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HIGHLIGHTS

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INITIAL COIN OFFERINGS (ICOS) FOR SME FINANCING

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Initial Coin Offerings (ICOs) are currently the object of much media coverage and hype around their potential for profit making. This extends to their potential for addressing gaps in SME financing. This document reproduces the highlights from recent OECD analysis of the potential for ICOs as a financing mechanism for SMEs.

Initial Coin Offerings (ICOs) are one of the most prominent applications of blockchain for finance. Although the lack of regulatory clarity currently exposes ICO participants to some risks, appropriately regulated and supervised ICOs offer a potential new way to raise capital for projects enabled by Distributed Ledger Technologies (DLTs) and the blockchain. ICOs in their current shape and form, however, carry important risks for the SME issuers and investors subscribing to token offerings. The uncertainty of the applicable regulatory framework for ICOs and crypto-asset markets, coupled with the lack of financial consumer protection safeguards, limitations in the structuring of ICOs and operational risks related to DLTs, exposes investors subscribing to ICO offerings and SMEs issuing tokens to significant risks.

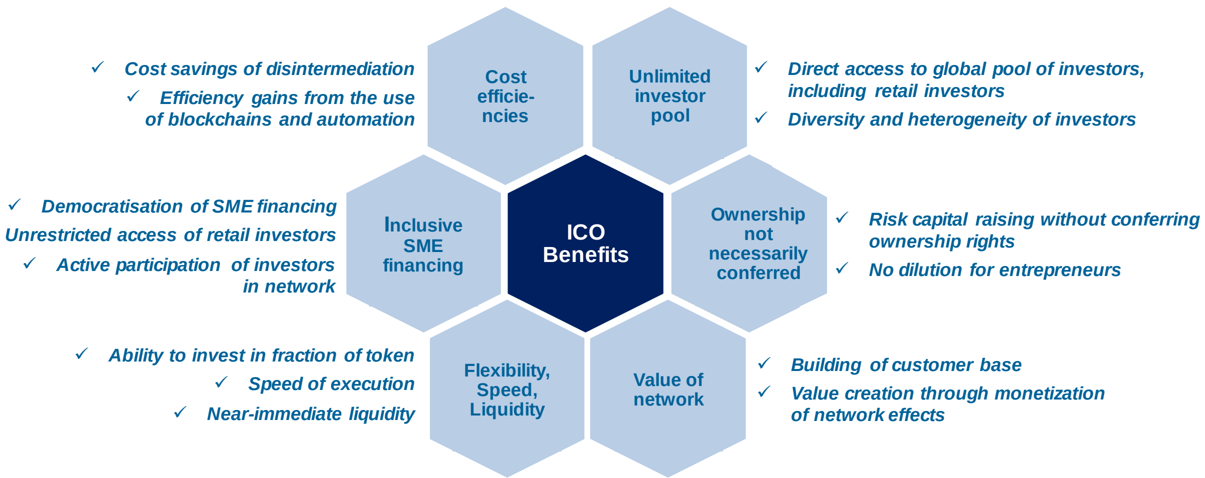
A recent OECD report traces the process of ICO fundraising, from conception to product launch, to weigh up the benefits and limitations of this innovative funding method from a practical perspective. The report highlights the importance of network effects as a significant source of value creation for ICOs. In the absence of a strong business rationale for the use of blockchains, such network effects cannot be materialised, pointing to the limits in the use of ICOs as a “mainstream” financing tool for SMEs.

While most of the discussion around ICOs has focused on the uncertainty of the applicable regulatory framework for ICOs and crypto-asset markets, this OECD report takes the analysis further, discussing tokenomics and limitations in ICO structuring which can give rise to conflicts of interest and expose investors subscribing to ICO offerings and SMEs issuing tokens to significant risks. It highlights issues around valuation, accounting and allocation of value, as well as the trading of tokens issued in ICOs, and compares ICOs to more traditional SME risk financing mechanisms, such as small IPOs, venture capital and crowdfunding.

The benefits of ICOs

ICOs enabled by DLTs and the blockchain have the potential to offer a new way to raise capital for projects, benefiting from efficiencies, cost savings and speed of execution, if appropriately regulated and supervised. Regulated ICOs can be a more inclusive financing vehicle by allowing small retail investors to participate in the financing of businesses and start-ups. Depending on the type of rights assigned to ICO tokens, companies can raise risk capital without sharing ownership, thereby addressing one of the main impediments to the use of public equity financing (dilution). SMEs are granted direct access to an unlimited investor pool and the liquidity of tokens issued in ICOs is one of most important benefits of ICOs when compared to conventional start-up financing mechanisms such as VC funding.

Figure 1. The benefits of Initial Coin Offerings (ICOs)



Tokenomics, structuring and valuation-related issues

The economics of ICO issuances, increasingly known as *tokenomics*, involve decisions related to the issuing and implementation of a token within an ICO ecosystem (structuring of the offering, sale models, pricing of tokens, allocation mechanisms), and the way holders of tokens are able to use these on the platform. Understanding ICO structuring is a prerequisite for the valuation and pricing of tokens by SMEs and investors.

Most ICO offerings do not fit the standard investment paradigm, partly because of the way value is created and attributed between the different participants of a network and the difficulty in quantifying that effect. Sharing and allocating the value created by tokens may not always be straightforward given the duality of the token's function both as a means to represent the future value of the company (similar to an equity share) but also as a means to transact on the platform or get access to the platform (usage or utility). The difficulty in assigning a fair value to tokens issued in ICOs at their current form may therefore be a limitation for the wider use of ICOs as a financing mechanism for SMEs and participating investors. What is more, in the absence of any agreed standards for the accounting of ICO tokens, the financial reporting of companies that have raised financing through a tokensale is currently a challenge for all ICO participants.

Subscribing to an ICO offering: what are the risks?

The OECD report examines limitations in ICO offerings that go beyond the regulatory uncertainty and arbitrage exploited by some issuers. Pitfalls in the design and structure of ICOs, issues related to authentication, disclosure and governance can lead to misalignment of interests between founders and investors in token offerings.

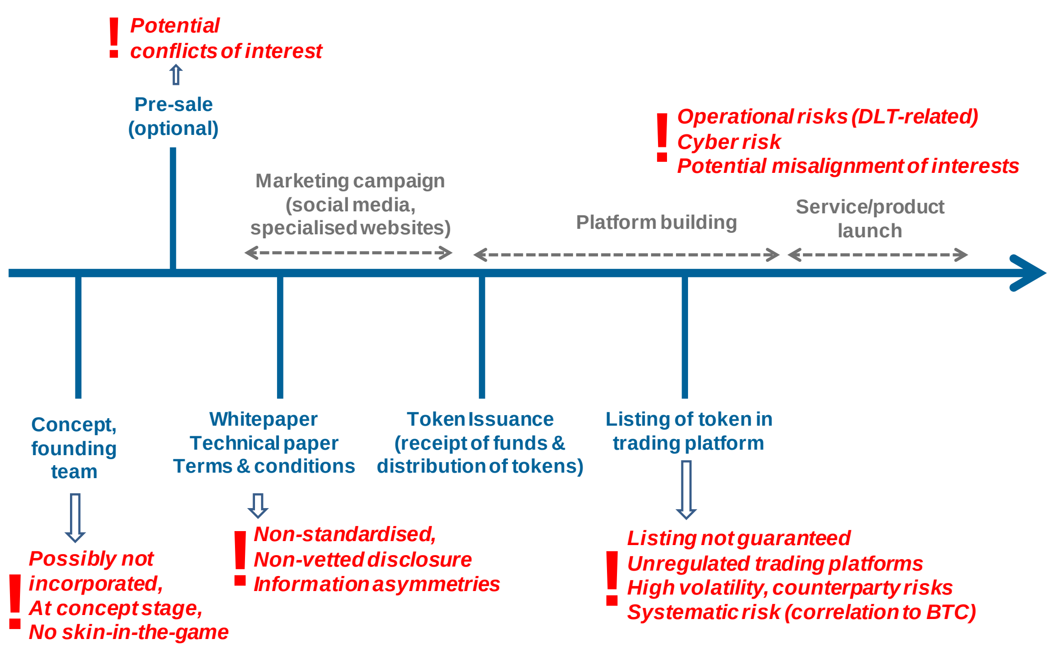
The structuring of ICOs can give rise to conflicts of interest by the issuer, particularly given the ability of entrepreneurs to receive tokens issued on the back of a concept that is yet to be executed and without having taken any personal financial risk in the venture. In the absence of lock-up period requirements, the lack of any "skin-in-the-game" from the entrepreneur can be a source of conflict (e.g. pump and dump schemes).

ICO issuers and subscribers are exposed to volatility that may be partly due to subscribers who are driven only by speculation and have no intention of participating in the newly-created network (e.g. “flipping”). This exacerbates the inability of SMEs to exercise their own pricing strategy when tokens may be the only way to consume the product or service. Additional potential conflicts of interest may arise from the pre-sale of tokens at a heavy discount, which hold exactly the same risk as the ones purchased by investors at the offering stage. The listing of tokens is neither automatic nor guaranteed, and research suggests that ICO tokens carry a common source of systematic (non-idiosyncratic) risk correlated with bitcoin returns.

The absence of disclosure requirements in ICOs exacerbates information asymmetries already present in early stage SME financing. In addition to the lack of transparency, difficulties in applying traditional valuation methodologies further prevent investors (particularly retail investors) from making rational, informed decisions and exposing them unduly to risks.

There is also a lack of financial consumer and investor protection safeguards in ICOs that would allow investors to obtain redress and compensation, in a situation where coverage by bankruptcy laws is not assured, and the risk of fraud is high. Operational risks related to DLTs, cyber risk and data privacy issues expose investors subscribing to ICO offerings and SMEs issuing tokens to significant risks.

Figure 2. Risks throughout the ICO process



Can ICOs become a "mainstream" SME financing mechanism?

Although ICOs are being hailed as the solution to SME financing gaps, ICOs are, by nature, not the right solution for every project. A differentiation should be made between blockchain-enabled projects or products/services and businesses or products/services that are not blockchain-enabled, as the former has a higher chance of benefiting from an ICO offering.

ICOs are particularly beneficial for products and services that are founded on the basis of a network. Token issuance allows for quicker adoption of the product/service and the creation of a customer-base before the launch of the project. Most importantly, maximising value creation through the *network effects* present in newly-created networks of investors purchasing tokens is one of the major comparative advantages of ICOs when compared to other forms of financing. In the absence of a business model that can benefit from such network effects, launching an ICO offering may not be a viable and sustainable financing solution.

The role of policy makers

Policy makers have a role in creating the conditions necessary to facilitate the development of ICOs in a safe and fair manner, allowing for the benefits of ICO structures to be enjoyed in a viable and sustainable way by SMEs, while protecting SMEs and investors from certain risks.

Clarity in the regulatory and supervisory framework applied to ICOs is a stepping stone to the safer use of token issuance for financing purposes. Standardised disclosure requirements, and enhanced investor protection for retail investors, coupled with greater awareness of risks by retail investors, can safeguard their informed participation in such financing. AML/CFT requirements on ICO issuances are equally important, given the relevant issues observed in the crypto-assets space.

A delicate balance will need to be achieved in the development or application of regulatory and supervisory requirements which do not deprive the ICO mechanism of its speed and cost benefits, particularly when it comes to smaller size offerings. Proportional application of regulatory requirements, as is the case in small public equity offerings in certain jurisdictions, could be considered.

Given the global nature of ICOs issuing and cross-border trading, cooperation at the international level is warranted for a coordinated global approach that will prevent regulatory arbitrage and allow ICOs to deliver their potential for the financing of blockchain-based SMEs, while adequately protecting investors.

References

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