

## Technical and legal framework of Initial coin offerings

**Haïssam Fadlallah**

Attorney at Law and Associate Professor, Faculty of law, Lebanese University–Filiere Francophone de Droit  
haissam.fadlallah@hotmail.com

### Abstract

Today, blockchain-based technologies, such as the Initial Coin Offering (ICO), are capable of providing solutions for financing SMEs. ICOs are the issuing of digital tokens that will be sold to investors in return for a cryptocurrency, allowing a project to be funded. This research examines the process of this novel and alternative method of business financing. At first glance, the ICO protocol appears to be very similar to the Initial Public Offering (IPO) procedure raising the question of how ICOs ought to be regulated. To answer this question, descriptive and analytical research will be conducted.

On a legal level, the study found that three approaches to the regulation of ICOs exist, with the American option being the most fascinating because it represents a middle ground between banning and developing a new independent law for token issuance, allowing ICOs to be included within an existing legal framework. The study recommends that the Qatar Financial Markets Authority adopt this American approach, so ICOs will be introduced in Qatar smoothly and without the need for new legislation. This will result in a desired goal of promoting Qatari SMEs.

**Keywords:** Blockchain; Cryptocurrency; Security; SME; Tokens

Cite this article as: Fadlallah, H. "Technical and legal framework of Initial coin offerings" *International Review of Law*, Volume 12, Regular Issue 1, 2023

<https://doi.org/10.29117/irl.2023.0261>

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OPEN ACCESS

Submitted: 02/03/2022

Reviewed: 26/03/2022

Accepted: 28/04/2022

## الإطار التقني والقانوني للعروض الأولية للعملة الرقمية المشفرة

هيثم فضل الله

محام بالاستئناف وأستاذ مشارك في كلية الحقوق بالجامعة اللبنانية، الفرع الفرنسي

haissam.fadlallah@hotmail.com

### ملخص

أصبحت التقنيات القائمة على تقنية سلسلة الكتل، مثل العرض الأولي للعملة الرقمية المشفرة، قادرة اليوم على توفير الحلول المناسبة لتمويل المشاريع الصغيرة والمتوسطة. إن العرض الأولي للعملة الرقمية المشفرة هو إصدار رموز تُباع للمستثمرين مقابل عملة مشفرة، مما يسمح بتمويل مشروع تجاري. تعرض الدراسة آلية عمل هذه الطريقة الجديدة والبديلة لتمويل الأعمال التجارية. وللوهلة الأولى، يبدو أن العرض الأولي للعملة الرقمية المشفرة يشبه إلى حد بعيد إجراء الاكتتاب الأولي؛ مما يثير التساؤل حول كيفية التنظيم القانوني لعمليات العرض الأولي للعملة. وللإجابة عن هذا التساؤل اعتمدنا المنهج الوصفي التحليلي.

وجدت الدراسة على المستوى القانوني ثلاث طرق لتنظيم العرض الأولي للعملة الرقمية المشفرة، مع الأخذ بعين الاعتبار أن الخيار الأمريكي هو الأكثر اهتماماً؛ لأنه يمثل حلاً وسطاً بين الحظر والإصدار لقانون مستقل جديد يسمح بإصدار الرمز، مما يخول إدراج العرض الأولي للعملة الرقمية المشفرة في إطار قانوني قائم. توصي الدراسة هيئة قطر للأسواق المالية بتبني المقاربة الأميركية؛ بما يسمح بإدخال عمليات العرض الأولي للعملة الرقمية المشفرة في قطر، بشكل سلس، دون الحاجة إلى إصدار قانون جديد؛ مما يؤدي إلى الترويج للمشاريع الصغيرة والمتوسطة القطرية.

**الكلمات المفتاحية:** سلسلة الكتل، العملة المشفرة، العملة الرمزية، المشاريع الصغيرة والمتوسطة الحجم، الأوراق المالية

للاقتباس: فضل الله، هيثم. «الإطار التقني والقانوني للعروض الأولية للعملة الرقمية المشفرة»، المجلة الدولية للقانون، المجلد الثاني عشر، العدد المنتظم الأول، 2023، تصدر عن كلية القانون، وتنشرها دار نشر جامعة قطر

<https://doi.org/10.29117/irl.2023.0261>

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## Introduction

Today's businesses, particularly start-ups, confront a serious problem in finding suitable fundraising to kick-start their activities in a world of cutthroat competition. More importantly, relying on the traditional means of a public offering in this regard could not necessarily ensure the success of fundraising, for a variety of reasons. Such is the fact that public offers are not open to all sorts of businesses, as well as the complexities of the process (the need for intermediaries, time limits, and the risk of not reaching the required cap)<sup>1</sup>. Moreover, the financial crisis, combined with banking rules, drastically reduced the resources available to small and medium-sized firms (SMEs), and much more so to new entrepreneurial operations.<sup>2</sup> Nonetheless, SMEs are today one of the most important economic cornerstones, and, in order to reach such an outcome, SMEs must be active. This scenario necessitates allowing SMEs to obtain adequate funding. However, as mentioned above, this objective is challenging for a variety of reasons. In brief, funding may be selective and heavily bureaucratic, and thus closed before SMEs. Moreover, investors and the banking industry may prefer to focus on large, well-established enterprises that are already generating significant profits. This situation is true for all countries in general, as well as Qatar in particular. This demonstrates the importance of finding new ways to fund SMEs. More particularly, we need to find funding tools that are as open to the public as feasible. In other words, more democratic funding tools are required today.

Due to such factors, entrepreneurs began to look for new alternative types of funding. Fortunately, new advances in digital technology are able today to provide some interesting options such as crowd fundraising and initial coin offerings introduced by decentralized blockchain businesses.<sup>3</sup> Indeed, technology and innovation tend to reshape the financial industry quicker than the legal and regulatory structure can effectively respond.<sup>4</sup>

Furthermore, because modern digital technology is made to be widely available to the general public, they may be able to quickly attain the goal of funding SMEs, highlighting the importance of this topic. This study looks at the ICO as one of the blockchain-based funding mechanisms. In fact, ICOs are valuable tools since they are particularly meant to fund corporate activity.

The initial coin offering (ICO) represents the current tendency among legal practitioners

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- 1 W. Fitts, "Initial Coin Offerings: Getting Rid of the Venture Capitalist", *The Tennessee Journal of Business Law*, Vol. 20, n. 2, 2019, p. 927.
  - 2 M. Dell'Erba, "Initial Coin Offerings: The Response of Regulatory Authorities", *New York University Journal of Law and Business*, Vol. 14, n. 3, 2018, p. 1117.
  - 3 I. Oren, "ICO's, DAO's, and the sec: A partnership solution", *Columbia business law review*, Vol. 2, 2018, p. 620.
  - 4 R. Ryan, & M. Donohue, "Securities on blockchain", *The business lawyer*, Vol. 73, 2017, 2018, p. 85.

of attempting to keep the best of both worlds: delving into the new area of blockchain and crypto-economics while pulling inspiration from the well-known concept of IPO “Initial Public Offering.”<sup>5</sup>

The ICO is an intriguing innovative process to investigate because it offers many benefits desired by entrepreneurs, such as simplicity (the absence of a third-party intermediary), a broad range of targeted public (internet users), and, most importantly, it would keep ownership of the shares with the initial founders or shareholders, granting the investor certain investment rights.

In this context, the term “Initial Coin Offering” refers to a public sale of digital assets, namely coins or tokens, by a company looking to raise external funds.<sup>6</sup> The purchase is managed and recorded on a blockchain, a “distributed ledger technology,” that aids in the recording of transactions or the tracking of assets in a corporate network.<sup>7</sup> This technology allows for the exchange of value without the need for a trusted central authority or middleman.<sup>8</sup>

As a result, an ICO is simply a means of generating funds in which the issuer issues a limited number of blockchain-created tokens in exchange for a payment in cryptocurrency. The tokens are distributed to online investors, physical or moral persons, by the fund issuer who issued them.<sup>9</sup>

Although ICO may have numerous advantages, it is important to note that, unlike IPOs, there is a lack of clarity regarding the legislative framework applicable to the offers and tokens produced.<sup>10</sup> Moreover, regulatory uncertainty arises regarding the underlying distributed ledger technology and its digital applications, on which ICOs are based.<sup>11</sup> It is important to note that legislation surrounding ICOs are still in the early stages of development and vary among jurisdictions. That is why companies and investors investigate ICOs in jurisdictions

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5 F. M. Laprade, «Premier encadrement des ICO en France: étude pratique», In Blockchain et droit des sociétés, Dalloz, 2019, p. 77.

6 P. Momtaz, “Initial coin offerings”, 2020, p. 1. Available at: [https://www.researchgate.net/publication/341555998\\_Initial\\_Coin\\_Offerings/link/5ecbc5dd299bf1c09add4646/download](https://www.researchgate.net/publication/341555998_Initial_Coin_Offerings/link/5ecbc5dd299bf1c09add4646/download) (Last visit, 13 February 2022).

7 J. Moran, “The impact of regulatory measures imposed on initial coin offerings in the United States market economy”, the catholic university journal of law and technology, Vol. 26, n. 2, 2018, p. 215.

8 M. Mendelson, “From initial coin offerings to security tokens: A U.S. federal securities law analysis”, Stanford technology law review, Vol. 22, n. 1, 2019, p. 57.

9 C. Guionnet-Moalic, & M. Dubois, «Le b.a.-ba sur l’ICO (initial coin offering) et sa fiscalité», La semaine juridique Générale, n. 43, 2019, p. 1924.

10 M. Ozeyzil, “Initial coin offerings (ICOs): a comprehensive review on start-up firms”, Pearson journal of social sciences and humanities, Vol. 6, I. 6, 2020, p. 285.

11 Initial coin offerings (ICOs) for SME financing, OECD, 2019, p. 32. Available at: <https://www.oecd.org/finance/ICOs-for-SME-Financing.pdf> (Last visit, 15 February 2022).

all over the world due to their worldwide nature.<sup>12</sup> More specifically, the disruptive and fairly modern nature of ICOs has resulted in a variety of approaches and solutions for their adoption. Indeed, the incorporation of ICOs into legal systems could be accomplished through a variety of mechanisms. This reality necessitates a discussion of the technical and legal basis of ICOs.

Based on the above, the fundamental question that we attempt to answer here is as follows: **What technical and legal frameworks apply to ICOs globally and what impact do these frameworks have on companies seeking funding?**

To answer this question, descriptive and analytical research will be conducted. We will be able to characterize the frameworks of the ICO through descriptive research. While analytical study will enable us to evaluate ICOs in terms of their ability to contribute to the funding of SMEs.

We will attempt to address this question by studying the technical (1) and legal (2) frameworks of ICO.

## **1. The technical framework of ICOs**

This section outlines the several steps that comprise the procedure of an ICO (1.1) and then compares ICOs to IPOs (1.2).

### **1.1 The process of an ICO**

The ICO process is carried out between issuer start-up enterprises and investors. In other words, only companies and investors are involved in the ICO process.<sup>13</sup> An oversimplified explanation of the ICO process is that issuers raise funds by selling digital tokens. These tokens are digital representations of value that may be traded electronically and serve as a medium of exchange, a unit of account, or a store of value.<sup>14</sup> Tokens can be promoted and sold once an issuer has finished creating them, which is often done through the use of an established platform such as Ethereum. Investors can exchange cryptocurrencies for the new tokens by using smart contracts.<sup>15</sup>

Simply put, an ICO is made up of electronic writings that follow the three basic procedures outlined below:

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12 P. Shrestha, O. Arslan-Ayaydin, J. Thewissen, & W. Torsin, "Institutions, regulations and initial coin offerings: an international perspective", 2020, p. 8. Available at: [https://www.researchgate.net/publication/344632580\\_Institutions\\_regulations\\_and\\_initial\\_coin\\_offerings\\_An\\_international\\_perspective/link/5f85be34a6fdccfd7b5d04dc/download](https://www.researchgate.net/publication/344632580_Institutions_regulations_and_initial_coin_offerings_An_international_perspective/link/5f85be34a6fdccfd7b5d04dc/download) (Last visit, 13 February 2022).

13 Ozeyzil, op. cit., p. 288.

14 E. Trotz, "Tangled up in blue: adapting securities laws to initial coin offerings", Northern Illinois university law review, Vol. 39-3, 2019, p. 434.

15 P. Maume, & M. Fromberger, "Regulations of Initial Coin Offerings: Reconciling U.S. and E.U. Securities Laws", Chicago Journal of International Law, Vol. 19, n. 2, p. 560.

### 1.1.1 The total funding amount and pricing of ICOs

The first step corresponds to the total funding amount and pricing of ICOs. Here, the entire financing amount should correspond to the goal of an ICO. A hard cap or a soft cap can ensure this. A hard cap is the maximum number of tokens that can be issued. In contrast, a soft cap is the minimal amount of investment required for a successful ICO, and thus the amount below which investors will be returned if the ICO fails to meet its funding target<sup>16</sup>.

Although an ICO's total fundraising amount should be set, an uncapped token sale with an unlimited number of tokens is still possible. However, the major danger of uncapped ICOs for investors is not knowing what percentage of the overall supply a coin represents.<sup>17</sup> Nevertheless, the fact remains, that most ICO offerings are capped, with a cap on the amount they seek to raise, which translates into a cap on the number of tokens released. This is explained by the fact that uncapped ICOs risk token "inflation," in which the value of existing tokens is diminished with each new token issuance.<sup>18</sup>

Furthermore, a difficulty may occur at this level because the price of ICO tokens may be dependent on the price of the major cryptocurrency used to purchase it and to which it would be converted when sold. Indeed, it is observed that tokens are typically exchanged against one of the major cryptocurrencies in primary or secondary markets, hence the price of the reference cryptocurrency is inextricably tied to the price of these coins. Given the significant instability seen in such reference cryptocurrencies, this subjects tokens supplied to heightened volatility.

Consequently, we could note that the difficulty in assigning a fair value to tokens produced in ICOs may thus hinder the widespread usage of ICOs as a financing method for SMEs.<sup>19</sup> Conversely, token prices may swiftly rise, creating an opportunity for investors to invest. Thus, this expectation of future financial gains is what may very well drive investors to purchase ICO tokens.

In other terms, if the startup's business model succeeds and the firm's value rises, investors can sell tokens at a higher price than they paid for them.<sup>20</sup>

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16 B. François, «Les offres au public des jetons (Initial coin offerings - ICO) en droit français et en droit comparé», In Blockchain et droit des sociétés, Dalloz, 2019, p. 63.

17 F. Steverding, & A. Zureck, "Initial coin offerings in Europe - The current legal framework and consequences for investors and issuers", p. 21. Available at: [https://www.researchgate.net/publication/340023639\\_Initial\\_Coin\\_Offerings\\_in\\_Europe\\_The\\_Current\\_Legal\\_Framework\\_and\\_its\\_Consequences\\_for\\_Investors\\_and\\_Issuers](https://www.researchgate.net/publication/340023639_Initial_Coin_Offerings_in_Europe_The_Current_Legal_Framework_and_its_Consequences_for_Investors_and_Issuers) (Last visit, 15 February 2022).

18 ICOs, op. cit., p. 14.

19 Ibid., p. 18.

20 Ozeyzil, op. cit., pp. 286-287.

### 1.1.2 The “whitepaper”

The second step corresponds to the issuance of a whitepaper or “terms of sale of tokens.”<sup>21</sup> Because investors do not own shares in this start-up company, the issuers face significant challenges. As a result, they must persuade investors and encourage them to invest. To accomplish this, the issuers provide financial rights to the investors in a smart contract that is made between the former and the latter.<sup>22</sup> That is why, at this level, the fundraiser publishes a document known as a white paper (which is generally available on the ICO’s website), before the sale of tokens to persuade investors of the viability of their ICO.<sup>23</sup>

The most typical aspects of whitepapers are descriptions of the entire project to potential investors, including the legal structure of the ICO, the initial token price, the rights and guarantees attached to the tokens to be issued, the determination of the soft cap and the hard cap.<sup>24</sup> Thus, whitepapers can provide information about the legal procedure, contractual terms, and the legal framework is generally incorporated in the terms and conditions of ICOs.<sup>25</sup>

It is worthwhile to mention that there are no rules for what should be contained in a white paper. However, as abovementioned, white papers most frequently contain project specifics, the necessary amount of capital, a description of the tokens to be sold, a valuation of the tokens, and how the company intends to use the offering funds.<sup>26</sup>

Although some white papers are fairly detailed, they cannot be compared to the prospectus required by security regulations. More precisely, while it is necessitated by security regulations that the prospectus provide thorough information on the issuer, this part is frequently lacking from whitepapers.<sup>27</sup>

### 1.1.3 The token sale

The third step corresponds to the token sale. The ICO’s fundraiser specifies to investors, in a guide available on the ICO’s website, the many wallets into which these investors must deposit their cryptocurrency to participate in the ICO.<sup>28</sup> In other words, when investors buy tokens, they often send funds in the form of cryptocurrency to a predetermined wallet address. From a technical standpoint, the cryptocurrencies are transferred from the investor’s wallet to the company’s wallet, frequently via a smart contract developed by the company.

21 A. Wis, “Initial coin offering as a funding source for projects”, ACC journal, Vol. 25, I. 2, p. 94.

22 Ozeyzil, op. cit., p. 288.

23 I. Subarkah, “Initial coin offering (ICO) in perspective law of sharia business”, Al-Ahkam, Vol. 30, n. 1, 2020, p. 11.

24 Guionnet-Moalic, & Dubois, op. cit., p. 1924.

25 Steverding, & Zureck, op. cit., p. 22.

26 Trotz, op. cit., p. 435.

27 Maume, & Fromberger, op. cit., p. 560.

28 Guionnet-Moalic, & Dubois, op. cit., p. 1924.

At this stage, it is worth noting that ICOs may succeed or fail after collecting funds. As previously mentioned, whenever the soft cap of the funding volume is not met, the ICO is deemed unsuccessful, and the funds contributed are normally returned to the investors. If the pre-defined financing level is met within the set time-frame, the ICO is successful and can be continued.

Trading of tokens on secondary markets after an ICO is neither automated nor guaranteed. A token's listing and active trading on a cryptocurrency exchange platform is seen as an indication of success for the IPO. Because secondary trading is important, simply launching an ICO and issuing a token is insufficient: SMEs must be capable of keeping tokens in the market by ensuring investors are eager to acquire them in the post-offering market.<sup>29</sup>

## 1.2 ICO versus IPO

A corporation distributing crypto tokens to the public online in exchange for funding unmistakably surely recalls an initial public offering (IPO), governed by security laws, wherein a company distributes securities to the public on a stock market.<sup>30</sup>

This analogy is used because, during an ICO, a corporation or individual creates and sells its cryptocurrency using blockchain technology to the wider public. This is comparable to a corporation selling stock to the public as part of an IPO.<sup>31</sup> In fact, an initial public offering (IPO) is when a security is sold to the public for the first time, allowing a private company to go public.<sup>32</sup>

Furthermore, IPOs are usually likened to ICOs because the former is an alternative for the latter. Indeed, both are public offerings of instruments with rights attached that are intended to raise capital for the issuing firm. However, the similarities between the two mechanisms are restricted to language, as the mechanisms diverge on many levels. Here, we focus on the following three major divergences:

### 1.2.1 Financing stages

First, it is stated that IPOs are for established firms with a proven running business, and a solid cash flow generation, whereas ICOs are for start-ups that may not even be incorporated and do not yet have established operations.

Thus, in terms of time in the SME life cycle, the two methods respond to distinct stages. In fact, IPOs are utilized as an exit after a venture capital funding, whereas ICOs seek launching

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29 ICOs, op. cit., pp. 19-20.

30 François, op. cit., p. 62.

31 Steverding, & Zureck, op. cit., p. 12.

32 J. Ritter, "Initial public offerings", *Contemporary finance digest*, Vol. 2, n. 1, 1998, p. 5; J. Brau, & S. Fawcett, "Initial public offerings: an analysis of theory and practice", *The journal of finance*, Vol. 61, n. 1, 2006, p. 400.



fundraise (series A funding).<sup>33</sup> Said differently, ICOs are a novel means of acquiring funds for early-stage enterprises, serving as an alternative to more established sources of startup funding such as venture capital and angel financing.<sup>34</sup>

### 1.2.2 The participants' rights

Second, the rights granted to offering participants are significantly different between the two financing forms. This is explained by the fact that IPOs provide shareholders with ownership rights in the firm, dividends distributed annually based on the company's earnings during a year, and voting rights; whereas the rights granted to token holders vary depending on the token's structure, but in general, ICOs do not confer ownership rights in the project.<sup>35</sup> This is a significant benefit to entrepreneurs that want to raise capital but do not want to give up a portion of their ownership, which is one of the key barriers to the use of public stocks (IPOs) by SMEs.<sup>36</sup> As a result, a tokens sale is a technique of selling participation in a project (that will begin at a later date), unlike an IPO offers a share of the company's ownership.<sup>37</sup>

In line with the previous observation, IPOs represent a share of a company's ownership and allow investors to benefit from the company's profits. A share is a security that symbolizes the ownership of a company's assets by a shareholder. This is evidence of co-ownership of a portion of the company's capital.<sup>38</sup> Tokens, on the other hand, provide project-specific rights.<sup>39</sup> In fact, various sorts of tokens exist, and they can be independently created and have a variety of purposes depending on the business of the entity.

### 1.2.3 Business democratization

Third, ICOs have fueled a steady trend of democratization and the involvement of small investors. As a result, ICOs contribute to the democratization process as well as the acceleration of banking disintermediation. Indeed, ICOs have the potential to eliminate many of the financial intermediaries in the world's security markets.<sup>40</sup> In other terms, ICOs allow startup developers to effectively fundraise for their activities, circumventing both banks and

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33 ICOs, op. cit., pp. 26-27.

34 A. Reygrobellet, «Projet de loi Pacte: les aspects intéressant le droit des affaires», *La semaine juridique Notariale et immobilière*, n. 27, 2018, p. 598.

35 Ozeyzil, op. cit., p. 280.

36 Ibid.

37 L. Arnold, M. Brennecke, G. Fridgen, & T. Guggenberger, "Blockchain and Initial coin offerings: Blockchain's implication for crowdfunding", p. 13. Available at: [https://www.researchgate.net/publication/325128747\\_Blockchain\\_and\\_Initial\\_Coin\\_Offerings\\_Blockchain's\\_Implications\\_for\\_Crowdfunding](https://www.researchgate.net/publication/325128747_Blockchain_and_Initial_Coin_Offerings_Blockchain's_Implications_for_Crowdfunding) (Last visit, 16 February 2022).

38 Wis, op. cit., p. 93.

39 Momtaz, op. cit., p. 6.

40 M. Fenwick, & E. Vermeulen, "Technology and Corporate Governance: Blockchain, Crypto, and Artificial Intelligence", *Texas Journal of Business Law*, Vol. 48, n. 1, 2019, p. 8.

non-banking institutions, conventional investors, by providing liquidity to small investors who would otherwise be unable to invest in highly innovative ventures.<sup>41</sup> An ICO, unlike an IPO, does not require financial institution underwriting and is substantially less expensive. ICOs can be many times less expensive than traditional IPOs given the lack of legal constraints and regulations, as well as the use of digital identity-based processes rather than paperwork throughout the process.<sup>42</sup>

## 2. The legal framework of ICO tokens

This section describes the several major kinds of ICO tokens (2.1), as well as their legal status (2.2).

### 2.1 The categories of tokens:

Tokens are, in theory, entries on a blockchain.<sup>43</sup> Utility tokens and security tokens, also known as equity tokens, are the two main forms of digital tokens released in an ICO.

#### 2.1.1 Utility tokens

To begin, utility tokens are tokens that must be used to benefit a service. As a result, owning utility tokens confers no unique rights within the network; rather, it entitles just the owner to use a service,<sup>44</sup> which means, this type of token grants its holder consumptive rights to a product or service.<sup>45</sup>

In terms of practicality, the utility token is the most extensively utilized sort of token. Utility tokens could be utilized as a vehicle of value exchange, but their primary function, as above-mentioned, is to serve as a pre-selling arrangement for investors to gain access to the issuer's project or to use future services. For example, some tokens just provide the right to use the service offered by a blockchain.

#### 2.1.2 Security tokens

Second, we find security tokens, sometimes known as "financial tokens," that confer on their bearers privileges similar to those conferred by financial securities, such as pecuniary or political rights in their issuer's governance.<sup>46</sup> This is why security tokens are comparable

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41 Fitts, op. cit., p. 927.

42 Dell'Erba, op. cit., pp. 1118-1119.

43 Montaz, op. cit., p. 5.

44 Trotz, op. cit., p. 434.

45 S. Howell, D. Yermack, & M. Niessner, "Initial coin offerings: Financing growth with cryptocurrency token sales", p. 1. Available at: [https://www.researchgate.net/publication/344944152\\_Initial\\_Coin\\_Offerings\\_Financing\\_Growth\\_with\\_Cryptocurrency\\_Token\\_Sales](https://www.researchgate.net/publication/344944152_Initial_Coin_Offerings_Financing_Growth_with_Cryptocurrency_Token_Sales) (Last visit, 15 February 2022).

46 J. Le Guen, «Tokenisation et crypto-actifs: Relate plurielle et enjeux de qualification», Cahiers de droit de l'entreprise, n. 6, 2021, p. 25.

to traditional securities in that they promise a portion of a project's growth, development, or profitability. They can also guarantee a portion of future corporate earnings or capital flows. As a result, a token promoted primarily to distribute dividends may be regarded as a security.<sup>47</sup> In terms of economic function, these tokens are thus analogous to stocks, bonds, or derivatives.<sup>48</sup> This is why, in terms of business investment, this type of token is more appealing than utility tokens.

Therefore, if security tokens incorporate profit participation and participation rights, such as voting rights within the firm, they can be used to invest in the company itself. In the United States, these tokens are covered by security laws based on the Howey test (see below).<sup>49</sup>

One of the key contrasts between security tokens and ordinary stocks in this regard is the method of registering ownership. While security tokens represent ownership on a blockchain, traditional equities are maintained in databases and may be validated by a paper certificate.<sup>50</sup>

## 2.2 The legal status of ICO tokens

For ICO regulation, jurisdictions have chosen one of the three main options. First, some jurisdictions have opted for a total prohibition (this is the case with China). Second, some jurisdictions have opted to integrate token issuances inside the existing regulatory framework of either financial instruments (USA) or payment services (Japan). Third, it appears that certain jurisdictions are considering the introduction of a new, specific framework for token issuances. This is unmistakably true in the case of France.<sup>51</sup>

Because U.S. security laws are frequently followed and adopted, at least informally, by many other nations, how U.S. courts interpret ICOs will have global ramifications.<sup>52</sup>

### 2.2.1 The American case

The most fundamental legal problem facing ICO tokens is whether they qualify as securities. The Securities and Exchange Commission (SEC) in the United States was the first regulator to take a firm stance on the application of US securities rules to token sales.

After the American stock market crash of 1929, Congress enacted two statutes: the Securities Act of 1933 governs securities issuance, whereas the Securities Exchange Act of 1934 governs the trading of issued securities.<sup>53</sup> The Securities Act of 1934 is the federal regulatory

47 Oren, op. cit., p. 637.

48 R. Houben, «Initial coin offerings (ICOs)», *Revue de droit bancaire et financier*, n. 4, 2019, p.1.

49 Momtaz, op. cit., p. 5.

50 Steverding, & Zureck, op. cit., pp. 18-20.

51 Francois, op. cit., pp. 67-70.

52 Howell, Yermack, & Niessner, op. cit., p. 10.

53 J. Rohr, & W. Aaron, "Blockchain-based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets", *Hastings Law Journal*, Vol. 70, no. 2, 2019, p. 486.

framework for security offerings in the United States. This statute only applies when a security is involved in a transaction. “In short, a security is an interest in a corporation or other legal entity with certain rights such as voting, ownership, cash flows, assets, statutory or contractual rights, corporate governance rights, and the expectation of profit. Stocks, bonds, commercial debt, futures, derivatives, and the list of traditional characters populate this list.”<sup>54</sup>

Accordingly, the term “security” is seen as a catchall word for innovative financial entities that lack the form of traditional securities (such as shares or bonds) but communicate equivalent rights. The Supreme Court created a standard in the “Securities and Exchange Commission v. W.J. Howey Co.”<sup>55</sup> decision to assess whether a transaction can be called an investment contract, and it was applied for the first time for a token in 2017.<sup>56</sup> In fact, an “investment contract,” a catchall subset of the term “security,” serves as the pivot for the application of US securities regulations.<sup>57</sup> Therefore, the term “investment contract” has been the most extensively defined in the definition of security (The 1933 Act, §2(a)(1)). If the coins of ICOs are deemed “securities,” it is most certainly because they are deemed “investment contracts.”<sup>58</sup>

In this line, the 1946 U.S. Supreme Court Howey decision established the threshold for evaluating what constituted an “investment contract.”<sup>59</sup> The Court used “the Howey test” to the contract in question to decide whether it met the definition of “investment contract” in the 1933 Act. In other words, the SEC used the four-part Howey test to control whether an investment program qualifies as a security in the United States.<sup>60</sup>

The test consists of four variables that must all be present for an investment contract to be formed: (1) monetary investment, (2) a joint venture, (3) a reasonable expectation of profit, and (4) profit obtained from the managerial efforts of others. If this criterion is met, the token constitutes an investment contract and is subject to US Securities rules.<sup>61</sup>

On July 25, 2017, the SEC issued a report, the 21A investigative report (the “DAO Report”), on the DAO token’s compliance (DAO is a network of smart contracts created in 2016 in Germany) with US securities laws.<sup>62</sup> The question was whether the DAO token was an

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54 Mendelson, op. cit., p. 65.

55 328 U.S. 293 (1946).

56 Plaweski, op. cit., p. 24.

57 Maume, & Fromberger, op. cit., p. 564.

58 J. Preston, “Initial Coin Offerings: Innovation, Democratization and the SEC”, Duke Law & Technology Review, Vol. 16, n. 1, 2018, p. 322.

59 N. Essaghoolian, “Initial Coin Offerings: Emerging Technology’s Fundraising Innovation”, UCLA Law Review, Vol. 66, no. 1, 2019, p. 297.

60 Howell, Yermack, & Niessner, op. cit., p. 10.

61 Plaweski, op. cit., p. 24.

62 Mendelson, op. cit., p. 54.

“investment contract “ or not.

As a result of using the four-part Howey test, the SEC ruled that investment tokens (for example, DAO) tokens are subject to US securities laws, and therefore the DAO token was needed to be registered with the SEC.<sup>63</sup>

Thus, ICOs that do not have obvious utility purposes, and non-utility tokens are almost likely securities under Howey. In other terms, coins that can be demonstrated to serve consumptive rather than financial purposes must fail the Howey test.<sup>64</sup> However, if a token purchaser plans to utilize a token as a consumer, it indicates that he is not driven by the desire for financial profit.<sup>65</sup>

In consequence, with Howey, the Supreme Court has strongly preferred the substance of the 1933 Act's definition of “security” over its form, allowing the SEC to wield extensive powers over a diverse range of transactions. As a result, the Howey test is purposefully broad, reflecting Congresses broad notion of “security.”<sup>66</sup>

## **2.2.2 ICOs: An alternative for funding Qatari SMEs**

### **2.2.2.1 Qatari SMEs financial barriers**

Small and medium-sized enterprises (SMEs) are critical to the development and growth of emerging countries around the world. SMEs account for 99 percent of all enterprises in the areas in which they operate, according to the European Bank for Reconstruction and Development. This is also true in Qatar, where 96 percent of the 25,000 registered enterprises fall within the SME category.<sup>67</sup>

The World Competitiveness Yearbook 2020 placed Qatar sixth in the world in terms of economic performance, as well as seventh in terms of government efficiency and eleventh in terms of business efficiency. Despite these realities, SMEs in Qatar confront hurdles from the start.<sup>68</sup>

In fact, SMEs are sometimes limited in their ability to raise critical funds without depleting personal reserves. These hurdles can be seen in Qatar, where regulatory requirements are high and the Qatari banking system is frequently tailored to favor larger firms, blocking

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63 Maume, & Fromberger, op. cit., pp. 564-565.

64 Preston, op. cit., pp. 323-324.

65 Howell, Yermack, & Niessner, op. cit., p. 10.

66 J. Park, & H. Park, “Regulation by Selective Enforcement: The SEC and Initial Coin Offerings”, Washington University Journal of Law & Policy, Vol. 61, 2020, p. 101.

67 M. AlThani, “How can Qatar improve SME support?”, 4<sup>th</sup> International conference on management, economics & finance, 10-12 September 2021, Zurich, Switzerland, p. 11. Available at: <https://www.dpublication.com/wp-content/uploads/2021/08/F8-8418.pdf> (Last visit, 28 March 2022).

68 A. Dahdal, J. Truby, & H. Botosh, “Trade finance in Qatar: blockchain and economic diversification”, Law and financial markets review, Vol. 14, I. 4, p. 224.

even successful and profitable SMEs from mainstream financial services.<sup>69</sup> In other words, many SMEs avoid attempting to receive trade finance due to the time-consuming aspect of the application procedure and the poor success rate.<sup>70</sup> Indeed, only 24 percent of SMEs used commercial bank loans in 2016, while 25 percent used loans from friends and family.<sup>71</sup>

Indeed, Qatar is ranked 108<sup>th</sup> in the World Bank's Doing Business 2020 report (Economy profile - Qatar) for starting a business. To register a new business in Qatar, 9 procedures, 10 days, and up to QR19,000 (approximately) are required.<sup>72</sup> The excessive quantity and cost of these procedures constituted a significant barrier to entry for new businesses.<sup>73</sup>

These restrictions must be reduced as much as feasible in order to improve the participation of SMEs to the Qatari economy. This necessitates financing policies that effectively promote and facilitate SMEs in their efforts to raise capital. Recognizing ICOs could be one of the possibilities for financing SMEs. In this view, ICOS recognition will be consistent with the State's goal of developing a sustainable economy in accordance with the Qatar National Vision 2030.<sup>74</sup>

### 2.2.2.2 Options for regulation of ICOs in Qatar

On the other hand, despite the growing trend and interest in ICOs, and as previously mentioned, certain jurisdictions throughout the world have explicitly prohibited them, notably the People's Republic of China, where the primary regulators jointly prohibited ICOs and the enacted freezes on them.<sup>75</sup> That is why a committee led by the People's Bank of China issued a prohibition on fundraising for new cryptocurrency operations known as initial coin offerings (ICOs) or "token sales" in September 2017.

In 2018, the Qatar Central Bank issued a circular with the same wording as the notice given by Chinese authorities. The Qatar Central Bank (Supervision and Control of Initial Institutions Division) released Circular No. 6/2018 on Bitcoin Transactions. According to this circular, Bitcoin is prohibited in Qatar. While the circular clearly prohibits Qatari banks from trading in

69 AlThani, op. cit., p. 15.

70 Dahdal, Truby, & Botosh, op. cit., p. 223.

71 Qatar Development Bank, The state of small & medium enterprises (SMEs) in Qatar, 2020, p. 63. Available at: <https://www.qdb.qa/en/Documents/State%20of%20SMEs%20in%20Qatar%202020%20EN.pdf> (Last visit, 28 March 2022).

72 Doing business 2020 - Economy profile Qatar, pp. 8-10. Available at: <https://www.doingbusiness.org/content/dam/doingBusiness/country/q/qatar/QAT.pdf> (Last visit, 7 April 2022).

73 R. Mammadov, "White paper for the Qatari development bank - Improving the Impact of SME Lending to Establish a Vibrant National SME Sector", July 2011, p. 5. Available at: [https://www.researchgate.net/publication/308730700\\_White\\_Paper\\_on\\_Improving\\_the\\_Impact\\_of\\_SME\\_Lending\\_in\\_Qatar/link/5bd35e4a92851c6b2791f812/download](https://www.researchgate.net/publication/308730700_White_Paper_on_Improving_the_Impact_of_SME_Lending_in_Qatar/link/5bd35e4a92851c6b2791f812/download) (Last visit, 28 March 2022).

74 QDB, op. cit., p. 13.

75 Preston, op. cit., p. 319.

Bitcoin, it might be interpreted as applying to all cryptocurrencies.<sup>76</sup>

Furthermore, we can deduce that ICOs in Qatar are implicitly prohibited since the circular states that: “Qatar Central bank urges all banks operating in Qatar not to deal with Bitcoin, or exchange it with another currency, or open an account to deal with it, or send or receive any money transfers for the purpose of buying or selling this currency. QCB shall impose penalties in accordance to the provisions of the Law of the Qatar Central Bank and the Regulation of Financial Institutions “Law no. (13) of 2012” in case of any violations of the above mentioned instructions.”

Other countries in the Arabic Gulf region have taken similar stance on cryptocurrency. This is the case, for example, in the United Arab Emirates (UAE), where all transactions in “virtual currencies” are illegal under article D.7.3 of the Regulatory Framework for Stored Values and an Electronic Payment System, established by the Central Bank of the United Arab Emirates in January 2017.<sup>77</sup> Although there is presently no particular regulation governing ICOs in the UAE, the Securities and Commodities Authority, the governmental organization in charge of regulating the UAE’s financial and commodities markets, issued a circular on 2 April 2018 warning investors against digital, token-based fundraising operations such as ICOs. The Securities and Commodities Authority emphasized that it does not recognize, regulate, or monitor any ICOs, and that investors are taking a risk by participating in any ICO.<sup>78</sup>

What is noteworthy in the case of Qatar, however, is that on the margins of the 5<sup>th</sup> Doha Islamic Finance Conference, the world’s first Islamic Electronic Exchange Platform for digital e-token I-Dinar was inaugurated on March 19, 2019. The I-Dinar platform is a blockchain-based e-token with an initial value of one dinar backed by one gram of actual gold. The Qatar Financial Centre has granted its primary clearance to operate the “I-Dinar exchange”, a multi-product digital trading platform that trades the I-Dinar with and against other commodities, financial instruments, and goods, as well as major fiat currencies globally.<sup>79</sup>

What is significant here is that this novel tool, the I-Dinar, may pave the way for the adoption

76 Durovic, M., & Trimidas, T., *New directions in European private law*, Hart publishing, 2021, p. 183.

77 H. De vaulpan, “Overview of ICO regulation around the world”, 2018, p. 36. Available at: <https://www.kramerlevin.com/images/content/4/6/v2/46184/181115-presentation-ICO.pdf> (Last visit, 14 February 2022).

78 Riaa Barker Gillette, “A guide to Initial coin offerings in the United Arab Emirates”, p. 1. Available at: <https://www.riabarkergillette.com/uae/wp-content/uploads/2018/05/RIAABG-Insight-Initial-Coin-Offerings-RIAABG-03.05.2018.pdf> (Last visit, 14 February 2022).

79 P. Alagos, “Qatar hosts global launch of world’s 1<sup>st</sup> Islamic digital e-token ‘iDinar’”, 19 March 2019. Available at: <https://www.gulf-times.com/story/626327/Qatar-hosts-global-launch-of-world-s-1st-Islamic-digital-e-token-iDinar> (Last visit, 14 February 2022); M. Shoeb, “World’s first gold-backed digital e-token launched”, 20 March 2019. Available at: <https://thepeninsulaqatar.com/article/20/03/2019/World%E2%80%99s-first-gold-backed-digital-e-token-launched> (Last visit, 14 February 2022).

of fund-raising strategies such as crowdfunding and ICOs in the future.

The implementation of ICOs necessitates a dual imperative: on the one hand, a prerequisite, which is the identification of a type of cryptocurrency that will be utilized to complete the ICO process. On the other side, there must be a legal framework in place for token issuances.

First, as previously stated, the I-Dinar platform is a blockchain-based e-token that has been granted primary approval by the Qatar Financial Centre (QFC) to operate the I-Dinar e-Exchange, and thus could be used to accomplish the capital fundraising desired by the ICO.

Second, if the American approach to ICO regulation is followed, we may include token issuance in Qatar under an existing financial instrument regulatory framework. What is particularly intriguing in this case is that the definition of securities in Qatari law is very similar to the one defined in the American 1933 act. That is why Law No. 8 of 2012 governing the Qatar Financial Markets Authority may be important in providing a legal foundation for any possible token issuance. In fact, article 1 of law No. 8 of 2012 defines “securities” as “the corporate shares and bonds of Qatari shareholding companies, bonds, sukuk (Islamic bonds), bills issued by the government or any public Qatari authority or institution, or any other securities, including non-Qatari securities, licensed by the Authority. The derivatives, commodities and other investment instruments licensed by the authority are considered equivalent to “securities.””

Tokens, more precisely security tokens, issued on a blockchain could be regarded as “investment instruments” in this context, making them equal to securities and, as a result, allowing the launch of a lawful ICO in Qatar.

Nevertheless, at any given time, the Qatar Financial Markets Authority must favor a balanced approach to token legislation in this regard. In practice, this means that before holding an ICO, a factual case-by-case investigation is required to ensure that each ICO involves the sale of securities and is thus subject to Qatari regulation.<sup>80</sup>

### 2.2.2.3 Fighting ICOs scams

Fraud is inextricably linked to early financial markets, and because many projects have yet to provide working goods, ICOs as a way of funding face credibility issues. That is why, despite the fact that ICOs became popular in 2017, raising hundreds of billions of dollars, ICOs project values were just a few months later at fractions of prior years’ highs, prompting some analysts to declare a “crypto winter.”<sup>81</sup>

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80 Mendelson, op. cit., p. 82.

81 S. Cohny, D. Hoffman, J. Skarloff, & D. Wishnick, “Coin-operated capitalism”, Columbia law review, Vol. 119, n. 3, 2019, pp. 694-597.



The following is a typical plan for fraudulent offerings and ICO scams: the owners of a company deceive investors through ICOs that promise to issue digital tokens backed by investments, such as real estate or gold. However, there is no real estate or gold backing the tokens, and the tokens actually have never been produced or sent to investors. Simply said, there are incidents of outright fraud in which there was no actual company and no assets or other commercial operations with the ability to create profits for token purchasers.<sup>82</sup>

ICOs raise numerous challenges. While some regard the ICO as an innovative and legitimate way to gather funds, others consider it as hazardous and fertile for fraud.<sup>83</sup> In fact, the general appeal of virtual currency and blockchain technology, like many lawful ways of obtaining funds, may be a tempting vehicle for fraudulent behavior. That is why we believe the Qatar Financial Markets Authority, like the SEC, should establish a dedicated Cyber Unit to assure a continuing protection for both investors and market integrity in this arena.<sup>84</sup> The SEC has taken a more aggressive position in monitoring ICO activities, along with the establishment of a new Cyber Unit inside the Enforcement Division with a broad scope to investigate cyber-related crimes, including, specifically, ICOs and digital token sales.<sup>85</sup>

## Conclusion

Today's capital formation and fundraising may be a difficult endeavor, especially in the present business environment, when competition among enterprises to attract investors may be described as fierce. This reality is much more difficult for start-ups and SMEs in general, and in Qatar, particularly.

That is why, when launching a firm, the entrepreneur must consider how to fund the venture. While debt funding is not always available, there are various equity funding choices. An ICO is one such source of finance for early-stage enterprises. ICO is a method of obtaining funds for a blockchain project by selling tokens before the system is operational.<sup>86</sup> A corporation generates its own money on a blockchain, which is represented by tokens or coins bearing its name. Tokens can then be exchanged for cryptocurrency or fiat currency on platforms.<sup>87</sup>

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82 R. Robinson, "The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings", *Tennessee Law Review*, Vol. 85, n. 4, 2018, p. 953; C. Dierksmeier, & P. Seele, "Cryptocurrencies and business ethics", *Journal of business ethics*, Vol. 152, n. 1, p. 3.

83 J. Tashea, "New money", *American Bar Association journal*, Vol. 104, n. 3, 2018, p. 58.

84 Mendelson, *op. cit.*, p. 70.

85 A. Parlow, "Securities liability and the role of DO insurance in regulating initial coin offerings", *University of Pennsylvania law review*, Vol. 167, n. 1, p. 215.

86 B. Gurcan, "The legal framework of the cryptocurrencies and initial coin offerings (ICOs)", Thesis, Budapest business school - Faculty of international management and business, 2018, p. 26.

87 V. Renoux, & S. Bernard, «Crypto-monnaies et initial coin offerings: voyage en terre inconnue», *Revue de droit fiscal*,

Some believe that ICOs are analogous to initial public offerings (IPOs), in which investors buy shares in a firm. Nonetheless, an ICO differs from an IPO in that it allows the project's developer to readily raise funding via cryptocurrencies, avoiding the lengthy, costly, and cumbersome legal process that includes an IPO, which may be clearly represented as a traditional fundraise.<sup>88</sup>

Although many see the ICO as non-regulated security that allows businesses to make unjustified capital increases, others see this lack of regulation as providing ICOs with great flexibility, allowing them to be game-changers in the traditional venture funding procedure.<sup>89</sup> In this vein, the SEC's 2017 ruling on DAO ICOs stated that the quality of a token as a security would be decided by whether it fulfills the four-part Howey test.<sup>90</sup> "The SEC has clearly drawn a line in the sand by asserting regulatory authority over ICOs pursuant to the Howey test. Major international regulators have followed suit."<sup>91</sup>

It is important to a legislator to ensure that this disruptive technology does not jeopardize legal progress in protecting investors and consumers. As a result, legislation must determine if new laws are required to protect digital assets or whether existing rules are sufficient.<sup>92</sup> The latter approach, adopted by the American model, simply integrates ICOs into existing regulations. This range of options highlights the contentious nature of ICOs. In this regard, the American method, which offers a smooth and middle path, appears to be the more appropriate in this field, as it allows to benefit from this new democratic finance instrument while remaining extremely cautious when investigating ICO situations.

In the case of Qatari law, such an innovative process could be aided, on the one hand, by the adoption of the I-Dinnar, the first hybrid cryptocurrency established by a State, in 2019. On the other hand, it might be done by including future security token issuance within the existing regulatory framework of "securities," as outlined in Law No. 8 of 2012. That is why, given Qatari authorities' desire and strategy to promote SMEs and entrepreneurship, it may appear appropriate to embrace ICOs as modern, and potentially, effective means of funding, while remaining cautious in the implementation of ICO operations to avoid uncertainties and funding frauds. Therefore, this solution allows Qatar Financial Markets Authority to incorporate ICOs into the Qatari legal system without the need for a new law. As a result, the

n.5, 2018, p. 2.

88 Guionnet-Moalic, & Dubois, op. cit., p. 1924.

89 Shrestha, op. cit., p. 5.

90 Ozeyzil, op. cit., p. 291.

91 Mendelson, op. cit., p. 93.

92 D. Legeais, Blockchain, Fascicule 534, Jurisclasseur Commercial, 2020, § 35.

Qatar Financial Markets Authority must conduct a fact-based case-by-case examination to guarantee that each ICO complies with Qatari regulations. Furthermore, a cyber unit under the Qatar Financial Markets Authority might be formed to fight ICO scams.

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