

INITIAL TOKEN OFFERINGS – FIVE THINGS THAT YOU NEED TO KNOW ABOUT THEM



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Initial token offerings (ITOs), also called initial coin offerings (ICOs), token launches or token generation events, are one of the latest trends in financial services. ITOs have emerged out of the increasing use of distributed ledgers and blockchain technology, the software that underpins cryptocurrencies, such as Bitcoin.

However, are ITOs just another buzzword or fad in the Fintech sector, or are we seeing a new method of investing emerge? Here are my top five things that you need to know about them.

1. WHAT ARE ITOS?

Tokens (or coins) are a virtual form of investment, which have been created using blockchain technology. Some start-up technology companies are "issuing" tokens as an alternative means of raising capital by using an existing blockchain platform, such as Ethereum, to create and record the distribution of tokens as a form of investment in the start-up.

The investment terms of the tokens are pre-programmed into the blockchain to form a "smart contract" that can be automatically performed by software. For instance, smart contracts can autonomously transfer tokens to investors once the smart contract has recognised that all the conditions for investment have been met (such as transferring the purchase price for the tokens,

usually in a cryptocurrency, to the issuer). A blockchain platform can securely verify and record transfers of tokens, and should be a transparent means for investors to monitor their investments (Bitcoin's open blockchain ledger is publically visible online, although other blockchain platforms can be private). Since the administration of the token issue is automated by software, it is very efficient, and typically only the token issuer and investors need to participate. This has the potential to disintermediate (cut out) many of the parties that are typically involved in traditional forms of issuing investments.

2. WHAT IS THE SIZE OF THE MARKET?

ITOs have become popular for start-up companies in the cryptocurrency, cloud computing and social media sectors to raise capital as an alternative to venture capital and initial public offerings (IPOs). According to Autonomous Research, a financial analytics firm, start-up technology companies have already raised over \$1.2 billion in 2017 from ICOs and ITOs in over 50 different businesses and projects. The first notable ICO was in 2014 by Ethereum, which raised \$18.9 million. More recently, Tezos raised over \$208 million from an ICO.

3. WHAT DO INVESTORS GET?

Typically, tokens give investors a right to an interest in the start-up, similar to traditional forms of investment such as company shares, and can include rights to a share of profits. Alternatively, tokens can be used to give investors other rights and licences to the products or services produced by the start-up.

4. ARE ITOS REGULATED?

Some ITOs have been promoted as an unregulated form of investment, relying on the argument that tokens are not a security for the purposes of the different investor protection laws in countries around the world. As a result, some token issuers have used ITOs as a means of avoiding regulation. However, depending on the nature of an investor's rights that attach to a token, it is possible that a token is a form of security, particularly if those

rights entitle the investor to a share of the profits of the token issuer and the investor is not involved in the day-to-day management and control of the token issuer. This view has recently been recognised by the US Securities and Exchange Commission (SEC) in its investigation into the coins issued by The DAO (decentralised autonomous organisation), which had raised over \$150 million from an ICO that the SEC classed as an offer of securities.

Tokens that give investors other rights, such as licences to products and services, could fall outside the scope of being classed as a security. However, token issuers and investors still need to proceed with caution, because it is possible that those types of tokens could also be classed as a security, depending on the facts and circumstances of each case and the investor protection laws that apply to the tokens. Further, how different countries want to tax gains made on tokens may also influence how they are recognised for regulatory purposes.

5. ARE ITOS JUST ANOTHER FINTECH BUZZWORD OR FAD?

Unlikely. Reports suggest that the ITO market grew over 800 percent in past two years, and a further 540 percent during the past six months, which is staggering. The market is also starting to diversify to include other types of businesses and projects, including investment funds. In essence, tokens and coins are the labels given to the means of granting investors' rights using blockchain technology, whatever those rights may be. Once traditional technology and investment firms start using blockchain technology for making investments, it is likely to quickly become a common method of investing. In this regard, IBM and the London Stock Exchange Group have recently announced a joint project to use IBM's blockchain platform to enable SMEs to more easily offer securities in the EU. I expect ITOs will be around for the foreseeable future.