Editorial

ICOs and Improvement Potentials for a Global Digital Market Infrastructure

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With the increasing popularity of initial coin offerings (ICOs), let's take an opportunity to better understand their framework as there is an expectation that they will become even more commonly used in the immediate future. Global ICO markets have grown rapidly. Recent EY research (initial coin offerings, aggregate data 2015-2017, January 2018) shows that 372 ICOs around the world raised USD 3.7 billion in funds in the past three years. Offerings are taking place on platforms that span national borders in a digital market environment. ICO projects use either existing or custom blockchain platforms, with 77% using Ethereum.

From Investor Frenzy to Bans

ICOs are a way to raise funds through crowdfunding efforts, where companies offer utility or security tokens for fiat currency or cryptocurrency instead of an equity stake in a company. This fund-raising method is beneficial for start-ups seeking funding as they have access to a larger pool of capital without giving up equity and voting rights in their business. Often, ICOs are used to bypass the rigorous and regulated capital-raising process required by venture capitalists or banks. Different regions have varying levels of regulatory strictness for ICOs and regulators around the world have raised a number of concerns in consumer warnings, public statements (i.e., US and Europe), or have banned ICOs (i.e., China). Key questions are about:

(1) the legal and regulatory status of a digital token or coin as a potential security or financial instrument, and
(2) the process of when, how, and where ICOs are offered.

Uncertain Regulatory Space

Tokens are not standardized like shares and are seen as an intangible asset utilizing blockchain technology. They are based on smart contracts that widely vary in terms, rights, and interests. Also, the interpretation of the nature of a token often is unclear: is it a utility, property, security, or currency? The consequence is that ICO concepts need to be analyzed carefully on a case-by-case basis to clarify the rules that apply. Issuers, promoters, influencers, and trading platforms are making transactions in a given regulatory framework, which does not provide full clarity for ICOs yet and raises uncertainty to keep in compliance with securities offering, investor protection, fraud, and anti-money laundering rules.

Selling a Little More than an Idea

Unlike initial public offerings (IPOs) in the stock market, ICOs are sold into the market before a business solution exists. Our research shows that many ICOs are either representative of the idea (84%) or prototype (11%) stages. Often, the only foundation for the ICO is a white paper that describes the planned technology and a small piece of software that governs how the tokens are issued. Accordingly, valuations are based solely on a conceptual document. The lack of fundamental valuation and due diligence process by investors is leading to extreme volatility in the market. That's why markets received "buyer beware" messages from many regulators.

Building Market Confidence

Like IPO markets, investor confidence and market integrity are key assets of a functioning marketplace. While ICOs can help create greater transparency in the fundraising process and can lower costs, we still need to consider improvements to further develop the ICO market, such as:

(1) standardize the minimum transparency requirements for issuers (legal structure of a token, the offering process and document pre-ICO, and use of proceeds and financial reporting disclosure post-ICO) to support confidence;
(2) establish clear regulations (prevent market abuse and fraud, taxation, and corporate governance to keep issuers accountable) and safe harbors for all market participants to enhance integrity;
(3) ensure global oversight and extraterritorial enforcement of rules to better protect investors.

ICOs are part of our future, so let's ensure we understand how to improve them.