

ICOs – The future of start-up funding?

ICOs

Increasing implementation of blockchain technology into business and everyday life eliminates the requirement for trusted third parties to act as intermediaries, for example, for financial transactions and introduces novel ways to raise capital. The terms ICO and ITO, which stand for Initial Coin Offering and Initial Token Offering respectively, describe corporate or project financing based on blockchain technology. In 2017/2018 alone, investors provided in excess of USD 22 billion in funding for such projects, cementing ICOs/ITOs as a legitimate alternative to traditional ways of raising capital for start-ups and projects in general.

The blockchain

The blockchain is a decentralized, chronologically updated database with a network-produced consensus mechanism allowing data to be stored and digitally distributed across various computer networks connected by a peer-to-peer network. Each new data entry is first cryptographically signed and secured by a public key, before being combined with a block and added to the existing chain of recent blocks (hence the name). With each transaction on the digital ledger being duplicated and distributed across all other nodes (computer systems), the individual blocks gain validity through a consensus control mechanism, subsequently making it nearly impossible to change or hack the validated information.

How it works

In essence, ICOs are fundamentally a form of crowdfunding mostly used by companies whose

business model is based on blockchain technology, with investors usually entering at the earliest stages of development. Therefore, with an orientation towards a classic initial public offering (IPO), a separate cryptocurrency (in the form of coins/tokens) is issued to a group of investors who pay either with fiat money or with other cryptocurrencies (e.g. Bitcoin or Ethereum). The coins or tokens received in exchange are in most cases related to the ICO organizer's company or project and often provide the acquirer with a stake in a company, frequently a start-up, and/or shares in future profits.

Token

While the term "crypto-asset" is often used as an umbrella term for designations such as coins or tokens, an explicit legal definition currently only exists for the term "virtual currency" (see Article 3(18) of Directive (EU) 2018/843). The literature makes a distinction between three different types of token:

- (i) Security / Investment Token
- (ii) Payment / Currency Token
- (iii) Utility Token

(i) Security / Investment token:

In most cases, these tokens embody claims to payment of capital, whether in the form of participation in the company's profits or in the form of interest and repayment. As a rule, security tokens qualify either as securities within the meaning of Regulation (EU) 2017/1129 and WAG 2018 or within the meaning of the KMG 2019 (Austrian Capital Market Act 2019) – the latter being the case when the token/coin is not transferable or only transferable to a limited extent, but still embodies claims to capital or returns.

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(ii) Payment / Currency token:

This is a token which embodies a certain value and whose primary purpose is a payment function (therefore acquiring goods or services). Therefore, both the concession elements of the issuance and administration of means of payment pursuant to Sec 1 Para 1 No. 6 BWG (Austrian Banking Act) as well as the issuance of electronic money as defined in the Electronic Money Act 2010 may be fulfilled.

(iii) Utility token:

This token primarily serves to provide the holder with a benefit with regard to a specific product or service – often granting exclusive access to a digital platform provided by the issuer. Depending on their design, utility tokens may be subject to a concession obligation, have an investment component, or be related to payment tokens due to their payment function. Therefore, legal classification must always be examined on a case-by-case basis.

Legal analysis – Austria

Due to the technical, functional and economic differences in the design of ICOs, a general regulatory classification is rendered rather difficult. As a result, there are currently no specific supervisory regulations for the implementation of ICOs at either the European or the Austrian level. Depending on the specific design of the ICO, the specific way of collection and use of capital as well as the legal position of the coin or token holder, issuing parties might be obligated to comply in particular with relevant provisions of the Banking Act (*Bankwesengesetz*), the Securities Supervision Act 2018 (*Wertpapieraufsichtsgesetz 2018*), Regulation (EU) 2017/1129 and the Austrian Capital Market Act 2019 (*Kapitalmarktgesetz 2019*), the

Electronic Money Act 2010 and the Austrian Payment Services Act 2018 (*E-Geldgesetz 2010* und *Zahlungsdienstegesetz 2018*), as well as the Alternative Investment Fund Manager Act (*Alternative Investmentfonds Manager-Gesetz*).

Since the 5th Money Laundering Directive contains definitions of the terms "virtual currencies", "exchange" and "electronic wallet providers" and the scope of application of the "anti-money laundering / combating the financing of terrorism" (AML/CFT) rules is also extended to so-called "wallet providers" and exchanges of virtual currencies, a risk-oriented examination of the origin of funds as well as the relevant reporting obligations in the event of suspected money laundering are to be regarded as essential.

General benefits

Obtaining financing by means of an ICO (or ITO) usually offers a significantly faster and cheaper alternative in comparison to conventional financing instruments, while at the same time allowing more flexibility and transferring the main financial risk to investors (rather than the founders). In addition to this, raising capital through ICOs/ITOs opens up a new market of previously untapped potential investors. For these specific reasons, these forms of financing are enjoying growing interest, especially among start-ups.

General (legal) risks

The lack of legal regulation coupled with legal uncertainty poses risks for both distributors and potential stakeholders. Both the European Securities and Markets Authority (ESMA) and the Austrian Financial Market Authority (FMA) have issued consumer warnings regarding ICOs in the past. However, these publications have acknowl-



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edged the status of ICOs as fundamental innovation with various benefits and therefore advised against possible over-regulation of these areas. Nevertheless, specific regulatory measures are essential to limit the potential for money laundering and terrorist financing and ensure appropriate consumer protection.

For more information

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