Initial Coin Offering: a Sustainable Source of Financing?

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Since the emergence of Bitcoin, Blockchain Technologies, also known as Distributed Ledger Technologies, have made headlines all over the world. Their successful application to the financial sector let to the creation of virtual currencies, paving the way for more complex financial uses such as Initial Coin Offerings (ICOs). **With ICOs emerging as a new tool for tech companies to finance themselves, the European Union and its Member States are exploring whether regulation is needed.**

From Blockchain to Tokens

Blockchain Technologies can be understood as a new layer of the Internet, where computers and their users are connected to each other, can interact directly and are aware of all modification made to the network without the need of an intermediary acting as a centralising party. Data is complied within distributed ledgers – or databases of transactions – which are replicated, distributed and synchronised in a number of computers rather than being stored on a central server

In 2015, Etherum used Blockchain technologies to build and run Smart Contracts, self-governing and self-performing computer protocols that verify and enforce the performance of a contract, without any downtime, fraud, control, or interference from a third party. Smart Contracts introduced into the Blockchain ecosystem the concept of tokens, lines of code – or entries – in a ledger granting their owners any type of rights and/or assets whether located on the blockchain or not.

The creation of Smart Contracts has fundamentally modified the Blockchain ecosystem. Tokens can be acquired by any means, from payment in cash, to transfer of ownership, to exchange of the provision of a service. Cryptocurrencies have become one of many token types available in the Blockchain environment, opening the door for Initial Coin Offerings.

What are Initial Coin Offerings?

With cryptocurrencies and tokens, Distributed Ledger Technologies (DLT) **have created new types of digital assets with assignable and transferable ownership that can be traded.** These digital assets enter financial markets through a specific mechanism known as Initial Coin Offerings (ICOs), in which start-ups engage to finance themselves.

In practice, a DTL company announces its upcoming ICO in an executive summary explaining the goal of the project to fund. The Blockchain ecosystem provides feedback to the company, which integrates them in a white paper laying down the technical and business dimensions of the project. On the basis of this white paper, the DLT company launches an ICO campaign during which early investors can buy cryptocurrencies or tokens in the hope that the project becomes successful after its launch and increases the value of their digital assets.

At the end of the ICO campaign, either funding requirements are met and the project is run on the money raised, or the ICO is deemed unsuccessful and the funds are returned to the backers. In the case of a successful ICO, the issued tokens are fungible and can be traded – usually on online secondary markets, which are created as the tokens gain traction.

Initial Coin Offerings are at the heart of a legal vacuum

Due to the mixed nature of the digital assets they sell, ICOs evolve in a legal vacuum. If cryptocurrencies are primary used to store and transfer value, tokens grant their owner a right or ownership to an asset according to the terms of the Smart Contract managing their distribution and allocation, preventing tokens from becoming a homogenous class of digital assets.

In regulatory terms, cryptocurrencies and tokens can be considered either as (i) **currencies** used to sell and buy goods and services, (ii) **commodities or assets** that store value or perform a given function like gold, as well as (ii) **securities or financial instruments** like equities and investment products. As such, cryptocurrencies and tokens could be subject to:

- *Anti-Money Laundering rules* as the digital and technical nature of cryptocurrencies and tokens allows for transactions without any control on the source of funds,
- *Securities and Financial Stability rules* since Blockchain Technologies issue new types of digital assets that could be considered as a security,
- *Taxation rules*,
- *Payment Services and eMoney rules*, as some tokens can be used as payment means and be traded within the Blockchain ecosystem or off-chain once issued.

ICOs rely on technologies that might be subject to regulation

As tokens are backed on a new technology – namely Blockchain, their value is dependant on the ability of the technology to exist. The general regulatory framework tackling the technological aspects of Blockchain will influence one's ability to trade tokens. The European Commission recently highlighted the main opportunities challenges Distributed Ledger Technologies raise in terms of:

- *Privacy regulation* since Blockchain Technologies might not satisfy privacy regulatory obligations such as the right to be forgotten,
- *Reporting requirements*, as Blockchain Technologies could grant regulators access to the data they oversee,
- *Neutrality of technology and infrastructure* with Blockchain having the potential to create more democratic mechanisms for validating, sharing and accessing information or value,
- *Cybersecurity* notably related to human errors during the coding phase and to hacking when running.

What is next?

The European Union and its Member States are investigating the opportunity to regulate Blockchain Technologies. The European Commission launched on 1 February 2018 of its European Blockchain Observatory and Forum to build expertise and address regulatory challenges across the EU. Member States such as France, Germany, Luxembourg and the United Kingdom are also exploring the need for crypto-regulation at national level, with notably the French PACTE Bill suggesting the creation of a public label for ICO issuers.

Still, the Blockchain ecosystem remains reluctant to regulation that would concentrate power in the hands of the few while the decentralised nature of Blockchain Technologies questions the very feasibility of regulatory oversight.