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Five Things to Know About Security Token Offerings

A security token offering (STO) is, as its name indicates, a public or private sale of a “security,” evidenced by a digital token transferable on a blockchain to investors to raise capital. Giving an asset another name (like “token”) does not transform it into something other than a security or exempt an issuer from compliance with securities laws.

(1) STOs are subject to the same securities framework that has existed for decades.

As the seminal case “SEC v. Howey Co.” explains, even an orange tree can be sold in a way that constitutes the sale of a security. The sale of a digital asset by any name will generally be deemed a security when it is touted as an investment opportunity or otherwise has features akin to stocks, such as the payment of dividends or voting rights.

The U.S. Securities and Exchange Commission (SEC) has repeatedly echoed this sentiment in its public statements and enforcement actions. SEC Chairman Jay Clayton stated that selling a digital token “does not change the fundamental point that when a security is being offered, our securities laws must be followed.”

At its core, an STO is simply new wine in an old bottle and must, therefore, comply with existing securities laws.

(2) A security token sold in an STO will not have immediate liquidity.

Most security tokens acquired in an STO cannot be transferred immediately because they are “restricted securities” sold in an unregistered, private sale, often under Regulation D, under the Securities Act of 1933. In fact, most security tokens will need to be held for a year before being sold in the public market. While the lock-up period may be reduced to six months if the issuer of the security token is a reporting company under the Securities

Exchange Act of 1934, issuers usually seek to avoid reporting company status. Blockchain technology provides a more elegant solution to this problem than the legends customarily placed on paper certificates, as the token can be “locked” in the purchaser’s wallet until the expiration of the applicable holding period.

(3) A security token cannot be sold anonymously.

Anonymity, or at least pseudonymity, may be a hallmark feature of distributed ledger technology, but it is inappropriate in an STO. An issuer must know to whom it is selling security tokens to comply with anti-money laundering laws, Office of Foreign Assets Control sanctions programs and its obligation to “know its customers.” Penalties for noncompliance can be severe and are unlikely to be worth any advantages associated with conducting anonymous transactions.

Additionally, issuers who want to promote their STOs via the internet will need to ascertain the “accredited” status of their investors prior to consummating any sale of a security token.

(4) A properly structured STO will be highly technical.

Finding an exemption from registration under the Securities Act of 1933 and applicable state law is but one hurdle standing between an issuer and a compliant STO. Two notable issues commonly encountered are as follows:

- Structuring a concurrent, domestic and international offering
- Implementing safeguards to avoid reporting requirements under the Securities Exchange Act of 1934

As for the latter, an issuer will generally be considered a reporting company under Rule 12g-1 of the Securities Exchange Act of 1934 (meaning it will have to file regular and periodic reports with the SEC) if the issuer has more than 2,000 investors or more than \$10 million in assets. An issuer can build protections into its offering documents, such as investor caps and buyback options, to avoid becoming subject to onerous Exchange Act reporting requirements.

(5) You should not go it alone.

The complexity of existing securities laws makes advice of counsel a crucial component of a successful STO. Implemented correctly, however, an STO can be an excellent source of capital for a new or expanding company in the tokenization, blockchain or broader distributed ledger space. Late last year, SEC Commissioner Hester Peirce highlighted the “growing eagerness” of U.S. regulatory agencies to better understand tokenized assets and enable legitimate projects to flourish.

For more information about crypto regulations for STOs and other token generation events, contact [Gray Sasser](#), [Kacy Joy](#), or any member of Frost Brown Todd’s [Blockchain and Digital Currency Group](#).

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