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Crowdfunded securities token offerings: a possible path to funding emerging growth companies

BY ROBERT C. BRIGHTON, JR.

The problems small companies have in obtaining growth capital are well known. The resources of founders and family and friends are typically limited. Venture capital (VC) and private equity (PE) firms are a resource for only a few such companies. Angels can sometimes provide limited funding but again only for a select few. Banks and non-bank lenders generally will not fund companies without collateral having readily ascertainable value.

Private offerings of equity securities are one path to obtaining growth capital, but such offerings have faced formidable regulatory obstacles.

To overcome these obstacles, companies, financial sources and regulators are

exploring innovative alternative sources. Equity crowdfunding and securities token offerings (STOs) are two alternative sources for growth capital for small companies. Equity crowdfunding seeks to tap the resources of individual investors eager to invest in companies having the potential for high returns on investment. STOs leverage the security and efficiency of the blockchain. Importantly, both funding alternatives use the internet to facilitate the flow of information and funding. These funding alternatives can be used separately or in tandem.

The Jumpstart Our Business Startups (JOBS) Act, together with Regulation Crowdfunding (the Crowdfunding Exemption) adopted by the Securities and

Exchange Commission (SEC), established an exemption from the registration requirements of the US Securities Act for certain offerings of securities by early stage businesses to individual investors.

The Crowdfunding Exemption exempts offerings of securities having an aggregate price of up to \$1m (\$5m after the January 2021 effective date of amendments to the Crowdfunding Exemption) by a company during any 12-month period preceding the date of the transaction (adjusted annually for inflation – currently \$1.07m). The aggregate amount sold by a company to any investor during the 12-month period preceding the transaction cannot exceed: (i) the greater of \$2000 or 5 percent of the investor's annual income or net worth

if such investor has an annual income or net worth of less than \$100,000; or (ii) 10 percent of the annual income or net worth of an investor, not to exceed a maximum aggregate amount of \$100,000, if either the annual income or net worth of the investor equals or exceeds \$100,000. The amended Crowdfunding Exemption revises these limits effective January 2021 to be based on the greater of annual income or net worth for non-accredited investors and allows unlimited investment by an “accredited” investor.

Significantly, the Crowdfunding Exemption does not limit the total number of investors or restrict sales only to “accredited” investors.

The Crowdfunding Exemption is available only to US domestic issuers that are not reporting companies under the Securities Exchange Act and that are not investment companies for purposes of the Investment Company Act. To be eligible, a company must have a specific business plan (other than to engage in a merger or acquisition with an unidentified company) and not be subject to the JOBS Act’s ‘bad actor’ disqualification.

The Crowdfunding Exemption must be conducted through an intermediary (either a broker or a ‘funding portal’) registered with the SEC. Information about the company and the transaction must be filed with the SEC and made available through the intermediary, including financial information based on the target amount offered. Following the closing of a transaction, companies must file their financial statements with the SEC (and provide access to investors) not less than annually.

Investors cannot transfer securities acquired in a crowdfunded offering for one year, other than transfers to: (i) the company; (ii) an ‘accredited investor’; (iii) a family member of the investor; (iv) an estate planning entity; and (v) third-parties in an offering registered under the Securities Act.

Under the Crowdfunding Exemption, a company must file a Form C with the SEC and the intermediary must post the filing or provide a link to the filing for investors. A Form C includes disclosures relating to the

company’s business, operations, officers, directors, control persons, use of proceeds, capital structure and results of operations. A Form C also includes the name and form of entity of the company, its jurisdiction and date of formation, website, number of employees and certain information about the intermediary, including its SEC file and Financial Industry Regulatory Authority Central Registration Depository (FINRA CRD) number and fees being paid to the intermediary.

The Form C must provide information about the offering amount and mechanics, including the target or maximum amount to be offered, and a description of the offering process. Subscription proceeds in a crowdfunding offering are held in escrow until the target offering amount is met.

The Form C must also provide disclosure to investors about their rights and the obligations of the company and intermediary in connection with the offering, including: (i) the investors’ right to cancel and receive back their investment at any time prior to 48 hours before the deadline identified in the Form C or if the target amount is not achieved by the deadline; and (ii) the intermediary’s obligation to notify the investors when the target amount has been met and, if met prior to the deadline, whether the company intends to close early, providing notice not less than five-days prior to closing.

The Form C must clearly state that if the investor does not timely cancel, the investor’s funds will be released to the company at closing. If a material change in the offering is made (and disclosed on a Form C-A filed with the SEC and posted by the intermediary), the investor must reconfirm its investment commitment or its investment will be cancelled and the company must return the investor’s funds.

Crowdfunded offerings are also subject to restrictions on advertising and solicitation, and payment of compensation to promoters of the offering.

Securities tokens are a form of cryptocurrency, based on the blockchain and digital ledger technology. These are relatively new concepts and regulations are still evolving to determine how they should be regulated under tax, securities

and commodities laws, and laws regulating the transmission of currencies. Regulators in the US have generally tried to fit cryptocurrency and the blockchain and digital ledger technology within the existing regulatory framework.

This article focuses on the regulatory issues affecting STOs in the US. However, similar regulatory issues are relevant to STOs traded outside of the US.

The SEC is the primary regulator of US federal securities laws, including transactions in cryptocurrencies deemed to be securities. The SEC considers most initial coin offerings (ICOs) to be securities.

Offerings of securities, including STOs, must be registered under the Securities Act, or fit within an exemption from registration, such as the Crowdfunding Exemption, or a private placement exemption.

Intermediaries, such as a broker, which participate in securities offerings must be registered under the Exchange Act. Funding portals have been exempted from registration as a broker provided that they meet the requirements of the Crowdfunding Exemption. These requirements include registration with the SEC as a funding portal and membership in FINRA (a self-regulatory organisation which oversees brokers and other intermediaries engaged in securities transactions). Funding portals are limited in the scope of activities they may engage in in connection with a crowdfunding offering. They cannot offer investment advice or make recommendations, solicit purchases, sales or offers to buy securities offered through the offering platform, receive or pay their employees transaction-based compensation and receive or hold investor funds or securities. In addition, neither a funding portal nor its directors, officers and partners can have a financial interest in any company that uses the funding portal’s services.

What is a securities token? At its most basic, a securities token is a tokenised, digital form of a traditional security (which may represent an ownership interest in a company, a right to profits or a creditor relationship with a company). What is a token? Generally described, it

is an instrument of value in its particular ecosystem, though it may have multiple roles in its native ecosystem.

Investors in STOs receive various benefits, depending on the structure of the STO, including voting rights, dividends or revenue shares in the company.

The offer and sale of a securities token in a crowdfunding is much like that of a conventional security. The key difference lies in use of the blockchain, which can either be used in place of or to complement traditional custody and transfer procedures.

Several new financial technology companies, such as tZERO (an affiliate of Overstock.com), as well as some traditional financial service companies, are pursuing initiatives to develop and commercialise financial applications of blockchain technologies. tZERO focuses on developing the supply side by creating

technology that enables users to issue, and relevant regulated market participants to support, the issuance, trading, clearance and settlement, of digital securities.

A subsidiary of tZERO, tZERO ATS, provides a licensed alternative trading system (ATS) for matching buy and sell orders to broker-dealers, including the trading of digital securities, permitting trades under an exemption from SEC regulations. Through a joint venture, tZERO ATS is seeking approval of the Boston Security Token Exchange, a US national securities exchange, to support trading in securities tokens.

In addition to compliance with securities law requirements, STOs and secondary trading of securities tokens require compliance with regulations governing broker-dealers, ATSs, securities exchanges, anti-money laundering, 'know your

customer' requirements, and custody and recordkeeping requirements, among others.

Because of these regulatory obstacles, STOs and secondary trading in digital securities have been limited.

However, as technology and regulatory developments are made – including recent SEC proposals to expand crowdfunding and rules for finders – more STOs and other crowd-funded digital securities transactions are occurring. Companies and investors, and market participants are beginning to realise the financial, efficiency and security benefits promised by crowd-funded transactions utilising blockchain and digital ledger technology.

The full potential of STOs for emerging growth companies and investors will only be realised when trades may be made on securities exchanges which facilitate a vibrant secondary market. ■

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