FINTECH

Blockchain CEOs urge policing of 'Wild West' fundraising

Established blockchain firms are worried initial coin offerings will tarnish the industry's reputation and draw fire from regulators and investors

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By Yolanda Bobeldijk

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The chief executives of some of the largest blockchain groups have urged regulators to restrict capital raising through the use of initial coin offerings, amid fears that such offerings could damage the reputation of the blockchain industry.

Insiders are particularly worried about the rise of initial coin offerings that claim to be regulatory compliant – despite the fact that UK financial watchdog does not regulate the practice and has not given guidance on whether it intends to do so in future.

The concerns come as approximately $1.8bn has been raised through ICOs so far this year, a significant increase on the $222m amassed in 2016, according to research provider Autonomous.

David Rutter, the CEO of leading blockchain group R3, believes regulators need to be "more aggressive" on this topic.

He said: "ICOs should be front of mind of all the regulators in the G20 countries to protect investors. Often these ICOs are done by one guy and a dog in a garage, and next thing you know they have raised tens of millions of dollars. This is the Wild West and it could hurt our blockchain industry."

He added that these coin offerings are "so incredibly absurd, with absolutely no protection" for investors. "Over the last 100 years, a regulatory framework has evolved for equity markets where proper investors can buy legitimate stocks from real companies under appropriate conditions. With ICOs we throw this all out of the window."

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In an ICO, startups sell tokens, typically in exchange for cryptocurrencies such as bitcoin and ethereum. Unlike shares, possessing tokens confers no ownership or economic rights in the company, though startups issuing ICOs generally promise the tokens will have some sort of exchange value if their product or platform is a success. Industry observers fear that inexperienced investors are failing to appreciate the significant risk that the tokens could ultimately be worthless.

Brad Garlinghouse, the CEO of blockchain group Ripple, which is helping the Bank of England with research on the emerging distributed ledger technology, said: “There’s certainly risk that bad actors in any ecosystem hurt all of the actors in the ecosystem and I think that’s certainly true… in the ICO market.”

Oliver Bussmann, ex-chief information officer at UBS and president of Crypto Valley Association, a not-for-profit organisation that aims to attract blockchain startups to Switzerland, added: “Absolutely, it needs to be regulated to make sure ICOs are run properly, as it could hurt the wider blockchain industry.”

He said some groups that are raising money have launched foundations, which means they are essentially not-for-profit organisations. “That means the investment is more like a charitable donation and it's not clear that all investors have understood that. Investors need to be protected.”

Coining it in

The industry's comments come as the ICO market continues to heat up. On August 10, Tezos, another blockchain group, said it had raised $232m in just two weeks through an ICO.

The regulatory concerns are paramount. The UK financial watchdog, the Financial Conduct Authority, does not currently regulate the practice and has not given guidance on whether it intends to do so in future. The US’ Security and Exchange Commission said in July that ICOs are deemed securities unless they have a valid exemption and that they are “therefore subject to the federal securities laws”. It has not made any further comments about the current state of the market.

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One entrepreneur working in the blockchain space who did not want to be named said he had alerted the UK's Financial Conduct Authority about ICOs that claimed to be regulatory-compliant. Ripple's Garlinghouse shared his concern and said people have been operating in "grey areas". "They are taking liberties by saying; 'hey, this is done in a regulatory compliant way'. Well, what does that exactly mean when there hasn't been a specific opinion issued on what that looks like?"

The FCA declined to comment on whether it is taking action against companies that claim to have the regulator's approval.

The Centre for Citizenship, Enterprise & Governance, which describes itself on its website as "a think tank focussing on the movement of non-financial and social value" is currently raising capital through an offering called seratio that claims to be a "regulatory compliant UK ICO".

When participating in the fundraiser, CCEG director Barbara Mellish said, "you'll get a seratio token and you can exchange them but we don't know what [you will receive in that exchange]. It's not like traditional shares". She said ICOs are "a bit like a donation with a reward".

She added that while the FCA has not officially made any statements on the coin offerings, the seratio ICO "complies with the UK's regulatory environment" and added, "Our marketing team might have put a slight spin on that". Mellish said that "with many ICOs it's hard to see who is even behind these things", but added, "We are very transparent. It is not aimed at naive investors".

Cryptocurrency: easy to get, hard to spend

Many ICOs claim to be aimed at a sophisticated investing audience, but the fact remains that anyone can participate, which is very worrying, according to R3's Rutter. "If your grandmother knows the price of Bitcoin, it's very scary – this is the same as when she was suddenly buying internet stocks in the late '90s without having any knowledge of these companies. History continues to repeat itself."

Yet while some groups are raising capital very quickly, spending that money is not as easy as it seems. If a blockchain group raises $200m, it would have raised that in a cryptocurrency such as bitcoin or ethereum. Unless staff agree to be paid in these currencies, the company would have to exchange them into a more widely accepted currency.

Banks themselves are very reluctant to offer bank accounts to ICO startups, because they often find it too risky, say industry insiders. Bussmann said: “In Switzerland, the banks are not offering them because they can't verify where the money is coming from and they need to comply with anti money-laundering and Know Your Customer regulations.”

Not everyone in the established blockchain industry believes ICOs are inherently illegitimate. Ripple’s Garlinghouse said: “There are some ICOs that are trying very hard to live up to what is effectively a security issuance and that’s great.” He said that ICOs “could actually be transformational”, but added that “it needs to be done with regulatory frameworks supplied”.

While regulation is needed, there should be a balance, Bussman said. “It cannot be so restrictive that nobody will use it. ICOs – when done correctly – could be a disruptive way of raising capital. It may replace the need to do an IPO for some companies and it could have an impact on wider M&A and traditional investment banking.” Bussmann believes two groups will emerge over time; one that demonstrates it complies with regulations and another that is less transparent.

Garlinghouse agreed that regulating the capital raising is a fine line. “If we are only enabling accredited investors to participate in the ICO market this idea of democratising private company investing is also no longer true. If it’s only for accredited investors then there’s nothing new here.”

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Clarification: This article previously included quotations from an interview with a Centre for Citizenship, Enterprise & Governance director. The director's quotations have been expanded to clarify the views they expressed in the interview. The article has been updated.

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