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SEC Qualifies First Token Offerings Under Regulation A

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On July 10 and July 11, 2019, the US Securities and Exchange Commission (the SEC) qualified the Regulation A token offerings of Blockstack PBC and YouNow, Inc., nearly two years after the *DAO Report* and a year and half after Chairman Jay Clayton stated that he had yet to see an ICO that did not have a sufficient number of hallmarks of a security. The offerings were qualified under Tier 2 of Regulation A and cover: (1) for Blockstack the offer and sale of Stack Tokens to current holders of non-binding vouchers, to qualified purchasers and the distribution of the Stack Tokens for non-cash consideration pursuant to the issuer's bounty program; and (2) YouNow to distribute up to $50 million Prop Tokens as in-app rewards.

The qualifications represent an exciting milestone for the blockchain industry, potentially creating an alternative path for financing the development of blockchain networks and distributing digital assets via Regulation A. However, whether Regulation A represents a viable and efficient path for offerings and distributions of digital assets continues to hinge on further regulatory action.

The path to qualification for both companies involved a lengthy timeline due to the SEC staff's review and comment process associated with qualification of Form 1-As. Blockstack filed an initial non-public draft offering statement on September 13, 2018. The 10 month review and comment process likely followed many months of preparing the offering circular disclosures, including audited financial statements, prior to the initial filing. Blockstack disclosed costs of the offering as $2.8 million. Qualified offerings will also have ongoing reporting obligations for at least one year from qualification pursuant to the rules governing Regulation A, Tier 2 offerings. It is clear from the amendments to the issuer's respective Form 1-A's and correspondence letters with the SEC, that blockchain companies are fully capable of satisfying the SEC's regulatory disclosure requirements.

> The extended and uncertain timeline and costs associated with the SEC disclosure review process may cause many issuers to eschew the Regulation A alternative. Both of the companies that had Form 1-As recently qualified had raised capital in prior fundraisings, which may have given them the financial runway required to pursue Regulation A. Although the SEC is not a merit regulator, meaning that they do not pass upon the merits of a particular investment, the staff have the authority to require any disclosures deemed material to achieve "full and fair" disclosure so that an investor can make an informed investment decision. This authority, however, can result in significant delays to qualification of a Regulation A filing (or a registration statement that is subject to the same review) as the staff determines what may be material in the case of novel and unique investments, such as a digital asset that may not have a true issuer, among other disclosure challenges. Now that some have been qualified, will the staff's familiarity with these disclosures and the underlying technology potentially streamline and shorten this process?

Blockstack disclosed in the offering circular: "If the Stacks Tokens are issued, there may not be a trading market available for the Stacks Tokens, or any digital token exchange on which holders of Stacks Tokens may transfer or resell their Stacks Tokens. As a result of recent regulatory developments, existing crypto exchanges are currently unwilling to list tokens such as the Stacks Tokens that may be deemed as securities under federal securities law. As a result, the tokens may initially only be traded on very limited range of venues, including US registered exchanges or regulated alternative trading systems for which a Form ATS has been properly submitted to the SEC." The disclosure continues by noting that "As far as we are aware, there are currently no national securities exchanges or exchanges that have been approved by the [FINRA] or registered under Form ATS with the SEC… to support the trading of Stacks Tokens on the secondary market."

> A significant challenge to the viability of Regulation A as an option for utility tokens seeking regulatory certainty or true security tokens is the lack of secondary markets noted by Blockstack. On this point exactly, the SEC and the Financial Industry Regulatory Authority (FINRA) released a joint statement on July 8, 2019, identifying some of the regulatory issues both are considering regarding the custody of digital assets by broker-dealers operating a registered exchange or ATS and intermediation of digital asset transactions. Unfortunately, the statement provided little insight and no resolution, but rather it summarized the various issues and regulatory questions that FINRA applicants have highlighted for FINRA and SEC staff for months, leaving many to wonder if the joint statement was simply a statement designed to communicate to the industry that they are aware of the legal and regulatory issues that must be addressed, but that they need more time to issue guidance that will allow FINRA broker-dealer applicants and ATS platforms to launch and begin to support trading in digital securities. Until there is guidance in these areas, the many companies reported to be ready and waiting for FINRA approval will be unable to provide the platforms and tools needed to support a viable and liquid secondary market for tokens treated as securities, and, as a result, it is unclear how those utilizing Regulation A will provide developers, miners or users with monetization options or incentives to drive growth and adoption.

Blockstack's disclosure states that it "anticipates treating the Stack Tokens as securities based on our view that the tokens are 'investment contracts' under the recent guidance provided by the SEC 'Framework for 'Investment Contract' Analysis of Digital Assets' … and the application of the test under [*Howey*]." Blockstack's offering also emphasizes the issuer's intention for the Stack Tokens to "transform" at some point into the future so as to no longer qualify as securities, describes the efforts it will take to achieve this (see below) and that the company's board intends to make this determination, triggering among other things the end of reporting obligations. The board will base this decision upon "whether the Blockstack network is sufficiently decentralized," which will in part "depend on whether purchasers of Stack Tokens reasonably expect Blockstack to carry out essential managerial or entrepreneurial efforts, and whether Blockstack retains a degree of power over the governance of the network such that its material non-public information may be of special relevance to the future of the Blockstack network."

> Blockstack's analysis of when a token transforms to no longer be a security draws heavily from FinHub's April 3 Framework for "Investment Contract" Analysis of Digital Assets and may provide insight into the primary considerations the SEC will weigh when evaluating whether a digital asset has "transformed" from security to non-security. This disclosure continues to articulate the SEC staff's views, expressed in the Framework and by Director William Hinman in his June 2018 speech that a digital asset, initially classified as a security and subject to securities laws, can later be offered and sold as a non-security over time. We agree that it is the manner of offer and sale that may result in an "investment contract" as opposed the the digital asset itself, in most cases, being an enumerated security. Like Blockstack and its legal advisors (we assume), we have no indication, let alone clarity, from the SEC staff as to the point at which such a transformation may occur or which of the Framework's 30 factors may, alone or in combination, trigger such a flip. Until the SEC clarifies the point of "transformation" blockchain companies interested in conducting token offerings in the US under Regulation A will face similar uncertainty as to the future status of their tokens as securities as those that used other means of financing their network or application. Those seeking to utilize Regulation A may ultimately submit themselves to the discretion and consent of SEC staff that such a triggering point has been reached, putting the SEC in the role of merit regulator rather than arbiter of "full and fair disclosure," which would be a significant departure from the staff's statutory mandate and its core mission.

The qualifications of token offerings pursuant to Regulation A represent a welcome alternative to private placements and foreign offerings, though all remain viable options for blockchain-based projects to consider. However, the uncertainty surrounding the future status of tokens as securities and lack of secondary trading markets may limit, for now, the overall viability of Regulation A for sale or distribution of digital assets. For the security token market to develop as a meaningful alternative for digital asset projects, the SEC and FINRA must still address the various legal issues identified in their July joint statement to allow compliant trading platforms,

broker-dealers and other financial intermediaries necessary to support liquid and efficient markets for digital securities.

Notes

1. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO,* Exchange Act Release No. 81207 (July 25, 2017).

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