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Security Token Offerings

How to Sell Security Tokens in a Manner that Complies with U.S. Federal and State Securities Laws

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INTRODUCTION

Security Token Offerings, or STOs, have recently received a lot of attention from both entrepreneurs seeking to utilize this innovative tool to raise capital and regulators who are trying to protect investors from potential fraud. In 2017, more than $2.2 billion was raised through the sale of blockchain-based digital or crypto tokens with some sales raising millions of dollars in mere seconds.[1]

Blockchain-based tokens generally fall within two categories: “security” tokens and “utility” tokens. Security tokens may entitle their holders to economic rights such as a share of profits generated by the issuing company, an equity ownership interest in the issuing company, a share of the profits generated directly by a token based blockchain project, or the expectation of profit from an appreciation in value of the token based on the efforts of the issuing company in building out the platform or network on which the token will be used in the future. On the other hand, utility tokens in their purest form merely entitle their holders to immediately use or consume goods or services, usually technological goods or services, or use of a technology platform, without an expectation of token appreciation or profit through the resale of the token on a secondary market cryptocurrency exchange.

In the recent past, both types of tokens have been traded on cryptocurrency exchanges without concern for securities laws. However, the initial issuance and subsequent resale of security tokens in the United States (U.S.) implicate complicated securities law issues and must be compliant with U.S. federal and state securities laws. Whether a particular token is a utility token or a security token is not well-defined, and both the Securities and Exchange Commission (SEC) and state regulators have taken a very conservative approach which requires token issuers to treat almost any token issued in the U.S. as a security token.

This White Paper discusses: (i) the differences between security and utility tokens; and (ii) the ways in which a security token may be issued in compliance with U.S. federal and state securities laws.

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[1] *See* CB Insights – Blockchain in Review, https://www.cbinsights.com/research/briefing/blockchain-trends-and-opportunities/.

<u>SECURITY VS. UTILITY TOKENS</u>

Utility Tokens

The best way to understand utility tokens is to consider the following real-life example. In the past, the NYC Transit Authority issued physical subway tokens that looked like coins with the NYC Transit Authority logo on them. A subway rider would buy a subway token for about a dollar and then immediately use it to ride the subway from one stop to another. The NYC Transit authority could issue an unlimited number of tokens and token purchasers did not expect the tokens to be worth anything more than the price paid, except, perhaps, for increases in the cost of tokens to cover inflation. These tokens were utility tokens and still would be today if the NYC Transit Authority had not switched to a metro card system.

Under this model, the key characteristics of a utility token are: (1) the token can be immediately used to acquire a good or service and the platform or network on which the good or service is offered has been substantially completed; (2) the token is offered in an unlimited supply at a price per token that is directly related to the value of the product or service being purchased; (3) there is no expectation that the token will appreciate in value other than as the result of inflationary pressures; and (4) the token is purchased by users for immediate use on the platform or network and not by speculators who expect to profit from the resale of the token on a secondary market crypto-exchange.

Security Tokens

In most cases, the blockchain-based tokens that companies are issuing today should be considered security tokens. In many instances, the tokens issued are intended for future use rather than immediate consumption. Funds are raised through the sale of a limited number of tokens so promotors or entrepreneurs can build their networks (or goods or services), and there is an expectation among token purchasers (read investors) that they can earn a return on their tokens by selling them in the secondary market on a cryptocurrency exchange once the promoters have completed the development and buildout of their network and the economic value of their enterprise increases. These tokens are initially purchased by persons who will not necessarily use the tokens for their intended purpose but instead will hold them as a speculative investment. The economic substance of this kind of transaction is substantially the same as in a traditional securities offering, and the applicable legal analysis has been provided by the U.S. Supreme Court under its “investment contract” test, or the “*Howey Test*,” first applied in *SEC v. Howey Co.*[2].

The Howey Test

Under U.S. federal and state securities laws, courts often apply the Howey Test to determine whether a paticular investment is a security. Under the Howey Test, which the SEC has now begun to apply to token offerings, if you have an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others, you have a security. Under this test, most token offerings today are offerings of securities. This is particularly true where: (i) tokens are sold to a set of purchasers that is much broader than the set of persons likely to use the tokens in the network; (ii) that purchaser set is passive, that is, it relies on the issuer of the tokens to complete the buildout of the network or to enhance its functionality once it is operational; and (iii) purchasers are seeking returns that do not reasonably correlate with the market value of the goods or services being offered in the network.

The SEC’s Position

The SEC has clarified and softened its position somewhat since SEC Chairman, Jay Clayton, stated "I believe every ICO I've seen is a security" at a U.S. Senate hearing on cryptocurrencies this past February. In his June 14th speech[3], William Hinman, Director of the SEC’s Division of Corporate Finance, reiterated the SEC’s position that if, among other things, a token purchaser has a reasonable expectation of profit based on your efforts as a promotor or network developer, your token is an investment contract and a security. On the other hand, Hinman confirmed that if a person is buying an asset (i.e., a token) for consumption only, it is likely not a security.

Hinman acknowledged that whether a particular digital asset is a security token or a utility token requires a fact-sensitive legal analysis. Central to that analysis is how the asset is being sold and the expectations of the purchasers. He also acknowledged that a token may be considered a security token at one stage and a utility token at another and he highlighted a path that might lead to a conclusion that a digital asset transaction that may have started out as a sale of a security token may no longer represent a security offering. For example, he indicated that based on the current operability of the Ethereum network and its decentralized structure, current offers and sales of ether (ETH) are not securities

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[2] *SEC v. Howey Co.*, 328 U.S. 293 (1946).

[3] William Hinman, Director, Division of Corporate Finance, Securities and Exchange Commission, Remarks at the Yahoo Finance All Markets Summit: Crypto,” June 14, 2018

transactions. This analysis would not apply, however, to new token offerings structured on top of the ERC-20 token.

Hinman also highlighted a list of factors that might enable contractual or technical ways to structure a digital asset so that it functions like a consumer good, that is, as a utility token rather than as a security. These factors include the following: (i) whether the application is fully functional or in the early stages of development; (ii) whether the tokens are sold to potential users only or to the general public; (iii) whether the tokens meet the immediate needs of users or merely feed price speculation; and (iv) whether the primary purpose for buying the tokens is for consumptive use or investment intent.

The current U.S. regulatory environment is very conservative and is primarily focused on protecting investors. The SEC believes that the safeguards in place to protect investors in security offerings, that is, the removal of asymmetry between promoters and investors and the provision of sufficient, non-misleading information to enable informed investment decisions, are appropriate for most token offerings. In this setting, taking the position that, in an initial offering in the U.S., a digital asset is a utility token would not be advisable except in the rarest of circumstances. We believe it is best practice to assume that any token offering made in the U.S. or offered to U.S. persons is security token offering which must comply with federal and state securities laws.

COMPLIANT SECURITY TOKEN OFFERINGS (STOS)

Once a determination has been made that a token sale is the sale of a security, that sale, like the sale of any other security, must be registered under Section 5 the Securities Act of 1933, as amended (the "**Securities Act**") or an exemption from the registration requirements of Section 5 of the Securities Act must be relied on. Registration is costly and time consuming. Similar to an IPO, it involves the preparation of a registration statement containing a prospectus (i.e., a written offer) for the offering. The prospectus must include two years of audited financial statements (or, if the issuer is less than two years old, financial statements from inception) and detailed disclosure regarding the issuer's business, risk factors, its management team, its capital and ownership structure, the nature of the securities tokens being sold and a discussion of the financial statements and results of operations contained therein, among many other things. After the registration statement is filed with the SEC, the SEC staff will issue comments that must be cleared before the registration statement may be declared effective and the security tokens can be sold. Registration of an STO can take several months and cost hundreds of thousands of dollars making it impractical for most STOs.

In April 2012, the JOBS Act was written into law to enable ordinary investors, or the "crowd," to invest in private placements of securities previously open only to high net worth individuals, or "accredited investors" as that term is defined by the SEC. The JOBS Act indirectly created a new framework within which there are multiple ways you can conduct an STO that is exempt from the registration requirements of the federal and state securities laws. Under the JOBS Act and other federal securities regulation, compliant STOs can be carried out within the following SEC regulations – Regulation CF, Regulation D, Regulation S and Regulation A.

Regulation Crowdfunding (Regulation CF)

Generally, under Regulation CF, an issuer can raise up to $1,070,000 in any period of 12 consecutive months by selling tokens, or securities, like SAFTs (simplified agreements for future tokens), that are convertible into tokens, to accredited and non-accredited investors alike on an SEC registered, FINRA member equity crowdfunding platform, or portal.

Regulation CF, however, cannot be used by the following types of token issuers: issuers that are not incorporated or organized in the U.S., issuers that are SEC reporting companies, certain investment companies, companies that have failed to comply with the Regulation CF reporting requirements in the past or blank check companies.

In order to conduct a Reg CF offering, a token issuer must file an offering statement on Form C with the SEC and post the Form C on the portal facilitating the offering before any security tokens are sold. The Form C requires disclosure about the issuer, its management team, the tokens being sold, the nature of the offering, risk factors and, if the issuer is raising more than $100,000 and it is its first offering under Regulation CF, two years of reviewed financial statements (or, if the issuer is less than two years old, reviewed financial statements from inception to present).

Advertising and general solicitation are permitted under Regulation CF, however, other than tombstone advertisements, issuers must not disclose the terms of the offering in any advertisement. The terms of the offering may only be disclosed through the portal or in a limited tombstone advertisement.

Security tokens purchased in a Regulation CF transaction generally cannot be resold for a period of one year unless the security tokens are transferred: (1) to the issuer of the securities; (2) to an “accredited investor;” (3) as part of an offering registered with the SEC; or (4) to a member of the family of the purchaser or the equivalent, to a trust controlled by the purchaser, to a trust created for the benefit of a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance.

Regulation D, Rule 506

Rule 506 (c) under Regulation D lets an issuer of security tokens raise an unlimited amount of money. Issuers may generally solicit and advertise their Regulation D, Rule 506(c) offering to the general public, so long as sales are made only to accredited investors. In 2017, Filecoin raised more than $200 million in a Regulation D, Rule 506(c) token offering, and this year, Telegram has raised more than $1.7 billion in a similar offering.

Although no specific disclosure requirements apply to Regulation D offerings, as a practical matter, disclosure requirements in a typical private placement memorandum for a Regulation D, Rule 506(c) offering are more burdensome than for a Regulation CF offering, and you must take extra steps to verify accredited investor status. On the plus side, there are no caps on the amount of money you can raise, and you can advertise your token offering widely, to help build your community. A Regulation D, Rule 506(c) offering tends to be more expensive than a Regulation CF offering, but less expensive than a Regulation A offering (discussed below).

The sale of securities under Regulation D involves “restricted” securities (except for in certain limited circumstances) and you and your investors must be comfortable with the required 12-month holding period. If the instrument being sold in a Regulation D offering is convertible into a security token, for example through a SAFT, the holding period of the security into which the original instrument is converted will relate back to the purchase date of the original instrument, assuming no additional consideration is paid at the time of conversion. Thus, such a security token would become unrestricted 12 months following the purchase of the original instrument.

Regulation A

Regulation A is a JOBS Act enhanced exemption from the registration requirements of the various state and federal securities laws that, under certain conditions, will allow you to sell up to $50 million in tokens or token related investment instruments in any period of 12 consecutive months. Regulation A offerings require the filing of an offering statement on Form 1-A with the SEC, which, subject to review and revision pursuant to SEC comment, is “qualified” by the SEC. Regulation A allows an issuer to offer and sell securities tokens to the general public, subject to certain investment limits for non-accredited investors. Under Regulation A, all tokens or other securities that are sold are fully and freely tradable, with no resale restrictions, except for those you may want to impose under your token offering framework. Disclosure requirements for a Regulation A offering are more rigorous than for a Regulation D or Regulation CF offering, and typically more expensive as well. As a plus, Regulation A lets you file your Form 1-A with the SEC for confidential review on a “quiet” basis allowing you to “test the waters” and build a following prior to publicly filing your offering statement to obtain SEC “qualification.” To make use of Regulation A, however, you must be a U.S. or Canadian organized company with your base of operations in the U.S. or Canada. With our broad understanding of the Regulation A environment, we can help you plan, structure, file and qualify your Regulation A token offering while limiting your costs and maximizing your chances for a successful offering.

Regulation S

Offers and sales of securities tokens under Regulation S must be conducted outside the U.S. and only to “non-U.S. persons.” Tokens or investment contracts such as SAFTs sold in a Regulation S offering will be restricted securities and holding periods will apply. Because of the restrictions against sales in the U.S. or to U.S. persons, compliance structures need to be rigorously applied. For example, if you want to take advantage of this exemption from the U.S. you will need to set up a geofence to block I.P. addresses in the U.S from your Regulation S offering website landing page.

Combination Offerings

You may want to consider conducting a Regulation CF crowd funded offering concurrently with a Regulation D, Rule 506(c) private placement offering, or a Regulation D, Rule 506 offering with a (more complicated) Regulation S offering. This, in the first instance, will let you sell to non-accredited investors as well as accredited investors, thus enabling you to expand your community of token holders to the broader public, and with the addition of a Regulation S component, you can take advantage of selling to off-shore, non-U.S. investors. We can counsel you on the pros and cons of such a combined offering with optimally structuring such an offering to be regulatory compliant.

SAFT (Simple Agreement for Future Tokens) or Securities Token Purchase Agreement

A SAFT, or Simple Agreement for Future Tokens, similar to a SAFE (Simple Agreement for Future Equity), is an investment contract that converts at a future date into a token. The SAFT can be used during the ICO pre-sale phase, when your network or token platform may not be up and running and you may not be ready to set a value on your to-be-issued, future tokens. The SAFT cannot, however, be used as a tool to circumvent the federal securities laws. The token issued upon conversion of the SAFT may very well be a securities token governed by all applicable securities laws and you will need to plan for the issuance of that securities token accordingly.

Bounty Programs, Airdrops and other Promotional Activities

Celebrity Promotions

Celebrity-endorsed ICOs such as those by Paris Hilton and Evander Holyfield have raised red flags with the SEC because offering incentivized rewards to help promote ICOs may be a violation of the anti-touting and broker/dealer provisions of the federal securities laws. If you pay people to endorse or otherwise promote your token offering, whether in cash or in tokens, and the tokens you are offering to the public are deemed to be securities, all compensation paid to such persons must be fully disclosed and their public statements must not be misleading in any way. If you pay such persons based on the amount of tokens they help sell, these persons could be deemed to be securities brokers or dealers and must be registered as such. Failure to be registered as a broker/dealer, if required, would be a violation of federal and state securities laws and, if not careful, you could be deemed to be aiding and abetting any such violations.

Bounty Programs

Bounty Programs, in which people or companies are awarded free tokens for endorsing ICOs or for otherwise performing various tasks necessary to the successful completion of an ICO, may involve the unregistered sales of equity securities. Although bounty programs are a great way to get your community involved in your token offering, or to get needed activities such as white paper translations performed without spending cash or cryptocurrencies, bounty program token payments may be unregistered sales of securities in violation of applicable laws, and statements that bounty program recipients make on their social media feeds, if not properly monitored, scripted and controlled by you, may end up violating federal or state regulations.

Air Drops

"Air Drop" programs whereby a company's supporters are issued free tokens may also violate federal and state securities laws. You may want to reward your community or kick start your network or platform by sending free tokens to your token users or supporters. Even though air drop token recipients will not pay you anything for these tokens, you may be deemed to have received consideration, for example, in the form of added liquidity to your token market. If your tokens are securities tokens, an air drop distribution may be an unregistered sale of securities in violation of applicable laws.

Secondary Market Trading of Security Tokens

Once the determination has been made that your token is a security token, the entire ecosystem of U.S. securities regulation comes into play. For example, a security token can only be traded on a secondary market that is regulated by the SEC, that is, on a registered securities exchange or a registered broker-dealer operated Alternative Trading System (ATS). A security token cannot be traded on an unregulated cryptocurrency exchange. Currently, there are a few security token secondary market trading platforms that have been approved by the SEC, but at the moment, no security token has begun trading on such platforms. This situation should change within the next few months when the 12-month restricted period begins to lift on security tokens sold in private placements in 2017.

The Uncertain Regulatory Landscape

U.S. Laws and Regulations

Cryptocurrency has commanded the attention of regulators such as the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Bureau of Investigations (FBI), the U.S. Department of Justice (DOJ), the U.S. Department of the Treasury through the Financial Crimes Enforcement Network (FinCEN), and the Internal Revenue Service (IRS). Certain existing laws and regulations are currently being applied to the new ICO landscape, and this can be seen, for example, in the various pronouncements and actions being taken by the SEC to return the ICO industry to the four corners of existing securities regulation. New laws and regulations will most likely be passed in the future to adapt to the new economic realities being created by blockchain, cryptocurrency and tokenized ecosystems, and to foster market stability, integrity and the confidence of investors, prevent fraud, tax evasion, money laundering and other potentially illicit activities, and to create an environment in which blockchain, cryptocurrencies and token economies will be able to flourish. Several states, including

Arizona, Wyoming and Vermont, have already passed laws related to cryptocurrencies and initial coin offerings, and we expect that this trend will continue.

As you contemplate your planned token offering, there are many laws that you need to be aware of, for example, the Federal Bank Secrecy Act (BSA) and the anti-money laundering (AML) regulations, in addition to the federal and state securities laws. The legal and regulatory landscape is complicated and ever-changing.

Do you have questions about U.S. laws and regulations on cryptocurrency and token offerings? Contact our Crypto Task Force attorneys today at 202-869-0888 (ext. 100) or info@bevilacquapllc.com to schedule a meeting.

If you want to read more about U.S laws and regulations on cryptocurrency and Security Token Offerings, see our blog.