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Tokenization Interest Group Webinar Series— Digital Asset Tokenization: U.S. Securities Laws, Rules, and Regulations

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Agenda

1. Securities Act of 1933
2. Securities Exchange Act of 1934
3. Federal case law – notes, securities, and investment contracts
 - *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).
 - *Reves v. Ernst & Young*, 494 U.S. 56 (1990).
4. Examples of Financial Instruments as Securities
5. Cryptocurrencies and Digital Assets
6. Security Token Offerings
7. Ethereum Security Token Standards

United States Federal Securities Laws

1. Securities Act of 1933 (the "Securities Act")
 - The offer and sale of securities is governed by the Securities Act.
2. Securities Exchange Act of 1934 (the "Exchange Act")
 - The Exchange Act governs securities transactions in the secondary market after issue.
3. SCOTUS has repeatedly held that the definition of a "security" under the Exchange Act is virtually identical to the definition under the Securities Act. See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982).
4. What is a "security" as defined under the Securities Act?
 - "Any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." Section 2(a)(1) of the Securities Act.

SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

1. In *Howey*, the principal question facing SCOTUS was whether a land sale contract together with a service contract constituted an investment contract under Section 2(a)(1) of the Securities Act.
2. SCOTUS held that an offering of units in the citrus grove development, coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investors, was an offering of an "investment contract" under the Securities Act and was therefore subject to the registration requirements promulgated thereunder.
3. Under *Howey*, "an investment contract is a contract, transaction, or scheme whereby a person invests her money in a common enterprise and is led to expect profits solely from the efforts of the promoter[s] or third part[ies]."
4. From this canvas, we discern four elements which is known as the *Howey* test.
 - An investment of money
 - In a common enterprise
 - With the expectation of profits
 - Derived substantially from the managerial or entrepreneurial efforts of others

Reves v. Ernst & Young, 494 U.S. 56 (1990).

1. In *Reves*, SCOTUS considered if an instrument denominated as a note fell within the definition of a security. SCOTUS did not apply the *Howey* test; rather, it adopted the Family Resemblance Test, which includes the following elements—
 - The motivation of the parties to enter into the transaction.
 - The plan of distribution.
 - The reasonable expectations of the investing public.
 - The presence of an alternative regulatory scheme.
2. Under the Family Resemblance Test, a note is presumed to be a “security” unless it bears a strong family resemblance to one of the categories of instruments that are not securities, which are as follows—
 - Notes delivered in consumer financings.
 - Notes secured by a mortgage.
 - Short-term notes secured by a lien on a small business with some assets.
 - Notes evidencing unsecured bank loans to individuals.
 - Short-term notes secured by an assignment of accounts receivable.
 - Notes that formalize an open-account debt incurred in the ordinary course of business.
 - Notes evidencing loans by commercial banks for current business operations.

Examples of Financial Instruments as Securities

1. Stock
2. Notes
3. Certificates of Deposit
4. Guarantees
5. Partnership Interests and Joint Ventures
6. Limited Liability Company (LLC) Interests

SEC Guidance – Digital Assets

1. SEC Division of Corporation Finance Strategic Hub for Innovation & Financial Technology (FinHub).
2. FinHub’s Framework for “Investment Contract” Analysis of Digital Assets (the “Framework”).
3. The Framework offers guidance to assess whether a digital asset is an investment contract and whether offers and sales of digital assets are securities transactions.
4. The Framework is scoped to the third and fourth prongs of the *Howey* test (*i.e.*, reasonable expectation of profits derived from reliance on the efforts of others).
 - *Reasonable expectation of profits*
 - Capital appreciation of the initial investment.
 - Profit share, dividend rights, distributions, voting rights, transferability.
 - *Reliance on the efforts of others*
 - Does the purchaser reasonably expect to rely on the efforts of the active participant(s)?
 - Are the efforts of the active participant(s) managerial or ministerial in nature?

Security Token Offerings – Categories, Features & Options

1. Security tokens may provide key financial rights to investors, including revenue share, profit share, dividend rights, voting rights, equity interests, and debt interests.
2. Categories of security tokens include without limitation—
 - Utility tokens (closely tied to the functionality of the network or application).
 - Virtual currencies (serve as a store of value or medium of exchange).
 - Securities (asset-backed tokens that function as a claim on an underlying asset or share-like tokens where the issuer promises token holders a share in the success of the enterprise).
3. Security Token Offerings: Options
 - Regulation A / A+ (mini-IPO)
 - Rule 506(b) Private Placement
 - Rule 506(c) General Solicitation Offering
 - Rule 504 Small Issuance Offering
 - Regulation Crowdfunding

Regulation A / A+

1. Regulation A / A+ public offerings are exempt from registration.
2. Two tiers
 - Tier 1: Offerings up to \$20 million USD
 - Tier 2: Offerings up to \$75 million USD
3. Issuers must file Form 1-A with the SEC together with an offering circular.
4. Securities sold in Regulation A / A+ offerings are not restricted.

Rule 506(b) Private Placement Exemption

1. Considered a “safe harbor” that allows companies to meet the requirements of the Section 4(a)(2) exemption.
2. No general solicitations or advertising.
3. Issuers can raise an unlimited amount of money from an unlimited number of accredited investors.
4. The offering is limited to 35 non-accredited investors.
5. Rule 506(b) purchasers receive restricted securities.
6. Subject to the bad actor disqualification under Rule 506(d).
7. Issuers must file Form D with the SEC within 15 days of the first sale.

Rule 506(c) General Solicitation Offering

1. JOBS Act of 2012 permits general solicitation and general advertising for offerings.
2. All investors must be accredited investors.
3. Issuers must take reasonable steps to verify accreditation, such as W-2 or bank statements from individual investors.
4. Rule 506(c) purchasers receive restricted securities.
5. Registration statement is required.

Rule 504 Small Issuance Offering

1. Exemption for offerings that do not exceed \$10 million USD.
2. This exemption is less popular and is overlapped by Tier 1 of Regulation A / A+.
3. Subject to the bad actor disqualification under Rule 506(d).
4. Certain companies are not eligible for Rule 504 offerings, including Exchange Act reporting companies and investment companies, to name a few.

Regulation Crowdfunding

1. JOBS Act of 2012 added Section 4(a)(6) to the Securities Act, which provides an exemption from registration for crowdfunding.
2. All transactions must occur online through an SEC-registered intermediary (*i.e.*, broker-dealer or funding portal).
3. Issuers may raise a maximum amount of \$5 million USD in any 12-month period.
4. Must file Form C with SEC both pre- and post-offering.
5. Limits the amount that individual non-accredited investors may invest.
6. The crowdfunding cannot be offered by a non-US issuer, reporting company, investment company, or private fund.
7. Subject to the bad actor disqualification.

Ethereum Security Token Standards

1. ERC-1400
2. ERC-1404
3. ERC-1450
4. ERC-884
5. ST-20
6. R-Token
7. SRC-20
8. DS-Token

Tokenization Benefits

1. Automate AML / KYC onboarding.
2. Streamline due diligence and investor accreditation processes.
3. Improve cap table management and investor reporting.
4. Reduce barriers for secondary market trading.
5. Automate token controls for compliance with securities laws.
6. Reduce settlement cycles and counterparty credit risk.
7. Ledger-based tokenization of debt and equity instruments.
8. Share registration and governance of fund management.

Thank you!

- Enterprise Ethereum Alliance Tokenization Interest Group
- Feel free to submit questions to benjamin.bukari@abbaci.io
- Stay tuned for the EEA's Tokenization IG Webinar Series—
 - Webinar 2: Technical Framework
 - Webinar 3: Tokenomics Framework
 - Webinar 4: Ethical Framework
 - Webinar 5: Industry Use Cases

Get Involved !

The EEA welcomes additional input on this important work and participation in the Tokenization Interest Group. Here's more about who should join and how to get involved:

Non-EEA Members:

If you are interested in the work of the EEA Tokenization Interest Group and would like to contribute, please contact james.harsh@entethalliance.org and visit the EEA Tokenization Interest Group page: <https://entethalliance.github.io/tokenization/> .

EEA Members:

Please contact the EEA Secretariat or your member council representative. You can also log into the Member Collaboration site and join the working group to receive future meeting invitations.

Learn more about becoming an EEA Member and be sure to follow us on Twitter, LinkedIn and Facebook for all the latest.