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INSIGHT: Structuring Secondary Token Sales: How to Monetize Digital Tokens Under U.S. Securities Laws

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With over $20 billion raised from the sale of digital, blockchain-enabled tokens since 2014, of which more than $14 billion was raised in the first two quarters of 2018 alone, it should not be surprising that these transactions (commonly referred to as initial coin offerings, ICOs, cryptocurrency crowdfunding, token sales, or token offerings) have become a fundraising tool that, at least theoretically, offers significant opportunities not only for the blockchain companies who will use these funds, but also to the investors, founders, engineers, and other stakeholders acquiring, earning, mining, and receiving the tokens in question.

For some that acquire tokens, the token value lies primarily in their utility (*e.g.*, the rights to obtain membership in a distributed platform or to pay for products or services offered by the company with tokens in lieu of cash). For many, however, the intent of the buyer is to achieve significant return on money or time invested by selling the tokens for a profit, and the intent of the issuer is to raise capital to develop or operate their business.

At this point, most market participants understand that when tokens are primarily sold for these latter purposes, these transactions are classified as sales of securities under U.S. federal securities laws. Accordingly, there is now wide legal consensus that organizations that seek to sell tokens for capital-raising purposes in the United States should register their tokens with the U.S. Securities and Exchange Commission (the SEC) or rely on available registration exemptions, such as Regulation D under the Securities Act of 1933 (the ''Securities Act'') for sales to accredited investors.

What many token investors and other recipients of tokens may not realize is that to the extent a token is a security, any sale that the *holder* makes of the token (*i.e.*, any ''secondary sale'') must also be in compliance with similar securities laws and regulations, just as the initial, or ''primary,'' sale of the token to the holder must have been. Although this basic requirement for secondary sales is similar to the requirement applicable to the organization selling the token in the first instance—*i.e.*, the sale must either be registered or made pursuant to an exemption—the exemptions available for secondary sales and primary sales differ.

In addition, token sellers must also comply with insider trading limitations, market manipulation rules, and other provisions of the U.S. federal securities laws, including, in some cases, requirements that the token issuer's audited financial statements be publicly disclosed. In the context of sales of stock and other traditional securities, these rules tend to be well understood and have been systematized, but they have not been adequately implemented and respected by many token market participants.

If a token holder fails to comply with securities rules and regulations that apply to secondary sales of that token, the holder may be subject to rescission rights and damages claims by third-party transferees as well as enforcement actions by federal, state, or non-U.S. securities regulators, which may result in fines, injunctions, and jail time.

And make no mistake: although the SEC's forays into ICO enforcement actions to date have focused on primary issuers of tokens, those efforts are only a first wave and—as this market matures—resales of tokens not in compliance with U.S. securities laws likely will be the focus of such efforts before long.

Registration, Available Exemptions, and the R-Token

To address the issues presented by the U.S. securities laws, market participants may consider a few alternatives, none of which, however, is perfectly suited for the blockchain world.

First, an investor could theoretically acquire tokens that had been sold in a transaction registered by the issuer under the Securities Act: tokens acquired in such a manner will not be ''restricted securities'' for purposes of the Securities Act Rule 144, permitting non-affiliates to resell without registration or limitation (although certain limitations would be imposed on affiliates). As of the date of this article, however, the SEC has not yet declared effective any registered ICO, or qualified any offering of tokens conducted in reliance on Regulation A. Thus, as a practical matter, investors who wish to participate actively in this market cannot wait to buy tokens in a registered transaction, nor should they assume they will be able to register the resale of their tokens in a timely or cost-effective manner.

Absent registration, a holder will generally be limited to certain exempt sale transactions, including public sales where the holder would not be deemed an underwriter or distributor for the issuer, private placements or overseas transactions. While these exemptions may seem to cover a broad range of potential secondary sales, the devil is in the details, as the qualifications of each exemption are both restrictive and complex.

Due in part to the difficulty for the average investor to understand these exemptions, and the need for issuers in good faith to seek to enforce them, in addition to turning to counsel, some issuers are considering technological means that leverage smart contract technology to enforce securities law requirements and restrictions on the trading of tokens.

Public Resales Under Rule 144

Rule 144 promulgated under Section 4(a)(1) of the Securities Act is a non-exclusive safe harbor designed to permit security holders to resell to the general public without being deemed an underwriter or distributor for the original issuer (and, therefore, without being subject to all of the rules, restrictions, and liabilities applicable to an underwriter or distributor for the original issuer). Once a security has been acquired in a transaction complying with Rule 144, it is cleared for resale in subsequent transactions, as long as the holder is not an affiliate of the original issuer.

A Rule 144 sale must satisfy both holding period requirements and manner of sale restrictions. The holding period requirement depends on whether the issuer has registered the tokens under Section 12 of the Securities Exchange Act of 1934 (the ''Exchange Act''), and is current in its public reporting obligations. If so, the holding period is six months. If not—which will likely be the case for most tokens—the tokens must be held for a full year before resale without registration is permitted.

In certain cases, sellers are allowed to ''tack'' the holding period of an issued security to the holding period of a related derivative security. The crux of the matter relates to the timing of the investment decision and payment of consideration for the shares. Accordingly, while the SEC has not issued guidance on this point, there are good arguments to be made that the holding period for tokens delivered pursuant a SAFT (''Simple Agreement for Future Tokens'') or certain convertible debt instruments or issued upon the settlement of an employee restricted token unit (''RTU'') would start with the date the SAFT or convertible debt instrument was purchased or the RTU awarded, not the date the token was actually delivered. Since many SAFTs, convertible notes, and RTUs will be subject to time-based vesting requirements or token release schedules, in some cases it may well be that the Rule 144 holding period will already be met by the time the holder has received the underlying tokens and is ready and able to sell. (Note that tacking would likely not be applicable for the exercise of any employee token options or the cash exercise of warrants to purchase tokens.)

Market participants tend to be aware of the one-year holding period under Rule 144, and it has become standard to impose a post-issuance one-year lock-up in the investment contract for the tokens—or, more recently, even in the code of the token itself. Many market participants do not seem to realize the lock-up period may actually start with the initial issuance of the SAFT, and that therefore one potential advantage of the SAFT is that it permits the issuer to raise money before conducting an ICO while effectively shortening the post-ICO lock-up period.

Market participants also do not yet widely understand the more onerous information requirements and volume restrictions for resales under Rule 144 by certain insiders. Due to the fact that insiders generally have significantly greater access to information regarding the issuer and own significantly more securities relative to other security holders, affiliates of the issuer, including directors, officers, and certain controlling shareholders (often including the founders), are further restricted in their ability to sell. The key goal of these provisions is to protect other security holders from insider trading and market manipulation.

Accordingly, in order for Rule 144 to be available to affiliate resellers, the issuer must either be subject to the reporting requirements under the Exchange Act and current in its reports, or must make publicly available (*i.e.*, to potential unaffiliated token buyers) information regarding the issuer analogous to what would have been required for a public company. This means disclosure regarding the number of outstanding tokens, the nature of the issuer's business, including its products and services offered and its facilities, the name of the issuer's chief executive officer and its board members, information regarding broker or dealer affiliations, and, most importantly, two fiscal years' financial statements in addition to the most recently available interim financial statements. Further, in any three-month period, these affiliate token holders may only sell up to the greater of 1 percent of all outstanding tokens and the average weekly trading volume over the four weeks preceding sale, as determined in accordance with Rule 144. Affiliate sellers may also be required to file a Form 144 with the SEC to provide disclosure about the terms of the sale. Notably, in signing a Form 144, an affiliate seller is required to represent that the seller does not know of any non-disclosed material adverse information about the issuer. That representation may be problematic for issuers that are not reporting companies.

In our experience, founders, directors, and officers are often surprised to hear that they will have a more difficult path to achieving liquidity from their tokens without the issuer making its financial information available to the world, particularly given that financial

information regarding a token issuer may be viewed as far less relevant to the value of a token as other data related to the token platform the issuer has created.

Assuming holding periods have been met, and, in the case of affiliates, adequate information is available, token holders have largely satisfied the requirements for relying on Rule 144. However, note that Rule 144 sales are not available for issuers with no or nominal operations and no assets or solely or predominantly cash assets (*i.e.*, a shell company). This last requirement may preclude the availability of Rule 144 for tokens of issuers who may have issued tokens prior to commencement of operations, or operating companies who have structured the tokens to be issued through a subsidiary that itself has no meaningful operations.

Qualified Institutional Buyer Resales Under Rule 144A

Rule 144A under the Securities Act serves as a complement to Rule 144. The rule provides another non-exclusive safe harbor under the Section 4(a)(1) exemption that allows financial intermediaries to resell tokens to a potentially infinite number of qualified institutional buyers (''QIBs''). Generally, QIBs are entities that fall within the category of ''accredited investors,'' as defined in Rule 501 of Regulation D, and are either foreign or domestic institutions (not individuals) that own and invest on a discretionary basis at least $100 million in securities of non-affiliates of such entity. QIBs often include, but are not limited to, investment companies registered under the Investment Company Act of 1940, investment advisors or business development companies as described in the Investment Advisers Act of 1940, employee benefit plans within the meaning of the Employee Retirement Income Security Act of 1974, and other regulated entities. Because QIBs are relatively financially sophisticated, the information requirements for Rule 144A are less onerous than for Rule 144, but still include disclosure of recent financial statements.

Unlike tokens sold under Rule 144, tokens sold under Rule 144A will be restricted securities in the hands of the purchaser and cannot be freely resold to the public without registration or further reliance on the Section 4(a)(1) exemption. However, QIBs generally may freely buy and sell tokens from and to each other so long as the QIB reseller determines that the purchaser is also a QIB and makes the QIB purchaser aware of the reseller's reliance on Rule 144A in the certain resale of the tokens.

Despite the potential advantages of reliance on Rule 144A and reports that institutional investors are increasingly interested in the cryptocurrency markets, QIBs presently do not appear to make up a large portion of the token trading market. Part of this issue may be that many QIBs are themselves regulated entities, and would face significant challenges when incorporating tokens into portfolios that are subject to complex liquidity, valuation, custody, or reporting requirements. Recently, a number of companies have announced products and services that attempt to solve some of these problems for institutional market participants. We expect that Rule 144A will play a more prominent role in token resales once those issues have been addressed.

Private Sales Under Section 4(a)(7) and Section ''4(a)(1½)''

Where Rule 144 or Rule 144A are not available, token holders wishing to resell tokens that qualify as securities in the United States without registration will need to structure such sales as ''private placement'' transactions that do not qualify as public offerings. In this regard, it is important to note that Section 4(a)(2), the general private placement exemption, is available only to issuers of securities and not to resellers.

Instead, resellers may rely on Section 4(a)(7) of the Securities Act, which is a specific provision applicable to resales in private transactions. As compared to Rule 144, a key advantage of Section 4(a)(7) is that the required holding period for tokens that have not been registered under the Exchange Act is only 90 days, not a full year. However, similar to the information requirement for affiliate resellers under Rule 144, a Section 4(a)(7) transaction requires the organization that initially issued the tokens to make certain information available to the purchaser, including the organization's audited financial statements—and if issuers are already reticent to do so even to more freely permit resale transactions by their officers, directors, and founders, they would have much less motivation to do so for others.

Due to the restrictive information requirements of Section 4(a)(7), we believe many holders may argue that their token resale transactions qualify under the so-called ''Section 4(a)(1½)'' exemption. This exemption is not a statutory safe harbor for secondary transactions, as with Rule 144 and Rule 144A promulgated under Section 4(a)(1), but has been developed by case law to permit secondary transactions that generally conform with the requirements of a primary private placement by an issuer under Section 4(a)(2)—hence the name.

It is unclear whether the ''Section 4(a)(1½)'' case law exemption will remain available for token sales, as Section 4(a)(7) is a recent addition to the Securities Act that was largely intended to codify the former case law exemption. But to the extent it can be relied on, a Section 4(a)(1½) transaction would need to be made to a limited number of purchasers and without public advertising or general solicitation, the purchasers should be provided with some set of information regarding the tokens available to the reseller and the token issuer to enable such purchasers to evaluate the merits of the investment, and the purchasers should be sophisticated enough to evaluate the merits of the investment based on that information, and should represent their intent to hold the tokens for an indefinite period of time, without immediate intent to resell or distribute.

It is difficult to imagine that these conditions could be met in connection with a token holder's resale on a token exchange. Instead, this exemption is more likely to be relied upon by investors making ''block trades'' of tokens to other interested buyers in negotiated transactions of sizeable value, for example, where a venture capitalist that has acquired tokens in connection with a distribution from a portfolio company sells its token wallet to another investment firm.

Note that because it is not a codified safe harbor, there is no specified period of time for which tokens must be held before they could arguably be resold under the Section 4(a)(1½) exemption. In order to support the argument that the exemption should remain available and the resale transaction is not merely a distribution on behalf of the original issuer, a minimum 90-day holding period, matching the period under Section 4(a)(7), seems reasonable. This means that the one-year holding period associated with Rule 144 compliance

should not be viewed as mandatory for all secondary transactions. Accordingly, while token investors may agree to certain lock-up or holding periods in connection with their original purchase of tokens from issuers for business reasons (*i.e.*, so the issuing organization can better control the flow of tokens into the market), in an ideal world, investors would wish for acquired tokens to enable exemptions to compliance-based one-year holding periods where secondary sales could be conducted pursuant to a valid exemption from U.S. securities laws other than Rule 144. On the other hand, while companies may in theory be amenable to this carve out, they would also want any investor selling outside of reliance on Rule 144 to provide the company with a legal opinion supporting the validity of the transfer under U.S. securities laws, given that exemptions other than Rule 144 are particularly dependent on facts and circumstances relating to the transfer.

As a practical matter, however, it is not clear yet that the available technology for token transferability terms is sophisticated enough to allow for this level of nuance; the smart contracts may need to get smarter.

Offshore Resales Under Regulation S

In addition to certain exempt public and private sales in the United States, a U.S. token holder can resell tokens in ''offshore transactions'' under Regulation S promulgated under the Securities Act. Typically, this means that the reseller reasonably believes that the purchaser is offshore at the time of the offer or sale (a so-called ''non-U.S. person''), or that the transaction is executed on a physical trading floor of an established foreign securities exchange or on a ''designated offshore securities market.''

Presently, most offshore resales of tokens occur through offshore exchanges and trading markets, rather than as direct sales to a known non-U.S. person. However, these transactions are problematic for a variety of reasons. For example, under Rule 902(b) of Regulation S, ''designated offshore securities market'' refers to: (i) certain enumerated foreign securities exchanges of international recognition, such as the London Stock Exchange or the Eurobond market; and (ii) any other foreign securities exchange or non-exchange market designated by the SEC. As of today, we are not aware of any offshore securities markets covered by Rule 902(b) that permit trading of tokens.

As a result, U.S. investors may currently only be able to rely on Regulation S for overseas sales to individually identified and verified investors in privately negotiated transactions, and, for the time being, generally will need to rely on Rule 144 for most resales through token exchanges and other systems.

''Security Tokens''

In light of the complex landscape outlined above, both market participants and regulators face challenges in keeping secondary token transfers compliant with the Securities Act. New technologies have emerged that seek to rise to those challenges by introducing tools to build compliance into token transactions.

Primarily, these tools assist issuers in building so-called ''security tokens,'' a misnomer in that whether or not a token uses technology to comply with securities laws has little - if any - bearing on whether the token is itself a security under those same laws. A typical product consists of a series of components, including a token architecture and an on-blockchain regulatory service or protocol that the token references. The regulatory service can generally be configured for regulatory, statutory, and even extra-legal compliance across jurisdictions, so that, for example, the ''security token'' can be traded only via transactions that comply with one or more specific rules promulgated under the Securities Act (typically Rule 144). These technologies may also include services intended to verify potential investors, identify which regulatory requirements apply to the token transactions, and execute the appropriate permissions.

In theory, these technologies can help ensure that token issuances and resales comply with laws, regulations, policies, and standards in various jurisdictions. At the same time, such technologies may not be a silver bullet given that some market participants view such measures as discouraging decentralization. Compliance also may be more difficult to achieve as laws and token holders' circumstances (such as jurisdiction of residence) change.

Insider Trading Identifying proper exemptions from the Securities Act's registration requirements is only the first hurdle in token resales. Sellers must also be mindful of the Exchange Act's anti-fraud provisions: if a security token holder is an ''insider'' with access to non-public material information of the issuer—as is likely to be the case if a holder is or was recently an executive officer, director, or major shareholder of the issuer—the holder will need to disclose such material non-public information to prospective purchasers.

This presents a number of problems. First, if the holder is seeking to resell on a token exchange, as opposed to in a privately negotiated transaction, the seller cannot practically make the information available to the prospective purchaser. Instead, the holder would need the token issuer to disseminate the information through press releases, website updates, or even official social media channels, to ensure that the market had access to the information.

In many cases, however, the token issuer may not be willing to make that information public, as it may be of a confidential or proprietary nature. Even in the case of privately negotiated transactions, the holder may be subject to a nondisclosure agreement with the issuer (particularly if the holder is a current or former employee) that precludes the sharing of material non-public information without express consent.

Further, the type of information that a reasonable investor would consider ''material'' in considering purchasing tokens from a seller may actually be something both an issuer and a seller may wish to keep confidential. For example, terms of token lock-up releases are often heavily negotiated and highly variable—in some cases staged over the course of a number of years, vastly more than the standard 90- to 180-day lockups for stock deals. Information regarding the timing and volume of lock-up releases is highly material to prospective token investors because of the impact on future supply and market price. However, issuers are naturally inclined to restrict knowledge about future token supply, and investors may not wish for companies to know what terms they have agreed to in the past.

Effectively, then, the insider trading rules can serve to lock-up an insider even beyond a commercially negotiated lock-up period or the holding period imposed by Rule 144. Insiders would therefore be well advised to ensure that the issuers are periodically reporting mate-

rial information about the issuer, its business, and its tokens to the public, to be careful, when possible, about the extent to which the insider is made aware of material non-public information, and to negotiate carve-outs to confidentiality agreements permitting sharing this information to prospective buyers.

To the extent an issuer is generally making public disclosures of material information regarding its token, insiders may be able to take advantage of Rule 10b5-1 under the Exchange Act to facilitate future sales of tokens. This rule permits the implementation of a program, typically referred to as a ''10b5-1 Plan,'' that enables an administrator to sell securities on a holder's behalf even while the holder might otherwise be prohibited from selling due to possession of material non-public information. Such plans are commonplace with respect to sales of stock by executive officers of public companies. A plan would need to be established during a period in time in which the insider was *not* in possession of material non-public information (*i.e.*, after the token issuer had already begun making public disclosures), to have sufficient detail on terms governing the amount and timing of future sales, and to have an administrator to implement its terms and coordinate Form 144 filings and other compliance with Rule 144. At this time, however, we are not aware of any administrators offering these services, likely in part due to most token issuers not making the information regarding the token as required by Rule 144 publicly available.

While the market is still too young to have seen insider trading litigation related to token resales, if and when these suits arise—as well as suits related to sales by insiders without proper reliance on the information and volume restriction requirements of the Rule 144 safe harbor—they will be distracting and likely costly for issuers whose tokens are involved, and will disrupt the ability of insiders subject to the litigation to manage the business. Issuers therefore have an interest in ensuring that their directors and officers will be restricted, through contractual agreements, insider trading policies, and other mechanisms, in their ability to resell tokens underlying awards while in possession of any material, non-public information.

Smart contracts can potentially ease compliance efforts by enforcing blackout periods on insiders. Indeed, some ''security tokens'' are being designed to deny certain trades where a designated regulatory service has determined that resales should not be permitted, for example, in the days surrounding an earnings report.

Market Manipulation Whereas many token re-sellers are inadvertently selling tokens in violation of the registration requirements of the Securities Act and the insider trading requirements of the Exchange Act, a different category of re-sellers are likely acting in bad faith violation of market manipulation rules.

Market manipulation, as provided under the Exchange Act, is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Techniques include pump and dump schemes or painting the tape (promoting the tokens to drive the price up), or in the inverse less common to the token world than the stock world, token bashing (posting false or misleading information about an issuer to drive down the price), churning or wash trades (buying and selling tokens at about the same price to magnify price shifts by increase in activity), spoofing (placing bids or orders in bad faith with the intent to cancel before filled), and other schemes to spread false or misleading information about a company, its business, or its tokens, or to rig quotes, prices, or trades to create a false or deceptive picture of token demand.

While the SEC has not to date said much publicly to caution against improper resales of tokens under the Securities Act, investigations and civil and criminal enforcement actions against token market manipulators have been top priorities of the SEC's recently formed Cyber Unit. Furthermore, the Commodities Futures Trading Commission has also asserted jurisdiction over fraudulent and manipulative activity in token markets, and should this jurisdiction be upheld by the courts, it will apply regardless of whether tokens are deemed to be securities as defined under the rules and regulations of the SEC.

The Challenge: Identifying and Providing Meaningful Disclosure A common theme of the rules and regulations applicable to the resale of tokens covered by U.S. securities laws is the desire to protect investors by correcting inherent information asymmetries between the buyer and seller. For this reason, as discussed above, disclosure obligations under Rule 144 become stricter to the extent a seller is an affiliate of the organization issuing the token, since, as an ''affiliate,'' the seller is likely to have significantly greater knowledge about the token and its prospects as an investment than the buyer.

Regulations, guidance, and case law around what constitutes ''material non-public information'' and what disclosures would be meaningful to investors generally contemplate traditional equity or debt securities, where the inherent value of the security ties to the inherent value of the issuer and its business. It is not necessarily the case that the same is true of all tokens. However, when tokens are issued to investors in transactions intended to finance the development of the issuer and its services, it is more likely that their value will in fact be tied to the value of the issuer and its business, since the utility of the token depends on the growth of the issuer.

Accordingly, when considering what information would be material to investors in connection with a resale transaction, analogies to typical disclosures in the stock sale context are informative, as purchasers would likely find the following types of information highly relevant to evaluating an investment:

- total number of outstanding tokens (analogous to total number of outstanding shares of stock), which a buyer would need to determine the token's ''market cap;''
- total number tokens issuable in the future (analogous to stock ''overhang''), which a buyer would need to calculate potential dilution to the token's market cap;
- total number of tokens mined in and spent in recent periods (analogous to disclosures of recent sales of unregistered securities and stock repurchases and redemptions), so investors can understand the impact of such transactions on the token's market cap;
- timing and size of lock-up period expirations (analogous to ''stock available for future sale'' disclosures), which would help a buyer to predict when to expect increases in market supply that will drive down price;
- known holders of 5 percent of outstanding tokens and organization insiders (analogous to beneficial

owner and management disclosures), so purchasers can understand the market drivers and their interests; and

- basic business and financial information regarding the organization that has issued the tokens, so investors can understand whether the company will have the resources available to render the services for which the tokens are to be used.

The true challenge lies in identifying what other disclosure would be material to investors in the unique context of tokens and where there is no good analogy to traditional securities. In this, resellers wishing to fully comply with U.S. securities laws—and insiders wishing to avoid insider trading claims by disappointed buyers—will be breaking new ground. For example, one can imagine an investor being interested in understanding the dollar value of services provided each year in exchange for tokens, so as to understand how much value the organization is providing—effectively for free—to holders surrendering tokens as payment. Such information, together with the organization's financial statements, could help an investor evaluate whether the organization may continue to have the financial health necessary to both stay in business and ensure the tokens have utility and, thereby, value.

At some point, however, a token may be sufficiently distributed so that there are no holders of 5 percent of its outstanding tokens, its network and operations may become so decentralized that there are no inside managers with access to the kinds of information discussed above, and the token platform may be so self-supported by market participants themselves that the financial health of the organization that originally issued the tokens is more or less irrelevant to the continued value of the token. In that case, it very well may be that the token is no longer considered a security by the SEC, in which case the disclosure and other obligations associated with secondary sales under the U.S. federal securities laws will have become moot.

However, token sellers should continue to remember that even if a token ceases to be treated as a security by the SEC, token resale transactions may still be subject to laws and regulations related to commodities, money transmission, consumer protection, and potentially state securities laws, and subject to oversight by the Department of Justice, the Commodity Futures Trading Commission, the Financial Crimes Enforcement Network, the Federal Trade Commission, the Treasury Department and state regulators.

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