THE CHANGING FACE OF FINANCE IN NIGERIA - REGULATING CRYPTOCURRENCY AND INITIAL COIN OFFERINGS: THE NIGERIAN PERSPECTIVE (PART 2)

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INTRODUCTION

This is the second part to the article on Regulating Cryptocurrency and Initial Offerings: The Nigerian Perspective, (read part one here). In part two, we explore Initial Coin Offerings (ICOs), how it is used to raise funds, the Nigerian legal framework on ICOs, and the pros and cons of ICOs.

A NEW WAY OF RAISING CAPITAL

The rapid increase in the value of cryptocurrency and the possibility of high gains within a short time frame has seen a number of companies deciding to use the technology driving cryptocurrency to raise funds.

Companies have started seriously considering ICOs as a viable tool to raise capital as opposed to Initial Public Offerings (“IPOs”). This is because ICOs are not subject to as much regulatory oversight as IPOs considering the definition of tokens fall outside the scope of regulated investment instruments in most jurisdictions, thus simplifying the offering process. In addition, companies get to protect their shareholding against dilution as the assets on offer during are ICO are tokens and not shares in the company.

In 2017, it was posited by financial experts that there was an ICO Bubble[1], (a situation where the price of coins far exceeded their fundamental value due to their connection to ICOs) This was supported by the fact that in 2017 alone, USD1,362,588,431 was raised from the top ten ICOs[2]globally.

Though the bubble may have burst in 2019 due to ICOs not being able to meet their targets and the prevalence of fraudulent ICOs, they are still being used by companies to raise capital[3] and the promise of rapid, large investment returns makes it more appealing to investors.

IPO V ICO

There is still a debate in the financial industry that tokens constitute a share or security of the company;

[1] The Financial Times, “ICO regulation inconsistent as cryptocurrency bubble fears grow” https://www.ft.com/content/32315636-cb01-11e7-ab18-7a9fb7d6163e accessed 5 August 2020.
[2]PWC, “Introduction to Token Sales (ICO) Best Practices” https://www.pwccn.com/en/financial-services/publications/introduction-to-token-sales-ico-best-practices.pdf accessed 5 August 2020.
[3] There are still ICOs occurring according to various ICO Calendars such as ICODROPS. https://icodrops.com/

therefore it is similar to an IPO because ownership is being sold through the use of the tokens instead of shares. This assertion has its flaws because fundamental differences exist between an IPO and an ICO which will be highlighted below.

IPO	ICO
The company sells part of its ownership through shares for additional capital.	The company has a unique technology or a project they need to raise funds for.
The capital gained is used to grow the company and help in operations.	The tokens are usually sold to gain stakeholders who will become users of the product or will be in the product ecosystem (blockchain native to the token).
The owners of the shares will usually gain dividends and reap the benefits of the company's growth.	The owners of a token gain product value as they are able to do various things with the token acquired from an ICO. They can sell their tokens for a higher price, exchange it for other tokens or coins, or use the product that the token was created for.[4]
IPOs are heavily regulated and are typically subject to regulatory oversight and requirements.	ICOs are hardly regulated and the level of entry is low. A company following the right steps can easily set up an ICO.
An IPO involves a lot of money as the company seeking to raise capital would have to invest in brokers, roadshows to discuss the benefits of their IPO to potential investors, issuing houses and even Underwriters.	An ICO does not involve spending large amounts of money since everyone on the internet can easily access the ICO and purchase the tokens and there are minimal third-party expenses required to ensure the success of the ICO.

[4] Deloitte, "Initial Coin Offering a new Paradigm" https://www2.deloitte.com/ru/en/pages/financial-services/articles/initial-coin-offering-a-new-paradigm.html. accessed 6 August 2020

The characteristics of an ICO and the freedom it affords companies looking to raise capital has aided the increasing popularity of token sales and in recent times, ICOs have been categorized and broken down for potential investors to understand the intricacies of the process.

THE TOKEN SALE

An ICO or a Token Sale is the process of raising capital through the sale of tokens to the public for a limited period in exchange for cryptocurrency[5]. Instead of receiving shares like a typical IPO, investors receive tokens and pay in cryptocurrency (or cash in some instances). The tokens received represent the participation of the investors in the project the ICO was created to raise capital for.

So, Investors in a Token Sale are usually called participants because ICOs are a form of Crowdfunding; however the company will be receiving cryptocurrency rather than cash. [6]
This can be compared to equity-based crowdfunding where the public donates cash in exchange for shares in the company[7].

TYPES OF TOKEN SALES

There are two major types of ICOs the Private ICO and the Public ICO.

In a Private ICO, a limited number of investors, typically financial institutions and high net-worth individuals, participate in the process. The company can choose to set a minimum investment amount[8].

A Public ICO on the other hand, is open to the general public, with no limits on who may participate, subject to any regulatory considerations in the relevant jurisdiction[9].

However, Private ICOs are becoming a more preferred option compared to public offerings as regulators are now looking at ways to regulate Public ICOs in order to protect the investing public.

CHARACTERISTICS OF A TOKEN SALE

In order to mitigate the risk investors associate with ICOs, companies have had to be strategic in structuring ICOs and four characteristics have emerged as the foundation for any Token Sale Model.

[5] PWC, “Introduction to Token Sales (ICO) Best Practices” https://www.pwccn.com/en/financial-services/publications/introduction-to-token-sales-ico-best-practices.pdf accessed 5 August 2020.
[6] ACCA, “ICOs: real deal or token gesture? Exploring Initial Coin Offerings” https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Initial-coin-offerings/pi-initial-coin-offerings.pdf accessed 6 August 2020.
[7] Oyeyosola Diya, “The Changing Face of Finance in Nigeria : Crowdfunding” https://www.aelex.com/wp-content/uploads/2020/03/THE-CHANGING-FACE-OF-FINANCE-IN-NIGERIA-CROWDFUNDING1.pdf accessed 6 August 2020.
[8] Corporate Finance Institute, “Initial Coin Offering (ICO) An initial public offering that uses cryptocurrencies” https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/initial-coin-offering-ico/ accessed 6 August 2020.
[9]Corporate Finance Institute, “Initial Coin Offering (ICO) An initial public offering that uses cryptocurrencies” https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/initial-coin-offering-ico/ accessed 6 August 2020.

- A cap on the amount of money that will be raised from the ICO;
- An appropriate time frame for the period the ICO will run in order to gain the attention of buyers.
- The time frame must not be too long so investors can see actual results and for the specified project to move to the next phase;
- Public information on the number of tokens that are in circulation, the amount that is going to be sold and the amount currently being held by all stakeholders in the ecosystem of the token; and
- The value of the token must be clear and unambiguous[10].

The structure of an ICO and the benefits a token offers determines the type of investors it attracts. The utility the token offers is also one of the factors that will determine whether an investor will use the token he acquired or trade it off in return for another token with a different utility or cash.

THE TYPES OF INVESTORS IN A TOKEN SALE

There are two types of participants in a Token Sale - Stakeholders and Speculators. Stakeholders are buyers who acquire a token to be able to use it for the true utility it was created for. In the first article, we talked about the Brave browser and how it is using its Basic Attention Token (BAT) to create value by rewarding people who advertise on its browser with the token when a user views their ad which does not have an ad tracker or is transparent[11]. If the Brave browser was to have an ICO, they would most likely sell their BAT and a Stakeholder buyer would acquire it to use in securing an advert space on the browser because the BAT can be used in the Brave ecosystem to gain products or services[12].

Speculators are investors who do not wish to use the utility that a token offers. They participated in the Token Sale with the hope of making a return on the token when its value rises, either by selling to Stakeholders or other Speculators.

[10] Deloitte, “Initial Coin Offering a new Paradigm” https://www2.deloitte.com/ru/en/pages/financial-services/articles/initial-coin-offering-a-new-paradigm.html accessed 6 August 2020
[11] Oluwapelumi C. Omoniyi, “ Regulating Cryptocurrency and Initial Coin Offerings: the Nigerian Perspective” https://www.aelex.com/regulating-cryptocurrency-and-initial-coin-offerings-the-nigerian-perspective/ accessed 6 August 2020.
[12] Deloitte, “Initial Coin Offering a new Paradigm” https://www2.deloitte.com/ru/en/pages/financial-services/articles/initial-coin-offering-a-new-paradigm.html accessed 6 August 2020

ICOs require an understanding of a combination of finance, technology and the regulatory requirements that may hinder the process in the jurisdiction the issuing entity resides in. Therefore, the steps highlighted below in order to be successful will entail an understanding of the subject matter aforementioned.

KICKSTARTING A TOKEN SALE

Because the mechanism for an ICO is fairly simple, it has a low barrier of entry and in most jurisdictions, it can be started without jumping through regulatory hoops. There are typically four stages in kickstarting an ICO:

Stage One:

This includes the preliminary stage where the company or the token issuing entity identifies their potential investors and the project they want to fund.

After identifying its potential investors and its underlying project, the token issuing entity will issue a White Paper (similar to a Prospectus for an IPO) that provides details of the underlying project and details of the tokens that will be issued in exchange for cryptocurrency[13].

The White Paper is made publicly available, usually through the issuing entity's website. The White Paper will include the mechanism for payment of cryptocurrency to the issuing entity's account. t is now common practice for payments to be made into an escrow account, to foster investor confidence in the validity of the ICO[14].

Stage Two:

The tokens are created. The tokens will be the representations of an asset or a utility on the blockchain native to the token and are tradeable for other tokens or coins[15].The issuing entity does not need to create new tokens, instead they can build on existing blockchains such as Ethereum which allows the creation of tokens on its blockchain.

Stage Three:

The issuing entity will usually run a promotion campaign to attract potential investors. These campaigns are usually executed online to achieve the widest investor reach. It should be noted that a lot of online platforms such as Facebook and Google ban the advertising of ICOs[16];

[13] ACCA, "ICOs: real deal or token gesture? Exploring Initial Coin Offerings" https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Initial-coin-offerings/pi-initial-coin-offerings.pdf accessed 6 August 2020.
[14] ACCA, "ICOs: real deal or token gesture? Exploring Initial Coin Offerings" https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Initial-coin-offerings/pi-initial-coin-offerings.pdf accessed 6 August 2020.
[15] Corporate Finance Institute, "Initial Coin Offering (ICO) An initial public offering that uses cryptocurrencies" https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/initial-coin-offering-ico/ accessed 6 August 2020.
[16] Corporate Finance Institute, "Initial Coin Offering (ICO) An initial public offering that uses cryptocurrencies" https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/initial-coin-offering-ico/ accessed 17 August 2020.

therefore, it is recommended that the campaign run on the issuing entities website or on cryptocurrency exchanges.

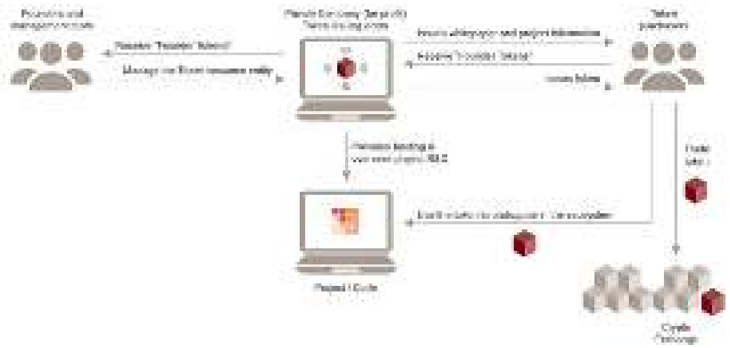
Stage Four:

After the creation of the tokens, the tokens are issued and the token purchasers or investors will pay for the tokens, usually in cryptocurrency. Issuing entities can request for fiat currency if they wish, but common practice is the use of coins to buy tokens.

Once the purchasers have paid for the token, they can use their tokens in the project ecosystem as a utility for the product or trade the token on a Cryptocurrency exchange, subject to any lock-in period prohibiting the exchange or sale of the token -this will be stated in the White Paper.

Cryptocurrency is financially risky as we highlighted in our first article, so in order to assuage the fears of investors, the management team of the issuing entity usually take tokens themselves to prove to potential investors that the ICO is relatively safe.

Below is a process flowchart highlighting the stages of a typical ICO:



THE NIGERIAN LEGAL FRAMEWORK ON ICOS

As defined in our first article, a token is an asset built on top of an existing blockchain, which has the ability to replicate such functionality or assets[18]. We also explained how securities are financial assets and provided the definition of securities according to the Nigerian Regulatory Framework for securities[19].

The regulatory framework for securities being offered to the public or to private individuals in exchange for cash comprises of the following rules and regulations:

[18] Oluwapelumi C. Omoniyi, "regulating Cryptocurrency and Initial Coin Offerings : the Nigerian Perspective" https://www.aelex.com/regulating-cryptocurrency-and-initial-coin-offerings-the-nigerian-perspective/ accessed 6 August 2020
[19] The Investment and Securities Act 2007 in Section 315 defines 'security' to mean: debentures, stocks or bonds issued or proposed to be issued by a government; debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate; right or option in respect of any such debentures, stocks, shares, bonds or notes; or commodities futures, contracts, options and other derivatives,
The definition of securities in the ISA included those securities which may be transferred by means of any electronic mode approved by the Securities and Exchange Commission (SEC) and which may be deposited, kept or stored with any licensed depository or custodian company as provided under the ISA

- The Investment and Securities Act 2007 (“ISA”); and
- The Rules and Regulations of the Security and Exchange Commission 2013 (“SEC Rules”).

Article 279(1)(c) of the SEC Rules provide that all securities subject to registration by the Securities and Exchange Commission (“SEC”) may be offered through the following methods:

- offer for subscription;
- offer for sale;
- rights issue;
- bonus issue;
- debt - equity conversion;
- private placement by public companies and other entities; and
- offer by introduction;
- debenture/loan stock;
- State and Local government bonds
- Sukuk

The SEC Rules also provide that an entity may offer or transfer its securities electronically: provided that where an investor elects to have a certificate, such certificate shall be issued by the issuer[20].

The aforementioned principles of the SEC Rules seem to give a legal foundation for potential ICOs in Nigeria but sadly, coins and tokens do not fall under the scope of securities set out in the ISA and therefore, cannot be registered as securities that can be offered to the public or to private entities in exchange for capital in Nigeria. Also, the SEC is yet to classify what coins or tokens are in Nigeria, hence, ICOs are unregulated in Nigeria.

This position may soon change as the Proposed Rules on Crowdfunding by SEC[21] seem to permit equity crowdfunding and ICOs are an offshoot of it. The proposed rules provide that an entity may issue other investment instruments approved by the Commission (including simple contracts) without registering the securities or investment instruments with the SEC. Tokens being offered in ICOs are investment contracts that are built on blockchains and are easily programmable to provide any type of utility the issuing entity programmes the smart contract to perform. This position has not been affirmed by the SEC but it is hoped that ICOs can take advantage of the proposed provisions of the Proposed Rules.

[20] Article 345 of the Rules and Regulations of the Security and Exchange Commission 2013 (SEC Rules).
[21] SEC Nigeria, “Exposure of Proposed new Rules to the Rules and Regulations of the Commission” https://sec.gov.ng/wp-content/uploads/2020/03/SEC-NG-Crowdfunding-Rules-for-Exposure-March-2020.pdf accessed 9 August 2020.

Also, the National Blockchain Strategy released by the Federal Ministry of Communications and Digital Economy, while admitting that there is no regulatory or legal framework for cryptocurrency in Nigeria, believes that there is a promising future for blockchain in Nigeria due to the adoption of blockchain by various Nigerian start-ups for numerous purposes. The Blockchain Strategy lists out the various regulations that the Federal Government has released to create an enabling environment for cryptocurrency in Nigeria[22].

It goes further to explain how the Federal Government wants to use cryptocurrency and blockchain technology as one of the paths towards a digital economy and one of the strategic objectives is the creation of investment opportunities through blockchain.

According to the Blockchain Strategy, “Blockchain has the potential to completely transform traditional models in several sectors both private and public.

By promoting blockchain adoption and providing an enabling environment, new business models will spring up to open opportunities for businesses that will drive investments in a market such as Nigeria.”

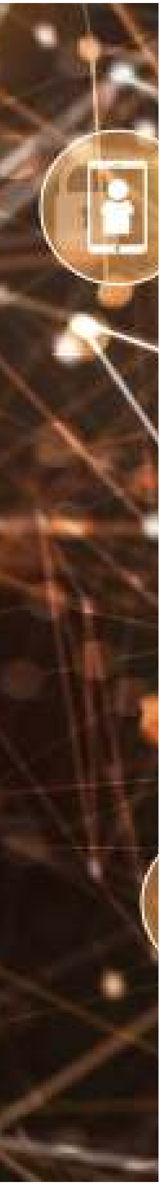
This seems to be a nod to ICOs and the government’s consideration of it to diversify the Nigerian Economy and the methods of investment in Nigeria.

Furthermore, the Final Report of the Fintech Roadmap Committee of the Nigerian Capital Market by the SEC, lists out recommendations that the Capital Market Community will take into consideration regarding ICOs:

- SEC should be responsible for the regulation of Virtual Financial Assets (VFAs) Exchanges and develop a framework around it.

- For the regulation of crowdfunding, interest-based crowdfunding should be regulated by the Central Bank of Nigeria (CBN) while equity-based crowdfunding should be regulated by the SEC (ICO, STO or IPOs).

[22] National Digital Economy Strategy and Policy 2020-2030, National IT Policy 2012, E-Government Master Plan, Nigeria Cloud Policy 2019, National Broadband Plan 2020-2025 and the Nigeria Data Protection Regulation 2019



- SEC should issue guidelines and standards for White Papers and ICOs.
- Advertising and issuance procedures should be defined without ambiguity.
- SEC should create appropriate licensing regimes for new entrants into the crowdfunding ecosystem.
- SEC should develop a detailed framework for VFA based economy.
- SEC should develop a stringent framework for KYC and due diligence which will apply regardless of the legal status of an ICO or token.
- SEC should have clear taxonomies of tokens based on their nature, characteristics and economic realities as their determining factors.
- The taxonomy of traditional securities should remain intact, and serve as useful, instructive and illustrative guide for the taxonomization of the new cryptocurrency capital market investment products and services.
- The global best practices in order to give a taxonomy to cryptocurrency assets especially jurisdictions like Malta should be followed by SEC. The Malta Guide broadly taxonomises tokens as;

  - Payment token
  - Asset token
  - Utility token

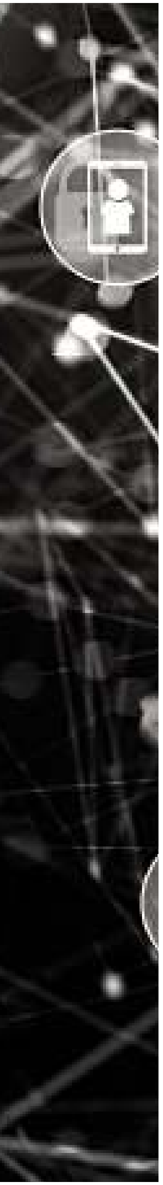
ICOS - RISKY BUSINESS OR NOT?

Though the advantages of an ICO were mentioned earlier in this article, they need to be highlighted again to understand why ICOs are being strongly considered by companies as a way to raise capital.

Lack of Regulatory Oversight: Most ICOs lack regulatory oversight, hence it is an interesting opportunity for founders or entities to adopt it as a method to raise capital. Bypassing the regulatory oversight that comes with IPOs is a major boost to the appeal of ICOs to issuing entities and even investors.

Substantial Gain Quickly: Since ICOs have a target and an estimated time to achieve the target which is usually short[23], investors usually gather their funds to invest heavily in ICOs due to the potential returns that are projected. Most times the returns projected is higher than returns on fixed or floating assets such as bonds or shares respectively.

[23] The longer the ICO period, the less appealing it looks to investors.



The recent furore for and discussion around the novelty and profitability of ICOs has whetted the risk appetite of certain investors hoping to make a huge return on their investments, which means that the issuing entity also sees a quick inflow of capital.

Anyone can Invest: Due to the nature and accessibility of ICOs which are typically offered online, issuing entities are not limited to investors within their geographical area, and do not incur costs that are typically seen with the traditional methods of raising capital. Anyone can invest in an ICO and the pool of potential investors is essentially every user of the World Wide Web. The use of cryptocurrency also means that the issuing entity does not need to worry with the currency in which to dominate the offer and thus, bypasses any foreign exchange concerns.

So, with all the advantages mentioned above, why are ICOs still considered risky business? Well in 2017 alone, 80% of ICOs were identified as scams by Statis group, an ICO advisory firm[24].

To put in context, US$11.9 billion of investor money fell to scams in 2017 and three fake ICOs alone consumed US$1.31 billion[25].

Also, the lack of regulatory oversight means most ICOs end up “going dead”[26] and investors cannot recoup their money due to the lack of a mechanism or a reporting procedure to reclaim their funds.

In addition, investors and issuing entities are faced with the risk of digital currency theft as cryptocurrency wallets - where the coins or tokens stored - are hackable. A study[27] from CipherTrace, a cryptocurrency intelligence firm based in Silicon Valley provided an overview of the major cryptocurrency thefts, scams, and fraud worldwide in 2019. The study showed that criminals and fraudsters netted approximately US$4.26 billion for the first six months of 2019 and US$1.7 billion for the entire 2018 according to the study.

[27] Cipher Trace, “Q2 2019 Cryptocurrency Anti-Money Laundering Report” https://ciphertrace.com/q2-2019-cryptocurrency-anti-money-laundering-report/ accessed 10 August 2020.
Jeb Su, “Hackers Stole Over $4 Billion From Crypto Crimes In 2019 So Far, Up From $1.7 Billion In All Of 2018” https://www.forbes.com/sites/jeanbaptiste/2019/08/15/hackers-stole-over-4-billion-from-crypto-crimes-in-2019-so-far-up-from-1-7-billion-in-all-of-2018/#229fc9a655f5 accessed 10 August 2020.

Although exchanges, wallets, and other cryptocurrency custody services are strengthening their defenses, hackers continue to innovate and outpace even the current state of the art in cybersecurity, the CipherTrace study notes[28].

CONCLUSION

ICOs are not popular in Nigeria and are hardly used to raise capital by entities in this part of the world. Also, given the fact that coins and tokens are not classified in Nigeria, the absence of classification makes Nigeria a very harsh terrain for an ICO to be conducted, but that may soon change.

In January 2018, SureRemit a Nigerian non-cash remittance start-up raised $7 million through an ICO[29]. ICOs may become the rave for Nigerian tech companies who do not want to jump through the regulatory loopholes of the SEC for raising capital and registering securities.

The drive of the Federal Government and SEC is also duly noted as the government and its apex capital market regulatory body looks into the future to tap the benefits of cryptocurrency and all the technology that comes with its use.

ENDNOTE

This article is part of the series titled THE CHANGING OF FINANCE IN NIGERIA highlighting the various modern financial developments in Nigeria.

Do look out for, and read, the next part of our series. Other articles in the series may be accessed here.

[28] Cipher Trace, "Q2 2019 Cryptocurrency Anti-Money Laundering Report" https://ciphertrace.com/q2-2019- ryptocurrency-anti-money-laundering-report/ accessed 10 August 2020. Jeb Su, "Hackers Stole Over $4 Billion From Crypto Crimes In 2019 So Far, Up From $1.7 Billion In All Of 2018" https://www.forbes.com/sites/jeanbaptiste/2019/08/15/hackers-stole-over-4-billion-from-crypto-crimes-in-2019-so-far-up-from-1-7-billion-in-all-of-2018/#229fc9a655f5 accessed 10 August 2020
[29] Victor Ekwealor, "3 things you need to know about ICOs in the Nigerian context" https://techpoint.africa/2018/02/14/ico-nigeria/ accessed 10 August 2020.

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