ICO: AN ALTERNATIVE SOURCE OF FINANCING SMES

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Consumatori e Piccole e Medie Imprese nel Mercato Unico Digitale (Digi-ConSME)

Consumers & SMEs in the Digital Single Market (Digi-ConSME)

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INTRO

- Distributed Ledger Technologies (DLT) are increasingly used as an alternative mechanism to traditional banking channels

- Initial Coin Offerings (ICOs): creation of digital tokens by start-up companies and their distribution to investor, in exchange for fiat currency or other cryptocurrencies.

- Similar to other financing methods, like the Initial Purchase Offer (IPOs), crowdfunding, venture capital?

- Legal and regulatory treatment of the ICOs is untested.

- Advantages and risks for SMEs.

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INITIAL COIN OFFERING

- Digital way to raise funds from the public

- Consist:
  1. creation of digital tokens;
  2. distribution to investors
  3. in exchange for fiat currency or cryptocurrencies.

- Tokens (i) created and disseminated using distributed ledger or blockchain technology (ii) may be tradeable on specific platforms without the need for a trusted central authority or intermediary (iii) are cryptographically-secured and benefit from the inherent characteristics of DLTs (iv) are bilateral arrangements which are not issued in the form of a security/certificate or similar type of transferable instrument.

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STRUCTURE

1. **Optional pre-ICOs step**: **pre-sale**, a private offering of tokens to a small number of identified parties. Tokens in such pre-sale enjoy a discounted price for the tokens and in most cases, proceeds raised are used to cover the set-up and expenses of undertaking the ICO transaction (for example marketing, advisory, ecc).

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2. **Announcement** to the public of the intention to perform an ICO informing about the project and the offering terms and conditions through the publication of a non-standardized offering document, called whitepaper.

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3. **Marketing campaign:** social media and specialized inte websites. "Airdrop": free distribution of native tokens by the issuers existing or new users of their platform.

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4. **Creation of the new token on blockchain:** investor receive in exchange for major cryptocurrencies or, less often, for fiat currency. Investors have to open a wallet on a digital exchange accepting fiat currency, and transfers fiat currency to the exchange. This is then converted into one of the prominent cryptocurrencies, mainly Bitcoin and Ether.

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5. **Listing on secondary market:** neither automatic nor guarantee after the issuance of tokens in an ICO. The price of the token traded on secondary markets is freely determined by the supply and demand forces of the market.

ICO vs IPO

Why ICO is this different from an IPO?

Timing :

- **IPO** is generally proposed by established companies with a mature business proposition, a proven operating business and healthy cash flow generation.
- **ICO** are undertaken by start-ups that may not even be incorporated and do not have established operation yet.

Framework

- **IPOs** are implemented on the basis of a comprehensive legal framework and established market practice.
- **ICOs** are very diverse in set-up and structure and there is no specific regulatory framework.

Post-offering:

- **IPOs** the trading phase is always guaranteed
- **ICOs** the trading upon listing on secondary market is not guaranteed.

Rights attributed to participants of the offering.

- **IPOs:** ownership right in the corporate capital of the company, rights in the future cash flows of the company, through dividends, and, depending on the type of the shares issues, also the voting right.
- **ICOs:** right to participate in the platform, rights to buy service or product of the issuer, claim on future revenues of the company, rights to contribute to the development of the software, voting right similar to those assigned to shares, and other governance rights.

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ICO vs CROWDFUNDING

- ICOs cannot even be considered an equivalent of the equity-based crowdfunding which generally confer equity ownership or participation in future revenue streams of the issuing company.

- Both financing mechanism are based on technology and online payment systems to facilitate transaction, and both are suitable for seed and early-stage financing of start-up.

- Crowdfunding takes place usually through an intermediating platform.

- ICOs, the intermediary are replaced by the blockchain

- Crowdfunding investments are privately-held and generally there is no secondary market to trade them.

- Crowdfunding activities are conducted within a set legal framework (both national and European), ICOs not.

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ICO vs VENTURE CAPITAL

- Venture capital is a form of financing that is provided by firms or funds to small, early-stage, emerging entities with high growth potential.
- VC investor generally, to invest in a company requires as a compensation, equity or an ownership stake in the company, which attributes various controlling rights.
- VC funds have participated in a number of ICOs offering either at the pre-ICO stage by taking part in private pre-sale or by funding the expenses of an ICO.

Stage of the post-offering/post-financing.

- **VC investment** are extremely illiquid and it can take several years for a fund to be able to exit the investment;

- **ICOs** give to the founders the possibility to “cash out” immediately upon raising financing for their company.

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ICOs for SMEs

1. distribution of the control among SMEs and participants/token-holders instead of concentrating decision power in the hands of financiers

2. SMEs could diversify their financing options

3. SMEs, in addition to cost saving, could have access to an unlimited investor pool

4. network effect created in ICOs by the mere participation of subscribers in the newly-built network is an important value creator and a comparative advantage of ICOs when compared to traditional methods of financing

5. companies can raise capital risk without necessarily conferring ownership rights

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REGULATORY FRAMEWORK

- ESMA, FCA, BaFin, and FINMA: each ICO shall be different and must be thoroughly evaluated in order to decide whether it falls or not within the scope of existing regulations.
- Absence of standardized disclosure requirements (whitepapers are not verified or vetted) absence of appropriate due diligence by financial professionals.
- Cross-border issues around marketing and issuance of tokens: disproportionate distribution of ICO offering in a small number of jurisdictions may be evidence of regulatory arbitrage and taxation.
- Regulatory uncertainty exists for example regarding the legal enforceability of smart contracts and the application of standard law on smart contracts.
- Each token or token offering is different, as different rights are attached to particular tokens. Depending on the nature of the token, different rules will apply (e.g. Prospectus Directive, the amended Markets in Financial Industry Directive (MiFID 2) Alternative Investment Fund Managers Directive (AIFMD), Payments Serivces Directive (PSD 2), Anti-Money-Laundering-Directive (MLD 4).

FINAL REMARKS

ICOs

- can be more inclusive financing vehicle by allowing small retail investors to participate in the financing of small businesses and start-ups.
- can provide SMEs with direct access to an unlimited investor pool, offering near-immediate liquidity and the potential to create economic value.
- may not be the right financial instrument for every person or every project, even in a more mature, safe and regulated form.
- A SME to benefit from the raising of financing through an ICO, need to have a business rationale that requires the use of a DLT solution to address real consumer need.
- Limitation in the use of the tokens by the non-blockchain based SME will further impede the viability of the business.

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