TOKEN
ALLIANCE

CHAMBER OF
DIGITAL
COMMERCE

UNDERSTANDING DIGITAL TOKENS

Considerations and Guidelines for Securities and Non-Securities Tokens

Prepared by the Token Alliance – an industry initiative of the Chamber of Digital Commerce

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CHAMBER OF DIGITAL COMMERCE

The Chamber of Digital Commerce is the world's largest trade association representing the blockchain industry. Our mission is to promote the acceptance and use of digital assets and blockchain technology. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop a pro-growth legal environment that fosters innovation, jobs, and investment.

TOKEN ALLIANCE

The Token Alliance is an industry-led initiative of the Chamber of Digital Commerce, developed to be a key resource for the emerging industry surrounding the generation and distribution of tokens using blockchain technology. Comprised of more than 400 industry participants, the Alliance includes blockchain and token and legal experts, technologists, economists, former regulators, and practitioners from around the globe. The Token Alliance develops community-driven guidelines for the responsible development of tokens.

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II. INTRODUCTION

This new installment of our series of reports is an important addition to the overall regulatory and market consideration of the token ecosystem. The way in which digital tokens operate is complex and can maintain multiple characteristics – from an investment contract, to something necessary for utilizing a digital platform, to a form of payment or exchange, to name just a few. We are in a moment when technological advancement is pushing the boundaries of decades-long established law – law that was made at a time when tokenized assets and instantaneous digital transfers of value were not contemplated. It is exciting to be a part of it, but it also entails risks.

To facilitate the development of token businesses as well as minimize incidents of fraud and compliance challenges, the Chamber embarked on a plan to tackle each of the issues impacting this ecosystem. This journey started with a publication of guidelines for digital tokens that were intended to operate outside Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC)-regulated products and services laws (so-called "utility tokens" and associated platforms).

Those Guidelines also sought to provide legal context by detailing the legal landscapes governing digital tokens in five countries – the United States, Canada, the United Kingdom, Australia, and Gibraltar. Taking up a sizeable portion of the Report, the description of the vast number of potential legal requirements and government oversight demonstrated that this is a regulated industry, no matter where you fall in the spectrum of token categorization.

Finally, we provided an economic perspective on the industry with an analysis of market trends. The sheer volume of capital raised demonstrates the passionate interest of so many around the world in the potential of these markets – whether as a way to make money, a way to use new and better services, or other reasons.

This installment expands on those initial resources to balance out the conversation around utility tokens to discuss the rules, regulations, and resulting considerations for those who wish to issue or trade tokens that are or otherwise represent securities. This sector of the market is growing with entrants from new technology companies as well as established institutional financial services providers. The securities laws are complex, generated in the 1930s and developing substantial legal and regulatory precedent. In some cases, that precedent has endured because it is principles-based. In others, it has become outdated as it no longer sufficiently contemplates the types of securities that can be created, issued, held, and traded digitally.

We are excited to introduce these guidelines for securities tokens to complement our work involving utility tokens. But we can't stop there. More areas need to be considered and addressed with thoughtful analysis. In the coming days and weeks, we also intend to publish guidelines around cyber security, consumer protection, and anti-money laundering. We will be supplementing our legal landscape on a rolling basis with the introduction of additional countries and the laws that apply to digital tokens. And finally, the market has had its ups and downs since the publication of our first Report. Smith + Crown will provide an update on trends, facts, and figures to better understand the scope of this growing evolution.

We hope you enjoy these publications and that they serve to help guide your analysis and views of the evolving digital token ecosystem. We look forward to sharing this series as we roll out these publications throughout the coming weeks!

A few words of caution:

THIS REPORT DOES NOT CONSTITUTE LEGAL ADVICE

» Specifically, nothing in this report should be construed as advice regarding the law of the United States or any other jurisdiction.

» This report's analysis of the criteria under which it is determined that tokens constitute securities or commodities do not constitute a restatement of law.

» This report, including its suggested guidelines, merely express the general views of the Token Alliance, and compliance with such guidelines cannot assure that the distribution or trading of tokens will fully comply with the laws discussed herein.

» These views are being offered for discussion purposes only, and they have not been sanctioned by the SEC, CFTC, or any other regulator or government agency.

CONSULT LEGAL COUNSEL BEFORE DISTRIBUTING OR HOSTING TRADES OF DIGITAL TOKENS

» Token Sponsors and associated parties seeking to generate or distribute a blockchain-based token should seek independent legal counsel with expertise in this area before proceeding with their project, particularly given the fast-paced nature of this industry and the quickly evolving legal landscape.

» Counsel can help consider the facts and circumstances surrounding particular issues within the contours of then-current regulatory and enforcement activity.

» This report does not attempt to address any individual case, and the thought leadership contained herein is not appropriate for use as a substitute for independent counsel.

» Further, the digital token market is rapidly shifting and therefore the cases and regulatory interpretations discussed in this report may be overtaken by future events.

The Token Alliance will continue to study the issues surrounding the appropriate regulation for tokens and it will offer additional insights, as appropriate, when new developments arise.

III. CHAPTER 1: CONSIDERATIONS AND GUIDELINES FOR SECURITIES TOKENS

I. INTRODUCTION

This paper describes the application of the securities laws, regulations, and rules of the United States to the issuance and trading of "tokenized securities" as that term is defined below. Tokenized securities, like other securities, are subject to the jurisdiction of the U.S. Securities and Exchange Commission ("SEC") but are different from other securities in that they apply blockchain technology to raise funds, track ownership, and deliver value to securities holders.

A "tokenized security" is a cryptographic token[1] built on a blockchain[2] (or distributed ledger) which represents or symbolizes an instrument that meets the definition of a "security"[3] under Section 2(a)(1) of the Securities Act of 1933, as amended (the "Securities Act"), including an "investment contract" as interpreted by the Supreme Court in *SEC v. W.J. Howey Co.*[4] In contrast to protocol or utility tokens, which typically are sold for consumptive use on a blockchain network, tokenized securities are issued to be securities within the meaning of the Securities Act. Tokenized securities are therefore securities with an "electronic wrapper," which enables new and evolving functionality and the ability to be traded on both public and private blockchains.

TOKENIZED SECURITY	UTILITY TOKENS
Cryptographic token which is, represents, or symbolizes an instrument that meets the definition of a "security."	Allows a holder to consume or redeem the token for a good or service in a functioning system, or a cryptocurrency token on a blockchain network.

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1   Digital tokens are computer code maintained on a blockchain-based ledger that are secured using cryptography, with each token typically representing a specific value or amount on the ledger.
2   A blockchain is a specific type of distributed ledger technology that organizes data into blocks that are "chained" together chronologically by a cryptographic hash function and confirmed by a consensus mechanism.
3   "The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." Securities Act of 1933, 15 U.S.C. § 77(b) (2012).
4   328 U.S. 293 (1946) (holding that the sale of units in a citrus grove development together with service contracts for cultivating and marketing the produce constituted a sale of securities).

Any traditional security, including an equity interest in a company,[5] a limited partner interest in a venture capital fund, and a range of other debt- and equity-like instruments, potentially can be issued as a tokenized security. In addition, tokenized securities can also be asset-backed, representing interests in real estate or fine art, among other assets. Further, the SEC and its staff (the "Staff") concluded that tokenized securities include interests in decentralized autonomous organizations.[6] Blockchain Capital is thought to have conducted the first offering of tokenized securities, also known as a security token offering ("STO"), when it raised capital for its Singapore-based fund pursuant to Regulations D and S under the Securities Act.[7]

Pursuant to Section 5 of the Securities Act, any offer or sale of a security made to U.S. persons must either be (1) registered with the SEC or (2) offered and sold pursuant to an exemption from registration. The following chart provides a summary of the unique regulatory requirements for the salient forms of offerings of tokenized securities. For more detailed information regarding each and associated legal requirements, please refer to the Appendix below.

REGISTRATION REQUIREMENTS AND RESTRICTIONS UNDER VARIOUS FORMS OF SECURITY TOKEN OFFERINGS

OFFERING TYPE	SECTION	ISSUER RQMTS	INVESTOR RQMTS	LIMITS ON AMT. RAISED	GENERAL SOLICITATION	STATE LAW PRE-EMPTION	TRANSFERS
FULL REGISTRATION	Sec. 6 Sec. Act.	None	None	None	No sales during pre-filing period	Yes, if listed on a national exchange	Freely tradeable on registered exchange or ATS
EXEMPT OFFERINGS:							
PRIVATE PLACEMENT	Sec. 4(a)(2) of Sec. Act and Reg. D (Rule 506(b) and (c))	None, but exlcudes "Bad Actors"	Accredited Investors, with "Bad Actor" exclusions Rule 506(b) permits up to 35 sophisticated but non-accredited investors	None	No general solicitation or advertising Rule 506(c) permits general solicitation	Section 4(a)(2) = none Reg D = yes Some reqmts to notice filings and state fees	"Restricted Securities" – not freely tradeable until expiration of restricted period; may have private transfers between accredited investors during restricted period

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5   *See*, *e.g.*, Overstock.com's December 2015 offer of Blockchain Voting Series A Preferred Stock. https://www.sec.gov/Archives/edgar/data/1130713/000104746916016691/a2230280z424b2.htm.

6   On July 25, 2017, the SEC issued a Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934 (the "Exchange Act") describing an SEC investigation of The DAO, a decentralized autonomous organization, and its offer and sale of DAO Tokens. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), https://www.sec.gov./litigation/investreport/34-81207.pdf ("DAO Report").The SEC applied Howey and concluded that the DAO Tokens were "securities;" see also Press Release, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), https://www.sec.gov/news/press-release/2017-131.

7   The Form D that Blockchain Capital submitted to the SEC for its Regulation D private placement is available here: https://www.sec.gov/Archives/edgar/data/1703926/000095017217000040/xslFormDX01/primary_doc.xml.

OFFERING TYPE	SECTION	ISSUER RQMTS	INVESTOR RQMTS	LIMITS ON AMT. RAISED	GENERAL SOLICITATION	STATE LAW PRE-EMPTION	TRANSFERS
EXEMPT OFFERINGS:							
PRIVATELY HELD COMPANIES	Reg. A	Privately held companies in U.S. or Canada	Tier 1 = None Tier 2 = None but non-accredited investors have investment limits	Tier 1 = $20M in 12 mo. Tier 2 = $50M in 12 mo.	None	Tier 1 = No Tier 2 = yes, pre-empted	None
CROWD-FUNDING	Reg. CF	No non-U.S., blank-check, reporting or investment cos, or "Bad Actors"	None, but investment limits based on income and net worth	$1.0M over 12 mo. period	Offered through one intermediary registered as a broker dealer or "funding portal" and also a member of FINRA	Yes	After 12 mo.

II. SECURITIES OFFERINGS WITH UTILITY TOKEN FEATURES

Tokenized securities can provide some of the benefits of a traditional security, such as a share of income or a dividend payment, or otherwise can represent an investment contract in which a purchaser acquires the tokenized security with the expectation of profits through the efforts of others. A tokenized security can also provide its holder with rights to a non-security token—either a so-called "utility token," which allows a holder to consume or redeem the token for a good or service in a functioning system, or a cryptocurrency token, which exists solely as a medium of exchange, store of value, or unit of account, like bitcoin.[8]

First, a tokenized security might represent a claim on a future, not-yet-extant non-security token (a "placeholder token"). This placeholder token will be swapped with the non-security token once the non-security token is created and the system in which the non-security token will be used is functioning and publicly available. Second, the facts and circumstances might show that the manner in which the tokenized security is used have changed such that the token no longer has the features of a security ("mutable tokens"). Third, a tokenized security might provide a dividend to its holder in the form of a second token, and that second token might constitute a non-security token ("dividend-paying tokens").

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8   The SEC has repeatedly indicated that it does not view bitcoin as a security through unofficial statements. *See, e.g.*, Hearing on SEC FY19 Budget before the Fin. Serv. and Gen'l Gov't Subcomm. of the House Comm. on Appropriations, 115th Cong. (statement of Jay Clayton, Chairman, Securities and Exchange Comm'n) ("A pure medium of exchange, the one that's most often cited, is bitcoin. As a replacement for currency, that has been determined by most people to not be a security."); *see also* William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo! Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

In each case, the tokenized security is designed to provide, through some mechanism, a non-security token to its holder. This section explores the legal issues surrounding these three scenarios.

The first and second types of tokenized securities described above present similar legal issues but address them in distinct ways. Currently, it is widely accepted that a pre-functionality (*i.e.*, pre-utility) sale of tokens may well constitute an "investment contract," and hence a security, within the meaning of Section 2(a)(1) of the Securities Act. This conclusion flows from the likelihood that a reasonable purchaser expects to profit in the secondary market for the tokens based on the efforts of the token seller to build the network or application in which the token is used. For example, in a 2017 Administrative Order against Munchee, Inc. (the "Munchee Order"),[9] the SEC found an investment contract based on the company "emphasiz[ing] the economic benefits to the purchaser [of a token] to be derived from the managerial efforts of the [token's] promoter." The tokens in the Munchee Order ("MUN") were intended for use in an application to advertise, review and buy meals from restaurants, although "no one was able to buy any good or service with MUN" at the time of their sale.[10] This meant that, "[a]t the time of the offering and sale of MUN tokens, no other person could make changes to the Munchee App or was working to create an 'ecosystem' to create demand for MUN tokens."[11] Thus, the SEC concluded, a purchaser of MUN was entirely reliant on the efforts of the sponsor to realize any value from his or her purchase of MUN. Given that the MUN token's value was zero when it was sold, a purchaser must have expected its value to increase due to these efforts, and a rational purchaser would only have purchased MUN in the expectation that this value increase would be great enough to constitute a profit above the purchase price. As a result, the pre-functionality MUN tokens represented an investment contract, and therefore a security.

The first and second types of the tokens discussed in this section seek to square this result with a Token Sponsor's desire to ultimately create a non-security token for general consumptive use.

TYPES OF SECURITIES TOKENS

PLACEHOLDER TOKENS	MUTABLE TOKENS	DIVIDEND-PAYING TOKENS
Will be swapped with a non-security token once the non-security token is created and the system in which the non-security token will be used is functioning and publicly available.	The manner in which the tokenized security is used have changed such that the token no longer has the features of a security.	A tokenized security might provide a dividend to its holder in the form of a second token, and that second token might constitute a non-security token.

9   Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf.
10   *Id.* at ¶ 10.
11   *Id.* at ¶ 33.

A. PLACEHOLDER TOKENS

Token Sponsors, as part of their token distribution may offer and sell a pre-functionality token sale agreement in accordance with Rule 506(b), Rule 506(c), or Regulation S, which represents a right, at a future time, to delivery of utility tokens. The agreement may take the form of a non-tokenized instrument, the most common of which is the Simple Agreement for Future Tokens ("SAFT"). In lieu of an agreement, a Token Sponsor might issue to purchasers a placeholder token, which would perform the same function as a SAFT or other non-token contract or instrument. In either case, the pre-functionality instrument is a security, and it is subject to the registration and exemption provisions of the Securities Act. At the point at which the future non-security tokens achieve a sufficient level of functionality, such that their value derives from the value of the services provided on and through the platform and not on the efforts of the persons who organized the enterprise to build out the platform, the pre-functionality security is effectively extinguished and the holder thereof receives delivery of the tokens; if the instrument is itself tokenized (i.e., placeholder token), then the token sponsor most often will effect an exchange between the placeholder token and the functional non-security token and will destroy, or "burn," the placeholder tokens.[12]

A pre-functionality token that promises the delivery of a specified amount of a future token at a specified price on a future date has many of the characteristics of a forward contract for the underlying future tokens. It is established that a forward or futures contract for non-securities, in fact any type of sales contract, normally does not entail an investment contract. For example, in SEC v. Commodity Options International, Inc., the Ninth Circuit stated that:

> *Commodity futures contracts are considered not to be securities per se. They are investments to be sure. The investment, however, is not in an enterprise but is in the underlying commodity, and we may assume, arguendo, that a conventional option to buy or sell a futures contract takes on the character of the contract that is the subject of the option and is no more a security than is that underlying contract.*[13]

A pre-functionality token differs from conventional forward contracts in an important respect: it typically involves a to-be-created novel product or service with no established market or value. In the words of the Ninth Circuit, such instruments are often "investments in the enterprise" of creating an operating token rather than an investment in just the token.

This would be the case if development of the functionality of the relevant platform allowed tokens to be used for their intended purpose on that platform at the time of the token swap. So long as there are no other efforts of others involved either—*i.e.*, (i) marketing materials are focused primarily on present functionality and use of the token, (ii) the seller has not built features into the token intended

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12   *See* Larry E. Bergmann, Updating SAFT: Breaking the Security/Utility Token Conundrum, Blockchain Law Center (June 12, 2018), https://www.blockchainlawcenter.com/newsitem/news/updating-saft-breaking-the-security-utility-token-conundrum-543/.
13   553 F.2d 628, 632 (9th Cir. 1977) (internal citations omitted).

to provide an investment return or support the price of the token in secondary markets, and (iii) the seller does not promise to take steps to support secondary trading of the token—then, at this stage, the seller's efforts would be limited to supporting the use of the tokens with the network or software application and any further increase in the value of the token should be derived from the efforts of others. Once the post-functionality tokens are delivered to the purchasers, each purchaser would have unfettered control over the tokens, and would have no reasonable expectation that the seller will take future steps intended to increase the market value of the tokens. Generally, "the courts will find a security is not present where the investor retains unfettered discretion over the distribution and marketing of the product."[14] At this point, unlike the DAO Token, which promised returns from projects undertaken by the DAO, any reasonable expectation of profits the purchaser might have should depend primarily on the market's demand for the functioning application and the purchaser's own efforts to find buyers and negotiate a favorable price for the tokens (akin to general expectations of appreciation in the demand for a commodity or real estate).

B. MUTABLE TOKENS

> **"CAN A DIGITAL ASSET THAT WAS ORIGINALLY OFFERED IN A SECURITIES OFFERING EVER BE LATER SOLD IN A MANNER THAT DOES NOT CONSTITUTE AN OFFERING OF A SECURITY?"…"CASES WHERE . . . THE DIGITAL ASSET IS SOLD ONLY TO BE USED TO PURCHASE A GOOD OR SERVICE AVAILABLE THROUGH THE NETWORK ON WHICH IT WAS CREATED[,] I BELIEVE IN THESE CASES THE ANSWER IS A QUALIFIED 'YES.'"**
>
> — *William Hinman, Director of the Division of Corporate Finance at the Securities and Exchange Commission, June 2018.*

Rather than issue a placeholder token that later is swapped for a post-functionality utility token, a Token Sponsor might choose to sell a pre-functionality token as a security, then subsequently develop the system in which the token ultimately will operate and, upon deploying the system, allow token holders to utilize that same token within the system and enjoy its consumptive value. Critical, and unique to tokens and this analysis, is the mutability of the token—it can be both initially representative of an investment opportunity and subsequently a functional tool for use on the blockchain application. As William Hinman, Director of the Division of Corporate Finance at the Securities and Exchange Commission, noted in remarks in June 2018: "the analysis of whether something is a security is not static and does not strictly inhere to the instrument."[15] Rather, when asking "Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an

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14   Wabash Valley Power Ass'n, Inc. v. Public Serv. Co. of Ind., Inc., 678 F. Supp. 757, 767 (1988).
15   Hinman *supra* note 8.

offering of a security?," Hinman asserted that, in "cases where . . . the digital asset is sold only to be used to purchase a good or service available through the network on which it was created[,] I believe in these cases the answer is a qualified 'yes.'"[16] By rendering the facts and circumstances surrounding the token such that it has functionality, the Token Sponsor may effect the evolution and development of the token from a pre-functionality security to a post-functionality non-security. Thus, rather than swapping one token for another, the token sponsor allows the single token to evolve from a security to a non-security. An investment contract arises from the understanding as to how the token will be developed into something of useful value; as that development occurs, those features that suggest that a token represents a security may fade in relevance or otherwise disappear and be replaced by features that suggest that the token represents a consumptive utility token or other non-security.

Such changing circumstances – achieving the functionality of the token – also allow the seller to take a different approach to marketing its network or software application, further modifying the extant facts and circumstances surrounding the token. The completion of the network or software application such that the tokens are immediately usable for their intended purpose allows the seller to focus on potential users, so any marketing materials would emphasize the value in using the goods and services accessible through the token. If the tokens are not digital securities by design, and if all the other facts and circumstances support the conclusion that the tokens sold at the time of the token sale should no longer be viewed as investment contracts, then tokens received by pre-functionality purchasers under those same circumstances should not be viewed as investment contracts either. The characteristics of the pre-functionality token sale by which the tokens were originally purchased should not be determinative of the status of the tokens as "investment contracts" with respect to the subsequent status of the tokens under changed facts and circumstances. Indeed, as CFTC Commissioner Brian Quintenz has recognized, that virtual currencies "can transform. They may start their life as a security from a capital-raising perspective but then at some point – maybe possibly quickly or even immediately – turn into a commodity."[17]

C. DIVIDEND-PAYING TOKENS

The third situation involving a security token that produces a non-security token for its holder is the most straightforward: a security token that delivers a dividend payment, either a pro rata share of income or otherwise, to its holder in the form of a second, distinct, non-security token. It is difficult to envision a situation where the dividend-paying token would not represent a security, because a reasonable purchaser would only acquire it to enjoy the passive income derived from the efforts of others. The token received as a dividend, however, need not necessarily be a security. If the dividend token were either a pure cryptocurrency, like bitcoin, with value only as a medium of exchange, store of value, or unit of account, then, like bitcoin, it would be less likely to be viewed

16   *Id.*
17   Matthew Leising and Brian Louis, Industry Executives Think a Bitcoin ETF Is on Its Way, Bloomberg (Oct. 19, 2017), https://www.bloomberg.com/news/articles/2017-10-19/a-bitcoin-etf-may-be-the-next-big-thing-on-u-s-exchanges.

as itself a security. Alternatively, if the dividend token were a post-functionality utility token, which could be used for some consumptive purpose in an existing system, then it might fall outside of the definition of a security. The best way to think about this is to change one fact from the *Howey* case itself – suppose the purchasers of interests in the citrus grove were paid in oranges instead of cash. If all the other facts remained the same, we would undoubtedly still consider the contracts representing the interests to be an investment contract (it would still be a contract to share profits, just denominated in oranges), but we would never conclude that the oranges, once fully grown and delivered, had somehow transformed into a security that could not be immediately sold by the purchasers upon receipt.

It is worth noting two scenarios that, on their face, might appear comparable to the dividend-paying token system but that differ in material ways from the dividend-paying token scenario. The differing facts and circumstances allow for an argument that neither token is a security. While these scenarios fall outside of the scope of this paper, it is worth briefly making note of each. First, a blockchain that uses a proof-of-stake consensus mechanism[18] might require a user to stake one token and receive a different token as his or her staking reward. In this case, the user is not receiving passive income through the efforts of others, but rather is receiving a reward for his or her own efforts—namely, providing computing power to assist with the maintenance of the blockchain. Accordingly, in this case, both the staking token and the reward token might not represent investment contracts under the *Howey* test. Second, a system involving a so-called "stablecoin" – a token for which the value is pegged to an external value, such as fiat currency, cryptocurrency, or other financial asset, or an algorithm, designed to limit price volatility. Users would hold the minting token and, by virtue of holding it, receive a variable number of stablecoins on a regular basis, with the number of stablecoins received governed by the system's algorithmic assessment of the change in supply necessary to maintain price stability. In this case, a suitably decentralized system might render the efforts of others irrelevant to the minting token's value.

> ## STABLECOIN
>
> **A token for which the value is pegged to an external value, such as fiat currency, cryptocurrency, or other financial asset, or an algorithm, designed to limit price volatility**

In both scenarios, the facts and circumstances specific to a given token will be key, and it is entirely possible that, in many variations of these scenarios, the staking token or the minting token would represent a security. Because one can envision scenarios where that might not be the case, however,

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18   *See* Proof of Stake FAQs, GitHub, https://github.com/ethereum/wiki/wiki/Proof-of-Stake-FAQs (last visited Apr. 25, 2019).

these two scenarios should be considered distinct from the dividend-paying token discussed above, which in every case would presumably represent a security.

III. U.S. REGULATION OF OVERSEAS TOKEN OFFERINGS

U.S. and foreign companies seeking to conduct a token offering outside the United States should be mindful of the broad application of U.S. federal securities laws. The token sold in a non-U.S. token offering might not be a security under the laws of that jurisdiction, but that same token might be viewed as security under the securities laws of the United States. In light of the potential application of U.S. securities laws to offshore offerings, a company should consider whether its token offering and resales of those tokens should either be registered under the Securities Act of 1933[19] (the "Securities Act") or comply with an exemption from registration under Section 5 of the Securities Act.[20]

Exemptions from SEC registration that an issuer may rely upon include Regulation D[21] and Regulation S.[22] Regulation S provides a non-exclusive safe harbor for extraterritorial offers, sales, and resales of securities in Rules 903 (safe harbor for issuers and "distributors"[23] of securities and their respective affiliates) and 904 (resale safe harbor) under the Securities Act.[24] While transactions falling outside of the Regulation S safe harbor might still be deemed to occur outside of the United States if there is an insufficient nexus to the United States,[25] compliance with Regulation S provides certainty. In the context of a global offering, the non-U.S. Regulation S offering is often conducted with a concurrent Regulation D private placement to accredited investors in the U.S. Regulation S, however, does not exempt a transaction from the antifraud provisions of U.S. securities laws.

Demonstrating compliance in the context of an initial sale may include obtaining appropriate representations from the buyer, and if an offer is conducted online, the implementation of "geofencing" of websites or similar restrictions. It is important to take such precautions in order to ensure that a sale is being marketed and is intended solely as an offshore transaction.

A. CATEGORIZATION OF TRANSACTIONS UNDER REGULATION S

The safe harbor provided by Regulation S contains three categories of offerings for an offer or sale by an issuer, "distributor", or affiliates or persons acting on their behalf, depending on whether the issuer

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19   15 U.S.C § 77a *et seq.*
20   15 U.S.C § 77e.
21   17 C.F.R. § 230.500 *et seq.*
22   17 C.F.R. § 230.901 *et seq.*
23   "Distributor" means any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered or sold in reliance on Regulation S. 17 C.F.R. § 230.902(d).
24   17 C.F.R. § 230.903; 17 C.F.R. § 230.904.
25   There has long been a longstanding recognition that if legislative text of a U.S. law does not speak of extraterritorial application, then there is a presumption against extraterritorial application of such U.S. law. *See* Foley Bros Inc v Filardo, 336 US 281, 285 (1949); Equal Employment Opportunity Commission v Arabian American Oil Co, 499 US 244, 248 (1991). In 2010, the Supreme Court held in Morrison V. National Australia Bank that the anti-fraud provisions in Section 10(b) of the Exchange Act do not provide a right to sue in transactions taking place outside the U.S. *See* 561 US 247 (2010). The Court held that Section 10(b) only reaches "transactions in securities on domestic exchanges, and domestic transactions in other securities." As a result, many have taken the view that the Court's reasoning applies to the U.S. securities laws generally unless Congress has affirmatively called for offshore application of such laws in a statute. However, Congress has subsequently amended the Securities Act and the Exchange Act to provide that the SEC may exercise jurisdiction over offshore transactions in its enforcement actions in certain circumstances.

is (i) foreign or domestic, (ii) issuing debt or equity securities and (iii) a reporting company under the Exchange Act,[26] as well as the nature of the transaction itself. The levels of procedural safeguards vary with the three categories. For purposes of determining what category a transaction falls into and what restrictions apply, three threshold questions must be answered:

HOW TO DETERMINE THE CATEGORIZATION OF A TOKEN UNDER REGULATION S

1

IS THE TOKEN DEBT OR EQUITY?

2

IS THE ISSUER "FOREIGN" OR "DOMESTIC"?

3

IS THE ISSUER A REPORTING COMPANY UNDER THE EXCHANGE ACT?

Is the Token Debt or Equity? Regulation S requires a security to be classified either as debt or as equity.[27] However, digital tokens often have more complex hybrid features than traditional debt or equity securities and may not fit neatly within either category. Unless a token has clear hallmarks of a debt security,[28] a more conservative approach would be to classify most tokens as equity securities for purposes of the safe harbor.

Is the issuer "foreign" or "domestic"? Greater restrictions generally apply to "foreign" issuers than "domestic" issuers. A "foreign issuer" is a "foreign government" or "foreign private issuer."[29] The determination of foreign private issuer status is highly technical. A foreign incorporated entity will not be a foreign private issuer if more than 50% of its outstanding voting securities are held by U.S. residents and any one of the foregoing applies: (i) the majority of its executive officers or directors are U.S. citizens or residents, (ii) more than 50% of the issuer's assets are located in the United States, or (iii) the issuer's business is administered principally in the United States.[30] A "domestic issuer" is in turn any issuer other than a foreign private issuer or foreign government.[31]

Is the issuer a reporting company under the Exchange Act? Currently, few issuers of digital tokens would be registered as reporting issuers with the SEC under the Exchange Act, but that may change in the future.

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26 15 U.S.C § 78a *et seq*.
27 The term "equity security" is defined to mean any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any convertible security, warrant or any right, put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so. *See* 17 C.F.R. § 230.405.
28 Debt securities of an issuer is defined to mean any security other than an equity security as defined in 17 C.F.R. § 230.405, as well as the following: (1) Non-participatory preferred stock; and (2) certain asset-backed securities.
29 *See* 17 C.F.R. § 230.902(e).
30 *See* 17 C.F.R. § 240.3b-4(c).
31 *See* 17 C.F.R. § 230.902(e).

B. IMPLEMENTATION OF RESALE RESTRICTIONS ON SECURITY TOKENS

Traditional means of implementing required restrictions on the resale of securities include issuing physical certificates, legending securities and offering materials, requiring purchaser or transferee certifications and legal opinions for transfer, and issuing stop transfer instructions for the issuer of securities. These measures can be effective for traditional securities but are often inefficient and overly restrict compliant resale transactions. Security tokens in turn present unique challenges for demonstrating compliance with applicable restrictions in light of the absence of physical certificates for securities, the absence of a central transfer agent to record transactions and act as a gatekeeper for transactions, the global distributed nature of participants and the liquidity provided by global trading platforms. Smart contracts and blockchain technology platforms are starting to come online to offer better ways to police restrictions and facilitate compliant resales of securities for the issuer of securities.

Below are some examples of such restriction methods that would naturally be applied to STOs.

» **Restrictive Legends.** Legends advising on the resale restrictions can be included on the relevant token sale documentation, including the token white paper, token sale terms, and purchase agreements. As discussed further below, restrictive legends can also be written into smart contracts associated with the token to ensure that resale restrictions are included on future transfers. The SEC has indicated that adding precautionary legends on securities requiring the purchasers to represent that they are not acquiring the securities for distribution, and in the case of equity securities, issuing stop-transfer instructions to the transfer agent prohibiting the transfer of the security, can be effective means of preventing illegal distributions. However, these methods are not regarded as a basis for an exemption from registration. The nature of the purchaser's past investment and trading practices or the character and scope of the purchaser's business may indicate an intent to resell securities despite representations obtained through legending.

» **Legal Opinion Requirements.** Requiring the seller of a token to provide a legal opinion to the issuer that resale is permitted is an expensive approach that can limit otherwise compliant transactions but may be appropriate for circumstances that do not fit within a clear safe harbor.

» **Repurchase Rights.** Requiring token purchasers to agree to the issuer's rights to repurchase the tokens if transfer restrictions are not complied with can also provide the issuer with a method to address noncompliant transfers.

» **Multi-Signature Wallets.** Multi signature wallets requiring more than one signature to authorize a transaction can be used to limit token transfers to approved purchasers.

» **Smart Contract Restrictions.** This method involves writing transfer terms and restrictions into the token smart contract. For example, the smart contract can be written to limit transfers of the token to certain categories of purchasers or purchasers who meet the requirements of a resale

exemption by adding a validation requirement in the smart contract's code. These restrictions can be customized to prohibit all token transfers, to allow transfers to receivers who meet certain requirements and/or to have token transfer restrictions fall away after a specified period of time. If the Regulation S exemption is used, transfers can be limited to whitelisted Non-US buyers located outside of the U.S. In the alternative, another option would be to condition any transfer upon the consent of the issuer so that the issuer can take steps to ensure that future transfers are made in compliance with a valid resale exemption.

» **Contractual Lock-Ups.** Token purchasers can be required to enter into lock-up provisions limiting the purchaser's ability to resell tokens in order to comply with requirements for a resale exemption. For example, to comply with the distribution compliance periods required by Regulation S, lock up periods can be added for each token purchaser, either in a traditional contract or written into smart contract code. Not all securities traded in compliance with Regulation S requirements subsequently become freely tradable, but addressing a lock up period in a smart contract can also allow tokens that are not equity securities issued by a domestic issuer to become freely tradable as soon as the required holding period is reached.

C. OFFSHORE RESALES OF SECURITIES

A person who bought a restricted security in a securities token offering would have to resell the securities under an exemption from U.S. securities laws. Section 4(a)(1) of the Securities Act generally exempts resales of restricted securities by a person who is not an issuer, underwriter or dealer. The holder of restricted securities would need to demonstrate that he or she did not purchase the securities with a view towards reselling it because of the expansive definition of "underwriter" under U.S. securities laws. The purchase could also resell under applicable safe harbors, which typically would require the purchaser to hold the securities for a specified period. Available and relevant provisions include Rule 144 (non-exclusive safe harbor from statutory underwriter status) and Rule 904 of Reg S (safe harbor for the resale of securities by a person other than the issuer).

An STO offered to non-US persons can effectively be structured with legal advice customized to the facts and circumstances of a particular issuer and leveraging available technology to yield a compliance process which is not overly restrictive.

D. OTHER GLOBAL TRADING CONSIDERATIONS

Additional trading considerations also arise from the differing approaches taken by jurisdictions other than the United States in regulating digital tokens. For example, a holder of a digital token issued in a jurisdiction where it would be classified as something other than a security) may seek to sell the token to U.S. persons. When viewed from a U.S. securities law perspective, the digital token could be viewed as a security token, which would make such sale subject to the trading restrictions and requirements under Regulation S. Issuers who are conducting utility token offerings outside of the United States

should therefore be cognizant of the issuance and resale restrictions under Regulation S, particularly if there is a possibility of such tokens being traded into the United States or to U.S. persons.

E. APPLICABILITY OF BLUE SKY LAWS

In addition to the federal securities laws, state securities or blue sky laws apply to the offer and sale of securities. Unless federal preemption of state law applies, offers and sales of securities in different states need to be registered or qualified in those states or fall within an available exemption. Because registration or qualification in 50 states can be burdensome and time-consuming, issuers of traditional securities seek to rely on federal preemption or limit the offering to fit within state law restrictions where applicable.

The National Securities Markets Improvements Act of 1996, as amended (the "NSMIA")[32] preempts the registration requirement of state blue sky laws from applying to certain "covered securities."

In addition to federal preemption, states have a variety of exemptions that are potentially applicable to certain facts and circumstances and can vary considerable from state to state. Some states have exemptions for exchange-listed issuers, which could be useful if an issuer with a class of securities already listed on an exchange (the list of eligible exchanges varies from state to state) wanted to issue tokens, since other securities of listed issuers may be exempt under these provisions. In addition, many states have exemptions for certain "blue chip" issuers, issuers who are listed in certain manuals (so-called "manual listings"), as well as for securities registered under the Securities Act, exemptions for limited offerings, or to various exemptions for transactions involving sophisticated investors.

If a token or transaction is not preempted or exempted from blue sky law, then a full blue sky registration process must be undertaken which, depending on the states involved, can be very difficult and time consuming. Methods of registration vary from state to state, but most states have adopted one or more of registration by: notification, coordination and qualification. Certain eligible issuers may also qualify for registration by qualification whereby designated states can take the lead in the review process on behalf of certain other states.

One key distinction of the blue sky review process when compared to the federal review process for a registered offering is that the federal review process only involves review of disclosure, while the states will actually evaluate the merit of an offering, including the terms of a security to evaluate whether a transaction is unfair to prospective purchasers or subjects them to unreasonable risks. If a state regulator is not satisfied as to the merits of an offering, it can stop the offering from taking place within the state. Tokenized securities may be subject to heightened scrutiny compared with traditional securities.

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32   Pub. L. No. 104-290, 110 Stat. 3416 (codified in various sections of the Securities Act, in particular Section 18 of the Securities Act).

IV. TRADING TOKENIZED SECURITIES

Purchasers of tokenized securities need liquidity for the securities that they buy in such issuances. The development of secondary markets is therefore crucial to the growth of tokenized security issuance. The following sections address legal and regulatory considerations relating to secondary markets for tokenized securities.

A. TRADING PLATFORMS

As a general rule, securities trade on one of two types of regulated markets: registered national securities exchanges and alternative trading systems ("ATSs"). Registered national securities exchanges and ATSs, while operating in similar manners, are subject to separate regulatory regimes and registration requirements. The NYSE and NASDAQ are examples of NSEs. A tZERO subsidiary offers an ATS, allowing tZERO tokenized securities to be traded.

A national securities exchange must register with the SEC under the Exchange Act through an application process.[33] The SEC must also find that the national securities exchange has rules that meet certain criteria.[34]

An ATS, unlike a national securities exchange, does not have to obtain SEC approval before commencing operations. Rather, to become an ATS, Rule 301(b) of Regulation ATS requires an entity to register as a broker-dealer and to file Form ATS with the SEC. Broker-dealer registration broadly consists of two components. First, the ATS must file Form BD with the SEC.[35] Form ATS is not an application and the SEC does not "approve" an alternative trading system before it begins to operate. However, the SEC staff will often undertake an informal review of a Form ATS and provide comments, and the ATS will need to address any deficiencies noted by the SEC staff during this informal review. Failure to do so before beginning operations could result in a referral to enforcement for having a deficient Form ATS. Second, a broker-dealer must become a member of a self-regulatory organization ("SRO"),[36] typically FINRA.[37]

1. MEMBERSHIP

Section 6(c)(1) of the Exchange Act prohibits exchanges from granting membership to any person not registered as a broker-dealer or associated with a broker-dealer.[38] Consequently, non-broker-dealer institutions cannot be members of a national securities exchange. However,

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33 15 U.S.C § 78f.
34 *See* 15 U.S.C. § 78f(b)(1). *See generally* 15 U.S.C. § 78f(b)(2) through (10).
35 17 C.F.R. § 242.301(b). Within 45 days of filing a completed Form BD, the SEC will either grant registration or begin proceedings to determine whether it should deny registration. Typically, the SEC grants registration of a broker-dealer on Form BD within a few days if the form has been properly completed.
36 Section 3(a)(26) of the Exchange Act defines "self-regulatory organization" as "any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 19(b), 19(c), and 23(b) of this title) the Municipal Securities Rulemaking Board established by section 15B of this title."
37 Unless a broker-dealer limits its security transactions solely to a national securities exchange of which it is a member, Section 15(b)(8) of the Exchange Act and Rule 15b9-1 thereunder require the broker-dealer to become a member of FINRA.
38 15 U.S.C. § 78f(c)(1).

ATSs are not subject to a similar restriction; therefore, an ATS can have non-broker-dealer institutional subscribers that directly access the ATS.[39]

2. DISCLOSURE OF OPERATIONS

National securities exchanges are subject to comprehensive rule filing requirements under Section 19(b) of the Exchange Act, requiring both their trading rules as well as details regarding their trading operations to be made public.[40] Any time a national securities exchange seeks to change its rules, it must first file a rule amendment with the SEC on Form 19b-4, which, if non-controversial, can become immediately effective upon filing, or otherwise be subject to public comment before SEC approval.

In contrast, an ATS has limited disclosure requirements, even to the SEC.[41] Form ATS is deemed confidential when filed. As a result, unless voluntarily provided to the public, the Form ATS is generally not available even to subscribers to the ATS. Additionally, only material changes must be filed with the SEC before implementation;[42] all other changes need to be filed on an amended Form ATS within 30 days after the end of each calendar quarter.[43]

3. LISTING OF SECURITIES

Section 12 of the Exchange Act prohibits a security from trading on a national securities exchange unless there is an effective registration with respect to such security for the exchange.[44] Once a security is registered and listed on an exchange, other exchanges may extend unlisted trading privileges to the security pursuant to Section 12(f) of the Exchange Act.[45]

An ATS must satisfy a similar gating function with respect to securities traded on the ATS. In particular, a broker-dealer wishing to publish any quotation for a security in a "quotation medium" (which includes an ATS) to gather specified information regarding the issuer.[46] Once a broker satisfies these information-gathering requirements and has begun quoting in the subject security, other brokers can "piggyback" on such quotations without having to satisfy the requirements.[47]

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39   17 C.F.R. § 242.300, 301.
40   15 U.S.C. § 78o.
41   The SEC has proposed rules to expand the disclosure requirements for ATSs trading an "NMS Stock," which includes any security or class of securities (other than an option) for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, other than a listed option. See Securities Exchange Act Release No. 76474 (Nov. 18, 2015). A security that is traded solely in the over-the-counter market is unlikely to fall within this definition. To date, the SEC has not taken further action on this proposal.
42   17 C.F.R. § 242.301(b)(2)(ii).
43   17 C.F.R. § 242.301(b)(2)(iii).
44   15 U.S.C. § 78l.
45   15 U.S.C. § 78l(f).
46   17 C.F.R. § 240.15c2-11.
47   17 C.F.R. § 240.15c2-11(f)(3).

4. DISPLAY OF QUOTATIONS

The SEC mandates in Regulation NMS that all national securities exchanges make available the best bid, the best offer, and aggregate quotation sizes for each security traded on that exchange.[48] Further, the SEC directs that all national securities exchanges act together to develop a national market system plan for the collection and consolidation of such quotation information into a single quotation stream.[49]

Unlike a national securities exchange, an ATS only has to display its quotations for inclusion in the public quote stream under specified circumstances. First, and most importantly, an ATS is only required to make its quotations available with respect to NMS stocks.[50] As a result, unless the security on the ATS is also being traded on a national securities exchange, it is unlikely that the ATS would ever have to provide its quotations in such a security to the public quote stream. Additionally, even if the security is an NMS stock, trading volume on the ATS would have to cross certain thresholds (five percent or more of the average daily trading volume) with respect to such security for at least four of the preceding six months before the ATS would be required to disseminate its quotation information in the public quote stream.[51]

Finally, an ATS could decide to remain completely dark (not display its quotations to any person other than an employee of the ATS) and thus not subject to publishing its quotations in the public quote stream.[52]

5. FINRA AND SEC RULES APPLICABLE TO ATS AND BROKER-DEALERS

As a broker-dealer, an ATS also will be subject to the full panoply of FINRA and SEC rules and regulations applicable to broker-dealers generally. For example, as a broker-dealer, an ATS would be subject to securities transaction reporting and broker-dealer net capital and books and records requirements, among others. Finally, Regulation SCI applies a set of rigorous cybersecurity requirements both to self-regulatory organizations, such as exchanges, and to certain ATSs.[53]

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48   17 C.F.R. § 242.602.
49   17 C.F.R. § 242.603. It is the combination of these two mandates that results in the creation of the Securities Information Processors ("SIPS") and dissemination of best bids and best offers (and respective sizes) from all exchanges in the public quote stream. All national securities exchanges provide quotation information and last sale information to the SIPs for the national market system plans governing trading in NYSE listed securities ("Tape A securities"), NASDAQ listed securities ("Tape C securities"), and securities listed on exchanges other than NYSE or NASDAQ ("Tape B securities"). The SIPs consolidate this information and disseminate the consolidated information to market participants.
50   17 C.F.R. § 242.301(b)(3)(i). Rule 300(g) of Regulation ATS provides that that neither a debt security nor a convertible debt security is an NMS stock for purposes of Regulation ATS. 17 C.F.R. § 242.300(g). We do not think that, at least initially, the securities that will trade on the Platform will be NMS securities because they are not likely to be securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.
51   17 C.F.R. § 242.301(b)(3)(i)(B).
52   17 C.F.R. § 242.301(b)(3)(i)(A).
53   17 C.F.R. § 242.1000 *et seq.* (2017).

B. TRANSACTION PROCESSING

After a transaction is effected on a market, the securities and associated payment must be processed and transferred between the parties. This activity raises potential issues with respect to "clearing agency" and "transfer agent" regulation.

CLEARING AGENCY	TRANSFER AGENT	BROKER - DEALER
Acts as an intermediary in making payments or deliveries or both in connection with transactions in securities; or otherwise permits or facilitates the settlement of securities without physical delivery of securities certificates.	Person who engages on behalf of an issuer or on behalf of itself as an issuer in: 1. registering the transfer of securities; or 2. transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.	Obtains custody of its customers' securities by maintaining "physical possession or control of all fully paid securities and excess margin securities carried by a broker or dealer for the account of customers."

1. CLEARING AGENCY

A "clearing agency," among other things, "acts as an intermediary in making payments or deliveries or both in connection with transactions in securities;" or

Otherwise permits or facilitates the settlement of securities without physical delivery of securities certificates.[54]

If the trading platform, in addition to executing transactions between the parties to a trade, also performs a function described above in effecting the transfer of securities and payments between transaction parties, then the platform may be performing the functions of a clearing agency. A clearing agency must register with the SEC, a lengthy process.[55] Clearing agency concerns may arise if, for example, a trading platform maintains wallets for its subscribers/members and securities and cash (cryptocurrencies or fiat currency) traded on the platform move between those wallets. The question is whether the platform's role in the movement of assets between traders constitutes a clearing agency function. The SEC has issued a warning that the need for clearing agency registration should be evaluated.[56]

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54   15 U.S.C. § 78c(a)(23)(A).
55   15 U.S.C. § 78q-1(b)(2); *see* Exchange Act Sections 17A(b)(2) and 19(a), 15 U.S.C. §§ 78q-1(b)(2), 78s(a), and Rule 17Ab2-1 thereunder, 17 C.F.R. § 240.17Ab2-1.
56   "[S]ome platforms offer digital wallet services (to hold or store digital assets) or transact in digital assets that are securities. These and other services offered by platforms may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency registration, among other things." Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, Sec. and Exch. Comm'n (Mar. 7, 2018), https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

There may be exceptions to registering a trading platform as a clearing agency. For example, broker-dealers registered with the SEC that are engaged in activities that fall within the definition of clearing agency are excepted from also registering with the SEC as such if the activities constitute customary brokerage activities.[57]

2. TRANSFER AGENT

A "transfer agent" is defined in Exchange Act Section 3(a)(25) and includes a person who engages on behalf of an issuer or on behalf of itself as an issuer in:

1. registering the transfer of securities; or

2. transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.[58]

A person that performs this function (or other defined functions) must register with its "appropriate regulatory agency"[59] as a transfer agent pursuant to Exchange Act Section 17A(c) if it is performing such functions for certain securities.[60] Although it may appear to be a relatively obscure recordkeeping operation, the SEC has emphasized the important function that transfer agents perform.[61]

Prospective issuers of digital securities may consider making offerings pursuant to SEC Regulation A.[62] An issuer that has issued securities pursuant to Tier 2 of Regulation A[63] and is required to file reports pursuant to Rule 257(b) of that regulation,[64] is not required to include such securities as "held of record" if, inter alia, it satisfies the conditions of Securities Act Rule 12g5-1((b)(7).[65] One of the conditions of this exemption is that the issuer must engage a registered transfer agent with respect to such securities.[66] One effect of this provision is that an issuer that has issued securities only pursuant to Tier 2 of Regulation A is not required to register its securities under Section 12, but, as noted, must utilize a registered transfer agent.

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57   *See* Exchange Act Section 3(a)(23)(B), 15 U.S.C. § 78c(a)(23)(B). That subsection also excludes certain banks engaged in customary banking activities from the definition of "clearing agency."
58   15 U.S.C. § 78c(a)(25)(C) and (E).
59   *See* Exchange Act Section 3(a)(34); 15 U.S.C § 78c(a)(34).
60   15 U.S.C. § 17q-1(c). *See also* Exchange Act Rule 17Ac2-1. *See generally* SEC, Division of Trading and Markets, "Transfer Agents," https://www.sec.gov/divisions/marketreg/mrtransfer.shtml.
61   "As agents for issuers, transfer agents play a critical role with respect to securities settlement, though they rarely receive much public attention." Securities Exchange Act Release No. 76743 (December 22, 2015), 80 Fed. Reg. 81848, 81949, https://www.gpo.gov/fdsys/pkg/FR-2015-12-31/pdf/2015-32755.pdf (proposing extensive changes to transfer agent regulation).
62   17 C.F.R. § 230.251-263. *See* Larry E. Bergmann, Regulation A as a Financing Alternative for Securities "Tokens": Some Considerations, Blockchain Law Center (Mar. 14, 2018), https://www.blockchainlawcenter.com/newsitem/news/regulation-a-as-a-financing-alternative-for-securities-tokens-some-considerations/.
63   Securities Act Rule 251(a)(2); 17 C.F.R. § 230.251(a)(2).
64   17 C.F.R. § 230.257(b).
65   17 C.F.R. § 230.12g5-1(b)(7).
66   Rule 12g5-1(b)(7)(iii), 17 C.F.R. § 230.12g5-1(b)(7)(iii).

C. CUSTODY – BROKER-DEALERS

A broker-dealer's obligation to "custody" the securities it carries for its customers is set out in Rule 15c3-3 under the Exchange Act. In particular, a broker-dealer obtains custody of its customers' securities by maintaining "physical possession or control of all fully paid securities and excess margin securities carried by a broker or dealer for the account of customers."[67] Control means that the broker-dealer holds the securities in one or more locations specified in Rule 15c3-3(c) "and free of any liens or any interest that could be exercised by a third party to secure an obligation of the broker-dealer."[68] Neither the SEC nor its staff has issued guidance on how a broker-dealer must comply with Rule 15c3-3 in obtaining custody of tokenized securities.[69]

1. POSSESSION OF TOKENIZED SECURITIES

A broker-dealer arguably could maintain the equivalent of physical possession, as that term is used in paragraph (b) of Rule 15c3-3, of customers' tokenized securities by holding those securities in wallets that the broker-dealer maintains for customers and for which the broker-dealer maintains the private keys. An auditor could confirm the broker-dealer's wallet holdings by requiring the broker-dealer to send messages from the wallets. The broker-dealer would carry customer tokenized securities long in customers' accounts, and the securities holdings in those accounts could be reconciled with the holdings in wallets maintained for the customers. This approach would be similar to the manner in which broker-dealers maintained physical possession of certificated securities. Broker-dealers often held customers' securities certificates in vaults and carried those positions long in customers' accounts. In this case, wallets and private keys would serve the same function as vaults.

2. CONTROL OF DIGITAL SECURITIES

Tokenized securities are not expected to be held at any of the control locations specified in paragraph (c) of Rule 15c3-3. Of the control locations enumerated in paragraph (c), only a securities depository, such as The Depository Trust Company ("DTC"), or a bank could hold tokenized securities. Moreover, the term "bank," as used in Rule 15c3-3, primarily includes federally-supervised banks. To date, federal bank agencies have not permitted federally-chartered banks to hold tokenized securities.

Paragraph (c)(7) of Rule 15c3-3 permits the SEC to designate (on a case-by-case basis) additional good control locations for purposes of complying with Rule 15c3-3. The staff of the SEC's Division of Trading and Markets (the "Staff") has issued guidance on "good" control

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67   17 C.F.R. § 240.15c3-3(b)(1).

68   Financial Responsibility Rules for Broker-Dealers, Release No. 34-70072, 78 Fed. Reg. 51,824 (Aug. 21, 2013), https://www.govinfo.gov/content/pkg/FR-2013-08-21/pdf/2013-18734.pdf.

69   Note, however, that the SEC Division of Trading and Markets and the FINRA Office of General Counsel issued Guidance describing regulatory gray areas. Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, SEC (July 8, 2019), https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities.

locations for "traditional" uncertificated securities.[70]

A broker-dealer arguably could rely on transfer agents as good control locations for the tokenized securities of a broker-dealer's customers. To rely on a transfer agent as a good control location for its customers' tokenized securities, a broker-dealer would need to hold its customers' securities in compliance with the terms of a no action letter permitting a transfer agent to be a control location. That letter provides that a transfer agent can be a good control location for a broker-dealer's customers' securities under the following conditions:

> » The broker-dealer carries the tokenized securities "long" in customers' accounts;

> » The broker-dealer reflects separately all customer tokenized securities positions in securities records or ledgers pursuant to Rule 17a-3 under the Exchange Act;

> » When accepting custody of the tokenized securities, the broker-dealer is not aware of any substantial problems of an operational nature that the issuer of those tokenized securities may be experiencing and which may endanger the interests of the customer;

> » The broker-dealer obtains written assurance that the tokenized securities are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the transfer agent or any person claiming through transfer agent;

> » The tokenized securities are registered with the Commission pursuant to the Securities Act of 1933, exempt from registration, or not required to be registered; and

> » The broker-dealer will maintain in a separate file a current list of all investments of tokenized securities that are carried on its books and records subject to the terms and conditions set forth above.[71]

Using a transfer agent to establishing control of tokenized securities for purposes of Rule 15c3-3, the books and records of a broker-dealer holding customer tokenized securities would show those securities as carried long in the customer's account with the broker-dealer, just as they would when establishing the equivalent of physical possession. The broker-dealer would hold its customers' tokenized securities in wallets that it establishes and for which it holds the private keys. The broker-dealer would have to ensure that the transfer agent shows the broker-dealer as the legal owner of the tokenized securities that the broker-dealer carries for its customers. The broker-dealer's books and records would show the customers as the beneficial owners of

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70   The Staff has recognized that the following can be good control locations for uncertificated securities: the general partner of a limited partnership (SEC Letter to Wayne Hummer & Co. (Mar. 6, 1986) and SEC Letter to Wilmer, Cutler & Pickering (July 30, 1997)); the designated manager of limited liability company (SEC Letter to Wilmer, Cutler & Pickering (Sept. 17, 1999)); and the contractual adviser to a REIT (SEC Letter to Holland & Knight, LLP (Jan. 18, 2000)).
71   SEC Letter to Sanford C. Bernstein & Co (June 9, 2009), https://www.sec.gov/divisions/marketreg/mr-noaction/2009/bernstein090809.pdf.

those securities.

A broker-dealer would perform a reconciliation to demonstrate its control of customers' tokenized securities. It would reconcile the amount of a digital security shown on the books and records of the transfer agent for that security with the aggregate amount of that security held in customer wallets, which amount can be verified on the blockchain. The broker-dealer would then compare the transfer agent records and wallet holdings for the digital security with the aggregate amount of that security that it carries in the accounts of all its customers, as reflected on its books and records. The amount of the digital security on the books and records of the transfer agent, in customer wallets, and held in customer accounts in aggregate should match. We understand that an auditor could verify that tokenized securities are held in a wallet by requiring a broker-dealer to transfer a small amount of securities held in that wallet to a wallet designated by the auditor, or by requiring a broker-dealer to sign a message from that wallet. This would allow the auditor to verify that the broker-dealer controls the private keys for that wallet.

State-chartered trust companies arguably should be permitted to serve as control locations for tokenized securities. We understand that the financial services agencies of certain states have permitted trusts to hold various types of crypto assets, including tokenized securities. The SEC, however, would have to designate state-chartered trusts as good control locations under paragraph (c)(7) of Rule 15c3-3. It is unclear whether the SEC is prepared to designate entities, such as trusts, that are not subject to federal supervision as good control locations.

D. CUSTODY – INVESTMENT ADVISERS

Rule 206(4)-2 (commonly referred to as the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") establishes certain safekeeping requirements applicable to funds or securities held on behalf of clients by registered investment advisers.[72] Although the Custody Rule applies only to registered investment advisers, its concepts are relevant for non-registered advisers as well, since clients of those advisers still have a practical interest in assuring that managed assets are appropriately safeguarded and the absence of appropriate custody arrangements may preclude a client from investing with a particular adviser.

1. SCOPE OF THE CUSTODY RULE

On its face, the Custody Rule applies to the custody of client "funds or securities". Digital assets can be characterized in a number of ways. Since the SEC has taken the view that such tokenized securities constitute securities for purposes of the U.S. federal securities laws,[73] and since the SEC has not provided any interpretations or guidance to the contrary, it would seem

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72   17 C.F.R. § 275.206(4)-2.
73   *See* Munchee Inc., *supra* note 9.

that security tokens would fall within the scope of the Custody Rule. In fact, a March 2019 letter to the President of the Investment Advisers Association from Paul G. Cellupica, Deputy Director and Chief Counsel of the SEC's Division of Investment Management, demonstrates that the SEC is continuing its efforts to engage with market participants and better understand how characteristics of digital assets impact the application of the Custody Rule.[74]

2. PURPOSES OF THE CUSTODY RULE

While appropriate custody arrangements can provide protections against inadvertent loss or theft by third parties, another key purpose of the Custody Rule is to protect against fraud or misconduct on the part of an adviser or its employees or representatives. So, broadly speaking, custody through an independent third party might be viewed as providing (or at least aimed at providing) three key protections:

» Protection against theft or misappropriation by third parties

» Protection against bankruptcy or insolvency of the adviser or custodian (i.e., by segregating the assets and identifying them as being held on the client's behalf)

» Protection against fraud, theft or misappropriation by the adviser itself

3. SUMMARY OF CUSTODY RULE REQUIREMENTS

Unless certain exceptions apply (which may make all or part of the Custody Rule inapplicable to certain securities or in certain situations), an investment adviser that is registered or required to be registered under the Advisers Act is required to comply with certain requirements if it has custody of client funds or securities. Among such requirements are the following: [75]

Qualified Custodian: Funds or securities held on behalf of clients must be maintained by a "qualified custodian".

Each of the following is a "qualified custodian" under the Custody Rule:

• A bank as defined in section 202(a)(2) of the Advisers Act[76] or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit

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74   Letter from Paul G. Cellupica, Deputy Director and Chief Counsel, Div. of Inv. Mgmt., Sec. & Exch. Comm'n. to Karen Barr, President and CEO, Inv. Advisers Ass'n (Mar. 12, 2019); *see also* Beagan Wilcox Volz, SEC Asks Industry How to Best Custody Crypto Assets, IGNITES. COM (Mar. 15, 2019).

75   *See* 17 C.F.R. § 275.206(4)-2(a).

76   In addition to federally-chartered banks, other member banks of the Federal Reserve System and certain other identified identities, the definition of "bank" for this purpose includes a state-chartered or federally-chartered trust company if a substantial portion of the business of such trust company consists of receiving deposits or exercising fiduciary powers similar those permitted to national banks. If a trust company is formed and operated solely for the purpose of providing custody services, a legitimate question might be raised as to whether such custody services are fiduciary in nature. Paul G. Cellupica, Deputy Director and Chief Counsel of the SEC's Division of Investment Management, may have been alluding to this potential issue when he asked (in a March 2019 letter addressed to the Investment Adviser Association) whether advisers have experienced similarities or differences in custodial practices of trust companies as compared to those of banks and broker-dealers. Letter from Paul G. Cellupica, Deputy Director and Chief Counsel, Div. of Inv. Mgmt., Sec. & Exch. Comm'n. to Karen Barr, President and CEO, Inv. Advisers Ass'n (Mar. 12, 2019).

Insurance Act

- Registered broker-dealers holding client assets in customer accounts

- Registered futures commission merchants holding client assets in customer accounts (but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon)

- Foreign financial institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.[77]

Notice to Client: Notice must be provided to clients if an account is opened with a qualified custodian on a client's behalf.

Account Statements: The adviser must have a reasonable belief that the qualified custodian is sending account statements to the client (or, in the case of a client that is a pooled fund or similar investment vehicle, the underlying investors in the pooled vehicle) at least quarterly.

Verification and Surprise Audit: The funds and securities held in custody must be verified at least once during any calendar year, generally by an independent public accountant. The examination and verification must be at a time chosen by the accountant without prior notice or announcement to the adviser or the custodian and must be a time that is irregular from year to year.

4. SELF-CUSTODY

The Custody Rule does not preclude self-custody by a registered investment adviser. However, the adviser or its "related person" that maintains actual custody of client funds or securities must itself be a qualified custodian.

In those circumstances, certain additional requirements generally apply. First, the independent public accountant retained to satisfy the surprise audit requirement must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules. Second, a written internal control report must be provided within six months of becoming subject to the Custody Rule and at least once per calendar year thereafter. The internal control report must be prepared by an independent public accountant and must include an opinion of a PCAOB-registered independent public accountant as to whether controls have been placed in operation as of a specific date and are suitably designed

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77   *See* 17 C.F.R. § 275.206(4)-2(d)(6).

and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held on behalf of the advisory clients, during the relevant year. Such independent public accountant must also verify that the funds and securities are reconciled to a custodian other than the registered investment adviser or its related person.

5. PRACTICAL IMPACT AND CONSIDERATIONS

Certain third-party service providers have begun providing digital asset custody services to investors in the space. In order to broaden their potential client base, certain of such service providers have actively sought to take steps to establish "qualified custodian" status. For example, certain service providers have acquired existing trust companies and broker-dealers or taken steps to establish a state-chartered trust company.[78]

There are a number of practical difficulties that may still need to be overcome with respect to the provision of custody services in a manner consistent with the purposes of the Custody Rule:

» *Limits on Scope of Custody Services:* Unlike typical broker-dealer arrangements, where one security is readily tradable for another security or cash and the proceeds of a transfer or sale can be received and held by the broker-dealer in the brokerage account on a "payment versus delivery" basis, typical current cryptocurrency custodians only provide for custody of a limited number of approved cryptocurrencies. They may or may not have the capability to hold cash for a client. They almost certainly will not agree to hold any and all cryptocurrencies in which a client may choose to invest. Without a significant expansion of the number and types of cryptocurrencies that may be held with a particular custodian, the practical ability of advisers to trade broadly in cryptocurrency investments may be limited.

» *Audit Difficulties:* It remains to be seen whether typical independent accountants will be willing to provide the surprise audits required by the Custody Rule. There are certainly some accounting firms that have taken an active interest in the digital asset space. But, without additional guidance from the SEC or accounting standards boards, accountants may have difficulty confirming that a private key held by a custodian actually represents an ownership interest in the particular underlying digital asset. Unlike typical investments in securities and debt instruments, there are no registrar records, trusted securities intermediaries, trusted counterparties, administrative agents or other traditional sources of ownership verification. Verifying ownership of digital assets may require technical expertise and knowledge that may not be readily available at this point to typical accounting firms.

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78   *See*, *e.g.*, Press Release, N.Y. Dep't of Fin. Services, DFS Authorizes Coinbase Global, Inc. to Form Coinbase Custody Trust Company LLC (Oct. 23, 2018), https://www.dfs.ny.gov/about/press/pr1810231.htm; Ben McLannahan, Wall Street starts to dip its toes in crypto Fin. Times (Aug. 13, 2018), https://www.ft.com/content/db5a20ea-9ca1-11e8-9702-5946bae86e6d; Kate Rooney, Companies Race to Solve Bitcoin's Security Problems Despite Slumping Prices, CNBC (Sep. 13, 2018), https://www.cnbc.com/2018/09/13/companies-race-to-solve-bitcoins-custody-problem-despite-slumping-prices.html.

» **_Adviser Fraud Risk:_** While current custody methods can provide significant protections against hacking and other cyber threats involving third parties, it is not clear that such methods will satisfy the goal under the Custody Rule of providing substantial protections against adviser fraud or misappropriation of assets. A custodian of digital assets primarily serves as a secure storage point for those assets. However, in the context of providing custody for assets managed for an investment vehicle or other ultimate client by an investment adviser, the custodian basically acts at the instruction of the adviser. If the adviser wants to transfer digital assets out of custody and does so in accordance with established procedures, the digital assets can leave the custody arrangement without cash or other replacement assets being received by the same custodian. Such transfers can occur relatively quickly, and an adviser may be able to abscond with digital assets or the proceeds thereof in quick order. It is possible, of course, that digital assets that are traced back to a fraudulent transaction can be blacklisted in some manner—which may limit trading of those assets going forward. However, this has the potential to harm innocent recipients of proceeds of the fraudulent transaction (i.e., those who had no knowledge that the original digital assets were misappropriated). It also may not be a significant deterrent to a large theft by an adviser, who can quickly exchange digital assets for cash and abscond with the cash before any custodian or digital asset exchange has knowledge of any wrongdoing.

Solving for these difficulties has implications beyond tokenized securities complying with the custody rules of the federal securities laws. Custody has been identified as an important issue in the larger efforts of institutional actors to adopt digital assets. In her January 2018 letter to two industry groups, Dalia Blass, the Director of the SEC's Division of Investment Management, identified the issue of custody and the custody requirements of the Investment Company Act of 1940 as necessary elements to address if the SEC is to approve an exchange-traded fund that invests in digital assets.[79]

V. PRINCIPLES AND GUIDELINES FOR SECURITIES TOKEN SPONSORS AND TRADING PLATFORMS

Given the increase in interest in securities tokens, the following points highlight a few key issues that require careful consideration before issuing a securities token or trading it on a platform.

TOKEN ISSUERS:

» Issuers must comply with registration requirements under the U.S. securities laws in issuing tokenized securities. Such securities either must be issued under a recognized exemption to registration or be

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79   Letter from Dalia Blass, Director, Div. of Inv. Mgmt., Sec. & Exch. Comm'n. to Paul Schott Stevens, President and CEO, Inv. Co. Inst. (Jan.18, 2018), https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

registered. Each regime – whether fully registered or issued pursuant to an exemption – carries specific

obligations and limitations, both at the outset of issuance and ongoing. The pros and cons of each will drive the determination of which option to use and are described in the Chart to this Chapter and more fully in Appendix A.

» Issuers of tokenized securities also may wish to issue utility tokens (for example, the securities token is used to raise funds, but the utility token will be used on the platform). An issuer may want to issue securities that exist temporarily until it can issue a utility token, or the issuer may wish to issue utility tokens in addition to securities tokens. Whether an issuer wishes to maintain one more classes of securities will determine whether it issues a tokenized security in the form of placement tokens, mutable tokens, or dividend-paying tokens. Each type of securities token brings varying levels of regulatory complexity, and each must be considered before issuing the token to ensure the model meets the needs of the platform and the business.

» Entities that issue tokens overseas must still be cognizant of U.S. securities laws, given the digital nature of the token and its ability to be issued and traded across borders. Moreover, a token that does not qualify as a security in one country may still be considered to be a security in the United States. Issuers must take precautions to ensure they comply with relevant exemptions or otherwise do not trigger U.S. law.

TOKEN TRADING PLATFORMS:

» Tokenized securities need secondary markets to provide liquidity to purchasers of such securities. Such securities will likely trade on a registered national securities exchange or an ATS. ATS are subject to a lighter regulatory touch and shorter application process, but national securities exchanges have the ability to list securities for trading and generate data fees.

» The nature of digital assets that qualify as securities introduces new considerations for broker-dealers attempting to meet securities law requirements. The below discussion has not been endorsed by the SEC and should be reviewed with legal counsel prior to implementing:

   a. **Physical possession.** Broker-dealers must maintain the equivalent of physical possession of their customers' securities tokens for purposes of Rule 15c3-3 under the Exchange Act. This could arguably be accomplished by holding them in wallets for which the broker-dealer holds the private key and by engaging an auditor to verify holdings.

   b. **Control.** Alternatively, broker-dealers must establish control of its customers' securities tokens for purposes of complying with Rule 15c3-3 under the Exchange Act. This could arguably be accomplished by using a transfer agent to establish the legal owners of such securities, coupled with engaging auditors to verify holdings. Nevertheless, this solution introduces additional

intermediaries that blockchain sought to streamline.

c. **Control Locations.** Rule 15c3-3 permits a bank to serve as a control location for customers' tokenized securities, but federal banking regulators have yet to approve banks to hold crypto assets. Some state financial regulators have approved state-chartered trusts to hold tokenized securities, but the SEC has to issue guidance permitting such trusts to serve as good control locations for purposes of Rule 15c3-3. Neither the SEC nor its staff has issued guidance on how broker-dealers may comply with Rule 15c3-3, however.

INVESTMENT ADVISORS:

» An SEC-registered investment adviser must hold tokenized securities in compliance with the SEC's Custody Rule, Rule 206(4)-2 under the Advisers Act. An investment adviser must hold such securities in a financial institution identified by the rule, and the adviser must conduct due diligence to ensure that it receives the range of custody services the adviser requires.

VI. CONCLUSION

Tokenized securities have many unique characteristics that offer dramatic improvements over traditional securities, but those involved in issuing or trading tokenized securities must understand and comply with regulations that were developed and designed for traditional securities. For instance, there are a number of special considerations for securities offerings with utility token features. In many cases, the application of existing regulations raises unique issues that will require policymakers and regulators to issue new guidance. This paper has addressed a number of key issues that should be carefully considered.

IV. CHAPTER 2: CONSIDERATIONS AND GUIDELINES FOR UTILITY TOKENS

DATED AS OF JULY 30, 2018[80]

SECTION 1: PRINCIPLES AND GUIDELINES FOR TOKEN SPONSORS

INTRODUCTION

This Section[81] provides introductory principles and guidelines for Token Sponsors as a way to promote sound business practices. Within the context of this report, a "**Token Sponsor**" or "**Sponsor**" is any clearly defined individual or group that (a) generates or distributes, or (b) undertakes to lead or control the development, adoption, or distribution of, a digital token that is not intended to be a security or CFTC Regulated Instrument. For these purposes, the activities of a Token Sponsor inherently entail more than the development and publication of a blockchain protocol that uses tokens. Hence, not all digital tokens are generated through the efforts of a Token Sponsor — indeed, bitcoin was generated independent of a Token Sponsor.

Digital tokens can take a variety of forms and serve many purposes. This Section provides principles and guidelines for Token Sponsors to manage the risk that the offering and distribution of a digital token may run afoul of certain federal securities and commodity laws by (a) discussing why a digital token may become subject to certain securities and commodities laws and regulations, (b) presenting steps that may reduce the risk of the token being treated as a security or a CFTC Regulated Instrument, (c) explaining a suggested path for Token Sponsors to follow when launching a digital token, and (d) offering guidelines for drafting token projects' white papers and other marketing materials.

> **TOKEN SPONSOR**
>
> Any clearly defined individual or group that (a) generates or distributes, or (b) undertakes to lead or control the development, adoption, or distribution of, a digital token that is not intended to be a security or CFTC Regulated Instrument (as defined above in Part 1).

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80   This Chapter was published on July 30, 2018 as Part 2: Considerations and Guidelines for Utility Tokens in Understanding Digital Tokens: Market Overviews and Proposed Guidelines for Policymakers and Practitioners (July 2018), https://digitalchamber.org/token-alliance-whitepaper/.

81   These principles and guidelines apply within U.S. securities and commodity regulatory regimes.

I. WHEN IS A DIGITAL TOKEN SUBJECT TO REGULATION BY THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION OR COMMODITY FUTURES TRADING COMMISSION?

CHARACTERISTICS OF A SECURITY

United States federal securities laws define "security" broadly. A digital token that demonstrates ownership of an instrument enumerated in these definitions, such as a note or other evidence of indebtedness, share of stock, or undivided fractional interest in mineral rights, would typically be subject to regulation by the SEC under the federal securities laws and by state authorities under their "blue sky" laws.

Although the application of United States federal securities laws and related regulations to particular situations, including interpretations by courts, emphasizes the underlying substance of a transaction, Token Sponsors must be cognizant of confusion that might arise in the marketplace from their use of imprecise or inapposite terminology. If a digital token is not intended to be a security, then it is advisable to avoid using securities-related terminology in white papers and other marketing materials that may confuse readers as to the nature of the token. Examples may include statements such as:

» Token holders will "own" or "profit" from a blockchain or network;

» Token holders will receive "interest" or "dividends" on their tokens; or

» References to the token's "market capitalization" or "market cap."

Even referring to an "initial coin offering" or "ICO" may invite comparison to an initial public offering of securities.

THE *HOWEY* TEST

Digital tokens may trigger United States federal securities laws if they are an "investment contract" – a catchall for securities that are not otherwise set out in the definition of a "security." The test for whether any instrument is an "investment contract" under the United States federal securities laws[82] is commonly referred to as the "*Howey* Test." Stemming from a 1946 Supreme Court case of the same name,[83] the *Howey* Test holds an investment contract to exist if there is:

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82   For the purposes of these Principles and Guidelines, "U.S. federal securities laws" refers to the Securities Act and the Exchange Act.
83   *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

THE HOWEY TEST AN INVESTMENT CONTRACT EXISTS IF THERE IS:

1	2	3	4
AN INVESTMENT OF MONEY	**IN A COMMON ENTERPRISE**	**REASONABLE EXPECTATION OF PROFITS**	**PROFITS DERIVED FROM THE SUBSTANTIAL EFFORTS OF OTHERS**

*BASED ON 1946 SUPREME COURT CASE SEC V. HOWEY

All four elements of the *Howey* Test must be met for an instrument (such as a token) to be considered an investment contract. Form and nomenclature hold no weight, rather it is the substance of the instrument in question that is important. **Thus, it is important for Token Sponsors to have an attorney expert in United States federal securities laws analyze the application of the *Howey* Test to a Token Sponsor's proposed digital token before the token is offered or distributed. This includes any form of distribution, including system-based rewards, "airdrops," and distributions to employees, founders, contractors, and consultants.**

COMMODITY REGULATION

The CFTC may exercise general anti-fraud and anti-manipulation authority over any digital token it deems to represent a "commodity," as broadly defined under the Commodity Exchange Act. Moreover, any arrangement that involves the future delivery of a digital token may subject the arrangement or the token to regulation by the CFTC as a futures agreement, swap, option to buy or sell the token, or retail commodity transaction, which are defined as "**CFTC Regulated Instruments**."

It thus should be a common practice for the Token Sponsor's legal counsel also to consider whether a digital token may create a CFTC Regulated Instrument under the CEA, or the impression of such an instrument. Even when this is not the case, working with counsel to conduct such analyses may provide valuable guidance regarding how the digital token should be distributed in compliance with the CFTC's anti-fraud and anti-manipulation regulations.

II. HOW CAN A TOKEN SPONSOR MANAGE THE RISKS OF HAVING A DIGITAL TOKEN TREATED AS AN INVESTMENT CONTRACT OR CFTC REGULATED INSTRUMENT?

Ultimately, there is no better means of assisting a Token Sponsor in complying with SEC and CFTC regulations than a candid assessment by experienced legal counsel of the token's intended uses and

the means by which the tokens will be generated, offered, and distributed. This assessment should be updated as circumstances of the digital token change and the regulatory landscape evolves.

The SEC, CFTC, and United States courts will consider all relevant facts and circumstances when considering whether a Token Sponsor's activities entail the offering or sale of an investment contract or a CFTC Regulated Instrument. Although the SEC's and CFTC's positions regarding digital tokens are evolving, the following factors may reduce the risk of a digital token becoming subject to such regulations.

» **Full development of requisite system(s) and/or application(s) before distribution:** A digital token distributed by a Token Sponsor should be one component of fully-developed system(s) and/or application(s) designed by a Token Sponsor. Upon distribution, the token should provide access to any affiliated services or applications. Otherwise, the Token Sponsor's continued development efforts may be (i) viewed by the SEC as efforts from which token holders reasonably expect to profit, or (ii) viewed by the CFTC as a promise for the delivery of a commodity at a future date.

» **Timing of the distribution of a digital token:** A Token Sponsor should not deliver its digital token to purchasers until everyone who receives tokens can use them to access applicable system(s) and/or application(s), unless expert counsel confirms that the token can be delivered at an earlier point in compliance with applicable SEC or CFTC regulations.

» **Tokenized commodities should be accessible:** If a Token Sponsor's digital token is designed to represent ownership interest in a specified commodity (including another token), the digital token should be related to a system or application that is able to provide token holders with timely access to the specified commodity. A token designed to adjust in price in response to the price, or change in price, of a commodity without entitling the token holder to obtain or control a corresponding amount of the commodity may viewed by the CFTC as a CFTC Regulated Instrument.

» **Token holders should not sell digital tokens on credit:** Selling digital tokens on credit, requiring purchasers to post collateral, or otherwise providing a leveraged exposure to the token or any underlying commodity may qualify as a CFTC Regulated Instrument. A delay of more than 28 days between the agreement to purchase a token and its delivery to the purchaser may increase this risk.

» **Focus communications on the value of using the digital token:** While a Token Sponsor will want users of its digital token to understand and appreciate the potential value of the token's project, the Token Sponsor should seek to be clear that the digital token is not intended to provide a passive investment opportunity for its holders. This may be aided by the Token Sponsor emphasizing the benefits of using or consuming the digital token and emphasizing any ways in which token holders and other network participants will contribute to the token's potential value.

» **For financial and accounting purposes, treat the digital token consistently with its use:** When permitted by generally accepted accounting principles, tax regulations, and similar rules, the treatment

and discussion of the digital token in the Token Sponsor's financial statements, reports and analyses should be consistent with its use in the related systems or applications. Characterizing the digital token as an investment, security, or CFTC Regulated Instrument for tax and accounting purposes could influence its regulatory treatment by the SEC or CFTC. This is not to suggest, however, that the use of a term mandated by tax or accounting rules, such as "forward contract" for example, would be considered dispositive as to the character of a digital token or contract relating to the token for purposes of SEC or CFTC regulations – only that it may give the appearance of inconsistent treatment.

» **Tokens should be designed so that holders do not expect profits from the token's project:**
Projects should not entail equity rights and should not result in the periodic distribution of funds (whether fiat or crypto-currency) to digital token holders, or the expectation of such distributions. Likewise, a Token Sponsor should not design or market digital tokens with any emphasis on price-appreciation or profit delivery to token holders. In particular:

- A Token Sponsor should try to avoid hallmarks of a traditional security, such as (1) a stake of ownership or control in a company or venture behind a digital token project (including a decentralized autonomous organization), or (2) the sharing of any of a Token Sponsor's profits with other token holders through distributions, dividends, interest, or other payments.

- A Token Sponsor should be wary of features in the digital token that would be reasonably expected by a prospective purchaser to cause the token to appreciate in price or otherwise provide passive returns to the token holders.

- A Token Sponsor should be cautious in using the digital tokens as financial incentives for employees or others, so as to avoid the appearance that these recipients reasonably expect the token to appreciate in price.

Distributions of a digital token before the underlying project for the token is complete can be at risk of creating investment contracts even if the token would not be subject to federal securities laws once the project is fully completed. Selling tokens at a discount to a projected public sale price or to raise funds for the project may contribute to this risk. In order to successfully conduct a pre-sale, a Token Sponsor may need to ensure compliance with the registration requirements or an exemption from registration under the Securities Act and delay delivery of the token until the project is constructed and fully functional.

When practical, a Token Sponsor may choose to fully comply with an applicable exemption from registration, including limiting the type of persons (such as accredited investors or eligible contract participants) to which its token is sold or the jurisdictions in which an offering is conducted, rather than rely on arguments for why the token should fail the *Howey* Test. Compliance with such an exemption should not prevent a Token Sponsor from subsequently concluding that its digital token does not qualify as an investment contract and permitting the digital token to be transferred without compliance with the exemption.

III. WHAT ARE THE STEPS FROM INCEPTION TO COMPLETION OF A DIGITAL TOKEN DISTRIBUTION?

A Token Sponsor should follow the steps set forth below, as applicable, when launching a digital token that is intended to be neither a security nor a CFTC Regulated Instrument. Following the order of the steps below is important, as any action taken out of order may compromise the regulatory standing of the token:

Concept and technology development: A Token Sponsor should fully develop its conception of its underlying system(s) and application(s) employing the digital token. This primarily includes the development of clear frameworks related to: (i) how the system will enable the provision of any applications, products, and/or services to which the token will provide access, (ii) the design and construction of any related external facing applications, and (iii) the writing and testing of code.

White paper and other materials: A Token Sponsor should draft a complete and accurate white paper, which should be reviewed by expert legal counsel before publication (including posting on a website or social media). Please refer to Section D of these Principles and Guidelines for Token Sponsors for more information on what, at a minimum, should be included (and excluded) from a white paper. It is recommended that, when appropriate, separate materials should be prepared to address how the token will be offered and distributed to users.

Regulatory review: The Token Sponsor, with counsel, should review its token project, its accompanying white paper, and any related applications, services, or marketing materials for issues related to state and federal money transmitter laws, import and export regulations, AML/OFAC compliance obligations, federal and state securities laws, commodity laws, and any other potential legal or regulatory considerations related to the sponsor's specific business. In particular, they should consider:

- The application of the *Howey* Test and other aspects of the definition of a "security" to the digital token;

- Whether a Token Sponsor's digital token involves a CFTC Regulated Instrument like a swap or retail commodity transaction;

- Tax and related reporting requirements that may arise from the creation and distribution of the token and the operation of the applications related to the token;

- Whether to register with FinCEN as a "money services business";

- Whether to conduct appropriate "know your customer" activities in relation to the distribution of the token to comply with any applicable money laundering, OFAC, and/or import/export laws; and

- Whether to consult with legal counsel in other jurisdictions.

Corporate review (*if appropriate for the token*): The Token Sponsor should establish all necessary corporate or other legal entities (which may include the drafting of corporate governance documents, board resolutions, etc.), register intellectual property, draft privacy policies and user terms, and prepare external communications strategies. The Token Sponsor should seek counsel to work on any transactions to raise capital for the project apart from a potential pre-sale.

Pre-utility sale (if appropriate for the token): A Token Sponsor may need to sell (but not deliver) digital tokens in advance of completion of the associated system(s) or application(s). This may require the Token Sponsor to sell the digital tokens in compliance with an exemption from the Securities Act and the CEA, even though the Token Sponsor does not anticipate that its digital tokens will qualify as securities or CFTC Regulated Instruments after the system(s) and application(s) are completed. The Token Sponsor should seek expert legal counsel to assess whether the sale requires an exemption and, if so, what exemptions would be available. If an exemption is required, legal counsel should assist the Token Sponsor in developing and executing a legal and regulatory compliance program relating to the pre-utility sale.

Public distribution: The Token Sponsor should develop and complete a token distribution closing checklist designed to ensure compliance with applicable laws and regulations. Also, if the Token Sponsor's planned token distribution so requires, counsel should assist the Token Sponsor in drafting appropriate terms and conditions, including representations and warranties, as well as any agreement that will govern the distribution.

IV. WHAT MINIMUM INFORMATION SHOULD BE INCLUDED IN A DIGITAL TOKEN'S MATERIALS?

Digital tokens generally have accompanying materials such as a white paper and marketing materials. A Token Sponsor that intends to generate and distribute a digital token should draft a clear and complete white paper explaining the relevant facts related to the token project, its utility and value proposition as well as any problem(s) it seeks to solve, any related products and/or services, and how the token
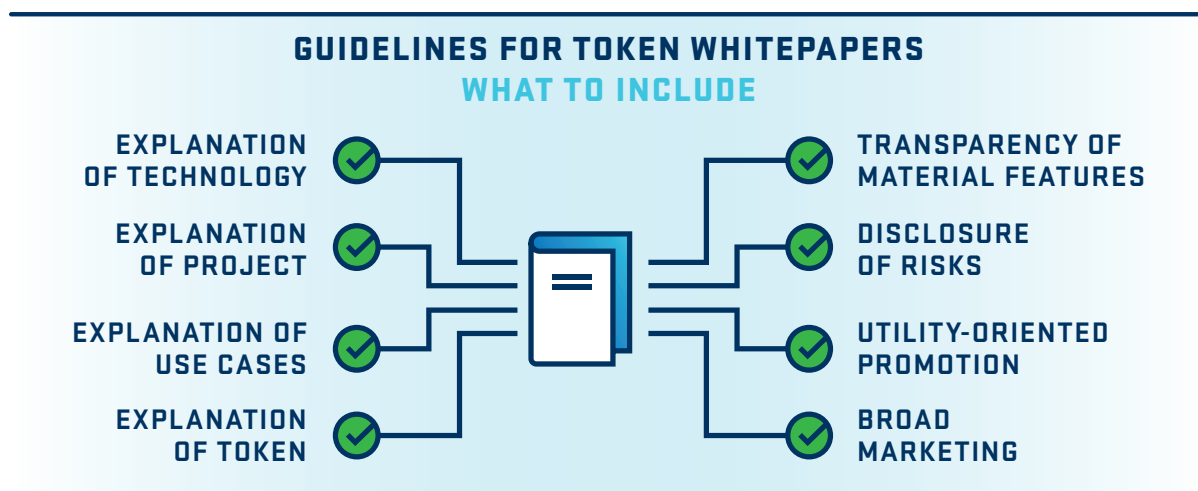
is intended to operate as an integral part of the project. Additionally, marketing materials themselves can come in many forms, both written and spoken. Marketing materials in any form should be crafted carefully. A clear division of labor can be helpful, with the white paper and certain other information focused on how people can use the token and other materials focused on how and why people should acquire tokens.

SPONSORS SHOULD MARKET A PRODUCT RATHER THAN AN INVESTMENT

Marketing materials should focus on the benefits of using the token for its intended application and be addressed to those likely to use the token in this manner. For example, if a token could only be used by members of a network, purchasers should be required to join the network before receiving their tokens. Marketing efforts should not be directed at those known to be in the business of or making a practice of recommending or purchasing tokens as investments.

INFORMATION THAT SHOULD BE INCLUDED IN A WHITE PAPER

A Token Sponsor's white paper is a critical document. A white paper provides background on a Sponsor's token project, as well as specifics on the project's technological application, any related products or services, and how the digital tokens will operate. If the tokens are designed to monetize the value of such products or services, it may be appropriate to explain the business model underlying the project. A white paper is not a business plan, marketing materials, offering memorandum, or prospectus – it is a factual description of how the token will operate as part of a system or within an application. The white paper will often form the objective basis for evaluating the regulatory implications of the projects, including the distribution of the tokens and the offer of any products, applications, and services. Thus, Token Sponsors should carefully consider what should and should not be included in their white papers.

GUIDELINES FOR TOKEN WHITEPAPERS
WHAT TO INCLUDE

EXPLANATION OF TECHNOLOGY ✓

EXPLANATION OF PROJECT ✓

EXPLANATION OF USE CASES ✓

EXPLANATION OF TOKEN ✓

✓ TRANSPARENCY OF MATERIAL FEATURES

✓ DISCLOSURE OF RISKS

✓ UTILITY-ORIENTED PROMOTION

✓ BROAD MARKETING

» **Explanation of Technology:** A Token Sponsor's white paper should explain the technology underlying the token project's token and affiliated system(s) and/or application(s). It might include such matters as a description of the underlying code, how an application interacts with the platform, why a blockchain-based product or service is critical to solving the problem(s) that the token project aims to address, and the operation of the token network. Any means by which the token's protocol enables control of, changes to, or corrections of the token's protocol should be discussed. Depending on the intended token recipient, the Token Sponsor should carefully separate hyper-technical or dense discussions of the technology from plain-language discussions of the technology to enable the widest possible audience to understand the project and its central components. While technical discussions of the technology may be very important, a Token Sponsor should consider including them as appendices to, or separate documents from, the project's white paper.

» **Explanation of Project:** A Token Sponsor's white paper should explain the utility of the token project and include a description of how the project seeks to achieve its intended purpose as well as how the token will be used for this purpose.

- • **Services and Products:** A white paper should describe system(s) or application(s) that may be acquired or utilized with the token.

- • **Use of Smart Contracts:** If the Token Sponsor's project uses smart contracts, the white paper should describe how the smart contracts are intended to be used, what purposes they are intended to serve within the application, and how the smart contracts are intended to operate, including how they self-execute in the context of the application.

» **Explanation of Use Cases:** A Token Sponsor's white paper should consider providing current use cases for the project's products and/or services and specifically the digital token. The explanation can include descriptive or illustrative case studies of the application to provide the reader an understanding of how the project's application and token will work in practice within the blockchain application.

» **Explanation of Token:** A Token Sponsor's white paper should provide a comprehensive description of a token that is imbedded in the product and/or service. The description should include the form of the token (*e.g.*, ERC20, etc.), and any rights of, or benefits to, and obligations of, token holders.

» **Transparency of Material Features:** A Token Sponsor, through published material or statements (such as a white paper and distribution terms), should transparently disclose the material features of its digital token and of the token's distribution, including information pertaining to pricing, structure, allocation, and utility.

» **Disclosure of Risks:** A white paper should disclose any foreseeable conditions that could disrupt or impair use of the tokens' application(s) or system(s). If the Token Sponsor has devised plans to mitigate certain risks, it should disclose the material details of such plans.

» **Utility-Oriented Promotion:** Promotion of the system or application for a Token Sponsor's digital token should not encourage interest in acquiring the token based solely on investment expectations or a fear of missing out on an investment. Depending on other facts, such promotion could affect the token's characterization as a security. The Token Sponsor should not link to or reference material the content of which is not in its control.

» **Broad Marketing:** The dissemination of a Token Sponsor's white paper should be focused towards the population who would most likely use or benefit from the Token Sponsor's product, service, or token. The marketing of a white paper should not be targeted toward general populations with an interest in investing, particularly those who speculatively invest in digital tokens, or who buy with the sole intention of selling for increased returns.

INFORMATION THAT SHOULD NOT BE INCLUDED IN A TOKEN SPONSOR'S WHITE PAPER

» **Allocation of the pre-mine:** A Token Sponsor's white paper should avoid discussion of any allocation of tokens for investors, developers, founders, or employees. Such discussions would appear to be more relevant to a potential investor in the project than a user of the application.

» **Plans for future additional features:** A Token Sponsor's white paper should not discuss any plans that the Token Sponsor may have for expanding the features or scope of the project's products, services or applications, or other proposed enhancements to the token's use after the launch of its token. Emphasis on plans for future development by the Token Sponsor may negatively affect a digital token's security analysis under the *Howey* Test.

GUIDELINES FOR TOKEN WHITEPAPERS
WHAT NOT TO INCLUDE

ALLOCATION
OF THE PRE-MINE

DESCRIPTION OF
TOKEN DISTRIBUTION

PLANS FOR FUTURE
ADDITIONAL FEATURES
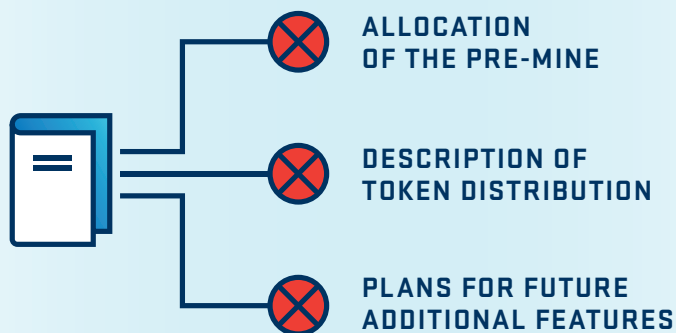
» **Description of the distribution of tokens:** If a Token Sponsor's digital token will be distributed in private sales, a limited public sale or auction, airdrop, or a similarly limited event, it may be more appropriate to describe the event in separate materials that can be superseded when the event is

completed, rather than in the Token Sponsor's white paper. Such materials may include details that would only be of interest to participants in the event. This may help keep readers from improperly regarding a Token Sponsor's white paper as marketing the token rather than describing its operation.

Of course, a Token Sponsor's white paper generally should discuss any means its system(s) or application(s) employ to distribute tokens as part of its regular operations. Such systemic distributions might include rewards for work done in generating or verifying new blocks and rewards for other work done to operate the system(s) or application(s).

INFORMATION THAT SHOULD NOT BE INCLUDED IN A TOKEN SPONSOR'S PROMOTIONAL AND MARKETING MATERIALS GENERALLY

» **Intentional misrepresentations or misleading statements:** A Token Sponsor should not make any misrepresentations, misleading statements, or omit any material facts that could be deemed important information for someone using or acquiring its digital token.

» **Promises of financial returns:** A Token Sponsor should take care that materials relating to its digital token not make statements that characterize the token as a passive investment opportunity or imply that the token holders will earn financial gains as a result of business activities of the Token Sponsor unrelated to the underlying utility of the tokens' system(s) and application(s). Examples of such statements are those made in the *Munchee* Order regarding how the "ecosystem" had been designed to cause the token to appreciate or, as discussed in more detail in Section 2, the prospects for a secondary market. Token Sponsors should avoid making promissory statements.

» **Discussion of matters that might primarily interest investors:** A Token Sponsor's materials should not make any statements that would be relevant to an investor but not to a user of the application(s) or system(s) relating to the digital token. Quantitative statements regarding current or potential markets for such application(s) or system(s) should be carefully considered. The user of a digital token to obtain a service, for example, may find the number of customers or the number of times the service is accessed more relevant than the dollar amount spent on the service. Sponsors should especially avoid projecting the project's takeover of market share or the token's future secondary market price.

» **Discussions of prior investments or major projects completed by the development team and its advisors or consultants:** In the *Munchee* Order, the SEC criticized statements highlighting "its founders had worked at prominent technology companies" and "their skills running businesses and creating software." This suggests a Token Sponsor should be cautious about discussing the management and entrepreneurial skills and records of those involved with its token project in the context of a token's future financial performance or in such a way that creates an expectation that their efforts will help the price of the relevant digital token appreciate.

CONCLUSION

Following these *Principles and Guidelines for Token Sponsors* provides no guarantee that a federal or state regulator will not take issue with the digital token issuance, sale, or other distribution. Rather, these principles and guidelines are intended to provide an overview to assist a Token Sponsor when thinking through critical issues related to its digital token issuance, sale and distribution. These *Principles and Guidelines for Token Sponsors* should be read in concert with the *Token Alliance's Principles and Guidelines for Token Trading Platforms*.

SECTION 2 - PRINCIPLES AND GUIDELINES FOR TOKEN TRADING PLATFORMS

This Section provides introductory principles and guidelines for entities that allow the trading of digital tokens on their platforms and for Token Sponsors seeking to have their tokens traded on such platforms. This Section only addresses platforms (collectively, "Token Trading Platforms")[84] through which market participants can convert virtual currency, fiat currency, or other digital tokens into other virtual currency, fiat currency, or other digital tokens that are not:

» Registered with the SEC pursuant to the Exchange Act as a "national securities exchange" or an "alternative trading system;" or

» Registered with the CFTC pursuant to the CEA as a "registered entity."

TOKEN TRADING PLATFORM

Any entity that hosts customer-oriented spot markets and is neither (a) registered with the SEC pursuant to the Exhange Act as a "national securities exchange" or an "alternative trading system" nor (b) registered with the CFTC pursuant to the CEA as a "registered entity".

Token Trading Platforms and other secondary markets for digital tokens play a critical role in the establishment of secure networks, enhance token utility, and promote the general adoption of cryptocurrency and blockchain technology. They provide an important mechanism for price discovery, which in turn allows systems that incentivize blockchain validation—such as proof of work—to function efficiently. They also expand opportunities for the general public (*e.g.*, the unbanked) to acquire and benefit from blockchain applications, and to purchase and sell tokens as their demands for particular token functionalities change and evolve and as new and improved tokens are developed.

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84   These Principles and Guidelines assume that the Token Sponsor is independent of the Token Trading Platform. Although a Token Trading Platform may make a market in a token for which it is the Sponsor, this reduces the need for formal reviews and agreements.

But secondary markets may also create securities law-related concerns. In the words of SEC Chairman Jay Clayton, a secondary market is a "key hallmark" of securities and of securities offerings.[85] Facilitating the trading of digital tokens may subject a platform to regulation by the SEC or the CFTC if the tokens are found to be securities or CFTC Regulated Instruments. The uncertainty surrounding the application of "facts and circumstances" legal tests to new and evolving blockchain technology makes compliance with those regulatory definitions challenging.

Of course, responsible Token Trading Platforms should do more than merely avoid regulation by the SEC or the CFTC. They should voluntarily conduct business in a manner that protects token consumers, protects the integrity of secondary markets, and builds public confidence in the broader blockchain industry.

These broader concerns, although important, are beyond the scope of this chapter, as are the following non-exhaustive list of other legal and regulatory issues that Token Trading Platforms should address:

» cyber security;

» whether their activities constitute money transmission under the relevant federal and state statutes and regulations;

» privacy and data transfer issues for international users;

» AML/KYC and OFAC procedures, including transparency surrounding such procedures so that users understand why they must provide their information;

» reserving the right to remove users from the exchange;

» reserving the right not to conduct cross-chain recoveries when people deposit the wrong tokens in exchange wallets; and

» how the exchange will treat victims of external phishing schemes or theft of tokens.

Rather, this Section will focus on how Token Trading Platforms may manage the risk that a regulator or a court may contend that a digital token trading on the platform is a security or CFTC Regulated Instrument notwithstanding the Token Sponsor's claims to the contrary. This is an important threshold concern for any Token Trading Platform because allowing even one security or CFTC Regulated Instrument to trade on the platform would require the Token Trading Platform to registered with either the SEC or CFTC, respectively.

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85   *See supra* note 49; CLAYTON *supra* note 45. [These citations refer to footnotes 49 and 45 in Understanding Digital Tokens: Market Overviews & Proposed Guidelines for Policymakers & Practitioners (July 2018).]

I. IMPORTANT CONSIDERATIONS FOR VETTING TOKENS FOR ACCEPTANCE ONTO A TOKEN TRADING PLATFORM

✓ Before it establishes a market for any digital token, a Token Trading Platform should examine the token to determine the risk that it might be deemed to be a security or CFTC Regulated Instrument and, consequently, that the Token Trading Platform might fall within the requirements of the Exchange Act or CEA. No token should be exempt from this examination. Digital tokens for which markets were established before a Token Trading Platform adopted written procedures as described below should be reviewed retroactively.

✓ The compliance officer or other senior managers of the Token Trading Platform should establish written procedures ("Procedures"), containing factors used to evaluate digital tokens for approval for trading on the platform, as well as standards for ongoing review of tokens to assess if they will no longer be permitted to trade. The Procedures should include:

- a review the token's present utility, based on the Token Sponsor's white paper and other documents, information, or demonstrations provided by the Token Sponsor;

- a review of promotional statements (and any subsequent disclaimers) made by the Token Sponsor or agents on its behalf on public-facing media;

- a current written analysis prepared by the Token Sponsor's counsel or by the Token Sponsor in consultation with its counsel explaining why the digital token is not a security or CFTC Regulated Instrument, which analysis should be reviewed by counsel for the Token Trading Platform; and

- a requirement that digital tokens are reviewed periodically to ensure that they remain compliant with existing law and regulatory expectations relevant to Exchange Act or CEA requirements.

✓ The same criteria should be used to close a market for a digital token as are used to deny a request to establish a market for a prospective token.

✓ A Token Trading Platform should memorialize the results of a token's examination and any re-examination and store them for no less than five years.

✓ A Token Trading Platform should not permit trading of any derivative instruments, including but not limited to any CFTC Regulated Instruments.

✓ A Token Trading Platform should carefully consider whether to permit trading of digital tokens on a leveraged, margined, or financed basis. If a Token Trading Platform were to permit trading of tokens in these ways, it should only do so where it has implemented appropriate measures to ensure such trading is in accordance with applicable CEA requirements.

✓ As illustrated by the *Munchee Order*, promises by a Token Sponsor to establish secondary trading markets for its digital token, or even publicized efforts by the Token Sponsor to do so, may be a

negative factor under the *Howey* Test. In light of this, a Token Trading Platform should consider its policies around (a) confidentiality of requests to establish a market and communications relating to such requests and (b) publicity regarding its decision to establish, to not establish, or to close a market for a digital token. The Token Trading Platform should take appropriate steps to inform applicants of and require applicants to abide by these policies.

✓ Adopt policies and procedures to ensure that a Token Trading Platform's directors, officers, employees, and affiliated third parties do not use nonpublic material information obtained through their work with the Token Trading Platform to engage in digital token transactions that could give the appearance of trading on material non-public information.[86]

✓ Have procedures for promptly investigating any reports of market manipulation.

✓ Establish criteria and procedures for suspending trading of a token suspected of being involved in manipulative trading activity.

✓ Involvement of a Token Trading Platform in the offering and distribution of a digital token may become a factor in determining whether a digital token qualifies as an investment contract under the *Howey* test. A Token Trading Platform may want to assess this risk with the Token Sponsor before becoming involved. Even after a market is established, a Token Trading Platform should avoid appearing to endorse as an investment any digital token that is trading on its platform and should make appropriate disclosures and disclaimers when necessary to counter any such appearance. This guidance is not meant to discourage communication between Token Sponsors and Token Trading Platforms for the purpose of clarifying or enhancing legal compliance or collaboration relating to technological issues associated with potential or continued inclusion of the digital token on the Token Trading Platform.

II. CONSIDERATIONS FOR TOKEN SPONSORS DEALING WITH TOKEN TRADING PLATFORMS

» A Token Sponsor should keep in mind that no Token Trading Platform is obligated to maintain a market for its digital token and should be prepared to work with the Token Trading Platform to answer all reasonable questions that the Token Trading Platform asks of it.

» A Token Sponsor should consider whether any financial dealings with a Token Trading Platform or its affiliates could create a reasonable impression that the Token Sponsor is "buying" the digital tokens' way onto the platform.

» A Token Sponsor that deals with Token Trading Platforms should have policies and procedures to prevent its affiliates and employees from trading based on non-public information regarding the token's status on the platform, such as a decision to open or close a market for the token.

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86   Sections 6(c) and 9(a) of the CEA, CFTC Regulation 180, and associated guidance and case law may be relevant to such policies and procedures.

» While a Token Sponsor may publicize that its token can be purchased or sold on a Token Trading Platform, once a market for the token is opened, the Token Sponsor should refrain from discussing the token's potential for price appreciation.

CONCLUSION

Following these *Principles and Guidelines for Token Trading Platforms* provides no guarantee that a federal or state regulator will not take issue with the trading of particular tokens on its Token Trading Platform. Rather, these principles and guidelines are intended to provide an overview to assist a Token Trading Platform when thinking through important considerations before establishing a market for digital tokens. These *Principles and Guidelines for Token Trading Platforms* should be read in concert with the *Token Alliance's Principles and Guidelines for Token Sponsors*.

V. APPENDIX

Whereas the information available in Chart 1 in the Introduction is condensed and provided as a means of comparison between the registration requirements and restrictions of certain types of offerings, the information below is intended to elaborate on the requirements and supplement the brief descriptions in the Chart.

I. SECURITIES TOKEN OFFERINGS

Pursuant to Section 5 of the Securities Act, any offer or sale of a security made to U.S. persons must either be (1) registered with the SEC or (2) offered and sold pursuant to an exemption from registration. Section 6 of the Securities Act, describes the method of registration and related considerations.

A. OFFERINGS REGISTERED WITH THE SEC UNDER SECTION 6 OF THE SECURITIES ACT

1. STRUCTURE

In order to register an offering of securities under Section 6, an issuer must file a registration statement with the SEC.[87] Pursuant to Section 10 of the Securities Act, the issuer must prepare a statutory prospectus to be delivered to prospective purchasers and integrated in the registration statement.[88]

Once the registration statement is filed, the SEC will review it, provide comments to the issuer and, if the statement is judged to be satisfactory, declare the registration statement effective.

2. MANNER OF SALE LIMITATIONS

Issuer requirements	There are no statutory limitations on the types of issuers that can undertake registered securities offerings. However, the Securities Act alleviates some of the regulatory burdens associated with registered offerings for certain well-known reporting issuers

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87   U.S. domiciled issuers generally would file Form S-1, while foreign issuers would file Form F-1.
88   Securities offerings that are not registered and do not have an available exemption are prohibited pursuant to Section 5 of the Securities Act.

Investor requirements	There are no statutory restrictions on the type of investors that can participate in registered offerings
Limits on amounts raised	Issuers undertaking registered offerings are not subject to any regulatory offering limit within a 12-month period.
General solicitation	Before a registration statement is filed, often referred to as the "pre-filing period", oral or written offers for the sale of securities are generally prohibited. The SEC has stated that during the pre-filing period, "the publication of information and statements, and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes a violation of the [Securities] Act." After an issuer files a registration statement, oral offers and certain written offers may be made pursuant to a statutory Section 10 prospectus, a Section 10 free writing prospectus and Rule 134 public notice (tombstone ad). However, until the registration statement becomes effective, there can be no sale of securities.
State law preemption	Only SEC-registered securities offerings that are listed on a national securities exchange are preempted from state registration requirements
Transferability of tokenized securities	Tokenized securities issued pursuant to a registered offering will be freely tradeable on registered exchanges or alternative trading systems ("ATS"), subject to complying with applicable exchange listing standards and meeting relevant ATS trading requirements.

3. RELATIVE COSTS AND BENEFITS

Registered offerings provide the most permissive structure with regard to manner of sale limitations, including the ability to sell tokenized securities to retail customers. However, the main drawbacks of this structure are: (i) Cost – An issuer in a registered offering is likely to incur costs in excess of $2 million; (ii) Time – The preparation of a registration statement along with the SEC review process is time consuming and can take longer than one year; (iii) Disclosure and Periodic Reporting – As part of the initial registration statement, issuers are required to include audited financial statements and will be required to continue public reporting on a quarterly basis.

4. EXAMPLES OF REGISTERED TOKENIZED SECURITY ISSUANCES

1. Overstock.com

2. Monster Products, Inc.

3. The Praetorian Group, Inc.

B. EXEMPT OFFERINGS

Given the high transaction costs associated with registered offerings and being a public company, issuers have increasingly relied on exemptions from registration, such as the ones discussed below.

1. PRIVATE PLACEMENTS GENERALLY

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering" from the Section 5 registration requirements. These transactions are commonly referred to as private placements. Pursuant to Section 4(a)(2), the SEC has promulgated Regulation D which provides a "safe harbor" rule for private placements (including Rule 506(b) and 506(c)).[89] While issuers are able to conduct private placements by relying solely on the Section 4(a)(2) statutory exemption, given the relative ambiguity of the statutory language and requirements[90] and the lack of state law preemption for statutory private placements, issuers typically structure their private placements to comply with Rule 506(b) or 506(c) under Regulation D.

a. Potential structures

Issuers relying solely on the Section 4(a)(2) statutory exemption need not file any documentation with the SEC but may need to produce disclosure documentation depending on the sophistication of the potential investors being targeted.

Issuers relying on Rule 506(b) or Rule 506(c) are required to file Form D[91] with the SEC within 15 days after the first sale of securities and provide different levels of disclosure information to investors depending on the sophistication of the potential investors being targeted.

b. Manner of sale limitations

Issuer requirements – There are no statutory limitations on the types of issuers that may conduct private placements in reliance of Section 4(a)(2). However, the Regulation D safe harbors are not available for any issuer if it or its affiliates, executives and certain

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89   17 C.F.R. § 230.500 *et seq.*
90   It is important to note that issuer's intending on relying on an exemption from registration will have the burden of proving that they have perfected the exemption by establishing that they have satisfied the necessary conditions.
91   https://www.sec.gov/about/forms/formd.pdf.

other related persons, have been subject to certain enforcement actions (the "bad actor disqualifications").[92]

Investor requirements – Issuers undertaking a private placement in reliance on Section 4(a)(2) must ensure that all persons to whom offers are made have financial sophistication (or have access to financially sophisticated advisors) and have access to the type of information that would be contained in a registration statement.[93]

Issuers undertaking a private placement pursuant to 506(c), must take reasonable steps to verify that all purchasers are accredited investors.[94] Certain bad actors are disqualified from participating in Rule 506(c) offerings.

Issuers undertaking a private placement pursuant to 506(b) are able to offer and sell securities to as many as 35 sophisticated but non-accredited investors. The issuer, prior to the sale, must "reasonably believe" that each non-accredited investor has knowledge and experience in financial and business matters and that he or she is capable of evaluating the merits and risks of the prospective investment.

Amount raised – There is no monetary limit to the amount of funds that can be raised pursuant to Section 4(a)(2) or Regulation D.

General solicitation – Pursuant to Section 4(a)(2) and Regulation D, an issuer cannot engage in "any form of general solicitation or general advertising."[95] As indicated by the SEC in various No-Action Letters, in the context of Regulation D, issuers may avoid "general solicitation" by limiting offers to prospective investors with whom they have pre-existing relationships that allow the issuer to evaluate a prospective investor's financial sophistication. Private placements conducted under Rule 506(c), however, permit general solicitation.

State Law Preemption – As compared to private placements done in reliance of Section 4(a)(2) where there is no preemption of state law, private placements pursuant to Regulation D preempt the application of state laws (including registration and qualification). However, in either case, the states retain the authority to require notice filings and collect state fees.

Transferability of tokenized securities – Tokenized securities issued pursuant to a private placement will be considered "restricted securities" under the Securities Act and the issuer should take certain precautions against their resale.

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92 17 C.F.R. § 230.262.
93 *See SEC v. Ralston Purina Co.*, 346 U.S. 199 (1953) at 124 (finding that the availability of the Section 4(a)(2) exemption turned on "whether the particular class of persons affected needs the protection of the [Securities] Act.").
94 Under Rule 501 "accredited investors" include certain institutional investors as well as individuals whose net worth, or joint net worth with a spouse, exceeds $1 million (not including the value of one's residence) and those who had an individual income exceeding $200,000 in each of the two most recent years (or $300,000 joint income with one's spouse) and who reasonably anticipate such an income for the current year.
95 17 C.F.R. § 502(c).

2. OFFERING PURSUANT TO REGULATION A UNDER THE SECURITIES ACT[96]

a. Potential Structures

Issuers intending to engage in a Regulation A offering will be required to submit Form 1-A for review by the SEC, which consists of three parts: Part 1 (Notification); Part 2 (Offering Circular); and Part 3 (Exhibits). The Offering Circular is fairly substantial and "akin to what is required for smaller reporting companies in a prospectus for a registered offering," including information about the issuer, risk factors, plan of distribution, use of proceeds, etc.[97] Offerings pursuant to Regulation A must comply with the requirements of either Tier 1 or Tier 2.[98] If issued pursuant to Tier 2, the issuer must file two years of audited financial statements, while Tier 1 issuers may file unaudited financial statements. Both Tier 1 and Tier 2 permit issuers to submit draft offering statements to the SEC for confidential review before filing. Offering statements must be "qualified" by means of a "notice of qualification" from the SEC before any sales may be made pursuant to Regulation A.

After a Tier 2 offering, an issuer becomes a "mini reporting company" that is required to furnish the SEC with annual and semi-annual reports, as well as current reports of significant events. Tier 1 issuers do not have continuing reporting obligations, other than the obligation to provide certain information on Form 1-Z within 30 days after the completion or termination of the offering. Tier 2 issuers provide similar information on either Form 1-K or Form 1-Z, depending on whether the offering is terminated or completed.

b. Manner of Sales Limitations

Issuer requirements – Regulation A offerings are limited to privately held companies domiciled and having their principal place of business in the United States or Canada.[99] Issuers can be barred from undertaking Regulation A offerings based on the presence of "bad actors." Issuers that are registered as investment companies under the Investment Company Act of 1940 may not conduct offerings under Regulation A. Regulation A is also not available for blank check companies nor special purpose acquisition companies. It also cannot be used by issuers that have a class of securities registered under the Exchange Act.

Investor requirements – Regulation A imposes no limits on the number of offerees or purchasers and offers and sales are generally open to both accredited and unaccredited investors. While Tier 1 Regulation A offerings have no statutory investor requirements,

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96   17 C.F.R. §§ 230.251-263.
97   Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Securities Act Release Nos. 33–9741; 34–74578; 39–2501 ,75 Fed. Reg. 21806 (Apr. 2015).
98   *See* Rule 251 of Regulation A, 17 C.F.R. § 230.251.
99   Recently enacted legislation requires the SEC to amend Regulation A to permit public companies to use Regulation A. *See*, *e.g.*, Regulation A+ Expansion, https://www.blockchainlawcenter.com/blog/blockchain-law-center/regulation-a-expansion.

Tier 2 offerings subject non-accredited investors to investment limits.[100]

Amount raised – Issuers undertaking a Tier 1 offering are subject to an offering limit of $20 million within a 12-month period. Issuers undertaking a Tier 2 offering are subject to an offering limit of $50 million within a 12-month period.[101]

General solicitation – For both Tier 1 and Tier 2 offerings, Regulation A authorizes general solicitation and the use of broker-dealers to advertise and distribute the securities. Prior to conducting a Regulation A offering, a prospective issuer may "test the waters" for potential investor interest, although special disclaimers for these communications are required by Rule 255 under the Securities Act.

State Law Preemption – If an issuer undertakes a Tier 1 Regulation A offering, state blue sky laws are not preempted. If an issuer undertakes a Tier 2 Regulation A offering, state blue sky laws regarding pre-offering review are preempted.

Transferability of tokenized securities – Securities issued pursuant to a Regulation A offering are freely transferable (i.e., they are not restricted securities).

c. **Relative costs and benefits for tokenized securities offerings**[102]

   i. **Benefits**

      1. Issuers gain the ability to sell tokenized securities to retail investors.

   ii. **Costs**

      1. This process is time consuming, expensive, and can take up to one year.

      2. Audited Financial Statements – If structured as a Tier 2 offering, issuers must include audited financials in the offering statement and be subject to ongoing reporting obligations.

II. REGULATION CROWDFUNDING

A. POTENTIAL STRUCTURE

Section 4(a)(6) of the Securities Act exempts an issuer from the Section 5 registration requirements for crowdfunding transactions that meet the requirements outlined below. Issuers relying on Section 4(a)(6) are required to file Form C with the SEC prior to the commencement of the offering.

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100   Unless the securities are listed on a national stock exchange upon qualification, the amount of Tier 2 securities that may be purchased by any single non-accredited investor in any year is limited to not more that (a) the greater of 10% of the investor's annual income or net worth, in the case of an individual investor or (b) the greater of 10% of the investors annual revenue or net assets, in the case of an entity.
101   "At the market" offerings are not permitted under Regulation A.
102   To date, the SEC has approved two token offerings under Regulation A. *See* Paul Vigna, *SEC Clears Blockstack to Hold First Regulated Token Offering*, WALL STREET JOURNAL (July 10, 2019), https://www.wsj.com/articles/sec-clears-blockstack-to-hold-first-regulated-token-offering-11562794848; *see also* Press Release, Props, Props Launches the First SEC-Approved Crypto Token for Consumers (July 11, 2019), https://www.businesswire.com/news/home/20190711005651/en/Props-Launches-SEC-Approved-Crypto-Token-Consumers.

Form C includes some basic information relating to the offering, including the name of the intermediary through which the tokenized securities will be offered, the compensation of the intermediary, the type and number of tokenized securities being offered, their price, and other information about the issuer. Form C is relatively simple when compared to Form 1-A, which is required for Regulation A offerings.

Issuers undertaking a Section 4(a)(6) offering must also provide a range of financial disclosure. Issuers offering tokenized securities in reliance of Regulation Crowdfunding for the first time must provide two years of financial statements reviewed by an independent public accountant. However, repeat issuers must provide two years of financial statements that are audited.[103] Issuers selling tokenized securities pursuant to the crowdfunding exemption are also required to file an annual report with the SEC no later than 120 days after the end of the fiscal year.

1. **MANNER OF SALE LIMITATION**

Issuer requirements – Excludes non-U.S., blank-check, reporting, and investment companies. "Bad actor" disqualifications apply.

Investor requirements – Sales are open to both accredited and unaccredited investors. Investment limitations are based on annual income and net worth.

» If either the annual income or the net worth of the investor is less than $100,000, the investor is limited to the greater of $2,000 or 5% of the lesser of his or her annual income or net worth.

» If the annual income and net worth of the investor are both greater than $100,000, the investor is limited to 10% of the lesser of his or her annual income or net worth, to a maximum of $100,000.

Limits on amounts raised – Issuers undertaking a Regulation CF offering are limited to raising $1.07 million over a 12-month period.

General solicitation – Issuers must undertake a Regulation CF offering exclusively through one intermediary that is registered as either a broker-dealer or a "funding portal," and that is also a member of a national securities association (e.g., FINRA).[104] Unlike Regulation A, issuers relying on Regulation CF are not permitted to "test the waters" to determine investor interest. However, after Form C is filed, issuers are permitted to engage in limited advertising. For example, issuers are permitted to communicate with potential investors through the intermediary's platform.

State Law Preemption – Tokenized securities issued pursuant to Regulation CF will not be subject to state blue sky laws.

Transferability – Tokenized securities issued pursuant to a Regulation CF offering cannot be transferred for 12 months after issuance.

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103 80 Fed. Reg. 71, 387 (Nov. 16, 2015).
104 Portals like Indiegogo, which already had a crowdfunding portal, have recently launched token offerings.

UNDERSTANDING DIGITAL TOKENS

Considerations and Guidelines for Securities and Non-Securities Tokens