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Regulating the 'Wild West' of Token-Based Business

Evolving standards of crypto regulation may actually result in sharper oversight than is common in the non-token world.

The rise of initial coin offerings (ICOs), initial exchange offerings (IEOs) and token business models have been subject to intense scrutiny over the past few years. A majority of them have been identified as scams, Ponzi schemes and the like. This has led to a widespread dismissal of token-based models, grounded in the belief that they constitute a kind of Wild West outside the reach of current laws. In reality, these models are not ungovernable. However, entities with two distinct value systems, such as tokens and traditional securities, will always be subject to disparities in governance. What follows is a proposal for how existing governance and accountability standards may apply to token business models. With some adaptation, they may result in more diligent oversight than is common in the non-token world.

Asking different questions

In the United States, the very definition of token and investor protection are linked to whether the token can be defined as a security. This depends on the Howey Test, a test based on three independent requirements: an investment of money, a common enterprise and an expectation of profits predominantly from the efforts of others. This would suggest that the traditional Bitcoin is not considered a security token.

Regulating security tokens raises corporate governance issues that are distinct from, but related to, those concerning traditional securities. For example, a publicly traded security has "promoters", i.e. underwriters, a founder and residual owners. The sales of tokens, too, are promoted, but somewhat differently. Relevant questions for regulators may include: Will promoters retain a stake in the firm that issued security tokens? Will they have decision power? What type of discretion will they have in using the cash raised by the token issue?

The next question is the "return" that the token holders expect to receive. Will this be just an increase in the value of the token or also a distribution of cash flows (profits) or some usage right? How much will the usage right compensate them for the loss of the voting rights? How much is the token expected to increase in value?

Related to the return, does the promoter have any duties, such as to induce an increase in value? And is such increase in value linked to the increase in value of the underlying firm? If not, will it be a duty of the promoter to engage in "speculations" (e.g. buying back tokens) to increase their value?

We can then turn to the "duty of care" of the promoter in terms of investing the proceeds of the token issuance. What are the constraints imposed on the promoter to expend these proceeds? This is a key source of friction. Indeed, on the one hand, laying out how the funds should be used in a binding and detailed contract may be very constraining for the promoter if the circumstances change and conflict with the principle of "best business judgement" that regulates enterprise business. On the other hand, the lack of proper checks and balances due to the scarce voting and supervisory power of the token holders may make it almost impossible to even assess whether the funds have been spent as opposed to held in cash or used to buy back tokens.

The final key question is about the degree of disclosure of the enterprise profits and how such disclosure will be regulated and enforced by the Securities Act. Aside from the promoter, who will control the company and what are the governance tools for the token holders?

All these questions suggest that the general protection afforded to the investors does not differ from the statutory regulation ("Securities Act") already existing for securities as well as the more flexible Law of Tort ("fiduciary duty"). Both will apply and can be used to protect token holders.

Shareholder value vs. firm value

Let us consider the role of boards and some key questions they face. How might they guarantee that companies issuing tokens do not engage in Ponzi schemes by, for example, distributing fundraising proceeds to some token holders or founders? Also, how can they ensure that cash is in fact invested? What is the degree of disclosure in the market beyond some almost unintelligible GitHubs?

The requirements for boards should at least formally be the same as the ones of board members in normal companies. In many countries, existing corporate governance mechanisms incentivise boards to act in the interest of the firm ("best business judgement"). This implies maximising shareholder value only when aligned with firm value. Of course, the key question is whether token value coincides with firm value or with shareholder value. In cases where the token is anything other than equity, the business has two distinct value systems. Operations such as token issuance or token repurchase should maintain fairness among the investors.

If the board determines that shareholder value can be unlocked through the issuance of a new token, it can do it even if this puts downward pressure on the price of the token as this will raise cash for investment. Similarly, the board may authorise the repurchase of tokens in order to increase the firm value – and therefore shareholder value.

For example, **Ripple** was revealed to have purchased some US$46 million worth of XRP tokens in the third quarter of 2020. Ripple claimed that it had done so in order to support "healthy markets" and that the buybacks could continue to support the brand's new Line of Credit initiative. The fact that the clients are paid in tokens to use their product and that the very same clients publicly state that they immediately dump the token for cash places a negative selling pressure on the token that Ripple can offset by buying back tokens. Of course, the ability of the clients to offload their tokens allows Ripple to capture market share and cultivate customer relationships. This maximises firm value.

In this case, as with standard companies, the buyback of equity does not need to be facilitated by retained earnings, as it is by itself instrumental in gaining market share and therefore increasing profits.[1]

The rights of token holders

So far, these governance issues are not different from the ones in normal companies except for the ability of the token holders to enforce their rights. This is the major issue with tokens. While in a normal company the shareholders can protect themselves through their voting rights, this is very highly restricted in the case of token-based businesses as voting rights are often null or replaced by usage rights. In such cases, protection will not go through the ordinary apparatus of assembly of shareholders and the board they elected.

These questions must be addressed by the regulatory authorities and require clear intervention that replaces the role traditionally played by boards and shareholders. In fact, in the absence of the latter, the main alternative is more flexible and effective supervision by regulatory authorities. Rules around token governance, issuances, buybacks and disclosures would need to be implemented. This would in fact make blockchain-based financing much more regulated than traditional stock exchanges.

Alternatively, a new set of "analysts", more skilled in checking the engineering-related intricacies of the GitHubs, should arise. They would play a role similar to the rating agencies and should cater to "enforcers" acting as short-sellers. Indeed, the ultimate regulation that will survive will be action of the short-sellers – the best enforcer of governance even in traditional markets.

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[1] Regulators, however, are still uncertain about the applicability of this principle to the world of tokens, as evidenced by **the SEC filing against Ripple.** The **WSJ** wrote, "Ripple has earned more than $700 million from selling XRP to the public since its founding in 2012, according to the SEC, which said the company had generated only $23 million in revenue from sales of software through 2019."

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