

HOW TO HANDLE AN INITIAL COIN OFFERING

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I. Executive Summary

The rapid development of cryptocurrencies and other digital tokens, coins and assets have led to increasing use of the blockchain to raise capital for crypto/digital token projects, issuing digital currency or assets to investors in a process called an “Initial Coin Offering,” or “ICO.” ICOs have become a major driving force in the development of decentralized finance and blockchain ecosystems. In an ICO, a company or business venture (“Issuer” or “Promoter”) creates a cryptocurrency, digital token, coin, or other asset and offers it for sale to investors on the blockchain, raising its capital by investor payment of Bitcoin, Ethereum or other cryptocurrency, or by fiat currency (government-issued currency not backed by a physical currency like gold or silver, such as the U.S. dollar, with the value of the currency residing solely in trust and confidence in the issuing government). This advisory will discuss how to handle an ICO, review special features of ICOs compared to traditional capital-raising like private placements, “Initial Public Offerings” (“IPOs”) and “Special Purpose Acquisition Company” (“SPAC”) IPOs, and how to avoid legal and regulatory pitfalls that many crypto/digital token issuers assume don’t apply to them, but which have sunk many ICOs. Familiarity will be assumed with our client advisories “Raising Capital through Private Placements,” its Appendix 1 Exemption Chart, “SPACs are Back: An IPO and Private Equity Alternative,” and “Forming Crypto/Digital Asset Funds using Wyoming Decentralized Autonomous Organizations (“DAOs”)/Blockchain and U.S. Securities Laws,” all available for download along with other resources at [Kurtin PLLC Raising Capital](#).

II. The ICO Market

According to ICO Bench,¹ since the first ICO in 2013 (by J.R. Willet to sell Mastercoin, which raised \$500,000), ICOs have raised over \$50 billion, with the largest, EOS, raising \$4.2 billion in 2018 during an ICO boom of over 1,000 offerings. However, over 80% of ICOs in the 2018 boom turned out to be scams, with the largest, Bitconnect, alone defrauding investors of \$2.6 billion, leading to increasing pressure in the U.S. to treat ICOs for digital assets exhibiting characteristics of securities as security offerings, to be regulated by the U.S. Securities and Exchange Commission (“SEC”).

¹ <https://icobench.com/stats/ico-statistics/#:~:text=Data%20from%20ICO%20Drops%20shows,Coin%2C%20which%20raised%20%24240%20million>.

ICOs have many advantages. They are completely decentralized owing to being offered on the blockchain. They offer immediate and rapid access to a global pool of investors, including retail investors, resembling Crowdfunding as a quasi-public offering but one not registered pursuant to the U.S. Securities Act of 1933 (see, “Raising Capital,” Section VI). ICOs offer the opportunity to raise capital without significant dilution of Promoters’ equity, and nearly complete liquidity while the offering is on the blockchain and can be traded on a blockchain exchange. The Issuer or Promoter does not need access to investment bankers, market makers, placement agents or venture capital firms to gain access to investors.

2023 data on over 3,000 ICOs indicates that over 36% were finance projects, followed by trading, payments, and infrastructure. Ethereum was by far the most-used blockchain platform, used for over 72% of the ICOs surveyed. The U.S. accounted for the largest number of ICOs, followed by the U.K. and Singapore. Some countries, notably China and South Korea, have flatly outlawed ICOs. The average ICO campaign lasts for 40 days, far shorter than private placements, IPOs or SPAC IPOs, and ends, for successful ICOs, with the listing of the token on the blockchain. However, ICOs have significant loss rates (although high initial returns of up to 179% between ICO pricing and opening market price) and offer no protection for investors, owing to their largely unregulated status.

III. What’s Involved in an ICO Compared to Private Placements, Traditional IPOs, and SPACs

A. Types of ICOs.

The digital coins or tokens issued in an ICO are generally classified as “Utility Tokens,” “Security Tokens” (in which case the offering is usually called a “Security Token Offering, or “STO”), or “Currency Tokens” (other digital assets, like Non-Fungible Tokens (“NFTs”) may be sold on the blockchain, but they function more like selling a work of art, or a vintage car, just a sale of a product). Utility Tokens are tokens that are issued to gain access to a particular platform, project or service, functioning as a kind of scrip, but not exchangeable for other platforms, projects or services. A useful analogy would be an Apple Card or Amazon Card, which can be used to make purchases on those platforms but nowhere else, and which cannot be traded for other assets, if an Apple Card or Apple Card could be resold and exchanged for more or less than face value.

Security Tokens generally exhibit the attributes of traditional securities, which are just as intangible as Security Tokens are. In the U.S., if the offering exhibits the hallmarks of a security pursuant to the classic *Howey* test, named after a 1946 U.S. Supreme Court case: being an “investment contract” by

reason of being an (1) investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others, the offering is of a security and is regulated in its initial issuance and in resales or exchanges by the SEC. A digital token not meeting the criteria of a Security Token might be classified as a commodity rather than a security, a derivative “futures” contract in the underlying asset, operating as a kind of put or call option giving the option holder the right to sell or to buy the futures contract at the then-current market price of the option, which will either be above or below the exercise price paid for the option.

Currency Tokens are cryptocurrencies, functioning as a kind of fiat currency, like Bitcoin or Ethereum; or as a “Stablecoin,” which, unlike a fiat currency, is pegged to an underlying asset such as the U.S. dollar or a precious metal, therefore functioning as a kind of derivative contract of that asset.

B. Three Big Things to Keep in Mind.

- (1) The first thing that every ICO Issuer or Promoter needs – urgently – to keep in mind is that the advent of blockchain-based cryptocurrency and other digital assets does NOT automatically suspend the U.S. securities, commodities, and currency regulatory regimes. Although under the Trump administration the SEC and Commodity Futures Trading Commission (“CFTC”) are expected to be more supportive of blockchain-based issues than was the case during the Biden administration, the body of U.S. securities and commodities law remains in place, as does the two agencies’ primary missions: for the SEC, of protecting U.S. investors from unscrupulous issuers and promoters and fraud; and for the CFTC, regulating futures and derivatives markets.
- (2) The second thing to understand is that, although the crypto/digital community has long supported having cryptocurrencies and digital tokens regulated as commodities and not securities, due to the relatively lighter commodities regulatory structure than the securities regulatory regime, we expect the existing securities/commodities regulatory and oversight regime to be adapted and generally apply with a deregulatory bias under the Trump administration (*see* “Cryptocurrency & Digital Asset Regulation in the second Trump administration: What to Expect and How to Prepare” and other resources at [Kurtin PLLC Information Technologies, Blockchain & Internet](#)). Assuming that to be the case, crypto/digital assets will continue to be regulated either as securities, commodities, currencies, or none of them (as in the case of NFTs).
- (3) The third thing to understand is that cryptocurrencies and related digital assets are no longer flying under anyone’s radar screen. There are 17,000 - 25,000 cryptocurrencies in existence

today, they are collectively a multi-trillion-dollar business, and their regulatory status, until now somewhat in flux with few hard and fast rules to rely upon, is bound to settle down and be resolved.

C. The ICO Process.

Initially the Promoter must create the digital coin or token to be offered in the ICO, developing its intended attributes and behavior. ICOs usually use a published “White Paper” to explain the Promoter’s project to investors. The White Paper should include the “Tokenomics,” an explanation of the token’s attributes and how it is to function, the “Soft Cap” (the minimum number of tokens the Issuer hopes to sell), the “Hard Cap” (the maximum number of tokens available), number of sales rounds, duration of offer, the number of coins or tokens reserved for Promoters, and so on. The White Paper usually does not contain all the kinds of disclosure that would protect investors from fraud (and ultimately protect the Promoter from fraud lawsuits by disgruntled investors). For that reason, especially for Security Tokens, but also for other tokens, we recommend including the kinds of disclosure materials expected in an SEC-regulated offering circular: explanation of the token, its use and function; use of the ICO proceeds, risk factors, Promoters’ management team, and so on. These materials can be incorporated into the body of the White Paper or pitched out to a separate offering circular.

After issuance of the White Paper (with or without offering circular), the Promoters engage in a marketing campaign for the ICO, similar to an IPO roadshow. The marketing campaign generally includes social media outreach, email outreach, community building, ICO influencers and other digital marketing. Then, the ICO is listed on the blockchain. As stated, the ICO is most frequently offered on the Ethereum blockchain, which uses the ERC-20 standard for token development. Tokens are generally sold in the ICO at a discount to expected market price, mimicking standard IPO technique, to ensure as much as possible that the ICO coins are “in the money” upon issuance and sale and that the price rises after listing.

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