ICOs: raising money by issuing cryptocurrency, with less regulation

Back in the day — I remember it well, it was only ten years ago! — when a large company wanted to raise money it would almost certainly issue equity or debt. These securities would then be exchanged with investors for the relevant currency, with the investors expecting higher cash flows in return at a later date. From my desk in London, the means of payment would almost certainly have been USD, EUR or GBP or another 'fiat' currency. Ignoring, of course, quirky funding structures such as mining firms issuing debt in gold.

Here in the United Kingdom, the activities surrounding the issuance of equity and debt are regulated by the Financial Conduct Authority (FCA). When issuing these securities in the UK you have to play by the FCA's rulebook. For investors at a more macro level, you may wish to set up a fund to invest in these securities. This too is a regulated activity, and again they would have to play by the rules of the regulator. It is important to note that a well regulated market is more competitive, open and liquid than an unregulated market, and that the UK regulator is considered one of the best in the world.

But what if, instead of issuing an instrument which represents a right to cash flows, a corporation were to issue a 'coin' not represented by a certificate but held cryptographically on behalf of the investor, the coin relating to the value of that company or a product that either it produces or is developing.

That token may or may not be regulated by the FCA and funding can sometimes be achieved without the need for developing the compliant processes and procedures expected in regulated markets. The structure of these 'coins' takes various forms, both in the required type of subscription that may be a fiat currency but is usually cryptocurrency (typically bitcoin and ether), and in the goods or services (if any) to which the value of the coin is attached.

These coin offerings, colloquially known as an ICOs, or initial coin offerings, have joined the funding toolkit for organisations in search of cash. Indeed they now form the majority of funding for blockchain-based projects (or, cynically, projects claiming to use distributed ledger technology). An ICO can raise funds with fewer regulatory concerns and in most cases the advantage of significantly cheaper capital. So why are these equity-like funding structures not regulated? Here in the United Kingdom, the FCA regulates certain instruments which it refers to in legislation as specified investments. These do not currently include tokens or cryptocurrencies, but this is obviously something that may change in the future.

However, derivatives are specified investments, and this includes derivatives of tokens and cryptocurrencies and hence those active in trading cryptos could fall under the FCA's remit. An example of such a derivative, which is a specified investment is the bitcoin future traded on the CME. If you are involved with instruments such as this and are not an authorised person regulated by the FCA, you must avoid acting in a manner defined by the FCA as performing a specified activity. These activities include, but are not limited to providing investment advice, investment management, dealing or arranging deals in investments.

The coins created at an ICO are typically split into two different categories. Utility coins and security coins. Utility tokens can be used to access certain products and services on a platform. As the holder of a utility coin I gain the right to purchase future goods and service. A security coin on the other hand is likely to give access to expected future profits or cash flows. As such these 'security coins' look awfully like conventional securities. Indeed the SEC – the US regulator – has stated that if a coin is held in expectation of future profits, then it would likely be classified by the SEC as a security. This presents issues for those issuing coins as if they do not abide by the standards expected of the security industry they are likely breaking the law.

For those looking at an ICO as a funding means either for a start-up or more established organisation, it's important to understand what kind of coin is being issued and the regulatory and legal issues created by that structure. In particular, the issuer should be sure that they are not in breach of Section 19 of the Financial Services and Markets Act.

Section 19 is known as the General Prohibition and prevents 'unauthorised persons' performing financial services. Those breaking the General Prohibition are likely to find that their contracts are unenforceable and are potentially subject to an unlimited fine and even the possibility of a custodial sentence, although these are rare.

Whilst the number of ICOs and the size of the fundraisings looks to have fallen since the end of 2017, ICOs are likely to remain as a funding option for startups given the intense interest in the subject and some of the advantages of the structure. A chief financial officer at an established start-up could look at raising money through equity, debt and coin issuance and hence achieve both funding diversity and presumably a lower cost of capital. The UK regulators interest in the subject is also clear. The FCA has developed a global reputation for innovation, and over half of the latest batch (July 18) of firms into Project Innovate utilise blockchain or distributed ledger technology.

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