CARLTON FIELDS

Foreign Token Sales May Be Subject to U.S. Securities Laws

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The term "token" as applied to virtual assets encompasses a wide array of technologies and financial instruments. As the popularity of virtual assets grows (and shrinks and grows), questions regarding the application of securities regulations to the issuance and sale of tokens and other virtual assets become difficult to answer. The U.S. Securities and Exchange Commission (SEC) recently issued a framework elaborating how it analyzes token sales and has published several settlements of enforcement actions that are instructive and provide guidance on the application of federal securities laws to virtual currencies.

Despite an increasing yet, still unsettled body of guidance, many mistakenly believe that limiting a token sale to foreign purchasers shields them from the reach of U.S. law. This is not the case, and token issuers must recognize that this strategy poses potential long-term risks. Practitioners dealing with tokens must consider these risks and how foreign and U.S. token issuers may mitigate the prospect of noncompliance when selling tokens outside the United States.

Under the Securities Act of 1933, a company that offers or sells a security, regardless of the form of the offering, where it is located, or to whom it is sold, must either register its securities with the SEC or otherwise qualify for an exemption from registration. Two recent announcements by the SEC offer guidance on the application of federal securities laws to token sales. Under Section 2(a)(1) of the Securities Act, a security is: any note, stock, treasury stock, security future, 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.

Unless a token represents an equity interest in a company a note, any profit-sharing interest in a company, or another of the enumerated items set forth in the definition, the determination of whether the tokens are securities requires an analysis of whether the offer and sale of these tokens constitute an "investment contract" under Section 2(a)(1) as that term has been defined under case law, interpretative releases of the SEC, and prior no-action letters.

The term "investment contract" has been broadly construed by the courts to encompass a variety of financial activities. For example, the U.S. Supreme Court's 1946 opinion in *SEC v. Howey*[1] sets forth a test with several factors for determining whether a sale constitutes an investment contract that, if applied, might subject tokens to securities regulations and registration. These include determining whether there is (1) an investment of money (2) in a common enterprise (3) where the investor has an expectation of profits from the investment (4) and the expectant profits are derived from the efforts of the promoter or third party.[2]

Thousands of judicial decisions analyze and apply the *Howey* factors to all sorts of investment contracts, but there is relatively little to no guidance analyzing how the Securities Act applies to the numerous and ever increasing types of virtual currencies. Notably, on April 3, 2019, the SEC issued its first no-action letter to a virtual currency issuer called TurnKey Jet Inc., a U.S.-based air carrier and air taxi service. The letter stated that the SEC's Division of Corporate Finance would not recommend an enforcement action if TurnKey sold its tokens without registering its offering with the SEC. The TurnKey no-action letter marks the first time the SEC has affirmatively stated that a token sale would not be deemed the sale of a "security" subject to SEC regulation and enforcement.

The facts provided by TurnKey to the SEC demonstrate that it intends to conduct a limited token sale that prevents the possibility of a secondary market for its token and that prevents the price of the token from increasing. Additionally, TurnKey's platform would be fully functional and developed upon its token's issuance, and no funds from the token sale would be used to build out the platform. Finally,TurnKey's token would be marketed for its functionality as a token to purchase air charter service rather than the potential for increasing its market value in the future.

The SEC's view that the TurnKey token is not a security is consistent with the SEC's recently published *Framework for Investment Contract Analysis of Digital Assets*, which has been criticized as leaving much uncertainty to token issuers and potentially creating an impractical set of requirements that make it difficult to develop platforms more robust and less centralized than TurnKey that require a virtual currency to operate.[3]

Second No-Action Letter

Almost four months after its first no-action letter and before expanding or clarifying its recent framework, the SEC issued a second no-action letter to Pocketful of Quarters (PoQ). Pocketful of Quarters is a cryptocurrency exchange for video game players (also known as gamers), which enables gamers to retain the Quarters they accumulate when they quit playing a certain game. In issuing its second no-action letter, the SEC focused on the same factors related to the TurnKey tokens, resulting in both the Quarters and TurnKey tokens falling outside the realm of an SEC-regulated "security." Indeed, the PoQ Quarters, like the TurnKey tokens, will be sold at a fixed price. Also, both TurnKey tokens and Quarters are intended specifically for use within their respective platforms, restricting transfers to outside platforms or wallets. Additionally, Quarter owners can use the tokens immediately for online gaming once they are sold, like those of the TurnKey's digital coins for air charter services. Finally, the Quarters, like the TurnKey tokens, will not be used to develop the respective platforms as both platforms are fully operational and developed. Hence, the limited use and restrictions rendered both TurnKey's tokens and PoQ's Quarters outside the scope of a security.

Notwithstanding the SEC's brief no-action letters, the determination of whether a token sale is or is not the sale of a security necessarily requires an analysis of the particular facts and circumstances surrounding the sale and marketing of the token offering to determine whether it is an "investment contract" under the Securities Act. Although the virtual currency industry could certainly benefit from clearer guidance and the development of case law interpreting the application of U.S. federal securities regulations on token sales, issuers could attempt to shield their offerings from U.S. oversight by limiting their token sales to only foreign purchasers. While doing so potentially eases the issuers' U.S. regulatory burden, it does not completely shield the issuer from U.S. jurisdiction and, if not done properly, may cause significant regulatory concerns for issuers who wish for their platforms to eventually have U.S. customers or users.

Registering the sale of a security with the SEC can be an impractically long and expensive process. Luckily, the Securities Act provides several registration exemptions that permit issuers to offer and sell securities without undertaking this burden. The most commonly used exemptions from registration (and most suitable for the sale of tokens that are, or could be, considered securities), are found in Rule 506(b) and 506(c) of Regulation D of the Securities Act and Regulation S of the Securities Act. Although the exemptions under Regulation D permit the sale of securities to individuals located in the United States, generally those individuals need to be "accredited investors." [4]

Under Regulation D, if the sale is to be generally advertised to the public, the issuer has an obligation to verify that all purchasers are accredited by requiring them to provide documentation evidencing they qualify as such, which can be a costly and cumbersome process. Given the income or asset threshold for qualifying as an accredited investor and the costs associated with verification, a token

sale that complies with this Regulation D safe harbor could severely restrict the pool of potential purchasers of the tokens.

For token issuers who wish to sell their token to nonaccredited investors, Regulation S provides a safe harbor from registration so long as the offer and sale of securities occur solely outside the United States (whether the buyers are U.S. or foreign investors).[5] Otherwise, the issuers will be subject to SEC regulation and enforcement. Indeed, the SEC filed an emergency action and obtained a temporary restraining order against two offshore entities, Telegram Group Inc. and its wholly owned subsidiary TON Issuer Inc., which offer a cloud-based mobile and desktop messaging application, as well as media, chat, security options, and data encryption solutions.[6] The SEC's complaint provides that Telegram and TON conducted an alleged unregistered, ongoing digital token offering in the United States and overseas of its cryptocurrency, the Gram, at discounted prices to 171 initial purchasers, including more than one billion Grams to 39 U.S. purchasers.[7] The SEC is now seeking injunctive reliefs and penalties against Telegram and TON for violation of the Securities Act.[8]

Regulation S Compliance

However, issuers can benefit from Regulation S by complying with two basic conditions. First, the offer and sale of the securities must be made in an offshore transaction, meaning, the offer to buy must not have been made to a person in the United States, and either the buyer is, or is reasonably believed to be, physically located outside the United States, or the transaction is executed on an offshore market. Second, there can be no "directed selling efforts" in or into the United States of the securities offered under Regulation S.[9]

To reasonably ensure that tokens are sold in offshore transactions and that no directed selling efforts in or into the United States are made, the issuer should restrict persons located in the United States from participating in the token sale and not market the tokens, or the platform in which they will be used, in the United States. It may also be good practice to prevent sales to investors registered, or that reside, in the United States, even if at the time of purchase those individuals were located outside the United States, in order to further ensure that the transactions occurred offshore.

For an offering to meet the requirements of the safe harbor of Regulation S, additional conditions also may need to be satisfied, depending on the status of the issuer, the type of securities offered, and the likelihood that the securities will flow into the United States. For a company with no public market for its securities on an exchange prior to the offering to comply with Regulation S, the company must take reasonable steps to restrict any resales of the security into the United States for a period of one year.[10] Moreover, in order to reasonably ensure that the tokens do not flow into the United States within this one-year period, the issuer should, where possible, create technical barriers that enforce applicable restrictions on transfers to U.S. wallet holders. Additionally, if the issuer lists

the tokens on an exchange, a conservative approach would be to make sure the exchange does not accept U.S. accounts to prevent any resale into the United States.

Issuers of tokens sold outside the United States may be subject to federal securities laws if the token sale meets the SEC's definition of an "investment contract." Whether such a sale would be considered the sale of a security is a complicated question that often yields unclear answers. As a result of this uncertainty, issuers may be tempted to domesticate their sale offshore in order to comply with the foreign sale of securities registration exemption contained in Regulation S of the Securities Act.

These issuers should take the following steps to ensure that they are not in violation of U.S. rules: implement IP address restrictions to prevent potential purchasers located in the United States from purchasing the tokens and reject potential purchasers who use technology that would obscure their Internet Protocol addresses like TOR, proxy servers, virtual private networks, or anonymizing technology; do not market the token or the platform in the United States; prevent any sales to purchasers registered, or that reside, in the United States, even if at the time of purchase these individuals were located outside the United States, to further ensure that the transactions occurred offshore; create smart contracts or impose other mechanisms that restrict the sale of the tokens into the United States or to a U.S.-located person for a period of one year after issuance; and list only the tokens on an exchange that, pursuant to its terms of use and listing contract, does not accept any U.S. accounts or that can segregate U.S. accounts and U.S. persons from purchasers who are provided an opportunity to purchase tokens.

If the SEC determines that the issuer has taken sufficient steps to prevent a security sold in an offshore transaction from redomesticating to the United States, it will be deemed to have complied with the safe harbor provisions of Regulation S, and the sale would not be a violation of U.S. federal securities laws.

Related Practices

Blockchain and Digital Currency

accuracy or completeness of this outside information, nor is the inclusion of a link to be intended as an endorsement of those outside sites.