PropTech in the United States – where we're heading

Part II: Real estate security tokens - potential challenges, potential benefits

PropTech Insights

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Tokenization in the real estate sector is the process of creating partial, or "fractionalized," unique digital ownership interests in real estate assets using blockchain-based technology that, once adopted for a particular investment or transaction, confers greater efficiency, security and liquidity for the counterparties while enhancing deal speed. Real estate owners can issue such tokens to investors to fractionalize ownership of the real estate or certain rights to the real estate; the tokens can disburse profits proportionally to each token holder and provide token holders with voting power in the company's decision-making. Each transaction is recorded immutably and chronologically and can be committed via self-executing smart contracts. After purchasers own the tokens, and assuming all applicable restriction periods have expired, the owners can trade the tokens in secondary markets that support security tokens – thereby significantly increasing liquidity within the traditional real estate asset class. Before pursuing this method of ownership or financing, however, market participants must pay careful attention to the regulatory challenges presented by tokenization as described later in this article.

Access to a greater pool of potential investors and increased liquidity

Real estate tokens can represent a variety of ownership interests in real estate, among them ownership of (1) the underlying real property, (2) an equity interest in a company that owns the real property, (3) a debt position secured by the real property, or (4) a cash flow stream from the income generated by the real property.[1] By issuing multiple tokens (perhaps numbering in the thousands), issuers can offer lower minimum investments and a variety of ways for people to participate – thus potentially opening new doors for investors who are otherwise unable to invest in such alternative asset classes due to the normally high minimum investment thresholds.

Under the current legal framework in the United States, tokens are largely viewed as securities by regulators and consequently token sales are subject to securities laws that impose limitations both on who may purchase tokens and how tokens may be offered and sold. But some observers predict that legislative innovation will soon lead to greater democratization within the real estate asset class, opening it up to retail investors without the current requirement of registering the securities with the SEC. Further, the digital marketplace created by tokenization has the potential to increase access to capital globally by enhancing settlement efficiency, providing for information transparency, reducing the need for auditing and providing liquidity.

A secondary market for investors to trade real estate tokens is viewed as another innovative way to unlock the value of real estate and make the sector more attractive to investors as an asset class. The sector's relative illiquidity would gradually be changed by the emergence of regulated security token exchanges. Although several platforms exist for trading security tokens, regulatory issues and compliance concerns have slowed the move toward regulated security token exchanges (*ie*, national securities exchanges or alternative trading systems) in the US. But time will tell: as technologies evolve and the real estate sector and US regulators grow more familiar with them, it will become easier to design regulatory and governance compliance into the real estate tokenization process in a manner that satisfies US regulators.

A more efficient capital raising process and investment management

Traditional real estate transactions involve many inefficiencies, with sometimes glacial transaction timetables and significant information asymmetry. The presence of multiple intermediaries significantly increases transaction costs. Even after a transaction closes, the management team must undertake additional interactions with investors, lenders, auditors, utility companies and other parties. When the property is to be sold, counterparties have to repeat the same complicated processes all over again.

Real estate tokenization, on the other hand, can help incumbents streamline the capital raising process – along with the property and investment management functions – based on automation using smart contracts. These contracts create automated protocols that self-execute, in real time, important processes – such as initiating payment requests, maintaining records, identifying and confirming the chain of ownership, performing escrow transactions, and the like – all of which are especially critical when potentially thousands of investors are involved.

Given these and other benefits, tokenization has an enormous capacity to disrupt traditional ways in which fundraising occurs in the real estate industry and to increase liquidity by facilitating swift, automatic, fully reconciled updates of share registries in both primary and secondary markets. Nonetheless, despite the growth of real estate token offerings, the underlying infrastructure to support these offerings is still in an early stage – as is mass adoption. Furthermore, the gulf between technology and law has created a regulatory lag, rife with legal and market uncertainties.

Some key regulatory and legal issues

Here are some key things to know about legal and regulatory issues surrounding real estate tokenization today.

Tokens may be securities subject to US securities law

With the July 2017 release of the DAO Report, a Securities and Exchange Act Section 21A investigative report, the Securities and Exchange Commission (SEC) made clear that digital assets, or digital tokens – meaning cryptocurrencies or other virtual coins represented by records in a blockchain or distributed ledger **–** ***may be investment contracts under the Howey test and, therefore, constitute securities*** subject to US securities laws, both in the offering and in secondary market trading.

Under the *Howey* test, a transaction will be deemed an "investment contract" if it is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) predominantly derived from, or in reliance on, the efforts of others.

Since 2017, in enforcement actions and speeches, the SEC and its staff have reinforced the regulator's position that most digital tokens are securities. In 2019, the SEC issued its "Framework for 'Investment Contract' Analysis of Digital Assets," a 13-page memorandum that expands the factors used by the SEC to determine whether digital tokens are "investment contracts." Because real estate tokens – which are backed by assets and offered to passive investors who rely on revenue generation by others and appreciation of the real properties – are likely to be treated as securities, prudent real estate companies tend to self-define their tokens as securities and comply with securities laws.

The United States has not implemented laws that differentiate between a security and a security token. Thus, security token offerings and trading must fit into the existing securities legal framework.

The mandate of these securities laws is to protect investors and prevent market manipulations. Real estate token issuers cannot offer or sell securities in the United States unless the offer and sale is registered or is qualified for an exemption from registration. Companies generally use exemptions when offering or selling securities in the United States because registration is time-consuming and expensive. The most common exemption is Securities Act Rule 506. Offshore transactions pursuant to Regulation S are also commonly used for the non-US portion of securities offerings.

Sale of tokens may be subject to tax

US securities laws are not the only regulations applicable to security token offerings, and the SEC is not the only government agency with regulatory oversight of tokens. For example, **selling real estate tokens may trigger tax liability** because the US Internal Revenue Services (IRS) characterizes a digital token as property and thus as taxable. The basis of a token that a taxpayer receives as payment for goods or services is the fair market value of the token in US dollars as of the date of receipt. Whether the gain or loss is capital gain or loss or ordinary gain or loss generally depends on whether the token is a capital asset in the hands of the taxpayer.

You may need a broker-dealer license

Entities that market and facilitate the sale of security tokens and enable disbursement of proceeds to issuers or purchase and resell security tokens for their own accounts **may need to obtain applicable broker-dealer licenses**. Some companies may run the risk of inadvertently becoming investment companies, which would require registration under the Investment Company Act. The Investment Company Act regulates certain companies that invest in, hold, or trade securities; the most common example of companies regulated under the Investment Company Act are mutual funds.

Money services business

Further, a company that facilitates transactions in tokens **may constitute a money services business** (MSB). The Financial Crimes Enforcement Network ("FinCEN"), a bureau within the US Department of the Treasury, has published guidance to clarify whether a person dealing in digital tokens would fall under the definition of an MSB. In its guidance, FinCEN has stated that those who issue and redeem digital tokens, and those who accept and exchange tokens for either fiat or other digital tokens as a business, would, unless an exception applies, be deemed an MSB. In addition to the federal regulation, the states also have laws regulating money transmission. The states requirements include licensing, bonding capital requirements and myriad of record-keeping obligations.

Your platform may be qualified as an alternate trading system

Platforms that offer trading in security tokens, such as bringing together orders for securities and entering such orders pursuant to agreed terms of the trade, may need to **register as a national securities exchange or qualify as an exempt "alternative trading system"** (or ATS) in compliance with Regulation ATS. Regulation ATS requires that every ATS must (i) register with the SEC as a broker-dealer; (ii) become a member of a "self-regulatory organization," such as FINRA; (iii) file an extensive initial operating report (Form ATS); and (iv) have an ongoing compliance program to maintain the ATS and broker-dealer operations.

The "token" attribute also imposes other unique legal requirements

The mechanics and risks associated with being a custodian of traditional securities, on the one hand, and digital security tokens, on the other hand, are significantly different. Transfer of a digital token generally relies on the use of a public key and a private key. A public key is for the token to be transferred to others, and a private key is for the owner of the security token to authorize such transfer. In other words, only the owner of the private key has control over the security token to which the private key is linked. Thus, the owner needs to follow best practices to keep the private key safe and secure.

From the legal perspective, it is not generally clear whether or how a claim to tokens that have been lost or stolen can be enforced, whether the context is a self-custody or a third-party custody. Several agencies have taken steps to address third-party custodian issues. On July 8, 2019, the Division of Trading and Markets of the SEC and the Office of General Counsel of FINRA issued a "Joint Statement on Broker-Dealer Custody of Digital Asset Securities." The Joint Statement seeks to address the ways in which the federal securities laws and regulations and FINRA rules apply to the intermediation of transactions in, and custody of, "digital asset securities."

And there's more. Real estate tokens, like other security tokens, raise important issues in other legal areas, as well, among them commodities, anti-money laundering, privacy, data protection, intellectual property, and compliance with laws and regulations across jurisdictions.

Examples in the marketplace

Several recent examples demonstrate the applicability of tokenization in real-world transactions. In 2018, for example, a hospitality-focused asset management company completed a tokenized real estate offering for a high-profile property in Colorado and raised $18 million using a blockchain-based platform. Not long after, a luxury condominium project in Manhattan valued at over $30 million was also tokenized on the blockchain. Other real estate tokenization projects exceeding hundreds of millions of dollars are in the pipeline.

Getting there

All of this may seem daunting. But we urge readers to keep in mind that it is early days yet. Traditional investors are standing at the gateway; ahead are superior technologies, untapped opportunities and swifter, more secure transactions. But many potential participants are hesitating, concerned by this complex landscape, questions of scalability, regulatory questions and, of course, by their ability to use the new technologies to achieve ultimate success.

We believe, however, that these technologies will be critical for the future of the real estate industry. Companies should monitor developments in the market to determine if those developments might apply to their businesses. Reconsidering existing systems and processes, carefully planning before investing in new technologies, and conferring with knowledgeable counsel will help the industry find ways to understand, and move into, this new world and efficiently unlock the opportunities inherent in tokenization.

Learn more about these PropTech issues by contacting either of the authors.

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[1] Existing US law supports the use of electronic records and signatures to create these various ownership interests. For more information on this topic, see *The Law of Electronic Signatures* (Thomson Reuters 2019) DLA Piper partners Margo Tank and David Whitaker. In addition, the ability to structure debt obligations utilizing electronic records so they are readily transferable is also already in place. See also, recent MERSCORP Holdings White Paper, *Enabled by Lenders, Embraced by Borrowers, Enforced by the Courts*: *What You Need to Know about eNotes* (2019), by the same authors.

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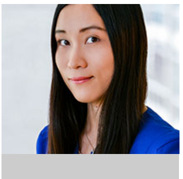

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