

Token arguments: What should investors know about ICOs?

Initial coin offerings are providing businesses with a revolutionary means of funding their projects and even building collaborative networks, as regulatory concerns mount over their disruptive and speculative nature.

While many would consider them fairly recent additions to the fintech landscape, digital currencies have been with us in popular form for almost 15 years. In 2006, ex-schoolteacher Ailin Graef stunned wealth watchers by becoming the first-ever real-cash millionaire in the virtual world Second Life, launched two years earlier. As avatar Anshe Chung, Graef had built a real estate empire in the platform made of mere pixels, selling slices to fellow users for generous heaps of in-world tokens, Linden Dollars. Hailed in the May 2006 issue of *Business Week* as the journal's first avatar cover star, "Chung" had, by the end of that year, racked up Linden Dollar profits in excess of US\$1 million.

When Bitcoin took hold three years later, the impetus was somewhat different. Rather than being anchored to a specific web domain, the new currency was decentralized, with the potential to spark a financial revolution. Powered by so-called blockchain technology, Bitcoin was linked to a holistic, distributed ledger—in other words, the transaction log was synchronized in real time across the entire network of participants. The currency threw down the gauntlet to traditional legal tenders—but despite being cryptographically secure, it has grappled with its own volatility ever since. In 2015,

Bitcoin cousin Ethereum emerged, offering virtual tokens that are not just symbols of value, but programmable units for initiating various computing functions—their range limited only by users' imagination.

Of all the innovations to have stemmed from those developments, initial coin offerings (ICOs) are perhaps the most challenging. Subject to heated debate among finance experts, ICOs demonstrate networked software's knack for unleashing disruptive new models that surge in popularity without pausing to seek regulators' views and often lacking adequate discussion of all the risks. Central to ICOs' appeal are the robust security and cost advantages that have come to be blockchain calling cards. The distributed-ledger system enables self-executing contracts to allot coins or tokens upon receipt of investors' monies—all without the need for traditional market intermediaries, such as book runners, clearing houses, trading exchanges or payment gateways.

“**ICOs are as geared to facilitating new modes of collaboration as they are to attracting finance**”

Seeding relationships

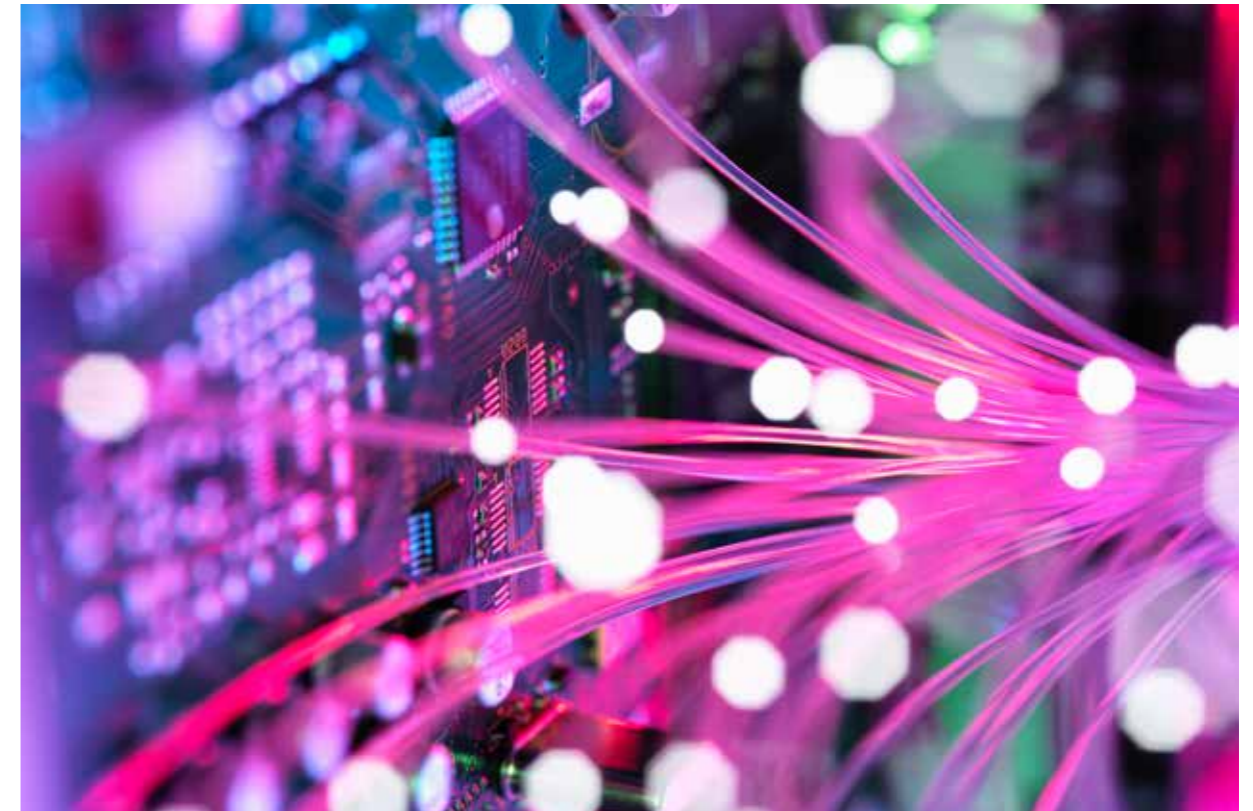
Much like the dawn of digital crowdfunding, ICOs have exploded onto the investment scene with such dizzying speed that regulators have struggled to keep pace.

Even defining what the term ICO means is tricky. As a starting point, one can merge the crowdfunding model with that of a traditional stock issue to form a useful, if superficial, likeness. On a set date, an issuer will roll out a fundraising campaign, typically accompanied by a white paper, for a particular venture and invite members of the public to take part, until a specific goal is reached. However, ICOs operate differently than more established models. For example, when participants enter ICOs they are not strictly securing a “stake.”

They are securing blockchain-based digital tokens—typically modeled on a flexible cryptocurrency, such as Ethereum. Those tokens determine the participants' ongoing relationship with the project.

In addition, fundraising is not always the entire point. Token distribution can be structured to reach specific parties with required expertise, or to seed an initial user base for the venture under development.

Distribution can also be tailored to interlace the project at the heart of the ICO with other, similar businesses—or even other ICOs—to help build ecosystems around shared technology interests. Finally, tokens can be custom-encoded to grant



participants certain rights, permissions or utilities that will shape their interaction with the project—such as governance or intellectual property (IP) rights, or access privileges.

Singular example

One prime example of token rights and utilities in action can be found in an ICO of October 2016, issued by SingularDTV, a firm set up as the world's first, decentralized media studio built on a blockchain. The tokens distributed in its offering—branded “SNGLS”—granted users IP rights to content, the ability to operate modules within the studio's platform and an income-flow management system for financial rewards. The ICO was capped at US\$7.5 million, which the

studio promised to devote to the production of a science-fiction miniseries and documentary content. Following intense hype among blockchain enthusiasts, the studio hit its target ceiling just 15 minutes after launching the ICO.

Given the vast array of potential combinations that can stem from distribution structures and token rights, it is impossible to say that ICOs are all struck from the same template. Indeed, they are as geared to facilitating new modes of collaboration as they are to attracting finance.

US\$185m
was raised for Block.One's EOS token in just five days

Massachusetts Institute of Technology Professor Christian Catalini—who specializes in the study of cryptocurrency trends—explains: “The ICO model is novel and will allow for the design of new types of digital

platforms. It will also change the types of ideas that can be funded, and how new entrants will compete against established players in digital marketplaces.” Best of all, he points out, the model is eminently compatible with other forms of finance. “Professional investors can still add a lot of value here,” he notes. “So, in time, expect investment to come from a mixture of tokens, angels and venture capitalists.”

High-stakes blockbusters

Despite their ingenuity and proven usefulness, however, ICOs are a fast-evolving field. Combine that with the sheer dynamism of their rise, and that results in a potentially volatile, and very polarized, model. And this has left a number of key stakeholders—particularly regulators—very concerned.

On one hand, 2018's biggest ICOs so far have spawned numbers that belittle

Regulating a phenomenon

Our regulatory "heat map" reveals the many contrasting levels of approval or hostility that watchdogs around the world have shown towards ICOs



Color key range:

- █ Interest and mild caution
- █ Investigating; moderate caution
- █ Moderate caution
- █ Highly skeptical
- █ Strong caution
- █ High caution
- █ Blanket ban

CANADA
Moderate caution

In late August 2017, the national finance council Canadian Securities Administrators (CSA)—a group of experts pooled from the country's provincial watchdogs—said that ICOs "can provide new opportunities for businesses to raise capital and for investors to access a broader range of investments." Even so, Canada's involvement this year with the US NASAA's wide-ranging Operation Cryptosweep (see US entry on this heat map) shows it has a high awareness of how ICO processes can be misused.

USA
Moderate caution

As ICOs have become more commonplace, the US Securities and Exchange Commission (SEC) has taken a steadily more cautious stance on their risks. In March, it warned investors that many online ICO trading platforms appear to be SEC-registered and regulated, when they are not. In May, the SEC took the innovative step of launching its own, fake ICO—dubbed the 'Howey Coin', after the famous test case—to show investors which sorts of red flags to watch out for when assessing crypto offerings. The same month, the North American Securities Administrators Association (NASAA) announced that, with the help of US and Canadian authorities, it was conducting Operation Cryptosweep: an investigation of fraud in the ICO space that, by August, encompassed 200 separate probes. In July, the US Chamber of Commerce urged the SEC to "regulate the products and services" enabled by crypto technology.

EUROPE
Highly skeptical

Speaking to Austrian business journal *Trend* on October 5, 2017, European Central Bank (ECB) governing council member Ewald Nowotny (who doubles as president of the National Bank of Austria) hit out at what he views as the "dangerous and deeply dubious hype" surrounding ICOs. He warned that the ECB is discussing plans to implement "concrete legal restrictions" on ICOs, although that stance has not yet been officially confirmed.

UK
Strong caution

"ICOs are very high-risk, speculative investments," warned the Financial Conduct Authority (FCA) in September 2017. It stressed: "You should only invest (if you are) prepared to lose your entire stake." One year later, the Parliamentary Treasury Committee published the wide-ranging report *Crypto-assets*, which stated: "The development of ICOs has exposed a regulatory loophole that is being exploited to the detriment of ordinary investors. The [UK] Regulated Activities Order should be updated to bring ICOs within the FCA's perimeter as a matter of urgency."

ESTONIA
Interest and mild caution

On April 11, 2016, the Estonian Supreme Court applied extra regulations to Bitcoin trading, including requirements to: i) meet customers in person, ii) keep identifications of all customers and iii) report those who trade more than €1,000 per month. In August 2017, Kaspar Korjus—managing director of Estonia's e-Residency scheme—reportedly proposed issuing a national crypto-token, launched via an ICO. But in June this year, Korjus clarified that 'Estoin' would only ease transactions among e-Residency members, and "would definitely not be a 'national cryptocurrency.'"

RUSSIA
High caution

In a stern September 4, 2017 message, the Central Bank of the Russian Federation warned stakeholders that the anonymous nature of cryptocurrency issuance could lead citizens and firms into "illegal activities, including laundering of proceeds from crime and financing of terrorism." As such, the Russian Ministry of Communications (MinCom) issued draft regulations in April requiring each ICO issuer to be backed with at least 100 million roubles of approved capital, with fundraising confined strictly to Federation's territory. Russian Association of Cryptocurrencies and Blockchain executive director Arseniy Shteltsin said that MinCom "should not be managing these financial platforms."

SOUTH KOREA
Blanket ban

Crypto-industry insiders are waiting to see whether South Korea's tough stance on ICOs will soften. In September 2017, the nation's Financial Services Authority imposed a complete ban on ICOs and threatened infringers with "stern penalties." But at an extraordinary session of the National Assembly in August this year, officials mulled the prospect of introducing guidelines to promote the crypto sector and safeguard investors. Business Korea reported: "...discussions to allow ICOs are expected to gain momentum along with preparations of investor protection measures and organisation of a task force to establish order in cryptocurrency trading."

JAPAN
Investigating; moderate caution

While Japan has yet to implement ICO regulations, it is thinking hard about the approach it could take. In April this year, its ICO Business Research Group—a cross-industry panel of experts—proposed a regulatory framework based on two, essential guidelines: i) ICOs should be acceptable to existing shareholders and debt holders, so their technological trappings neither advantage, nor disadvantage, key stakeholders, and ii) ICOs should not present the existing equity finance field with legal loopholes. The proposal also stressed that operators should observe best-practice Know Your Customer standards.

SWITZERLAND
Interest and mild caution

Following a review of blockchain technology in a specialist working group, Switzerland's Financial Market Supervisory Authority (FINMA) published formal guidelines on ICOs in February this year. FINMA noted that it would vet issuers with particular reference to anti-money laundering and securities rules, but would judge each case on its own merits. FINMA CEO Mark Branson said: "Our balanced approach... allows legitimate innovators to navigate the regulatory landscape and so launch their projects in a way consistent with our laws protecting investors and the integrity of the financial system."

ABU DHABI
Strong caution

On July 21 this year, the United Arab Emirates' Securities and Commodities Authority (SCA), based in—and with jurisdiction over—Abu Dhabi, announced: "In light of the rapid development of the digital tokens market and the response thereto by regulators in a number of countries worldwide towards regulating ICOs, the SCA Board of Directors approved [a] plan to regulate ICOs and recognise them as securities... The plan developed by the SCA includes a set of mechanisms as part of an integrated project to regulate digital securities and commodities."

DUBAI
Strong caution

On September 13, 2017, the Dubai Financial Services Authority (DFSA) said that ICOs, and their underlying technology, are "complex." It stressed: "They have their own unique risks, which may not be easy to identify or understand; such risks may increase where offerings are made on a cross-border basis. These offerings should be regarded as high-risk investments." The watchdog urged investors to conduct due diligence on issuers. See also the adjacent entry on Abu Dhabi—the UAE's SCA, which recently announced plans to regulate ICOs as securities, also has jurisdiction over Dubai.

SINGAPORE
Moderate caution

Last November, the Monetary Authority of Singapore (MAS) published A Guide to Digital Token Offerings, which stated that ICOs fall under the city-state's securities laws. In February this year, Singapore's deputy prime minister and MAS chief Tharman Shanmugaratnam told Parliament: "We will continue to encourage experiments in the blockchain space that may involve the use of cryptocurrencies, because some of these innovations could turn out to be economically or socially useful. But equally, we will stay alert to new risks."

HONG KONG
High caution

"As digital tokens involved in ICOs are transacted or held on an anonymous basis," said Hong Kong's Securities and Futures Commission (SFC) on September 5, 2017, "by their nature they pose inherent, and significant, money-laundering and terrorist-financing risks." In its latest Annual Report, the SFC noted: "In February 2018... we took regulatory action against a number of cryptocurrency exchanges and issuers of ICOs. Subsequently, in March 2018, an issuer halted its ICO to the Hong Kong public and agreed to unwind ICO transactions for Hong Kong investors."

CHINA
Blanket ban

In a joint statement of 4 September 2017, seven of China's biggest watchdogs—including the Ministry of Industry and Information Technology, China Securities Regulatory Commission and People's Bank of China—condemned ICOs as "illegal financial crimes" and accused issuers of "disrupting" markets. The agencies promptly prohibited the "opening, registering, dealing, clearing or settling of accounts related to ICOs."

AUSTRALIA
Interest and mild caution

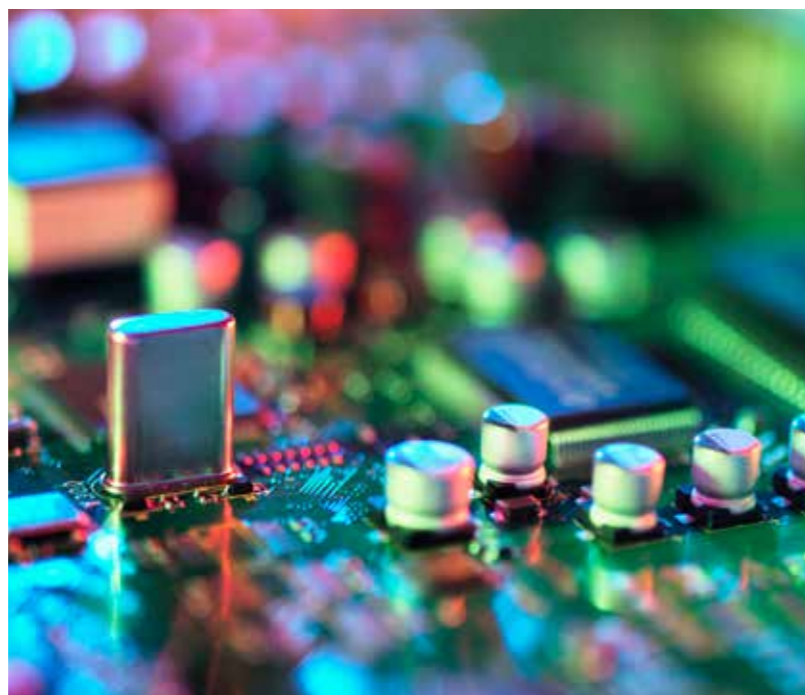
Addressing fintech players in April this year, senior Australian Securities and Investments Commission (ASIC) official John Price said: "We are determined... to see Australia's innovative fintech [sector] flourish in the right regulatory environment, and that means maintaining an open mind when it comes to new technologies and 'early-days' business models. But... ASIC must be focused on both protecting Australian consumers and facilitating innovation... When it comes to cryptocurrencies and our engagement with ICOs, this position is no different." Price stressed that parties who make "misleading or deceptive statements" about their offerings will be a "key focus" for ASIC going forward.

SingularDTV's takings – for example: US\$300 million for Huobi Token, a coin deployed across a South Korean cryptocurrency exchange; US\$320 million for decentralised casino currency Dragon; US\$1.7 billion for messenger-based tokens network Telegram and US\$4.1 billion for the second-phase issue of crypto token EOS (trouncing its first-phase issue of June 2017, which raised US\$185 million). Indeed, according to a recent, joint report from PwC and specialist market analysts the Crypto Valley Association, the 537 successfully closed ICOs issued in the first five months of 2018 raised more money than all pre-2018 ICOs put together – pulling in a grand total of US\$13.7 billion.

On the other hand, high numbers equal high stakes. In October 2017, it emerged that the senior managers behind cryptographic ledger project Tezos – which had raised US\$232 million through an ICO – had collapsed into infighting, holding up the project's delivery and crashing the value of Tezos-token derivatives on cryptocurrency exchanges. The immense size of the platform's ICO was cited as the cause of their acrimony. In parallel, the tokens industry is still haunted by the massive hack of ICO-backed platform The DAO in June 2016, which left it with a fatal, US\$55 million hole—highlighting how vulnerable virtual funding can be to cybercrime.

In addition to those extreme highs and lows, regulators have become increasingly unsettled by fundamental aspects of how some ICOs operate. While agencies that have formed opinions on the model have a host of different views (see our regulatory heat map on page 26 for details), certain common concerns have emerged from their statements. These reflect the fact that ICOs have sprung up as creatures of technology, bypassing traditional finance regulators.

Anonymity and lack of accountability give rise to some of the misgivings; significant numbers of issuers (though not including the examples already mentioned) choose to remain anonymous. And, as



tokens are cryptographically secure, backers are unable to learn the identities of fellow participants unless issuers volunteer that data, which makes it difficult for them to unify their voices in the event of qualms with regard to a project's progress. Many ICO projects do not provide detailed prospectuses explaining how they will work, or how funds will be applied, leaving backers without concrete information on the nature of issuers' intentions.

Risk and volatility are also a focus. Projects tend to be early-stage experimental efforts that may not have been well thought through, and could flounder in the marketplace. Meanwhile, as with standard cryptocurrencies, the value of ICO tokens can fluctuate wildly.

Gaming the system?

Professor Arjya Majumdar—a capital-markets scholar at India's Jindal Global Law School—raises significant issues in his own assessment of the ICO market's information gaps. "I suspect that many

ICO founders could be using this method for illegal purposes," he says. "In light of the prevailing regulatory concerns, my impression is that a lot of the projects coming out now are either: a) borderline or completely fraudulent; or b) designed so poorly that their ICOs risk falling flat, because the founders can't deliver. Other founders may simply choose not to deliver.

"One ICO I looked into was raising funds to set up a gaming platform, and backers would receive tokens that granted them access to the gaming services. That doesn't look like a problem at first, because the project is effectively buying its customers before the business even exists. But no one was looking at the ability of the founder, or senior team, to execute." Majumdar notes: "When you compare that to the standard securities market, which is regulated—and where fund seekers are required to make disclosures that record, in extensive detail, the business objectives, strategy, key personnel, material contracts and

risks—anyone investing in an ICO faces significant risks."

By contrast, Brian Lio—CEO of specialist blockchain research house Smith + Crown, which advises budding issuers on their ICO models—says: "Almost all of the projects we've talked to are very eager to do things the right way. They want to be good actors. They want to follow best practices. They want to be compliant."

Lio continues: "Everyone who participates in the token economy feels the same way. They want protections much like they have in other domains. They want to participate in projects that come from the best intentions. Both sides of the equation are looking for features that serve them better—so it's in both sides' interests to find regulatory models that work. The trick is getting to a place where that security is provided, but it's not so onerous that it blunts what is an outrageously fast-moving technology."

Voices of experience

In Lio's view, there are "too many genies out of too many bottles" to expect ICOs to fade away. Where he and Professor Majumdar agree is that they both expect to see the emergence of a standards-setting body—one that will formulate a globally acknowledged set of best practices for issuers to observe. In the meantime, though, what should issuers do to ensure that their offerings are legally and ethically sound?

"The reality is that you have to get experienced counsel," says Lio. "We're excited by the advisory work we do with projects—particularly helping teams to think through the crypto-economic design of an entire token economy. But before we even start those discussions, we ask: 'Who is your counsel?' If you're going to distribute a token publicly, you are going to be dealing with a number of

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Kevin Petrasic, partner, White & Case in Washington, DC

complex, legal issues. We haven't seen a single jurisdiction where this process is simple or straightforward. There is expert analysis in place, and the only way to navigate it is with experienced, professional counsel."

Indeed, issuers and investors alike will have plenty of ICO threads to keep track of over the coming years as the field evolves, says Kevin Petrasic, partner and Head of the Global Financial Institutions Advisory practice at White & Case in Washington, DC. In his own jurisdiction, the key question will be whether regulators continue to treat ICOs in the same way as traditional securities, in line with the current, official stance of the Securities and Exchange Commission (SEC).

In US law, such judgments hinge upon interpretations of the so-called Howey Test—derived from the 1946 case *SEC v. W.J. Howey Co.*—which sets legal standards for how securities are marketed to the general public. "At this point," says Petrasic, "one significant gray area is whether the pre-purchasing of products or services—for example an access token—via ICO tokens, or the seeding of a user base, fits within the Howey Test's definition of a security. So there's potential for friction between some of the more unique and flexible properties of

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US\$55m

The cost of a hack of ICO platform The DAO in June 2016

laundrying (AML) policies and the relevant legislation.

"At the same time, it's important for issuers to make things easier for investors by maintaining high standards of disclosure—regardless of whether or not their local regulators require them to. In the US, I certainly see scope for the Consumer Financial Protection Bureau to take a greater interest in ICOs if bad actors leave a sequence of investors financially damaged. And then, of course, there's the question of how individual states will react. In many ways, there's an irony here: A set of new-age financial services products that have arisen to get away from official oversight are now beginning to attract considerable regulatory attention. But, in the end, that may legitimize the space."

Petrasic argues that law firms have a pivotal role to play in defining safe turf within the ICO realm. "This is going to play out on several fronts," he says. "Attorneys can advise issuers on the Howey Test viability of their offerings, and examine those products for AML compliance. Firms will also be well placed to monitor the space for emerging risks, and guide clients through that risk matrix as it develops.

This is a burgeoning field, so my hope for ICOs is that those who are working out how to do it responsibly will create models that benefit all stakeholders." Concerns remain that a succession of high-profile ICO failures could prompt regulators to react punitively, damaging some of the field's more positive strides. However, the more widely best practices spread, the smaller that threat becomes. ☺