

THE FEATURES OF CAPITAL RAISING MECHANISM THROUGH ICO AND STO

CARACTERISTICILE MECANISMULUI DE COLECTARE A CAPITALULUI PRIN ICO ȘI STO

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Rezumat. Dezvoltarea criptomonedelor și intensificarea popularității acestora în sfera afacerilor a condus spre metode noi de colectare a capitalului, în principal ICO sau Ofertă Inițială de Monede și STO sau Ofertă de Jetoane de Securitate. Caracteristicile ce stau la baza funcționării acestor mecanisme se deosebesc de cele tradiționale prin facilitatea de colectare a fondurilor necesare, disponibilitatea în mediul virtual, având la bază tehnologia blockchain, cât și beneficiile ulterioare unice aduse utilizatorilor. În această lucrare, bazându-ne pe metode de cercetare precum metode general-științifice de cunoaștere, analiză logică, metodă documentară ș.a., urmărim scopul general de determinare a posibilității de implementare a metodelor de colectare a capitalului în Republica Moldova prin analizarea caracteristicile mecanismelor ICO și STO.

Cuvinte cheie: criptomonede, ICO, STO, blockchain, investiții, piața de capital

JEL CLASSIFICATION: D53, G23, O16, O31

INTRODUCTION. The development of cryptocurrencies and the increase popularity that they present within the society and the economy, especially in the business sector, has led to new methods of crowdfunding, as well as new capital raising mechanisms. From the traditional mechanisms such as Initial Public Offering (IPO) or the placement of shares on primary market, the capital market evolved till the stage when the capital that a businessperson needs to gather may be done through mechanisms such as Initial Coin Offering (ICO) and Security Tokens Offering (STO) which are innovative and advantageous options for the business sector.

The objectives of this paper are to determine the specific features of ICO and STO, to emphasize the differences between them, to forecast the dominant method in the future according to the dynamics of the past years and analyze the possibility and feasibility of introducing these modern mechanisms for attracting investment resources in the capital market of the Republic of Moldova.

PROPOSED RESEARCH METHODS. Presented in this article investigation was implemented based on such research methods as: general-scientific methods of cognition, logical analysis, documentary method, analogy and grouping data method, graphical method, method of synthesis.

THE RESULTS OF RESEARCH. As both ICO and STO imply the use of blockchain and cryptocurrencies, most of the times people that do not have at least basic knowledge in this field tend to confuse them and even to conclude that these are the same and have the same features. In order to differentiate them, the definitions of each of them might be helpful for our research.

On the one hand *ICO's are crowdfunding options* that in exchange for their investment, the investor will receive a number of utility tokens, or, user tokens in other words. These tokens represent future access to a company's product or service. On the other hand, STO is in its essence similar to ICO but it also conforms to regulatory requirements. STOs surfaced as a reaction to the lack of oversight when it came to ICOs, to bring regulation to blockchain-based crowdfunding and offer more guarantees in the space of raising funds using tokens issued on a blockchain [9].

Referring individually to each type, an *ICO is a type of crowdsale*. In an ICO, the startup creates digital tokens that it sells to participants in a crowdsale, usually in exchange for a cryptocurrency like Ethereum or Bitcoin. Once the startup hits its fundraising goal, the tokens are automatically distributed to the participants in the sale. If the company doesn't hit its goal, however, the participants receive their funds back. The purpose of the new token varies for every startup that runs an ICO. However, the token should have some utility within the new company. This means that the crowdsale participant will be able to use

the token in the future to buy products, gain access to features, or otherwise transact with the startup. The new tokens are not shares. Crowdsale participants don't receive equity in the new company. ICOs use blockchain technology to secure the digital tokens, preventing forgery and double spending. While still relatively new, ICOs have become wildly popular. In 2017, ICOs generated more funding for startups than early and seed venture capital. Startups have earned hundreds of millions of dollars in a matter of hours through ICOs [7].

Generalizing the ICO mechanism, we can mention that the *most outstanding features* are the following:

- an ICO investment is made using a cryptocurrency and investors get tokens (or 'coins') rather than 'shares';

- many ICOs have so far fallen outside existing securities regulation. The majority of regulators have issued warnings to investors about the risks of these investments;

- early ICOs were focused on new, innovative developments in blockchain technologies (on which cryptocurrencies such as bitcoin are based). However, the rapid increase in interest in ICOs has led to a much broader scope of offering;

- owning tokens do not always give the investor a right to vote on the direction of a project, with the rights of the investor embedded within the structure of the ICO;

- there are risks to ICOs, especially for investors, who can easily lose their investment or fall victim to a scam. There are also wider risks to consider, such as their being used as vehicles for money laundering.

ICOs may have multiple rounds of fund raising, increasing in value until the release date, with early investors likely to have greater rewards embedded within their coins as an incentive [4]. However, the features of ICO did not fit the expectations of the business persons and in few years the volume of funds raised through ICO decreased dramatically as it is represented in Figure 1.

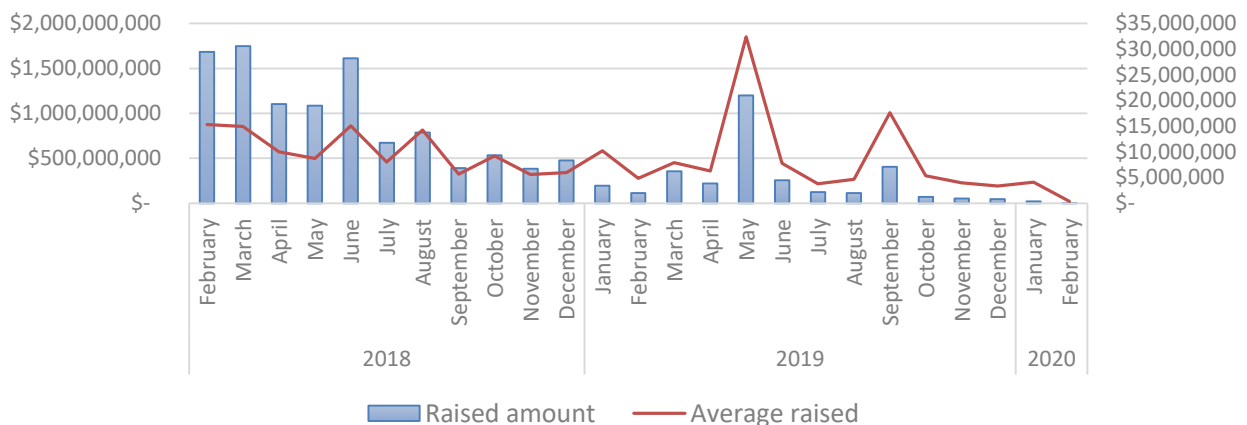


Figure 4. Evolution of funds raised through ICO, 2018-2020, USD

Source: elaborated by the author based on www.icobench.com

The main difference between ICO and traditional methods of capital raising, such as IPO, is the fact that IPO is usually used for well settled companies, whereas ICO is more for the young and risky. There are a number of requirements that a company has to fulfill before listing its shares through an IPO. Traditional IPO issuance can be a lengthy process, due to the requirement of legal and compliance processes. The stocks acquired through an IPO represents an *ownership stake* on the future earnings on the company. Shareholders get dividends yearly, depending of the company progress during the year or get profit when the stock value rises. ICOs do not require adherence to any regulatory framework and legal protocol. The entire ICO process is much shorter in duration. The main thing investor needs to start investing in ICO is access to the Internet. At the same time, the **coins do not grant ownership of the project, but there are** many ways that investors of the coins (ICO) may reap future benefits, and that depends on how the coin is structured [1].

ICOs have been a tremendously exciting means for blockchain startups to quickly and efficiently fund their projects in ways that wouldn't have been possible with more traditional fundraising efforts. The problem is that the combination of new and often misunderstood technology with rapid capital gains will inevitably lead to greed, corruption, fraud, and a general slew of malfeasance. There is an undeniable need

for standardization and some form of regulation in order for this industry to truly progress. By transitioning from an ICO to an STO, the companies aimed to be at the forefront of this ongoing industry-wide regulatory transformation. They wanted to ensure that investing in their companies is as secure, stable, and transparent as possible [5].

There is no big difference between ICOs and STOs. The main difference is that *STOs are regulated by main regulators* like the Securities and Exchange Commission (SEC) in U.S.A. The STO technology or process has made it easy for companies from around the world to access a large pool of capital. In the meantime, since this is a new industry, there is a lot of misconception on what constitutes a security token [8]. Throughout first ten months in 2019, more than 380 token offerings have been successfully completed, managing to raise a total of ca. USD 4.1 bn [11]. Most of these companies are from the United States, Switzerland, and Germany. Most companies that issue these STOs are in the financial sector.

There are several reasons why STOs are becoming more popular today. In fact, most companies launching crypto projects are using the STO model. Some of these benefits include that STOs are: regulated, time efficient, cost-effective, global; offer instant settlement; have high degree of liquidity and give 24/7 access. At the same time, as with all fundraising methods, there are some drawbacks such as: complex compliance, young market, global challenges, security risks.

Overall, the *main features of STOs* that are the most relevant for our paper are:

- it is important to obtain legal compliance for your STO, abiding by the laws and regulations to ensure smooth business;
- the STO should enable the investor to pay any way they want, i.e with fiat currencies, cryptocurrencies, and even debit/credit cards, etc. This makes your STO user-friendly, which will eventually attract more investors;
- the STO should enable users to exchange different types of currencies for a seamless experience;
- the security token platform should be built-in with advanced blockchain technology and smart contracts integration to ensure a secure, smooth, and quick transaction process;
- the issuer may charge or pledge the underlying security/asset under custody of a credible intermediary (e.g. custodian). Certain terms of the token would be coded into the token;
- with STOs, the issuers might be able to raise liquidity without selling the entire asset [3].

Regarding the use of ICO and STO in European Union, first we need to mention that *one of the most important problems in EU cryptocurrencies development is the fact that crypto-assets do not completely fit under any of the relevant EU legal acts*. Where crypto-assets qualify as transferable securities or other types of *MiFID* financial instruments, a full set of EU financial rules, including the Prospectus Directive, the Transparency Directive, MiFID II, the Market Abuse Directive, the Central Securities Depositories Regulation and the Settlement Finality Directive, may be applied to their issuer and/or firms providing investment services to those instruments [2].

However, there are a number of gaps and issues within the existing regulatory framework when applied to crypto-assets. In particular, some of the risks that are specific to their underlying technology may be left unaddressed and where crypto-assets do not qualify as financial instruments (or where they do not fall within the scope of other EU rules applicable to non-financial instruments such as the e-money Directive as identified in the EBA's report and advice on crypto-assets), the absence of applicable financial rules leaves consumers exposed to substantial risks.

Despite the use on large scale in different countries around the world, including USA and European Union, of the capital-raising mechanism that ICO and STO provide, The National Bank of Moldova (NBM) repeatedly warned since 2018 about the risks associated with investing in the so-called cryptocurrencies, pointing out on high risks of losing money invested in such assets. *According to the NBM, the "virtual money", are virtual assets without real coverage, have a high volatility and a low degree of security, compared to money issued by central banks and regulated electronic currencies*. Taking into account the technical characteristics of virtual currencies, high volatility and lack of regulatory framework that would ensure investors protection, the National Bank of Moldova recommended maximum caution when deciding on whether to invest capital in such assets [10].

At the same time, a number of crypto-assets services are going to start in Moldova. Thus, there are two projects in cryptocurrencies mining, are going to appear some Bitcoin ATMs etc. Due to the non-acceptance of cryptocurrencies by the national authority, the lack of regulations in this field, as well as the low level of development of the capital market and the popularity of the traditional ways of capital-

raising through IPO, in the Republic of Moldova there are not used neither ICO nor STO. In the current situation, financial regulators began consultations regarding potential solutions to regulate the phenomenon of “cryptocurrency”, and to avoid the risks.

CONCLUSIONS AND RECOMMENDATIONS. The Security Token Industry has been growing in the past few years and the main reason is that investors seem confident that they won't lose money in STO as they did in ICOs. Even though the investments in ICOs decrease and in STOs improve, the latter will keep this trend only if the conditions for complying will be simplified, if the concept and the benefits that it offers to the economy will be wider explained for those who want to raise their capital through STOs, but don't have experience in this field.

The features of the capital raising mechanisms shows the development of the economy and of technologies, widening the range of options in the capital market. However, the newness that it brings furtherly provokes a mistrust in people, as this brings a set of risks that need to be prevented, such as the security of the investors or the global challenge.

As a generalization for legal framework from the Republic of Moldova, the implementation of STO, and even of ICO, are almost impossible in the present conditions, as the responsible authorities in this filed do not support and recommend the use of cryptocurrencies, a step that is fundamental in this process. Therefore, my recommendation is to establish a legal framework for the use of cryptocurrencies and to try the implementation of ICO in order to analyze the behavior of investors towards a decentralized way of fundraising.

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