

TOKENS AND CROWDFUNDING: A PERFECT MATCH?

Ruth Hughes*and Ken Wang**

*Associate Professor of Business Law, Wilkes University, Wilkes-Barre, PA 18766

**Assistant Professor of Finance, Wilkes University, Wilkes-Barre, PA 18766

Abstract

The JOBS Act of 2012 and the resulting Regulation CF implemented by the Securities and Exchange Commission created a new exemption for securities offerings under the Securities Act of 1933: Equity Crowdfunding. Under this exemption issuers may conduct securities offerings using registered internet platforms. The rationale of the legislation was to create new funding opportunities for businesses that had never had access to the equity market for capital, including small and emerging ventures.

Equity Crowdfunding allows issuers to choose the type of security offered and data collected since the exemption implementation in May 2016 shows a variety of innovative securities being offered. Among the most recent securities appearing in offering filings are securitized tokens. The first crowdfunding issued that involved a token happened December 29, 2017. Since then 18 others have filed with a securitized token tied to their funding with six of the 19 showing successful outcomes. This article examines the rise in token crowdfunding as well as the risks and benefits of using token offerings. The conclusion focuses on the use of token offering to provide a consistent secondary market for crowdfunding issuers

I *Introduction to Crowdfunding*

Background

The Securities Act of 1933 requires that issuers register with the SEC any “sale of securities” but includes several statutory exemptions from this requirement.¹ The listed exemptions resulted from extensive negotiation and compromise, in particular with those legislators who felt that cumbersome registration would slow any recovery in the financial market.² Thus, the Act prioritized disclosure to any offering to investors needing the most protection, either because of lack of sophistication or numbers of investors involved.³ In general, the Act made a distinction between “public” and “private” offerings, requiring full offering registration only with a public offering.⁴

Crowdfunding, or the solicitation of financing from many investors using the Internet, began organically as small entities and nonprofits used websites to allow people to fund their ventures in return for some tangible or intangible reward, but not ownership equity.⁵ Because these entities were not selling “securities” as defined by the Securities Act of 1933, the solicitations were not covered by the registration requirements.⁶ In particular the traditional definition of “investment contract” used by the SEC to determine whether an offering is subject to the 1933 Act registration requirement would not

¹ 15 U.S.C. 77D(a)(6); See also Landis *supra* note 41, at 30.

² See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, at 37 which described the process of separating “public offerings” from “private offerings”, the latter of which became one category of exemption from 1933 Act registration as currently codified at 15 U.S.C. 77d(a)(2).

³ Landis *supra* at 37. Milton Cohen, “*Truth in Securities Revisited*”, 79 HARV. L. REV. 1340 (1965), 1348. Other transaction exemptions can be found at 15 U.S.C. 77d(a)(1)-(5), (7).

⁴ Landis *supra* at 37.

⁵ CROWDFUNDING: A GUIDE TO RAISING CAPITAL ON THE INTERNET, 10 (Steven Dresner, ed. 2014); R. Kevin Saunders II, Note, *Power to the People: How the SEC Can Empower the Crowd*, 16 VAND. J. ENT & TECH. L. 945, 951-2 (2014).

⁶ See, David Mashburn, *The Anti Crowd Pleaser: Fixing the Crowdfund Act’s Hidden Risks and Inadequate Remedies*, 63 EMORY L. J. 127, 135-139 for a good summary of the origins of crowdfunding and the ability to raise money without registration requirements.

apply.⁷ Thus, small businesses used these “reward based” crowdfunding websites to raise money for startup, growth or other capital needs without having to register any offering under the 1933 Act.⁸

In 2012 Congress passed the Jumpstart Our Business Startups Act (JOBS Act) which, among other things, created a new transaction exemption under the 1933 Act for equity offerings using crowdfunding.⁹ In allowing crowdfunding portals to sell equity securities, small businesses now have the opportunity to raise significantly more capital at a lower cost than with reward crowdfunding.¹⁰ Some commentators have also applauded the increased access for small investors to equity investment opportunities through crowdfunding.¹¹

However, this specific exemption for what would otherwise be considered a public offering has arguably made the line drawn between “private” and “public” offerings made in the original 1933 Act a bit less clear.¹² Thus, the legislation and Securities and Exchange Commission (SEC) regulations have tried to balance this desired access to capital and investment opportunities with the goals of disclosure at the foundation of the 1933 Act. The JOBS Act requires that all equity crowdfunding offerings be made through an “intermediary” registered as a broker-dealer under the Securities Exchange Act of 1934.¹³ These registered intermediaries must monitor any issuer using their online sites to ensure that the issuer is providing all disclosures required by crowdfunding regulations.¹⁴

The law includes mandatory disclosure for crowdfunding issuers, in keeping with that central premise of the 1933 Act.¹⁵ In drafting the regulations, one key issue was the appropriate amount of disclosure to require, balancing the needs of the issuer with the goal of adequately informing all investors of key risks.¹⁶ In the final version of the legislation and regulation, required disclosure is substantially less than that required of a full registration, but still ensures that prospective investors get information about the issuer.¹⁷ However, rather than being reviewed and enforced by the SEC, the regulations rely on the intermediary to ensure that disclosure from the issuer to the public is adequate and that individuals are aware of all risks of investment.¹⁸

Lack of regulation of securities types

⁷ C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 8 (2012) which notes the offerings of rewards would not fit the definition given in *SEC v. Howey* for an “investment contract” which is also the traditional definition used for a security subject to the 1933 Act registration requirement. Howey states that an “investment contract” is “an investment of money in a common enterprise with an expectation of profits arising solely from the efforts of the promoter or third party”. While the term “solely” has been changed by the courts to “significantly”, the definition otherwise has been unchanged over the years. Bradford at 8.

⁸ See e.g., Bradford *supra* at 2.

⁹ See JOBS Act, Pub. L. No. 112-106, 126 Stat 306 section 3012 (2012) adding section 4 (a) (6) of the Securities Act of 1933, 15 U.S.C. section 77 (d) (a) (6).

¹⁰ See, Gregory C. Dreschler, “Wisdom of the Intermediary Crowd: What the Proposed Rules mean for Ambitious Crowdfunding Intermediaries” 58 ST. LOUIS L. J. 1145 which cites President Obama’s praise for the Act allowing “ordinary Americans to go online and invest in entrepreneurs the believe in”.

¹¹ See e.g. Usha Rodrigues, *Securities Law Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013), Jeff Thomas, *Making Equity Crowdfunding Work for the Unaccredited Crowd*, 4 HARVARD BUSINESS LAW REVIEW ONLINE 62, 63-4 (2014).

¹² Robert Thompson and Donald Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013) has a good overview of the debate over this line of demarcation and the relationship between the 1933 Act and the JOBS Act.

¹³ 15 U.S.C. 77d(a)(6)(C).

¹⁴ 17 C.F.R. 227.301.

¹⁵ 15 U.S.C. 77d(a)(d)(3), 17 C.F.R. 227.201

¹⁶ Joan MacLeod Heminway, *The Disclosure Debates: The Regulatory Power of an Informed Public*, 38 VT. L.REV. 827,844-847 (2014); R. Kevin Saunders, *Power to the People: How the SEC Can Empower the Crowd*, 16 VAND. J. ENT & TECH. L. 945, 970-971 (2014).

¹⁷ 15 U.S.C. 77d(a)(d)(3); 17 C.F.R. 227.201.

¹⁸ Michael Vignone, *Inside Equity Based Crowdfunding: Online Financing Alternatives for Small Business*, 91 CHI-KENT L. REV. 804, (2016).

The 1933 Act has never attempted to regulate the types of securities offered, but has focused instead on disclosure to ensure that investors have adequate information to evaluate all risks of investment.¹⁹ The JOBS Act, after discussion, also allows issuers to use any investment vehicle as long as they give the appropriate disclosure to investors.²⁰ As of August 2018, data shows that equity crowdfunding offerings vary in the types of investment being offered. In addition to traditional offerings, such as common stock, promissory notes, limited liability company units and partnership units, offerings have included Simple Agreements for Future Equity (SAFE's), Simple Agreements for Future Tokens (SAFT's) and Securitized Tokens.²¹ The recent trend in offering securitized tokens will be the focus of this article.

Lack of Secondary Market

Regulation CF requires that any purchaser of a security purchased in a crowdfunding campaign must agree not to sell that security for at least 12 months.²² While this requirement is a regulatory obstacle to investors, the larger obstacle is that the lack of a platform for secondary trading once that 12 month period is lifted.²³ Under the current system, investors must rely on a purely private market of potential purchasers for their securities.²⁴ If one assumes that crowdfunding investors are motivated by the same desire for investment value growth and liquidity,²⁵ the current system does not provide those benefits to investors.

Slow Growth of Crowdfunding

Both the popular and academic press have lamented the disappointing lack of growth and enthusiasm for Regulation CF Crowdfunding.²⁶ The consensus in both circles is that the regulatory burdens are too time consuming and costly for both issuers and intermediaries.²⁷ However, firms are still registering as broker-dealers to become Regulation CF intermediaries indicating that the industry sees promise for

¹⁹ Landis, *supra* note 2, at 34.

²⁰ Joseph M. Green and John F. Coyle, *Crowdfunding and the Not So Safe SAFE*, 102 VA L. REV. ONLINE 168,169 explains that the SEC made a conscious decision not to restrict the type of securities, trying to ensure maximum flexibility for issuers.

²¹ Data retrieved from Form C's filed between May 16, 2016 and August 31, 2018 at www.sec.gov. All issuers using Regulation CF crowdfunding exemption to sell securities must file a Form C with the SEC that includes information about the issuer and the offering.

²² 17 C.F.R. section 227.501; For a good discussion of the resale restrictions, see Joan Heminway, *Selling Crowdfunded Equity: A New Frontier*, 70 OKLA. L. REV. 189, 200-201 (2017).

²³ Heminway, *supra* at note 22, 208-212.

²⁴ Similar to the traditional market for private placements, which have no platform, secondary trades are nothing more than individually negotiated agreements.

²⁵ See eg, Sabrina Howell, Marina Niessner and David Yermack, *Initial Coin Offerings: Financing Growth with Cryptocurrency Token Sales*, European Corporate Governance Institute (ECGI) Finance Working Paper no. 564/2018 (2018) www.ecgi.org/wp.

²⁶ See eg, Jo Won, *Jumpstart Regulation Crowdfunding: What is Wrong and How to Fix It*, 22 Lewis & Clark L. Rev. 1393 (2018), *Have the Wheels Fallen Off Regulation CF Crowdfunding*, April 19, 2017 retrieved from <https://www.crowdfundinsider.com/2017/04/98769-wheels-fallen-off-reg-cf-crowdfunding/>
Why Equity Crowdfunding Is Not Living Up to the Hype, Inc. Magazine, May 9, 2018, retrieved from <https://www.inc.com/associated-press/equity-crowdfunding-investing-business-not-working-hype-investors-regulation-sec.html>.

²⁷ *Id.* Won, *supra*, points out that while international crowdfunding campaigns have grown dramatically while US crowdfunding under Regulation CF has raised “less than 1% of the capital raised under the other crowdfunding models.” He cites the reason as the “substantial transaction costs associated with complying with its disclosure requirements, which were not required under the other crowdfunding models” Won at 1405.

Regulation CF Crowdfunding ventures and for that market.²⁸ While federal regulators and industry officials have met to discuss the situation, Regulation CF requirements have not changed.²⁹ Without any prospect of a regulatory structural change, intermediaries need to innovate in order to boost interest in these Regulation CF offerings. Use of digital securities and the attendant platforms may be one such innovation.

II Rise of Token Offerings in Crowdfunding

Summary of Token Offerings

Tokens are a subcategory of digitally traded assets that typically use a decentralized system of verification to identify and verify the assets.³⁰ Security tokens are those that have been identified as having the characteristics of a “security” using the Howey test.³¹ The Howey test, enunciated by the United States Supreme³²Court states that any investment contract is a “security”, and therefore subject to regulation under federal law, if it is an investment of money in a common enterprise with the expectation of profit from the efforts of others.³³ While the SEC has recently issued one no action letter indicating that a specific token offering was not a “security”³⁴, the trend in enforcement has been to assume that most token offerings are indeed securities offerings.³⁵ In particular, tokens offered on digital platforms are “numbered entries on a blockchain-based electronic ledger. These ledger entries may indeed be structured to look very much like traditional ‘securities’-representing promises to pay amounts in the future, ownership, and other interests in an entity, etc. ...”.³⁶

Blockchain plays an important role in token offerings. Blockchain, also known as Distributed Ledger Technology, was first introduced in 2009 by an anonymous source.³⁷ As described in a recent article, blockchain is “a kind of distributed ledger. It is ‘distributed’ in that there is no master copy. Any participant in the network can maintain an instantiation of the ledger, yet be confident that it matches all

²⁸ As of January 2019, there were a total of 46 FINRA approved Regulation CF funding portals (also known as intermediaries).

²⁹ Crowdfund Insider reported that the SEC and the North American Securities Administrators Association (NASAA) as well as representative crowdfunding intermediaries had met to discuss the situation. “Have the Wheels Fallen Off” *supra* at note 26.

³⁰ The SEC has provided the definition of tokens in a variety of recent statements and opinions, including, for example, the Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017, available at <https://www.sec.gov/litigation/investreport/34-81207.pdf> (commonly known as the DAO Report); *See also*, “Digital Asset Transactions: When Howey Met Gary (Plastic)”, June 14, 2018 Speech by William Hinman, Director of Corporation Finance, SEC, made at the Yahoo Finance All Markets Summit: Crypto retrieved from <https://www.sec.gov/news/speech/speech-hinman-061418> .

³¹ *See* Crosser, *Initial Coin Offerings as Investment Contract: Are Blockchain Utility Tokens, Securities*, 67 U. KAN. L. REV. 379 (2018) and Michael Mendelson, *From Initial Coin Offerings to Security Tokens, A U.S. Federal Securities Law Analysis*, 22 STAN. TECH. L. REV. 52 (2019)

³² The SEC in the DAO Report, *supra* note 30, issued a strong opinion stating that token offerings could be securities and if defined as such would be subject to regulation.

³³ *Securities and Exchange Commission vs. WJ Howey Co*, et al, 328 U.S. 293 (1946).

³⁴ TurnKey Jet, Inc. SEC No-Action Letter, April 3, 2019 retrieved from <http://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm> . This letter noted that the specific use of funds, structure of the tokens and other unique aspects of the offering as support for its opinion that the tokens being sold were not “securities”.

³⁵ *See e.g.* DAO Report, *supra* note 30 , Hinman Speech *supra* note 30. *See also*, Joshua Ashely Klayman, “Mutually Assured Disruption: The Rise of the Security Token” in BLOCKCHAIN AND CRYPTOCURRENCY REGULATION 2019, 62(Global Legal Insights 2019).

³⁶ Joshua Ashley Klayman, Lewis Rinaudo Cohen and Robin Sosnow, *There are Two Sides to the Initial Coin Offering Debate*, (Oct. 31, 2017), available at <https://www.crowdfundinsider.com/2017/10/123863-perspective-two-sides-initial-coin-offering-debate/>.

³⁷ *See* Kevin Werbach, *Trust but Verify: Why the Blockchain Needs the Law*, 33 BERKELEY TECH.L. J. 487, 489,498 (2018). Crypto lore has identified the “inventor” of Blockchain as Satoshi Nakamoto.

the others.³⁸ One of the benefits of using distributed ledger technology is that the transactions are verified by multiple, unaffiliated parties if the ledger records all transactions on a public, transparent system.³⁹

Token Offerings in Crowdfunding

Since Regulation CF does not restrict the types of securities offered by issuers, crowdfunding campaigns have had a variety of securities offered. While debate in the academic and regulatory community has raged about whether a token is a “security”, Issuers and Intermediaries in crowdfunding offerings have acknowledged that their token offerings are securities offerings by complying with applicable law.⁴⁰

The first security token was offered in December 2017 by Medchain, Inc. Medchain is a very early stage software company focusing on the healthcare industry and was seeking in this offering to raise capital to invest in technology research and development.⁴¹ Medchain’s offering of a Simple Agreement for Future Tokens (SAFT) raised \$ 467,396 from investors.⁴² The Simple Agreement for Future Tokens, a protocol developed by a group at Protocol Labs/Cooley, allows an issuer to solicit funds in anticipation of a larger, future investment.⁴³ Subsequent crowdfunding offerings have moved away from the SAFT format and instead are offering opportunities to invest directly in Security Tokens or Securitized Tokens.⁴⁴ Since that initial token offering, 18 other issuers have filed with the SEC for token offerings under Regulation CF. 6 of these offerings have successfully raised funds, 2 have officially withdrawn offerings and 11 have not provided updates.⁴⁵

Because tokens are digital securities, the offering, there is no instrument other than the digital code; the issuer and investor enter into a virtual investment contract with terms disclosed in the offering document.⁴⁶ For example, in the case of the Epigen, Inc. offering of securitized tokens, Epigen offered a fixed number of tokens that are given revenue sharing rights based on the issuer meeting certain financial benchmarks.⁴⁷ The tokens do not give investors any direct ownership interest in that case and so do not allow investors any role in corporate governance.⁴⁸

Risks and Benefits of Tokens

³⁸ *Id.* At 500.

³⁹ *Id.* at 502-3. In addition, on pages 510-11, the author explains that “With the blockchain, every new block reconciles its transactions across the entire system. Each participant knows that its copy of the ledger is identical to every other. The truth-or what scientists call the network’s ‘state’ - is shared among them.”

⁴⁰ For examples of the debate, *See eg* Crosser *supra* note 31; Jonathon Rohr, Aaron Wright, *Blockchain-based Token Sales, Initial Coin Offerings and the Democratization of Public Capital Markets* 70 HASTINGS L. J. 463 (2019).

⁴¹ MedChain Offering Memorandum filed on December 29, 2017 with the SEC.

at <https://www.sec.gov/Archives/edgar/data/1726640/000166516017000720/offeringmemoformc.pdf>.

⁴² MedChain Offering Memorandum *Supra*.

⁴³ Juan Batiz Benet, Jesse Clayburgh, Marco Santori, *The SAFT Project: Toward a Compliant Token Sale Framework*, October 2, 2017 Whitepaper published by Protocol Labs. The SAFT is similar to the Simple Agreement for Future Equity described at the beginning of this paper. However, unlike the SAFE, investors under a SAFT are never promised any ownership in the company but only tokens to “cash in” for future growth.

⁴⁴ One reason for this shift may be the recognition that the SAFT does not offer the benefit to investors that investing directly in a token would. *See*, Anthony Zeoli, *Initial Coin Offerings: Why the SAFT is DEAD*, www.crowdfundinsider.com/2018/03/131044-initial-coin-offerings-why-the-saft-is-dead/ which argues the original rationale for the SAFT was to allow issuers to avoid securities regulation. Since the SEC has taken the position that tokens and thus also SAFT’s are securities in most cases, the SAFT serves no purpose. It should be noted that MedChain complied with federal securities regulation by complying with Regulation CF in its offering.

⁴⁵ Data retrieved from Form C’s filed between 5/16/16 and 8/31/2108 at www.sec.gov.

⁴⁶ *See eg* Offering Memorandum Part II of Offering Statement (Exhibit to Form C) for EpigenCare, Inc. retrieved from <https://www.sec.gov/Archives/edgar/data/1727821/000166516018000222/offeringmemoformc.pdf>.

⁴⁷ *Id.*

⁴⁸ *Id.*

Tokens offer benefits to an early stage issuer, but also pose risks.⁴⁹ Risks of token investment include the risk of fraud, breach of security, an uncertain regulatory environment and investor confusion.⁵⁰ Investment in digital assets have particular risks related to their nature since they are so new and may be more vulnerable to economic downturns than other types of securities.⁵¹ Security of the digital assets depends on the distributed ledger technology platform used to hold and, eventually, transfer token. Epigen, for example, uses the Ethereum network for its token transaction mechanism; that network, like any network, is subject to disruption, breach or an eventual incompatibility with the digital assets being offered.⁵² However, as noted by Epigen in its offering memorandum, issuers could move the tokens to another blockchain network.⁵³

Despite the risks, issuers and intermediaries have gravitated to tokens for their benefits. As discussed previously, Regulation CF campaigns have not resulted in the capital growth anticipated and intermediaries have sought innovative ways to try and generate excitement in the financial markets for these offerings.⁵⁴ As discussed below, token offerings may have the characteristics needed to generate the excitement needed. Token offerings, as part of the growing FinTech financial market, tap into certain investors' desire to invest in an innovative, albeit speculative, type of security.⁵⁵ Under the "herd theory" that investor excitement of an innovation in the financial markets should multiply to create additional interest in token offerings, because of their innovative nature.⁵⁶

Since these token offerings do not give any ownership stake in the company, either present or future, small, early stage issuers do not have to worry about corporate governance. One concern with crowdfunding has been the burden on new ventures that find themselves suddenly with large numbers of shareholders.⁵⁷ Although the JOBS Act exempts companies using the crowdfunding exemption from registration as a public company, the corporation is still responsible for all duties to shareholders under state law.⁵⁸

⁴⁹ Statistics from Regulation CF filings show that the vast majority of issuers have less than 3 years in operation and that many are in the first year of operation.

⁵⁰ See, William Magnuson, *Regulating Fintech*, 71 VAND. L. REV. 1167 for a good discussion of risks related to the FinTech industry, including digital assets such as tokens. See also, for example, the risks listed in the EpigenCare Offering Memorandum *supra* note 46 which states that "There is unpredictability regarding regulations for blockchain and cryptocurrency related or derived assets" explaining that there is a lack of clarity in current government regulations, as well as the potential for manipulation by "unsavory third parties" in the digital market.

⁵¹ *Id.* At 1172.

⁵² Epigen Offering *supra* at note 46.

⁵³ *Id.*

⁵⁴ See eg "Indiegogo Has Quietly Exited Equity Crowdfunding", <https://www.crowdfundinsider.com/2019/03/145226-indiegogo-has-quietly-exited-crowdfunding/>

Indiegogo, one of the leaders in reward crowdfunding, was expected to be an equally large presence in equity crowdfunding, but decided to withdraw as an intermediary. The article notes that because of the regulations and the relatively small cap on offerings, "Investment crowdfunding platforms are looking to scale by becoming broker-dealers and issuing securities under Reg D and A+."

⁵⁵ Magnuson, *supra* at note 50 at 1183.

⁵⁶ https://www.investopedia.com/university/behavioral_finance/behavioral8.asp.

⁵⁷ See e.g. J.W. Verret, *Uber-ized Corporate Law: Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications*, 41 IOWA J. CORP. L. 927, 930.

⁵⁸ Regulation CF Rule 12g-6 exempts crowdfunding issuers from registration under the Securities Exchange Act of 1934. The SEC in its final rule adoption explains that companies that would otherwise be required to register are exempt "provided the issuer is current in its ongoing annual report required..., has total assets at the end of its last fiscal year not in excess of \$25 million and has engaged the services of a transfer agent registered with the commission...".

[https://www.sec.gov/rules/final/2015/33-9975 at 482-483](https://www.sec.gov/rules/final/2015/33-9975%20at%20482-483). In contrast with token offerings, those companies offering ownership positions, such as common stock offerings, would generally have to comply with state corporation laws giving shareholders the right to elect directors at an annual meeting, potentially allowing the shareholders control over the operations of the company. See Model Business Corporation Act (2016 revision enacted on December 9, 2016), Section 8.03.

Another potential benefit derives from the accounting categorization of tokens. If tokens are not categorized as liabilities on a balance sheet, the early stage issuer financial statements appear stronger and not burdened by debt. While United States and international accounting standards have yet to develop a standard for cryptoasset accounting, all of the governing bodies recognize that tokens are not a liability, but would be categorized most likely as an intangible asset for the purchaser and equity investment by the issuer.⁵⁹

Token offerings also have an inherent benefit in the ability to have third party verification of these securities. The role of distributed ledger technology (also known as blockchain) gives investors some sense of confidence of a third party verification of the tokens with any future trading or transactions. This potential platform for a secondary market for crowdfunding issued securities may be the most potent benefit for issuers. In particular, the distributed ledger technology may allow for development for a trading platform available to all token investors in crowdfunding campaigns; a platform not necessarily available for other types of securities.

III Alternative Trading Systems

As noted previously in this paper, investors, including early stage investors such as those in crowdfunding, value liquidity.⁶⁰ This focus on liquidity and the ability to trade securities purchased in a secondary market highlight the need for a trading platform for securities purchased in a crowdfunding issuance.

In order to have a consistent secondary market for securities, investors need access to a platform for exchange to facilitate trades between willing buyers and sellers.⁶¹ After the failure of unregulated trading exchanges in 1929, the Securities Act of 1934 required registration of securities exchanges and imposed specific requirements on those registered exchanges⁶². The purpose of such regulation was, and continues to be, to ensure fairness and transparency to the investing public in these secondary market transactions.⁶³ While these exchanges available to the public have always been regulated by the 1934 Act, private exchanges were not subject to regulation. For example, a broker dealer arranging trades between clients was not regulated, nor was a private exchange available only to members.⁶⁴

With the advent of technology systems, Alternative Trading Systems (ATS) began to appear on the market.⁶⁵ The SEC realized that they needed to update their regulatory structure and so adopted Regulation NMS to include registration of these ATS as regulated exchanges.⁶⁶ These rules use a test based on the actual functions of the platform to determine whether they are subject to regulation, including registration and compliance with requirements.⁶⁷ Functions of a platform that would lead to

⁵⁹“IFRS Accounting for Cryptoassets” at [https://www.ey.com/Publication/vwLUAssets/EY-IFRS-Accounting-for-crypto-assets/\\$File/EY-IFRS-Accounting-for-crypto-assets.pdf](https://www.ey.com/Publication/vwLUAssets/EY-IFRS-Accounting-for-crypto-assets/$File/EY-IFRS-Accounting-for-crypto-assets.pdf).

⁶⁰ ECGI *supra* note 25 at p. 3.

⁶¹ For a nice background on securities exchanges see, Kristin Johnson, *Regulating Innovation: High Frequency Trading in Dark Pools*, 42 IOWA J. CORP. L. 833,839- 846. (Summer 2017).

⁶² 15 U.S.C. section 78c (a) (1). The 1934 Act defines an Exchange subject to regulation as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities or functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

⁶³ SEC Strategic Plan, <https://www.sec.gov/about>.

⁶⁴ See “Statement on Digital Asset Securities Issuance and Trading”, SEC Public Statement issued on November 16, 2018 for background on SEC regulation of trading in digital assets.

⁶⁵ Johnson *supra* note 61 at 854.

⁶⁶ Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70863 (December 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) (hereinafter Regulation ATS Adopting Release)

⁶⁷ 17 CFR 240.3b-16 (Exchange Act Rule 3b-16(a)). See also Regulation ATS Adopting Release, *Supra*.

regulation include a platform or program that “(1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers centering such orders agree to the terms of the trade”.⁶⁸

Any platform requiring registration under this regulation is required to register as a broker dealer under Section 15 of the 1934 Act,⁶⁹ and to file an initial report on Form ATS at least 20 days before beginning operations.⁷⁰ As of February 28, 2019, 55 entities had filed Form ATS with the SEC.⁷¹ At least 3 of these filings were for platforms available for trading security tokens.⁷² These Alternative Trading Systems would be available for all token offerings, including presumably those offered in Regulation CF crowdfunding campaigns. These ATS platforms have the advantage of the tokens using Distributed Ledger Technology (blockchain) to verify and track the token securities.⁷³

However, an opportunity might exist for an existing intermediary, already registered as a broker-dealer intermediary under Regulation CF, to also provide a system for trading tokens sold by its issuer clients. One intermediary taking the lead with this idea is StartEngine. In examining Form C filings of crowdfunding issuers, 74% of the token offerings use StartEngine as the intermediary.⁷⁴ StartEngine has publicized their intent to expand services to include trading; The CEO of StartEngine articulates the company’s growth plan as follows:

Our priority in 2019 is getting registered as a broker-dealer and ATS (Alternative Trading System). Once registered, we will launch StartEngine Secondary, our planned trading platform, where investors can buy and sell shares that were originally issued by companies raising capital on StartEngine. StartEngine Secondary will use StartEngine Secure, our registered transfer agent. It is our intention that StartEngine Secure will allow StartEngine Secondary to function with the speed and efficiency expected by today’s investors. The full implementation of StartEngine Secondary, though, is ultimately dependent upon the SEC’s and FINRA’s approval of StartEngine as a registered broker-dealer and an ATS.⁷⁵

⁶⁸ 17 CFR 240.3b-16(e) (Exchange Act Rule 3b-16(e)). Note that Rule 3b-16(b) excludes from regulation any entity that “performs only traditional broker dealer activities including (1) systems that route orders to a national securities exchange, a market operated by a national securities association or a broker-dealer for execution, or (2) systems that allow personal to enter orders for execution against the bids and offers of a single dealer if certain additional conditions are met.”

⁶⁹ 17 CFR 242.301(b)(1) (Exchange Act Rule 301(b)(1)).

⁷⁰ 17 CFR 242.301(b)(2)(i). In the Adopting Release, the SEC explained that Form ATS would allow the Commission to identify problems before operations begin and would thus better protect investors from potential impact. See Regulation ATS Adopting Release, *supra* note 66 at 70864.

⁷¹ “Alternative Trading Systems with Form ATS on File with the SEC as of February 28, 2019 retrieved from <https://www.sec.gov/foia/docs/atstlist.htm>.

⁷² Sageworks Capital, LLC (operating as CFX Markets and OpenFinance Network), Sharepost Financial Corporation and Templum Markets, LLC have all identified themselves as Security Token Alternative Trading Systems. See *OpenFinance Opens a Security Token Alternative Trading System*, <https://bitcoinexchangeguide.com/openfinance-opens-a-security-token-alternative-trading-system-ats/>

SharesPost Trades First Security Tokens on Regulated Platform, <https://www.tokenmarket.net/news/security-tokens/sharespost-trades-first-security-tokens-regulated-platform/>

⁷³ In an interview, Alexander Hoptner, CEO of the Borse Stuttgart in Germany explained that “For digital assets, the technology can replace clearing and custody institutions that are necessary for traditional securities today.” *Stuttgart Stock Exchange and Digital Asset Trading: A Discussion with Alexander Hoptner, CEO of Borse Stuttgart*, <https://www.crowdfundinsider.com/2019/04/146421-stuttgart-stock-exchange-and-digital-asset-trading-a-discussion-with-alexander-hoptner-ceo-of-borse-stuttgart/>.

⁷⁴ Data is for filings through August, 31, 2018. Form C is the required filing for all Regulation CF issuers and includes information about the type of security being offered as well the intermediary. www.sec.gov.

⁷⁵ <https://www.startengine.com/own>. On the same web page, the Question and Answer portion includes the following:

How do I make money on my investment?

Traditionally, you would have to wait until StartEngine went public or the company was acquired by another business to receive a return on your investment (a process that took anywhere between 5-10 years), but once we are approved to operate

While StartEngine articulates a clear plan for providing a secondary platform, company executives have also been clear on the obstacles to such a path. In a forum hosted by StartEngine, one of the panels was titled “Where to Trade Security Tokens”.⁷⁶ In this interview, StartEngine executives explained that they have taken steps to achieve their goal, including implementation of StartEngine Secure, a transfer agent registered with the SEC.⁷⁷ While the transfer agent cannot act as a trading platform, StartEngine’s ultimate goal, the registered transfer agent can have a centralized database to hold all investor information, control trades (allow or block transactions) and to relay results of transaction to the blockchain.⁷⁸ Participants in this November 2018 panel noted the difficulty of operating an Alternative Trading System, explaining that an ATS must create liquidity solutions and achieve trading velocity to have an operational market for token trading.⁷⁹

Thus, there is an opportunity for the Securities and Exchange Commission to revisit the regulations regarding trading systems, particularly for trades using blockchain verification.⁸⁰ While the SEC have issued clarification regarding regulation of digital assets and securities, most of these have focused on definitional issues rather than trading.⁸¹ However, a recent Fintech Forum hosted by the Commission gives hope that they are in the process of developing a regulatory framework that will facilitate digital asset trading platforms for crowdfunding and similar ventures.⁸²

IV Conclusion

The StartEngine proposal to offer secondary market opportunities for its security token issuers highlights the current lack of a consistent secondary market for securities initially purchased in a crowdfunding campaign. Instead, purchasers were reliant on a negotiated private transaction or, more likely, an exit strategy provided by the initial issuer. If StartEngine is able to implement its alternative trading system for token offerings, that innovation could signal a dramatic increase in crowdfunded offerings. Investors not only would have the opportunity to invest in a potential high growth, early stage company, but would also have the security of a secondary market for their investment should they want to liquidate. This secondary market might even give crowdfunding an advantage over other exempt offerings that traditionally have been more popular.⁸³ The future of crowdfunding may indeed rely on this rapidly evolving technology. However, regulators must examine the current structure of securities trading rules to ensure that the framework recognizes the distinct features of trading digital securities, such as tokens, and the role of blockchain verification.

an ATS, you will be able to sell your shares on StartEngine's website to other investors by posting the price per share you are willing to sell at, as well as how many shares you're selling, and see if there are any takers on the market. However, having a platform to sell your securities does not guarantee that there will be any purchasers for those securities at your desired price (or at any price).

⁷⁶ See <https://www.startengine.com/blog/where-to-trade-security-tokens/>.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.* Shari Noonan, CEO of Rialto Solutions, a registered ATS was particularly vocal on these points.

⁸⁰ One entity registered under Rule ATS has already proposed a rule change to accommodate its trading of securitized token trading using blockchain technology. See, BOX Exchange LLC Proposed Rule Change filed on 5/30/2019 with the SEC found at <https://cdn.crowdfundinsider.com/wp-content/uploads/2019/06/SEC-Box-Exchange-Proposed-Rule-Change-SR-BOX-2019-19.pdf>. BOX Exchange’s 421 page form gives an extensive argument for recognition of the current trading needs of digital securities.

⁸¹ See eg DAO Report *supra* at note 30.

⁸² On May 31, 2019, the SEC hosted its FinTech Forum. The agenda included a session on trading and market considerations, <https://www.sec.gov/news/press-release/2019-59>.

⁸³ These more traditional exempt offerings would include Regulation D and Regulation A which have been in existence longer, but which also traditionally lack a consistent secondary market for securities sold.