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FRAUD AS THE BASIC RISK OF FAILED ICO

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Abstract. In the article, the peculiarities of ICO as a form of financing the company are examined, as well as the main advantages and disadvantages of this way of fundraising are characterized. In analyzing the phenomenon of ICO, the author defines fraud as the key risk of ICO failure and suggests a system of project evaluation based on WhitePaper for preliminary identification of a possible deception.

Keywords: ICO, blockchain, crypto-currency, WhitePaper.

Along with the development of modern technologies and forms of doing business, a new way of attracting financing for innovative projects has emerged, called ICO (initial coin offering - initial placement of coins (tokens)). This method of fundraising is based on the use of blockchain technology - decentralized digital transaction register.

ICO facilitates the simplification of the procedure for attracting financial resources, avoiding regulatory actions of the government and mediation of intermediaries. Startups that wish to conduct an ICO issue tokens for a new crypto-currency, which can be purchased by interested investors. People who invest in the project count on the increase of the price of tokens, which will ensure them a return on investment.

The similarity between ICO and IPO (initial public offering) is obvious, but in the case of ICO, the investor instead of shares receives tokens that do not confer ownership rights, but allow to receive economic benefits from the increase in funds at the conclusion of the ICO. There is a common feature in ICO and crowdfunding: funding is involved to implement a particular project, when a real product does not exist, but there is an idea.

The main advantage of ICO over an IPO is the ease of attracting financing. For project founders, this method is cheaper, allows them to conduct active communication with

the target audience and delegate some of the financial risks to investors. At the same time, investors should be careful not to take part in fraudulent ICO projects. To do this, each potential investor, while deciding whether to invest, should independently or with the help of specialists assess the reliability and potential of the project.

Recently ICO has spread around the world, and with it certain difficulties of this method of financing became apparent. Investments in ICO are characterized by considerable risks because you cannot have absolute certainty about the receipt of a profit. The main factors impeding the successful development of projects will be briefly described below. The most serious reason for the failure of ICO projects, in our opinion, is the emergence and development of financial fraudsters in the industry who seek to raise funds to provide non-existent companies.

According to statistics for 2017, given by TokenData (the Website that is the base of all conducted ICO), 418 out of 902 ICO projects failed: 140 failed at ICO stage, 276 stopped existence after ICO. In addition to these already stopped startups, there are 113 projects whose activities are not known, and their founders do not answer investors and the media, and therefore they can be classed as fraudulent.

For the second quarter of 2018, 827 projects attracted \$ 8, 359 million, which is 151% more than in Q1 (\$ 3,331 million). For the first half a 2018 year, in total, ICO projects raised \$ 11.690 million, which is 10 times more than the same figure in 2017. At the same time, statistics is still disappointing: 55% of projects failed.

The United States Securities and Exchange Commission (SEC) regulates the activities of ICO projects on the territory of the country. On July 25, 2017, the SEC introduced a document that establishes the possibility of applying US securities laws to sales of corporate tokens, thus equating them to assets and imposing certain bans on them.

The result of this regulation was the suspension of the Centra project and the arrest of its organizers, to whom the SEC filed charges of fraud. According to the regulator, the company's founders raised \$ 32 million, trading unregistered tokens. At the same time, entrepreneurs disseminated information about the non-existent team and even created WhitePaper (the main document of the ICO project). As a punishment the founders of the company will be obliged to return all collected funds, as well as fines and interest. Moreover, project managers are banned from further distribution of any securities and deprived of the opportunity to occupy managerial positions.

The largest scam in the history of ICO occurred in Vietnam because of Modern Tech company, which announced two projects: Pincoin and iFan. In total, the organizers deceived about 32,000 people, appropriating \$660 million. Pincoin attracted investors, promising a monthly stable return on investment of 40%, and iFan was seen as a platform for celebrities, offering them communication with fans and promoting their content.

In the ICO market, such fraud cases are called "scam", and as practice shows, every year they become more and more popular, while the number of promising and cost-effective projects is decreasing. Therefore, before investing financial resources in any ICO startup, it is necessary to conduct a thorough analysis. Despite the apparent complexity of this assessment, most of the

information for it can be found through any search engine.

The question is how to distinguish a failed or fraudulent project from a real, potentially successful and profitable one? The first factor is the uniqueness and significant advantages of the idea underlying the project. It is necessary to evaluate the usefulness of the project for people, make sure that it is not plagiarism of another, even useful product.

Next, you should think about the feasibility of the project. To do this, you should carefully study WhitePaper - the main paper of each ICO project. WhitePaper is a document containing an in-depth analysis of the project, the purpose of which is to convince the potential investor of the prospects and value of the idea and the product. Each WhitePaper has a fairly formal structure:

1. Identification of obligations and risks associated with investing and the degree of investor's responsibility;
2. Abstract describing a problem existing in a society that objectively requires a solution;
3. Review of the industry and proof of the existence of a niche and target audience for the submitted project;
4. A solution proposed by the team that can solve the problem described earlier;
5. Business model: implementation and concept of the project;
6. The economy of the token: its description, practicality and functionality. Here it is important to pay attention to the distribution of the token: what percentage will be released for sale, what will be involved in the private sale, what will remain for developers and consultants.

Next, you should see whether the project team plans to prohibit the reselling of tokens - this action will serve as evidence of the seriousness and long-term nature of the project.

It is necessary to evaluate the correlation between the proposed technology or the product and its value. If the token has less than three functions and can be replaced by crypto currency, then this is one of the signs of the project's groundlessness. In the plan where the token is not integrated into the project economy, it is likely that the team uses it only to raise funds.

7. The reasonableness of the need for the use of blocking technology;

8. Details of ICO: the procedure for conducting a closed sale of tokens, pre-sales and main sale;

9. A roadmap describing the stages of the project implementation, its main dates - in this paragraph it is necessary to pay attention to which stage of the project is at this time period and to assess the degree of implementation of the previous stages;

10. Characteristics of the team with brief biographies of developers and project consultants. First you should pay attention to the composition of the team, make sure of the competence and availability of the necessary experience of its participants, the presence of specialized professionals. Suspicious factor will be the disunity of team members or their absence in social networks or reduced activity there.

11. References to the evidence of statements indicated in WhitePaper (their absence may indicate falsification of data) and links to social networks.

It is necessary to evaluate the uniqueness of the WhitePaper itself, as many scammers compile paper, only slightly modifying, and the original can be easily found on the Internet.

Also, each project has OnePaper – a one-page description of the project, which is a short version of WhitePaper. Often it consists of schemes and graphs, and is characterized by the lack of important information. Therefore, the decision to invest is inappropriate to accept, based only on this document.

Another important point for consideration is the program code of the project. It should be laid out on the GitHub (web service for placing the codes of IT projects) and have a discussion page on Bitcointalk (a forum for analyzing the technical side of the block projects).

To make a profit, a valid ICO project must have a real legal and physical address. The project team should organize a system for the sale of goods or services, the characteristic of which is formulated by real projects prior to the fundraising. If there is no information on the ways to monetize the project, it can also be referred to as fraudulent. You should check the official website and the communication facilities of the project founders with their target audience, including social networks (Facebook, Telegram, etc.).

One of the most obvious signs of a fraudulent project is guaranteed yield. If the site offers a stable percentage, the likelihood of fraud is high (as the situation was in the previously reviewed Pincoin project). This is especially evident in projects where the distribution of tokens is carried out according to the principles of network marketing – attracting new investors with the help of already existing.

Thus, ICO is an innovative and promising way of attracting financing, with undeniable advantages, the main of which are low access to the market for both entrepreneurs and investors.

However, in practice it turns out that a significant proportion of ICO projects do not succeed. This happens for various reasons, considered in the article, but the most dangerous is the rapidly developing risk of fraud.

The Crypto-currency community needs to become more vigilant and cautious while choosing a project for investments, and governments of the world should take measures to organize ICO in order to restrict fraudulent activity.

It is simple to deceive ignorant investors, despite the fact that the methods of scammers do not differ in originality. The analysis technique of reliability and potential success of ICO based on WhitePaper is considered in the article in order to help to identify the fraudulent projects and secure investments.

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