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Capital Formation in the Age of Blockchain

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I. Dawn of the Initial Coin Offering (ICO)

Few things have been more lucrative and controversial in the last year than the expansion of the Initial Coin Offering (ICO) as a method of raising capital. In 2017 alone, nearly \$2.4 billion was raised to fund blockchain related projects, an increase of roughly 4400% from the year before.¹ Despite growing regulatory concerns, enterprises have continued to utilize this method of capital formation to fund the creation of their protocols with enormous success. In the first quarter of 2018 alone, \$6.5 billion of capital was raised capital raised through ICO's.²

ICO's show incredible promise as a fundraising option by allowing talent to bypass traditional funding intermediaries and connect directly with capital, but are these new instruments all they're cracked up to be? In order to assess this, we must conceptually understand how capital formation works, how it's evolved with technology over time and how blockchain could potentially impact this evolution.

II. Bridging the gap between talent and capital

Funding landscape pre-venture capital

For the first half of the 20th century, investment opportunities were predominantly funded by debt lent against tangible assets or by equity lent against the expectation of future cash flows. In the case of technology startups in the digital age, these traditional funding methods proved to be less practical as most early stage technology companies did not possess appreciable tangible assets

¹ Icowatchlist.com

² Gensler, Gary. Faculty at MIT Sloan School of Management.

to serve as collateral for debt funding from banks, nor did they have a proven business models, recurring profitability, or stable cash flows for equity issuance. This funding gap was initially filled by private equity firms funded by wealthy investors, as banks and the public were hesitant to invest in these high-risk ventures.

By the late 1950s, technology firms had set up operations around Menlo Park CA, attracted by the presence of Stanford University as an entrepreneurial hub due to military contracts and government funding post World War II. These ventures were mostly still funded by wealthy individuals, the military-industrial complex or other technology firms³ (as was Fairchild Semiconductors). A few years later, Intel was formed, giving rise to the personal computing industry, which needed a new model of business funding in order to manage the immense financial risk associated with high tech investment in personal computing.

The birth of venture capital

At the same time, venture capital, a new form of financing was being established. In 1957, Draper, Gaither and Anderson opened the first West Coast venture capital firm with the aim of investing in small technology startups. The Small Business Act of 1958 gave management teams access to government funding to manage small enterprises, including technology firms, in the US. In the late 1960s, the legal form of private equity firms and venture capital was established – limited partnerships managed by general partners earning carried interest. Soon after, independent management firms formed across Sandhill Road in 1957, including Caufield & Byers and Sequoia Capital, and further growth in the venture capital industry grew with the rise of the personal computing in the 80s.

³ <https://salon.thefamily.co/a-brief-history-of-the-world-of-venture-capital-65a8610e7dc2>

Venture capital funding

These venture firms differentiated themselves from private equity firms by having specialized technical expertise to pick out new technologies that had the potential to succeed, evaluating technological risks in new ventures, and managing entrepreneurial companies at very early stages of growth. As opposed to a buyout private equity fund that invested in companies with stable cash flows, venture capital funds provide equity to startups without assets, revenue or profitability but with high growth and profit potential with the expectation of high returns upon exit. Financing is typically provided in stages with seed funding being the earliest funding followed by Series A, B, C and so on to fund growth, until the VC finally exits the investment via a secondary sale or publicly lists the firm in an IPO. VC firms invest via preferred stock or venture debt, however when the firm goes public, common stock is issued to public investors. At each stage of funding, venture investors are evaluating the progress of their investments against market potential to determine how resources should be allocated.

Apart from financing, VCs also provide support to startups. Professional VCs understand the market dynamics, meet the team and check their prior experience, analyze legal issues and are often connected to other firms which might provide synergies to their growing portfolio of investment companies. An investment by a VC serves to boost confidence in a project which helps attract talent, customers and future funding. VCs also provide a network of contacts which help startups in hiring, legal disputes, scaling projects and raising capital as well as governance, oversight and strategic partnerships.

The dark side of venture capital

The venture capital industry has grown to \$84 billion in 2017⁴, bridging the gap between financing requirements of technology startups and availability of funding. However due to the high risks of these ventures, with a success rate of venture backed startups of 25%⁵, venture investments take into account their investments in technology, people and ideas might fail.

First, the venture capital model is designed to pool funds from limited partners in a limited partnership, which is managed by a general partner who invests various amounts in firms varying by industry, stages of investment and time horizons. Diversification of investments allows VCs to spread risk, not put their eggs in one basket. Even if most of the firms fail, if one firm becomes a “unicorn” by achieving an unusually large valuation, the VC fund makes money overall. To find these “unicorns”, VCs are highly selective in the firms, industries and teams they invest in, avoiding unproven technologies, teams or market segments.

VC investors screen and pre-screen investments and prefer to invest in teams with a proven track record. If you’ve graduated from Harvard, Stanford or MIT or if you’re an ex-Google employee, it’s relatively easier to get access to venture financing. Access to venture capital is often restricted by geographical, language and social barriers, and can be heavily relationship based. A top-notch team isn’t always enough to obtain funding. Often, VCs prefer to invest in “hot industries”. For example, areas such as cloud computing, AI, and Biotech are often more sought after as investments because it is often easier to find secondary buyers or garner a larger market appetite to IPO in these industries should the VC choose to exit the investment. Often, this results in capital being allocated to ideas with the most obvious market potential at the expense of riskier, but potentially more innovative projects which address untested markets or technologies. Ultimately,

⁴ KPMG Venture Pulse Survey 2018

⁵ <https://www.wsj.com/articles/SB10000872396390443720204578004980476429190>

if an entrepreneur's venture does not have a team with recognizable backgrounds, or possess certain desired industry fit characteristics, it may be difficult to obtain VC financing.

Perhaps the greatest problem with the VC model is the fact that it is equity dilutive and frequently requires further fundraising. By obtaining VC funding, an entrepreneur gives up equity in their business, with more equity given up to investors with additional funding rounds. Equity ownership comes with benefits to the VC fund with regards to voting on expansion projects, key personnel changes, acquisitions, and a reduction of voting rights for the entrepreneur. In addition, VC firms typically invest in rounds and co-invest with other VC firms to mitigate the high risk of ventures. Thus, a CEO has to spend considerable efforts meeting different VC firms to secure future financing. The CEO becomes an expert in fundraising rather than operating the business.

Due to the difficulty and costs of obtaining VC financing, startups have started turning towards equity crowdfunding via platforms like AngelList and SeedInvest, which help to democratize investing by providing another bridge for talented entrepreneurs to more easily connect with capital. However, these platforms are still limited in their reach and come with regulatory requirements. It is in this vain that investors and talent alike have continuously sought new and innovative methods of capital formation.

III. A Decentralized Bridge to Capital

The Evolution of Capital Bridges

The economic model of capitalism is dependent on the trusted formation and deployment of capital towards some productive use of talent and resources. Not surprisingly, the financial tools, instruments and institutions that have emerged in our financial system as a means to allocate capital in a secure and trusted way have evolved substantially over time to match the needs of

new types of enterprises. Today, our global financial system is filled with advanced institutions and mechanisms that help to facilitate this continuous process of “bridging the gap” between talent and resources across. Over time, this system has embraced leaps in technical innovation to develop new ways of bridging this gap in ever more efficient ways. Is it possible that the blockchain, and associated innovations such as the ICO, could be one of these major leaps that drastically changes the paradigm by which talent accesses capital?

Blockchain as a Decentralized Capital Bridge

At its core, the blockchain is about trust. As a software-based platform that uses cryptography to securely preserve a distributed record of value on a network, a blockchain can provide a very effective decentralized method to securely transfer and track value. By implication, this characteristic creates a path through which business founders could more easily bypass third party intermediaries such as banks, venture capitalists and other financial institutions that have previously served as the eminent bridges to capital, and sell the future utility of their venture directly to potential users.

Specifically, since the blockchain has created a new way to securely exchange and track value on a network, it has allowed for the creation of scarce native digital assets of account which can be sold directly to potential users in the form of an Initial Coin Offering (ICO). Thus, ICO’s offer talent an avenue to access capital more directly by bringing the value of their venture more directly to the end-user through the creation and sale of a native digital asset which promises to deliver this value in some form of future asset utility. Brayton Williams of Boost VC, a venture capital firm that has invested heavily in blockchain related companies, expresses both optimism in ICO’s as a method of raising capital, and healthy skepticism about effectiveness in their current form. “This innovation has been the greatest source of crowdfunding we’ve ever seen”, yet, at present, ICO’s

do “very little to ensure that proceeds are used effectively.”⁶ In a broad sense, devices like the ICO, which help to bridge the gap between capital and talent, have helped to democratize finance, but have also created new challenges which had more comprehensively been solved in mature forms of financing.

As such, though still likely underdeveloped, this seemingly basic technical advance could have revolutionary implications on the future of capital formation. By using cryptography-based software to securely maintain a public ledger of the distribution and exchange of value on a network, the blockchain drastically reduces the security costs and requirements of verification necessary for the safe transfer of value and formation of capital. In the past, a transaction that would require the security of a costly middleman or institution, can now be carried out for a fraction of the cost by a trusted decentralized system. Perhaps more significantly, ICOs offer a new paradigm by which product end-users can more directly participate in the capitalization of business ventures by actively acquiring units of future utility in the sale of native digital assets.

Unique Benefits

The innovation of the blockchain has essentially unlocked the ability of all parties to exchange value directly in a trusted and frictionless way without the need for an intermediary to facilitate the transaction. Accordingly, it has the potential to give talent instantaneous access to global capital from day one without major sacrifices in the form of equity to third party investors. In an interview with Chris Burniske, a founding partner at a prominent blockchain focused VC fund, and coauthor of “Cryptoassets”, Chris advocated his unique perspective on the value of this type of capital formation in stating that, “we think that cryptoassets are superior to equity as a capitalization and monetization structure for information networks. Period.”⁷

⁶ Williams, Brayton. Partner at Boost VC. From phone interview conducted on May 11th, 2018.

⁷ Burniski, Chris. Partner at Placeholder Capital. From interview conducted on April 24th, 2018.

By allowing the decentralized distribution and trading of native digital assets created through an ICO, it's possible for entities looking for capital formation to bypass the expensive and time-consuming process of raising capital through more traditional financial instruments. This is really only possible because the blockchain solves for trust which allows people to exchange value without the necessity of a third party.

Finally, the very design of the ICO enables the creation of network incentives which drive users to the platform more quickly. This acceleration of network effects is positive not only for companies, but also for consumers and the broader ecosystem.

Unique Risks

Despite the benefits and opportunities of using blockchain-related innovations to raise capital, newness of its mechanics, lack of accountability and uncertainty about its regulatory future each cast a major shadow on its short-term feasibility.

According to a paper written by Christian Catalini of the MIT Sloan School of Management that covers a multi-year study on ICO's, somewhere between 5-25% of all ICO's involve some sort of fraudulent behavior, whereby money is raised with a promise to investors and the promises are not fulfilled or in some cases the money raised is stolen in its entirety.⁸ In the majority of these cases, there is no easy recourse to recover the money lost by investors because of the lack of legal structure involving the issuance and trading of digital assets,.

⁸ Catalini and Gans. "Initial Coin Offerings and the Value of Crypto Tokens". Published March 9th, 2018.

Even in cases where there is no apparent fraudulent activity, entities raising funds may inadvertently be putting their investors at risk by raising a pool of capital that is substantially larger than required for product development. This can be extremely dangerous because having a larger pool of capital than needed for development can create disincentives for efficient use of capital and in some extreme cases, it's possible that the amount of capital raised could be greater than the entire conceivable future utility value of a fully functional network. Telegram, a popular social messaging app has come under fire recently for carrying out a private token sale ICO where it sought to raise \$1.7 billion despite not having a clear roadmap as to how they plan to create an amount of utility in the future commensurate with the sum of money raised. This is just one example where there is evidence to suggest that significantly more capital than was necessary for network development was raised in an ICO.

Finally, because there is still uncertainty as to how this new asset class should be categorized, there is major regulatory risk whereby even honest new enterprises which choose to do ICO's could be subject to harsh penalties in event they are found to be in violation of existing SEC rules and regulations. According to Gary Gensler, former Chairman of the Commodities Futures Trading Commission and Visiting Professor at MIT, a large majority of the ICO's which have been executed in the past could be considered securities according to the Howey Test and would thus face heavy penalties if they hadn't previously been registered as securities.⁹

Realistic Assessment of the ICO

The ICO as a decentralized bridge to capital succeeds in providing a wider array of potential talent with near instantaneous access to capital on a global level, while reducing the costs traditionally associated with raising funds. ICO's can also create a built-in incentive mechanism which can

⁹ Gensler, Gary. Statement was made while presenting at the MIT Technology Review Business of Blockchain conference on April 23rd, 2018.

help accelerate the adoption of a network protocol, thus reducing the challenges associated with overcoming inertial network effects. Transitively, increasingly rapid network formation in global business could serve as a catalyst which could generate enormous positive market externalities.

However, despite the potential advantages of using an ICO to fund a new venture, ICO's lack many critical properties of incentive alignment, accountability and guidance that exist in more developed forms of fundraising. Additionally, there are extraordinary risks and unknowns which cannot be ignored. Specifically, current lack of regulatory clarity creates an environment where fraud and scams can flourish and seemingly legitimate enterprises could be excessively penalized with the release of new regulatory standards. Thus, it is essential that these considerations are given adequate analysis in evaluating funding sources and options for capital formation.

IV. Breakdown of the Fundraising Landscape

The advent of blockchain technology has opened interesting new doors in the world of early stage financing. Traditionally, equity financing was restricted to a select group of expert investors, while investment in non-equity stakes was mostly done through crowdfunding models. Blockchain technology has enabled new market dynamics which is explained in the framework below:

Early Stage Framework

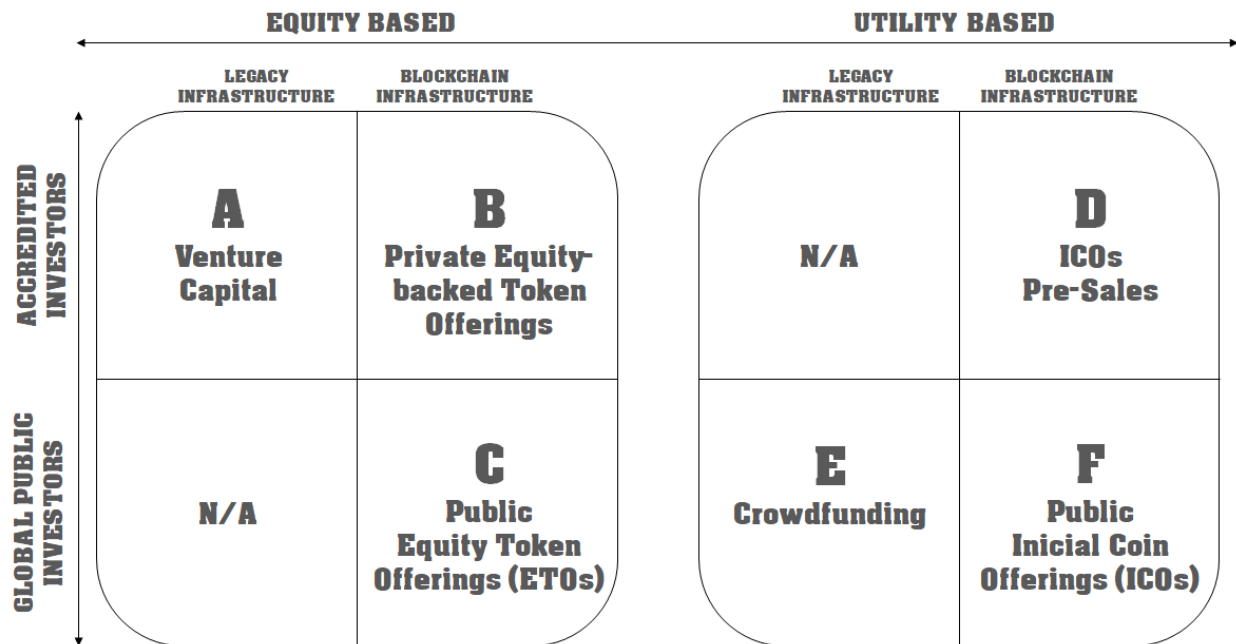


Figure 1: Three-Axis Framework

Three-Axis Framework Explained

Asset Class Axis

Equity based instruments grant the investor an ownership stake in the venture that is being backed. Before blockchain, early stage investments were traditionally restricted to a select group of accredited investors.

Utility based instruments allow entrepreneurs to raise funds in exchange for simply delivering their tangible products or providing access to future services that will be developed with the capital raised.

Infrastructure Axis

Legacy Infrastructure entails any and all mechanisms that have been traditionally used to source early stage capital such as venture capitalists, angel investors and crowdfunding platforms.

Blockchain Infrastructure comprises all uprising capital formation features that were enabled by distributed ledger technology such as cryptographic signatures, smart contracts and token sales.

Investor Type Axis

Accredited Investors are persons or entities that can deal with securities not registered with financial authorities by satisfying one of the requirements regarding income, net worth, asset size, governance status or professional experience.

Global Public Investors are constituted by any and all individuals that are willing to back projects out of their own pockets. Before the blockchain era, regulatory burdens and lack of infrastructure limited investment opportunities for this group almost exclusively to crowdfunding platforms.

Understanding Each Early Investing Niche

A: Venture Capital

Venture Capital funding remains as the biggest capital formation alternative in the world for early stage startups. Prestigious venture capitalists provide not only funding, but mentoring, networking and expertise as well. It's generally a win-win deal - provided the entrepreneur is able to secure a coveted investment offer from one of these firms. The Venture Capital industry has long been criticized for being elitist: companies headed by caucasian males graduated from Ivy League universities still receive the vast majority of all investments done by venture capital firms¹⁰.

Moreover, the fact that the Venture Capital funding model is largely attached to the legacy infrastructure further limits the possible reach this funding option could have for bridging the gap

¹⁰<https://www.elitedaily.com/money/venture-capitalists-still-overwhelmingly-fund-white-male-entrepreneurs-minorities-women>

of talent and capital. Finally, on the investor side Venture Capital is also restricted to a select few accredited investors by the very nature of the industry funding model.

B: Private Equity-Backed Token Offerings

Equity tokens grant ownership to an asset such as debt or more commonly company stock. Early stage ventures can leverage blockchain technology to issue shares and voting rights directly through a distributed ledger, theoretically bypassing the costly and bureaucratic legacy infrastructure. This exciting new option for forming capital opens interesting doors for startups, as companies that choose to use equity tokens are essentially mimicking traditional share issuance but leveraging efficient technology to improve the process. It's worth mentioning though that current regulation limits any private token sale to a \$50 million threshold.

C: Public Equity Token Offerings (ETOs)

Should a venture wish to raise more than fifty million dollars, by regulation such offering will be categorized as a Public Equity Token Offering and should be registered as an official public offering with the U.S. Securities and Exchange Commission (SEC). As a result, ETOs must comply with all applicable federal securities regulations in place for public offerings. Because startups generally lack the resources and legal sophistication to fully abide to SEC securities laws, it is still unclear how useful and impactful the blockchain technology will be in this case for early stage ventures.

D: ICOs Pre-Sales and Private Token Sales

A Pre-ICO Sale is the token sale which precedes the official ICO crowdsale that is open to the general public. During this phase fundraising targets are lower and tokens are usually sold at a discount to incentivize early investors. The main difference between a Pre-Sale and an ICO is that the former is usually dominated by few large institutional investors, going against the common

concept of decentralization that derives from ICOs, while the latter is typically accessible to the general retail public. The usage of different smart contracts for Pre-Sale and Public stages of an ICO is a common practice to avoid mixing of funds from each stage.

Many companies use the Pre-Sale funding method as a way of testing interest and product-market-fit of its offerings before launching a full scale ICO token sale. It allows the founding team to experiment and iterate with an early version of the token in a relatively low-stakes environment, before it is scaled to the broad public, at which point a mistake could jeopardize the entire project. However, because of the massive discounts typically offered during Pre-Sale which can reach up to 70% compared to the ICO price target, many participants in this stage are mostly looking for fast and profitable investment opportunities. They are taking advantage of the excessive enthusiasm surrounding the crypto space, as opposed to being actual early-adopters of the technology. In which case, this dynamic is actually contradictory to principal purpose of a decentralized token sale, which is to deliver a broad audience of supporters early-access to project utility.

E: Crowdfunding

Crowdfunding is process of raising capital through an online platform reaching out a large group of people. Typically, those who invest in a crowdfunding project are not entitled to an ownership stake in the company, but rather are supporting an early stage project because they believe in the cause of such project and would like to see it come to life. Rewards are generally given at different tier levels based on the amount of money pledged. The chief advantages of this type of early-stage financing are its ability to enable companies to reach a large market, access a free customer acquisition channel, promote its product offerings early on, and raise money without selling ownership stake in the company.

However, crowdfunding also comes with a few drawbacks which limit its usefulness and impact for early stage ventures. Because of its rewards-centric model for individuals, business-to-business startups might find difficult, if not impossible, to take advantage of crowdfunding. Complex or highly technical projects might also not be able to harness the interest of the layman target audience. Lastly, crowdfunding projects typically raise no more than \$100,000 due to its very nature, making it a non-viable alternative for cash intensive projects.

F: Public Initial Coin Offerings (ICOs)

Initial Coin Offerings can be a misleading term due to its resemblance to Initial Public Offerings - a traditional and deeply understood rigorous process for taking a company public. In reality, ICOs are unregulated sales of digital tokens that, like crowdfunding, do not grant equity to investors or other benefits that come from holding a stake in a company such as voting rights and dividends. Instead, so-called utility tokens are focused on offering digital assets that will have usability in the network that's being developed: if done correctly, a well-designed token should allow for its holder to participate in the network and by doing so gain some sort of tangible benefit or value, as opposed to being merely a funding instrument.

Because of this innovative concept, a brand-new asset class has been created: network value. By choosing to participate in public ICOs, investors gain exposure to upside on the inherent network potential, as opposed to the company that is creating such network. As such, the worth of a network is segregated from the company that built it. On the other hand, individuals who wish to take part in the network must also acquire tokens to do so.

Theoretically, such incentives should help solve the recurrent chicken-and-egg problems networks face before growing¹¹. However, many of the ICOs conducted up to date lack a legitimate reason for existing - other than opportunism for raising significant amounts of capital fast. The lack of efficient token design and governance is one of the main reasons the crypto asset industry has experienced unparalleled volatility up to date.

V. New Doors Opened

Regulatory Oversight is Long-Term Force of Stability

While there have been great successes in the development of blockchain technology, the industry has also been tainted by fraud and scam, by some estimates affecting as much as 25 percent of the industry.¹² However, the regulatory landscape is quickly catching up to the developments in this space - an advance that may ultimately be positive for the space as clarity on regulations could provide a greater level of certainty that may stimulate even greater investment and interest.

As an example, in March of 2018, the SEC subpoenaed 80 cryptocurrency companies¹³ requesting more information on the nature of their ICOs. Since then, ICO activity has actually declined as companies have become more thoughtful about raising funds through ICOs, paying closer attention to the terms of how they raise capital and how they plan to use the proceeds to ensure they are not directly or deliberately in violation of existing U.S. Securities laws.

Blockchain Networks opt for Private Funding

More recently, blockchain based startups have opted to raise money through venture funding and other more traditional private means in order to fund the creation of their network, opting to either

¹¹ <https://brianbalfour.com/essays/the-network-effect-marketplaces>

¹² The Digital Privacy Paradox: Small Money, Small Costs, Small Talk by Susan Athey, Christian Catalini and Catherine E. Tucker

¹³ <https://www.ccn.com/sec-subpoenas-80-cryptocurrency-firms-including-techcrunch-fund/>

defer or avoid doing a public ICO entirely. Blockchain companies have more recently opted for this path, due largely in part to regulatory and administrative burdens. By keeping funding private, projects are less likely to be in violation of existing regulations and programmers are less beholden to the network demands of the general public during critical early development.

This flexibility can be highly valuable early on, as companies raising capital through an ICO typically must choose the governance and monetary policy of their scarce digital asset prior to ICO. Changing governance and monetary policy rules after an ICO can be extremely difficult without the community feeling betrayed, losing faith in the governing body, and potentially a loss of trust in the network. As such, keeping network development funded by private means may actually provide advantages (e.g. Underscore Venture model, see below).

Examples of new models in blockchain venture funding

A: Simple Agreement for Future Tokens (SAFT)

As blockchain companies rely more to private funding, different more streamlined processes for funding blockchain networks have evolved. Rather than going directly to an ICO, many companies have opted to fund their development through a private funding instrument described as a Simple Agreement for Future Tokens (SAFT). A SAFT is modeled after the YC Combinator Simple Agreement for Future Equity (SAFE) which has become a standard angel and seed round investment agreement used by startups. A SAFT is generally a private deal with a few VCs (accredited investors only) committing a certain amount of money into a startup in exchange of a promise to one day receive a set amount of utility tokens the startup sells in an ICO¹⁴.

¹⁴<http://www.businessinsider.com/bitcoin-price-what-is-a-saft-blockchain-the-crypto-fundraising-craze-shaking-up-venture-capital-2017-11>

B: From SAFT to Regulation D (Reg D)

At the point of the SAFT, the startup must also file Regulation D form with the SEC. Companies that go through this route, do not register with the SEC with the belief that their tokens are not securities and meet SEC's exemption. Contrary to the goals of ICOs, regulation D usually limits sales to accredited investors. For "non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment." according to the SEC¹⁵.

Once the funds are raised through a SAFT and the required Regulation D documents are filed, startups can utilize the funds raised to develop the network. Once the network is up running, the startup may establish a utility structure for its tokens and sell tokens to the public. At this point, investors of SAFT receive their tokens and sell in the open market to realize their profit¹⁶.

C: Regulation A+ (Reg A+)

With issues and uncertainties regarding regulations, blockchain startups have also looked to leverage a more established paths for fundraising. The regulation A+ IPO is one example whereby companies can legally sell equity to the public in an offering as long as it is below \$50 million. Regulation A+ IPO was a funding avenue created to enable smaller companies to access public equity markets with lower administrative and regulatory burdens. Chia, a blockchain startup that's building its network on proofs of space and time is planning its mini-IPO through Reg A+ instead of ICOs¹⁷. It's worth noting that Chia already raised \$3.395 million in its seed round backed by

¹⁵ <https://www.sec.gov/fast-answers/answers-rule506htm.html>

¹⁶ <https://saftproject.com/#saft-whitepaper>

¹⁷ <https://techcrunch.com/2018/03/28/chia-vs-bitcoin/>

prominent investors such as AngelList's Naval Ravikant, Andreessen Horowitz, Greylock. Through Reg A+, Chia could raise up to \$50 million from the public, including non-accredited investors. In addition, the fees and ongoing disclosure requirements are much less burdensome than a traditional IPO¹⁸.

Leveraging Reg A+, startups such as Chia are working directly within the rules of the SEC, following its published rules in 2015, mandated by Title IV of the Jumpstart Our Business Startups (JOBS) Act. According to SEC Chair Mary Jo White, "It is important for the Commission to continue to look for ways that our rules can facilitate capital-raising by smaller companies" and "These new rules provide an effective, workable path to raising capital that also provides strong investor protections."¹⁹

D: New Venture Capital Models and Strategies

In addition to traditional venture funding models, new models are emerging. Placeholder VC's model is an example of a new venture capital structure to capture value in this space while providing regulatory shelter and flexibility to the development team. As its name suggests, Placeholder sets up a limited liability company (LLC) structure to invest in funding the development of networks prior to launch, as a placeholder for its ownership portion of tokens. Upon launch of the public network, the LLC dissolves and its equity is converted into tokens. This structure allows for concentrated early network development to be funded privately and an avenue for investors to capture network value upon the launch of the public network. In our interview with Chris Burniske, founder and CEO of the fund, Chris stated that the firm usually invests about \$2

¹⁸ <https://www.seedinvest.com/blog/regulation-a-equity-crowdfunding-rules>

¹⁹ <https://www.sec.gov/news/pressrelease/2015-49.html>

million at this stage to fund early network development. According to Burniske, capital is a small part of what Placeholder provides. The firm strategically makes only four to six investments a year, particularly to reserve majority of the partner time to portfolio companies, advising through strategic, governance and operational issues.

Unlike, SAFTs and direct ICOs, this model provides more flexibility for companies to design and test robustness of its business strategies and monetary policies. Burniske suggested for his portfolio companies that 90% plus of tokens should be earned by people who provide utility to the network and roughly 10% to the developer pool, of which 10% is invested by his LLCs (i.e. 1% of the total token pool). This structure aligns both early investors and developers in a more cohesive way.

E: Non-profit profit and Airdrop

Another emerging trend related to funding in the blockchain space is the non-profit structure. Rather than fundraising through ICOs, companies are distributing tokens to a chosen community for free. The effort is used to drive adoption of the network, utilities of the tokens and ultimately the value of the tokens. Developers of the projects who whole a large proportion of these tokens benefited by the value appreciation.

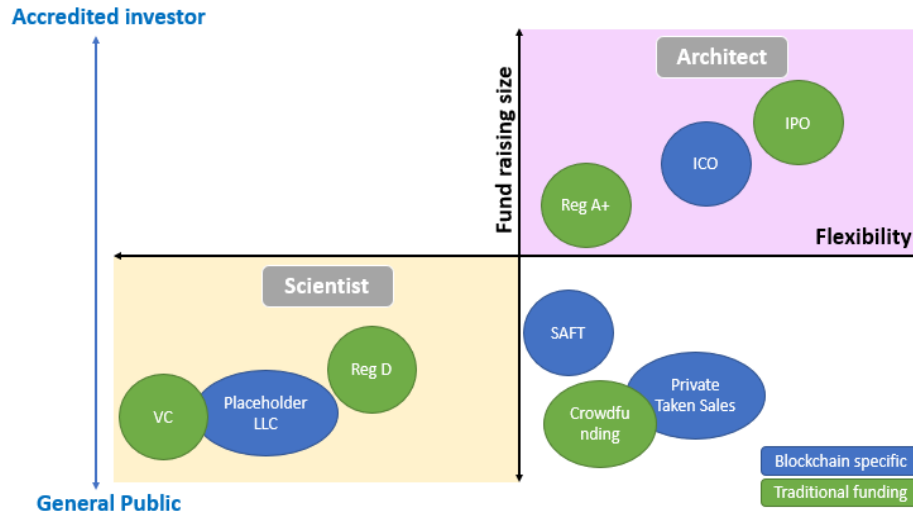


Figure 2: Blockchain Startup Funding Model Matrix

VI. The Hazy, Yet Promising Future for Blockchain and Capital Formation

Despite the obstacles and challenges associated with blockchain related fundraising methods, there is an unrelenting global thirst for models of efficient capital formation. While it is perhaps too early to predict the future of the ICO or other blockchain related funding strategies, it seems logical to suggest that investors and talent alike will continue to pursue ever more innovative strategies for utilizing new technologies to meet their financial aims and objectives.

While it is certainly possible that the ICO is merely a figurative “blip” in the evolution of capital formation, the ever-present necessity to bridge the gap between talent and capital is an inexorable force which will continue to drive innovation in funding methods. This fact serves to suggest that when it comes to blockchain derived methods of capital formation, we’re likely only be seeing the tip of the iceberg.