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Digital Offerings and Mandatory Disclosure: A Market-Based Critique of MiCA

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Abstract

In this paper we argue that, as market mechanisms have worked acceptably well and there has been no investor protection crisis, ICOs and IEOs have so far failed to offer arguments in favour of a mandatory prospectus-like regime. Investors in the blockchain space know where to get information and what they risk. Accordingly, we offer a preliminary market-based critique of MiCA's white paper regulation, arguing that blockchain startups offering securities or utility tokens should be left free to decide what information to offer to investors, as long as the information provided is free from false or misleading statements, and does not omit any material fact. We also argue, contrarily to the Commission's proposal, that to facilitate private enforcement the burden of proof in liability actions should be on the issuer and not on the investor. This approach would offer a chance to reduce red tape and return to a more manageable regime, where general provisions against fraud and misrepresentation are applied with well-defined private liability rules and burden of proof allocations. As a result, blockchain startups would not only be left free to signal their quality and develop their channels of communication with potential investors, but concurrently also be effectively responsible for the information provided.

Keywords: financial regulation; mandatory information; prospectus; digital offerings; initial coin offerings; ICO; MiCA; Regulation on Market in Crypto-Assets

JEL Classifications: K22

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Digital Offerings and Mandatory Disclosure: A Market-Based Critique of MiCA

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In this paper we argue that, as market mechanisms have worked acceptably well and there has been no investor protection crisis, ICOs and IEOs have so far failed to offer arguments in favour of a mandatory prospectus-like regime. Investors in the blockchain space know where to get information and what they risk. Accordingly, we offer a preliminary market-based critique of MiCA's white paper regulation, arguing that blockchain startups offering securities or utility tokens should be left free to decide what information to offer to investors, as long as the information provided is free from false or misleading statements, and does not omit any material fact. We also argue, contrarily to the Commission's proposal, that to facilitate private enforcement the burden of proof in liability actions should be on the issuer and not on the investor. This approach would offer a chance to reduce red tape and return to a more manageable regime, where general provisions against fraud and misrepresentation are applied with well-defined private liability rules and burden of proof allocations. As a result, blockchain startups would not only be left free to signal their quality and develop their channels of communication with potential investors, but concurrently also be effectively responsible for the information provided.

1. Introduction

Initial Coin Offerings (ICOs) and Initial Exchange Offerings (IEOs) have raised a lively international debate on whether digital tokens issued by blockchain startups should be characterized as securities (US) or financial instruments (EU) and therefore whether registration requirements (US) or prospectus regulation (EU) should apply to token offerings. In a paper co-written with a financial economist, we argued that under the European Prospectus Regulation[1] a large part of token offerings should be treated as financial instrument offerings.[2] However, the debate has not been accompanied by a

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[1] Regulation 2017/1129 [2017] OJ EU L168/12.

[2] *Dmitri Boreiko/Guido Ferrarini/ Paolo Giudici*, "Blockchain Startups and Prospectus Regulation", European Business Organization Law Review 2019, 20, 665. See also *Guido Ferrarini/Paolo Giudici*, Transferable Securities and Prospectus Regulation: The Case of ICOs, in: Danny Busch/Guido Ferrarini/Jan Paul Franx (ed.), Prospectus Regulation and Prospectus Liability, 2020, p. 129; *Philipp Hacker/Chris Thomale*, "Crypto-

wider discussion concerning policy issues. There has been discussion on the benefits of not suffocating the rising digital market with excessive regulatory burdens, also considering that ICOs have a worldwide dimension with teams and target investors potentially operating in any part of the world. Nevertheless, a deeper analysis of the overall policy issues concerning mandatory disclosure in securities regulation has not been conducted with respect to the ICO phenomenon. We would like to raise this issue here, also in the light of the new proposal for a regulation on Markets in Crypto-assets submitted by the Commission on 24.9.2020 ("MiCA").[3]

The paper proceeds as follows. We start from the theoretical underpinning of mandatory disclosure and the empirical evidence regarding its allegedly positive effects, in order to show that the consensus over the virtues of this regulatory technique is only apparent (paras. no. 1 and 2). We then analyse some recent cases where the role of mandatory disclosure has been debated, namely equity crowdfunding regulation and high leveraged loan securitizations (para. no. 3). Then we move to ICOs and IEOs, to show how blockchain startups have sought to signal quality through their white papers and other communication mechanisms, and how the academic literature has assessed those attempts (paras. no. 4 and 5). We then offer a brief analysis of MiCA, focusing exclusively on the mandatory disclosure regime that the proposal would like to apply to crypto-assets (paras. 6 to 8) and on the liability regime that it presents, which curiously is not favourable to investors (para. 9). In the last paragraph we present our tentative proposals and conclusions.

Securities Regulation: ICOs, Token Sales and Cryptocurrencies under Eu Financial Law", European Company and Financial Law Review 2018, 15, 645.

[3] See the Proposal for a Regulation on Markets in Crypto-assets, and amending Directive (EU) 2019/1937, COM(2020) 593/3 2020/0265 (COD). The proposal is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593 (last access 5 February 2021).

1. The debate concerning the theoretical underpinnings of mandatory disclosure

The proposed inclusion in MiCA of a white paper regime with mandatory disclosure requirements, similar to the prospectus regime, for utility tokens might appear so obvious that it requires no discussion. As the argument goes, more information is better than none; and almost anybody dealing with mandatory disclosure regimes has pointed out that they are aimed at solving the problem of asymmetric information, which gives rise to a market failure.[4] A believer in mandatory disclosure would also argue that the uncontested theoretical literature is in favour of mandatory disclosure and that this should be sufficient to justify the extension of mandatory disclosure to any type of digital offerings.

However, the views in the theoretical literature are more nuanced. With regard to securities regulation, several arguments have been offered to justify its extensive disclosure regime, whose essential goals relate to the protection of investors and market efficiency. However, many of these arguments contradict one another and the different views are far from settled. We cannot review here all the extensive literature that discusses the pros and cons of a mandatory disclosure regime in securities regulation, but can only quickly refer the reader to that literature. The relevant scientific discussion concerns the extent of mandatory financial disclosure and its real purpose;[5] the selection

[4] "Recall that the essential problem with the public offering of truly new securities is the adverse selection that arises from a situation of severe information asymmetry. (…) Without solutions to this information-asymmetry problem, the market will unravel" *Merritt B. Fox*, "Regulating Public Offerings of Truly New Securities: First Principles", Duke LJ 2016, 66, 673, 719.

[5] Cf *Paul G. Mahoney*, "Mandatory Disclosure as a Solution to Agency Problems", University of Chicago Law Review 1995, 62, 1047; *John C. Coffee Jr.*, "Market Failure and the Economic Case for a Mandatory Disclosure System", Virginia Law Review 1984, 70, 717; more recently, *Luca Enriques/Sergio Gilotta,* Disclosure and Financial Market Regulation, in: Niamh Moloney/Eilís Ferran/Jennifer Payne (ed.) The Oxford Handbook of Financial Regulation, 2015, p. 511; *Kevin Haeberle/Todd Henderson*, "A New Market-Based Approach to Securities Law", University of Chicago Law Review 2018, 85, 1313; *Henry T. C. Hu*, The Disclosure Paradigm: Conventional Understanding and Modern Divergences, in: Danny Busch/Guido Ferrarini/Jan Paul Franx (ed.), Prospectus Regulation and Prospectus Liability, 2020, p. 99.

of the most appropriate regulator, with particular reference to the costs and benefits of regulatory competition compared to those of centralized or highly harmonized regulation;[6] and the possibility of any serious cost and benefit analysis in the field of securities regulation and mandatory disclosure.[7]

We would like to point out here, with regard to what we will discuss vis-à-vis MiCA, that there is an aspect of the debate that is not sufficiently stressed. The arguments in favour of mandatory disclosure and, in particular, mandatory disclosure in connection with public offerings by issuers who are new to the market, being based on the asymmetric information problem, are articulated with no distinction between retail and professional investors, since asymmetric information concerns any person and entity different from the issuer. However, both US and European law accord exemptions to private placements, thereby recognizing that market-based solutions can work when professional investors are concerned, mostly because the collective action problems that are at the basis of the asymmetry of information rationale can be sorted out. With regard, in particular, to European law, the Prospectus Regulation provides for an exemption when the offer of securities is addressed solely to qualified investors and there is no admittance of the securities to trading on a regulated market within the EU.[8] If the

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[6] *Paul G. Mahoney*, "The Exchange as Regulator", Virginia Law Review 1997, 83, 1453; *Roberta Romano*, "Empowering Investors: A Market Approach to Securities Regulation" Yale Law Journal, 1998, 107, 2359; *Stephen J. Choi*, "Regulating Investors Not Issuers: A Market-Based Proposal", California Law Review 2000, 88, 279. See also *Emilios Avgouleas/Guido Ferrarini*, A Single Listing Authority and Securities Regulator for the CMU and the Future of ESMA: Costs, Benefits, and Legal Impediment, in: Danny Busch/Emilios Avgouleas/Guido Ferrarini (ed.), Capital Markets Union in Europe, 2018, 4.01.

[7] *Eric Posner/E. Glen Weyl*, "Benefit-Cost Analysis for Financial Regulation", 103 American Economic Review 2013, 103, 393; *John C Coates IV*, "Cost-benefit analysis of financial regulation: Case studies and implications", Yale Law Journal, 2014, 124, 882; *Omri Ben-Shahar/Carl E Schneider*, "The futility of cost-benefit analysis in financial disclosure regulation" The Journal of Legal Studies 2014, 43, S253.

[8] *Frank Graaf*, Private Placements in the Capital Market Union, in: Danny Busch/Emilios Avgouleas/Guido Ferrarini (ed.), Capital Markets Union in Europe (fn. 6), ch. 14.

securities are offered to qualified investors and are traded on a multilateral trading facility, there is no prospectus obligation, even though the listing rules of the trading facility could require some voluntary light prospectus requirement. Accordingly, the mandatory disclosure regime should actually be referred to retail investors exclusively, since both EU and US law do not mandate disclosure in offerings addressed to professional, accredited or institutional investors. Thus, the prospectus regime is mainly a retail investor's regime of protection, and should be treated and discussed as such.

Unsurprisingly, therefore, securities regulation and its mandatory disclosure regime have been imitated in many different areas of regulation concerning consumer protection. A significant number of influential papers have pointed out, however, that this particular form of protection has been a spectacular failure, since consumers and retail investors do not read standard form contracts, prospectuses and disclosure documents, as any reader who is also a consumer can easily confirm through her own experience.[9] Accordingly, prospectus regulation is a large and expensive mandatory disclosure regime aimed at protecting people that do not read prospectuses.[10]

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[9] *Omri Ben-Shahar/Carl E Schneider*, More than you wanted to know: The Failure of Mandated Disclosure, 2014; *Omri Ben-Shahar/Carl E. Schneider*, "The Failure of Mandated Disclosure", University of Pennsylvania Law Review 2011, 159, 647; *Ian Ayres/Alan Schwartz*, "The no-reading problem in consumer contract law", Stanford Law Review, 2014, 66, 545.

[10] See *Emilios Avgouleas*, "The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform", European Company and Financial Law Review, 2009, 440, 466, advocating the use of economics experiments to test the impact of disclosure rules on investors and, in particular, lay investors; John Armour/Daniel Awrey/Paul Lyndon Davies/Luca Enriques/Jeffrey Neil Gordon/Colin P Mayer/Jennifer Payne, Principles of Financial Regulation, 2016, p. 160 et seqq.. Luca Enriques, EU Prospectus Regulation: Some Out-of-the-Box Thinking, www.law.ox.ac.uk/business-law-blog/blog/2016/05/eu-prospectus-regulation-some-out-box-thinking (accessed 7 February 2021): "when an offer is made with a view to having securities admitted to trading on a regulated market (ie, in IPOs), mandating disclosure may only serve the purpose of laying down once and for all the information items that sophisticated buyers and investment analysts would anyway deem necessary in order to price the securities. Retail investors are not users of issuer disclosures in this context. Rather, they free ride on the

2. The empirical research on mandatory disclosure is moot

Researchers have tried to understand the value, if any, of mandatory disclosure through empirical studies. These studies are not restricted to prospectus regulation, but cover mandatory disclosure in general. Empirical research does not support the mandatory disclosure paradigm. Indeed, it is a moot point whether mandatory disclosure increases global welfare. In a widely cited paper, Leuz and Wysocki review the literature on disclosure and financial reporting in search for an empirical ground for regulatory measures. However, they point out that researchers are far from being able to perform appropriate quantitative cost-benefit analysis, as there is no real evidence of the welfare effects of disclosure and reporting regulation.[11] In fact, studies increasingly consider as totally unrealistic the idea that disclosure provides a public good that can be easily used by investors. Reading and understanding lengthy information takes time and therefore requires a private investment, which transforms the apparent public good in a private one.[12] For example, there has been much discussion on whether financial statements have become less informative over time, since in the past investors used to respond immediately to financial statement releases that contained significant changes, while this announcement effect is currently less pronounced. In a recent and important paper, Cohen, Malloy and Guyen find that the lack of announcement returns is not caused by financial statements having become less informative, but by investors' lack of attention, which the authors suspect can be attributed to the increase in complexity and length of financial reports over the last 25 years.[13] This research outcome is important because it

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mechanisms (usually in the form of the bookbuilding process) that lead to setting an IPO price reflecting available information".

[11] *Christian Leuz/ Peter Wysocki*, "The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research", Journal of Accounting Research 2016, 54, 525.

[12] *Elizabeth Blankespoor/Ed deHaan/ Ivan Marinovic*, "Disclosure processing costs, investors' information choice, and equity market outcomes: A review" Journal of Accounting and Economics 2020, 70, 1.

[13] *Lauren Cohen/Christopher Malloy/Quoc Nguyen*, "Lazy Prices", The Journal of Finance, 2020, 75, 1371.

confirms that information acquisition is an expensive task and that information overload has economic effects.[14]

3. Crowdfunding and high leveraged loan securitizations

Empirical studies try to insulate situations where markets evolved without mandatory disclosure, in order to see what happened and infer policy indications for other markets. Two interesting natural experiments have been recently reported by the law literature. The first concerns investment-based crowdfunding. In the EU, investment-based crowdfunding is regulated also with respect to disclosure, but with a light-touch approach and less stringent requirements than for IPOs.[15] In fact, the securities distributed through crowdfunding platforms are offered in amounts which are usually set below the thresholds fixed either by the European Prospectus Regulation for its applicability (EUR 1,000,000) or by the individual Member States (under the option granted to them under the European Prospectus Regulation to increase this threshold up to EUR 8,000,000).[16] Consistently, the European Crowdfunding Services Providers Regulation will only apply to securities offered for a consideration below EUR 5,000,000.[17] In addition, the disclosure regime included in this Regulation is milder than

[14] *Troy Paredes*, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation", Washington University Law Quarterly 2003, 81, 417.

[15] *John Armour/Luca Enriques*, "The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts" Modern Law Review 2018, 81, 51; *Guido Ferrarini/Eugenia Macchiavello*, "Fintech and Alternative Finance in the CMU", in: Danny Busch/Emilios Avgouleas/ Guido Ferrarini (ed.), Capital Markets Union in Europe, 2018, 208, 10.45.

[16] See Articles 1 (3) and 3 (2) Prospectus Regulation. On the treatment of small offerings under this Regulation, see *Kitty Lieverse*, The Obligation to Publish a Prospectus and Exemptions, in: Danny Busch et al., Prospectus Regulation (fn. 2), 145, 7.25.

[17] See Art. 1 (2) (c) of Regulation (EU) 2020/1503 of 7 October 2020 on European crowdfunding service providers for business and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937, OJEU L347/1.

that found both in the European Prospectus Regulation and in MiFID II.[18] Before the Crowdfunding Services Providers Regulation and the Prospectus Regulation were adopted, the regime applicable to investment-based crowdfunding under *ad hoc* legislation in the Member States was similarly milder as to disclosure than that provided for public offers under the rules on prospectuses and on investment services.[19]

The lighter treatment of crowdfunding under national laws has contributed to the remarkable rise of crowdfunding in several Member States.[20] As one of us has argued in a previous paper from a comparative perspective, crowdfunding laws tend to favour capital formation by reducing transaction costs, while trying to protect investors from fraud.[21] However, the costs that crowdfunding investors face when assessing a new company are great in comparison to the amount invested by a single user. Such information costs are even higher with innovative start-ups, which typically do not provide a reasonable basis for forecasting future earnings and face the inherent uncertainty of innovation.[22]

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[18] See *Eugenia Macchiavello*, "The European Crowdfunding Service Providers Regulation and the Future of Marketplace Lending and Investing in Europe: the 'Crowdfunding Nature' Dilemma", forthcoming in European Business Law Review 2021, 3, available at https://ssrn.com/abstract=3668590 or http://dx.doi.org/10.2139/ssrn.3668590.

[19] See *Guido Ferrarini/Eugenia Macchiavello*, Investment-based Crowdfunding: Is MiFID II Enough?, in: Danny Busch/Guido Ferrarini (ed.), Regulation of the EU Financial Markets: MiFID II and MiFIR, 2016, p. 659.

[20] See the Explanatory Memorandum to the Commission's Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business, Brussels, 8.3.2018 COM(2018) 113 final, 2018/0048 (COD), and the accompanying Commission Staff Working Document including the Impact Assessment, where data on the EU crowdfunding market.

[21] See *Guido Ferrarini/Andrea Ottolia*, "Corporate Disclosure as a Transaction Cost: The Case of SMEs", European Review of Contract Law 2013, 9, 363, 375 seq.

[22] *Gerrit K.C. Ahlers/Douglas Cumming/Christina Guenther/Denis Schweizer*, "Signaling in Equity Crowdfunding", Entrepreneurship Theory and Practice 2015, 39, 4, 955.

Strengthening mandatory disclosure obligations to solve this problem may not be a viable solution since start-ups have no historical data nor relevant track records. The possibility for evaluating them may derive from the chance to analyse the quality of their innovations. However, in the absence of exclusive rights on such innovations, the indirect costs of disclosure would be particularly high. Crowdfunding investors should then benefit from market-based mechanisms of indirect disclosure, as when the funders have previously used the products or known the people that they decide to support and benefitted from the information received by their online or offline network. In the case of innovative start-ups, whose products or services cannot yet be tested, such voluntary mechanisms are more sophisticated and include patents, ties with venture capitalists and the services provided by crowdfunding portals.[23]

Accordingly, in the crowdfunding space market-based mechanisms are very important and probably are more effective than regulatory measures aimed at imposing mandatory disclosure. Indeed, it is reported that at least one jurisdiction decided to get rid of any form of mandatory information with regard to equity crowdfunding without negative consequences. A recent paper highlights the success of crowdfunding in New Zealand, where disclosure is purely voluntary and where no market unravelling has occured so far.[24]

The second natural experiment is probably even more interesting, given the volumes of the relevant markets. Elisabeth De Fontenay has shown that high leveraged loans are functionally similar to high yield bonds also with regard to the production of information by issuers (corporate debtors, in the loan world) who find appropriate incentives to

[23] See *Ferrarini/Ottolia* (fn. 21), 380, where the reader can find further references.

[24] *Andrew A. Schwartz*, "Mandatory Disclosure in Primary Markets", Utah Law Review 2019, 5, 1069.

inform even in the absence of mandatory disclosure.[25] ICOs similarly concern investor protection in truly primary offers and suggest another natural experiment.

4. ICOs and mandatory disclosure

When ICOs started and literally exploded in 2017 as a financial phenomenon, teams generally disregarded the possibility or even the risk that the offering could be characterized as a securities offering and therefore subject to registration with the SEC in the US or with national securities authorities elsewhere. There were many reasons for this general disregard of securities regulation, amongst which the idea that tokens could work and be considered like money, therefore escaping the rigours of securities regulation, or that utility tokens were very different from financial investments.

We do not want to repeat here the arguments that can draw token offerings either inside or outside securities regulation. We stress, however, that a large part of the ICOs which occurred in 2017-2018 had features that would certainly fit the arguments of believers in mandatory disclosure, apart from any legal assessment on whether the tokens offered in those ICOs could be characterized as securities or not. Consider, for instance, the so called "utility tokens", which present some type of functional utility to their owners, who use them to get access to a blockchain platform that offers some product or service. Utility tokens distributed through ICOs are almost invariably admitted to trading on crypto-exchanges through the efforts of their promoters. Investors can be interested to buy a token either in order to get cheaper access to the utilities that the pertinent platform will offer or to hold and then trade a crypto-asset that might increase in value in the future and be easily exchanged within the eco-system at issue or in crypto-exchanges.

No doubt, one of the reasons for their success is that ICOs help to solve the coordination problems that any new platform raises. Platforms benefit from network effects, since a

[25] *Elisabeth De Fontenay*, "Putting the Securities Laws to the Test", Regulation 2014, 37, 22; *Elisabeth de Fontenay*, "Do the Securities Laws Matter? The Rise of the Leveraged Loan Market", Journal of Corporation Law 2014, 39, 725.

user's utility increases with the number of those utilising the platform. The promoters try to solve this coordination problem by offering a stake in the future success of the platform to early potential users, who are therefore incentivized to embrace and support the platform, counting on the secondary market of tokens as a mechanism to trade future cash flows for present ones. Indeed, thanks to token tradability, early adopters can sell their tokens at a higher price when the platform is successful, thereby becoming vested in its success. As a result, lower incentives are needed to get early users to access the platform, thus reducing overall transaction costs.

In essence, and this is what concerns us here, tradable utility tokens are equivalent to equity, not as an investment in the company, but as an investment in the platform that the blockchain startup wishes to develop.[26] Consequently, token offerings are very similar to offerings of new securities and present many of the same problems that pushed securities regulators to the adoption of mandatory disclosure. The initial main target of those regulators were the problems created by newly formed companies with ambitious purposes, selling shares to the public for the first time. In particular, as argued by Paul Mahoney in a well-known paper, the mandatory disclosure system was introduced in order to combat a specific agency problem – the promoters' propension to use the cash raised by the sale of stock to enter into pre-arranged transactions between the newly formed company and entities owned by the promoters or their family and friends, with the purpose of getting part of the money contributed to the company by investors.[27]

From this perspective, ICOs truly represent a return to the past, also considering that they are structured as one round of financing. Since raising funds is not staged in ICOs and therefore is not a repeated game such as, for instance, in venture capital financing, there is a significant danger of fraud.[28] When promoting teams ask for money needed to finance

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[26] *Dmitri Boreiko/Guido Ferrarini/ Paolo Giudici* (fn. 2), 470 et seqq.

[27] Paul Mahoney (fn. 5).

[28] *Lars Klöhn/Nicolas Parhofer/Daniel Resas*, 'Initial Coin Offerings (ICOs): Economics and Regulation' (2018) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3290882 (last access 8 February 2021);

grandiose change-the-world projects through the blockchain, there are huge opportunities for self-enrichment through pre-arranged related party transactions at the expenses of gullible investors attracted by the lure of easy gains. Thus, ICOs offer a step back in history, in addition to being a natural experiment of what can happen today where mandatory disclosure does not exist.

5. Signalling quality in the ICO world

It is not a surprise that a large number of studies have sought to analyse what actually has happened in ICOs. The relevant papers show that investors have used several information sources to assess the quality of the token sale, such as GitHub, Twitter, Telegram/Slack/Discord, Bitcoinwiki, Facebook, Bitcointalk. As to issuers, many papers agree that good blockchain startups have been quite effective in signalling their quality. Yermack et al. find that liquidity and trading volume are higher when issuers offer voluntary disclosure, credibly commit to the project, and signal quality.[29] Rosemboom et al. find projects that disclose more extensive information to investors (i.e. have a higher profile rating) are more successful in fundraising, and experience more post-ICO project success; in addition, they find that a higher rating by cryptocurrency experts on both the quality of the project and project team is associated with more success in fundraising and better ex-post performance.[30] Zhang and others find that an ICO whitepaper narrative with more readable disclosures is likely to result in a higher initial return for ICO investors.[31] Fisch argues that a technical whitepaper and a high-quality code are

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Dmitri Boreiko/ Gioia Vidusso, "New blockchain intermediaries: do ICO rating websites do their job well?" The Journal of Alternative Investments 2019, 21, 67.

[29] *Sabrina T Howell/Marina Niessner/David Yermack*, "Initial coin offerings: Financing growth with cryptocurrency token sales", The Review of Financial Studies 2020, 33, no. 9, 3925.

[30] *Peter Roosenboom/Tom van der Kolk/Abe de Jong*, "What determines success in initial coin offerings?", Venture Capital 2020, 22, 161.

[31] *Shuyu Zhang and others*, "Readability of token whitepaper and ICO first-day return", Economics Letters 2019, 180, 58.

associated with increased ICO funding.[32] According to these results, blockchain startups can effectively and efficiently signal their quality to investors. [33] However, ratings do not seem to be indicative of ICOs' success and are so far not very informative.[34]

These results are not undisputed. Momtaz finds that firms exaggerate information in white papers; a moral hazard in signalling that investors only learn in the aftermarket, when the token price plummets.[35] Accordingly, Momtaz argues that, in the logic of the classic Akerlof model, the moral hazard in signalling may even entail a 'market for lemons,' and that good firms cannot credibly distinguish themselves from bad ones.[36] However, the same author recognizes that, even though the ICO market has been criticized for providing fertile soil for scams, using a conservative definition of what constitutes a scam, their number appears not so high (less than 40, measured presumably at the end of 2018).[37] Cohney et al. show that many ICOs failed even to promise that they would protect investors against insider self-dealing, and fewer still manifested smart contracts in code. Indeed, the authors point out that a significant fraction of issuers retained centralized control through a previously undisclosed code permitting

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[32] *Christian Fisch*, "Initial coin offerings (ICOs) to finance new ventures", Journal of Business Venturing 2019, 34. 1.

[33] Albrecht et al find evidence of significant relationships between startups' raised volume and a) the general blockchain discourse as measured by search trends; b) their average Twitter sentiment; c) increasing emotionality in their tweets towards the ICO end date: *Simon Albrecht/Bernhard Lutz/Dirk Neumann,* How Sentiment Impacts the Success of Blockchain Startups-An Analysis of Social Media Data and Initial Coin Offerings (2019)

[34] *Boreiko/Vidusso* (fn. **Error! Bookmark not defined.**), 11.

[35] *Paul P Momtaz*, "Entrepreneurial Finance and Moral Hazard: Evidence from Token Offerings", forthcoming, Journal of Business Venturing (available online 14 March 2020, 106001).

[36] *George A. Akerlof*, "The Market for "Lemons": Quality Uncertainty and the Market Mechanism" Quarterly Journal of Economics 1970, 84, 488.

[37] *Paul P. Momtaz*, "Initial Coin Offerings", Plos One 2020 (available online, last access 25 February 2021). The author makes reference to a presentation by Lars Hornuf and Armin Schwienbacher, which is commented infra in the text.

modification of the entities' governing structures.[38] However, their important paper does not analyse whether these problems affect capital raising and therefore does not offer evidence that decisively contradicts the signalling argument. Also Hornuf at al. seek to understand the incidence of fraud in ICOs.[39] Their working paper reports a high incidence of fraud. However, the authors classify as fraud a large number of situations, among which frauds that are induced by persons not related to the issuer, such as pump-and-dump schemes and, more importantly, phishing and hacking attacks, which the authors report as the most frequent example of fraud in their sample. As to issuer's and team's frauds, they classify as such, for instance, violations of registration requirements and ensuing SEC's actions, which they call "securities frauds" but which of course are not cases of fraud but cases of violation of mandatory disclosure rules. The most significant cases reported by the authors are "exit frauds", where the promoters get the money or the cryptomoney and then disappear. They report 21 suspected and 25 confirmed cases of exit fraud out of 1,393 ICOs considered in their sample, a number which looks extraordinarily low and which in any event should be assessed in the light of the money syphoned off more than the mere number of occurrences.[40] Thus, research does not seem to support the view that market mechanisms are not able to function when issuers have to signal their quality.

When moving from research papers to real life cases, there are no strong arguments that offer clear evidence that in the ICO market a mandatory disclosure regime is really needed in order to protect gullible investors. No doubt, there have been scams, but there is no clear evidence of significant cases showing the true capacity of fraudulent offerings

[38] *Shaanan Cohney and others*, "Coin-operated capitalism" Columbia Law Review 2019, 119, 591.

[39] *Lars Hornuf/Theresa Kück/Armin Schwienbacher*, "Initial coin offerings, information disclosure, and fraud" CESifo Working Paper No. 7962, 2019, available at SSRN (last access 25 February 2021).

[40] The concern should be on the ability of fraudsters to convince gullible investors to give money for nothing, and therefore an overall measure of this ability should consider how much money was taken in exit frauds compared to the overall money raised in ICOs.

to lure disingenuous investors. In the US there are class actions against many token issuers, but these class actions mainly claim that issuers did not comply with securities regulation and therefore cannot be used as evidence that prospectus regulation would have avoided the investors' problems and that prospectus regulation costs would be inferior to prospectus regulation benefits.[41]

Without any clear sign that voluntary disclosure is not working well or, from a different perspective, that the absence of a mandatory disclosure system has drawn millions of naïve investors around the world to put their wealth at risk in irrational token bets, ICOs might be a signal that it is time to rethink the mandatory disclosure paradigm. Possibly, today retail investors are different from those that populated the markets a century ago. In a world of social networks and open access to information, it is perhaps better to incentivize retail investors to find information through the channels that they prefer rather than insisting on their reading hundreds of prospectus pages, requiring issuers to draft them and regulators to take charge of the issue. It has been pointed out that rather than relying on traditional sources of information such as financial statements and SEC filings, professional investors have started looking at alternative data such as satellite imagery, social media posts, insurance policy,[42] and patents.[43] The ICO market seems to show a similar trend, but also referred to nonprofessional investors.

In the light of these conclusions, the regulation of ICOs and IEOs could be a starting point for a new approach to information regulation in primary markets, which gradually abandons the great regulatory costs of prospectus regulation and embraces a new era, for instance one with lesser micro-regulation of information channels and templates and more widespread enforcement of rules concerning true and correct information and against material omissions. The proposed MiCA instead follows the prospectus regulation paradigm, albeit with an apparent light touch.

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[41] On the complexities of cost and benefit analysis in this area see *supra*, fn. 7.

[42] *Hu* (fn. 5), 110

[43] *Ferrarini/Ottolia* (fn. 21), 18 et seq.

6. MICA in brief

On 24 September 2020, the European Commission published a much anticipated proposal on the establishment of an EU-level regime for crypto-assets, the Markets in Crypto-Assets Regulation (MiCA).[44] On the same day, the Commission also published a proposal for a regulation on a pilot regime for market infrastructures based on DLT.[45] The draft text of MiCA sets out a regime to regulate issuers of crypto-assets and providers of crypto-asset services, including exchanges, custodians, and firms providing investment type services in respect of crypto-assets. The effect of the MiCA proposal, if ultimately adopted, would be to bring substantially all crypto-assets within the perimeter of EU financial services regulation. The proposal would represent a significant expansion of the EU's regulatory perimeter and likely result in a significant upheaval for firms wanting to operate or promote a crypto-asset project in the EU or to provide services in respect of crypto-assets.

The Proposal of MiCA stresses that crypto-assets which qualify as financial instruments are already subject to the Markets in Financial Instruments Directive (MiFID). However, the Proposal does provide some crossover insofar as firms authorized under other EU directives and regulations could issue crypto-assets, provided that they comply with the additional disclosure obligations under MiCA. The Proposal then distinguishes the following types of crypto-assets: (i) e-money tokens, which are defined as crypto-assets the main purpose of which is to be used as a means of exchange, and that purport to maintain a stable value by referring to the value of a fiat currency that is legal tender; (ii) asset-referenced tokens, which are defined as those crypto-assets that purport to

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[44] *Supra*, fn. 1. For a preliminary comment of MiCA see *Dirk Zetzsche et al.*, "The Markets in Crypto-Assets Regulation (MICA) and the EU Digital Finance Strategy", 2020, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3725395 (last access 8 February 2020).

[45] See the Proposal for a regulation on a pilot regime for market infrastructures based on distributed ledger technology (COM(2020) 594 final), 2020/0267 (COD).

maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets; (iii) crypto-assets other than asset-referenced tokens and e-money tokens. The third class includes "utility tokens," which are defined as a type of crypto-asset intended to provide digital access to a good or a service available on DLT and accepted only by the issuer of that token. However, it is not clear from the Proposal if there are "crypto-assets other than asset-referenced tokens and e-money tokens" that are not utility tokens. Recital no. 9 seems to imply that utility tokens make up the whole class, but not so Article 4(3), where it is assumed that utility tokens are a part of that class. Whatever the correct answer, the utility token category is used principally in relation to disclosure requirements for projects that are not yet in operation and that carry a risk that the proposed good or service may never be provided.

MiCA imposes investor disclosure requirements on issuers of all crypto-assets covered by the regulation, although more onerous obligations apply to issuers of asset-referenced tokens and e-money tokens. We consider exclusively crypto-assets other than asset-referenced tokens and e-money tokens, since these are the tokens that mainly concern blockchain startups that are not involved in the attempt to create new, private forms of money.

7. MiCA's provisions on crypto-assets other than asset-referenced tokens and e-money tokens

For a general crypto-asset to be offered to the public in the EU or to be admitted to a crypto-asset trading platform in the EU, the issuer must be a legal entity and must first draft a "white paper." This provision seems to confirm that the market comes first and then regulation ensues. Indeed, we are not aware of any significant successful ICO that raised capital without a white paper; the term is new in EU financial and consumer regulation and comes from market practices.

The contents of the white paper, which must be dated, are provided for in Article 5. The white paper must contain a detailed description of the issuer and a presentation of the main participants involved in the project. ICO white papers are usually very detailed in the description of the team participants, even though less so with regard to the issuer entity. Annex 1 sketches in further detail the information that must be presented on the issuer.

The white paper must contain a detailed description of the issuer's project and the planned use of the fiat currency or other crypto assets collected via the offer to the public. According to Annex I, where the offer to the public of crypto-assets concerns utility tokens, the key features of the products or services developed or to be developed must also be contained in the white paper. This type of information is richly offered by ICO white papers. As mentioned, no ICO has any prospect of success if this type of information is not voluntarily provided for.

The white paper must describe the type of crypto asset that will be offered to the public or for which admission to trading is sought; once again, this is a type of information that is always voluntarily provided by white papers. The white paper must also explain the reasons why the crypto assets are offered to the public or for which admission to trading is sought, another type of information that is almost invariably provided by white papers in practice.

The white paper must contain a detailed description of the characteristics of the offer to the public, in particular the number of crypto-assets that will be issued or for which admission to trading is sought, the issue price of the crypto-assets and the subscription terms and conditions; a detailed description of the rights and obligations attached to the crypto-assets and the procedures and conditions for exercising those rights; information on the underlying technology and standards applied by the issuer of the crypto-assets allowing for the holding, storing and transfer of those crypto-assets; a detailed description of the risks relating to the issuer of the crypto-assets, the crypto-assets, the offer to the public of the crypto-asset and the implementation of the project. Generally

speaking, this type of information is less detailed in ICO white papers, especially with regards to risk factors; but the most successful ICOs have generally offered similar information to purchasers.

All information must be fair, clear and not misleading. The crypto-asset white paper must not contain material omissions and must be presented in a concise and comprehensible form. It must state that the issuer is solely responsible for its content and that the white paper has not been reviewed or approved by any competent authority in any Member State of the European Union. The crypto-asset white paper must not contain any assertions on the future value of the crypto-assets, and must warn investors that the crypto-assets may lose their value in part or in full, may not always be transferable, may not be liquid, and where the offer to the public concerns utility tokens, that such utility tokens may not be exchangeable against the good or service promised in the crypto- asset white paper, especially in case of failure or discontinuation of the project.

Every crypto-asset white paper must contain a statement from the management body of the issuer of the crypto-assets, confirming that the crypto-asset white paper complies with MiCA requirements and that the information it presents is correct and that there is no significant omission. As usual for modern prospectus regulation, MiCA also requires that the white paper must contain a summary.

The white paper must be registered with (but not approved by) a designated EU authority in one of the Member States where the crypto-asset will be marketed or admitted to trading on a crypto-asset trading platform, and published on the issuer's website. However, issuers of general crypto-assets need not be established in the EU; nor do they have to be authorized under any EU directive. From this perspective, MiCA should remove fragmented national regimes, and provide the ability for a general crypto-asset to be marketed on a pan-EU basis from a single point of entry, including by non-EU issuers. The scope of MiCA as an antifragmentation measure seems to be more important than does its scope as a mandatory disclosure instrument that sorts out unresolved market failures.

The notification to the regulator must explain why the crypto-asset is not to be characterized as a financial instrument – a topic on which MiCA offers no clarification to issuers who can be in doubt on how to characterize their offer.

MiCA contains a provision on marketing communications (Article 6) and another on offers that are limited in time (Article 9). Article 11 provides that issuers must modify their published crypto-asset white paper and published marketing communications to describe any change or new fact that is likely to have a significant influence on the purchase decision of any potential purchaser or on the decision of holders of such crypto-assets to sell or exchange the same. This is the link between information to primary market investors and information to secondary market investors. Accordingly, MiCA covers also *ad hoc* information. The issuer must immediately inform the public through its website of the notification of a modified crypto-asset white paper and has to provide a summary of the reasons for the changes. The amendments must be time-stamped.

Issuers of crypto-assets, other than asset-referenced tokens and e-money tokens, must offer 14-day right of withdrawal to consumers who buy directly from the issuer or from a crypto-asset service provider that places the crypto-assets on behalf of that issuer. However, the right of withdrawal does not apply where the crypto-assets are admitted to trading on a trading platform for crypto-assets.

Issuers of crypto-assets, other than asset-referenced tokens or e-money tokens, must act honestly, fairly and professionally; they must communicate with the holders of crypto-assets in a fair, clear and not misleading manner; they must prevent, identify, manage and disclose any conflicts of interest that may arise; they must maintain all of their systems and security access protocols to appropriate Union standards. Moreover, they must act in the best interests of the holders of such crypto-assets and treat them equally, unless any preferential treatment is disclosed in the crypto-asset white paper and in the marketing communications. If the offer is cancelled, the issuer must return the funds to the purchasers.

8. MiCA's implications

MiCA assumes that a large part of utility tokens cannot be characterized as negotiable securities and, without any guidance on how to distinguish crypto-assets that are to be considered financial instruments from crypto-assets that are not, creates an *ad hoc* prospectus regime for the latter. This position, however, would have significant implications for the interpretation of EU financial law. Since all MiCA's regulation mirrors existing financial regulation, and since MiCA explicitly recognizes that utility tokens can be traded and custodied through crypto-asset service providers and exchanges that reflect and readapt the traditional financial market infrastructures to blockchain, *de facto* MiCA would elicit the importance of the reference to capital markets contained in the definition of transferable securities provided for by Article 4(1)(44) MiFID II.[46] If and when MiCA becomes effective, the crypto-asset world will be transformed into an almost perfect reflection of the traditional (even though simplified) capital market regulation; and the presence of crypto-asset brokers, custodians and exchanges will no longer be sufficient to argue, as we have done in our previous paper, that those professional figures are typical features of the capital markets and contribute to making the crypto assets that are traded through them 'transferable securities' under EU law (especially when there is an investment component on the purchasers' side).[47] Unfortunately, however, the boundary between transferable instruments and crypto-assets as defined in the Proposal is blurred, creating uncertainty as to the applicable regulation and opening numerous arbitrage opportunities to the interested parties to the extent that MiCA includes a lighter regime, for instance with regard to non-approval of the white paper by the registration authority.

As to mandatory disclosure in particular, MiCA mirrors prospectus regulation and introduces a prospectus-like regime with regard to crypto-assets that are not to be considered as financial instruments. An easy forecast is that these crypto asset

[46] Please refer for a more thorough analysis of this specific point to *Boreiko/Ferrarini/Giudici* (fn. 2), 678-682.

[47] *Boreiko/Ferrarini/Giudici* (fn. 2), 678-682.

prospectuses will become lengthy and not particularly useful for retail investors who will no longer read them, since they will be packed with legalese and will be written simply to appease the authority that will receive the notification and will register the white paper - rather than the geek audience to whom white papers were originally addressed in the blockchain space - and to defensively escape liability and litigation, even though in this area, as we point out in next paragraph, MiCA is not aimed at facilitating investors' claims, rather counterintuitively given its investor protection fanfare.

9. **MiCA's liability regime**

MiCA would also introduce an *ad hoc*, detailed liability regime, which is unusual in European financial regulation. A special European liability regime is foreseen with regard to rating agencies,[48] but the rest of EU financial regulation does not include common liability rules and contains broad provisions on liability. Article 11 of Prospectus Regulation, for instance, provides that Member States ensure that responsibility for the information given in a prospectus, and any supplement thereto, attaches to at least the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be. Pursuant to Article 11, the persons responsible for the prospectus, and any supplement thereto, have to be clearly identified in the prospectus by their names and functions or, in the case of legal persons, their names and registered offices, as well as declarations by them that, to the best of their knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission

[48] *Giorgio Risso*, "Investor Protection in Credit Rating Agencies' Non-Contractual Liability: the Need for a Fully Harmonised Regime", *European law review* 2015, 5, 706.

likely to affect its import. Nothing is stated, accordingly, on the nature of the liability regime or the allocation of the burden of proof.[49]

According to the proposal, where an issuer of crypto-assets, other than asset-referenced tokens or e-money tokens, and/or its management body have infringed Article 5 - by providing information which is not complete, fair or clear, or by providing information which is misleading in the crypto-asset white paper (or in a modified one) - a holder of such crypto-assets may claim damages from that issuer or its management body for damages caused to her as a result of the infringement. Any exclusion of civil liability shall have no effect. However, the effectiveness of the liability provision is fully diluted by the adoption of a standard burden of proof regime, where it is on the holder of crypto-assets to offer evidence indicating that the issuer has infringed Article 5 and that such an infringement has had an impact on her decision to buy, sell or exchange the crypto-assets. In jurisdictions with no fee-shifting mechanisms, no collective litigation instruments and, above all, no recourse to discovery, this burden of proof might become unsurmountable.[50] If this is the intention, it clashes with a regulatory framework that is expressly addressed at protecting investors and that seeks to reduce the intervention of public authorities, for example by eliminating the prospectus approval procedure. More important, this approach conflicts with the widespread view that private enforcement matters - apart from any assessment on whether it is more or less important than public enforcement in the construction of efficient capital markets - and that regulation in Continental Europe is excessively oriented towards public enforcement and puts too

[49] On European liability rules concerning financial information and transparency see *Paolo Giudici*, Private Enforcement of Transparency, in: Vassilios Tountopoulos/Rüdiger Veil (ed.), Transparency of Stock Corporations in Europe: Rationales, Limitations and Perspectives, 2019, p. 297.

[50] *Guido Ferrarini/Paolo Giudici*, Financial scandals and the role of private enforcement: the Parmalat case, in: John Armour/Joseph A. McCahery, After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US, 2006, p. 159, 193 et seqq.

much reliance on administrative bodies.[51] From this critical perspective, MiCA would be in line with a criticisable European tradition of great regulatory frameworks and poor enforcement, where regulation gives with one hand and takes away with the other.

10. Our tentative proposals and conclusions

Our conclusions are tentative. The ICO explosion has offered a chance to rethink mandatory disclosure of public offerings. Rather than creating a parallel framework that mirrors Prospectus Regulation, it could be worth investigating the possibility of exempting from prospectus-like regulation any offering regarding tokens (whether securities or utility tokens), where the issuer is a blockchain startup, the entity issuing the tokens and the persons involved in the offering are clearly identified, and no intermediary is involved in the placing of the offering.[52] For example, blockchain startups could be left free to decide what information to offer to investors, so long as the information provided to investors is free from false or misleading statements, and does not omit anything that can make the statements false or misleading. A regime of this type is provided for by Rule 506 of Regulation D in the US, and we think that it might be

[51] The literature on the issue is huge and mainly concerns antitrust law and securities law. With regard to the latter, cf. *Rafael La Porta et al*., "What Works in Securities Laws?" Journal of Finance 2006, 61, 1 (who find little evidence that public enforcement benefits stock markets, but strong evidence that laws facilitating private enforcement benefit stock markets); *Howell E. Jackson/Mark J. Roe*, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence" Journal of Financial Economics 2009, 93, 207 (reversing the results on both liability standards and public enforcement). Both works find evidence about the importance of mandatory disclosure, but we do not think that they contrast the arguments we have presented in the first part of the work, since their reference to mandatory disclosure mainly concerns disclosure in secondary markets. See also the literature mentioned in *Ferrarini/Giudici* (fn. 50), 193 et seqq.; *Giudici* (fn. 49), 300 et seqq.

[52] The last requirement reflects the idea that, of course, intermediaries placing products on behalf of issuers have a strong incentive to push sales and sell free advice to clients on the advantages of the product. Nevertheless, we believe that if intermediaries are involved in the placing of products, they have to be held liable for their recommendations as financial advisors and a mandatory prospectus regime is not necessary.

sufficient at this stage, especially if coupled with a standard of strict liability on the issuer or a reversal of the burden of proof. From this perspective, ICOs could be a great chance to return to a more manageable regime, where general anti-fraud provisions are applied with well-defined private liability rules and burden of proof allocations, and startups are left free to signal their quality and develop their channels of communication with potential investors.

The MiCA proposal goes in the opposite direction by mirroring, even though in small scale, the EU framework of financial regulation. However, we know from past experience that there is no way to escape from political pressure to expand regulation when a statute is aimed at protecting investors and some scams happen. At that point in time the debate will not centre on whether the statute was really necessary, but on the measures to be taken to enlarge its scope and provide more detailed rules in to prevent future scandals. In this way, regulation gets out of control and is potentially able to hold back EU competitiveness in the blockchain space for a long period.

MiCa looks also well-rooted in the EU tradition of designing grandiose regulatory frameworks aimed to protect investors without offering the protected parties effective instruments of private enforcement of their rights.

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