BLOCKCHAIN AND INITIAL COIN OFFERINGS (ICOS)

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Introduction

As subsets of financial markets, capital markets are integral parts in producing monetary output in economies globally, through which debt or equity-backed securities are bought and sold. The blockchain concept has generated a huge amount of interest within capital markets. Blockchain offers a new approach to data management and sharing that is being proposed as a solution to many of the inefficiencies afflicting the industry. The idea is to have a new architecture, where all capital market participants work from common datasets, in near real-time, and where supporting operations are either streamlined or made redundant.[1]

ICOs

A new method of capital raising called the Initial Coin Offering has exploded this year. It is a process where tech start-ups, mainly from inside the digital-currency sector, create a new virtual coin or token and offer it for public sale.[2] It lies somewhere between a traditional initial public offering (IPO) and investment-based crowdfunding. However, the term ICO is somewhat misleading: these flotations are quite different from the similar-sounding IPOs (when companies list on a stock exchange). For example, whereas investors in shares receive ownership rights and dividends, those who put their money in ICOs get crypto-currency, or tokens issued on a blockchain. They are meant to serve as the currency for the project they finance: to pay for storage space on blockchain data storage network - Filecoin for example (in October 2017 Filecoin has officially finalised its ICO, raising more than $257 million over one month of activity).[3] They can also be traded by speculators; investors hope that successful projects will cause tokens' value to rise.[4] This new method of financing is turning the traditional venture capital model on its head, because then, theoretically, companies do not need venture capitalists.

Another big difference between IPOs and ICOs is that most ICOs are currently unregulated. Instead of providing an audited prospectus, for instance, issuers just publish a "white paper" which often describes the project's aspirations in glowing terms.[5] In fact, regulators worldwide are getting extremely worried on how ICOs are being marketed. For example, in September 2017, the SEC charged a businessman and two of his companies for defrauding investors in an alleged ICO scheme. The SEC said it charged the parties with selling unregistered cryptocurrency securities reputedly backed by investments in real estate and diamonds, when it found no such investments had taken place.[6]

It is expected that in the short-term, ICOs will continue to impact what investors are thinking about and effect how relatively small amounts of capital are allocated. In the medium-term, the number and size of crypto-funds will grow and a few decentralised protocols of tremendous value that deliver actual value to end users (not just speculators) may emerge.

[1] http://www.dltmarket.com/docs/BlockchainInCapitalMarkets-ThePrizeAndTheJourney.pdf
[2] https://www.wsj.com/articles/whats-an-initial-coin-offering-icos-explained-in-11-questions-1506936601
[3] https://www.coindesk.com/257-million-filecoin-breaks-time-record-ico-funding/
[4] https://www.economist.com/blogs/economist-explains/2017/08/economist-explains-17
[5] https://www.economist.com/blogs/economist-explains/2017/08/economist-explains-17
[6] hhttps://www.sec.gov/news/press-release/2017-185-0

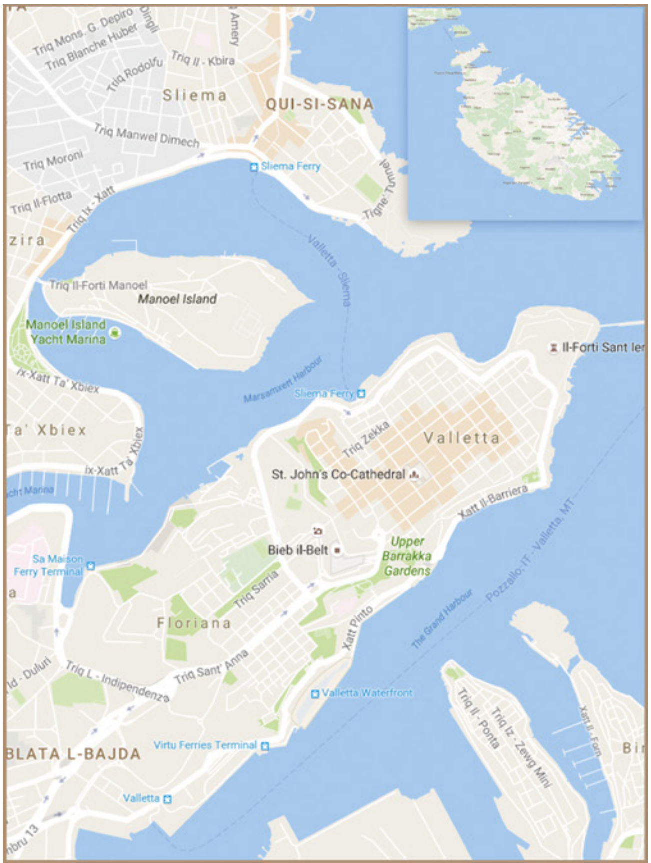
This is a challenging, but at the same time, very exciting area to be in. In fact, an investment in ICOs comes with a lot of caution. It opens up the way to evaluate companies.[7] For example, it is extremely important that all the due diligence aspects are done (like what is done in start-ups). One also has to look at the resilience of the crypto-sale that the company is planning. Thirdly, it is vital to look at the level of transparency that these companies are giving to investors. Finally, it is extremely important to look at the business model and how it ties into the token that the company is issuing. This area is a very important one, and sometimes it gets disconnected from the actual operations of the business.[8]

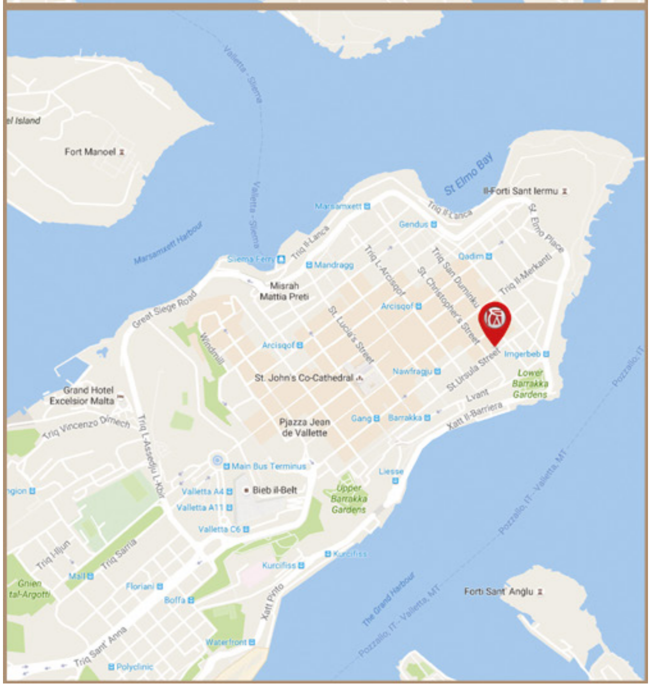
ESMA's Opinion on ICOs[9]

On the 13th of November 2017, ESMA issued two warnings concerning ICOs (one addressed to investors and another to firms involved in ICOs). ESMA announced that ICOs are extremely risky and highly speculative investment vehicles. Furthermore, it also issued a warning to those firms involved in ICOs that they should give careful consideration as to whether the ICO qualifies as a financial instrument. ESMA pointed out that if the activities constitute regulated activities, then the firms involved in the project need to comply with the relevant legislation, including for example:

- the Prospectus Directive;
- the Markets in Financial Instruments Directive (MiFID);
- the Alternative Investment Fund Managers Directive (AIFMD); and
- the Fourth Anti-Money Laundering Directive.

[7] https://cryptopotato.com/10-keys-evaluating-initial-coin-offering-ico-investments/
[8] http://www.huffingtonpost.com/entry/william-mougayar-the-future-of blockchain_us_588ab294e4b02d07f20d918a
[9] https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms





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