The ICO is dead, long live the ICO

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Abstract

Cryptocurrencies. Tokens. ICOs. The buzzwords of the moment. But what exactly are they and what is causing market commentators to speculate that their time is up? From the infamous attack on The DAO to the struggle with legal categorisation of tokens, it is no surprise that the market for ICOs has started to decline. Will security token offerings now become the norm and how will cyber-utopians react to this clear move towards a more regulated and industry-compliant asset class? One thing is certain – ICOs in their existing form are not sustainable. What comes next remains to be seen.

Keywords: cryptocurrencies; tokens; COs; securities; future scenario

In the beginning

Bitcoin was propelled into popular consciousness in 2009 following the publication of a White Paper by Satoshi Nakamoto.[i] What followed was a gradual rise in the development of cryptocurrencies and a growing interest in the capabilities of the underlying distributed ledger technology (DLT). In 2014, Ethereum, the DLT platform created by Vitalik Buterin, entered the arena with its initial coin offering (ICO) that raised US$18.4m in 42 days. The gates opened and by the end of 2017 it was estimated that the ICO market exceeded US$4bn. Appetite for ICOs seemed insatiable. That is until 2018 when the number of ICOs started to decline and it appeared that the market had lost its enthusiasm for this new form of capital raising. In many ways this was unsurprising. How could such rate of growth be sustainable, when companies such as Brave, the internet browser which rewards users with cryptocurrency, launched an ICO that raised around US$36m in less than 30 seconds? But what was it that changed and does this slowdown in ICOs signify its demise? The answer is not straightforward, but there can be no doubt that increased regulatory pressure, public scrutiny and legal uncertainty have all contributed. One ICO in particular has brought these issues to the forefront and demonstrates that in order for the ICO to survive it will need to adapt.

Under Attack

A decentralised autonomous organisation (DAO) aims to codify the rules and decision making apparatus of an organisation, eliminating the need for central control. It epitomises the pinnacle of the cyber-utopian dream. "The DAO" is the name of a particular DAO built as a smart-contract on the Ethereum blockchain which, when launched in 2016, raised over $100m in just 15 days. By the end of its funding period it represented the largest crowdfunding in history. But only a month after launch, an unknown attacker found a fault in the underlying code and managed to steal more than 3.6m in tokens, representing a loss of around US$60m.

Buterin, as creator of Ethereum, stepped in with a proposal to quell the attack whilst at the same

time sending a message to tokenholders encouraging them to "*sit tight and remain calm*".[ii] The billion-dollar euphoria started to fade. Angry tokenholders took to the internet to express their views. Some called it "*a bailout by a central authority, i.e., the antithesis of the crypto world*".[iii] The ethos that digital code is the ultimate arbiter without the need for any central oversight was challenged.

The DAO attack showed us that cryptocurrencies and ICOs do not exist in a vacuum, but involve real people who have invested real money, exposing them to a risk of large losses. How should those tokenholders claim their lost tokens? What value do the tokens represent? Who is the counter-party to any potential claim?

Is this your token?

In essence, ICOs are a form of crowdfunding facilitated through the use of DLT involving the issue of transferable tokens to investors. The form of the tokens issued varies widely. In some ICOs they resemble traditional securities, while in others they may represent rights to receive or access future services. ICOs are typically used by SMEs who may not otherwise have access to the highly regulated world of traditional equity capital markets.

To date there is no universally accepted definition of cryptocurrency. Without a standard measure by which to define what a cryptocurrency or token is, legal characterisation becomes blurred. Under English law, property is traditionally characterised as either real or personal property. Personal property then divides into two further categories: choses in possession and choses in action.[iv] Tokens, *prima facie*, do not fit comfortably into either category. Some have argued that tokens should be considered a *sui generis* form of intangible property,[v] a view supported by a High Court finding that tradable carbon emission credits constituted intangible property under English law, notwithstanding that they cannot be claimed or enforced by action.[vi] Whilst this seems a logical view, it is by no means an accepted principle and leaves investors in ICOs exposed to the significant risk of legal uncertainty (and this is without giving regard to the equally complex question of jurisdiction). It is likely that, at least under English law, as increasing number of cases are litigated, common law will evolve to encompass the inclusion of virtual rights.

Read all about it!

In order to attract investors, ICO issuers typically prepare a white paper which acts in many ways like a prospectus used in regulated market offerings, but with one key difference: an ICO white paper is an informal and unverified document. This leaves investors open to the risk of misrepresentation made by fraudsters looking to raise easy money with little to no accountability. In the aftermath of The DAO attack, in one of the first regulatory interventions of its kind, the United States Securities and Exchange Commission (SEC) issued a report defining certain tokens as securities under federal US securities laws, thereby requiring companies issuing similar tokens to prepare and file a formal prospectus with the SEC.[vii] This move was significant, not least because it demonstrated that regulators are willing to take action to protect investors from the current risks of ICOs. Similarly in Europe, the Basel Committee on Banking Supervision recently issued a statement declaring in that "crypto-assets and their related services" carry significant risk and urging investors to proceed with caution.

Three's a crowd

It would be a mistake, however, to say that the current ICO market is entirely unregulated. ICOs, as a form of crowdfunding, have the potential to fall under existing crowdfunding regulations. In the UK these comprise three different categories: reward crowdfunding, equity crowdfunding and loan crowdfunding. Of the three, reward crowdfunding is the only category which is not subject to a regulatory regime meaning that tokens are not classified as 'financial instruments' or 'securities'. To date, most ICOs trying to target

the UK market have been structured so as to fall outside of these regulatory regimes. Nevertheless, in the aftermath of The DAO attack it seems that the tide may slowly be turning and market participants, including even the most hardened of cyber-utopians, are realising that ICOs in their existing form are not a viable long-term option if there is no ultimate investor protection.

Herein lies the problem with the current ideology underlying the ICO markets: *laissez-faire* capitalism is all very well until things start to go wrong. There is a lesson to be learned here and it is not without irony. Remarking on the aftermath of The DAO attack, one media commentator aptly described it as "*further proof that Polybius' theory of anacyclosis prevails in all matters*".[viii] In other words, those cyber-utopians who were the loudest advocates for decentralisation, upon finding themselves without recourse, began to call for regulation and better protections in light of the "*dangerous pitfalls for potential investors*" in the "*current "wild-west" environment*" of the ICO markets.[ix]

Security in securities

While highly publicised litigation continues in the aftermath of The DAO attack (and more recently has been commenced in connection with the collapse of Quadriga CX) and as market participants and lawyers alike struggle to find a legal basis to claim for the resulting losses, a new capital raising contender has emerged in the form of security token offerings (STOs). Just how different STOs are from ICOs remains to be seen, but they are undoubtedly a move towards making tokens a more regulated and industry-compliant asset class. What's in a name, so the bard says, but perhaps this choice of label is a deliberate attempt to reassure market participants that token offerings can provide investors with the protections that are so clearly lacking in the current ICO market. The cyber-utopians will not be happy but, as history has taught us, achieving consensus across systems with numerous stakeholders is a difficult feat without some form of central oversight. The beauty of technology is its ability to adapt. Perhaps the ICO is not dead, but is merely due an upgrade.

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[i] Satoshi Nakamoto, 'Bitcoin: A Peer-to-Peer Electronic Cash System' (2009).

[ii] Ethereum Blog posted by Vitalik Buterin, 'Critical Update re: DAO Vulnerability' (17 June 2016).

[iii] Anonymous Reddit user in a discussion chain, 'Critical update RE: DAO Vulnerability'. https://www.reddit.com/r/ethereum/comments/4oiqj7/critical_update_re_dao_vulnerability/

[iv] Halsbury's (Volume 13 (2017) para 1.

[v] Sinclair and Taylor, 'The English Law Rights of Investors in Initial Coin Offerings' 4 JIBFL 214 (2018).

[vi] *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10 (Ch) [2013] Ch 156.

[vii] Securities and Exchange Commission Release No. 81207/July 25, 2017: Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO.

[viii] Kaminska, 'Cryptocurrency: No longer sticking it to the MAN', Financial Times (22 June 2016)

[ix] Anonymous message posted on Pastebin (a text storage website).