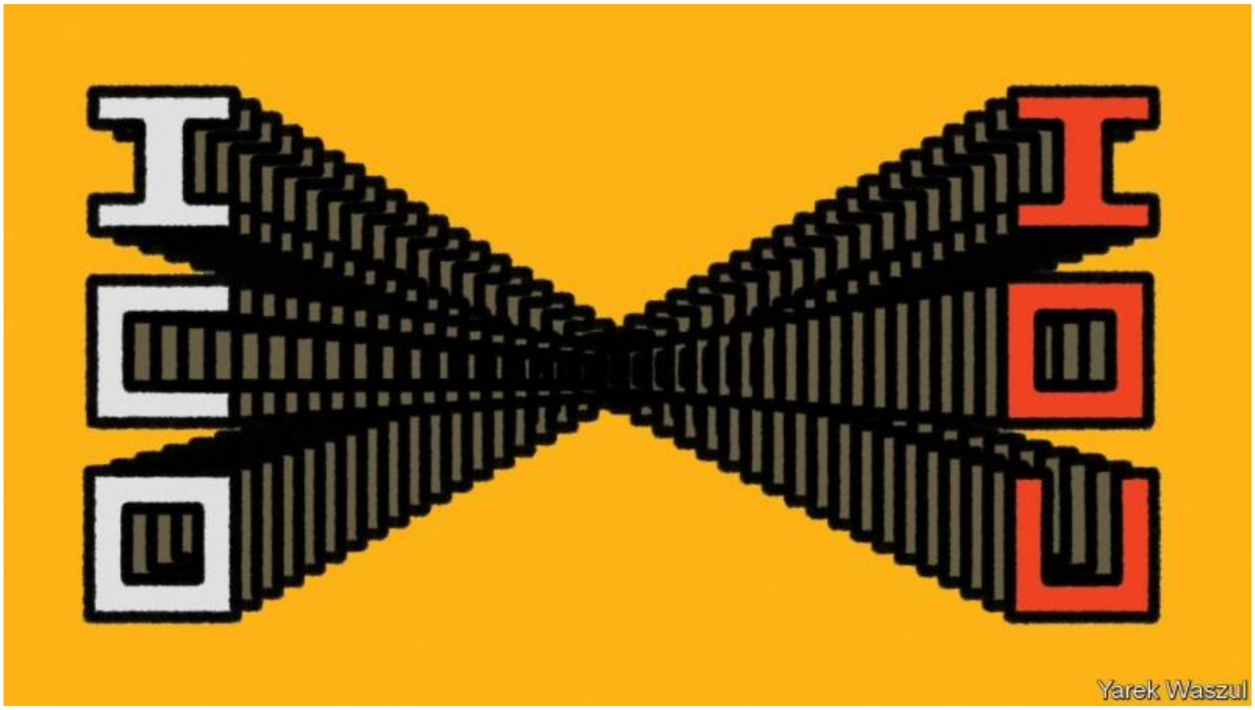
The Economist

Initial coin offerings have become big business

Fundraising with cryptocurrencies is booming, but is that a good thing?



IT LOOKED like just another cryptocurrency scam. On April 18th the website of Savedroid, a German company, went offline, to be replaced by an image from “South Park”, a scatological cartoon, bearing the legend “Aannnd it’s gone”. Yassin Hankir, Savedroid’s boss, published a Twitter post that showed him first in an airport and later on a beach, with the caption “Thanks guys! Over and out…” The implication was that the company was gone and its founder had made off with $50m raised from sales of its cryptocurrency, SVD.

Savedroid had been running an initial coin offering (ICO), a form of fundraising popular among cryptocurrency firms. An issuer will create a pile of crypto-tokens, often running on top of an existing blockchain such as Ethereum, then sell some to raise money for developing its product. The hope is that once that product is launched, the associated tokens will rise in value, leaving those who bought them early with a tidy profit. Matt Levine, a journalist at Bloomberg News, has possibly the snappiest definition: “They’re like if the Wright brothers sold air miles to finance inventing the aeroplane.”

The idea is not new. Ethereum itself got started in this way, raising $18m in 2014. But ICOs have become big business. According to Coinschedule, an average of 18 ICOs per month took place in 2017. As of July, the number for 2018 was 99 a month. So far those ICOs have raised $17bn, up from $3.7bn for the whole of 2017.

Some have been enormous. Block.one, a firm based in the Cayman Islands, raised more than $4bn with an ICO for EOS, an Ethereum-like blockchain on top of which firms can write software. Earlier this year Telegram, which runs an instant-messaging service popular with cryptocurrency fans, raised more than $1.7bn when it sold its cryptocurrency to a group of private investors.

ICOs have attracted institutional investors as well as individuals. Protocol Labs, a firm based in San Francisco, is working on several blockchain-powered applications, including the Interplanetary File System, which would pay users in cryptocurrency to let others use their spare computer capacity, in a sort of user-powered version of cloud-storage firms such as Dropbox. It has presold $52m in cryptocurrency to Silicon Valley venture-capital firms such as Sequoia, Union Square and Andreessen Horowitz.

Though the names sound similar, ICOs are not like IPOs (initial public offerings), in which buyers acquire shares and voting rights in a company. Instead, most just offer a token, theoretically tradable at a later date for whatever service the ICO's issuer plans to provide. Depending on how well the project does, those tokens may or may not be worth anything.

ICOs offer a way to raise cash to build decentralised versions of everything from social networks to cloud computing that would allow users to deal with each other directly without any central control. The modern internet, say supporters, is in effect controlled by a small number of vast firms that run the platforms on which most online activity takes place. By building decentralised alternatives, the power of those monopolies could be broken. Much of the early internet was developed this way. For example, SMTP, which specifies how e-mail should work, is an open protocol that anyone can use without paying, and made no money for its creators. ICOs can create a financial reward for the builders of such systems instead of relying on kindly coders.

Another attraction of ICOs is less noble: they avoid the bothersome paperwork and regulatory oversight that comes with more traditional methods of fundraising. This side of the business is now beginning to attract attention from the authorities. In Vietnam, for instance, police are investigating two ICOs, Pincoin and Ifan, run by a firm called Modern Tech, which is accused of duping buyers out of $660m. BitConnect, based in Britain, which described itself as a bitcoin lending platform, promised its investors returns of more than 1% a day, which would turn an initial investment of $1,000 into $37,800 within a year. Its website features pictures of happy investors frolicking amid money trees and piles of gold. Authorities in Texas and North Carolina obtained cease-and-desist orders against the company in January this year. A few days later BitConnect said it was shutting down, blaming those orders and the subsequent "bad press".

Careful now

Pump-and-dump schemes are rife. An ICO's creators talk up the value of their tokens before selling them and making off with the money. The Securities and Exchange Commission, one of America's financial regulators, has created a spoof ICO website which appears to plug a product called HoweyCoin but is in fact designed to warn potential buyers of the pitfalls.

(The name refers to the “Howey test”, which determines whether something counts as a security in American law and therefore falls under the SEC’s regulatory umbrella.) A paper by Hugo Benedetti and Leonard Kostovetsky, both at Boston College, found that ICOs can be very profitable, with average returns of 179% between the ICO price and the price the token fetches on its first day of trading. But they also found that less than half such projects remain active for more than 120 days after they have finished issuing tokens to the public.

It is an open question whether ICO tokens count as securities, and whether their issuers must therefore comply with the rules that regulate stock offerings. Regulatory responses vary from country to country, says Preston Byrne, a financial lawyer and cryptocurrency watcher. South Korea banned ICOs last year, as did China, though many carry on regardless. American regulators have taken a cautious approach. In June Jay Clayton, the SEC’s boss, advised would-be ICO-issuers to talk to the agency before proceeding. But William Hinman, the SEC’s director of corporate finance, said later that month that he was not minded to treat ether, Ethereum’s cryptocurrency, as a security, because of its “decentralised” nature. Regulators in jurisdictions such as Switzerland and the Isle of Man have been offering detailed guidance on how to conduct a legitimate ICO.

For now, says Mr Byrne, even honest ICOs are living in an uncomfortable legal limbo, with “some vexing questions about the liability of the people starting the scheme”. Probably the only way to get clarity, he says, is to wait for a court case. Technology companies, for their part, have moved faster than regulators: Facebook, Google, Microsoft and Twitter have all banned ads for ICOs, citing the financial risks to their users and worries about fraud.

As for Savedroid, furious punters eventually tracked down its boss to a resort on the Egyptian Red Sea coast. But the next day the firm’s website was back up, with an announcement that the shutdown had been a stunt. The point, claimed Dr Hankir, had been to warn investors just how easily the company could have disappeared. “There’s so much scam happening, from the beginning to the end of ICOs,” he said. “Even we, as a regulated German stock corporation, could have just run away…with all the funds.”

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