

Part II — The smartest securities on the block: Blockchain-based digital securities look to disrupt securities offerings and the capital markets

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Part II — a vehicle for digital securities offerings

This is the second part of a two-part article that examines the key considerations associated with Digital Securities Offerings. Part I provided a high level overview of Digital Securities and Digital Securities Offerings. This Part II provides an overview of Regulation D of the Securities Act of 1933, as amended, and why it has emerged as a preferred vehicle for Digital Securities Offerings.

Regulation D: A measured approach to the growing digital securities market

Issuers pursuing Digital Securities Offerings accept that the Digital Securities being offered constitute “securities” as such term is defined by the U.S. securities laws,¹ and, therefore, their offerings must either be registered pursuant to the Securities Act or exempt from registration.

The U.S. Securities and Exchange Commission registration and public offer process can be burdensome and expensive, and the process can pose significant uncertainty and risk for emerging technologies such as blockchain-based digital securities. As a result, Digital Securities Offerings have been primarily conducted in reliance on exemptions from registration, including Regulation A, Regulation Crowdfunding, Regulation D and Regulation S.²

The exemption from registration provided under Regulation D of the Securities Act for unregistered private placements of securities has emerged as a preferred vehicle for Digital Securities Offerings.

In particular, Rule 506(b) and Rule 506(c) of Regulation D provide a scalable platform for Digital Securities Offerings unconstrained by limits on the aggregate amounts raised but without the document intensive, time consuming and expensive public offering process.

In addition, such offerings are typically limited to accredited³ and other sophisticated investors who may be better able than public investors to understand the key features and particular risks associated with Digital Securities.

Rule 506(b) and Rule 506(c) offerings

Rule 506(b) and Rule 506(c) offerings share common elements but have nuanced differences that issuers must take into account when deciding whether to avail themselves of Rule 506(b) or Rule 506(c).

Rule 506(b) is focused on the “method” of the offering, whereas Rule 506(c) is focused on the ultimate investor in the offering. Rule 506(b) does not allow for general solicitation⁴ in connection with the offering, but the Digital Securities may be offered and sold to a small number of non-accredited investors.

Rule 506(c), on the other hand, does allow for the use of general solicitation in connection with the offering of Digital Securities but limits the investors that may participate in the offering to accredited investors.

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While Rule 506(b) allows for a certain number of investors to be non-accredited, any non-accredited investors that participates in Rule 506(b) offering must be otherwise qualified and must be, or the issuer must reasonably believe them to be, capable of evaluating the merits and risks of an investment in the securities.⁵

Rule 506(c), which focuses on the ultimate investor, only allows issuers to sell Digital Securities to verified accredited investors.⁶ In practice most investors that participate in Regulation D offerings are accredited investors, a term that is defined very broadly in rule 501(a) of Regulation D.

Rule 506(b) is a non-exclusive safe harbor exemption authorized under Section 4(a)(2) of the Securities Act. Many private offering that rely on Rule 506(b) also typically rely on Section 4(a)(2).

In the event that an issuer fails to satisfy the requirements of Rule 506(b) (e.g., an issuance involving a “bad actor”), Section 4(a)(2) operates as a back-up preserve the private offering exemption as long as the issuer is otherwise complying with all regulatory requirements (e.g., blue sky laws which are not preempted by Section 4(a)(2)).

Unlike Rule 506(b), Rule 506(c) is a stand-alone exemption and, as such, issuers making Rule 506(c) offerings typically do so without relying on any other exemption as a fallback (e.g., Section 4(a)(2)). If an issuer unintentionally fails to satisfy its obligations under

Rule 506(c), there is no fallback and the issuer will be required to register the offering.

However, issuers take great care to comply with the requirements of the rules, particularly compliance with the rules governing the method of the offering and the ultimate investors in the offering.

Disclosure considerations

The private and unregistered nature of Regulation D offerings does not eliminate the application of the anti-fraud provisions of the U.S. securities laws (including Section 10(b) of the Exchange Act and Rule 10b-5).

Digital Securities offerings introduce investors to novel risks and, therefore, require additional disclosures about the risks that are particular to the key features, technology, blockchain platform, cybersecurity and legal and regulatory uncertainty associated with this asset class. For these reasons, many market participants opt to provide robust disclosures in the offering documentation for Digital Securities, including information about material risks.

Digital securities platforms

For issuers seeking to participate in a Digital Securities Offering pursuant to Regulation D, a number of platforms ("Platforms") have emerged that help facilitate these transactions.

The Platforms assist issuers with the process of pursuing a Digital Securities offering, starting with evaluating the appropriate blockchain platform for the contemplated Digital Security and then developing smart contracts that will effectively and efficiently carry out the Digital Security's features throughout the life of the security (e.g., exercising voting rights and distributing PIK dividends).⁷

Many, if not all, of the Platforms have developed robust internal KYC and AML compliance procedures on which the issuers can rely for regulatory compliance in connection with the Digital Securities Offering.

The Platforms provide an easily accessible online marketplace where qualified investors can participate in Digital Securities Offerings.

However, the issuers must still exercise great care with respect to how they interact with potential investors in Regulation D offerings. The SEC has noted that issuers relying on Regulation D cannot simply place information about their offerings on their public

websites for all to access — even where issuers rely on Rule 506(c) and are allowed to engage in general solicitation.⁸

Issuers participating in both Rule 506(b) and Rule 506(c) offerings, are well advised to follow the existing parameters provided by SEC No-Action letters, Compliance & Disclosure Interpretations and other SEC guidance and stay current on regulatory developments.

Conclusion

Blockchain-based, smart contracts-enabled Digital Securities have the potential to disrupt the capital raising process and the ongoing maintenance and service of such securities throughout the life of the securities.

Many market participants opt to provide robust disclosures in the offering documentation for Digital Securities.

Companies, fund managers, investors and even regulators stand to benefit from the promise of Digital Securities. Securities law practitioners and capital market participants are well advised to keep an eye on developments in this space that promise to change the way financial markets are operated and regulated.

Notes

¹ See 15 U.S.C. § 77b(a)(1).

² <http://bit.ly/3Jhrs9l>.

³ An "accredited investor" is generally one that the SEC believes is likely to be financially sophisticated and capable of fending for themselves in evaluating investments. See <http://bit.ly/3Jgnpdx>. See also 17 C.F.R. § 230.501(a).

⁴ The term "general solicitation" is a key term in Regulation D offerings, but it is not defined in the regulation itself. Market participants are left to patch together the rules for the road from Rule 502(c)'s non-exhaustive list of activities that are deemed forms of general solicitation and the examples of "general solicitation" included in the Rule 506(c) adopting release.

⁵ 17 C.F.R. §230.506(b).

⁶ 17 C.F.R. §230.506(c).

⁷ See generally, Thomas Lambert, Daniel Liebau and Peter Rosenboom, "Security Token Offerings" in *Small Business Economics* (Jun. 25, 2021).

⁸ C&DI, Question 256.23 (Aug. 6, 2015).

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