



*An effort to spread
awareness about **Legal**
and **Regulatory Aspects of**
CRYPTOCURRENCY*

INITIAL COIN OFFERING

LEGAL FRAMEWORK
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ICO Regulations and Legal Framework

Summary

Initial Coin Offerings (ICO) and Cryptocurrencies are attracting investors at an exciting pace, whereas regulatory aspects of ICO and cryptocurrency present major challenges across various nations. This e-book is aimed at discussing legal, tax, accounting, know your customer (KYC), anti-money laundering (AML) and business due diligence aspects for the FinTech (Financial Technology) sector, with a special focus on ICO and Cryptocurrencies.

Goals / Key takeaways

The author aims to spread awareness about legal and regulatory aspects of ICOs and cryptocurrencies. In addition, readers can get in touch with the author to discuss how a legal framework can be developed to launch their own ICOs and raise funds from global investors. Readers can further subscribe to author's dedicated list of members to learn more about laws and regulations that impact ICO, Blockchain and Cryptocurrency.

Introduction

ICOs and Cryptocurrencies have proven to be a boon for small businesses and startups as these offer the privilege of raising funds using peer-to-peer (P2P) approach, which bypasses traditional funding requirements, such as, regulatory compliance, Initial Public Offering (IPO), due diligence etc.

However, next generation funding opportunities using ICOs and Cryptocurrencies can lead to roadblocks for technology companies if certain legal implications are ignored, depending upon the jurisdiction (country or region) of operation. This write-up is aimed at developing a possible legal framework for ICOs and Cryptocurrencies, which can assist the companies in formulating best in-house practices to avoid future legal and regulatory issues.

Legal Framework for ICOs

Although a handful of companies have amended their laws and regulations to adapt to ICOs, Blockchain and Cryptocurrency, there exist certain standard category of regulations that need to be considered before raising funds by way of ICOs. These include:

- (a) Adhering to anti-money laundering (AML) and know your customer (KYC) regulations.
- (b) Execution of proper registration and disclosure statements.
- (c) Drafting and inclusion of strong legal disclaimers across all documents.
- (d) Determining if tokens or coins fall under the scope of securities.
- (e) Taxation implications at the time of buying / selling tokens or coins during the ICO.
- (f) Taxation implications at the time of exercising their rights by the investors / buyers of tokens or coins after the ICO.
- (g) Duly considering legality of the products (tokens or coins) being offered to the investors and buyers via the ICO.
- (h) Protection of investors' rights and fair trade practices during the pricing and trading of coins or tokens.

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(i) Ensuring all safeguards to prevent Counter-Terrorist Financing (CTF) in accordance with local laws and regulations

Applicability of Securities Law

With a view to determine if tokens or coins fall under the scope of securities, it is crucial to ensure that the token purchasers should not expect to profit and the token has a specific purpose or a utility.

In essence, digital tokens are created using Blockchain technology by executing software instructions, which are decentralised. Such tokens may be used as a digital currency (Bitcoin), or may also be used for distributed applications using novel protocols and networks.

As it has been observed across multiple jurisdictions that various regulatory authorities are closely following the ICO related regulatory developments in US, it would be apt to consider the US Supreme Court case of *SEC v Howey* wherein it established the test for whether an arrangement involves an investment contract.

Specifically, an investment contract is a type of security. In the context of blockchain tokens, the Howey test can be expressed as three independent elements and all three elements must be met in order for a token to be a security. The three elements are, (i) an investment of money, (ii) in a common enterprise, and (iii) with an expectation of profits predominantly from the efforts of others.

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Legal Documentation for Initial Coin Offering (ICO)

Generally, a common agreement executed for the purposes of ICO is known as SAFT (Simple Agreement For Future Tokens), which includes all the provisions to define the transactions between the Company and the Buyers of the tokens or coins, specifically describing the nature of tokens or coins as a utility and not a security. More details about SAFT can be read in “[The SAFT Project Whitepaper](#)”, published by Juan Batiz-Benet, Jesse Clayburgh and Marco Santori.

All the ICO related documentation shall ensure that tokens do not confer upon the buyers any right to vote or to consent to or to receive notice as a shareholder of the Company, as such, in respect of any matters whatsoever, or any other rights or liabilities as a shareholder.

In addition to the above, it is strongly advisable that all the buyers agreements are executed in a manner such that the buyers represents and warrants to the Company that buyers is acquiring the Tokens voluntarily and the buyers has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of a transaction in the SPS Tokens (SPS Coins) and the underlying utilities.

The ICO related documentation should clearly describe the architecture and future implementation of the ICO project to the buyers, in addition to the blockchain implementation protocol. The issuance of coins or tokens should also be described including the value of each coin or token, total number of coins or tokens to be issued, along with accepted currencies. For example, accepted currencies can be Bitcoins (BTC) or Ethereum (ETH), which shall be converted into equivalent USD amount at prevailing conversion rates.

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It is further advisable to explain the token or coin utilization process to the buyers, which can be done by clearly defining the benefits and value of the tokens or coins bought by the buyers during the Initial Coin Offering. Explaining token or coin exchange or transfer process among the buyers and to third parties can also be helpful along with rights and responsibilities of the buyers.

To further strengthen the Company's relationship with the buyers, details regarding distribution of funds and distribution of tokens can be shared with the buyers. For example, distribution of funds can include categories for funds allocation, like, product development, marketing, and the like. Similarly, distribution of tokens can include amount of tokens that will be distributed to founders, new contributors, and the like.

ICO Structuring

The first step to formulate a structure for ICO requires determining an appropriate jurisdiction to incorporate the required legal entity. The jurisdiction can be selected based upon a legal opinion on the possible method of operation in light of the local laws and regulations that should generally allow the transactions involving cryptocurrency, thereby leading to a seamless opening and operation of a local bank account.

Once the requisite legal structure is finalized, corporate documentation to strengthen the company's operations shall be prepared. Important corporate documentation includes, shareholders agreement, contributors agreement, website terms and conditions, privacy policy, mobile app terms and conditions, and regulatory documents required for compliance and cooperation with local authorities.

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Token Sale and Taxation

After successful completion of corporate and legal documentation, the legal framework requires establishing a process to execute the sale of tokens or coins. As discussed above, the process to sell coins should be developed in a manner such as to ensure that the tokens do not amount to security. Additional detailed measures are required to reduce the tax risks for the company, founders and investors, by reviewing the applicable tax laws and international taxation regulations.

Documentation Audit

With a view to comply with blockchain and cryptocurrency regulations, a regular and thorough audit of legal and corporate documentation is highly beneficial. There are certain documents that require regular audits, such as, for example, processing policy, contributors agreement, privacy policy, data transfer policy, AML and KYC documents, terms of use, online ICO terms and conditions, sale of token agreement, electronic contracts to govern click-wrap and browse-wrap agreements, NDA for employees, dispute resolution mechanisms for users, employment agreements, loan and barter agreements, financial statements etc.

Such audit provides credibility to the investors, both existing and potential, thereby ensuring a seamless journey for the ICO venture.

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Conclusion

ICO represent a novel and inventive path to raise capital and it has gained a high degree of popularity since 2016. The tokens or coins issued during the ICO are based on blockchain, which is electronically distributed and provides a fraud-resistant ledger. As may be seen, global regulatory authorities are pursuing different approaches to regulate ICOs and hence, non-compliance brings a greater risk to the companies.

The best way to navigate the regulatory landscape involves providing all the stakeholders with sufficient and accurate information in a comprehensive and transparent manner along with developing a smart legal strategy.

Tech startups and companies can avoid legal issues associated with ICOs and cryptocurrencies by following a well formulated legal framework based on applicable laws and guidelines, both locally and globally, thereby allowing new businesses and entities to create and self-organize, raise funds, create value and manage their financial infrastructure in a dynamic fashion.

applicability of Securities Agreement executed for the purposes of ICO is known as SAFT (Simple Agreement For Future Tokens), which includes all the provisions to define the transactions between the Company and the Buyers of the tokens or coins, specifically describing the nature of tokens or coins as a utility and not a security. More details about SAFT can be read in "[The SAFT Project Whitepaper](#)", published by Juan Batiz-Benet, Jesse Clayburgh and Marco Santori.