

Regulatory Scrutiny of the ICO Market – What Fund Managers Should Know

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Last week, former CFTC Chairman Gary Gensler [explained in remarks at M.I.T. that he believes](#) the second and third most widely used virtual currencies—Ether and Ripple—may have been issued and traded in violation of securities regulations. This comes on the heels of [a crackdown on cryptocurrency-related securities](#) by the SEC, which is particularly focused on initial coin offerings (ICOs). For fund managers, we believe the increased regulatory pressure will be felt in some expected, and some not-so-expected, ways.

ICO enforcement is trending: The SEC’s Cyber Unit has ramped up enforcement pressure, issuing dozens of [subpoenas](#) and information requests to technology companies and advisers involved in the ICO market. The requests have sought information about the structure for sales and pre-sales of ICOs. This uptick in enforcement pressure isn’t surprising, especially given Chairman Clayton’s repeated warnings that participants in the ICO space are not complying with the required securities laws (for example, notably stating that he has yet to see an ICO that “[doesn’t have a sufficient number of hallmarks of a security.](#)”) There are no signs the SEC will slow down its scrutiny of crypto-related assets. The SEC has already [indicated](#) that it will devote significant resources to policing the ICO market.

- SEC and CFTC enforcement cases have to date focused on the anti-fraud provisions, involving traditional types of schemes (offering frauds, market manipulation) feeding on interest in new technology.
- Clayton has repeatedly warned attorneys and other advisers involved in structuring ICOs to stop advising their clients that these instruments don’t need to be registered.
- The SEC is looking at potential registration issues for ICOs, under the principle that every offering of securities must be registered or subject to a valid exemption.
- Businesses operating as ICO exchanges or advising on ICO investment decisions may have to consider registration under the Securities Exchange Act of 1934, the Investment Company Act of 1940 or the Investment Advisers Act of 1940.
- The SEC’s [Section 21\(a\) report of investigation regarding The DAO](#) sets out the framework

for how the Commission is likely to analyze whether a crypto coin or token is a security.

As such, those who interface with this market in any way should beware that they can face heightened scrutiny merely by virtue of their involvement with these instruments.

OCIE exam focus is also high: The Office of Compliance Inspections and Examinations is following the lead of the Chairman, but with a different focus. It has been publicly [reported](#) that the exam staff intends to examine up to 100 fund managers as part of a sweep of crypto-focused funds. However, while SEC examiners could refer any red flags they observe to enforcement investigators, the effort is principally to inform the Commission how to address the new world of cryptocurrency investments. Two key areas of focus are likely to come to light:

- Have cryptocurrency related risks been adequately disclosed to LPs in offering docs (i.e., potential investment losses, liquidity risks, price volatility, hacker-related frauds, etc.)?
- Are there adequate risk management policies and procedures that have been put in place by firms registered with the Commission given novel issues implicated by crypto-related investments?

To this end, fund managers should be prepared to explain how disclosures to LPs adequately reflect the risks involved in any crypto-related investments. Because of the potential for regulatory spillover, fund managers should satisfy themselves that investments in this space comply with applicable laws and regulation—the question will be asked.

Regulatory uptick has been felt by the market: This increasing regulatory pressure appears to be affecting the market—while the number of ICOs in March [dipped only slightly](#), the gross proceeds were only \$795 million—a 45% decrease from the \$1.44 billion raised in February. This decrease may signal a shift to a higher degree of “pre-sale” fundraising, mainly focusing on institutions and accredited investors—often through Simple Agreements for Future Tokens (or SAFTs), which have also [garnered significant regulatory attention](#). However, given the increasing focus on this area (along with crypto-related investments in general), fund managers should be sure to commit the upfront effort to carefully analyze emerging regulatory risks.

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