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ICO REVOLUTION: RETHINKING VENTURE CAPITAL APPROACHES IN THE CRYPTO AGE

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ABSTRACT

The ascendancy of the crypto economy presents both opportunities and challenges for the venture capital (VC) industry. Distributed ledger technologies have opened up novel avenues for investment, enticing traditional VCs to broaden their portfolios by engaging with crypto-assets and blockchain projects. This shift is accompanied by the establishment of crypto-centric funds by conventional venture capital firms. Simultaneously, VC funds are exploring hybrid financing models to emulate the fundraising mechanisms of initial coin offerings.

However, the multifaceted and ever-evolving nature of crypto-assets introduces fresh risks to the venture capital landscape. This paper delves into the emerging models within the venture capital crypto sphere, highlighting the associated risks and scrutinizing existing regulatory and contractual solutions. Additionally, the study puts forth recommendations for the future of the venture capital crypto landscape, emphasizing the necessity for enhanced regulations concerning crypto-centric funds and their managers.

INTRODUCTION

Blockchain technologies are reshaping the financial industry, introducing novel methods for start-ups to secure financing directly from the public through Initial Coin Offerings (ICOs), also known as 'token sales' or 'initial token offerings.' ICOs, born from the marriage of blockchain technology and crowdfunding, operate in a digital realm where start-up companies release tokens to the public for purchase using either cryptocurrency or fiat currency. Each token issuance comes with specific conditions dictating the rights, returns, or utility for investors.

The core of the ICO funding model revolves around leveraging blockchain technology and smart contracts to automate financial agreements through code, bypassing traditional regulatory and contractual frameworks. Smart contracts, conceptualized by Nick Szabo, are digital promises specifying protocols for parties to fulfill commitments. The idea is that these smart contracts

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could replace conventional legal structures, embedding consumer protection and securities regulations while managing risks and information imbalances between parties. However, this theoretical construct doesn't align with practical outcomes. Since around 2013, when the first ICOs emerged, the ICO funding model has fallen short of delivering on promises, exposing investors to various risks, as demonstrated by Cohney et al.[1]

Investing in crypto-assets through ICOs represents one of the riskiest non-leveraged asset classes available to investors. ICO issuers often lack historical track records, conduct offerings online across jurisdictions, and depend on the volatile pricing of cryptocurrencies. ICO investors face challenges in negotiating contractual terms and have no recourse for demanding preference shares. Additionally, the absence of effective gatekeepers in ICO markets raises concerns about the legitimacy of companies participating in ICOs. The main risks include the uncertainty surrounding crypto-asset volatility, high agency costs, information asymmetry, lack of tangible assets and operational track records, absence of intermediaries for pricing and valuation, cybersecurity risks, and inadequate custodian solutions for crypto-assets.

Despite consensus among practitioners and regulators about the significant risks posed by ICOs and crypto-assets, there's a lack of comprehensive regulation and enforcement measures across jurisdictions. Market institutions, including contractual designs, reputation, and insurance, are underdeveloped in this rapidly evolving market, contributing to challenges related to market integrity and investor protection.

The advent of ICOs has disrupted the venture capital landscape, with ICOs surpassing traditional funding methods for blockchain tech start-ups by mid-2017. This shift continues, with a growing number of ICOs and increased venture capital interest in the crypto market. However, academic literature on the legal aspects of VC involvement in ICOs and the crypto sector is lacking.

The structure of the article comprises a discussion of the interaction between venture capital and the ICO model, an examination of novel or hybrid models and their risks, an elaboration on risks arising from VC-ICO interactions, and proposals for regulatory and market mechanisms. The conclusion underscores the importance of addressing these challenges for the development of a robust venture capital-crypto ecosystem.

[1] Shaanan Cohney et al., *Coin-Operated Capitalism* (DEC. 17, 2023), COLUMBIA LAW REVIEW, https://ssrn.com/abstract=3215345.

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THE COMPETITIVE INTERACTION BETWEEN ICO MODEL AND VENTURE CAPITAL

The surge of Initial Coin Offerings (ICOs) has sparked discussions about the potential replacement of traditional venture capital as a more efficient means of financing start-ups. This funding model is appealing to issuers due to its efficiency and convenience. Issuers benefit from community engagement, allowing blockchain enthusiasts to directly contribute to projects, lowering transaction costs without the need for underwriters, avoiding dilution pitfalls associated with venture capital, and creating a community that actively promotes the business idea.

Crypto-assets have gained popularity as investment instruments through ICOs, offering investors various rights such as product or service usage, resale options on secondary markets, and voting privileges. The disruptive impact of ICOs is evident in the decentralization of capital allocation, democratizing access to investment opportunities and increasing flexibility compared to traditional venture capital lock-in equity investments.

Entrepreneurs and investors may favour ICOs over venture capital for several reasons. ICOs are more efficient in raising public finance as they tap into a global pool of potential investors online, eliminating geographical constraints and reducing transactional costs. Additionally, ICOs offer greater liquidity, allowing crypto-assets to be listed on various crypto-exchanges for trading, potentially providing quicker returns compared to the less liquid nature of venture capital, which may take a decade or more to exit via IPOs or M&A.

However, counterarguments assert that venture capital remains irreplaceable. VCs contribute both financial and non-financial value to start-ups, conducting due diligence, offering mentorship, and guiding entrepreneurs in building sound revenue models. The information asymmetry in ICOs is considered more extreme than in venture capital, as retail investors lack knowledge and rely on limited information, often leading to opportunistic behavior or fraud. Unlike venture capital, ICOs lack well-developed contractual techniques to address information asymmetry and agency costs, potentially exposing investors to scams.[2]

Furthermore, VCs employ protective covenants, extracting significant rights to monitor and

[2] Andrea Minto et al., *Separating apples from oranges: identifying threats to financial stability originating from FinTech* 12(4), CAPITAL MARKETS LAW JOURNAL 428, 462 (2017).

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control portfolio companies, whereas ICO investors lack similar control rights, increasing agency costs. Venture capital cycles and reputation also play crucial roles in mitigating risks and constraining VC behaviour, distinguishing them from ICOs. ICOs are currently confined to the narrow market segment of blockchain or crypto start-ups, while venture capital invests in various high-tech start-ups. Additionally, regulatory responses to ICOs vary globally, from outright bans in some countries to more permissive regimes in others. The nascent regulatory landscape for ICOs may change, potentially increasing the costs of using ICOs for capital raising and prompting start-ups to turn back to venture capital.

EVOLVING MARKET RISKS

Investing in crypto-assets, Initial Coin Offerings (ICOs), and blockchain technology start-ups entails inherent risks typical of early-stage ventures. This section emphasizes the key risks associated with this particular asset class.

Gilson has observed that venture capital investments involve extreme information asymmetry due to the early-stage, high-tech nature of these investments. This is particularly pronounced in the case of crypto-assets, a novel asset class, and the intricate functional nature of blockchain tech companies. As previously discussed, the information asymmetry in Initial Coin Offerings (ICOs) surpasses that in traditional venture capital. ICOs, occurring at an even earlier stage, leave crypto investors reliant on little more than the start-up's whitepaper, creating fertile ground for opportunistic behaviour and potential fraud.

In a limited partnership-type crypto fund, there is likely to be a reduced understanding on the part of Limited Partners (LPs) regarding target acquisitions. Consequently, LPs must place heightened trust in General Partners' (GPs) decision-making, intensifying traditional agency costs within crypto funds. Agency problems manifest on both the LP-GP and venture capital fund-portfolio companies' levels. At the primary level, LPs expect GPs to manage duties to maximize returns, while GPs may be motivated by self-interest, potentially leading to managerial abuse. This abuse results from LPs relinquishing control to GPs, as LPs are not permitted to participate in firm management under partnership law.[3]

[3] Julia Khort, *Protection of Private Equity Fund Investors in the EU*, 12 EUR. CO. L. 97 (2015). https://www.jur.uu.se/digitalAssets/585/c_585476-l_3-k_wps2014-6.pdf

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GPs may engage in side agreements with parent companies or crypto-exchanges, potentially leading to opportunistic behaviour and maximizing carried interest at the expense of LPs' long-term interests. Additionally, GPs may misuse raised funds or make risky investments outside their mandate. The inability of LPs to assess investment risk and reliance on GPs' unilateral valuation is accentuated in the context of crypto-assets, as valuation models for this new asset class are still under development.

On a secondary level, GPs' objectives may misalign with those of entrepreneurs, particularly when investing in crypto-assets. The absence of contractual powers over crypto-asset issuers and the inability to influence business management pose challenges to traditional negative covenants. The unique nature of the asset class complicates matters further. ICO whitepapers are often preliminary, lacking sufficient information for effective due diligence or risk management, intensifying the information asymmetry between investors and entrepreneurs. The lack of accepted methods for evaluating and auditing crypto-assets exposes investors to high risk, as entrepreneurs may exploit the absence of consistent and transparent audit approaches to exaggerate project prospects and attract financing from VC funds. This lack of transparency can also be manipulated by GPs to conceal true profits from investors.

A. REGULATORY UNCERTAINTY

Entities operating in the crypto space, including Venture Capitalists (VCs), investors, and entrepreneurs, often encounter significant challenges in comprehending the regulatory framework that governs their operations, the applicable regulations, and ensuring adherence to them. This lack of clarity results in a substantial gap in the understanding and expectations between regulatory authorities and market participants. The prevailing regulatory uncertainty escalates transaction costs and acts as a deterrent for parties considering entry into the market.

The ambiguity in regulations exposes entrepreneurs to a 'black swan risk,' indicating the potential for an unforeseen event to subject the entrepreneur to market risk. This risk is heightened in the Initial Coin Offering (ICO) market due to the concentration of crypto-exchanges and enthusiasts in specific jurisdictions. An illustrative example is the Chinese government's 2017 prohibition of cryptocurrency trading and the issuance of crypto-assets, which had a significant impact on cryptocurrency prices, exemplifying the susceptibility of the ICO market to unexpected regulatory developments.

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B. CYBERSECURITY

VCs with investments in crypto projects might choose various specialized custodian solutions, each varying in the level of security they provide, thereby potentially making them susceptible targets for hacks and other cyber-attacks. This risk extends to cyber-attacks on crypto-asset trading platforms as well. When such attacks occur, victims often encounter challenges in recovering losses from hackers or compromised trading platforms. The scarcity of qualified custodian solutions poses a distinctive challenge for crypto-asset funds.

THE WAY FORWARD

Given the outlined issues and risks in the venture capital-ICO landscape, various arrangements aligning with either compulsory adherence through government regulations or private agreements will be explored.

A. PROTECTION THROUGH CONTRACTS

In theory, smart contracts are envisioned to serve as substitutes for traditional legal frameworks, incorporating contractual safeguards for investors. Examples of such protections may include limitations on the supply of Initial Coin Offering (ICO) tokens and constraints on token transfer by insiders, typically outlined in the ICO's whitepaper and encoded into the project's underlying code. However, empirical studies reveal a contrasting reality, indicating that ICO code often falls short in delivering essential investor protections, sometimes granting founders undisclosed authority to modify investor rights.

Moreover, conventional contractual mechanisms mitigating agency costs between Venture Capital (VC) funds and portfolio companies are less effective in the crypto-asset context. Staged financing and disproportionate control rights, common in traditional VC contracts, are challenging to adapt to crypto projects, given the one-time nature of ICOs and the absence of such control rights for ICO investors.

Consequently, VCs require new structures when investing in tokens, and various contractual frameworks can be considered based on commercial needs and the start-up's token model. The first option involves separate transactions for token and equity investments. The second option is to purchase equity through a Simple Agreement for Future Equity (SAFE), similar to a

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convertible note but without accruing interest or a maturity date.[4] However, SAFEs lack certain investor protection guarantees. The third alternative is a Simple Agreement for Future Tokens (SAFT), specifically designed for VCs in ICO pre-sales and developed in accordance with U.S. securities regulations. While SAFT aims to avoid securities classification, critics argue that its reliance on future tokens being treated as utility tokens is not fool proof.

The fourth contracting alternative is a pre-sale instrument known as a Simple Agreement for Future Tokens or Equity (SAFTE), providing investors with the flexibility to convert to equity and/or tokens. SAFTE agreements offer a more adaptable structure, allowing for an early agreement closing and providing a contractual safeguard in case the promised ICO does not materialize.

Furthermore, before acquiring tokens, VCs should assess the profile and trading history of the tokens to ensure they haven't been involved in illicit activities. Employing third-party tracing analytics can be valuable for this purpose.

Presently, the effectiveness of the reputation mechanism in the ICO sphere is questionable. An empirical analysis by Rhue, utilizing data from ICO rating websites such as ICO Drops, Etherscan, and ICO Rating, revealed inconsistent and insufficient reputation measures. None of these platforms provided complete coverage of all listed ICOs, and the most common reputation score across platforms was neutral, offering limited information for investors. Moreover, different websites assigned varying reputation ratings to the same cryptocurrency or ICO, adding to the inconsistency. Empirical data also indicated that these reputation scores did not reliably predict actual success outcomes, diminishing their reliability.[5]

B. INSURANCE

Furthermore, the existence of insurance options can help mitigate the risks associated with Initial Coin Offerings (ICOs) and investments in crypto-assets. Currently, some insurance coverage is available to compensate for loss or theft, which can offer a degree of relief regarding the cybersecurity risks related to cryptocurrencies, such as hacking. However, the insurance market for crypto is still in its early stages, with many traditional insurers hesitating to provide coverage

[4] 'The SAFT Project', https://saftproject.com/ (last accessed Dec. 26, 2023).
[5] Lauren Rhue, *Trust is All You Need: An Empirical Exploration of Initial Coin Offerings (ICOs) and ICO Reputation Scores,* SSRN (DEC. 16, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3179723.

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due to the substantial risks involved, including fraud, money laundering, and financial crime. This reluctance may be intensified by the challenges in determining premiums for such policies, given the multitude of risks and the rapidly evolving nature of the technology. In fact, there are reportedly only a limited number of Directors and Officers (D&O) policies accessible in the crypto space.

A significant concern frequently expressed by Venture Capitalists (VCs) revolves around the secure storage of crypto-assets. Traditionally, VCs enlist third-party "qualified custodians," often banks, to safeguard their clients' assets, with the expectation of security and impartiality. In the context of cryptocurrencies, VCs assume the responsibility of holding both the private and public keys associated with these assets. The primary risk associated with holding private keys, granting access to crypto-assets, is the potential for theft or misuse. VCs are currently deliberating the most secure methods for storing crypto-assets to meet the requirements of institutional investors as well. This decision involves choosing between relying on a licensed and insured depository or opting for cold storage solutions.

C. REGULATORY CONSIDERATIONS

The cryptocurrency economy has witnessed significant volatility, attributed to factors like extreme uncertainty, information asymmetry, and agency costs. This exponential growth has exposed investors to persistent risks, prompting global market regulators to implement diverse measures. These measures include regulatory warnings, guidance, regulatory sandboxes, statutory reforms, rule-making, and enforcement actions. Despite these efforts, there remains a need for a clearer regulatory framework, addressing investor protection, data protection, and cybersecurity. A cohesive regulatory framework could enhance the overall ecosystem of the crypto economy.

It has been proposed that implementing measures to regulate the control of raised funds could be beneficial in safeguarding investors. This could entail designating predefined authorized holders, such as a wallet account in the ICO company's name or an escrow arrangement, as opposed to allowing ICO issuers to hold the funds in their personal wallets, which may facilitate fraudulent activities. Similarly, Rodrigues recommends a nuanced escrow arrangement that imposes additional conditions, such as securing founders' tokens for a specified period. For instance, the ICO issuer might withhold a portion of the proceeds until it is evident that there is no fraud in the

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initial disclosures and that the ICO issuer fulfills the promised developments. Linked to the escrow arrangement is the idea of establishing a 'lock-up' period for ICO tokens, particularly for insiders or those with access to the pre-sale. Preventing these insiders, who typically acquire ICO tokens at a lower price during the pre-sale, from selling to the public once the ICO becomes open to the public reduces the likelihood of 'pump-and-dump' schemes. Additionally, introducing a 'lock-up' period addresses potential agency problems, mitigating the risk of VCs misusing the funding in the account for personal interests.

Financial regulators face challenges in developing the necessary technical expertise to inform effective policymaking in the rapidly evolving blockchain space. An example is the case of United States of America v. Ross William Ulbricht, highlighting the difficulty in tracing identities in such cases. To address these challenges, regulators must deepen their technical knowledge and collaborate closely with industry practitioners. Regulatory decisions, or the lack thereof, can significantly impact the crypto economy. Striking the right balance is crucial, as overly stringent approaches may stifle the domestic market and push trading activities to other jurisdictions. Given the crypto economy's volatility and risks, regulatory actions play a vital role in fostering a balanced market and steering it away from speculative bubbles towards sustainable growth.

CONCLUSION

The pivotal role of venture capital in nurturing cutting-edge technology companies is undeniable. The emergence of crypto-markets, introducing a novel asset class, and the advent of Initial Coin Offerings (ICOs) as an alternative funding model have instigated a transformative shift within the venture capital landscape. The critical inquiry centers around determining the more advantageous business model, whether hybrid or pure, that can provide enhanced value to start-ups and serve as the most suitable legal framework for investors. Given the evolving dynamics in venture capital, particular attention needs to be given to addressing the fresh risks posed by the innovative hybrid models combining venture capital and ICOs. Effective investor protection strategies must be devised, especially in the face of regulatory uncertainties.

While regulations should persist in fostering innovation, including the adoption of beneficial technologies like blockchain, there is room for enhancement in the regulatory framework. Increased clarity in regulations concerning crypto-centric funds and fund managers is essential. Regulatory improvements should be complemented by robust enforcement mechanisms, along

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with leveraging market tools such as thoughtful contractual design, reputation management, and insurance. This comprehensive approach aims to strike a balance between supporting innovation and safeguarding the interests of investors in the rapidly evolving landscape of venture capital and ICOs.