NON-COMPLIANCE IS THE "INNOVATION." HERD THE CATTLE BACK INTO THE BARN.

BY TIM SWANSON

My view, argued below is that a "legal ICO" is a contradiction in terms, an oxymoron. Either you structure a capital raise with existing exemptions and/or filing requirements. Or you ignore these requirements and just raise capital without doing so. The latter is commonly called an ICO whereas the former is a traditional offering.

I was recently on a panel in Arizona and one of the panelists – a consultant at a large consultancy – was an avid fan of ICOs. He mentioned that ICOs democratized the funding of projects like never before.

I challenged that comment then and will do so again in this article.

First off, crowdfunding has existed for years in various forms and fashions. In the United States, there have been legal carve outs that enable platforms like KickStarter and GoFundMe to successfully empower investors and entrepreneurs

Generally speaking, what has made ICOs very attractive, is the ability for issuers to utilize regulatory arbitrage to raise capital without having to file disclosures forms and compliance processes (e.g., AML and KYC) that they would otherwise have to in many jurisdictions around the world. Coupled with an investor base that is by default anonymous, ICOs became a haven for massive amounts of fraud, deceit, and hype since day one.[i]

The first initial coin offering – ICO – was supposedly Mastercoin (later rebranded as Omni), a project that spawned the white paper-is-the-equivalent of an S1 trend. Mastercoin did a month-long ICO beginning in July 2013 and raised 5,120 bitcoins, which at the time was worth $500,000. Several months later, during the tail-end height of the 2013 frenzy, the Mastercoin Foundation published a press release claiming that they had raised $5 million. It was poorly timed because within 6 months those same bitcoins lost about 50% of their USD-denominated value.

WHAT HAPPENED TO THESE FUNDS?

Most of it was squandered via poorly executed bounties – open artificially time boxed offers to independent developers to build wallets, a block explorer, and even a decentralized cryptocurrency exchange. Consequently, the only noteable application that really ever used Mastercoin was Tether. Tether, which was originally called Real Coin, was initially the brainchild of Brock Pierce and Craig Sellars, both of whom were founding executives of the Mastercoin Foundation. Pierce, who has been involved in numerous ICOs since then – including Factom, Maidsafe and EOS - is also one of the founders of Bit Angels one of the first, of many, early-stage funding syndicates involved in financing cryptocurrency-specific projects. Unsurprisingly, Bit Angels as a whole also had a large stake in Mastercoin's ICO and were also involved in Maidsafe which *coincidentally* uses Mastercoin's platform.

Is this self-dealing? Maybe, maybe not. But for those keeping track at home: the thesis by many ICO promoters has been that ICOs somehow now enable disenfranchised entrepreneurs - who typically don't have access to capital pools due to a variety of restrictions – to have access new pools of capital without those same restrictions.[ii]

But empirically that does not seem to be the case.

While we don't have the room to go into all of the details the ICO market has bifurcated into at least two different subtypes over the past 6 months. And while many advocates passionately argue that there are real uses such involving "financial inclusion" because ICOs empower the general public to participate, unfortunately these same promoters will likely just point to capital raises that failed to file disclosure forms -- that's not innovation.

In practice, as of February 2018, the ICOs that are considered "good" don't look much like the Mastercoin, Factom, Maidsafe or even the Ethereum ICOs of 2013 and 2014.

Today, typically "good" ICOs fill out their entire coin or token allocation privately and *only* to accredited, sophisticated, and KYC'ed investors such as family offices, hedge funds, and high net worth individuals. While the structure of these deals varies in shapes and sizes (a few have utilized exemptions known as Reg S and Reg D; others have tried using something dubiously called a "SAFT"), a highly demanded private offering are known to raise $20 - $50 million often in less time than it would take to raise a traditional seed or Series A – but with explicit language acknowledging that these coins or tokens grant the buyers no rights, such as voting or dividends.

In contrast, due to the evolution in the market, the "junk" ICOs, which account for 90%+ of the current coin offerings, are still frequently solicited to the general public via social media and prey upon unsophisticated retail investors. Often the use verbiage that either implicitly or explicitly states that coin owners will have voting rights and/or residual income streams once the coin is formally launched. Many times participants are not KYC'ed which means that money laundering can and does take place. In addition, a group of insiders and early backers have access to undisclosed deal terms enabling them to purchase the new coins at substantial discounts of 10% or usually much more than what investors in the public sale are able to. As one of the perks for being an insider and early buyer, there is often no lockup periods such that once the public sale is over and a coin is listed on a secondary market, the insiders can and do quickly dump their coin holdings onto retail investors who effectively become bag holders.

These quick flips effectively provide the insiders risk-free liquid investments.

I along with several other writers have highlighted these concerns for well over a year and unfortunately there has been very little accountability and/or punishment for the ICO issuers and promoters who benefited from flipping "junk" ICOs onto unsophisticated retail investors.

Since its publication of The DAO report, the SEC and other federal and state law enforcement and regulatory agencies in the US have been more proactive in ceasing and stopping egregious ICOs, often without extracting fines from the organizers. Nicolas Morgan has chronicled many of these movements at the national level.

What hasn't really happened however, is much accountability or punishment for the ICOs that were conducted from their genesis – with Mastercoin – up through July 2017 when The DAO report was published. Yet The DAO report in itself arguably fell short as it gave creative and less scrupulous lawyers the chance to punt the "if profits aren't promised it's not a security line" which has recently, explicitly been shot down by representatives of the SEC. The SEC and others have been relatively slow at responding - partially because it had coin promoters and lobbyists white washing what was really happening – but eventually woke up when the problem became too big to ignore.

Due to the statute of limitations, several of the first ICOs likely no longer administratively fall within the cross hairs of regulatory and criminal prosecution. Some ICOs were less egregious as others. A handful have created what can arguably be described as "app utility." But many utilized brazen methods for circumventing perfectly good securities laws and could get away with it.

For perspective, E&Y estimates that about $3.57billion was raised via ICOs in 2017, about 10% of which was stolen by hackers and insiders. So in the scheme of things, fraud and theft around ICO is probably deemed relatively small compared to other types of 'white collar' financial crime that bedevils traditional capital markets.

Still the same, there are countless entrepreneurs who played by the rules while their competitors did not. These by-the-book entrepreneurs attempted to raise capital via traditional equity raises whereas a few of their competitors not only were able to sell "worthless" coins, but did not have to give up equity in the process, thereby giving them extra wiggle room to incentivize skilled developers to join their team.

But what about ICOs that eventually comply with the various regulations and laws discussed above?

I don't think they will be called ICO. Again, the whole idea of an ICO - even the name itself - was to bypass listings regulations. If you have to adopt existing regulations, then you aren't really doing an ICO, you're doing a regulated (or at least, exempted) offering.[iii]

Keep in mind, ICOs are distinctly separate than cryptocurrencies. All ICOs (as a funding mechanism) currently result in the creation of some kind of cryptocurrency, but not all cryptocurrencies need to be funded or capitalized by an ICO process.[iv]

CONCLUDING REMARKS

There are many injustices in this world, some more existential than others: not punishing egregious ICOs sends the message to the market that not only do the bad guys get away, but they get to be rich and famous and invited to conference circuit as bonafide "thought-leaders." This is not the right message that should exist in the US capital markets or any other.

The question then is: is it too late to corral the herd of livestock back into the barn? Maybe, maybe not.

Either way, the evolution of the ICO market place has clearly diverged: with one side shifting back towards the capital fund raising structures that have existed for years, one involving disclosures and investor protections.

Whereas the other side exists to serve as a reminder that as well-intentioned and back-slapping awesome as "democratized" fund raising sounds, most of these 'junk' efforts are simply get-rich-quick and pump-and-dump schemes that have existed much longer than any existing stock exchange has been around for.

2018 should be the year the sheriff and his deputies bring the cattle and the cattle hustlers, back into the barn. Let's just see how serious regulators consider the egregious behavior.

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BIOGRAPHY

Tim Swanson is the founder and director of research at Post Oak Labs. He was previously a visiting research fellow at the Singapore University of Social Sciences as well as at Sim Kee Boon Institute at Singapore Management University. He worked in East Asia for more than six years and is currently based in the San Francisco Bay Area. His 2015 paper: "Consensus-as-a-service: a brief report on the emergence of permissioned, distributed ledger systems" popularized the term "permissioned" blockchain (or ledger), a topic which remains a mainstay at fintech conferences globally. He is the author of three books and is currently a consultant at Elm Labs. He is an advisor to Clearmatics and was an advisor to Hyperledger (acquired by DAH). He does not own any cryptocurrencies in any of the companies or projects he has written about, nor has he received financial compensation for including companies or projects within his articles. He was previously the Director of Market Research at R3 and is a graduate of Texas A&M University. His research papers have been cited in a variety of media and has appeared on more than one hundred industry panels and events over the past four years. He is also frequently quoted in media including: Wired, MIT Technology Review, Reuters, The New York Times, Bloomberg, The Wall Street Journal, The Financial Times, The New Republic, American Banker, and International Business Times.

Endnotes

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[i] Historically organizers of capital raises have been able to use many different types of methods to perpetuate fraud, so ICOs certainly don't have a monopoly on that. What ICOs typically do provide though, is enable near-irreversible crowdfunding that is quickly liquid on secondary markets, bought by retail investors who typically haven't done much diligence and as a result have little recourse in the event that fraud takes place.

[ii] It bears mentioning that in most developed countries there is a formal, accessible process for changing and modifying laws and regulations around raising capital and that there really are a number of good laws that exist -- especially around disclosures -- because of the fraud and scams that took place in the '20s and '30s.

[iii] Again, over the past 3-6 months, many of the "legit" coin sales have involved reintegration with the existing system with established laws, or at least a superficial attempt to do so (via SAFTs, which may not stand the test of time in court).

[iv] The simplest, but perhaps most controversial, way of putting cryptocurrencies back in a barn or at least preventing them from growing is to crack down on: exchanges, wallets, and all types of custodians that hold onto the coins. Unclear if this will ever happen. If we are making predictions: ICOs as they were in 2013-2017 will likely continue to exist due to sheer "FOMO" and mania that unsophisticated retail investors have, but it is doubtful they'll grow at the rate they were last year, largely because regulators and law enforcement globally have finally caught onto their game.