PROGRAM MATERIALS
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Securities Regulations Applied to Security Token Offerings

Celesq® AttorneysEd Center
www.celesq.com

5301 North Federal Highway, Suite 180, Boca Raton, FL 33487
Phone 561-241-1919 Fax 561-241-1969

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Marc Boiron
Partner
FisherBroyles, LLP
marc.boiron@fisherbroyles.com

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What are security tokens?

- What is a security?
  - "[A]ny **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, . . . or, in general, any interest or instrument commonly known as a "security", or any . . . warrant or right to subscribe to or purchase, any of the foregoing." (15 U.S.C. § 77b(a)(1))

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What are security tokens? (continued)

- Traditional securities
  - These are securities such as equity, debt, and derivatives that rely on blockchain technology to establish their terms, features and transferability.
- Compliant network tokens
  - These are utility tokens or rights to receive utility tokens for use in a distributed network that constitute an investment contract under U.S. laws.
- Also known as “smart securities,” “programmable securities” and “digital securities.”

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Why use security tokens for private securities?

- Enhance liquidity
  - Security tokens do not create liquidity for private securities, but they enable increased liquidity.
    - Transfers have less friction.
    - Intermediaries may be removed.

- Efficient creation and transfer of fractional ownership
  - Fractional ownership of assets exists without security tokens, but they make the creation and transfer of those fractional interests efficient.

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Why use security tokens for private securities? (continued)

- Greater compliance with laws
  - Security tokens allow compliance with laws to be governed by smart contracts and automated.
- Efficient cross-border trading
  - Global security laws compliance in smart contracts permits compliant transfers without intermediaries.
- Better cap table management
  - Transfers of security tokens are recorded automatically on a blockchain, which is efficient, cost-effective and less prone to error.

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Why use security tokens for private securities? (continued)

- Facilitates corporate governance
  - Stockholder votes and any other actions can be taken on a blockchain for an immediate result and perfect record.
- Efficient distributions
  - Distributions to equity or debt holders can be more frequent and automated with payments in cryptocurrencies.
- Utility features
  - Build special rights for token holders in security tokens, such as a discount on the issuer's products.

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How do security tokens work?

- Version 1.0 (current)
  - Issuance of the securities follows traditional practices.
  - Applicable documents provide the framework for use of security tokens, including the blockchain.
  - Token smart contracts are created and linked to securities.
  - Tokens are distributed to all purchasers of the securities.
  - Purchasers self-custody the security tokens.
  - Issuers list the security tokens on regulated "exchanges."
  - Security tokens do KYC and tokens are transferred to exchanges.
  - Security token holders transfer securities to other "whitelisted" wallets.

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How do security tokens work? (continued)

- Version 2.0 (future)
  - Issuance of the security follows traditional practices.
  - Applicable documents explain security tokens.
  - Token smart contracts are embedded with all rights of security token holders.
  - Tokens are distributed to all purchasers of the securities.
  - Purchasers self-custody the security tokens or have them custodied by a qualified custodian.
  - Issuers list the security tokens on securities exchanges.
  - Security tokens do KYC and transfer tokens to exchanges.
  - Security token holders transfer securities to any smart contract approved wallet.

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What is the state of security tokens?

- Issuers
  - Robust: interested in offering security tokens.
- Issuance platforms and compliance protocols
  - Robust: many operational and dozens more being built.
- Exchanges
  - Medium: few operational and dozens more being built.
- Custody
  - Medium: few operational and only a few being built.
- Investors
  - Weak: not interested in buying security tokens.

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How are security tokens offered in compliance with US laws?

- All securities offerings must be made pursuant to a registration statement or an exemption from registration.
- Registered offerings (17 C.F.R. § 230.401 et seq.)
- Exempt offerings
  - Regulation A (17 C.F.R. § 230.251 et seq.)
  - Regulation D (17 C.F.R. § 230.501 et seq.)
  - Regulation S (17 C.F.R. § 230.901 et seq.)
  - Regulation CF (17 C.F.R. § 227.100 et seq.)

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What are the benefits of registered security token offerings (“STO”)?

- Diverse investor pool: issuers may include accredited and unaccredited investors in the offering.
- General solicitation: issuers may engage in general solicitation.
- Freely transferable: securities can be transferred immediately after issuance.
- Unlimited capital raise: issuers are not subject to a limit on the amount of capital they raise.

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What are drawbacks of registered STOs?

- Uncertainty: no registration statement has become effective after Overstock's 2016 offering.
- Cost: registered offerings are expensive.
- Disclosure: significant disclosures are required.
  - If smart securities are being offered, then the disclosures should be similar to other equity offerings.
  - If a compliant network tokens are being offered, then the disclosures will be extremely complex and do not make sense in the current disclosure framework.
- Periodic reporting: reporting required, including material events and quarterly and annual filings.

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What are drawbacks of registered STOs? (continued)

- Time: registered offerings are time consuming.
- Waiting period: the registration statement must be effective to make written offers to sell the securities.
- Blue sky laws preemption: a registered offering is not exempt from blue sky laws (except for securities listed on a national securities exchange, such as NASDAQ, sold to qualified purchasers or sold by registered investment companies).
- Alternative trading systems: They are the only trading options for secondary market trading but exchanges have deeper liquidity pools and more price transparency.

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What are the benefits of Reg A+ STOs?

- Diverse investor pool: issuers may include accredited and unaccredited investors in the offering.
- General solicitation: issuers may engage in general solicitation.
- Freely transferable: securities are transferable immediately after issuance.
- $50MM capital raise: issuers can raise up to $50 million under Tier 2.
- Blue sky laws preemption: the issuance is exempt from blue sky laws under Tier 2.
- 12(g) exemption: issuers may be exempt from Section 12(g) of the Exchange Act.

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What are drawbacks of Reg A+ STOs?

- Uncertainty: no offering memorandum has been qualified by the SEC after almost 1.5 years.
- Disclosure: significant disclosures are required.
  - If smart securities are being offered, then the disclosures should be similar to other equity offerings.
  - If compliant network tokens are being offered, then the disclosures will be extremely complex and do not make sense in the current disclosure framework.
- Ongoing reporting: the issuer must file semi-annual and annual reports and semi-annual reports, creating an additional cost and distraction for management.

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What are drawbacks of Reg A+ STOs? (continued)

- Only U.S. or Canadian entities: issuers must be U.S. or Canadian entities, which limits structuring options and result in unfavorable tax consequences.
- Blue sky laws preemption: Blue sky laws apply to secondary market trading (except for securities listed on a national securities exchange, such as NASDAQ, sold to qualified purchasers or sold by registered investment companies).
- No investment company: an issuer satisfying the definition of an investment company in the Investment Company Act of 1940 cannot rely on Reg A+.

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What are the benefits of Reg D (506(c)) STOs?

- Unlimited capital raise: since registered offerings are often expensive and complex, raising an unlimited amount pursuant to exemptions has gained importance.
- General solicitation: issuers may engage in general solicitation.
- Blue sky laws preemption: securities issued under Reg D are "covered securities," which are exempt from blue sky laws.

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What are drawbacks of Reg D (506(c)) STOs?

- Accredited investors only: limiting the pool of investors is less of a drawback than many believe as past securities offerings show that a significant majority of funds are raised from accredited investors.
- Restricted securities: with limited exceptions, securities sold under Reg D cannot be transferred for 12 months, which creates an issue because liquidity for security tokens is desirable or necessary.
- Accredited investor verification: the issuer must take reasonable steps to verify each investor's accredited investor status, which adds friction to the process.

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What are the benefits of Reg S STOs?

- Limited U.S. compliance: issuers may sell securities to non-U.S. people without any U.S. law compliance, except on the flowback of the securities into the U.S.
- Diverse investor pool: subject to non-U.S. laws, issuers can sell securities to anybody, whether or not they are accredited.
- Non-U.S. transfers: subject to non-U.S. laws, securities can be transferred freely outside of the U.S.
- Integration: Reg D and Reg S offerings can be conducted simultaneously without integration.

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What are drawbacks of Reg S STOs?

- Complexity: Reg S requires that the offer and sale of securities occur in an "offshore transaction" and that there be no "directed selling efforts" within the U.S., which can be complex at times.
- Domestic issuers: a sale of securities by a U.S. company or U.S. founders requires more steps to be taken to comply with Reg S and benefit from it.
- Failed compliance: failing to comply with Reg S is more likely than with other exemptions and results in a blown exemption and, thus, violation of securities laws.

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What are the benefits of Reg CF STOs?

- Diverse investor pool: issuers may include accredited and unaccredited investors in the offering.
- General solicitation: issuers may engage in general solicitation through a registered crowdfunding platform.
- Cost: completing an offering under Reg CF is very cost-effective.
- 12(g) exemption: issuers may be exempt from Section 12(g) of the Exchange Act.
- Integration: Reg CF, Reg D and Reg S offerings can be conducted simultaneously without integration.

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What are drawbacks of Reg CF STOs?

- Limited capital raise: issuers can raise only up to $1.07 million in any 12-month period.
- Transfer restrictions: with limited exceptions, no investors can transfer the securities for 12 months.
- Domicile: the issuer must be a U.S. entity.
- Ongoing reporting: after the sale is completed, the issuer must file annual reports.
- No investment company: the issuer cannot be an investment company.

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What issues must security tokens address?

- Rule 144 restrictions
  - No transfers are permitted within 12 months of the investments being made.
  - Affiliates have additional volume, informational and manner and notice of sale requirements.
  - Exception under Section 4(a)(7) of the Securities Act of 1933 for transfers between accredited investors.
  - Exception under Section 4(a)(1)(1/2) of the Securities Act for transfers by non-issuers with the same restrictions as under Section 4(a)(2) of the Securities Act.
  - Exception for transfers under Rule 144A to qualified institutional buyers.

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What issues must security tokens address? (continued)

- Issuer-specific restrictions
  - Private investment companies are limited to 100 equity holders before requiring registration.
  - REITs must have 100 or more beneficial owners of their stock.
  - REITs must not have more than 50% of the value of its outstanding stock owned directly or indirectly by or for five or fewer individuals at any point during the last half of the taxable year.
  - REITs must distribute at least 90% of its taxable income for any taxable year.

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What issues must security tokens address? (continued)

- Reg S
  - Allow transfers to non-U.S. persons in compliance with non-U.S. laws during the distribution compliance period.
  - Do not allow transfers to U.S. persons during the distribution compliance period.
  - Do not use Reg S to evade registration requirements.
- Restrictive legends
  - Remove the restrictive legend for Rule 144 or Reg S.
- Blue sky laws
  - Peer-to-peer trading must be in compliance with blue sky laws, unless a broker-dealer executes the sale.

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What issues must security tokens address? (continued)

- Information asymmetry
  - Ensure that required information about the issuer is available to the purchaser or to the public.
- Cap table management
  - Ensure the issuer always has control over its cap table and has correct information regarding securities holders.
- Trading
  - Unregistered securities generally can trade only on alternative trading systems and not on national securities exchanges, unless registered pursuant to 12(b) or 12(g) of the Exchange Act of 1934.

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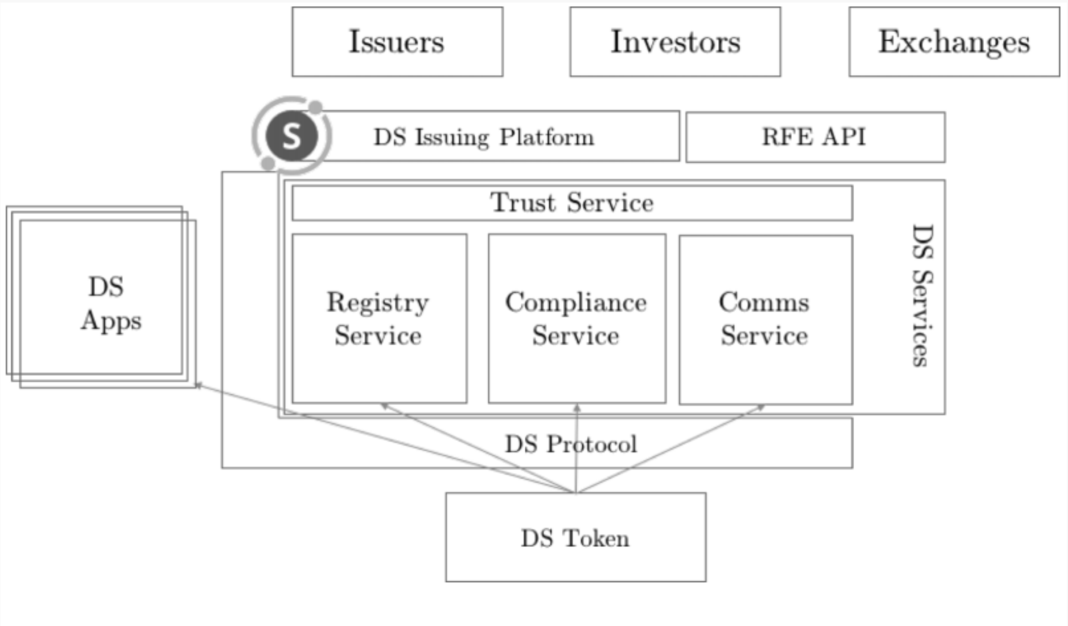
How do issuers address those issues?

- Public blockchain



Securitize's DS Protocol Ecosystem

- Private blockchain

Source: Carlos Domingo, Shay Finkelstein, and Jorge Serna, *DS Protocol – Securitize's Digital Ownership Architecture for Complete Lifecycle Management of Digital Securities, Version 1.0.0, June 5, 2018 (last visited Feb. 25, 2019)*

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How do issuers address those issues? (continued)

- Rule 144 and Reg S restrictions
  - DS token ensures compliance with restrictions.
- Issuer-specific restrictions
  - DS token ensures compliance with issuer-specific restrictions.
  - Automated stablecoin purchase and payment ensures distribution compliance.
- Restrictive legend
  - Issuance platforms believe the smart contract permitting trades should constitute removal of the legend.
  - Issuers believe a Rule 144 opinion should be required.

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How do issuers address those issues? (continued)

- Blue sky laws
  - Issuers generally are relying on preemption with broker-dealers executing transactions.
  - Many issuers are simply ignoring this issue believing it will be solved through a change in laws.
- Information asymmetry
  - No consistent solution but more sophisticated issuers are creating their own portals for reporting information.
  - Use of big boy letters is unclear.
- Cap table management
  - Compliance solutions build cap table management into products.

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How is liability amongst participants being allocated?

- Issuance platforms vs. issuers
  - As with most software, software developers (i.e., issuance platforms) are forcing users (i.e., issuers) to assume all risks and indemnify them for any liability.
  - An issuance platform could be subject to participant liability under Section 5 of the Securities Act if it is "both a necessary participant and substantial factor in the sales transaction."[1]
  - The enforceability of any indemnification of the issuance platforms by the issuer for securities laws violations will be highly fact specific.[2]

1. *SEC v. CMK Diamonds, Inc.*, 729 F.3d 1248, 55 (9th Cir. 2013).
2. *See Gould v. Am.-Hawaiian Steamship Co.*, 387 F.Supp. 163, 66 (D. Del. 1974) ("[M]ost of the cases on indemnity under the Securities Acts can be read to support the proposition that an unsuccessful defendant may obtain indemnity from one significantly more responsible for the injury to the plaintiff.").

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How is liability amongst participants being allocated? (continued)

- Compliance protocols vs. issuers
  - The relationship is the same as with issuance platforms who are also often providing the compliance protocol.
- Compliance protocols vs. exchanges
  - Compliance protocols and exchanges do not appear to be allocating risk between themselves, leaving the issuer with all of the risk.
  - Expect to see many unexpected events that lead to litigation between compliance protocols and exchanges.
- Issuers vs. exchanges
  - The relationship is the same as with issuance platforms.

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What unknowns exist?

- More than anyone can imagine and below are a few:
  - Will nodes in public blockchains be acting as unregistered broker-dealers?
  - Will the SEC ever get comfortable with security tokens trading on public blockchains?
  - Will airdrops of free network compliant tokens be deemed to be “offers” or “sales” under the Securities Act?
  - Can one security token be used to represent two different equity interests in a master feeder fund structure?
  - What happens in a 51% attack where all relevant portions of transactions on a blockchain get re-written?

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Questions?

Marc Boiron

Email: marc.boiron@fisherbroyles.com

LinkedIn: www.linkedin.com/in/marcboiron

Twitter: @boironattorney

Thank You

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