The SEC just raided the cryptocurrency party

Retrieved Monday 21st of August 2017 09:00:59 PM

It's been a very busy few weeks for cryptocurrencies. While everyone's been distracted by bitcoin's breakup, there's actually been an even more fundamental shift in the market – but this got far less press. Of course, in *Exponential Investor*, we concentrate on getting to the heart of the issues affecting your wallet.

You might be familiar with the concept of the "intial coin offering" (ICO) – the moment when a new cryptocurrency is born. These ICOs have been attracting major investor interest, recently – which is why our investment guides have proved extremely popular with readers.

However, the Securities and Exchange Commission (SEC) has just kicked in the door of the ICO party – and now it's carrying the sound system out of the door. It's insisting that firms using this investment approach are regulated.

The US loss could be the UK's gain. Just as we've eaten the Americans alive on equity crowdfunding, this could be great news for the UK financial technology industry. I spend much of my time on a day-to-day basis working in London fintech – and it's worth mentioning a couple of features of this scene that very much please me.

The first is blockchain – the technology that underpins cryptocurrencies. These new "coins" are an ongoing source of astonishing profits for investors. However, it's the possibilities of the blockchain for disrupting conventional industries, which really inspires me. Recently, I was at a presentation from one of the leading music rights collection agencies, who was waxing lyrical about its new technology approach. I put my hand up (like the boy calling out the emperor's nudity) and asked "Wouldn't you be better to just scrap the whole thing, and rebuild it using blockchain?" You could have heard a pin drop, after the sharp intake of breath from the audience. Yes, blockchain is a very big deal for financial services – and it's that which is underpinning the attractiveness of ICOs.

The second thing I'm a very big fan of, is the Financial Conduct Authority's sandbox scheme. This is a kind of regulatory playpen, for the toddlers of the fintech world. In it, the nanny state carefully shields these young firms from the nasty regulations used to beat the grown-up fintech firms into submission. If a startup can get into the sandbox, it seems that they're allowed to do pretty much what they want – as long as they aren't a barefaced bunch of criminals, and they don't do anything that destabilises the entire financial system. And that's A Very Good Thing – because onerous regulation is a huge barrier to startups' development, in the fintech space. I far prefer this approach, to the US' regulation by force.

Today, we're talking to a startup who combines these two of my Favourite Things. But it won't be carping on about its startup. Instead, it's going to be giving you the lowdown of the SEC's recent move.

Now, I'll hand you over to Nikola Tchouparov, co-founder and CEO of Oraclize Financial Subsidiary (OFS). He'll set out some of the risks of cryptocurrency ICOs – and explain why the SEC had to act.

AL: Firstly, what is OFS?

NT: OFS is the Financial Subsidiary of Oraclize. We use Oraclize's award-winning blockchain technology to build regulated financial services. We have been accepted into the FCA's regulatory sandbox in the UK, to use blockchain and digital identity as an online payment mechanism for goods and services. To accomplish this, we are offering fiat-backed sterling tokens on the public Ethereum blockchain. You secure the tokens with your Estonian e-residency card – which is an easily-obtainable form of digital identity, not limited to Estonian nationals. Effectively, we are turning existing forms of digital identity into a platform for financial services.

AL: Are you planning to do an ICO (initial coin offering)?

NT: This is something we have discussed internally at length. We can probably raise in excess of 20 million USD through an ICO. Something to keep in mind is that a raise is typically denominated in bitcoin and ether – and we don't really have a need for so much bitcoin or ether. Converting back into fiat money could impact on the price. We are not able to produce meaningful long-term returns on such a large sum. I expect this applies to many of the 50+ ICOs that we have seen so far this year. Building a browser or a messaging app does not cost 30-90 million USD. With funding in that range you can build a global corporate and investment bank with dozens of products and apps.

AL: Could you expand a bit more on the risks of ICO projects?

NT: We have seen projects raise large sums of money based on a white paper, a slick website and vague promises. In that sense, ICOs are being used to fund idea-stage risk. This risk is normally reserved for the founders, and their immediate friends and family. Most professional investors would not touch such risk, but ICOs have created an easy mechanism to share this risk globally with any. One feedback from the legal profession is that your contribution to an ICO is often a “charitable donation” to an NGO (non-governmental organisation) in Switzerland or the Cayman Islands. Other jurisdictions have been used as well, but most of the time you have no legal recourse. The rules around investor protection don’t apply to charitable donations.

AL: What about the recent ruling from the SEC?

NT: The SEC recently released a ruling that the DAO ICO was a security offering under US federal law. This matters, because 700 US residents participated in the ICO. The SEC also emphasised that other ICOs might qualify as unregistered securities offerings and that trading platforms (such as crypto exchanges) are specifically “not exempt” from securities regulations. That is nice for US residents, but provides no protection or recourse to anyone outside the US. A team launching an ICO should seek appropriate legal advice, and offer strong arguments why their tokens are not a security. Alternatively, you could impose investor vetting, to prove that none of the token buyers are US residents. This is the approach taken by some of the ICOs in China. Lastly you may choose to accept the burden of complying with US securities law. Either way, it is not sufficient to say on the ICO website that US residents are not eligible to participate.

AL: Are all ICOs securities?

NT: This is the interesting part. The SEC applies the so-called Howey Test, created by the US Supreme Court, to determine if the tokens are securities. Many crypto projects can put forward strong arguments why they are not securities. Others may decide to accept the regulatory burden of being securities. Yet others may find effective ways to vet their contributors and exclude US residents. Either way, the token economy is still in its early days and exciting opportunities will continue to emerge. Time will tell.

Our very own Sam Volkering has got some very strong opinions about the risks of investing in cryptocurrencies. While there are potentially huge profits to be made in the cryptocurrency world, you need an experienced guide to show you the risk. Find out which cryptocurrencies you need to avoid, here.

Do let us know your thoughts on this fascinating, profitable and challenging market: andrew@southbankresearch.com.

Best,

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