

## **BLOCKCHAIN PRACTICE GROUP**

# **How to Launch STO**

Things to consider when structuring  
and launching STO in the U.S.

# ABOUT US

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DILENDORF  
KHURDAYAN

## Blockchain, VC/PE & Real Estate

Dilendorf & Khurdayan offers practical and effective legal solutions to innovators and visionaries in the blockchain, real estate and private capital space.

We guide our clients through issuing (STOs), marketing and re-selling digital tokens in the U.S., tokenizing assets, setting up crypto funds and operating DLT projects.

Our clients - blockchain startups, individual investors, funds, family offices, real estate owners/operators, art collectors, high net worth individuals and FinTech firms. We help these clients navigate multiple regulatory regimes and laws in the industry that changes by the second.

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# TOPICS

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- What is an **STO**?
- **How to launch** an STO in the U.S. without registering with the **SEC**
- **Broker-Dealer & KYC/AML** issues in STOs

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# WHAT IS AN STO?

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## STO – Security Token Offering

- A way to describe a token offering that is compliant with U.S. securities regulations
- Security Token Offering  $\neq$  Offering of Tokenized Securities
  - Much broader scope, including revenue sharing tokens, asset-backed tokens, fund tokens, etc. **and** even SEC-compliant ICOs

# SECURITY TOKENS

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We refer to all tokens that meet  
the legal definition of security as  
**“security tokens”**

# WHAT IS A SECURITY?

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- The infamous *Howey* test: U.S. law defines “security” broadly → **any contract, transaction, or scheme** whereby:
  - A person **invests money** or anything else of value
  - In a **common enterprise** (which different courts define differently)
  - And is led to **expect profits**
  - Predominantly from **the efforts of others** (central management).
- It doesn't matter what you call a token, whether it serves a function on a platform, whether or not it entitles the holder to a share in profits — **if it meets the test for a security, it's a security.**

**THUS, SECURITY TOKENS ARE NOT JUST TOKENIZED SECURITIES**

# TYPES OF SECURITY TOKENS

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- **Utility Tokens:** serve some function on the sponsor's platform/ecosystem.
- **Equity Tokens:** look more like a traditional security - lets users vote or entitles them to share profits, e.g.
- **Debt Tokens:** provide a fixed-rate return on future income/revenue.
- **Asset-Backed Tokens:** represent a right to an underlying asset or asset pool (real estate, art, etc.)
- **Fund Tokens:** represent interest in a tokenized fund. Allow fund managers to invest in illiquid assets, yet provide liquidity to investors.



# OUR FOCUS TODAY

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## NON-UTILITY TOKENS

- Equity/Debt
- Asset-backed
- Fund tokens, etc.

# WHY TOKENIZE?

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- Access to capital on a global scale
- Liquidity
- Fractionalization of ownership
- Access to assets with traditionally high barriers to entry
- Attractive to both traditional and crypto investors

# MOST COMMON STO STRUCTURES

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## ➤ SPV / trust

*Example: Thelephant, BrickBlock*

## ➤ Fund / GP

*Example: 22x, Science Blockchain*

## ➤ Hybrid

*Example: Property Coin*

## ➤ Utility Token Structures

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# SALE OF SECURITY TOKENS IN THE U.S.

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- **General Rule:** You must register a security with the SEC before you can offer or sell it.
  - Consequence of selling unregistered securities: **Strict liability.**
- **However:** Even if a token is a security, it may qualify for an exemption from registration.
  - As a practical matter, there is usually no need to register because you can almost always structure an STO to qualify for an exemption.

# EXEMPTIONS FROM REGISTRATION

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- If your security qualifies for an exemption, you don't need to register it.
- **Examples of federal exemptions from registration:**
  - 3(a)(10)                      - Regulation D: Rule 504                      - Regulation A+
  - 3(a)(11)                      - Regulation D: Rule 506(b)                      - Regulation CF
  - 4(a)(2)                      - Regulation D: Rule 506(c)                      - Regulation S

# GOOD FOR STO?

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**MOST COMMONLY USED EXEMPTIONS -**  
506(c) under Regulation D and Regulation S

# REGULATION D – 506(c)

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## ➤ Overview of Rule 506(c)

- No restrictions on advertising—**general solicitation** is permitted
- **No prospectus required** (although issuers generally release a private-placement memorandum)
- Issuers can raise an **unlimited amount of funds**
- **No financial reporting requirements** for the issuer
- State securities laws are **pre-empted** (no need to seek registration or exemption on a state level)
- Only **accredited investors** may participate in the sale
- Purchasers **cannot transfer their securities for one year** (subject to certain exceptions)
- **Form D must be filed** with the SEC after the sale (but doesn't need SEC approval)



# U.S. ACCREDITED INVESTORS

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- **ACCREDITED ≠ PROFESSIONAL:** Accredited investors do not have to be professional or institutional investors.
- An “**accredited investor**” includes a **natural person who**:
  - **Earned income that exceeded \$200,000** (or \$300,000 together with a spouse) **in each of the prior two years**, and reasonably expects the same for the current year; **or**
  - **Has a net worth over \$1 million**, either alone or together with a spouse (excluding the value of the person’s primary residence)
- An “accredited investor” may also be an entity such as a bank, partnership, corporation, nonprofit, or trust, when the entity satisfies certain criteria.

# CONCURRENT REGULATION D + S

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- Although not as well-known as Regulation D, token sponsors should structure a **concurrent offering under Regulation S** for non-U.S. investors.
- **Advantage:** Non-U.S. investors under Regulation S do not have to undergo the same accreditation process as U.S. investors under Regulation D.
  - If you don't use Regulation S for foreigners, **you must accredit all your investors** under Regulation D—not just U.S. investors.
- **Advantage:** Non-U.S. investors who are not **distributors or affiliates** of the issuer or its distributors can **resell immediately** to other non-U.S. investors.

# REGULATION S

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## ➤ Overview

- Rule 901 says that “offers and sales that **occur outside the United States**” don’t have to be registered.
  - **BEWARE:** The SEC has never clearly explained when an offer and sale occur outside the United States, so you shouldn’t rely on Rule 901 alone.
- Fortunately, Rule 903 provides a **safe harbor**—if an offer and sale satisfy the following requirements, they are deemed to occur outside the United States:
  - Offer and sale made in an **offshore transaction**;
  - No **directed selling efforts** are made in the United States; and
  - **Certain other requirements** described in 903(b) are satisfied.

# EXAMPLE: CONCURRENT REG D + S

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- Telegram's Pre-Sale was conducted as concurrent offerings under Regulations D and S:

## 13. Offering and Sales Amounts

Total Offering Amount      \$850,000,000 USD or  Indefinite

Total Amount Sold          \$850,000,000 USD

Total Remaining to be Sold      \$0 USD or  Indefinite

Clarification of Response (if Necessary):

This \$850,000,000 offering was made under a claim of federal exemption under Rule 506(c) and/or Regulation S under the Securities Act of 1933.

*Source: [https://www.sec.gov/Archives/edgar/data/1729650/000095017218000030/xslFormDX01/primary\\_doc.xml](https://www.sec.gov/Archives/edgar/data/1729650/000095017218000030/xslFormDX01/primary_doc.xml)*

# BUT - INTEGRATION DOCTRINE

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- **What is it?** The SEC can treat multiple offerings under different exemptions as a single offering. In other words, **using one exemption might destroy your ability to use another, and both offerings might fail.**
- **Example:** Rule 506(c) (Regulation D) says you can openly advertise your security in the United States, but Rule 903 (Regulation S) says you can't make "directed selling efforts" in the U.S. **These rules present a potential conflict between Regulation D and Regulation S.**
  - Although the SEC has said concurrent offerings are OK, it hasn't provided clear guidance on that conflict, or what sorts of activities might cross the line and require integration of the offerings.
- How to avoid integration goes beyond the scope of this presentation—just remember you need to take certain steps to ensure you properly run concurrent offerings.

# COMPLIANT STO UNDER REG D + S

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- How long does it take? **4-8 weeks.**
- What's involved? **At a minimum:**
  - Determination of the appropriate sale structure and corporate structure
  - Implementation of appropriate corporate/governance structure
  - Preparation of a private-placement memorandum
  - Preparation of a purchase agreement
  - Preparation of necessary investor and disqualification questionnaires
  - AML/KYC checks and investor verifications
  - Filing Form D with the SEC
- Anything else? **Additional tasks may include:**
  - Review of advisory and marketing arrangements
  - Referral and bounty programs advice
  - Arrangements with STO platforms
  - Broker-dealer issues

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# BROKER-DEALER ISSUES IN STOs

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## ➤ What is a broker-dealer?

- Under U.S. law, **any person who receives compensation for marketing a security may be a broker-dealer.**
- To determine if someone is a broker-dealer, the SEC looks at the unique **facts and circumstances** of each case—**there is no bright-line rule.**
- **Factors considered include:**
  - Does the person participate in important parts of a securities transaction, such as solicitation, negotiation, or execution?
  - Is the person's compensation dependent upon or related to the outcome of the transaction?
  - Does the person otherwise engage in the business of effecting or facilitating securities transactions?
  - Does the person handle the securities or funds of others in connection with securities transactions?

## ➤ Why does it matter?

- Broker-dealers **must be registered with the SEC.**
- **The SEC can shut down an offering if even one person acting as a broker-dealer is not registered.**



# POTENTIAL BROKER-DEALERS IN STOs

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## ➤ **Advisors and Consultants**

- **STO advisors and consultants** who help market the token sale or introduce investors to the sponsors may be broker-dealers.

## ➤ **STO Platforms**

- **STO platforms** help market and process a token sale, conduct AML/KYC and accreditation checks, find investors for the sale, and collect a percentage of the purchase price.

## ➤ **Bounty Program Participants**

- **Bounty programs** offer rewards to users who complete specific tasks, such as marketing the token sale on social media.

## ➤ **Referral Program Participants**

- **Referral programs** reward users who refer investors to the token sale.

# KYC/AML ISSUES IN STOs

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- AML/KYC requirements are **separate from securities regulations** (governed by FinCen and Department of Justice in the US; similar regulations worldwide)
- DOJ recently formed a cybersecurity taskforce to bolster AML/KYC rules for virtual tokens
- Know your customer (**KYC**) checks refer to due diligence activities companies must perform to ascertain relevant information from their clients and ensure that the identities of new and existing purchasers are verified to a reasonable level of certainty
- Anti-Money Laundering (**AML**) checks are designed to prevent money laundering and to mitigate the risk that the company is being used to facilitate financial crime.

## **THINGS TO REMEMBER:**

- KYC/AML always remains responsibility of the company even if 3<sup>rd</sup> party providers are hired to perform the checks
- Always do KYC/AML checks first before accepting funds
- Have KYC/AML policy in place (and implement it!)

# SUMMARY

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# DISCLAIMER

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This presentation outline and the presentation itself are for *general* educational purposes only and are not intended to provide *specific* guidance or legal advice about what to do or not to do in any particular case. You should not rely on this general information and should seek the assistance of an attorney to help you resolve any issues.

Thank you.

# THANK YOU!

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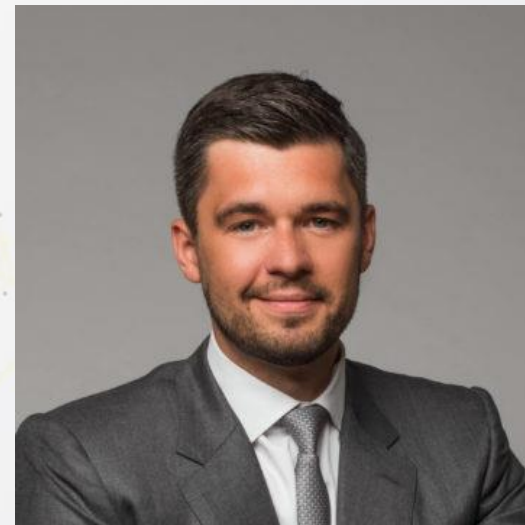


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