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## Being Secure About Your Security Token Offering

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**Many experts have declared that the Security Token Offering is less onerous and less expensive than traditional capital raising. But issuing a STO requires more than writing smart contract code. For issuers contemplating a Security Token Offering, there are risks that fall outside of the technology realm. As global regulatory scrutiny intensifies, potential issuers need to understand the business/legal framework to formulate a sound game plan. Here are four questions every potential issuer should ask before jumping into the STO arena.**



### Preparing for the Evolving World of Digital Assets

Over the past several years, we have witnessed the rise of digital, tokenized assets attempting to break out of the confines of stock exchanges and illiquid private investments.

Security Tokens are a third category of tokenization, different than Crypto-Currencies (Bitcoin, Ethereum, etc.) and Utility Tokens, in which the tokens represent fractional ownership in a potentially broad range of financial investments or hard assets. The marketplace has been slow to fully embrace this new paradigm in investing, but the tides are changing. More frequent announcements of asset tokenization are being released, while sizable pools of investors become educated and embrace the potential of these digital investments.

Imagine the ability to create digital investments with programmable transparency, reporting, liquidity and risk control. These promises, that blockchain technology offers, are being realized as the improvements above are now becoming standardized protocols. Blockchain brings forth the use of determinative code (known as “smart contracts”) in order to create programmable structuring and risk control, unique methods of exchange, and security issuance that can be more automated than currently exist. It is for these reasons that Security Tokens have attracted the attention from individuals to institutional investors, all seeking the beneficial attributes tied to attractive investment opportunities.

***[Related: “Will Libra Catalyze a Token Revolution in Finance?***

***(<https://tabbforum.com/opinions/will-libra-catalyze-a-token-revolution-in-finance/>)”]***

If you are an issuer contemplating a Security Token Offering (STO), there are risks that fall outside of the technology realm that we want to discuss in this article. This rapidly evolving technology and investment ecosystem is being scrutinized by regulators across the globe, along with highly specialized attorneys, consultants, and investment professionals. It is against this backdrop that it is worth looking at Security Tokens, a particular type of offering made possible through the adoption of certain blockchain technology.

*This article is based upon the experiences and observations of an experienced financial professional, Barry Seeman, and a crypto-seasoned attorney, Susan Joseph. Both contact details are found at the end of the article.*

A reader should view this article as a good thought-process outline to follow, if you are contemplating a STO. As you may consider some of the issues raised within, you can formulate a sound game plan for your STO, keeping developments on time and within budget. Additionally, this article will not dwell upon the technology underlying various specific distributed ledgers that support Security Tokens but will focus upon a business/legal framework in order to keep you “*Secure About Your Security Token Offering.*”

## **The Security Token Revolution Is an Evolution**

The revolutionary goal of Security Tokens, secured digital assets issued and managed in the form of tokens through distributed ledgers, is to create a global marketplace of overwhelming investment opportunities, while significantly improving the manner in which security investments are offered.

Terms like “democratization,” “digital shares” and “liquidity” are often attributed to these offerings and promoted within the offerings’ white papers. While on their own, these concepts do not offer direct revolutionary impact, collectively they do reflect an evolutionary improvement over our current arcane investment environment by providing programmable logic embedded within the security and adding in additional compliance and transparency capabilities through blockchain-based record and message transfer systems. If you are currently working on or considering a Security Token Offering (“STO”), then this article will give you more fundamental background concepts, observations and concerns to consider and address in the launch of your offering.

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Even though many Security Token advocates have declared the STO to be a less onerous and less expensive process to a private fund or corporate offering, we find this is not exactly the case today. Issuing a STO requires more than writing smart contract code. While certain reconciliation and administration steps in the life of an investment are anticipated to be less onerous if they are maintained by well-functioning smart contract computer code, many of the steps to issue a STO are still similar to a traditional private offering.

We often suggest taking a “belt and suspenders” approach to all aspects of the offering, since STOs are still relatively new territory for investors, regulators, exchanges, and issuers. As the evolution of digital investments proceeds and more STOs become commonplace as capital raising investment vehicles, there will be a compression of launch time and costs compared to the environment today. Those who have mastered the STO process early on will be well positioned to move more quickly and efficiently as the marketplace advances.

### **When Jumping into the STO Arena, Four Questions You Should Ask:**

***Question 1: What is the nature of the investment that is being sold through the proposed Security Token?***

We need to first discuss the nature of the investment and the legal construct of the Security Token Offering. If a Security Token is simply a digital security, then we must act to ensure that the underlying legal structure provides a sound vehicle for investors. The determination of a “sound” legal structure takes into account various aspects of jurisdictional regulations and compliance, taxes and other attributes of the offering. Digital Asset regulatory burdens do not disappear merely because the investment is now created as a digital security. This remains one of the key misconceptions of the crypto-investment space – that you can avoid regulatory compliance because you issue a “token.”

A “typical” Security Token (quoted because we are not certain there are any typical security tokens) reflects an investment in any of the following possibilities:

- Equity ownership in a company
- Limited partnership interest in a private equity fund
- Shares of a Cayman Feeder into a REIT for U.S.-domiciled real estate holdings
- Portfolio of bonds
- Equity ownership in hard assets, such as mineral rights
- Equity ownership in other types of income streams

Anything with a legal ownership structure is possible as the underlying asset of a Security Token. It is for this critical reason that the token does not circumvent rules and regulations of the host country’s regulatory and tax environment. You must strongly consider the investment vehicle structuring and look to work with astute legal counsel along with tax counsel, to address both regulatory rules for asset ownership and many of the investment objectives of your token holders.

A great example of a STO is the concept of tokenization of real estate. Over the past several years, there have been a number of highly touted articles describing the use of security tokens in order to allow for fractional ownership of property. There have been a number of STOs that have approached various forms of real estate. In theory, STOs make perfect sense and are simply an extension of vehicles that already exist in order to promote fractional ownership of real estate.

Such existing vehicles include Real Estate Investment Trusts (REITs), Real Estate Cooperatives, Limited Partnerships, Limited Corporations and Time Shares. Each one of these legal structures can hold real estate as the underlying asset and offer fractional ownership units, but each exists to serve different purposes to the end investor. These types of vehicles are candidates for Security Token Offerings that, once implemented, should be easier to track, trade, and reconcile as compared to the current paper or legacy technology-bound systems. It is important to note that “should” is a relative word, as STOs are still new types of offerings that are being tested both as products themselves and as powered by emerging blockchain technologies.

More important, financial regulatory authorities across the globe are beginning to pass rules pertaining to the issuance and sale of Security Tokens. These rules will evolve over time as the digital shares become more accepted. But you must be conscious of what security laws and tax laws are applicable to your investment and your investors and seek the appropriate advice from engaged counsel. Here are some important resources:

- SEC (<https://www.sec.gov/ICO> (<https://www.sec.gov/ICO>))
- FCA (<https://www.fca.org.uk/firms/cryptoassets> (<https://www.fca.org.uk/firms/cryptoassets>))
- AMF ([https://www.amf-france.org/en\\_US/Reglementation/Dossiers-thematiques/Fintech/Vers-un-nouveau-regime-pour-les-crypto-actifs-en-France](https://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/Fintech/Vers-un-nouveau-regime-pour-les-crypto-actifs-en-France) ([https://www.amf-france.org/en\\_US/Reglementation/Dossiers-thematiques/Fintech/Vers-un-nouveau-regime-pour-les-crypto-actifs-en-France](https://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/Fintech/Vers-un-nouveau-regime-pour-les-crypto-actifs-en-France)) )

This highlights the important point, that a *Security Token represents an investment made by an investor, who has the expectation of an increase in the value of said investment*. Therefore, most securities regulators consider Security Tokens to fall under their purview and will require issuers to adhere to the regulatory ruleset that applies to whatever underlies the Security Token and how it is being sold.

*Which leads us to the next question ...*

### **Question 2: Who are the target purchasers of the proposed Security Tokens?**

This is the nice way of saying: “Where is the money?!?” Are you interested in raising money in the United States? Can you source investors in Asia? Can you offer this Security Token in Europe? There is a litany of issues that come to light, once you determine where your potential investors reside and how you intend to conduct your money raise.

Over the past several years, there has been a big push to offer Security Tokens giving investors access to many different opportunities. While it is exciting to see cutting-edge products on the market, these early crowdfunding money raises focused on the notoriety of the Token, while diminishing the message surrounding the true nature of the investment. Some of these earlier issued Tokens may have been Security Tokens whose issuers did not follow investment rules and compliance. As a result, today regulators are in the midst of sorting out past offerings through various enforcement actions.

What can we learn from this? If you are offering an investment, get proper professional advice! We must take the approach that the underlying investment is the most important component of the offering, and the Security Token is the “whip cream on the dessert.” We cannot emphasize enough

that the underlying investment is the main attraction and the digital security is an enhancement component that brings other attributes to the offering.

It should be noted that even if STOs evolve past digital securities as enhancements to become brand-new types of digitally native investments, STOs will still fundamentally be investments that will have to fit within regulatory regimes, and appropriate compliance must be observed.

Other concerns should be addressed in connection with any offering. You should also determine the potential sensitivities that your investors may have. Are they individuals who may be sensitive to certain tax triggers in the investment, or are they institutional investors looking for a specific yield in the payouts? These answers will help you understand any nuances that should be introduced into the structuring. Once you have answered the money raising questions, you have the basic information to begin discussions with your legal counsel.

### *Let's Look at a Practical Example:*

We will return to the real estate example to explain why understanding and respecting the underlying asset is critical. Imagine we have several single-family homes in the United States that we want to tokenize as a package for investors. On a base level, can we sell fractional ownership in these homes? The answer is “of course.” But what about the following:

- How do you handle the title registry of fractional owners on individual properties?
- Who makes any decisions regarding the leasing, upkeep, accounting, tax payments and eventual sale of the properties?
- How do you decide what to do if you do not have unanimous agreement among token holders – i.e., in the sale of a property?
- What happens if any one of the fractional owners/token holders disappears or cannot be reached regarding decisions involving the property? Does this impact the quality and transferability of property title?
- What is the basis for distribution of any earnings?
- How do you handle the fractional responsibility for property taxes?
- These questions bring about other questions and we realize this list is by no means exhaustive.

Suddenly, we begin to realize that there are a number of structural and legal hurdles to overcome when tokenizing assets. Today, these types of hurdles can be more easily addressed in traditional investment vehicles teamed up with tokens that represent the shareholder units. And, so, these hurdles typically force the issuer to revert back to standard fund and corporate entity issuances, as you would see in non-tokenized deals, with the anticipation of marginal gains to be made through tokenization on top.

In this same real estate tokenization proposal, consider the following:

- We transfer the single-family homes into an investment vehicle known as a Real Estate Investment Trust, or “REIT.” We choose this structure because the properties have the potential to generate rental income, and we want to minimize the tax impact at the vehicle level.
- Because it is a REIT, we must distribute at least 90% of the net taxable income to the unit holders, with certain tax benefits also passed onto the unit holders (distribution of 100% of the net taxable income will eliminate an entity-level C-Corp. tax).
- We must have a designated Investment Manager, which will be paid a management fee from the REIT’s activities for its role in managing the investments.
- We will also need to address the number of shareholders rule for REITs.
- If we have non-US unit holders, then they are subject to withholding tax on both the net income and the proceeds from the sale of underlying properties (FIRPTA withholding). This is because the single-family homes are US domiciled.
- In order to simplify and minimize certain tax impacts to non-US unit holders, we create a Cayman-Island feeder, associated with “tax-blockers.” These blockers do not eliminate the tax, but rather minimize some of the impact and simplify the tax filing.
- We must engage the services of a fund administrator, audit firm and other service providers in the management of the investment vehicles.

This is not the complete structure, nor the complete picture. We still have not even mentioned the addition of the token overlay on top, which will add another level of complexity. You can see from the structure above that we are attempting to deal with different tax issues faced by US and non-US investors in the same underlying assets.

Once you add in the prospect of offering tokens, you also need to decide if you will offer separate tokens for US investors and non-US investors, and whether having two tokens confuses or dilutes your money-raising efforts.

If you do choose the two-token approach, then the US token can represent direct ownership interest into the REIT, while the non-US token would represent ownership interest into the Cayman Feeder. Your money-raising activities would need to ensure that the appropriate investors would purchase the appropriate tokens, and that you disclose the potential for different returns in the two different tokens.

This example is meant to highlight some of the complexities faced in the formation of one type of STO, a REIT Security Token Offering. Other STOs have their own quirks specific to the type of underlying investment contemplated. It is critical to have the legal and investment structure worked

out before coding the token begins. What is coded in the contract must be a technological match to the offering documents. For this reason, we strongly stress the engagement of solid and well-respected legal and tax counsel.

Besides advising on the general legal structure for the offering, you also rely upon your counsel for drafting the offering documents, registering the appropriate entities with regulatory bodies, and drafting all the associated service agreements within the structure. They will give you advice on the Anti-Money Laundering (AML) and Know Your Customer (KYC) protocols you need to follow in your offering. You will use them to review your marketing materials and white papers, so that you do not cross the regulatory line into dangerous territory. You may want to ask for a review of the smart contract protocols built into the technology of the tokens, in order to reconcile the offering documentation with the workings of the Security Token.

Many law firms have built out expertise in Cryptocurrencies, Tokenization and Blockchain. When considering a law firm and/or a consultant, take into account that you will need expertise in the underlying asset issues, the security and/or fund structuring, and the technology and tokenization itself. Smart contract technology audits are newer services being offered by law firms, technologists and other practitioners. Security Token Offerings are quickly becoming a cutting-edge practice. Be sure to ask whether your engaged expert practitioners have specific expertise in these areas of cryptocurrencies, tokenization and blockchain technologies. In addition to the structuring and issuance of Security Tokens, your legal counsel will be able to assist in the protection of intellectual property associated with the tokens.

Multi-national firms such as Clifford Chance ([www.cliffordchance.com](http://www.cliffordchance.com) (<http://www.cliffordchance.com>)), Baker & McKenzie ([www.bakermckenzie.com](http://www.bakermckenzie.com) (<http://www.bakermckenzie.com>)), Shearman & Sterling ([www.shearman.com](http://www.shearman.com) (<http://www.shearman.com>)), Katten Muchin Rosenman ([www.katten.com](http://www.katten.com) (<http://www.katten.com>)) and Skadden, Arps, Slate, Meagher & Flom ([www.skadden.com](http://www.skadden.com) (<http://www.skadden.com>)) are all increasing their capabilities in the blockchain and cryptocurrency space.

Other, smaller firms, such as DlxLaw ([www.dlxlaw.com](http://www.dlxlaw.com) (<http://www.dlxlaw.com>)), formed by prior big-law partners with experience in blockchain and cryptocurrency, exhibit deep bench strength and capabilities that can be beneficial in a STO. All in all, several hundred attorneys list blockchain or cryptocurrency as part of their expertise, and the number of attorneys practicing in this area is rapidly increasing. *Please note, this is not an exhaustive list of law firms engaging in this type of practice.*

*Which leads to the third question ...*



***Question 3: How do you intend to raise the funds for the Security Token Offering?***

There was a time very recently, like in many “hot” markets, when you could simply announce the launch of a new token and expect a groundswell of interest and the formation of numerous wallets for investments. We believe we have evolved from that euphoric state to come back to earth for a more traditional and rational approach to money raising. Investors must be compelled to invest because of the economic potential of the underlying business or assets.

The Security Token adds both complexity and notoriety to your offering, and you must decide if your money raise is going to be solely targeting token investors, or accepting investments from non-token investors, as well. In either case, you must examine your approach to raising money and follow the proper rules and regulations of the domiciliation of the investor source. Security regulators take this very seriously and, as mentioned earlier, they are beginning to scrutinize the marketing and money-raising approaches of recent crypto-coins and Security Tokens.

In the United States, regardless of the nature of the investment offering, if any minutia of the investment is offered or sold to US investors, all activities associated with the money raise must comply with the Securities Act of 1933 and other Federal and State rules regarding the sale of security interests. For this reason, many Security Token Offerings are structured and distributed as private placement offerings, thus avoiding many of the rules and requirements for a public/retail offering.

As much as we may believe a website and crowdfunding approach will raise ample funds, you must be careful not to cross the line into a public offering without the supporting compliance in the marketing materials and offering to all of the regulatory requirements. Additionally, some cryptocurrencies may also fall within money transmitter regulations. More than one regulatory scheme may impact a particular investment. Again, advice of counsel is recommended.

How you intend to raise the funds for the Security Token Offering will determine a number of next steps. Your legal counsel will not only document the offering to reflect the approach but will also give you guidance on selection of brokers and/or placement agents that will ensure compliance with the regulations.

In the US, a private placement offering will restrict investors to only those that meet the SEC’s “Accredited Investor” thresholds. This approach impacts the dynamics of every step of the money raising process. Obviously, it impacts the type of investor you are targeting, but a subscription into the private placement should only occur after a “Know Your Customer” due diligence process, which

will include the disclosure and paper trail of the investor's personal information, a cross check by a reputable shareholder service or fund administrator, and lastly that the source of funds are also known to cover your requirements under Anti-Money Laundering (AML) rules and sound protocols.

Furthermore, these investors will be subject to Rule 144 and will be required to hold the investment for a period of one year. So, actual token liquidity cannot be achieved until a year after issuance. This should be emphasized, as often we hear claims that the issuance of security tokens will automatically make the market more liquid. While this ultimately may become the case, the initial holding period applies to tokens, and automatic liquidity is not expected.

Let's return to the environment of increased scrutiny that the SEC has placed upon the sale of Security Tokens to investors. It is critical that you take a conservative approach, meaning that if you hire placement agents or broker dealers, these entities must be registered as a broker-dealer, with the Form BD credentials to sell private placements. Their agents must be registered representatives with the broker-dealer or an affiliated one. Furthermore, Blue Sky Laws in the US typically require the broker-dealer to be registered in the states where it is raising investment capital. You can conduct much of your own due diligence on FINRA's broker check website: <https://brokercheck.finra.org/> (<https://brokercheck.finra.org/>).

Some broker-dealers to consider that have embraced the Security Token Offering market are US Capital Global ([www.uscapglobal.com](http://www.uscapglobal.com) (<http://www.uscapglobal.com>)), Entoro Capital ([www.entoro.com](http://www.entoro.com) (<http://www.entoro.com>)), Boustead Securities ([www.boustead1828.com](http://www.boustead1828.com) (<http://www.boustead1828.com>)), Harbor Platform ([www.harbor.com](http://www.harbor.com) (<http://www.harbor.com>)), and Amerx ([www.amerx.com](http://www.amerx.com) (<http://www.amerx.com>)). There are many broker-dealers moving into this space, so conduct your own due diligence, and certain crypto-exchanges such as Gemini ([www.gemini.com](http://www.gemini.com) (<http://www.gemini.com>)) have applied for an ATS license. Suffice to say this is a rapidly evolving arena.

*Which leads us to our final question ...*

#### **Question 4: Who are the other Service Providers you should consider in this Security Token Offering?**

This section is going to drop some names, but it does not imply that these are the best or only service providers in the marketplace. You will need to understand, in excruciating detail, the extent of the services offered, and the costs for said services.

Since aspects of Security Token Offerings are still new, some service providers will require a bit more hand holding in understanding the nuances of the offering. Certain service providers are not interested in participating in Security Token Offerings until more rules and regulations are in place, giving them more comfort about their liability risks associated with the provision of services.

You may require the services of a Fund Administrator or a Transfer Agent and Custodian. Many of these service providers, such as SS&C GlobeOp ([www.ssctech.com](http://www.ssctech.com) (<http://www.ssctech.com>)) and MG Stover ([www.mgstover.com](http://www.mgstover.com) (<http://www.mgstover.com>)), provide a broad range of services. Some firms, such as PrimeTrust ([www.primetrust.com](http://www.primetrust.com) (<http://www.primetrust.com>)), provide compliance/transfer agent/custodial services strictly affiliated with token issuances. These firms may also insist that all investors are subject to their own internal KYC/AML checks, even if your tech team has built all the protocols into the token blockchain structure. The firms will be responsible for accepting investment funds, calculating Net Asset Values (NAVs), calculating and wiring dividend payments, and coordinating annual audits.

In providing good governance and oversight for your investors, consider a strong representation from a board of directors, of which at least half are independent in nature. There are excellent firms, such as DMS Governance ([www.dmsgovernance.com](http://www.dmsgovernance.com) (<http://www.dmsgovernance.com>)), that supply directors to funds and other corporate structures.

Your Security Token investor will also be looking for a strong audit firm to conduct annual audits. Your investor may even ask for assurance opinions. Major firms, such as PWC ([www.pwc.com](http://www.pwc.com) (<http://www.pwc.com>)), Deloitte ([www2.deloitte.com](http://www2.deloitte.com) (<http://www2.deloitte.com>)), EY ([www.ey.com](http://www.ey.com) (<http://www.ey.com>)) and KPMG ([www.kpmg.com](http://www.kpmg.com) (<http://www.kpmg.com>)), have all been increasing their abilities to handle Security Token Offerings. Given the size of many token offerings, you might consider a mid-to-large size firm, as an alternative to a major firm, for its level of service and a potentially lower cost structure, such as EisnerAmper ([www.eisneramper.com](http://www.eisneramper.com) (<http://www.eisneramper.com>)), Richey May & Co. ([www.richeymay.com](http://www.richeymay.com) (<http://www.richeymay.com>)), BDO ([www.bdo.com](http://www.bdo.com) (<http://www.bdo.com>)), Marcum ([www.marcumllp.com](http://www.marcumllp.com) (<http://www.marcumllp.com>)) and Friedman LLP ([www.friedmanllp.com](http://www.friedmanllp.com) (<http://www.friedmanllp.com>)).

Lastly (at least for this article), we briefly discuss the technology build and platform support for the Security Token itself. Many of the up-and-coming Alternative Trading System (ATS) platforms are also interested in creating the coding for the token, such as Openfinance ([www.openfinance.io](http://www.openfinance.io) (<http://www.openfinance.io>)), tZERO ([www.tzero.com](http://www.tzero.com) (<http://www.tzero.com>)) and, most recently, Harbor Platform, mentioned above. New platforms with experienced coders are also being approved on an ongoing basis, and this is an area with a lot of activity. Leaseum Services

([www.leaseumservices.com](http://www.leaseumservices.com) (<http://www.leaseumservices.com>)), a platform to which the author is affiliated, is building out tools and processes to assist companies in accessing investment solutions on the blockchain.

Certain non-platform smart contract providers are looking at creating standard offering documents. You need to determine the best approach here, because there are a number of firms that sit outside of the ATS platforms that can build the token. And, since these smart contracts should be audited, there are a small number of firms that specialize in that service.

We leave you with this: Security Tokens, as a widely accepted investment vehicle, will evolve and grow in the coming years. We may be on the precipice of an explosion of offerings. There are many companies, asset managers and investment product providers looking at this space and its growth potential. When contemplating an offering, do consider many of the factors, issues and potential solutions discussed herein. Do your homework! Choose excellent counsel and service providers. Make the Security Token all about the investment and not about the Security Token, and you will be on the path to a successful launch.

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