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ICO vs. IPO?

Digital Flotations complement different Forms of Financing

With its ICO (initial coin offering), the start-up Bancor managed to raise about USD 156 million in just three hours. In 2017, the number of ICOs has reached almost 100 so far, raising more than USD 1.25 billion[1]. But what exactly are ICOs, and what are their implications for the capital market? **By Dr Alexander Vogel, Dr Wolfgang Müller, Dr Reto Luthiger and Samuel Ljubicic**

The term ICO (also called "token sale" or "token-generating event") is derived from the term IPO. However, in contrast to an initial public offering, no shares are issued and listed on a stock exchange. Instead, purely digital tokens are sold for virtual or fiat currency. Transactions and the order book are not managed centrally via an exchange or depository but locally on millions of computers with the help of distributed ledger technology (DLT).

Put simply, ICO is a kind of digital DLT-based crowdfunding. It often starts with just a white paper that describes the project to investors in technical and commercial terms. The money raised through the ICO on the internet within a specific timeframe is used to finance project development and operating costs.

ICO: more than simply a form of financing?

Although the main focus during an ICO is on raising funds, companies should also consider the versatility of tokens in their business models. Tokens may interact with freely programmable smart contracts, thus enabling automated completion of standardised processes and transactions almost in real time and with relatively low transaction costs.

However, in comparison with stock market trading, a stock exchange is missing due to the decentralised nature of the system. Although an exchange places high demands on issuers, it also creates transparency, trust and trading liquidity for the market and investors. Conversely, an ICO can enable a start-up with no track record to raise funds before it has even started its commercial activities.

The key to and for investors

The token is the only consideration for the investor. In technical terms, a token is a digital code or a digital unit of payment that is kept in a "wallet". The potential applications for tokens are almost unlimited: they can be used as an access right or key to a platform, as payment for goods, services and rights, for uncertificated functions (e.g. a synthetic share, option or future) or as entitlement to commission-like revenue sharing. Since the tokens can be traded, investors have the opportunity – if there is demand and liquidity for that particular token – to make a trading profit.

"Unregulated" does not mean "not regulated"

Legislation and regulators are naturally lagging behind the rapid development of the digital world. As tokens are still not separately regulated in many jurisdictions, their issuance may – depending on the features of the token – involve significant risks for issuers/promoters due to the violation of legal provisions (in particular, authorisation and prospectus regulations), and for investors in the form of a complete loss of their investment. As a result, regulators try to categorise ICOs/token sales under the existing legislation. However, the token's versatility makes it impossible to apply a generally applicable regulatory approach and gives rise to a type of functional analysis of the individual token.

Many legal systems distinguish in particular between equity- and debt-based financial instruments and impose different requirements on the issuance, sales and trading activities of the persons and platforms involved. Such requirements may be expressed through a wide range of authorisation, prospectus and conduct obligations, particularly those governed by financial market and corporate law.

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1) CNBC, Initial coin offerings have raised $1.2 billion and now surpass early stage VC funding, http://gp-mag.de/ico

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Anglo-American legal systems tend to regulate equity-based financial instruments very heavily, while Switzerland, for example, focuses more on debt-related financial instruments. However, the Financial Services Act, which is currently being deliberated in Swiss parliament, will bring equity linked instruments closer in line with international standards by passing a completely revised prospectus law.

Due to the lack of similarity with equity and debt capital, pure usage tokens face fewer regulatory hurdles. They are a kind of reward token for the purchase of goods or services. Typically, they do not confer any entitlements at the time of issue and do not qualify as a financial instrument. However, usage tokens can also be found in legally more delicate hybrid forms with other token functions.

Conclusion

ICOs are very much in vogue right now. They generally provide an alternative form of financing for start-ups in particular. They do not replace IPOs, but rather complement the range of financing forms available for different business situations and provide additional structuring options. However, the latest regulatory developments in various countries, such as the US and China, emphasize the importance of a precise analysis of the domestic and foreign regulatory framework in the planning and implementation of an ICO and the subsequent trading of tokens. ■

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