McDermott Will & Emery

Special Report

# DIGITAL TOKEN OFFERINGS AND SALES UNDER REGULATION S

McDermott Will & Emery

SPECIAL REPORT


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Since the inception of Bitcoin in 2009, certain digital tokens (often referred to as cryptocurrencies[1]) have been popularized as secure, decentralized and private alternatives to government-controlled currencies. More recently, various other kinds of blockchain "tokens," representing many different kinds of assets, services or rights, have been offered in initial coin offerings (ICOs). Although certain cryptocurrencies and some other blockchain tokens may not be securities as defined in the federal and state securities laws, many blockchain tokens, in view of the rights they represent, the manner in which they are marketed and the expectations of purchasers, constitute securities. If that characterization applies, offers and sales of these types of tokens must be made in a transaction registered under Section 5 of the Securities Act of 1933 (Securities Act), pursuant to an exemption from those registration requirements or in an offshore transaction that is not subject to the Securities Act.[2] This *Special Report* discusses potential options for structuring ICOs of tokens that constitute securities as offerings and sales pursuant to Regulation S under the Securities Act, which provides a useful safe harbor for certain offshore transactions.

## OVERVIEW OF REGULATION S

The US Securities and Exchange Commission (SEC) adopted Regulation S to clarify the application of the Securities Act registration requirements (US Registration Requirements) outside the United States and its territories.[3] Regulation S consists of five rules:

1. Rule 901, which sets forth the general statement that the US Registration Requirements apply only to "offers and sales" of securities that occur within the United States and its territories;
2. Rule 902, which sets forth definitions for Regulation S;
3. Rule 903, which provides a safe harbor for transactions involving issuances of securities that comply with specified guidelines (Primary Offer Safe Harbor);
4. Rule 904, which provides a safe harbor for offshore resales that comply with specified guidelines (Secondary Market Safe Harbor); and
5. Rule 905, which provides that equity securities of US domestic issuers sold in compliance with the requirements of the Primary Offer Safe Harbor are deemed "restricted securities" as defined in Rule 144 under the Securities Act and subject to holding periods (and related requirements) before they can be resold without restriction in the United States.

Given its structure as a "safe harbor" rule, Regulation S does not comprehensively prescribe when an offer or sale of a security is deemed to occur outside of the United States, but instead establishes criteria to take advantage of the safe harbor. Under this approach, a transaction that does not comply entirely with a safe harbor may still not cause a violation of the US Registration Requirements.[4] Also, the Regulation S safe harbors may not be available for transactions that are technically in compliance with Regulation S but are part of a "scheme to evade" the US Registration Requirements.

## THE PRIMARY OFFER SAFE HARBOR

Qualifying for the Primary Offer Safe Harbor requires that:

1. An offer and sale be made in an "offshore transaction";
2. No "directed selling efforts" be made in the United States by the issuer or its affiliates, any distributor or their affiliates or any person acting on behalf of the foregoing; and
3. Any additional requirement for transactions classified as "Category 1," "Category 2" or "Category 3" under the regulation are satisfied.[5]

## WHAT IS AN "OFFSHORE TRANSACTION"?

A transaction qualifies as an "offshore transaction" for purposes of the Primary Offer Safe Harbor if (1) no offer has been made to a person located in the United States and (2) either (A) when the buy order is originated, the buyer either is or is reasonably believed to be physically located outside of

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1 Cryptocurrency, expressed in a virtual currency or token, is a "digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account or store of value." SEC Investor Bulletin: Initial Coin Offerings (July 25, 2017).

2 If offers and sales are made in the United States, compliance may also be required with state "blue sky" laws.

3. *Offshore Offers and Sales*, Securities Act Release No. 33-6863 (April 24, 1990) (referred to below as the *Regulation S Promulgating Release*), text at note 1.

4 See the brief discussion of the implication of the Supreme Court's Morrison opinion under "Other Considerations" at the end of this Special Report for more information.

5 For a description of the category classifications, see below at "Who Can Make an ICO Offering Complying with One of the Categories?"

the United States or (B) the transaction is executed in or through a physical trading floor of an established foreign securities exchange that is located outside the United States.

### WHAT ARE DIRECTED SELLING EFFORTS?

"Directed selling efforts" are activities that have the purpose, or could reasonably be expected to have the effect, of "conditioning the market" for the sale of the offered securities in the United States.

When it promulgated Regulation S, the SEC noted that "mailing printed materials to US investors, conducting promotional seminars in the United States or placing advertisements with radio or television stations broadcasting into the United States or publications with a general circulation in the United States" would all reasonably be expected to condition the US market and be a prohibited directed selling effort.[6] After the advent of the Internet, the SEC outlined measures an issuer relying on Regulation S should take when posting online in order to avoid making a "directed selling effort" to the United States.[7] These measures include a prominent disclaimer on the issuer's website clearly indicating that the offer is directed only to investors in foreign countries and implementation of procedures that guard against sales to US persons, such as a requirement that the mailing address or telephone number of a purchaser be provided prior to any sale of the offered securities. On the other hand, solicitations that, by their content, appear to target US persons, such as mentions made regarding the ability to avoid US income taxes on the investment, may be considered to condition the US market and to be prohibited directed selling effort. Given the complexity in determining what constitutes directed selling efforts, issuers and their distributors should consult counsel on the subject.

### WHO IS COVERED BY THE PRIMARY OFFER SAFE HARBOR?

The Primary Offer Safe Harbor is available to not only issuers and their affiliates but also to "distributors" and their affiliates. "Distributors" are "underwriters," "dealers" or any "person who participates pursuant to a contractual arrangement" in the distribution of the securities in question.

### WHO CAN MAKE AN ICO OFFERING COMPLYING WITH ONE OF THE CATEGORIES?

*Category 1*

Transactions are eligible for Category 1, which imposes the fewest restrictions, if, as relevant here, the issuer is a "foreign private issuer" that reasonably believes there is no substantial US market interest (SUSMI) in its securities.[8]

### WHAT IS A FOREIGN PRIVATE ISSUER?

Generally, a "foreign private issuer" is a national of a foreign country or an entity organized under the laws of a foreign country, except for an entity as to which "as of the last business day of its most recently completed second fiscal quarter" (1) more than 50 percent of the outstanding voting securities were directly or indirectly owned of record by residents of the United States and (2) either (A) a majority of the executive officers or directors were US residents or citizens, (B) more than 50 percent of the assets were in the United States or (C) the business was administered principally in the United States.[9] As used in this *Special Report*, "US issuer" means a non-governmental issuer that is not a foreign private issuer.

### WHAT IS SUSMI?

So long as a foreign issuer reasonably believes that no SUSMI exists with respect to the offered securities, this requirement of Category 1 is satisfied. SUSMI turns upon whether a security is an equity security or debt security. Although "debt securities" and "equity securities" are both defined in Rule 902 of Regulation S, determination of which category a digital token fits into may not be straightforward and will require a close examination of the characteristics of each token offering.[10]

For equity securities, SUSMI means either (1) securities in which the single largest market for the class of those securities is the aggregated securities exchanges and inter-dealer quotation systems of the United States as measured for the shorter of the issuer's prior fiscal year or the period since the issuer's organization or (2) securities for which 20 percent or more of all trading in the class of the securities

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6 Regulation S Promulgating Release, text at note 49.

7 "Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore," Release Nos. 33-7516, 34-39779, IA-1710, IC-23071; International Series Release No. 1125 (March 23, 1998).

8 Foreign government entities may also qualify for Category 1. However, this Special Report does not treat offerings by governmental entities.

9 The relevant definitions contain additional details and are subject to interpretations by the SEC staff that should be discussed with counsel.

10 The basic components of the definitions of "equity" and "debt" securities are outlined in Appendix A.

occur in or through securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of trading occurs in or through any single foreign country's securities markets, measured for the shorter of the issuer's prior fiscal year or the period since the issuer's organization.

For debt securities, SUSMI means that (1) the debt securities of the issuer are in the aggregate held of record by 300 or more US persons, (2) US persons hold of record at least $1 billion or more of the outstanding principal balance and liquidation preference or par value (in the case of nonconvertible preferred stock) of the issuer's debt securities and (3) US persons hold of record at least 20 percent or more of the outstanding principal balance and liquidation preference of the issuer's debt securities.

### "OVERSEAS DIRECTED OFFERING" ALTERNATIVE IF SUSMI IS PRESENT

If SUSMI exists, an alternative to obtain Category 1 treatment is to conduct an "overseas directed offering," which is an offering (1) directed to the residents of only one country other than the United States and (2) made in accordance with the local laws and customary practices and documentation of that country.[11] We believe the overseas directed offering alternative may not be attractive in an ICO by a US issuer because a US issuer may use the option only for an offering of nonconvertible debt securities that are not denominated in, or convertible into, US dollars or their equivalent.[12] While a foreign issuer may use the option for any security, regardless of whether it is debt or equity or denominated in dollars, we believe the "single country" limitation will frequently render it unattractive in that case as well.

*Category 2*

As noted above, Category 2 is available for offerings by certain issuers when Category 1 is not because of the existence of SUSMI. Category 2 is available for sales of (1) equity securities by a foreign issuer that files periodic reports with the SEC under the Securities Exchange Act of 1934 (Exchange Act), (2) debt securities by a US issuer that files periodic reports with the SEC under the Exchange Act and (3) debt securities by a foreign issuer regardless of whether it files reports under the Exchange Act.

The additional requirements that apply to Category 2 offerings are described below.

*Category 3*

Category 3 is available for offerings that do not qualify for Categories 1 and 2. These are sales of (1) equity securities by any US issuer, regardless of the presence of SUSMI and the issuer's Exchange Act reporting status, and (2) equity securities of foreign issuers and debt securities of US issuers when SUSMI is present and the issuer does not file periodic reports with the SEC under the Exchange Act. Because it is likely that an issuer will file periodic reports with the SEC under the Exchange Act when SUSMI is present (although that may not be the case), Category 3 predominantly applies to sales of equity securities by US issuers.

The additional requirements that apply to Category 3 offerings are described below.

### PRIMARY OFFER SAFE HARBOR REQUIREMENTS AND RESTRICTIONS BY CATEGORY

In addition to the always-applicable requirements that the offer and sale occur in an offshore transaction without the use of directed selling efforts, the following additional requirements apply by category.

*Category 1*

In a Category 1 offering, no additional requirements apply and the issuer is not required to impose restrictions on subsequent transfers of the securities that the issuer sells. However, as discussed further below,[13] we strongly recommend that the issuer include in its subscription documentation a representation that the purchaser is not purchasing the tokens with a view to resell them in the United States. In a Category 1 offering it is *not* required that an offeree/purchaser be a "non-US person," but in order to comply with the offshore transaction requirement, it *is* required that the person who receives the offer and transmits the buy order is offshore, or reasonably believed by the issuer and its distributors to be

[11] Note, however, that the European Union qualifies as a "single country" for this purpose.

[12] We note, however, that if an ICO of a debt security is denominated solely in a cryptocurrency such as Bitcoin, which is not denominated or convertible into dollars, a domestic issuer may be practically able to engage in an overseas directed offering.

[13] See the discussion below under "The Secondary Market Safe Harbor -- Resales of Securities Sold in Category 1 Primary Offerings."

offshore, both when the offering materials are received and when the buy order is transmitted.[14]

*Category 2*

In a Category 2 offering, "offering restrictions" must be imposed during a 40-day "distribution compliance period."

As it applies to a Category 2 offering, the "offering restriction" requirement specifies that all offering materials and documents (other than press releases) used in connection with offers and sales of the securities prior to the expiration of the distribution compliance period include statements to the effect that the securities have not been registered under the Securities Act and may not be reoffered or resold in the United States or to US persons (other than distributors) unless the securities are registered under the Securities Act or a registration exemption is available. Those statements must appear (1) on the cover or inside cover page of any prospectus or offering circular (including a white paper) used in connection with the offer or sale of the securities, (2) in the underwriting section of any prospectus or offering circular used in connection with the offer or sale of the securities and (3) in any advertisement made or issued by the issuer, any distributor, any of their respective affiliates or any person acting on behalf of either the issuer or a distributor. These statements must be included in communications made over the Internet and recorded communications made to potential investors.

A "distributor" (which may not exist in an ICO) is an underwriter, dealer or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered or sold in reliance on this Regulation S. If a distributor exists, in order to satisfy the offering restriction requirement it must agree that (1) all offers and sales of the securities prior to the expiration of the distribution compliance period will be made only in accordance with the primary or secondary market restrictions imposed by Regulation S, pursuant to registration of the securities pursuant to the US Registration Requirements or pursuant to an available exemption from the US Registration Requirements and (2) in the case of offers and sales of equity securities of US issuers, not to engage in hedging transactions with regard to those securities prior to the expiration of the distribution compliance period unless in compliance with the Securities Act's requirements.[15]

*Category 3*

In a Category 3 offering, additional restrictions must be imposed, with greater restrictions on offerings of equity securities than offerings of debt securities. Also, if the offering is of equity securities by a US issuer, special resale restrictions apply to all holders of the securities until the passage of specified time periods. These restrictions are designed to prevent an issuer in a Category 3 offering from evading the protections that the Securities Act imposes on the unrestricted resale in the United States of securities that are not registered under the Securities Act.

*Equity Securities*

The distribution compliance period for equity securities sold in a Category 3 transaction (either by a US issuer or a foreign private issuer that does not file periodic reports with the SEC under the Exchange Act) is either one year or, if the securities are issued by a US issuer that files periodic reports with the SEC under the Exchange Act, six months.[16] With regard to offering restrictions, in addition to the requirements that apply to a Category 2 offering, in offers and sales of equity securities by US issuers, the offering materials and other documents must state that hedging transactions involving the securities may not be conducted unless in compliance with the Securities Act.

During the distribution compliance period, offers or sales of equity securities by the issuer under Category 3 may not be made to a US person or for the account or benefit of a US person (other than a distributor). In addition, in offers or sales of equity securities made before the expiration of the distribution compliance period,

1. The purchaser (other than a distributor) must certify that it (a) is not a US person and is not acquiring the securities for the account or benefit of any US person or (b) is a US person who purchased

[14] We do not describe here the Regulation S definition of "US person," except to note that in the case of individuals the definition keys off residency rather than citizenship. Issuers should consult knowledgeable counsel concerning that definition in connection with applying Regulation S.

[15] The applicable hedging transaction restrictions are complex and beyond the scope of this *Special Report*.

[16] As previously noted, a foreign private issuer that files periodic reports with the SEC under the Exchange Act may offer and sell equity securities under Category 2.

securities in a transaction that did not require registration under the Securities Act;[17]

2. The purchaser must agree to resell the securities only in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration and that it will not engage in hedging transactions with regard to the securities unless in compliance with the Securities Act;

3. In the case of securities of a US issuer, the securities must contain a legend to the effect that transfer is prohibited except in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration and that hedging transactions involving the securities may not be conducted unless in compliance with the Securities Act;

4. The issuer must, either by contract or a provision in its bylaws, articles, charter or comparable document, refuse to register any transfer of the securities not made in accordance with the Regulation S restrictions, pursuant to registration under the Securities Act or pursuant to an available registration exemption (provided that if the securities are in bearer form or foreign law prevents the issuer of the securities from refusing to register securities transfers, other reasonable procedures such as a legend described in 3 above are implemented to prevent any transfer of the securities not made in accordance with the requirements of Regulation S);[18] and

5. Each distributor selling securities to a distributor, a dealer (as defined in the Exchange Act) or person receiving a selling concession, fee or other remuneration must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.

In further reinforcement of these requirements, Rule 905 of Regulation S provides that equity securities sold by a US issuer under Category 3 are "restricted securities" as defined in the SEC's Rule 144 under the Securities Act (which provides a safe harbor for the resale of securities issued in the United States in a transaction that does not require registration under the Securities Act), regardless of how those securities are acquired. That means that a purchaser from the issuer or subsequent owner is at risk for liability as a "statutory underwriter" if the holder transfers the equity securities to another person without complying with the US Registration Requirements or a registration exemption such as Rule 144. Rule 144 provides a nonexclusive safe harbor under which holders who are not affiliated with the issuer can freely resell the securities in the United States after a period of one year (or six months if the issuer files periodic reports under the Exchange Act) from the purchase from the issuer or one of its affiliates. Persons who acquire the securities from an unaffiliated purchaser, either in a resale under the Regulation S secondary market safe harbor (described below), a private secondary market resale in the United States or by gift, can generally "tack" their Rule 144 holding periods with the holding periods of predecessor owners.[19]

*Debt Securities*

As previously noted, with respect to debt securities, Category 3 applies only to sales by a non-reporting US issuer. In such an offering, during a 40-day distribution compliance period:

1. The offer or sale by the issuer must not be made to a US person or for the account or benefit of a US person (other than a distributor);

2. The securities must be represented upon issuance by a temporary global security that is not exchangeable for definitive securities (*i.e.*, securities that may be held directly by their owner or the owner's nominee) until (a) the expiration of the distribution compliance period and (b), if the

[17] The allowance of a resale to a US person pursuant to a US registration exemption may appear to contradict the requirement that a sale may be made by the issuer under Regulation S only to a person that is not a US person (other than a distributor) and not for the benefit of a US person, but there is no actual inconsistency. The issuer itself may not sell to a US person (other than a distributor), but a distributor may sell to a US person in an exempt transaction if that person agrees that it may engage in resales in the United States only pursuant to a registration or an applicable exemption. This is consistent with the general principle that sales can be made simultaneously under Regulation S and in the United States in a registered offering or pursuant to a registration exemption.

[18] Implementing these restrictions in an ICO may not be straightforward.

[19] Various complexities can arise in the interpretation of Rule 144 and other resale exemptions, and holders of equity securities sold by a US issuer in a Regulation S offering should consult counsel before reselling their securities in a transaction that does not utilize the Secondary Market Safe Harbor.

exchange is requested by a person who is not a distributor, until certification of beneficial ownership of the securities by a non-US person or by a US person who purchased the securities in a transaction that did not require registration under the Securities Act; and

3. Each distributor selling securities to a distributor, a dealer (as defined in the Exchange Act) or a person receiving a selling concession, fee or other remuneration in respect of the securities must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.

## CONSEQUENCES OF A FAILURE TO SATISFY ISSUER SAFE HARBOR REQUIREMENTS

If the issuer, distributor or any of their respective affiliates engage in directed selling efforts in the United States, the Primary Offer Safe Harbor becomes unavailable for that offering. By contrast, noncompliance with the other requirements of the Primary Offer Safe Harbor makes the safe harbor unavailable only for the noncompliant entity, its affiliates or persons acting on its behalf.[20]

## THE SECONDARY MARKET SAFE HARBOR

The Secondary Market Safe Harbor, set forth in Rule 904 of Regulation S, applies to resales of securities that occur outside the United States. The Secondary Market Safe Harbor applies to any offshore transaction in a security regardless of whether that security was issued in reliance on the Primary Offer Safe Harbor. As a result, if a digital token was originally issued in the United States in reliance upon a private placement or other exemption, the resale of that token is eligible for the Secondary Market Safe Harbor and use of the Secondary Market Safe Harbor would not impact the validity of the initial exemption.

## RESALES OF SECURITIES SOLD IN CATEGORY 1 PRIMARY OFFERINGS[21]

When the resold securities were acquired in a Category 1 offering (or a subsequent secondary market transaction), resales can generally be freely made under the Secondary Market Safe Harbor if the resale both occurs in an "offshore transaction" and does not involve any directed selling efforts. However, in the case of a resale by an officer or director of the issuer or a distributor, under the Secondary Market Safe Harbor no selling concession or fee may be paid in connection with a resale other than a usual and customary broker's commission.

The Secondary Market Safe Harbor does not apply to sales that actually occur in the United States or to transactions in which there have been directed selling efforts. Correlatively, the SEC has indicated that Category 1 purchasers should not assume that their US resales will qualify for the Securities Act exemption that applies to "transactions by any person other than an issuer, underwriter, or dealer" in securities.[22] That could be significant for a purchaser because the Securities Act definition of "underwriter" includes "any person who purchased from an issuer with a view to … the distribution of any security...." As a result, if a person other than the issuer or a "distributor" engaged by the issuer to sell tokens on the issuer's behalf purchases a security in a Category 1 offering with a "view to" deliberately reselling the security into the United States, that person could be a "statutory underwriter" who is not entitled to rely on the Securities Act exemption for sales in the United States by a person who is not an underwriter. An issuer and its distributors are generally not responsible for actions or intentions of a purchaser that might make the purchaser a statutory underwriter (*i.e.*, a purchaser's status as a possible statutory underwriter should not affect the issuer's right to rely on the Category 1 Primary Offer Safe Harbor for the initial issuance) if the issuer and its distributors sell securities in a Category 1 offering to a person that they believe in good faith does not have an intention to resell those securities in the United States. However, an issuer's or distributor's knowledge or reckless disregard of indications that a purchaser intends to resell into the United States market could obviate the issuer's or distributor's ability to rely on the Category 1 Primary Offer Safe Harbor. Accordingly, we strongly recommend that an issuer include in its Category 1 subscription materials a representation that the purchaser is not purchasing with a view to reselling the securities in the United States. This *Special Report* is not directed to persons who might be statutory underwriters, and any person who thinks she or he might be a statutory underwriter should

[20] Regulation S promulgating release at note 109.

[21] Additional requirements that we do not describe in this *Special Report* apply to offerings of convertible securities and warrants.

[22] Section 4(a)(1) of the Securities Act.

consult counsel before engaging in resales that would not qualify for the Secondary Market Safe Harbor.

### RESALES OF SECURITIES SOLD IN CATEGORY 2 OR 3 PRIMARY OFFERINGS

In addition to the resale restrictions, in a Category 2 or Category 3 resale Rule 904 of Regulation S requires that until the expiration of the applicable distribution compliance period, (1) a dealer (as defined in the Exchange Act) or a person receiving a selling concession, fee or other remuneration in respect of the securities offered or sold must not know (and any person acting on its behalf must not know) that the buyer is a US person and (2) if the seller or any person acting on the seller's behalf knows that the purchaser is a dealer or a person receiving a selling concession, fee or other remuneration in respect of the securities sold, the seller or a person acting on the seller's behalf must send to the purchaser a confirmation or other notice stating that the securities may be offered and sold during the distribution compliance period only in accordance with Regulation S, pursuant to registration of the securities under the Securities Act or pursuant to an available registration exemption. As noted above in the discussion of the Primary Offering Safe Harbor as it applies to Category 3, other restrictions that affect resale rights must be imposed by the issuer in order to comply with Category 3.

## OTHER ASPECTS OF REGULATION S

### SCHEME TO EVADE

The Regulation S safe harbors are not available for "any transaction or series of transactions" that, despite its "technical compliance" with Regulation S, is conducted as a "scheme to evade" the US Registration Requirements. While the SEC has identified some scenarios that constitute a "scheme to evade," analysis of whether any particular token transaction constitutes a "scheme to evade" such that it would prevent reliance on Regulation S is a fact-intensive undertaking.

### SIMULTANEOUS OFFERINGS IN THE UNITED STATES

Offshore transactions made in compliance with Regulation S will not be integrated with registered or exempt US domestic offerings, whether or not conducted contemporaneously with a Regulation S offering. Therefore, a Regulation S ICO can be conducted concurrently with a registered or properly exempt token offering of the same securities in the United States. Among others, permitted offerings in the United States include a "public private" offering under Rule 506(c) of Regulation D under the Securities Act and public offerings under Regulation A+. However, if the Regulation S offering is continuous and extends beyond the development of a secondary market in the United States, or if the Regulation S offering is intermittent and recommences after the development of a US secondary market, it may be necessary to reassess the existence of SUSMI and the effect, if SUSMI exists, on the availability of the Regulation S safe harbor.

### INVESTMENT COMPANY ACT INTERACTIONS

Special requirements and prohibitions apply to securities offerings by entities that are either investment companies as defined in the US Investment Company Act of 1940 or exempted from investment company status by virtue of one of the so-called "private investment company" exemptions under that Act. All issuers of digital tokens should obtain advice of counsel to determine whether concerns of that kind apply to a token issuer.

### OTHER CONSIDERATIONS

Transactions in securities that take place offshore may not be subject to the provisions of the US securities laws at all. In *Morrison v. National Australia Bank*,[23] the US Supreme Court held that Section 10(b) of the Exchange Act (the principal anti-fraud provision of the Exchange Act) does not provide a right to sue in transactions that take place outside of the United States. Many have taken the view that the Court's reasoning applies to the US securities laws generally except when Congress affirmatively calls for offshore application in statutory language. In *Morrison*, the Court, overturning many years of lower court interpretation, laid down a new "transactional" rule that Section 10(b) reaches only "transactions in securities on domestic exchanges, and domestic transactions in other securities." The implications of *Morrison* are still being played out, and we note that Congress subsequently amended the Exchange Act and the Securities Act to provide, in the view of most securities practitioners, that in enforcement actions the SEC can exercise jurisdiction over offshore transactions in certain circumstances. However, if the case ever arises, there is a distinct possibility that a court would hold that, as a matter of statutory interpretation, the US

[23] 561 US 247 (2010).

Registration Requirements do not apply to at least as broad a class of offshore transactions as those permitted by the Regulation S safe harbors.

It is also important to note that, assuming the tokens are securities, other registration rules, laws and regulations may come into play. For example, the Exchange Act regulates broker-dealers and securities exchanges, and it remains unsettled whether blockchain transfer mechanisms fall within the definitions of either of those terms when transactions occur in the United States. Also, if tokens that constitute securities are held by the requisite numbers of investors,[24] the issuer may be required to register as a public company under the Exchange Act, subjecting the issuer to ongoing reporting, proxy rules and other requirements. Although those Exchange Act requirements may be reduced in the case of foreign issuers that meet defined requirements, knowledgeable counsel should be consulted in that connection. Finally, subject to the holding of the US Supreme Court in the *Morrison* decision, certain anti-fraud provisions of the US securities law, including Section 10(b) of the Exchange Act and the SEC's Rule 10b-5 under Section 10(b), may apply to a token offering or subsequent token trading, potentially giving rise to both private rights of action and enforcement proceedings by the SEC. As a result, issuers of tokens that are securities should consult knowledgeable counsel to assure that their disclosures in connection with token issuances are accurate.

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This discussion is highly general and should not be relied upon without consultation with knowledgeable counsel. For further information, please contact your regular McDermott lawyer or one of the key contacts.

## +APPENDIX A

Regulation S Definition of Equity and Debt Securities

Under Regulation S, a security is either an equity security or a debt security—there is no third or "in between" option. Under Regulation S, a debt security is any security that is not an equity security as defined in Rule 405 under the Securities Act, provided that the following are debt securities under Regulation S, regardless of whether they would otherwise be equity securities under Rule 405: "(1) Non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer" and (2) "asset-backed securities." Regulation S further defines "asset-backed" security with more specificity, but we do not provide those more detailed provisions here because we believe it unlikely that a blockchain token would be an asset-backed security.

In turn, Securities Act Rule 405 defines "equity security" as: "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so."

[24] The requisite number of investors to require Exchange Act registration is either 2,000 holders of record or 500 holders of record who are not "accredited investors" (as defined under Rule 501 of Regulation D under the Securities Act).

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