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Tokenfunder: democratizing funding and investing with blockchain

Alexander Li wrote this case under the supervision of Professor Jean-Philippe Vergne solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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On a late night in Toronto in the middle of January 2018, Alan Wunsche, chief executive officer, and Laura Pratt, chief operating office, of TokenFunder Inc. (TokenFunder) were reflecting on their road show across the country and all the different people they had met. In the process of raising money for their business, they were also thinking about different partnerships that could help them grow their operations and contribute to the ecosystem of their blockchain-based online funding platform. They had met with accounting firms, lawyers, venture capitalists (VCs), and incubators interested in getting involved in the blockchain space through a partnership with TokenFunder. Building a platform to help companies raise money through initial token offerings (ITO) legally was no small feat, and doing it alone would be impossible. There was no question that these partnerships would be critical to taking the business to the next stage. Wunsche and Pratt had to thoroughly analyze all the options before them and strategize on how to obtain the partnerships they wanted but did not yet have.

BLOCKCHAIN TECHNOLOGY

Blockchain was a new type of database technology that had gained prominence through the astronomic rise of cryptocurrencies (see Exhibit 1). Information on a blockchain was stored in blocks that were linked together and secured using cryptography. The power of blockchain ledgers laid in their ability to be fully decentralized, meaning that no single entity had the power to manipulate the data. Rather, all the participants (nodes) on a blockchain each held a copy of the data and had to reach consensus before any changes could be made. With this decentralization came transparency, which built trust into the system. Beyond the decentralization and security, blockchains were usually immutable databases. This meant that once a transaction had been recorded, it could not be deleted or modified. From a business perspective, blockchain technology introduced the possibility of triple-entry accounting. While double-entry accounting, in use since the fifteenth century, made every transaction have equal and opposite effects in two different ledgers (respectively maintained, for instance, by a seller and a buyer), blockchain ledgers added a third account to the mix—namely, a distributed digital database that every network node had to maintain an identical copy of—thereby providing a single source of truth that was independent of both the buyer and the seller.[[1]](#footnote-1)

However, blockchain did have several weaknesses. It could be very wasteful computationally, as every node repeated a task to agree to each change across the blockchain. Furthermore, a lot of blockchains currently had scalability issues that were resulting in slow transaction speeds and higher-than-expected transaction costs. Lastly, the immutability aspect of blockchain could be a double-edged sword. For instance, in the event of a dispute between parties, a decision sometimes had to be made to cancel or reverse a transaction, as was regularly the case with credit card chargebacks.

The first real-world application of blockchain technology came with the 2009 launch of Bitcoin, the first decentralized cryptocurrency that utilized the decentralization, security, and peer-to-peer capabilities of the architecture to enable disintermediated value transfers (i.e., no bank or payment processor was needed to send Bitcoin from one user to another). Bitcoin was introduced shortly after the financial crisis in a white paper by an unknown entity called “Satoshi Nakamoto.”[[2]](#footnote-2) No one is sure if Nakamoto was a person or a group of people, but what was certain was that the Satoshi blockchain paved the way for a new category of start-ups. Bitcoin itself could be acquired on the open market or “mined” by lending computing power to secure and maintain the database. Following the introduction of Bitcoin, users of the technology began to take note of the different applications that blockchain could have beyond currency. Many concepts began to translate into businesses that used blockchain as the database architecture for their product.

INITIAL COIN OFFERING AND ASSOCIATED ISSUES

An initial coin offering (ICO) occurred when a nascent organization sold tokens of a new cryptocurrency to investors, who typically paid in bitcoin, ether, or fiat currency. These new tokens could have different functionality depending on the goal of the issuer. The most common categories of tokens were as follows:

1. Utility tokens—These were redeemed to use a product or a service. An example would be the US$257 million Filecoin ICO.[[3]](#footnote-3) Filecoin was a decentralized online-storage start-up that issued tokens to facilitate the lending or renting of storage space for its users’ data.
2. Equity tokens—These offered entitlement to equity and equity-like benefits including profits and voting rights. For example, TenX, a cryptocurrency debit card, sold tokens with rights to a portion of revenue generated by the company.[[4]](#footnote-4)
3. Asset tokens—These were backed by real-world assets. Intex, a Norwegian mining company, had recently conducted an ICO with tokens that were backed by the company’s copper and metal reserves.[[5]](#footnote-5)

There were multiple benefits for both issuers and investors participating in an ICO. For the issuer, conducting an ICO that distributed usage tokens was a great way to build a user base and generate customers before a product was even finished. This was similar to crowdfunding, but instead of funding projects or ventures, blockchain-based applications were being funded. Furthermore, ICOs allowed businesses to broaden their investor base to a retail level. For ideas that a traditional VC might not touch, ICOs presented a great alternative for entrepreneurs (see Exhibits 2 and 3). Compared to an initial public offering (IPO), an ICO was currently a much more simplified process; however, it was not exactly an apples-to-apples comparison, given that the financial markets were much more mature and had regulations already in place.

On the investor side, ICOs provided opportunities to invest in businesses regardless of nationality (in most cases), wealth level, and network. Almost anyone was allowed to invest, and minimum investments were usually much lower than the amount a traditional VC would write cheques for. Dividing up the risk and return of investing in the asset class provided another avenue of capital gains for people who traditionally did not have access to investing in early-stage businesses. By using cryptocurrencies, investors could deploy capital globally without worrying about roadblocks in banking infrastructures across different countries. Also, in theory, cryptocurrencies could create much more continuous liquidity for investors. Rather than relying on liquidation events such as an IPO or an acquisition offer, investors could liquidate their holdings and be mark-to-market on a much more frequent basis—provided that online exchanges (e.g., Kraken, Binance) supported the token and allowed for its trade. However, as with all emerging technologies, there were significant growing pains.

The issues facing the majority of ICOs and investors were the prevalent fraud and lack of regulation in the market. There were cases where ICOs were launched with white papers detailing a business that the founders had no intention of building; instead, they just took the funds and disappeared. A case in point was Benebit, a company that claimed to have a blockchain system that would act as a rewards currency. On the surface, the company looked legitimate and had a digital presence on social networking sites like Twitter. It was estimated that US$500,000 was put towards marketing the ICO.[[6]](#footnote-6) However, the site eventually went offline, and a reported $2.7 million of funding was gone. Although ICOs democratized access to the investing in early-stage start-ups, examples like Benebit showed that creating accountability on issuers was important for protecting investors.

Beyond fraudulent ICOs, the secondary market for these coins was rampant with speculation. According to Wunsche, some investors were looking for fast cash and “don’t really care to be any sort of patient capital or helping these companies build.” In addition, market manipulation by third parties to drive prices artificially high in the short term destroyed long-term shareholder value and drew the attention of regulators.[[7]](#footnote-7)

INITIAL TOKEN OFFERINGS: TOKENFUNDER’S SOLUTION

With all the chaos in the ICO world, TokenFunder was looking to build a platform that brought regulatory infrastructure for both issuers and investors. To emphasize what it was doing differently and distinguish itself from some of the scandal-stricken ICOs of the recent past, TokenFunder promoted the use of the more general term “initial token offering” (ITO). The company was started by a slew of experienced financial-services professionals after several meetings at Blockchain Canada, a non-profit organization dedicated to the discussion, advancement, and education of the technology. At these meetings, one common issue that arose was the lack of understanding and regulation from the authorities. Active members of Blockchain Canada began speaking with and helping the Ontario Securities Commission understand blockchain-based funding. Two of these members, Wunsche and Pratt, realized there could be a business dedicated to being a conduit between regulators, issuers, and investors. Wunsche had a financial services background, with experience as an accountant and as a risk manager at a Big Five[[8]](#footnote-8) Canadian bank. Pratt was one of the founding members of Blockchain Canada and had previous experience as a project manager. After incorporating the business, and after continuous dialogue with regulators, approval was given in the form of exempted relief from certain Canadian securities law requirements for TokenFunder to conduct an ITO of FNDR tokens[[9]](#footnote-9) as securities (see Exhibit 4). The ITO would end on April 30, 2018, and the team hoped to raise CA$10 million in funding from investors, both retail and institutional. FNDR tokens would entitle holders to future distributions and voting rights on the future of the projects that went onto the platform.[[10]](#footnote-10) The hope was to use this approval and the ITO to prove the model worked for regulators before replicating the process for other issuers. Investors would have a centralized platform to find the ITOs they wanted to invest in, with peace of mind that the companies were legitimate and complying with regulation, while issuers would benefit as follows:

1. The guarantee that regulation was met and guidance towards the process of meeting regulation including legal, know-your-client (KYC), accounting, and business due diligence
2. Signalling of legitimacy towards investors through compliance with regulation
3. Access to investors and advisors through the TokenFunder platform

TokenFunder would make money by taking a portion of the tokens from the companies they were helping through this process. If it were to be liquidated, the proceeds would be distributed to FNDR token holders. Regarding the economics of the business, the average seed investment was normally between one and 5 million.[[11]](#footnote-11) Assuming that TokenFunder would keep around 1 per cent of the coins, it would receive anywhere from CA$10,000–$50,000 per offering. Although this represented a lot of money, the reality was that there would be a lock-up period on the tokens and, given the high failure rate of start-ups, that some tokens would be worthless.

For regulators, TokenFunder represented a way to legitimize and contain an industry rampant with issues. Before an investor could invest, they had to go through a KYC process in which they learned about blockchain, Ethereum, and cryptocurrency. They were quizzed on these subjects to ensure they had completed the content, and they were then asked a series of personal questions including financial net worth, risk tolerance, and investment time horizon. If they failed the quiz or if their profile did not align with TokenFunder’s targeted investor, they were redirected to the home page. TokenFunder’s relationship with regulators also represented a competitive advantage for the firm. Being the only firm that had dialogue with the regulators effectively gave it a say in setting the standard and understanding the direction for compliance within Canada surrounding ITOs.

Beyond proving to regulators that its model worked (see Exhibit 5), TokenFunder needed to use the proceeds from its offering to build the business. It had not taken any outside capital and had been bootstrapped up to this point. Building a production-ready version of its platform was going to take significantly more resources and was important in the face of growing competition. Ultimately, Wunsche had stated that his vision was to “help as many companies as possible get funded through crypto-capitalism.”

COMPETITORS

TokenFunder was not alone in its pursuit of building a platform to bring regulation to ICOs and connect them to investors. There were both domestic and international competitors, especially in the category of platforms connecting investors with start-ups in need of capital. The most notable and relevant competitors were as follows:

**iComplyICO**:A Vancouver-based company that connected issuers with counterparties to assure a legal ICO along with potential investors. It was the most direct Canadian competitor, with a more developed product, but no direct regulatory relationships. On the issuer side, a dashboard let it collaborate with its own legal, compliance, and business team to structure its offering during live secondary trading.[[12]](#footnote-12) Unlike TokenFunder, iComplyICO had a software-as-a-service pricing model rather than one that took tokens.[[13]](#footnote-13) For investors, it had a product that let them manage their own information and see who accessed it from KYC processes. The company had recently received an angel investment from Conrad Whelan, a member of Uber’s founding team.[[14]](#footnote-14)

**Harbor**: A U.S.-based platform that had designed the “R-Token,” a new type of token that could automatically enforce regulatory standards such as lock-up periods through smart contracts. The company was pushing towards standardizing R-Tokens for tokenizing traditional securities and to securitize assets more broadly.[[15]](#footnote-15) Their thesis was that traditional private securities were much easier to issue and far more cost effective than going public, but secondary trading was highly inefficient.[[16]](#footnote-16) The company’s mission was to solve this through tokenization and to take care of the compliance behind secondary trading. Tokenized securities could be traded without the administrative burdens, while having the liquidity of the public markets and the cost effectiveness of traditional private securities. Harbor catered to accredited investors and institutions, with heavy emphasis on complying with the Securities and Exchange Commission in the United States. The company was backed and co-founded by David Sacks, an ex-executive at PayPal and founder of Yammer, a company sold to Microsoft for US$1.2 billion in 2012. Harbor had raised US$40 million as of April 2018.[[17]](#footnote-17)

**Waves**: A Russian platform designed for users to conduct an ICO through its proprietary blockchain. The largest ICO on its platform to date was MobileGo, a company trying to tokenize the gaming industry, which had raised US$52 million.[[18]](#footnote-18) In parallel to running their platform, the Waves team was planning to create a self-regulated body in partnership with Deloitte Touche Tohmatsu Limited to set standards in ICO reporting, legal, accounting and tax, KYC, and business due diligence.[[19]](#footnote-19) It was evident that Waves recognized the pressure that regulators were applying to ICOs and the need to adapt in order for its business to survive. This naturally paved the way for Waves to compete with TokenFunder, as Waves would likely offer the very same standards TokenFunder was setting out to create. Waves raised 30,094 bitcoins (worth US$16 million at the time) in the second quarter of 2016.[[20]](#footnote-20)

The ICO platform space was becoming more saturated every day. Companies like TokenSoft,[[21]](#footnote-21) a white-label token-sale platform, were providing the tools start-ups needed to perform an ICO legally, while BlockEx, for instance, was an ICO platform that only allowed projects the team deemed worthy. Existing crowdfunding websites like Indiegogo were also looking to offer ICO services.[[22]](#footnote-22) Other known competitors included Cointopia, Coinlist, and Republic. With the importance of the network effect on platform-based businesses and the ascent of competition, TokenFunder needed to build its business sooner rather than later. One advantage it believed it had, according to Pratt, was that competitors, even though they “claimed to be compliant, were in fact not working with regulators, and would eventually get in trouble.”

PARTNERSHIP STRATEGY

With blockchain blowing up, incumbents started to show interest in striking up partnerships to get in on a piece of the action. TokenFunder also knew that it needed to build an ecosystem around its platform to make it fully functional—and it could not do this alone. It was in talks with accounting firms, legal firms, incubators, and VCs.

Accounting Firms

Three global accounting firms were interested in partnering with TokenFunder. They would be in charge of milestone vetting and auditing the companies looking to perform ITOs on TokenFunder’s platform. Given how nascent the space was, all the accounting firms had very limited experience and little track record in dealing with the technology. It was imperative that TokenFunder picked an accounting firm with the best team, one that could navigate through unchartered territory with it. Each firm had its own strength.

PricewaterhouseCoopers had a more advanced relationship with regulators, which was important on a move-forward basis, especially when it came to auditing and milestone vetting. KPMG was the furthest along in dealing with ICO companies, but almost all of its past experience came from outside of Canada. Nevertheless, this experience could be useful in getting all the infrastructure set up. Ernest & Young was the strongest in thought leadership among the three on a global level. It boasted many publications in the blockchain space that showed its familiarity with both the technology and the business landscape. Finally, Deloitte Touche Tohmatsu Limited had assembled a solid team of blockchain experts in Canada and was heavily involved with digital business models.

Legal Firms

Any fundraising and potential issuance of securities involved a host of legal work. Legal firms naturally served as a great pipeline for sourcing companies. Start-ups looking to raise funds usually had to engage with a lawyer, and having a partnership with law firms was a natural fit for TokenFunder. Legal firms could funnel start-ups to raise funds through an ICO with TokenFunder’s platform as well as guide them along the way. TokenFunder needed to find a way to pitch to law firms to recommend their clients pursue the ICO route as opposed to alternative funding sources. Lawyers tended to be risk-averse, and getting them to buy into something not fully proven would be challenging.

Incubators

Incubators served as a pipeline for companies looking to raise capital. Start-ups would apply to give up some equity in their business in order to access the mentorship, network, and potential office space the incubators provided. For TokenFunder, this was a great way to source promising companies that were already vetted. One of the challenges TokenFunder faced with incubators was how it would extend its offering in an incubation environment beyond funding. TokenFunder was competing with angel investors and VCs, both of which provided financial and intellectual capital. TokenFunder was aiming to build an advisor network where experienced professionals received tokens for the companies they were advising. However, TokenFunder needed a way to match the connections and expertise its private-capital counterparts possessed while it was scaling its virtual network.

Venture Capital

VCs took equity positions in early-stage companies and assumed an active role in helping to grow these businesses. By providing capital, knowledge, and a network, VCs enabled start-ups to accelerate their growth. While TokenFunder was hoping to raise most of its money from an ITO, the reality was that fundraising was an arduous task involving uncertainty. A strategic partner like a VC could provide immediate capital that would let TokenFunder go to market much faster. However, a VC would dilute the equity of the founding team and have a say in the direction of the business—something Wunsche and Pratt were not comfortable with. Furthermore, raising all of the required capital through the ICO was something that would proxy as a proof of concept for the Ontario Securities Commission. For future customers, TokenFunder needed to show that ICOs were a valid alternative to venture capital. Partnering with the very people it was aiming to disrupt was certainly an interesting proposition with these two considerations in mind.

DECISION

Faced with objectives in each partnership category, Wunsche and Pratt had to make multiple decisions to build the TokenFunder partnership ecosystem in accordance with their overall strategy. They had to decide how to win over professional-services firms and start-ups alike. Furthermore, there was also the question of whether they should take venture capital funding. It was important to deliver a strong product in the early stages of the business to prove to customers and regulators that ITOs were a viable concept that could operate with regulation. However, the industry was rapidly growing, and competition was fierce. Going to market quickly was important to establish TokenFunder among both investors and issuers. Beyond the partnerships, TokenFunder needed to think about the economics of its business. How many start-ups would it need to fund, and what would be the finalized pricing on its service? Time was of the essence, so decisions had to be made quickly.

Exhibit 1: Market Capitalization of Cryptocurrencies (US$)

Note: b = billion

Source: Created by the case authors using data from “Cryptocurrencies by Market Cap (Historical) Summary,” Coin Dance, accessed July 14, 2018, https://coin.dance/stats/marketcaphistorical.

Exhibit 2: ICO versus traditional Venture Capital Funding of Blockchain

start-ups (US$)

Note: ICO = initial coin offering; VC = venture capital; b = billion; Q = quarter

Source: Created by the authors using data from CB Insights, “Blockchain Equity Funding Pales in Comparison to ICOs: Quarterly Blockchain Equity and ICO Financing. Q3’16 – Q4’17,” accessed July 14, 2018, https://s3.amazonaws.com/cbi-research-portal-uploads/2018/01/18150717/2018.01.11-Blockchain-Equity-vs-ICOs.png.

Exhibit 3: SOME OF THE Largest ICOs of 2017

|  |  |  |  |
| --- | --- | --- | --- |
| **Name** | **Amount Raised (US$ millions)** | **Date** | **Summary** |
| Filecoin | $257.0 | September 7, 2017 | Decentralized file storage |
| Tezos | $232.0 | July 14, 2017 | Decentralized blockchain that governs itself |
| EOS | $196.0 | June 26 2017 | Decentralized application infrastructure |
| Bancor | $153.0 | June 12, 2017 | Decentralized liquidity network |
| Status | $107.0 | June 20, 2017 | Mobile Ethereum client |
| MobileGo | $106.0 | May 25, 2017 | Bringing cryptocurrencies to gaming |
| Comsa | $95.0 | November 6, 2017 | ICO solution for centralized businesses |
| TenX | $80.0 | June 24, 2017 | Allows users to spend their cryptocurrencies in the real world |
| Tron | $70.0 | September 2, 2017 | Decentralized digital-content platform |
| DomRaider | $67.2 | October 9, 2017 | Auctions on blockchain |

Note: ICO = initial coin offering

Source: Created by the case authors using data from Coinist, “Top 10 ICOs in Terms of Money Raised,” accessed September 20, 2018, www.coinist.io/top-10-icos-of-2017/; Bhushan Akolkar, “Best of 2017: Top 10 ICOs,” January 7, 2018, accessed September 20, 2018, www.coinspeaker.com/2018/01/07/top-10-initial-coin-offerings-icos-2017/.

Exhibit 4: The ontario securities commission Sandbox exemption summary

The Ontario Securities Commission (OSC) granted exemptive relief from applicable Canadian registration requirements to TokenFunder Inc. (TokenFunder) for its initial offering of FNDR tokens. This was part of a regulatory sandbox that the Canadian Securities Administrators launched to support financial technology businesses looking to innovate products in Canada. Only TokenFunder and Impak Finance had been allowed to play in this sandbox with their initial coin offerings. Both of these companies were leaning on the offering-memorandum exemption set out in the *National Instrument 45-106* *Prospectus Exemptions*.

TokenFunder and Impak Finance had received very similar relief packages from the OSC, with the following exceptions:

1. The relief would expire October 17, 2018.
2. TokenFunder was required to report back to the OSC about any customer complaints.
3. Given the nature of the platform TokenFunder was creating, the smart token asset management platform (STAMP), TokenFunder was required to become a registrant immediately after its initial token offering and could not raise capital through STAMP until it was registered.
4. TokenFunder had to file an initial report with the OSC containing metrics outlining regional and average investor purchase amounts upon either

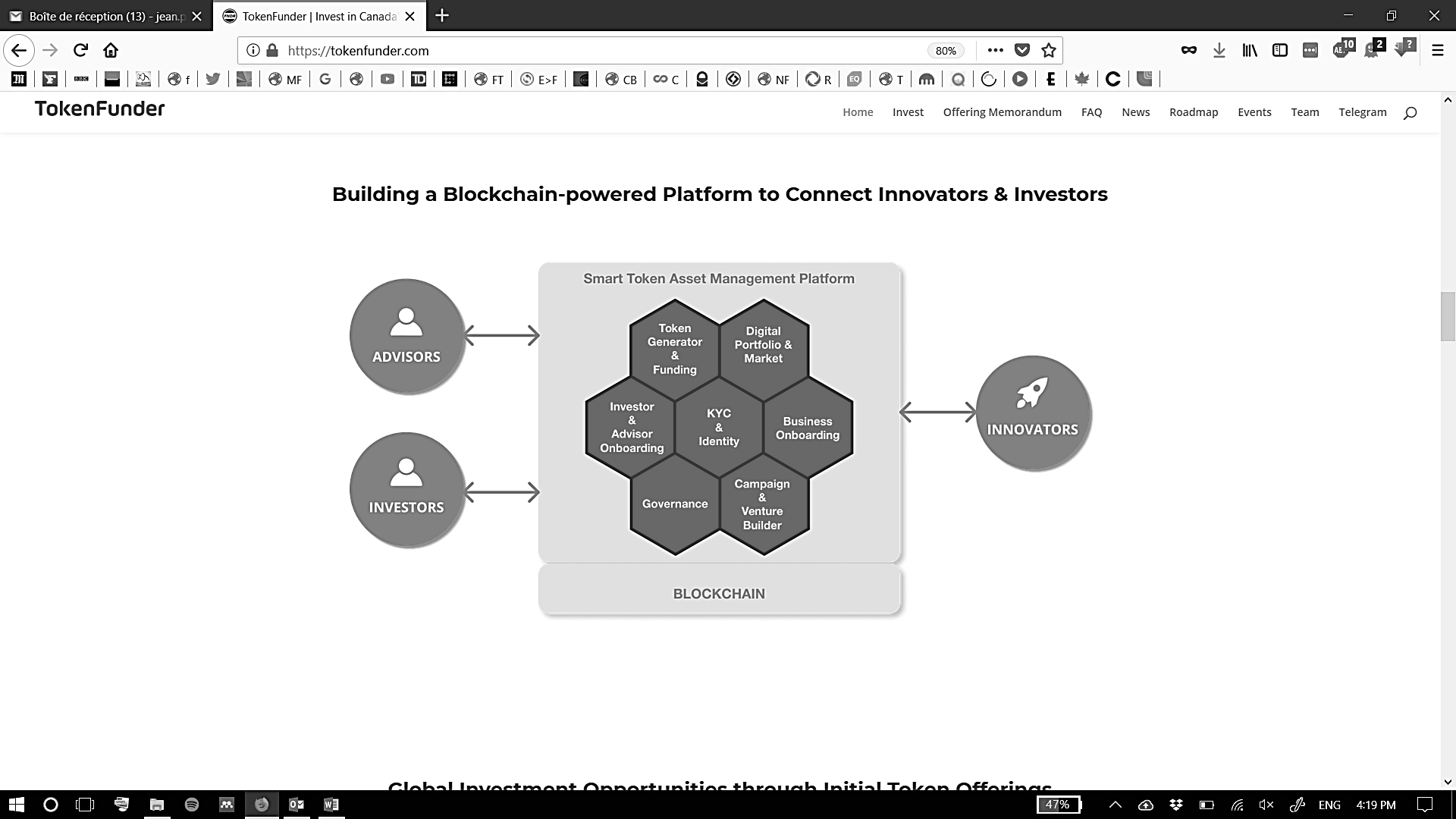
* closing the offering,
* January 17, 2018, or
* raising CA$10 million.

For investor protection, the OSC had mandated surveys as part of a know-your-customer process to determine if clients actually understood blockchain and the features of the asset class they were investing in to ensure that investors were making informed decisions.

The OSC had clearly stated that the exemptive relief given to TokenFunder would be not considered a precedent for any future cases. Any token or coin offering would be considered on a case-by-case basis, and any relief would be granted specifically to each offering.

Source: Created by the author based on Mindy B. Gilbert, Geoffrey L. Rawle, and Zain Rizvi, “OSC Invites TokenFunder to Play in the CSA Sandbox,” Davies Ward Phillips & Vineberg LLP, October 26, 2017, accessed July 14, 2018, www.dwpv.com/en/Insights/Publications/2017/OSC-Invites-TokenFunder-to-Play-in-the-CSA-Sandbox.

Exhibit 5: TokenFunder’s model



Note: KYC = know your customer

Source: Company files.

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