

## 'Security Tokens' Slow To Take Off Following ICO Collapse

By Tom Zanki

*Law360 (June 10, 2019, 5:20 PM EDT)* -- Following a U.S. regulatory crackdown that chilled the once booming but unregulated market for initial coin offerings, more startups are attempting to structure digital token sales that comply with securities laws, though lawyers say the transition to legitimacy remains a work in progress.

The digital tokens climate is far cooler in mid-2019 compared with the not-so-distant past when so-called ICOs, a nascent form of fundraising that took off mostly outside the watchful eye of regulators, were growing like wildfire. Coinschedule.com shows just more than \$2.4 billion was raised year to date through token sales, down from \$17.5 billion raised in the first half of 2018.

The plunge coincides with a steep decline in cryptocurrency prices coupled with the U.S. Securities and Exchange Commission's repeated warnings that it views most token sales — whereby blockchain technology startups sell digital tokens in order to fund projects — as securities offerings. As such, businesses must either register their token sales or seek an exemption.

Amid tighter scrutiny, some companies now market their sales as “security token” offerings, or STOs, rather than ICOs to demonstrate their intent to comply with securities regulation and pursue aboveboard deals. The name change is partly a rebranding, though accounting giant PricewaterhouseCoopers in a recent report noted there is some substance behind the shifting terminology, calling STOs a “more mature and regulated form” of offerings compared with ICOs.

Whatever the label, some lawyers see the trend toward some form of “security token” offerings as irreversible. Morgan Lewis & Bockius LLP counsel Albert Lung said that all of his firm's clients that are working on token offerings are preparing what can be described as STOs.

“An STO is, in our view, the only way these days to raise capital by issuing digital tokens in the U.S.,” Lung said. “There is really no other way, given where the SEC is coming from.”

The SEC cracked down on ICOs starting in 2017 on the premise that tokens sold in such sales contained the hallmarks of securities — despite claims by ICO issuers that their tokens were consumer goods intended to access a product or service — and alleged that many were scams.

Just last week, the SEC sued Kik Interactive Inc., alleging the Canadian social messaging platform's \$100

million ICO amounted to an unregistered sale of securities. Kik disputes the charge, insisting its Kin token is a currency. The SEC is not alleging fraud in the Kik case, which is being closely watched.

In other recent guidance and enforcement actions, the SEC has sought to point token sellers toward paths of fundraising that conform to its regulatory framework.

Lawyers note that companies looking to structure a token offering that complies with federal securities laws have several options. But all capital-raising avenues have limitations of some kind, forcing companies to carefully weigh the costs and benefits of whatever path they choose.

“You need to think through who the investors will be, and how you will market the offering,” said Mitchell Silberberg & Knupp LLP partner Arina Shulga.

For instance, a startup could fully register their token sale just like an initial public offering, a costly undertaking even for a large business, though none have completed such a sale.

Businesses are more likely to conduct a private placement using an exemption from registration, known as Regulation D. This exemption allows issuers to raise unlimited money and, under a provision in the Jumpstart Our Business Startups Act of 2012, market their offering online.

However, such unregistered offerings can only be sold to “accredited investors,” or wealthier individuals who are considered capable of fending for themselves without the full protection of public securities laws. Fox Rothschild LLP partner Kristen Howell noted that restricting sales to accredited investors “does not fit with the ethos” of advocates for blockchain technology, the underlying digital ledger that powers cryptocurrency, which is to dissolve barriers that limit participation.

Issuers conducting a Regulation D offering can reach more investors by adding a simultaneous offering under Regulation S, an exemption that allows unregistered securities to be sold to offshore investors. But such a company must make sure that the foreign investors are indeed non-U.S. persons, and must take care not to integrate the concurrent offerings, or risk penalty.

“To do it properly, it’s not so easy,” Fenwick & West LLP counsel Dan Friedberg said. “But it certainly can be done and it’s often done by our issuers.”

Another path being explored is a so-called Reg A+ offering, though the SEC has yet to approve any such deals for token sellers. Created by the JOBS Act, Reg A+ offerings are sometimes dubbed “mini-IPOs” in that they allow a company to raise \$50 million annually under less rules than a full-blown IPO.

Reg A+ offerings haven’t fared well among traditional businesses that have used this exemption for nontoken offerings, several of whom have seen their shares plunge after listing them on exchanges. Attorneys are now watching to see whether Reg A+ can do better with token sellers.

“What I would like to think is that once we get through this slow period, this will ultimately help bring this Reg A+ market to life,” Howell said.

Lawyers note that the \$50 million cap is within many blockchain startups’ funding ambitions, while Reg A+ offerings, unlike traditional private placements, can be sold to anyone regardless of wealth.

Yet Reg A+ also has rules that predate the growth of blockchain technology, including a requirement

that companies use a transfer agent to record ownership of shares. This rule is seen as contradicting the intent of blockchain advocates to reduce reliance on intermediaries.

Baker & Botts LLP partner Sam Dibble said that, to his knowledge, the SEC hasn't been willing to ease up on the transfer agent requirement.

"It's the proverbial square peg that's trying to go through the round hole and the SEC hasn't shaved off those edges to allow the peg to pass through, at least in terms of Reg A+," Dibble said.

Blockchain software firm Blockstack is among companies hoping that the SEC will approve a Reg A+ token offering. Blockstack filed plans in April to raise up to \$50 million through a token sale, saying it expects its transaction to be the first SEC-qualified token offering of its kind.

But Blockstack said in its regulatory filing that it does not intend to hire a transfer agent, which it sees as duplicative. The company told the SEC that the "types of activities a transfer agent would normally engage in are performed automatically on the blockchain."

Lawyers say that other requirements of Reg A+, namely that companies submit audited financial statements, also pose a hurdle for companies of scant assets. Still, proposals are filed.

Lung said Morgan Lewis has clients that have been working on Reg A+ token offerings for more than a year but "we don't know what's the holdup." Lung said he suspects the SEC knows that "once they approve one, they are going to open the floodgate to thousands" of submissions.

"So they want to be very careful, which I understand," Lung said. "But still it's taking an awfully long time."

The SEC declined to comment.

The SEC's approach to regulating token sales reflects a 1946 U.S. Supreme Court decision called *Howey*, which relates to investment contracts — a catch-all term for securities. The so-called *Howey* test broadly defines an investment contract as an agreement in which a person invests money in an enterprise, expecting to profit based on the efforts of others.

Using this criteria, the SEC has concluded that most ICOs are securities, requiring issuers to comply with regulations meant to protect investors. The agency has left the door open to narrow exceptions. The SEC in April said a token offering sold by a charter flight service should not be treated as a securities sale because the tokens were sold to consumers not looking to profit.

STOs, by contrast, more resemble traditional securities in that tokens sold in such offerings can be backed by a hard asset or represent an interest in a company's profits. The hope behind issuing such securities through a digital ledger rather than traditional means is that such tokens would have more liquidity, meaning the degree to which a security can be quickly bought or sold, given blockchain technology's perceived advantages of providing speedier, less costly transactions.

Whether the embryonic market for security tokens grows will depend on the availability of secondary platforms to provide investors an avenue to sell their stakes.

No full-fledged exchanges for security tokens exist, but several alternative trading systems, which are

limited platforms that operate under fewer regulations than traditional exchanges, allow accredited investors to trade security tokens. These include platforms run by Overstock subsidiary tZero, OpenFinance and Sharespost, and more companies are seeking approval.

“Until the ATs really emerge as liquid markets, the use of these STOs will be somewhat limited,” Friedberg said.

--Editing by Rebecca Flanagan and Aaron Pelc.