Governance Needed for Initial Coin Offerings

By Andrew Shipilov , INSEAD Professor of Strategy

Traditional board-like governance can provide credibility for companies raising capital via ICOs.

The market for initial coin offerings (ICOs) is booming. The latest example is Telegram's plans to attract US$1.2 billion in funding. With all the hype, there is surprisingly little said about the importance of ICO governance. The problems of governance are not unique to Telegram; they apply to any company that wants to attract investors' money.

The wild swings in the value of cryptocurrencies and the lack of official recognition for them suggest that ICOs are riskier that investing in the stock market's initial public offerings (IPOs). However, both IPOs and ICOs are subject to the same principal-agent problem: The agent (e.g. issuing company) makes decisions on behalf of principals (e.g. investors in tokens). The agent's interests might not always be aligned with those of the principals. For example, should the founding team increase its compensation or invest funds in ecosystem growth? In an ICO, investors buy virtual tokens, but they cannot be considered company shareholders in a conventional sense. ICOs are not regulated. But token investors contribute their capital to the company’s operations. Hence, investors should be entitled to at least some mechanisms that would align their interests with those of the management team.

One solution for the ICO issuers could be to create a board of directors. Just like in the non-cryptoworld, the board should consist of individuals who ensure that the company works in the interests of token holders. Where should companies find directors? One option could be **token-curated registries**. To simplify, imagine a platform where potential directors submit their profiles to be considered by the broad community as a “qualified ICO director”. To post their profile, these individuals also put a significant monetary deposit. Individuals deemed by community members to have good potential director qualifications get on the list and get their money back. Those who are not chosen, lose their deposit. Companies that plan ICOs could draw directors from these **lists**.

Conventional boards can disagree with the CEOs and even replace them. This would be difficult to implement in the cryptoworld (e.g. it is hard to think that any board can replace Telegram’s founder Pavel Durov), but the board should be able to publicly object to the company’s strategy and/or value-creation approach. One can envision an open registry that gathers directors’ votes on the company’s plans. The investors would see an aggregate index of the extent to which directors agree with the founders. Investors could then take notice of variations in this index and react by buying or selling tokens. If the board mostly agrees that the founding team continues to act in the interests of the investors, this could help to boost the token price. Directors could identify themselves with unique IDs and their votes made visible to all.

Follow the money

Normally boards have an audit committee which validates the company’s accounts. Blockchain technology should help facilitate this committee’s work. If one can trace how the money is spent on blockchain across different accounts, then one should also be able to trace how the company spends the money it collects from token sales. I am not sure how much disclosure of the company’s financials is necessary, but those who put their money into the company ought to know whether the value of their tokens is justified. Just like in a conventional annual report, token owners ought to know what their company’s costs and revenues are, where they come from and how they evolve over time. And the board should validate these results by public votes.

Most of the ICOs already have “advisors”, i.e. individuals with some credentials in the cryptoworld (and beyond) whose reputation could suffer if the company goes under. But reputational penalties in case of company failure are unlikely to be enough: The interests of directors should be very strongly aligned with the company’s long-term health. For example, the directors should get all their compensation in the form of tokens with a delayed maturity (e.g. every 12 months). Essentially these compensation tokens could be released via smart contracts, unlocking value for directors upon attainment of previously agreed milestones. If the tokens become worthless within 12 months, newly allocated tokens should be worthless too.

A recent idea by Vitalik Buterin, the creator of Ethereum, is to improve the ICO funding model by incorporating elements of decentralised autonomous organisations (DAOs). After an ICO, investors’ money goes into a smart contract (called **DAICO)** controlled by token holders, ideally, the investors themselves. At certain intervals after the ICO, the investors can be asked whether they are willing to release a new pool of funds from the contract to the development team, subject to the achievement of certain milestones. One can imagine a variation of DAICO in which only company directors are authorised to initiate such polls.

Leaders of some companies that now plan their ICOs have a disdain for any form of authority and think of an ICO as a way to quickly crowdfund capital. However, the board should be more than a vehicle to run a company; it should also be a mechanism of oversight. The pioneering leaders who create board-like governance mechanisms prior to launching ICOs will be sending a signal of their quality to the investors that would be difficult for a lower-quality company to replicate. After all, trust is and will always be the most important currency in either physical or digital world. Even for Telegram.

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