

SECURITY TOKENS OFFERING REGULATION AS THE WAY OF THE VENTURE INVESTMENT

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Abstract

Today there are a lot of options for crowdfunding. One of the most popular ways of crowdfunding options in start-up and venture projects was ICO. But generally tokens which were the subject of such ICO did not provide any property rights for investors. Moreover it was impossible to specify the value cap of the company on the basis of price of this company which is not based on the cap of the companies property or on the basis of the audit report of well known company. Additionally the specificity of this ICO market that there were some breaches at this market. On the author point of view, security token offerings is the reaction for all abovementioned problems. New type of crowdfunding of the venture investments considers the option to issue of the security tokens which provide the property rights or nature of the financial instrument. Such offer should be made bothly in accordance with the securities legislation of the jurisdiction of issuer and jurisdiction of buyers. All investors of such offer should strictly be in accordance of legislation of their own jurisdictions related in particular to the rules for accredited, professional investors e.t.c. STO can be a new way of the crowdfunding investment development, that is why author decide to focus this article to this type of venture investment.

Keywords: Blockchain, STO, IEO, security tokens, venture financing, investments, SEC.

1 INTRODUCTION

Over the next two decades, a number of small innovative companies began to emerge that were funded through the expanding private equity market. The larger firms, in turn, focused their efforts on commercializing and marketing technologies created by such business entities.

The early successes by venture capital firms gave rise to significant growth in the venture capital industry. An important change in federal policy in 1979 allowed U.S pension funds to invest in venture capital, resulting in significant growth in the industry. The late 1990's were a "boom period" for venture capital as firms benefited from a surge in interest in the civilian applications for the internet and other computer technologies. Investments in both venture capital funds and portfolio companies reached record highs[7].

Within last years there is a trend for digitalization of the economy around the world. Such trend has its own specificity in different spheres. ICO become one of the easiest ways for raising of the capital for venture projects. But such novelty in venture financing, when every non-qualified or non-professional investor had a lot of negative specifics, such as lack of guarantees for the investors to revert their capitals provided during ICO, lack of any compliance restrictions for such projects and regulation in this matter. That is why, under authors point of view, after the boom of 2017, the year 2018 was marked by a number of scandals in the

global digital asset market. ICO as a way to attract cryptoactive assets to startups received its negative assessment from investors, a large number of projects were recognized as scam (fraudulent) by world regulators, in particular, by SEC. Many tokens issued within the framework of ICO projects did not provide investors with any rights in return, except for the right to demand services (use of the blockchain system in the future), but investors did not receive any property rights.

The situation was further aggravated by the fact that if the token issuer granted direct or indirect rights to the token holder, such a proposal could be qualified as an offer of securities, which in itself entailed sanctions on the issuer of the tokens and potential risks of investment loss for the investor.

Moreover at this moment there are a lot of legislative initiatives from the legislators which can resolve the majority of the above-mentioned problems. Raising capital through ICO and STO (Security Tokens Offering) is now regulated by the special acts (for example by VFA Act in Malta or by the amendment of the current legislation (for example – Russia).

The main purpose of the author of this article is to analyze the most interesting and fruitful legislative framework related to security tokens offering regulation in different jurisdictions as new form of the venture investments.

2. SECURITY TOKENS OFFERING VS CLASSIC VENTURE INVESTMENT REGULATION

The term “venture capital” is sometimes broadly used to include any equity or debt investment that the investor perceives as risky because the company in which the investment is made is not well established or has not been profitable for long. Consequently, one hears of equipment lease companies that specialize in venture deals and individuals who refer to themselves as private venture capitalists. Organized groups of “angel” investors often structure investments that look very much like investments by professional venture capital firms. In addition, some venture capital funds that historically financed only new privately held companies now invest in public companies and participate in leveraged and management buyouts, further extending the meaning of venture capital. The focus of this chapter is the financing of privately held companies by traditional venture capital funds [7].

STO and ICO unlike classical venture investment do not provide venture investors or venture angels in the same role as within classic venture investments. Under the authors point of view Initially non-professional investors are involved within an offering. Whitepaper or any other type of the document which considers all main conditions of the offering, business plan.

STO and venture financing as the way of raising capital have a certain characteristics.

For example, venture capital firms and STO framework is traditionally focused on investments in high-technology companies generally, in recent years.

By such way of funds raising - venture financing have increased a many segments of the economy, specializing in more narrowly defined areas such as retail, services, medical, materials, biotechnology, clean technology (e.g., renewable energy, recycling, and conservation), telecommunications, Internet infrastructure, computer networking, and wireless communications.

Venture capital funds traditionally invested early in a company's history, tried to assist the company in developing a successful business, and planned to realize their gains at the time the company had its first public offering of stock. Although initial public offerings (IPOs) receive great publicity, a majority of exits result from mergers and acquisitions.

Massachusetts has been a major center of venturecapital activity for at least the past fifty years. As of June 2009, there were 589 professionally managed venturecapital funds in Massachusetts (source: Thomson Reuters). A significant number of successful high-technology companies in Massachusetts have received venturefinancing from Massachusetts or out-of-state venturecapital funds. For many years the goal of venturecapital funds was to match the success of American Research and Development, one of the first professionally managed venturecapital funds in Massachusetts, which purchased approximately 70 percent of Digital Equipment Corporation for approximately \$70,000 in 1957 [7].

Security Tokens Offering is unlike ICO where an issuer issues utility tokens or tokens which in any event cannot be defined as financial instrument represents an investment contract into an underlying investment asset, such as stocks, bonds, funds and real estate investment trusts. That is why from time to time such tokens proposals can be defined as classic securities proposal, such as IPO or private placement of the

securities.

Many ICOs are marketed not just to potential end users of the network services or applications but also to cryptocurrency investors attracted by the potential for the tokens to increase in value or to otherwise profit from the tokens based on the efforts of others. In the SEC's view, these are key hallmarks of a security and a securities offering. But few, if any, ICOs have been registered with the SEC, and many unregistered ICOs have not complied with SEC registration exemptions [11].

But one of the most significant difference between STO and this classic securities offerings is their character – there can be recorded in digital form. The point provides to everybody a possibility to buy, collect and sell the securities around the world. Moreover, such securities will be recorded on blockchain and collected through special custodian services.

Each jurisdiction has its own features (specificities) related to the regulation of the security token offerings. That is why author intends to analyse the current regulation which could be applied to the security token offerings in Russia, Malta and Switzerland to specify all features/regulation for this institution of raising capital in each of the abovementioned jurisdictions.

3. CURRENT REGULATION OF SECURITY TOKENS OFFERING

3.1.1. Regulation of STO in Russia

At this moment here is no any regulation of the security tokens offerings in Russia. The adoption of the proposed project of the Federal Law “On Digital Financial Assets” (at this moment this act within the procedure of its adoption) will allow formally to fix new and revolutionary norms of civil legislation on such previously unknown civil law institutions as digital money, digital rights, which will certainly allow to ensure judicial protection of the rights of participants in these legal relations, as well as the implementation of these rights in the territory of the Russian Federation. The introduction of the concepts of crypto-currency, smart contract, digital rights and other concepts will allow to settle the relationship between parties to the contract [3]. But this project of the Federal Law is still in the process of its adoption in the Russian Parliament.

At the same time, amendments to the Civil code of the Russian Federation which implemented a term “digital rights” into the Russia legislation are already adopted and will come into force in 2019. Digital rights under the amended version of the Civil Code are “the obligations and other rights mentioned in such quality in the law, the content and conditions for the exercise of which are determined in accordance with the rules of the information system that meets the criteria established by law. Implementation, disposal, including transfer, pledge, encumbrance of a digital right by other means or restriction of disposal of digital law are possible only in the information system without recourse to a third party”[3].

The explanatory note to the project of the amendments states that the creation of digital rights, the scope of their use and features of turnover will be determined by federal laws containing public law and developed with the participation of the Bank of Russia, the Ministry of Finance, the Ministry of Economic Development and other ministries. This means that the content and circulation of digital rights will be specifically regulated at the level of laws and by-laws.

But unfortunately the Russian Law does not regulate any offerings of the tokens or other digital rights with a financial instrument nature, that is why, under the authors point of view such offering can be classified as the offering of the security and could be a subject of the regulation of Federal Act on Securities Market which provide a certain special requirement and procedures for the securities offerings.

3.1.2. Regulation of STO in Malta

On the 30 November 2017, the Malta Financial Services Authority (MFSA) published a discussion paper on Initial Coin Offerings, Virtual Currencies and related Service Providers. This followed the general principles set out in a statement issued by ESMA on 13 November 2017.

At the 2019 the Virtual Financial Asset Act (VFA Act), Innovative Technological Arrangement and Services Act (ITAS Act), and the Malta Digital Innovation Authority Act (MDIA) which aim to create new infrastructure for the digital rights framework, were adopted and come into force in Malta. Let's pay attention to the VFA Act.

The VFA Act, sets out to regulate the field of Initial Virtual Financial Asset Offerings and Virtual Financial Assets and to make provision for matters ancillary or incidental thereto or connected therewith. This Act provides a comprehensive set of rules that will both protect consumers and support the growth of the industry and its stakeholders. Moreover, this Act outlines stringent requirements for those that are launching

cryptocurrencies, as well as other service providers including brokerages, portfolio managers, custodian and nominee service providers, e-wallet providers, investment advisors, and perhaps most crucially, cryptocurrency exchanges. Such activities are subject to requirements and conditions which must be adhered to by individuals or entities who issue VFAs or who provide certain specified activities in relation to VFAs are also clearly defined.

Additionally, it regulates the type of VFAs which may be issued through an Initial VFA offering and admission to trading on a Distributed Ledger Technology (DLT) exchange, which must be made with a registered whitepaper to be delivered to the Malta Financial Services Authority as the competent authority.

This Act also provides clear guidelines on what information such whitepaper should include, how collected funds may be used, and how due diligence on the individuals behind the fund-seeking entity is to be carried out. It also clearly clarifies that businesses will be liable to pay damages to anyone that loses money due to false statements contained in the whitepaper [13].

Initial VFA Offerings are defined as DLT-enabled methods for raising funds whereby an issuer, who must be a legal person duly formed in Malta, issues or proposes to issue a VFA in or from within Malta, and offers it to the general public in exchange for funds.

The Act defines a VFA as 'any form of digital medium recordation that is used as a digital medium of exchange, unit of account or store of value and that is not:

electronic money

a financial instrument, or

a virtual token.

Virtual tokens, or 'utility tokens', are DLT assets which have no utility, value or application outside of the DLT platform on which they were issued and may only be redeemed for funds on the platform directly by the issuer of the DLT asset.

The issuer of an ICO is required to appoint a VFA agent, who must be approved by the MFSA as the competent authority and will be tasked with specific reporting and monitoring obligations [13].

Moreover under the VFA Act, ICOs issuing virtual currencies that do not qualify as financial instruments are still subject to minimum transparency requirements and other obligations of the relevant parties involved.

3.1.3. Regulation of STO in Switzerland

16 February 2018 FINMA published Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), which states a certain requirements for ICO in Switzerland.

All types of tokens are classified for the following:

- Equity tokens represent the company's shares;
- Utility tokens reflect some value within the business model of the online platform (reputation, scores for certain actions, game currency);
- Asset-backed tokens are digital obligations for real goods or services (kilograms of carrots, hours of work of the builder, etc.) [6].

Moreover tokens could be clarified as the securities on the following legal definitions. Securities in the sense of the Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading (FMIA) are standardized certificated or uncertificated securities, derivatives and intermediated securities (Art. 2 let. B FMIA), which are suitable for mass standardised trading, i.e. they are publicly offered for sale in the same structure and denomination or are placed with more than 20 clients, insofar as they have not been created especially for individual counterparties (Art. 2 para. 1 FMIA).

Uncertificated securities are defined as rights which, based on a common legal basis (articles of association/issuance conditions), are issued or established in large numbers and are generically identical. Under the Code of Obligations (CO), the only formal requirement is to keep a book in which details of the number and denomination of the uncertificated securities issued and of the creditors are recorded (Art. 973c para.3 CO).

In accordance with the point 3.3. of these guidelines If FINMA comes to the conclusion that the tokens of an ICO constitute securities, they fall under securities regulation. Under the Federal Act on Stock Exchanges

and Securities Trading (SESTA), book-entry of self-issued uncertificated securities is essentially unregulated, even if the uncertificated securities in question qualify as securities within the meaning of FMIA. The same applies to the public offering of securities to third parties. The creation and issuance of derivative products as defined by FMIA to the public on the primary market is however regulated (Art. 3 para. 3 Ordinance on Stock Exchanges and Securities Trading, SESTO). Underwriting and offering tokens constituting securities of third parties publicly on the primary market, is, if conducted in a professional capacity, a licensed activity (Art. 3 para. 2 SESTO) [6].

4. CONCLUSION

Today an STO is an interesting and of course a perspective way for raising a capital for technology start-up, but at the same time a crypto-market does not stay and continues to achieve a new ways for the raising of the capital, in particular IEO (Initial Exchange Offering).

The gradual transformation from ICO to DSO is happening as the market of digital securities is being formed carefully and methodically so will likely not mirror the ICO boom that inevitably precedes a bust, proving that patience is indeed a virtue in the world of longer term investment[1].

Investing in utility tokens (providing under ICO) did not require any accreditation, which is part of the reason they were so popular. That meant virtually anyone could participate in the sale of a utility token, provided they register in advance of the sale (i.e., whitelist) and meet the minimum investment requirements.

Of course STO has advantages to classic venture investment framework:

1. STOs are lower-risk investments because they are enforced by applicable regulation. Unlike an ICO, a security token has all the attributes of a security in that it is a fungible, negotiable financial instrument that represents actual monetary value. STOs are backed by real assets and follow the SEC's guidance on compliance, issuance, and trading.
2. When collateralized assets are tokenized, they allow for fractional ownership of real assets, which gives investors more options to diversify their portfolios – again, at a lower cost. This means STOs will continue to offer opportunities to smaller investors who were originally drawn to the ICO model [12].
3. It is cheaper than classic instruments of raising capital

But at the same time there are a couple of disadvantages of STO as the form of venture investments:

1. Although regulation is considered advantageous from the perspective of investors, compliance is relatively complex for token issuers. That largely explains why the STO market has been much slower to launch than its predecessor. In fact, during the ICO boom, many blockchain companies refused to sell their tokens in the United States due to complex regulations and the need to identify as a security token [12].
2. Their ability for the exchange – major crypto-exchanges have yet to say whether they will support security tokens.

Under the authors point of view new legislation in Malta, Switzerland and in Russia creates a regulatory environment that will provide much sought after legal certainty and lucidity in both the local and international crypto community.

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