

Initial Coin Offerings: Key Considerations You Absolutely, Positively Need to Know About Before Launching an ICO

Article By:

Edward Dartley

Anthony R.G. Nolan

Mary Burke Baker

John ReVeal

Initial Coin Offerings (ICOs) have rapidly emerged as the hottest trend in FinTech financing, albeit one that is not without controversy. Put simply, an ICO is a method of fundraising somewhat akin to an initial public offering of securities, except that in an ICO, the fundraiser uses blockchain technology to issue customized cryptocurrencies (commonly known as coins or tokens), typically in exchange for other established cryptocurrencies such as Bitcoin and Ether.^[1] The proceeds of an ICO can provide kick-start funding to develop the technology and platforms for the token holder's access. An ICO that is properly conceived and structured can provide relatively easy transferability of tokens and the potential for those tokens to be traded on exchanges or resold and converted to government-issued legal tender, also known as fiat currency.

The dramatic rise in value of Bitcoin, Ether, and other cryptocurrencies in recent months has generated great interest in this new form of financing, with new players entering the market literally every day and raising millions in new financing in very short offering times. At the same time, ICOs raise a myriad of complex legal issues in the United States and around the world.

United States regulators and enforcement agencies have recently increased their attention on this burgeoning market and are trying to determine whether and under what circumstances offerings of and transactions in cryptocurrency are subject to their rules and regulations. The regulatory posture of the market for cryptocurrencies has developed quickly and is likely to continue to evolve as regulators grapple with the important questions about how to properly categorize the features implicit in each particular token offering. How U.S. and foreign regulators will eventually come to terms with these issues is difficult to predict. Among the regulators that have staked claims over the regulation of one or more facets of token offerings are the Securities and Exchange Commission (the "SEC"), the Commodity Futures and Exchange Commission (the "CFTC"), the Internal Revenue Service (the "IRS"), and the Financial Crimes Enforcement Network ("FinCEN").

In this article, we describe several key considerations for ICO sponsors seeking to navigate some of the regulatory waters in this rapidly developing space. As described below, we also discuss how the Simple Agreement for Future Tokens (“SAFT”) may facilitate compliance with certain legal and regulatory issues in an ICO offering. The SAFT represents an emerging approach to assisting sponsors to seek to comply with certain securities law, tax law, and financial services regulatory issues.

1. The Securities Laws: Is a Token a Security?

a. Is a Token a Security?

An important threshold question is whether ICO sponsors are offering securities within the meaning of the U.S. securities laws (specifically, the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”). The question is generally whether the tokens constitute investment contracts under standards established by the U.S. Supreme Court in SEC v. W.J. Howey Co.^[2] Under the Howey test, a token is an investment contract — and accordingly constitutes a security — where there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived primarily from the entrepreneurial or managerial efforts of others.

Whether a token is a security depends on the facts and circumstances underlying the ICO, and in particular the function the token performs. For instance, if the tokens issued in the ICO can be used solely to purchase existing goods and services from the platform (“utility tokens”), they may not be an “investment contract” under the consumptive use doctrine developed by courts and the SEC applying the Howey test. On the other hand, a token that represents an interest in an enterprise or to-be-formed enterprise will likely be considered to be a security. The SEC recently addressed the status of one type of digital token under the U.S. securities laws, confirming that digital tokens issued by a virtual organization known as “the DAO” were securities.^[3] Moreover, in recent enforcement actions involving alleged fraudulent ICO offerings, the SEC alleged that the underlying tokens constituted illegal offerings of securities for which no registration was filed and as to which no exemption from registration was available.

The SEC staff in its report on the DAO investigation noted that the question of whether a token is a security is a facts and circumstances analysis that will differ for each token.

b. Offering Tokens through Private Placements

If tokens are securities, the SEC has made clear that they may only be offered to U.S. investors in a registered offering or in a transaction that is exempt from registration, such as through a private placement to accredited investors pursuant to Regulation D under the Securities Act or an unregistered offering under Securities Act Regulation A+. Tokens that are securities and offered publicly will need to be offered and sold pursuant to a registration statement that is filed with the SEC. Because a registered offering involves significant regulatory hurdles and is costly, among other things, ICO sponsors have generally conducted their offerings under the private placement regime.

Once the decision has been made to do a private offering, the sponsor needs to decide whether to conduct the ICO as a traditional private placement, which prohibits the use of general solicitations and advertising, in compliance with Rule 506(b) of Regulation D, or alternatively under the relatively new Rule 506(c), which permits the use of general solicitations and advertising, but requires private placement sponsor to take heightened steps to ensure that the investors are eligible to participate in

the offering. Regardless of the private offering method selected, a sponsor will also need to consider how the limitation on the transferability of tokens may impact the ability of the token to be resold in a secondary market and what impact this may have on prospective investors' decisions to purchase tokens in an ICO.

An ICO could also fall within the SEC's crowdfunding regulation ("Regulation Crowdfunding") if issued by a U.S. person, although the ICO would be limited in other significant respects, including limitations on the offering amount per 12-month period, the size of the investment per individual investor, and restrictions on the resale of tokens. As a practical matter, Regulation Crowdfunding may be unavailable because most ICO issuers are organized outside the United States and because securities offered under Regulation Crowdfunding must be offered and sold through funding portals and broker-dealers that are registered under the Exchange Act.

Private placements are a very common conduit for fundraising, and once the ICO sponsor makes the determination that the token is a security, an ICO private placement would in large part proceed as any other such offering. Rule 506's relaxation on the ban on solicitation is an attractive alternative for some sponsors, given heightened sponsor interest in being visible in this rapidly evolving space. As discussed below, the SAFT may mitigate uncertainty in the application of certain securities laws issues in the case of certain ICOs.

c. Is the ICO Sponsor an Investment Adviser?

Sponsors of ICOs also need to consider whether they are offering investment advice such that they would be subject to SEC registration requirements applicable to investment advisers. The Investment Advisers Act of 1940, as amended (the "Advisers Act"), applies to any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, selling, or purchasing them. Depending on the structure of a token offering, Advisers Act considerations may be applicable if a token is a security. The Advisers Act may apply to the sponsor of an ICO if the tokens are a security and if the platform's business involves the acquisition of securities, including digital tokens that are investment contracts. A particularly important consideration for an investment adviser relates to how such an adviser can comply with the SEC's custody rule. For instance, how can a password for a token be stored for purposes of the custody rule? Notably, a sponsor may be an investment adviser but could be exempt from registration as an Exempt Reporting Adviser (an "ERA"). An ERA will still remain subject to certain regulations under the Advisers Act.

2. Tradability and Intermediaries

Often, one of the features desired by ICO sponsors and their potential investors is the ability to trade the offered tokens after they have been acquired in the ICO. At bottom, there is a regulatory trade-off in seeking tradability of tokens, and sponsors that want to offer this feature need to address the added regulatory requirements that arise under U.S. securities laws and commodity futures laws.

a. Commodity Exchange Act Considerations

Providing for secondary market trading and liquidity for tokens issued in an ICO requires a consideration of whether the token is a "commodity" under the U.S. commodity laws. A commodity is typically defined as a reasonably interchangeable good or material, bought and sold freely as an article of commerce, which includes all services, rights, and interests in which contracts for future delivery are traded presently or in the future. The CFTC has taken the view that Bitcoin and other

primary digital currencies are “exempt commodities.” As such, they are subject to regulation by the CFTC under the Commodity Exchange Act.

If a platform offers a transaction in cryptocurrencies that are considered to be commodities and the transaction is margined, leveraged, or financed, it needs to “deliver” the relevant cryptocurrency to the buyer within 28 days or it must register with the CFTC as a futures commission merchant. The chairman of the CFTC recently announced that the CFTC is working to provide a suitable definition of “actual delivery” for a virtual commodity. In addition, sponsors of ICOs that may involve trading in cryptocurrencies that are considered to be commodities or other commodity interests may be required to register with the CFTC as commodity pool operators or commodity trading advisors.

b. Are Intermediaries Securities Exchanges or Broker-Dealers?

The Exchange Act regulates securities exchanges and broker-dealers. If a token is a security, exchanges on which it is traded would have to be registered under the Exchange Act and intermediaries would have to be registered as broker-dealers under the Exchange Act or as registered investment advisers under the Advisers Act. Because most — if not all — cryptocurrency exchanges are not so registered, the exchanges will accept tokens for unrestricted trading only if they believe the tokens are not securities. As discussed above, the Exchange Act would also apply to intermediaries and funding portals used in primary offerings under Regulation Crowdfunding.

Depending on facts and circumstances, an issuance of tokens that are considered securities may implicate the Investment Company Act of 1940, which, generally speaking, applies to issuers of securities that invest in securities. A platform that invests proceeds of an ICO in investment securities pending build-out may inadvertently be an investment company.

3. Tax Considerations

The IRS characterizes digital currencies as “property” rather than as currencies. This means that the proceeds of an ICO are taxable income to the entity selling the tokens. This might be mitigated to some extent if the Cryptocurrency Tax Fairness Act of 2017 (the “Act”) becomes law. This bill, which is currently pending in the U.S. House of Representatives, would exclude from gross income up to \$600 in gains on certain cryptocurrency sale and exchange transactions while creating a reporting regime for cryptocurrency transactions. However, sales or exchanges of virtual currency for cash or cash equivalents would not qualify for the exclusion, so the form of the proceeds of an ICO would affect the taxable gain. Further, since the Act is intended to facilitate common usage of cryptocurrency, it is unclear whether ICO transactions would be within its purview. Buyers of tokens also could realize taxable gains if digital currencies are used to make purchases. Tokens may also be considered interests in partnerships or unincorporated associations, giving rise to various tax considerations. The burden of U.S. tax laws could be one reason why token issuers tend to be established in jurisdictions outside the United States.

4. Bank Secrecy Act Considerations

The ICO market has recently come under criticism from prominent figures within the financial services industry because of its potential to facilitate money laundering, terrorist financing, and other criminal activities. Participants in an ICO in the United States or targeted at U.S. persons should be sensitive to the U.S. Bank Secrecy Act and its related regulations (collectively, the “BSA”).

The BSA generally requires entities meeting the definition of “financial institution” to maintain and

develop appropriate programs to assist the U.S. government in detecting and preventing criminal activities. A “financial institution” under the BSA includes not only banking institutions, SEC-registered broker-dealers, and CFTC-registered futures commission merchants, but also includes money transmission businesses. In certain cases, ICO sponsors and other companies engaged in activities relating to virtual currencies could be subject to BSA regulation as money transmitters.

a. General BSA and Anti-Money Laundering Obligations

Each financial institution subject to the BSA must maintain a written anti-money laundering (“AML”) program that is reasonably designed to prevent the business from being used to facilitate money laundering and the financing of terrorist activities. The AML program must be commensurate with the risks posed by the location and size of the business and the nature and volume of its financial services. The program must include policies, procedures, and internal controls designed to achieve ongoing compliance with applicable BSA requirements, designation of one or more compliance officers, ongoing training of appropriate personnel, and independent monitoring. The requirement to verify customer identities creates a tension in an industry where the purchase of tokens typically involves anonymous or pseudonymous transactions.

b. Money Transmitter Licensing Considerations

Token sale participants may be money transmitters because the BSA regulations define “money transmission services” as the acceptance of currency, funds, *or other value that substitutes for currency* from one person and the transmission of the currency, funds, or other value to another location or person by any means. While FinCEN has provided interpretive guidance and administrative rulings, the issues surrounding whether the activities of an ICO sponsor might subject it to federal or state regulation are beyond the ambit of this article. As a general matter, an ICO sponsor in a decentralized virtual currency such as Bitcoin generally would not be subject to federal regulation as a money transmission business, but an ICO sponsor running a centralized platform where the sponsor has the ability to redeem tokens or accept and transmit the virtual currency on behalf of others may be subject to these regulations. A SAFT may represent a way to help address certain regulatory issues, including money transmitter licensing concerns.

5. The SAFT

The SAFT is emerging as a device that may address some of the regulatory uncertainties in ICOs of utility tokens where the utility does not exist on the date of the ICO.

The SAFT is intended to be an investment contract (i.e., a security as defined under the Securities Act) that provides investors with the right to obtain delivery of digital fully functional utility tokens once the platform or network is created and the tokens can be used to obtain goods or services on the platform. The SAFT is modeled on the Y Combinator SAFE notes, which are widely used to finance early-stage venture companies, with the difference being that the holder is entitled to receive tokens instead of equity.^[4]

The SAFT is a framework that seeks to navigate certain of the securities law and money transmitter regulatory issues discussed above and to enhance the flexibility for issuers and investors to manage tax liabilities.

With respect to securities law compliance, the SAFT framework is designed to permit an issuer to comply with the federal securities laws in an exempt offering while having those requirements (and

any concern about underwriter liability) fall away when the SAFT is redeemed for a utility token (i.e., a token that is not a security). From the perspective of money transmitter laws, the SAFT is arguably one step removed from a “convertible virtual currency” and may also reduce the possibility that the issuer or the investors will be considered to be an exchanger or that the issuer may be considered an administrator. From a tax perspective, the SAFT is generally intended to be taxed as a forward contract, which may mitigate — but does not eliminate — tax inefficiencies in token transactions. If that characterization is upheld, the first taxable event in the ICO would occur only when the tokens are delivered to the investors upon redemption of the SAFT.

It is important to be mindful that the SAFT has not been endorsed by the SEC, the IRS, or FinCEN and has not been the subject of any judicial decisions. However, it may be regarded as representing an emerging consensus on a responsible approach to addressing certain regulatory issues posed by ICOs.

6. The Weiji Forward ??

Notwithstanding the various legal and regulatory considerations, the wave of enthusiasm for ICOs shows no signs of abating. The Ethereum blockchain has rapidly accelerated the potential of distributed ledger technology by making possible the practical use of smart contracts to convert Bitcoin (as well as Ether and other cryptocurrencies) into a wide range of tokens that can represent an astonishing array of decentralized applications providing real and virtual goods and services. This creates a fascinating tension between the way in which markets are evolving through new technology and the requirements of regulatory schemes that were created in a vastly different technological world. The rapid evolution of technology that has made ICOs possible is matched by a rapid evolution of the views of regulators and of how to regulate this new market. This will create opportunities for entrepreneurs but also creates a unique regulatory risk profile for market participants considering participating in ICOs or other cryptocurrency transactions.

[1] Cryptocurrency refers to decentralized digital assets that use cryptography as a means of securing transactions independent of clearinghouses while preserving anonymity in the traditional sense. Cryptocurrency typically takes the form of digital coins or tokens that exist on the Ethereum blockchain or

distributed ledger, whereby owners receive a key that serves as the password to ownership of the coin or token.

[2] 328 U.S. 293, 301 (1946); see also *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852–53 (1975). Other standards may apply to the

characterization of a token under the Securities Act depending on the characteristics of the token. See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56

[3] Report of Investigation Pursuant to Section 21 of the Securities Act. Report linked here.

[4] For more information about the SAFT, see the white paper developed by the SAFT Project, <http://saftproject.com/static/SAFT-Project-Whitepaper.pdf>.

Copyright 2025 K & L Gates

National Law Review, Volume VII, Number 312

Source URL: <https://natlawreview.com/article/initial-coin-offerings-key-considerations-you-absolutely-positively-need-to-know>