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MARKETS

Crypto Startups Are Raising Money Again, With a Twist

'It's like ICO 2.0.': Investors are jumping into initial exchange offerings as cryptocurrency prices rebound

Changpeng Zhao, chief executive of Binance, one of the world's largest cryptocurrency exchanges, speaks at an event in Malta late last year. **PHOTO:** DARRIN ZAMMIT LUPI/REUTERS

By Steven Russolillo

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The market for initial coin offerings is mostly dead. Instead, entrepreneurs are flocking to a new way to raise money with digital tokens.

Many startups that did ICOs during the cryptocurrency craze of 2017 and early 2018 were little more than ideas without real business models. Most of the digital coins they sold now trade below their original issue prices.

But now, money is starting to pour into what are called initial exchange offerings, amid a broad rebound in the price of bitcoin and other cryptocurrencies.

Although IEOs share similarities with, and sound almost like, ICOs, there is one key difference: Digital tokens are sold to investors through a crypto exchange, not directly by a startup. Users typically must already hold the exchange's own tokens to participate.

About $518 million has been raised through 63 IEOs this year through May, according to John Todaro, director of digital currency research at TradeBlock, a New York-based data provider.

Critics say the new deals don't necessarily solve the problems that plagued ICOs, and give even more power to mostly unregulated crypto exchanges. Some of these platforms have had trouble with hacks, security lapses, fake trading volumes or fraud.

"It's like ICO 2.0," said Michael Conn, a managing partner at Quail Creek Ventures in Los Angeles, which invests in digital assets. "Frauds are waiting to happen. A lot of people got burned in ICO land and I think a lot of people are going to get burned in IEO land."

In these deals, the crypto exchange plays the role an investment bank would occupy in an initial public offering, researching the prospective issuer before listing it.

For example, Binance, one of the world's largest cryptocurrency exchanges, produces a report on the new token that resembles a slimmed-down prospectus, and later distributes the tokens to buyers.

The trading venue typically takes a cut for doing this. In Binance's case, this can run between 2% to 5% of the sums raised, according to a startup that listed on its platform. The exchange also stands to earn trading fees once the digital coin launches.

Proponents say IEOs are an improvement on ICOs because cryptocurrency exchanges risk reputational damage if they list bad projects.

"People feel that since the exchange does not wish to be associated with a scam, they're more likely to do their homework before becoming associated with any given project," said Mati Greenspan, an analyst at eToro, a brokerage firm.

Jeff Dorman, chief investment officer at Arca, an asset-management firm that invests in digital currencies, said: "Any investor looking at these IEOs needs to do their own research and not blindly trust the exchange."

However, Mr. Dorman, a former capital markets banker, said IEOs are a positive step forward from ICOs. "Exchanges are making a ton of money," he said. "They have every incentive not to kill the golden goose."

Many IEOs are avoiding the U.S. for regulatory purposes. The Securities and Exchange Commission has already taken action against several crypto startups. On Tuesday, it sued Canadian social-media company Kik Interactive Inc., alleging the company's 2017 ICO evaded U.S. investor-protection laws.

"The stars seem perfectly aligned for the SEC to target IEO purveyors and expel them from U.S. markets," John Reed Stark, a cybersecurity consultant and former SEC lawyer, wrote in a recent report.

Much of the action has instead come from exchanges outside of the U.S., including Binance, OKEx, Huobi and KuCoin.

In an emailed statement, Binance Chief Executive Changpeng Zhao said his exchange had a full-time team scrutinizing candidate projects for listing on its Launchpad IEO system, looking at issues such as the project's personnel, technology, economics and strategy.

Mr. Zhao said issuers generally assumed legal liability, but the exchange works with them to block token sales in places where they would be legally problematic. Binance also requires projects to obtain legal opinions that their tokens aren't securities, he said.

In a blog post introducing IEOs, OKEx said it wasn't in an exchange's interest to scam customers. KuCoin had no comment. A Huobi representative said its model, called Huobi Prime, slightly differs from other exchanges because it doesn't help startups raise money, but does offer a platform for users to purchase tokens at a discount before they list.

To be sure, capital raised is still way down from the crypto boom. Funds raised through IEOs, ICOs and private sales totaled $1.2 billion this year through May, down from about $10 billion in the same period a year ago, according to Ricky Tan, founder of TokenData, a cryptocurrency data and research firm.

Harmony Protocol, a San Francisco-based blockchain startup that specializes in faster so-called smart contracts, recently raised $5 million through an IEO on Binance.

Co-founder Nick White said Binance representatives spent a month asking "a ton of questions," getting to know his team and scrutinizing Harmony's business model. He said the vetting was far more rigorous than the ICO process, and showed how the industry was maturing.

Adrian Lai, managing director at BlackHorse Group, a cryptocurrency-investment company in Hong Kong, said he invested $3,000 in three IEOs to see how these new offerings worked. He said he isn't planning on investing in others, partly because he doesn't trust the vetting process the exchanges undertake.

"It's a black box basically," Mr. Lai said. "You just have to trust these exchanges and that's really tough."

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—Paul Vigna contributed to this article.

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