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Initial Coin Offerings (ICO's): serious risks

The AFM is issuing a warning regarding serious risks associated with Initial Coin Offerings (ICOs). While the AFM recognises the potential of blockchain technology for financial services, ICOs are currently vulnerable to misrepresentation, fraud and manipulation. ICOs may also be structured in such a way that they are not subject to supervision by the AFM. In addition, due to their unregulated status and the anonymous nature of the transactions involved, ICOs are attractive for the laundering of money obtained by criminal means. The current hype surrounding cryptocurrencies and ICOs may blind investors to these risks. Because of these risks, there is a strong possibility that investors will lose their entire investment. Given the circumstances, the AFM's current advice to consumers is to avoid investing in ICOs.

What is an ICO?

An ICO is a way for companies – usually start-ups – to obtain funding for the development of services. With an ICO, the provider issues digital tokens by means of blockchain technology. ICOs have a cross-border nature: in principle, anyone with Internet access and a digital wallet can buy these tokens. The tokens may sometimes be purchased in euros or dollars, but more frequently in cryptocurrencies, such as Bitcoin or Ethereum.

Tokens vary widely in their design and function. Usually they represent a (prepaid) entitlement to the service to be developed, which may be a reward, or even have no value whatsoever. It may also be that they give entitlement to a share in a project or a portion of the expected returns. ICOs are often structured in such a way that they fall outside the scope of financial supervision. The protection offered to investors by financial regulation is therefore not applicable. Apart from a few exceptions, the AFM can therefore not exercise any supervision of ICOs.

In the current hype, the risks of ICOs are a dangerous cocktail

There are increasingly often reports in the media about consumers investing in ICOs with money intended for later, or even with large amounts of borrowed money. They are afraid to miss the boat and hope that the price of the tokens will rise as explosively as the price of Bitcoin. The promise of high returns can, however, make investors blind to the serious risks associated with ICOs. In combination with the recent explosive growth of ICOs, which displays all the hallmarks of a hype, these risks form a dangerous cocktail for investors. Investors run the risk of losing their entire investment. For this reason, the AFM currently considers ICOs to be unsuitable for retail investors. In addition to the AFM's previous warning regarding investment in cryptocurrencies, the AFM notes the following specific risks with respect to ICOs:

ICOs are currently an ideal means for fraudsters

The cross-border nature of blockchain technology means that private investors around the world are able to participate in an ICO. At the same time, the anonymous and cross-border nature of blockchain technology enables advanced forms of a traditional pyramid scheme that are difficult to recognise. The current hype of ICOs thus forms an ideal opportunity for fraudsters to take advantage of investors who are afraid to miss the boat. There have been several examples of fraudulent ICOs outside the

Netherlands, and the AFM has serious concerns regarding the risk that investors in the Netherlands could be misled.

Example

The US supervisor, the Securities & Exchange Commission, has recently brought charges against the issuers of two ICOs (REcoin Group Foundation and DRC World), among other things because they have provided false and misleading information to investors ([url: https://www.sec.gov/news/press-release/2017-185-0](https://www.sec.gov/news/press-release/2017-185-0)) . They promised high returns from activities in relation to real estate and diamonds while in fact the providers were not involved in any of the promised activities.

Exaggeration of expected returns

Many investors let themselves be tempted by the promise of tremendous returns, but they are not sufficiently aware that this is a development that is still very much in its infancy. As with the Internet bubble at the beginning of the century, the promise of new business models enabled by new technology – in this case blockchain technology – generates the risk of overoptimistic expectations. It is very likely that these expectations will not be realised. The reality is that the projects in an ICO are in a very early stage of development, meaning that it is highly uncertain whether the promised plans can be realised. And even if they are realised, there is a high risk that the ultimate value of the product or service will be far too low in comparison to the amount invested. Furthermore, the underlying blockchain technology is itself still in the development phase, meaning that there are real risks of errors in the code or theft of the tokens. This could lead to permanent loss of the tokens, or access to the tokens.

The knowledge and expertise required is underestimated

Until recently, investing in start-ups was restricted mostly to professional parties with specialist knowledge and experience. Blockchain technology, however, enables start-ups to obtain financing through an ICO from anyone with an Internet connection and a digital wallet. Most retail investors underestimate the specialist knowledge and expertise needed to be able to make a well-informed decision regarding this kind of investment. Without this expertise and in-depth knowledge of blockchain technology, it is virtually impossible to distinguish viable business models from projects with little or no added value.

Lack of transparency

The providers of ICOs are often not transparent when it comes to the information they provide to investors. Essential and basic information such as the risks of the project, the rights of the holder of the tokens, or how the financing will be used is described in very summary terms or even not at all. Without this kind of information, it is almost impossible for investors to assess the true value of an ICO and to distinguish bona fide ICOs from fraudulent projects. This lack of transparency is also an obstacle to efficient pricing of the tokens.

Market driven by speculation and even manipulation

In the current environment, many people invest in ICO's with speculative goals in mind. They are investing in the hope of being able to sell their tokens quickly at a higher price. This highly speculative feature of ICOs is contributing to very high volatility in the prices of tokens traded on specialist trading platforms. These platforms are not subject to financial supervision. Daily price fluctuations of tens or even hundreds of percentage points are not unusual. The tradability of many tokens is moreover limited, meaning that it is relatively simple for malicious parties to manipulate prices.

Anonymity is an ideal cover for criminal money

There is little or no possibility of tracing transactions in cryptocurrencies, including tokens in an ICO, to natural persons due to their decentralised and anonymous nature. In addition, large amounts of money can be raised through ICOs in a short period of time. This makes ICOs an attractive vehicle for laundering

criminal money. Services relating to ICOs or cryptocurrencies by financial institutions can therefore quickly create a serious conflict with the statutory requirements for the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

Example

Most ICOs offer the possibility of purchasing the tokens with other cryptocurrencies such as Bitcoin. It is very possible that criminals will use an ICO to launder the Bitcoins they purchased with money obtained by criminal means. They can then sell the tokens obtained on a trading platform for cryptocurrencies in exchange for euros or dollars, and have the money transferred to their bank account.

International

Supervisors around the world have warned of the risks associated with ICOs, including the UK Financial Conduct Authority (url: <https://www.fca.org.uk/news/statements/initial-coin-offerings>) , the US Securities and Exchange Commission (url: https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings) , the People's Bank of China (url: <http://www.nifa.org.cn/nifa/2955675/2955761/2967610/index.html>) , the German Bundesanstalt für Finanzdienstleistungsaufsicht and the Securities and Futures Commission of Hong Kong (url: <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR117>) . At European level, the AFM is proposing that more clarity should be provided with respect to the status and risks of ICOs. At European level, the AFM is proposing that more clarity should be provided with respect to the status and risks of ICOs via the European Securities and Markets Authority (ESMA), the European securities markets regulator. At international level, the AFM is involved with efforts by IOSCO (International Organization of Securities Commissions), the global cooperation between securities commissions, with respect to the developments surrounding ICOs.

Information for consumers

What is blockchain technology?

Blockchain technology is based on the principle of openness and a decentralised system. A blockchain consists of a network of computers that are not exclusively owned by a single participant. Using algorithms, all the participants in the network decide which information (such as transactions executed via the network) is valid and which is not. This information is included in blocks that together form a chain (leading to the term 'blockchain'). All the participants in the network thus possess the same information in the blockchain at any one time, in the form of a single shared ledger. This makes it impossible for individual participants to manipulate information. There are many variants of a blockchain, of which Bitcoin is the best known application. Many blockchains are open in nature. Anyone with access to the Internet can use such a blockchain, for example to execute transactions. The participants in the network then verify these transactions and include the valid transactions in the blockchain.

Difference between an ICO and a cryptocurrency

There is no clear distinction between cryptocurrencies such as Bitcoin and tokens issued via an ICO. Both terms are frequently used interchangeably. One important distinction in this context is that anyone with some understanding of programming can create and issue tokens, while cryptocurrencies such as Bitcoin are created by an algorithm with a previously determined set of rules. Cryptographic techniques are used to regulate the creation of the units (known as mining) and to verify transactions on the decentralised blockchain network. The volume of units (such as Bitcoins) issued and how their issuance is to be regulated are thus determined in advance. So-called 'miners' receive Bitcoins as payment for finding blocks. This requires a lot of computing power. The transactions in Bitcoins are recorded in these blocks. The block is then added to the existing chain of blocks. Since every participant in the network has a copy of this chain, it is impossible to interfere with the transactions recorded in the blocks.

Digital tokens, on the other hand, are units that are often created on an existing blockchain. The designer of the tokens can decide how many tokens they wish to create, and which other functionalities will be added to the token. Most of the recent ICOs concern digital tokens issued on the Ethereum blockchain. The Ethereum blockchain was designed specifically for this purpose.

Difference between warnings ICOs and virtual currency

In both these situations, the AFM is warning against a hype that can lead to rash investment decisions. The risks mentioned are similar, but they are more serious in the case of ICOs, due to the ease with which issuers can raise large amounts of money in a short space of time. There have, for instance, been ICOs that have raised millions of euros in a fraction of hours, minutes and even seconds. This means that the risks associated with ICOs are even more serious than those associated with virtual currency. Given these circumstances, the AFM does not consider ICOs to be suitable for retail investors at this point in time, regardless of whether they invest with borrowed money or money that they cannot afford to lose. This is a separate consideration from the risks associated with cryptocurrencies that the AFM has mentioned previously.

Why are ICOs not supervised by the AFM?

The scope of the AFM's supervision is established in the Financial Supervision Act (Wet op het financieel toezicht, or Wft). The AFM assesses whether an ICO is subject to its supervision on a case by case basis, based on the definitions in the Wft. Most ICOs are (intentionally) structured in such a way so that they are not covered by the Wft and therefore are not subject to supervision by the AFM. Only under certain circumstances, depending on the structuring of the tokens, there can be activities that fall under the scope of the Wft. This may be the case if the tokens represent a share in the project or give entitlement to a part of the future returns. Consumers suspecting that an ICO is subject to supervision by the AFM can notify this to the AFM Financial Markets Hotline ([url: /en/over-afm/contact/consumenten](http://en/over-afm/contact/consumenten)) .

Is the AFM against ICOs in principle?

The AFM has issued warnings in relation to the hype surrounding cryptocurrencies and ICOs, which in combination with the above-mentioned risks could lead to serious disappointments for investors. Investors may lose their entire investment. Because the transactions are anonymous, malicious parties can use ICOs to defraud investors. There is also the danger that investors have excessive expectations. The AFM currently considers these risks to be serious enough that it believes that ICOs not subject to financial supervision are not appropriate for retail investors at this time.

For issuers of ICOs:

When does an ICO fall under the Financial Supervision Act (Wet op het financieel toezicht, or Wft)?

Most tokens can be structured, for instance in the form of a (prepaid) entitlement to a future service of the issuer, so that they fall outside the scope of the Wft. One exception to this is if the token for instance represents a share in the project or if the token gives entitlement to part of the (future) returns from the project. In these circumstances the token may qualify as a security or a unit in a collective investment scheme as defined in the Wft. The AFM assesses each case separately to determine whether the Wft applies and will closely supervise whether or not the Wft might apply. Potential issuers need to properly analyse the extent of any overlap with financial regulation and supervision before launching their ICO.

Qualification of a security (effect)

In each case, it has to be determined whether a token qualifies as a security as defined in Section 1:1 Wft on the basis of the token's legal and other features. In line with the definition in this Section, it is important to establish the extent to which the token qualifies as a negotiable instrument that is equivalent to a

negotiable share or other negotiable instrument or an instrument equivalent to a right. A token may also qualify as a security if it represents a negotiable bond or other negotiable debt instrument.

A token additionally qualifies as a security if a share or bond can be acquired through the exercise of the rights attached to a token or through conversion of these rights. Lastly, a token meets the definition of a security if it is a negotiable security that can be settled in cash, where the amount to be settled depends on an index or other measure.

For a token to qualify as a security equivalent to a share, one important consideration is whether the token holders participate in the company's capital and receive a payment for this. This payment must correspond to the return achieved with the invested capital. Any controlling rights are not decisive in this respect. The AFM moreover uses a wide and economic approach for the term negotiability. Further information on this is available in the Negotiability Policy Rule ([url: https://www.afm.nl/~profmedia/files/wet-regelgeving/beleidsuitingen/beleidsregels/beleidsregel-verhandelbaarheid.ashx](https://www.afm.nl/~profmedia/files/wet-regelgeving/beleidsuitingen/beleidsregels/beleidsregel-verhandelbaarheid.ashx)) of the AFM.

If the tokens qualify as a security, a prospectus approved by the AFM is compulsory – to the extent that no exception or exemption applies. Further information is available on the AFM website ([url: /en/professionals/doelgroepen/effectenuitgevende-ondernemingen/aanbieding-notering-effecten/prospectusplicht](https://en.professionals/doelgroepen/effectenuitgevende-ondernemingen/aanbieding-notering-effecten/prospectusplicht)) . In any case, investment firms facilitating trading in such securities must observe the requirements with respect to the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

Qualification of unit of participation in collective investment scheme

An ICO is subject to financial supervision if it concerns the management and offering of units in a collective investment scheme. This is the case if an issuer of an ICO raises capital from investors in order to invest this capital in accordance with a certain investment policy in the interests of those investors. The funds raised have to be used for the purpose of collective investment so that the participants will share in the proceeds of the investment. An increase in net asset value also qualifies as the proceeds of an investment. In this connection, among other things the AFM applies the guidelines published by ESMA on key concepts of the Alternative Investment Fund Managers Directive ([url: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma_2013_00600000_nl_cor.pdf%20](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma_2013_00600000_nl_cor.pdf%20)) .

Under Section 2:65 Wft, a licence from the AFM is required for the offering of units in a collective investment scheme unless the issuer is eligible for the registration regime. Further information is available here on the AFM website ([url: /en/professionals/doelgroepen/aifm/aifm](https://en/professionals/doelgroepen/aifm/aifm)) .

Trading of tokens falling under the Wft

Platforms facilitating the trading of tokens falling under the Wft also require a licence from the AFM for the provision of investment services pursuant to Section 2:96 Wft. Further information is available on the AFM website ([url: /en/professionals/doelgroepen/beleggingsondernemingen](https://en/professionals/doelgroepen/beleggingsondernemingen)) . Potential issuers considering an ICO and wishing to issue it subject to financial supervision may contact the InnovationHub ([url: /en/professionals/onderwerpen/innovation-hub](https://en/professionals/onderwerpen/innovation-hub)) of the AFM and DNB for any questions.

Is the AFM against ICOs in principle?

The AFM's current warning relates to the rapidly increased popularity of ICOs, which in combination with the above-mentioned risks could lead to serious disappointments for investors. Because the transactions are anonymous, malicious parties could use ICOs to defraud investors. There is also the danger that investors have excessive expectations. In addition, the lack of transparency increases these risks.

This warning has nothing to do with the AFM's recognition of the importance of innovation in the financial markets and that fintech and other companies wish to be able to raise capital by such means. Potential issuers considering an ICO and wishing to issue it subject to financial supervision may contact the InnovationHub ([url: /en/professionals/onderwerpen/innovation-hub](https://en/professionals/onderwerpen/innovation-hub)) of the AFM and DNB for any questions.

Information for financial institutions wishing to provide services relating to cryptocurrencies

The Money Laundering and Terrorist Financing (Prevention) Act (Wet ter voorkoming van witwassen en financieren van terrorisme, Wwft) and the Sanctions Act 1977 (Sanctiewet or 'Sw') apply to financial institutions in order to prevent the financial system from being used for criminal activities. In this connection, the AFM supervises collective investment schemes and investment firms, among others. Like DNB (url: <https://www.dnb.nl/nieuws/dnb-nieuwsbrieven/nieuwsbrief-betaalinstellingen/nieuwsbrief-betaalinstellingen-juli-2014/dnb309446.jsp>) , the AFM takes the view that financial institutions involved in or wishing to become involved in services related to cryptocurrencies, including the tokens offered via an ICO, may be exposed to serious integrity risks. In particular, the anonymous nature of cryptocurrencies leads to potentially serious conflict with the following requirements.

Know your client

Institutions must continually establish and identify the identity of customers and the ultimate beneficiary or beneficiaries. The term 'client' has to be very widely interpreted in this context. This means that institutions must also trace and establish the identity of the legal or natural person effecting a cryptocurrency transaction, also for commercial relationships. Data and documentation from a reliable and independent source must be used for this.

Reporting of unusual transactions

If an institution has reason to believe that a transaction involves money laundering or the financing of terrorism, it must report this immediately as an unusual transaction to the Financial Intelligence Unit-Nederland (url: <https://fui-nederland.nl/nl>) (FIU-Nederland) . The term 'transaction' has to be very widely interpreted and is not restricted to a transfer.

Screening for inclusion on sanction lists

Institutions must screen anyone involved in a financial service or transaction for inclusion on national and international sanction lists, both on inception of the service and periodically. Institutions must report a 'hit' immediately to the AFM and, depending on the sanction, must cease providing certain services with immediate effect.

Further information on the supervision of the AFM under the Wwft (url: </en/professionals/onderwerpen/wwft-wet>) and the Sanctions Act (url: </en/professionals/onderwerpen/sanctiewet>) is available on the AFM website.

The AFM is committed to promoting fair and transparent financial markets. As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

Read more about the supervision of the AFM.

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