ICOs are more than a token gesture

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In brief…

With total amounts raised in initial coin offerings (ICOs) this year exceeding US$2 billion and a number of sales coming forward each month there is an understandable interest in the operation of this new phenomenon.

In addition to private investors, the funds world is taking interest with a number of hedge funds already investing in portfolios and building strategies based on cryptocurrencies and token offerings. This interest in the technology is only likely to increase.

Against this background there is a huge divergence in opinion as to attitudes regulators should take to the product. At one end of the spectrum is the view that this will revolutionize the finance market with cheaper more efficient access to direct holdings of assets and closer and better links between companies and their customers, supplier and investors. At the other end of the spectrum is the belief that these offerings will be used mainly for abusive or fraudulent purposes. The reality is likely to be somewhere in between. Properly advised and supported by an open regulatory framework, ICOs could provide a new and valuable range of business and stimulate innovation and enterprise as a truly global product.

What are ICOs?

ICOs are a form of digital currency or token using blockchain technology. Typically an issuer accepts a cryptocurrency such as bitcoin or ether in exchange for a new digital coin or token that carries rights in respect of assets associated with a business or project. ICOs are being structured in a wide variety of forms and may be used for various purposes. Some ICOs are directed at customers or suppliers as a form of loyalty program or to provide a form of access or purchasing power (preferential or otherwise) in respect of assets of the issuer’s business. Other ICOs are similar to venture capital, more focused on raising initial funding; and they have proved popular for funding new blockchain or cryptocurrency ventures. Some of these offers will be highly speculative and involve substantial levels of risk for example into new and untested technology products which put the whole of the upfront investment at risk. It is essential to examine the legal and regulatory basis for any ICO as an unauthorized offering of securities is illegal and may result in criminal sanctions in a number of jurisdictions. Legal analysis of the underlying token will determine if it should be treated as a specified investment or form of regulated security or is more appropriately a form of digital asset that is not itself subject to the regulatory regime.

How are the regulators treating ICOs so far?

While a few jurisdictions and most notably China, have banned ICOs outright, most jurisdictions are applying a more thoughtful approach to the new technology. ICOs are not generally regulated as a specific product under most financial regulatory regimes. The financial regulator will typically apply the existing regulatory regime to the
underlying product and business (e.g., is it a security, a commodity, electronic money or does the business of the offeror constitute a peer-to-peer platform or exchange). Based on this analysis, the offering or platform may fall outside the regulatory perimeter or may be subject to regulatory permissions or authorization.

**What are key considerations and some of the typical aspects of ICOs?**

The nature of the token product will vary based on the underlying venture and the style of offering. However, typical attributes provided by tokens will include:

- Access to the assets or features of a particular project
- The ability to earn rewards for various forms of participation on the platform
- Prospective return on the investment

The nature of the business and the purpose and structure of the token offering will typically be set out in a white paper available to potential purchasers. As the white paper is not required to comply with any regulatory disclosure standard (unlike a prospectus), the quality and information covered can be varied. While the best white papers can provide a clear and detailed analysis of the underlying business and technology involved and highlight relevant risks and concerns, some provide scant details and a poor understanding of the business uses and risks involved and should be avoided.

Key aspects to consider will include the:

- Availability and limitations on the total amount of the tokens
- Decision-making process in relation to the rules or ability to change the rules of the scheme
- Nature of project to which the tokens relate
- Technical milestones applicable to the project
- Basis and security of underlying technology
- Amount of coin or token that is reserved or available to issuer and its sponsors and the basis of existing rights
- Quality and experience of management
- Compliance with law and all regulatory requirements

If ICOs are to succeed, the standard of risk management and disclosure will need to improve. Those that are securities should be regulated as such, while those that are in effect a sale of a digital asset continue to be sold outside the regulatory framework. In either case, it is likely that a large number of token offerings will fail to deliver the perceived benefits much like any high-risk investment pool. Investors should not be misled by the marketing papers or market hype. Different types of token offerings carry different levels of risk and it is hoped that over time the market will identify and properly categorize the appropriate level of risk and disclosure associated with a token offering.

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