

Guide To Launching Security Token Offerings (STOs) In The US

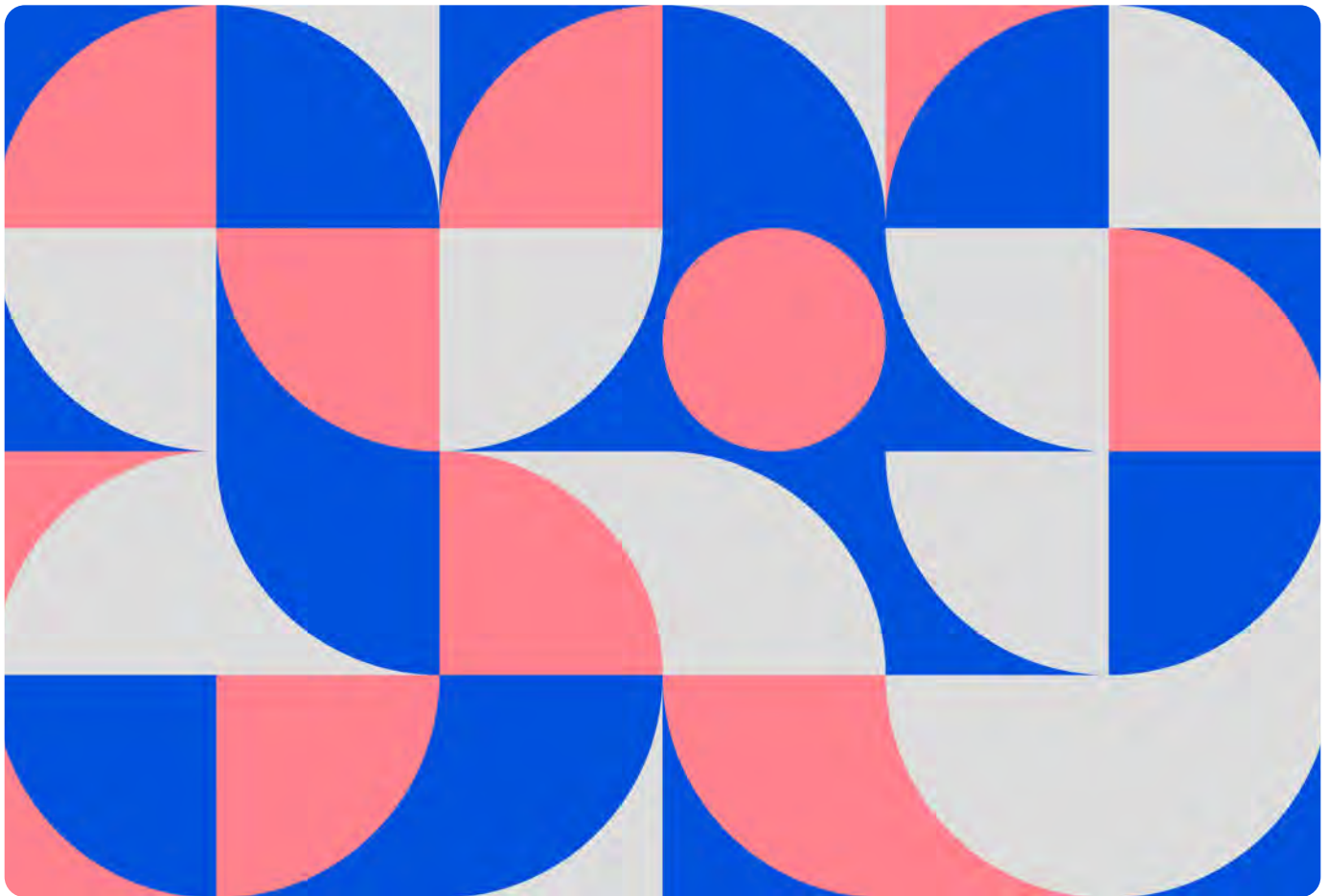


Table Of Contents

Table Of Contents	1
Security Token Offerings – Dilendorf Law Firm	2
Type Of Interest Being Tokenized	3
Place Of Incorporation	4
Corporate Structure & Governance	5
AML/KYC	6
Tokenization Platform	7
Banking	8
Exchanges/ Secondary Trading	9
Tracking Secondary Market Trades & Maintaining Cap Tables	10
Token Custody	11
Securities Regulations	12
Foreign Securities Regulations	13
Tax Consequences	14
Marketing & Press Relations	15
Time & Budget	16
Conclusion	17
Contacts	18

Security Token Offerings – Dilendorf Law Firm

Authors

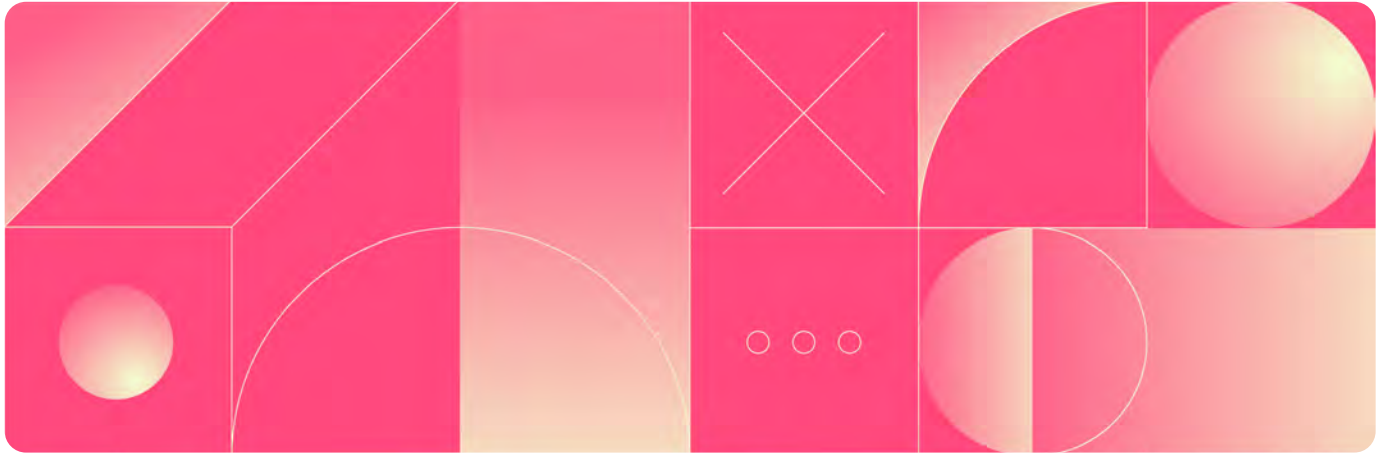
Max Dilendorf, Rika Khurdayan, Gleb Zaslavsky

As virtual tokens have come under increasing scrutiny from securities regulators and other government authorities in the United States and around the world, blockchain startups have begun to embrace the classification of virtual tokens as securities. Today, a growing number of blockchain companies are planning and launching legally compliant security tokens that look increasingly like traditional investments.

However, these companies are discovering that successfully launching a security token offering (STO) is a highly complex undertaking. The process requires careful consideration of a wide array of practical, technical, and legal aspects.

This article briefly discusses 14 key issues to consider when embarking on a journey to launch STO. Prospective issuers should review each of these considerations with their team and professional advisers to ensure that STO is well-positioned for success.

Type Of Interest Being Tokenized



Security tokens are versatile instruments in terms of what they represent. Depending on how a token is structured, it could represent any of the following interests:

- ✓ Ownership of a physical asset;
- ✓ Ownership of an equity interest in a business entity or fund;
- ✓ Ownership of a debt; or
- ✓ A right to receive distributions of income arising from a physical asset, business entity, or debt.

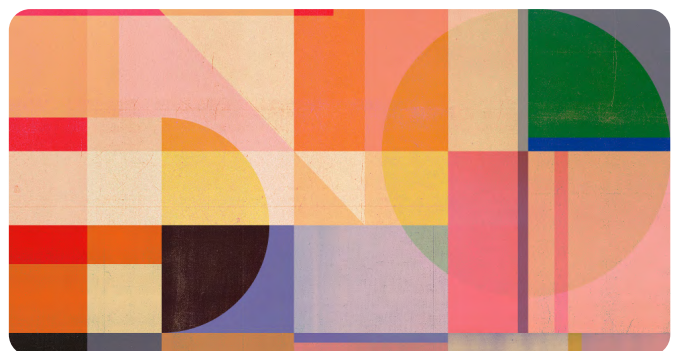
Which type of interest is tokenized affects not only the token's appeal to investors but also what legal requirements attach to it. For example, laws governing equity securities impose different requirements than those governing debt securities.

Place Of Incorporation

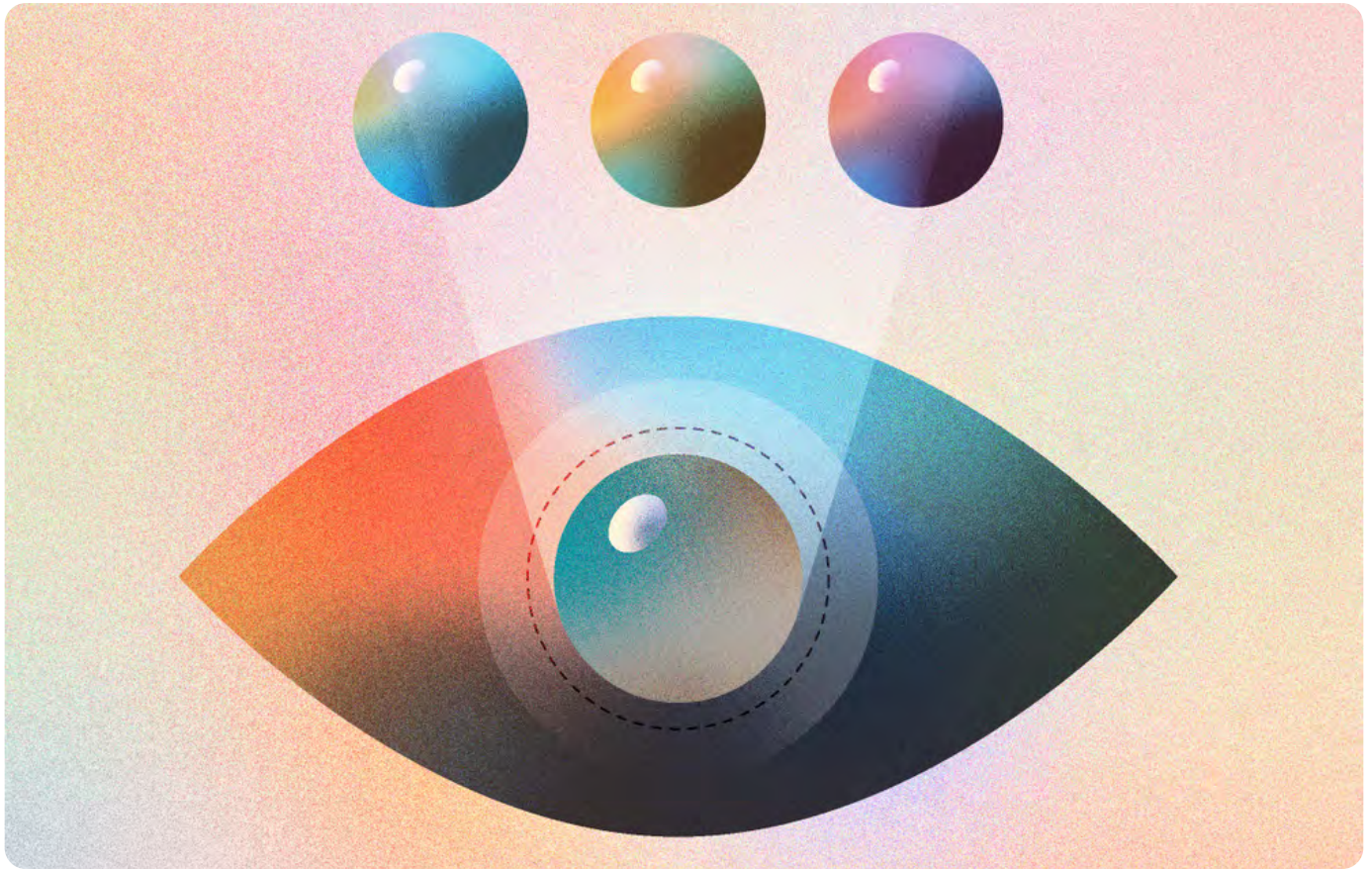
The jurisdiction in which a security token issuer incorporates can have a profound impact on STO structure. Choosing appropriate jurisdiction of incorporation of the issuer depends on many factors, including:

- ✓ The physical location of an asset/interest to be tokenized;
- ✓ The country or countries where the founders of the issuer are considered residents for tax purposes, applicable tax laws, and income-tax rates;
- ✓ Type of interest to be tokenized and classification of such interest;
- ✓ Whether the issuer is targeting U.S. investors or investors outside the U.S.;
- ✓ Whether the issuer will need access to certain banking services (g. to convert cryptocurrencies to fiat or accept fiat in exchange for its tokens);
- ✓ Marketing strategy;
- ✓ Relevant securities regulations and other applicable laws.

Token issuers should be aware of and discuss various jurisdictional factors with a knowledgeable attorney and tax advisor before choosing where to incorporate them.



Corporate Structure & Governance



Launching STO requires proper corporate structure and governance. For example, the issuance of security tokens should be authorized by the issuer's corporate documents – particularly if the tokens will resemble traditional equity securities.

In addition, the number of holders of security tokens may be limited by law. For example, some US-based tokenized funds, subject to the Investment Company Act, are limited to 99 U.S. investors. Similarly, if US issuer has more than \$10 million in assets, then its equity securities (including tokenized equity securities) can only be held by up to 2,000 investors without triggering Exchange Act reporting requirements.

The corporate structure of the issuer itself can range from one entity with the second class of securities to be tokenized, to classic securitization structures involving a special purpose vehicle (SVP) and a trustee, to various fund structures, to hybrid structures.

AML/KYC

Almost all countries impose Anti-Money Laundering and Know-Your-Customer (AML/KYC) requirements on financial businesses, including security token issuers. These requirements help ensure that the funds used to invest in security tokens have not come from illicit sources. Know-Your-Customer screening can also be essential in complying with securities and other laws. For example, some exemptions from securities registration in the United States require that tokens be sold only to “accredited investors.”

The Know-Your-Customer process is a critical step in determining which investors must also undergo the accreditation process

. Depending on the exemption from registration utilized by the issuer, the issuer might have the burden of verifying whether such U.S. investors are in fact “accredited”. Services like Verify Investor seek to serve this critical need.

In addition, KYC process allows issuers to determine whether any U.S. residents are participating in the token sale. The sale of unregistered securities in the United States is a strict liability violation: the issuer need not have known that a purchaser was from the U.S. to become liable. The only way to protect against that possibility is to engage in KYC efforts. Services like IdentityMind platform offers flexible KYC / AML compliance solutions.

Tokenization Platform

Token developers and issuers today can choose from more than two dozen online tokenization platforms, such as:

- ✓ Securitize
- ✓ Token IQ
- ✓ Blackmoon
- ✓ Tokensoft
- ✓ Harbor
- ✓ Bankex
- ✓ Polymath
- ✓ Swarm
- ✓ TokenNY

Each platform takes a unique approach to the process of tokenization, ongoing support after the token's launch, and secondary-trading issues. In addition, each platform has its own pricing model. In some cases, depending on the complexity of an offering, the price of partnering with a tokenization platform could be more than \$100,000, plus a percentage of the funds raised.

Important questions to ask about a tokenization platform before committing to it include:

- ✓ How many offerings have already been launched on the platform?
- ✓ How are token holders of record tracked during secondary trading?
- ✓ Can the platform provide the necessary tools for KYC/AML checks not only at the time of token issuance but during secondary trading?
- ✓ Does the platform hold a broker-dealer license? If not, what services does the platform provide and how is it being compensated.

Banking

To date, there are very few crypto-friendly banks in the world. That gives the few banks that offer crypto services a wide degree of discretion in setting their requirements for onboarding new clients

For example, in the Cayman Islands, establishing a crypto-friendly bank account requires conducting a thorough KYC review (collecting certified copies of passports and utility bills for all investors, directors and beneficial owners, including reference letters for individuals from high-risk jurisdictions), and, once the account is open, the bank will require to use its own custodian to hold the cryptocurrency raised through the STO.

Token issuers should understand their banking needs and research their banking options ahead of time to ensure a smooth banking process at the time of launch.



Exchanges/ Secondary Trading

To accommodate the shift in the blockchain community to compliant security token offerings, several companies have launched or are in the process of launching compliant security token exchanges (more accurately referred to as alternative trading systems or online trading platforms). In the United States, these include Templum, OpenFinance, and tZERO.

Security token exchanges are also being established in other countries. The Gibraltar Blockchain Exchange (GBX), for example, currently offers trading in major cryptocurrencies. GBX recently applied for an extension of its license to permit listing security tokens on its exchange.

Likewise, MSX, a subsidiary of the Malta Stock Exchange, recently partnered with OKEx to develop a new exchange aimed at “institutional-grade” security tokens.

When considering a platform for secondary trading, token issuers must determine whether such a platform is compliant with the local laws of the countries where it operates. Token issuers should also research the platform’s listing and KYC requirements.

Tracking Secondary Market Trades & Maintaining Cap Tables

As discussed above, various legal restrictions apply in the United States to investors who can hold certain types of security tokens, including the quantitative, residency, and time limits. To ensure compliance with these limitations, token issuers must be able to maintain a current cap table showing all holders of record of security tokens.

In general, this will require token issuers to communicate with the various exchanges on which their tokens are sold to track secondary market trading or place certain restrictions via smart contracts.



Token Custody



One of the biggest issues in the security token industry is custody. Customarily, online trading platforms have served as both marketplaces to link buyers and sellers of blockchain assets and custodians of those assets. But institutional investors have been reluctant to purchase digital assets from online trading platforms because of the security concerns and legal requirements to use qualified custodians when holding clients' funds or securities.

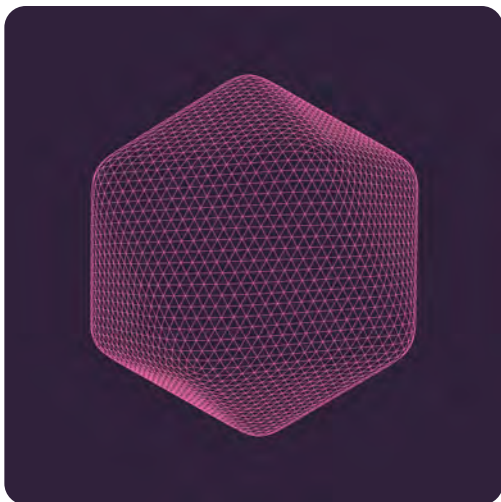
Security token issuers must be sensitive to developments in custodial solutions to be able to appeal to a broad range of potential investors and to ensure their own compliance with the law.

Securities Regulations

In the U.S., security tokens cannot be offered or sold without first being registered with the Securities and Exchange Commission (SEC), unless qualified for an exemption from registration.

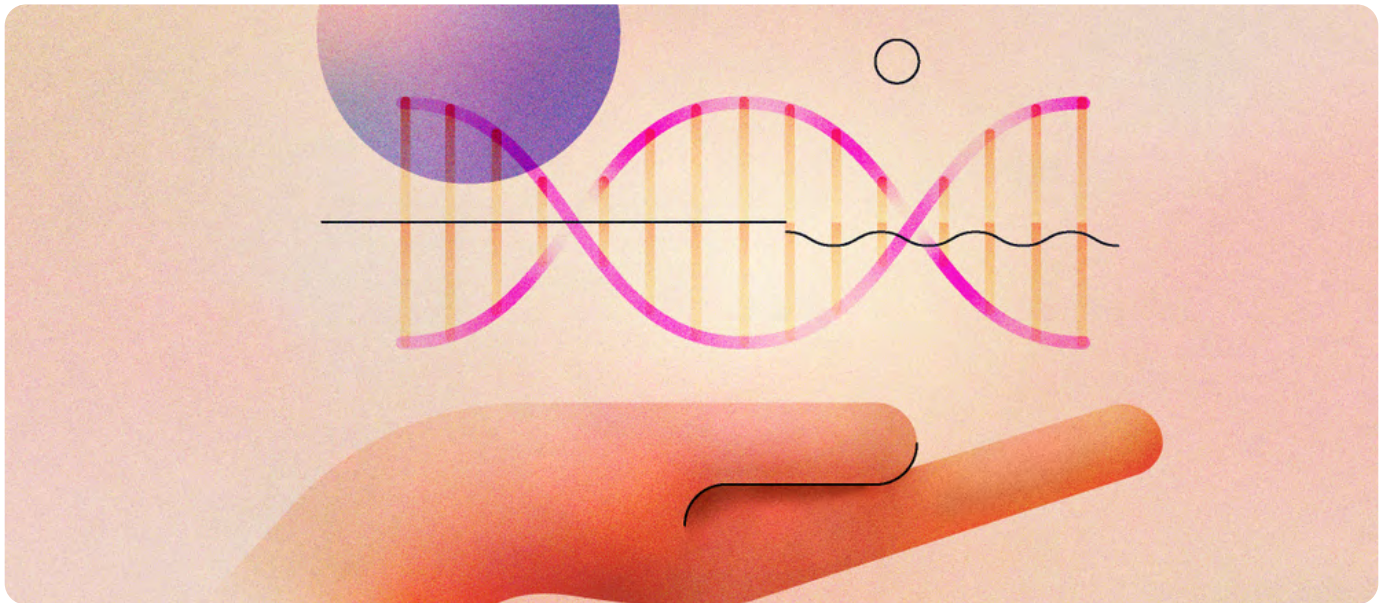
Registration is a slow and arduous process. Most of the time, issuers structure their token sales to be exempt from registration using one of the several legal exemptions available, such as:

- ✓ Regulation A+ (limited public offerings);
- ✓ Regulation CF (crowdfunding);
- ✓ Regulation D (private offerings); or
- ✓ Regulation S (foreign offerings).



Different exemptions offer different advantages and impose different restrictions. Which exemption is best in each particular case is a complex question that should be investigated with the help of an experienced lawyer.

Foreign Securities Regulations



Although the U.S. is a major market for security tokens, it is not the only one. In fact, many past token offerings prohibited the participation of U.S. residents in an effort to avoid U.S. securities regulations. However, other countries also regulate offerings of securities.

For example, because the interest rates in Japan are currently ultra-low or negative, security tokens backed by income-producing assets in the U.S. could be very appealing to Japanese investors. However, as in the United States, securities must be registered before they can be sold in Japan, and the process of registration is lengthy and expensive.

Token issuers should consult local counsel in each country where a token will be offered to ensure that the sale complies with that country's securities laws.

Tax Consequences

Token issuers must consult professional tax advisers to develop a sound tax-planning strategy in the weeks and months before an STO. Any such strategy must account for (among other issues):

- ✓ The type of tokenized interest and the rights associated with the token;
- ✓ How income generated in the token sale will be treated for tax purposes;
- ✓ What reporting and withholding requirements may apply.

For example, in a real estate tokenization deal, issuers of tokenized U.S. real estate interests must be mindful of FIRPTA – a federal law that generally requires withholding a part of the sales proceeds from U.S. real estate owned by a foreign person and remitting the withheld amount to the IRS.

The IRS issued IRS Notice 2014-21, IRB 2014-16, as guidance for individuals and businesses on the tax treatment of transactions using virtual currencies.

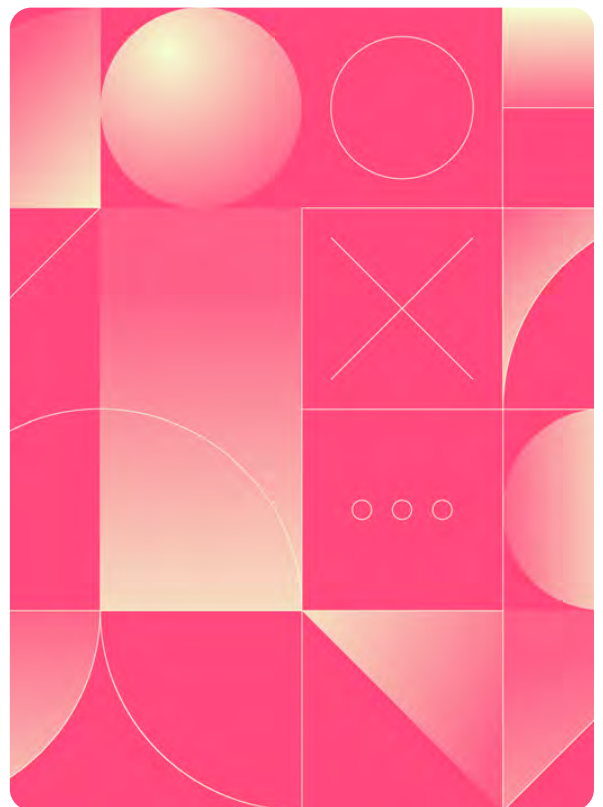
The IRS also published Frequently Asked Questions on Virtual Currency Transactions for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of selling cryptocurrency.

Marketing & Press Relations

Launching a virtual token is a business venture. As such, a comprehensive business plan should be in place before the launch. This plan should address marketing questions such as:

- ✓ Who is the target market?
- ✓ How will the issuer reach the target market?
- ✓ What competitors exist in this space?
- ✓ How much will marketing cost?
- ✓ Is the marketing of security tokens allowed by the applicable securities laws?

Marketing a virtual token may be the most expensive part of a token launch, and the marketing plan should be appropriately robust, sophisticated, and legally compliant. In the U.S. and other countries, paid promoters of security can be classified as broker-dealers. If an unregistered broker-dealer is involved in a security token offering in the U.S., the entire offering may be found invalid by regulatory authorities.



Time & Budget

Effectively structuring and implementing STO can generally take four to six months. Issuers must be ready to spend all the necessary time addressing the considerations described in this article and resolving other issues, the full list of which will depend on a particular project.

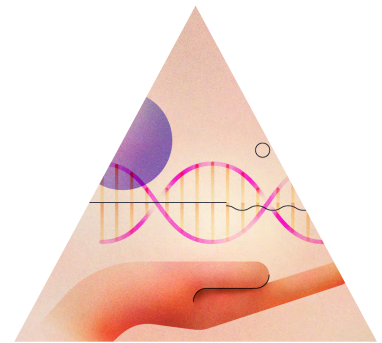
The potential for extensive delays in launching a token sale poses a financial risk for the issuer: if money is not coming in from investors or purchasers of a product or service, how can the issuer continue paying for development, platform fees, marketing, and other expenses in the meantime?

One of the solutions for a startup may be an offering under Regulation CF through existing crowdfunding platforms, like StartEngine or Indiegogo. Under Regulation CF, an issuer can raise up to \$1.07 million in a 12-month period, which it could then apply to its ongoing expenses until the formal token launch.



Conclusion

Launching a security token offering is a highly complex process that requires thorough research and careful planning. This list of 14 key considerations is just a starting point for a successful token launch and is far from being exclusive.



Contacts



Dilendorf Law Firm, PLLC

E-mail: info@dilendorf.com

Phone: 212.457.9797

Address: 85 Broad Street, New York, NY 10004



Max Dilendorf, Esq.

Partner

E-mail: md@dilendorf.com

 [@dilendorf_law](https://t.me/dilendorf_law)



Gleb Zaslavsky, LLM

Attorney

E-mail: gz@dilendorf.com