital raising and a token sale is that a token does not equate to a share in a company, and so a token holder will not normally receive any direct equity in a business when purchasing a token, unless the terms of the token offer allow

Blockchain

Raising capital using tokens relies on a technology called the 'blockchain'.

The blockchain is a tamper-proof, open-source, computerised data structure – often decentralised (i.e. distributed across a network of users) – that records and stores information, in encrypted form.


It is the blockchain that facilitates and underpins the creation and transfer of tokens.

Token creation and sale

In order to sell tokens to investors, a business will first need to decide what it is they are seeking to 'tokenise' (for example, a present or future utility, the right to receive rights in an asset etc) and the applicable 'tokenomics', or value proposition, quantity of supply and price at which, the business will sell the token to investors.

A business should seek expert technical advice on a number of areas, including (among other things) determining the manner in which the tokens are sold, whether directly to investors or by way of a centralised or decentralised exchange – these options are more commonly referred to as an 'initial coin offering', a 'security token offering', an 'initial exchange offering' or an 'initial decentralised exchange offering', the comparison of which is beyond the scope of this article – choosing the appropriate blockchain platform, setting up the token framework, ensuring appropriate security protocols are in place, establishing a token wallet for the business and implementing appropriate 'smart contracts' to govern token sale and receipt of payment. ('Smart contracts' are essentially contracts with terms and conditions embedded in computer code which 'execute' once a set of pre-determined conditions are satisfied, without the need for third party oversight.)

In terms of the actual token sale, there is typically a pre-sale promotional campaign to stimulate as much interest in the token as possible. The sale window itself can last a period of weeks – but is usually



completed within a matter of hours – and investors are ordinarily required to pay for tokens in either fiat currency (e.g. NZD, USD) or other forms of cryptocurrency (e.g. Bitcoin, Ethereum, Solana etc).

Regulation

Careful consideration needs to be given to the various legal issues that may impact a token sale. Some of the key legal issues are set out below.

Securities law issues

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An offer to the public in New Zealand for funds (regardless of where the offeror is resident or incorporated) is likely to come under New Zealand's financial markets regime in some form and needs expert legal advice, which we can provide. New Zealand has a disclosure-based approach to offers of 'financial products'. Under this approach, an offer to the public requires disclosure unless an exemption applies. Exemptions can apply in relation to the nature of the offer or to whom the offer is made. However, the applicability of exemptions is stringent and can change with time. Even where an offeror relies on an exemption, certain simplified disclosures or notifications may still need to be made. Accordingly, expert advice is needed before relying on an exemption from the disclosure requirements. This means that the proposed token sale is likely to require either disclosure in the form of a Product Disclosure Statement ("PDS") (previously known as a prospectus) or at least comply with simplified disclosure or notification requirements. Disclosure must follow detailed and prescriptive requirements, in terms of content and form, and in the case of the PDS, it must be lodged with the Registrar of Financial Service Providers. Information contained in the PDS and the Registry must be kept up-to-date at all times.

As to whether a token is a 'financial product' under the Financial Markets Conduct Act 2013 ("FMCA") will depend on the token's characteristics and economic substance.

The four categories of 'financial product' under the FMCA include 'debt securities', 'equity securities', 'managed investment products' and 'derivatives'. Each category has its own definition in the FMCA and, depending on the nature of a token sale, a token could fall into one of these categories. (A token that is a financial product is more commonly known as a 'security token', the 'security' being in the 'financial security' sense rather than the 'repayment security' context.)

Even if not coming under the 'debt security' or 'equity security' categories, an issue of tokens tied in some way to the business's financial performance or other obligations is likely to be designated a 'financial product' under the Financial Markets Authority ("FMA")'s designation powers. Designations are not applied retrospectively and are only made after consultation. There is currently no specific designation in place for tokens. However, the FMA has exercised this power in relation to managed investment products and has issued a designation notice which enables the FMA to treat newly-issued shares in investment companies as managed investment products, if those arrangements are found to circumvent the form and compliance requirement of a managed investment scheme.

Regulatory requirements for an offer of financial products are complex and, due to the FMA's designation powers, subject to change. Each token sale, its structure and specific characteristics needs, therefore, to be looked at on an individual basis to determine whether, and to what extent, the FMCA applies.



Financial service provider issues

If the proposed token sale involves the provision of a '*financial service*' under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 ("**FSPA**"), the business will need to:

1. be registered on the Financial Service Providers Register (for each category of financial service provided); and
2. be a member of one of the four available dispute resolution schemes, if the financial services are provided to retail investors in New Zealand. At the time of writing, these dispute resolution schemes include the Banking Ombudsman, the Insurance and Financial Services Ombudsman, Financial Services Complaints Ltd or the Financial Dispute Resolution Service.

The list of financial services under the FSPA is extensive and, much like the analysis required in order to determine whether a token sale is a regulated offer, each token sale needs to be looked at on an individual basis to determine whether it involves the provision of a financial service. For example, a business looking to sell tokens may, depending on the nature of the token sale, be found to be 'operating a value transfer service' or 'issuing and managing means of payment', each of which is a specific financial service under the FSPA.

Anti-money laundering issues

If the token sale involves the provision of a financial service under the FSPA, then the business may also be a '*financial institution*' for the purposes of, and be required to comply with various anti-money laundering obligations under, the Anti-Money Laundering and Countering Financing of Terrorism ("**AML/CFT**") Act 2009 and its regulations ("**AML/CFT Act**").


As its name suggests, the AML/CFT Act imposes obligations on financial institutions (along with a host of other organisations) to detect and deter, and manage and mitigate the risk of, money laundering and financing of terrorism.

At a high-level, these obligations include: the requirement to assess the AML/CFT risk the business may reasonably expect to face in the course of its business; establish, implement and maintain an AML/CFT programme; verify the identity of customers in certain circumstances; observe certain record-keeping obligations; and report suspicious activities and specific transactions.

Fair dealing issues

If the proposed token sale amounts to a regulated offer under the FMCA, or the provision of a financial service under the FSPA, then the business may also be required to comply with the 'fair dealing' provisions of the FMCA.

These provisions prohibit a business from engaging in 'misleading conduct' or making 'false, deceptive or unsubstantiated statements' in any promotional material associated with the token sale (for example, in relation to the costs, benefits or features of the tokens or the nature and extent of the business's relationships that are purportedly in place).



Again, it should be noted that the 'fair dealing' requirements under the Fair Trading Act 1986 will apply if the token sale does not amount to a regulated offer under the FMCA or the provision of a financial service under the FSPA. These requirements apply to the trading of assets, commodities and other goods and services, and will prohibit misleading and deceptive conduct in all communications in relation to the token sale.

Other

There are also a range of other, no less important, legal issues that may impact a token sale (for example, under New Zealand's tax, company, criminal and financial adviser laws) but they are beyond the scope of this article.

We recommend you seek specialist legal advice in relation to any capital raising project that has a token or crypto element to it.

Our [Cryptocurrency / Crypto assets](#), [Financial Markets & Capital Raising](#), [Tax](#) and [Dispute Resolution](#) teams understand crypto and the legal issues associated with token sales. For further assistance, please contact one of Stace Hammond's team members to discuss.

The above overview has been provided for general information purposes only. It is not an exhaustive list of all possible legal issues associated with token sales. It is not intended to be treated as legal advice and is subject to change without notice.

About Stace Hammond

With our expertise in the business, finance and corporate fields together with our dispute resolution team, we provide solutions for our clients.

Our firm widely advises on securities law, securities enforcement, insolvency, establishing business and persona asset structures, business strategy, cryptocurrency, Internet law, and immigration.

In addition to servicing corporate and commercial clients, we have extensive experience providing full-service legal advice for both onshore and offshore clients.

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