

Submission to the Treasury's review into Initial Coin Offerings (ICOs)

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INTRODUCTION

This submission is in response to the Treasury's review into Initial Coin Offerings (ICOs). The aim of this submission is to provide an informed debate on the key issues surrounding ICOs and the regulation of cryptoassets.

256 Ventures is a global early-stage cryptocurrency investment fund run by a team of young Australians. We have a portfolio of approximately fifteen companies, none of which are based in Australia. However, it is important for us to note that while we have not invested in any Australian companies, we have invested in numerous Australian founders who have set up their businesses overseas. These include Republic Protocol and Perlin Network, whom have enjoyed significant amounts of success in the space and raising substantially more funds than any Australian project (if that is a metric to be used). But what this submission wants to focus on, is the amount of money, jobs and talent lost to the missed opportunity of friendly regulation. The absence of regulation has already had clear impact on Australia as a blockchain hub, however, it is not too late to for the position here to change, to both retain and attract talent within our borders.

The suggestions that have been provided reflect the author's experience as an active investor in the space and researcher in the area of the regulation of cryptocurrencies.

If any of the responses require further explanations, please contact David Lu at david@256.ventures.

SUMMARY OF OBSERVATIONS MADE IN THIS SUBMISSION

This submission makes the following recommendations:

- Provide clear token definitions and categories for anyone looking to conduct an ICO;
- Clarify how ICOs, if applicable, interacts with existing financial services law as defined in Ch 7 of the *Corporations Act 2001* (Cth);
- Describes the risks attached to tokens and how they differ to shares;
- Outlines the drivers & factors behind the ICO and secondary trading markets;
- Compares the difference between ICOs, venture capital and equity crowdfunding;
- Evaluates the approaches other regulators such as FCA, FINMA and MAS have taken towards regulating ICOs and discusses how such approaches could be incorporated in Australia

DEFINITIONS AND TOKEN CATEGORIES

1.1. What is the clearest way to define ICOs and different categories of tokens?

1.1.1. Defining ICOs

An ICO can be defined as an open call through the internet where entrepreneurs offer a certain amount of tokens in exchange for other cryptocurrencies such as Bitcoin or Ether.¹ The tokens generated from the project represent a form of future value or rights for the holder.² ICOs have emerged as an increasingly popular means of fundraising, raising approximately \$5 billion in 2017,³ and over \$6.3 billion in Q1 2018.⁴

1.1.2. Token Categories

The labels of “security” and “utility” when describing tokens is fundamentally shaped by the US securities laws,⁵ and too ill-suited to apply to countries such as Australia. The scope of a financial product defined in Chapter 7 of the *Corporations Act* is far broader than a security. Consequently, a “utility” token may also fall under the definition of a financial product in Australia. **Tokens need to be defined the rights they generate, not by the labels placed on them.**

¹ Saman Adhami et al, ‘Why do businesses go crypto? An empirical analysis of initial coin offerings’ [2018] *Journal of Economics and Business* (forthcoming).

² Ross Buckley et al, ‘The ICO Gold Rush: It’s a scam, it’s a bubble, it’s a super challenge for regulators’ (Working Paper No 17-83 UNSW Law Research Paper, 2018), 8; See also Monetary Authority of Singapore, *MAS Clarifies Regulatory Position on the Offer of Digital Tokens in Singapore* (Media Release, 1 August 2017) <<http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx>> where a digital token is defined as a cryptographically-secured representation of a token-holder's rights to receive a benefit or to perform specified functions. Examples of rights include: access to future services, voting rights in the project, allocation of dividends or royalties.

³ CoinDesk, *State of Blockchain Q4 2017* (31 December 2018) <<https://www.coindesk.com/research/state-blockchain-q4-2017/>>.

⁴ David Floyd, *\$6.3 Billion: 2018 ICO Funding Has Passed 2017's Total*, CoinDesk (19 April 2018) <<https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017/>>.

⁵ See Aaron Stanley, *SEC Official Offers New Hope For Utility Tokens In Congressional Testimony*, Forbes (28 April 2018) <<https://www.forbes.com/sites/astanley/2018/04/28/sec-official-offers-new-hope-for-utility-tokens-in-congressional-testimony/#72e6e9a9fcf9>>; SEC, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec 11, 2017), <<https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>>; See also, *Securities Act* (1933) s 2(a)(1); *Securities Exchange Act* (1934) s3(a)(10). The labels of “security” and “utility” has been quite popular to date in the industry.

This submission puts forth three categories of tokens: investment, utility and payment tokens.⁶ This approach is drawn from papers across different countries, attempting to apply jurisdiction neutral terminology in the assessment of tokens.⁷

A. Investment Tokens

Investment tokens represent the class of tokens that are considered assets which promise investors a future financial return or benefit.⁸ The characteristics of an investment token may include distributions of profit or an ownership-style interest an investor has in the company.⁹ The scope of this definition is deliberately wide to account for new types of tokens that may not yet exist but exhibit characteristics that would place them in the scope of an investment, regardless of jurisdiction.¹⁰ A recent study surveying 253 ICOs found that 26% of tokens were offering profit rights.¹¹

The DAO Token is an example of an investment token which permitted the participant to vote and entitled them to financial rewards.¹² Christoph Jentzsch likened this to “buying shares in a company and getting ... dividends”.¹³ Since the token had characteristics of profit distribution through dividends, there was an expectation of a future return or benefit which the definition of an investment in numerous jurisdictions.¹⁴

⁶ Philipp Hacker and Chris Thomale, ‘Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law’ [2017] *European Company and Financial Law Review* (forthcoming); Philippa Ryan et al, ‘Sydney Node’ [2018] *Stanford Journal of Blockchain Law & Policy* (forthcoming).

⁷ See Ross Buckley et al, ‘The ICO Gold Rush: It’s a scam, it’s a bubble, it’s a super challenge for regulators’ (Working Paper No 17-83 UNSW Law Research Paper, 2018), 8; Philipp Hacker and Chris Thomale, Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law [2017] *European Company and Financial Law Review* (forthcoming).

⁸ Philipp Hacker and Chris Thomale, ‘Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law’ [2017] *European Company and Financial Law Review* (forthcoming).

⁹ Jonathan Rohr and Aaron Wright, ‘Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets’ (Cardozo Legal Studies Research Paper No. 527, 4 October 2017), 27. Examples of profit distribution include dividends, revenue share or token price appreciation, interests include shares in a company or an interest in a fund, trust or foundation.

¹⁰ See, FINMA, *FINMA publishes ICO guidelines* (16 February 2018)

<<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung>>; FCA, *Initial Coin Offerings* (12 September 2017) <<https://www.fca.org.uk/news/statements/initial-coin-offerings>>. Noting the difference in how the Swiss and UK approach ICOs but both recognise how financial market law may not be applicable to all ICOs, and each ICO needs to be analysed with a case-by-case approach.

¹¹ Saman Adhami et al, ‘Why do businesses go crypto? An empirical analysis of initial coin offerings’ [2018] *Journal of Economics and Business* (forthcoming).

¹² Slok.it, *Slok.it DAO demo at Devcon1: IoT + Blockchain* (13 November 2015) <<https://www.youtube.com/watch?v=49wHQoJxYPo>>.

¹³ Ibid. Christoph Jentzsch was one of the founders.

¹⁴ See *Securities Act of 1933* § 2(a)(1); *Securities Exchange Act of 1934* § s3(a)(10) for US; See *Corporations Act 2001* (Cth) s763A for Australia.

B. Utility Token

The concept of a utility token does not currently fit within a defined body of law. A utility token proposes to provide the participant with future access or utility to a company's product or service.¹⁵ These tokens have a specific use case inside the project and although they do not represent ownership in a company such as a share, that is not to say they do not bring any possibility of profit or capital gains. The value of a utility token is derived from increased usage of the token within a network where the supply of tokens is usually mathematically fixed.¹⁶

A utility token acts like a digital coupon for a service or product that is being developing. A good way to picture this is to compare the function of a utility token to a paid Application Programming Interface (API) key.¹⁷ When a user wishes to use Amazon Web Services (AWS), they can generate API keys that allows the user to send commands to AWS to perform certain actions for them on the network in exchange for dollars or pre-paid credits. The API key acts in the same manner as ether tokens; they can be used to redeemed computing time on the Amazon server and Ethereum Virtual Machine respectively.¹⁸ The redemption value gives the token an inherent utility.¹⁹ For instance, Golem (GNT) raised 820,000 Ethereum, by selling GNT tokens for future access to a peer-to-peer market for user's excess Central Processing Unit (CPU) power over a decentralised network.²⁰ There are numerous examples of similar projects, such as Storj or Filecoin that are attempting to provide decentralised versions of cloud storage services like AWS whose tokens function in a same manner to Golem's.²¹

¹⁵ Aaron Stanley, *SEC Official Offers New Hope for Utility Tokens in Congressional Testimony*, Forbes (28 April 2018) <<https://www.forbes.com/sites/astanley/2018/04/28/sec-official-offers-new-hope-for-utility-tokens-in-congressional-testimony/#5f90ae7efcf9>>.

¹⁶ When utility tokens are used on a network, they increase the transaction volume which in turn increases the price for them due to higher demand. Utility tokens are also known as "user tokens" or app coins.

¹⁷ Balaji Srinivasan, *Thoughts on Tokens* (28 May 2018) <<https://news.earn.com/thoughts-on-tokens-436109aabcbe>> .

¹⁸ Unlike the Ethereum Network, AWS does not use digital coupons or tokens – the service charges your credit card or deducts the number of pre-purchased credits you have.

¹⁹ If someone were to gain access your API keys, they can bill your Amazon account. Similarly, if someone were to gain access to your private keys, they can take your digital currency. However, unlike API keys, tokens can be exchanged and transferred between parties without the consent of the API key issuer.

²⁰ Alex Sunnarborg, *Blockchain for CPU? Analysing Golem's Ethereum Token Sale*, CoinDesk (11 November 2016) <<https://www.coindesk.com/analyzing-golems-blockchain-token-sale/>>; See also <<https://golem.network/>>. The price of Ethereum was US\$11 as at November 2016.

²¹ Storj, *A Peer-to-Peer Cloud Storage Network* (15 December 2016) <<https://storj.io/storj.pdf>>; Filecoin, *Filecoin: A Decentralized Storage Network* (19 July 2017) <<https://filecoin.io/filecoin.pdf>> .

C. Payment Token

Payment tokens refer to the broad classification of tokens that may be used as a means of payment, which may be transferrable between wallets, but are not backed by any real-world assets.²² These tokens represent a ‘store of value’ that do not have any utility usage on a specific platform but are solely used for the purpose of payments and transactions. Examples of payment tokens include Bitcoin and Monero.²³

DRIVERS OF THE ICO MARKET

2.1. What is the effect and importance of secondary trading in the ICO market?

One of the fundamental advantages of tokens is their ease of being traded on the secondary market. Early stage businesses that are funded by venture capital may remain illiquid for years, with liquidity events predominantly only occurring every time a new round of funding is raised, which on average occurs every two to three years, depending on the company. Traditionally, the secondary trading of a company’s shares only became available to those who conducted public offerings and had their shares listed on regulated exchanges. Projects funded by way of ICOs may have their tokens trading on exchanges almost immediately, effectively granting them early liquidity, despite the fact their business may not have a working product or service.

The immediate liquidity offered to founders who are operating early stage businesses, is a highly enticing one as it provides additional exit options for the business and inevitably encourages more founders to pursue fundraising through ICOs.

Legally however, the secondary trading of a token in the ICO market makes the legal status of a token difficult to assess. It is unclear if a utility token falls within the definition of a financial product in Australia. The purchase of a utility token that is purely functional, *prima facie*, is unlikely to be a security.²⁴ **However, if the same digital token is traded on an exchange or a secondary market, then the legal status of the token is less certain.**²⁵ ASIC

²² FINMA, *FINMA publishes ICO guidelines* (16 February 2018)

<<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung>>.

²³ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (31 October 2008)

<<https://bitcoin.org/bitcoin.pdf>>. Bitcoin is intended to be used as a pure peer-to-peer version of electronic cash. Nicolas van Saberhagen, *CryptoNote v 2.0* (17 October 2013) <<https://cryptonote.org/whitepaper.pdf>>. Monero has proposed their own version of electronic cash that is intended to be private and untraceable.

²⁴ Gordon Walker, ‘New Zealand: Crowd-sourced funding, cryptocurrencies and initial coin offerings in Australia and New Zealand’ (2017) 36 *Company and Securities Law Journal* 111.

²⁵ See Power Ledger, *Token Generation Paper* (4 August 2017)

<<https://cdn2.hubspot.net/hubfs/4519667/Documents%20Power%20Ledger%20Token%20Paper%20.pdf>>.

Since Power Ledger (POWR) has been trading on exchanges (i.e secondary markets), there have been questions as to whether the token sale would have constituted a managed investment scheme for the same reasons as was

notes that the mere fact that a token is described as a utility does not preclude it from being a financial product, nor the existence of a statement claiming that an ICO or token is not a financial product.²⁶

2.2. What will be the key drivers of the ICO market going forward?

Regulation and liquidity are arguably the largest drivers for the ICO markets moving forward. Currently, the legal nature of tokens and ICOs is still unclear in Australia. As the rights of the token may vary, they currently fall within a regulatory grey area which subsequently means that the issuance of these assets is also opaque. For example, some ICOs may fall within the scope of a managed investment scheme (MIS) whereas others will not. There is an important point of differentiation for a business here as operating a MIS presents a higher barrier of entry due to additional licensing required and costs. Without clear guidance on what which token offerings require licensing or otherwise, companies will be discouraged to conduct ICOs as any perceived advantaged provided by ICOs will be subject to “regulatory discretion” when assessed.

For example, this is approach is demonstrated in the actions ASIC took against an ICO in Australia after “fundamental concerns were identified with the structure of an ICO, the status of the offeror and the disclosure in its white paper.”²⁷ The company was a betting startup that intended to raise \$55mn through the sale of its token, Nedscoin. The Nedscoin website and whitepaper described the following which came under scrutiny:²⁸

- An offer to sell tokens called NEDS;
- A plan to create a token ecosystem and steps to be taken to increase the value of NEDS;
- The promotion of NEDS coins to purchasers across forums, social media and websites;

discussed in the US section. If the issuer was seen to promote or promise a future listing, then it is quite clear that the issuer is creating an expectation to generate a profit for purchasers of POWR, which would place it under the scope of a financial product and managed investment scheme. If a holder or third-party facilitated the token listing on an exchange, then that would be a matter outside the scope of the issuer and likely place the token outside the definition.

²⁶ ASIC, *INFO 225: Initial coin offerings and crypto-currency* (1 May 2018) <<https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-currency/>>.

²⁷ ASIC, *ASIC takes action on misleading or deceptive conduct in ICOs*, 18-122MR, 1 May 2018 <<https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-122mr-asic-takes-action-on-misleading-or-deceptive-conduct-in-icos/>>.

²⁸ Neds, *Neds ICO Whitepaper* (23 March 2018) <https://promos.neds.com.au/rs/821-PQQ-766/images/Neds_ICO_whitepaper.pdf>.

- A statement claiming that “nedscoin will be listed on various exchanges allowing for speculation on the tokens valuation”;
- The reasonable expectation for the purchaser to believe that they would obtain a profit; and
- Critically, the nature of Nedscoin would allow token holders to receive a quarterly dividend equal to 0.25% of the company’s quarterly turnover.

The combination of these elements led ASIC to conclude that the offer represented an unregulated managed investment scheme, and that the offeror would have been in breach of the relevant provisions of the *Corporations Act* had the offer proceeded.²⁹

The ICO market differs to a traditional stock market in that tokens may be traded on public and secondary markets at much earlier stages of a business’ lifecycle. Hence it is easy to jump to the conclusions that tokens have immediate liquidity as they may be listed on ‘exchanges’ that have a far lower barrier to listing. However, this is often an illusion as while **they may be openly traded on an exchange**, the reality is without market participants trading the token, it may as well be an illiquid asset like early stage venture capital.

For example, even though CanYaCoin is listed on numerous exchanges,³⁰ the liquidity is extremely low, with a 24hr trading volume of less than \$USD2,000. Any coin or token will only be as liquid as its trading volume.

²⁹ ASIC, *ASIC takes action on misleading or deceptive conduct in ICOs*, 18-122MR, 1 May 2018 <<https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-122mr-asic-takes-action-on-misleading-or-deceptive-conduct-in-icos/>>. The dividend element of the token appears critical in firmly rendering the token a financial product.

³⁰ See <https://coinmarketcap.com/currencies/canyacoin/#markets> for market information on CanYa’s token. The time of the screenshot is dated 26 February 2019.

CanYaCoin Markets

| # | Source | Pair | Volume (24h) | Price |
|---|--|-------------------------|--------------|------------|
| 1 |  KuCoin | CAN/BTC | \$915 | \$0.015195 |
| 2 |  Bancor Network | CAN/BNT | \$620 | \$0.014586 |
| 3 |  KuCoin | CAN/ETH | \$441 | \$0.014650 |
| 4 |  COSS | CAN/ETH | \$0 | \$0.013531 |
| 5 |  COSS | CAN/BTC | \$0 | \$0.021134 |
| 6 |  IDAX | CAN/BTC | \$0 | \$0.001900 |
| 7 |  IDAX | CAN/ETH | \$0 | \$0.005165 |
| 8 |  Lykke Exchange | CAN/ETH | ** \$0 | \$0.012841 |

Compare this to BitCoin which did a volume of over \$USD 8 million in the past 24 hours.

| # | Name | Market Cap | Price | Volume (24h) |
|---|--|------------------|----------------------------|---------------------------------|
| 1 |  Bitcoin | \$67,475,046,759 | \$3,842.82 | \$8,702,107,721 |
| 2 |  Ethereum | \$14,500,727,346 | \$138.09 | \$4,323,794,009 |
| 3 |  XRP | \$13,140,971,850 | \$0.317678 | \$1,166,903,860 |
| 4 |  EOS | \$3,164,653,848 | \$3.49 | \$1,747,455,540 |
| 5 |  Litecoin | \$2,752,013,901 | \$45.38 | \$1,154,410,064 |

3.1. How can ICOs contribute to innovation that is socially and economically valuable?

ICOs can provide early-stage technology businesses the opportunity to raise money and pre-sell their products. Traditionally, angel investors (angels), venture capitalists (VCs) and financial institutions have been the main providers of capital for these early stage companies.³¹ In the early stage of business development, funding is restricted until the entrepreneur is able to demonstrate to investors the existence of a profitable business model.³² Consequently, entrepreneurs are placed in a dilemma – in absence of a track record, it is difficult for them to raise the funding they need to succeed.³³

In addition, it allows founders to raise money to build and test a product or service without having to give up equity in their company, which will be covered in more detail below.

3.2. What do ICOs offer that existing funding mechanisms do not?

The benefits of ICOs is best understood by examining the current means of fundraising available to founders and early stage businesses. Common fundraising options for early stage companies include venture capital and crowdfunding.

Venture capital is primarily concerned with investing in the equity of a business.³⁴ Venture capitalists will not only take equity in an early stage business (which represent their financial upside), but also control rights.³⁵ This may take the form of a board seat on the company or specific decisions that require the venture capitalist's approval. Often, the interests of a VC (to generate a return on the investment) will differ to that of the founder's (to build the company) and the conflicting interests may lead to adverse situations where the company may be forced to proceed in a way that is not optimal for them. VCs are sophisticated

³¹ Paul Gompers and Josh Lerner, 'The Venture Capital Revolution' (2001) 15(2) *Journal of Economic Perspectives* 145, 146.

³² Bert Scholtens, 'Analytical issues in external financing alternatives for SBEs' (1999) 2 *Small Business Economics* 137, 148.

³³ Thomas Hellman 'The allocation of control rights in venture capital contracts' (1998) 29(1) *RAND Journal of Economics* 57.

³⁴ Jean-Etienne De Bettignies and James Brander, 'Financing Entrepreneurship: Bank Finance versus Venture Capital' (2007) 22(6) *Journal of Business Venturing* 808, 832; See also Steven Kaplan and Per Stromberg, 'Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts' (2003) 70(2) *Review of Economic Studies* 281, 315 which reports that approximately 80% of venture capital is preferred equity.

³⁵ Paul Gompers and Josh Lerner, 'Venture capital investment cycles: The impact of public markets' (2008) 87 *Journal of Financing Economics* 5.

investors and in Australia, a wholesale managed investment scheme is usually more than enough to conduct the offering.

Equity crowdfunding involves making an offer to shares to a broader stakeholder base that includes retail investors. The equity crowdfunding rules are also significantly more stringent as the offer is being made to retail investors, detailed in CSEF regime. For the purposes of efficacy, this submission will not go into the details of equity crowdfunding.

Fundamentally, the instruments being issued in an ICO (i.e a token) is different to a share that is issued in the cases of venture capital or equity crowdfunding. A token holder will not receive the same rights as a shareholder would. They only participate in the blockchain organisation which provides them with tokens that may grant certain right, but these tokens do not represent any asset or relationship to contractual rights within the organisation.³⁶ This distinction means that shareholders of a company operating an ICO would still remain the ultimate claimants of any residual profits in event of liquidation or sale of the business while token holders would not.

3.3. Are there other opportunities for consumers, industry or the economy that ICOs offer?

ICOs have enabled retail investors the same level of access to that of accredited or institutional investors, and similarly allowed investors from allow the world to invest in Australian projects.

At a consumer level, while there are opportunities for the retail audience to invest on a level platform to accredited investors, the risks still remain the same – to protect the retail investor from losing significant portions of their money to ICOs they might not be well informed about. This will be discussed in greater detail in 3.5 below. However, what the ICO wave has demonstrated is that there are many savvy investors who may not be accredited under the definition but regardless, are able to make smart investment decisions from a class of new investment products. So perhaps the requirements for CSEF regimes or the standards for “accredited investors” ought to be revisited.

At an industry and economy level, ICOs have allowed projects to raise millions of dollars of investment from investors across the world. More SMEs and startup projects mean more jobs

³⁶ Philipp Hacker & Chris Thomale, ‘Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law’ [2017] *European Company and Financial Law Review* (forthcoming).

for the Australian economy and from the stance of the Treasury, this is pertinent when it comes to measuring levels of employment.

3.4. How important are ICOs to Australia’s capability to being a global leader in FinTech?

ICOs specifically only play a small part in Australia’s capability to be a global leader in FinTech. More importantly to this capability is the responsiveness of the regulators to any innovative or new technologies, as it signals to companies whether said jurisdiction will work with or against this new technology. Taking a global stance, we can see that differing approach to ICOs has led to remarkably different outcomes for these jurisdictions. Countries such as China and South Korea have announced outright bans on ICOs,³⁷ which has created a blanket ban on ICO activity in such regions. This represents one extreme of the scale. Next, are countries such as the US where the SEC has issued numerous warning with regards to ICOs and set clear precedents with cases like the DAO,³⁸ or Munchee.³⁹ Such actions have prompted subsequent projects to not raise from US investors for concerns of getting approached or shut down by the SEC.

Countries such as Malta or Singapore, or even cantons such Zug have punched well above their weight when it comes to attracting talented founders and companies to their jurisdictions. Central to this has been their friendly and sandbox approach towards ICOs, allowing founders and projects to experiment within a defined set of parameters, with the assurance that the regulators will not come after them. As a founder, the natural action to take is to find a jurisdiction that is favourable to ICO and blockchain activity and unfortunately for Australia, this country has already lost significant amounts of talent and jobs to other countries.

For example, Republic Protocol and Perlin are two projects that are founded by Australians, Taiyang Zhang and Dorjee Sun respectively but operate out of Singapore.⁴⁰ Each team is approximately twenty members strong, meaning that the Australian economy has already lost

³⁷ David Meyer, *South Korea Follows China by Banning ICOs*, Fortune (29 August 2017) <<https://finance.yahoo.com/news/south-korea-follows-china-banning-075307361.html>>.

³⁸ SEC, ‘Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO,’ (Media Release, 81207, 25 July 2017), 13 <<https://www.sec.gov/litigation/investreport/34-81207.pdf>>; see also the facts in *Howey*.

³⁹ SEC, Securities Act of 1933 (Release No. 10445 (“*Munchee Order*”), December 11, 2017) <<https://www.sec.gov/litigation/admin/2017/33-10445.pdf>> (order instituting cease-and-desist proceedings pursuant to Section 8A of the *Securities Act of 1933*, making findings, and imposing a cease-and-desist order).

⁴⁰ For full disclosure, 256 Ventures has invested in Republic Protocol and Perlin and remain as advisors to both companies.

forty jobs to Singapore. This only represents a tiny sample size of the Australian founders who have gone abroad. When questioned, both founders indicated the move abroad was motivated by a stronger blockchain community and clearly regulation of the industry.

Without talent, Australia can never hope to be a global leader in FinTech. Singapore is far smaller than Australia both in terms of size and population but has carved a reputation for being a FinTech hub where entrepreneurs flock to. Without the fundamental policies that attract pioneer entrepreneurs to a jurisdiction, there will be no community or network to entice subsequent waves of companies and founders.

3.5. Are there other risks associated with ICOs that policymakers and regulators should be aware of?

ICOs and tokens raise an increasing number of risks despite the innovation they bring to finance and technology, including information asymmetry and lack of investor protection.

A. Information Asymmetry

ICOs are typically preceded by the release of a whitepaper, which can be similar to an IPO prospectus or disclosure document.⁴¹ Whitepapers will usually detail the value proposition of a token, technical elements of how the token operates within the project, a breakdown of how the proceeds will be spent, along with information on the team and advisory board.⁴² However, most whitepapers are unlike product disclosure statements or information memorandums – they are often nowhere near as comprehensive, nor are they monitored by any third-party authority, as they fall outside predefined regulatory procedures.⁴³

A recent empirical study indicated that 17.96% of whitepapers merely provide technical information on the project that is intended to be developed,⁴⁴ 23.28% do not offer any information of the project's financial circumstances, and 85.8% are silent on whether the funding from participants is to be pooled or separated.⁴⁵ Prospective contributors are presented with such limited information on the project that no decision to invest could be

⁴¹ Deloitte, *ICOs – The New IPOs? How to fund innovation in the crypto age*

<<https://www2.deloitte.com/content/dam/Deloitte/de/Documents/Innovation/ICOs-the-new-IPOs.pdf>>.

⁴² Sabrina Howell et al, 'Initial Coin Offerings: Financing Growth with Cryptocurrency Token Sales' (Working Paper No w24774 NBER Working Paper, 2018), 10.

⁴³ Wulf Kaal and Marco Dell'Erba, 'Initial Coin Offerings: Emerging Practices, Risk Factors, and Red Flags,' in Florian Möslein and Sebastian Omlor (eds) *Fintech Handbook* (Verlag C.H. Beck, 2018) (forthcoming).

⁴⁴ Ross Buckley et al, 'The ICO Gold Rush: It's a scam, it's a bubble, it's a super challenge for regulators' (Working Paper No 17-83 UNSW Law Research Paper, 2018), 17.

⁴⁵ Ibid.

considered rational. Unlike traditional funding vehicles, the tokens that ICOs issue are liquid from an early stage of the business and may be easily traded on various exchanges.⁴⁶ Most projects are in the ideation stage, with only 5% of projects having a product and 11% having developed prototypes.⁴⁷ Given the limited information available at the point of investment, any new information pertaining to the project will result in high volatility to the token price. High volatility and low liquidity in a market promotes speculation and encourages so called ‘pump and dump’ schemes.⁴⁸

B. Lack of Investor Protection

Most ICOs have relied on loopholes in the legislation or sought to operate in a regulatory grey area, with only 31% of whitepapers containing any information on the applicable and relevant law.⁴⁹ More concerning is that in 33.26% of cases, the name given as the author of the whitepaper will differ from the issuer of the token.⁵⁰ Without the basic information required to identify the person behind the ICO, it becomes incredibly difficult to bring an action against potential fraudulent claims. In the absence of regulation, ICOs are available for anyone to take part in, unlike traditional venture capital or equity crowdfunding projects which were only available to institutional or accredited investors.⁵¹ Raising money in an unregulated retail market without intermediaries is problematic and creates difficulties for uneducated market participants to distinguish between high-quality projects and sham projects seeking to opportunistically raise capital.⁵²

⁴⁶ Wulf Kaal and Marco Dell’Erba, ‘Initial Coin Offerings: Emerging Practices, Risk Factors, and Red Flags’ in Florian Möslein and Sebastian Omlor (eds) *Fintech Handbook* (Verlag C.H. Beck, 2018) (forthcoming). Exchanges in the cryptocurrency setting are not regulated like traditional exchanges such as the New York Stock Exchange (NYSE) or Australian Stock Exchange (ASX).

⁴⁷ Ernst & Young, *EY research: initial coin offerings (ICOs)* (December 2017), <<https://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>>.

⁴⁸ Jeff John Roberts, *SEC Warns Scammers Are Using ICOs to Pump and Dump*, Fortune (29 August 2017) <<http://fortune.com/go/tech/sec-blockchain-ico-scam/>>. A pump & dump scheme will involve a leak of speculative information (usually from an insider) which will lead to a rapid buying frenzy that “pumps” up the token price, at which the fraudsters will “dump” their tokens and sell off their position which leads to an overall drop in price.

⁴⁹ Ross Buckley et al, ‘The ICO Gold Rush: It’s a scam, it’s a bubble, it’s a super challenge for regulators’ (Working Paper No 17-83 UNSW Law Research Paper, 2018), 18.

⁵⁰ *Ibid* 19.

⁵¹ Ryan Amsden and Denis Schweizer, ‘Are Blockchain Crowdsales the New ‘Gold Rush’? Success determinants of Initial Coin Offerings’ (Working Paper, 2018), 14.

⁵² Thomas Bourveau et al, ‘Initial Coin Offerings: Early Evidence on the Role of Disclosure in the Unregulated Crypto Market’ (Working Paper, 2018), 2.

4.1. Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?

To adequately answer this question, the definition and scope of found in Ch 7 of the *Corporations Act* (2001) needs to be given proper consideration.⁵³ There are three arms to this:

1. The functional definition – found in subsection Section 763A;⁵⁴
2. Specific inclusions that are financial products – found in Section 764A;⁵⁵ and
3. Specific exclusions that are not financial products – found in Section 765A.⁵⁶

As the concept of ICOs activity is new, the functional definition of financial products will be the focus of the discussion with links to inclusions and exclusions where appropriate.

The functional definition of a financial product is a facility which is used for:

1. Making a financial investment;⁵⁷
2. Managing a financial risk;⁵⁸ or
3. Making a non-cash payment.⁵⁹

For the purposes of this submission, only financial investments will be considered as managing a financial risk and making a non-cash payment is unlikely relevant to ICO activity.

A person makes a financial investment when an investor gives money to another party who uses the contribution to:⁶⁰

1. Generate a return, or intends for a financial return or other benefit to be generated from the contribution (whether realised or otherwise); and
2. If the investor has no day-to-day control over the contributions to generate the profit.

⁵³ *Corporations Act 2001* (Cth).

⁵⁴ *Ibid* s763A.

⁵⁵ *Ibid* s764A.

⁵⁶ *Ibid* s765A.

⁵⁷ *Ibid* s763B.

⁵⁸ *Ibid* s763C.

⁵⁹ *Ibid* s763D.

⁶⁰ *Ibid* s763B.

A person paying money to a company for the issue of shares or contribution of money to acquire interests in a registered scheme would be making a financial investment.⁶¹ Purchasing property or bullions however, will not constitute a financial investment as while the property or bullion may generate returns, it is not a return generated by the use of the purchase money by another person.⁶²

The *Corporations Act* sets out the definition of each regulated product in a flexible and general definition. The term managed investment scheme ('MIS') is included in the legislation to capture the variety of structures for the issue of interests that are not traditional financial products or regulated investments in the *Corporations Act*.⁶³ Each element is to be interpreted broadly and not to be read down as it is intended to capture investment schemes that are not regulated nor expressly excluded from regulation.⁶⁴

A MIS is an investment contract where people are brought together to put money to gain an 'interest' in a common enterprise that is managed by a third party to produce a financial benefit or benefits consisting of rights or interests in property, where the members do not have day-to-day control of the venture.⁶⁵ The investment must be pooled or in a common enterprise.⁶⁶ Furthermore, a MIS will need to be registered with ASIC if the scheme is being marketed or promoted to persons other than sophisticated investors.⁶⁷

This question is a difficult one to assess since it turns on the characteristics and nature of the token that is being offered. As discussed in the definition in 1.1, an investment token will likely fall within the scope of the financial services law (*Corporations Act*) however, a utility and payment token is far more opaque. The argument is that the ICO of a utility or payment token is a pre-sale of a good or service that is intended to be used rather than held to gain a financial return or other benefit. Thus such offerings would fall outside the scope of the definition set out in Section 763 of the *Corporations Act*.

⁶¹ Ibid Note 1.

⁶² Ibid Note 2.

⁶³ Pamela Hanrahan, *Funds Management in Australia: Officers' Duties and Liabilities* (LexisNexis Butterworths 2007) Ch1; See *Corporations Act 2001* (Cth) s 9.

⁶⁴ *Australian Softwood Forests Pty Ltd v Attorney-General for NSW* (1981) 148 CLR 121, 51.

⁶⁵ *Corporations Act* (2001) (Cth) s9; ASIC, *Managed Investment Schemes* (10 May 2018)

<<http://asic.gov.au/regulatory-resources/funds-management/#mis>> 'interests' in a scheme are a type of 'financial product' and are regulated by the *Corporations Act* (2001).

⁶⁶ Robert Baxt et al, *Securities and Financial Services Law* (LexisNexis Butterworths, 8th ed, 2002) 115.

⁶⁷ *Corporations Act 2001* (Cth) s601ED. The term in Australia is 'wholesale investor'.

4.2. Do current regulatory frameworks enable ICOs and the creation of a legitimate ICO market? If not, why and how could the regulatory framework be changed to support the ICO market?

The current regulatory framework is not suitable for the creation of a legitimate ICO market. To date, ASIC has not provided any positive indication on the definition of a token or what an ICO is, instead opting to take action on projects for “misleading and deceptive conduct.”⁶⁸ The amount of guidance, outlined in an INFO paper, largely talks about the potential risks of ICOs and tokens falling into the category of a financial product.⁶⁹

There are very few countries that have made rulings on how ICOs should be regulated, with most regulatory bodies putting forth either a series of guidelines or regulatory warnings to investors and potential issuers.⁷⁰ FINMA for example, has set forth one of the clearest set of guidelines for the categories of tokens, putting forth three distinct categories of asset, payment and utility tokens. The FCA and MAS have also taken similar approaches to define what ICOs and tokens are, with MAS opting to run a sandbox for blockchain and cryptocurrencies. It is crucial for the Australian regulators create some frameworks around this for early-stage companies to understand the processes and risks around ICOs.

⁶⁸ ASIC, *ASIC takes action on misleading or deceptive conduct in ICOs*, 18-122MR, 1 May 2018 <<https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-122mr-asic-takes-action-on-misleading-or-deceptive-conduct-in-icos/>>.

⁶⁹ ASIC, *INFO 225: Initial coin offerings and crypto-currency* (1 May 2018) <<https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-currency/>>.

⁷⁰ Wolfie Zhao, *China's ICO Ban: A Full Translation of Regulator Remarks* (5 September 2017) <<https://www.coindesk.com/chinas-ico-ban-a-full-translation-of-regulator-remarks/>>; FSC, *Joint TF for virtual currency-related institutions* (29 September 2017) <http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=&sword=&r_url=&menu=7210100&no=32085>; Monetary Authority of Singapore, *MAS Clarifies Regulatory Position on the Offer of Digital Tokens in Singapore* (1 August, 2017) <<http://www.mas.gov.sg/News-andPublications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-inSingapore.aspx>> FCA, *Initial Coin Offerings* (12 September 2017) <<https://www.fca.org.uk/news/statements/initial-coin-offerings>>; FINMA, *FINMA publishes ICO guidelines* (16 February 2018) <<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung>>.