

## FinTech, Crypto, Trading & Markets

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### **On-chain or Off-chain, Federal Securities Laws Remain Un-chain-ged.**

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#### What You Need To Know:

- Tokenization does not change securities law obligations. SEC staff confirm the obvious and make clear that securities represented on a blockchain remain subject to the full scope of the federal securities laws, including Securities Act registration requirements (or valid exemptions) and Exchange Act obligations applicable to trading, clearing, and settlement activities.
- Issuer-sponsored and third-party tokenization models carry different regulatory risks. The recent joint statement from the Securities and Exchange Commission's (SEC) Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets statement distinguishes between issuer-led tokenization (where on-chain records align with the issuer's official securityholder records) and third-party custodial or "synthetic" tokenization structures, which industry participants have long known may introduce additional compliance, disclosure, and investor-protection concerns.
- Broker-dealers and market intermediaries must apply existing regulatory frameworks to tokenized securities. Unsurprisingly, firms facilitating the offering, trading, custody, or transfer of tokenized securities should expect to comply with existing broker-dealer, ATS, recordkeeping, and supervisory requirements. Consistent with virtually all prior staff statements, staff yet again remind market participants that tokenization does not create a new regulatory category or provide automatic relief from current registration and compliance obligations.

On Jan. 28, the Securities and Exchange Commission's (SEC) Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (collectively referred to as Staff), released a joint staff statement (Statement) supposedly clarifying how the federal securities laws apply to "tokenized securities" and related offering and issuance structures. Somewhat comically, the Statement claims to provide regulatory clarity for market participants. Unfortunately, it adds little in terms of substance for an industry that has been pursuing blockchain-based issuance, custody, and trading models for more than a decade.

#### What is a Tokenized Security (in case you forgot)?

The Staff reminds us that a Tokenized Security is a financial instrument that meets the statutory definition of a "security" that is represented in the form of a crypto asset, where ownership records are maintained or supported, in whole or in part, on decentralized ledger technology such as a blockchain. The Statement recaps the generally accepted market fundamental that while representing securities on a blockchain affects the method of ownership, recordkeeping, and settlement infrastructure, it does not change the legal nature of the underlying security or the applicability of existing registration and regulatory requirements.

#### Categories of Tokenized Securities:

The Statement distinguishes between two principal regulatory categories of Tokenized Securities: issuer-sponsored tokenized securities and third-party-sponsored tokenized securities. Regardless of structure, the Staff reiterates that regulatory treatment is determined by economic substance rather than technical form.

### *Issuer-Sponsored Tokenized Securities*

Issuer-Sponsored Tokenized Securities are securities directly issued by the issuer that have been integrated into a system whereby decentralized ledger technology (e.g., a blockchain network) is used to record, in whole or in part, the chain of ownership. When the crypto asset is issued, transferred, redeemed, or burned, the master securityholder file (whether maintained partly on-chain or wholly off-chain) is updated to reflect the corresponding changes.

From a technical perspective, the Statement identifies two primary methods by which issuers and transfer agents may implement blockchain-based issuance and ownership tracking, both of which reflect issuer-sponsored tokenization architectures.

In the first model, the issuer or its transfer agent maintains a portion of the master securityholder file directly on-chain, capturing information such as wallet addresses, ownership quantities, and transaction history, while retaining investor identity and related information off-chain as part of a hybrid recordkeeping system. In the second model, securities continue to be issued in traditional book-entry form, with corresponding crypto assets used to record on-chain issuances and transfers and to provide reconciliation or instruction functionality for updating off-chain ownership records. In both cases, blockchain technology operates alongside, rather than replacing, the traditional securities infrastructure, with the issuer or its agent retaining control over the authoritative ownership records.

The Staff confirm that an issuer may offer the same class of securities either in traditional book-entry form or as Tokenized Securities. However, where the only difference between two classes of securities is the form (i.e., traditional book-entry securities versus Tokenized Securities), the two classes of securities will likely be treated as a single class for certain federal securities law purposes.

### *Third-Party-Sponsored Tokenized Securities*

Third-Party-Sponsored Tokenized Securities are crypto assets that may provide indirect rights, obligations, and benefits associated with the underlying securities of the issuer. The Staff focus on three forms of Third-Party-Sponsored Tokenized Securities:

- Tokenized Security Entitlement: A third party custodian may issue a security entitlement in the form of a Tokenized Security by maintaining custody of the underlying securities and issuing crypto assets in a substantially similar manner as an Issuer-Sponsor Tokenized Security (i.e., where the ownership records are directly integrated on-chain or where the token is used as a tool to reconcile off-chain records). In this structure, the Tokenized Security is really a tokenized representation of beneficial ownership, and customer ownership is represented through possession of the Tokenized Security itself (and not through a traditional brokerage entry)
- Tokenized Linked Securities: One form of Synthetic Tokenized Securities includes tokenized “linked securities” (Tokenized Linked Securities), which are securities issued by a third party (i.e., not the issuer of the underlying securities) that provide synthetic exposure to the underlying securities without a direct obligation of the issuer and/or rights or benefits from the issuer. In practice, this model is typically achieved by a special purpose vehicle (SPV) owning the underlying securities and issuing Tokenized Securities in the SPV that provide equivalent economic exposure.
- Tokenized Securities Based-Swaps: Another form of Synthetic Tokenized Securities that meets the statutory definition of a security-based swap under Exchange Act Section 3(a)(68)<sup>1</sup> are Tokenized Security-Based Swaps. The Statement recognizes the conspicuous reality that a crypto asset may constitute a security-based swap if it in fact meets the statutory definition of a security-based swap under Exchange Act Section 3(a)(68) (Tokenized Security-Based Swaps). Unfortunately, other than highlighting relevant statutory language, and acknowledging the separate regulatory requirements that attach to Tokenized Security-Based Swaps, the Statement fails to elucidate any actual, practical application considerations.

## Practical Takeaways

The crypto market has clamored for regulatory guidance over the last decade. Despite the Statement's pretense as an instrument of regulatory clarity, it largely recycles the Staff's historic, and typically tepid, statements regarding tokenized securities. While market participants have long accepted that tokenization does not change the legal status of a security, Staff continue to refrain from providing meaningful, granular instruction, other than to acknowledge that U.S. federal securities laws do in fact apply to Tokenized Securities. While the Statement no doubt confirms that Staff are thinking about Tokenized Securities, it serves more as an issues list rather than functional guidance.

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<sup>1</sup> Under Section 3(a)(68) of the Securities Exchange Act of 1934, as amended (the Exchange Act), the definition of a "security-based swap" includes any agreement, contract, or transaction that is a swap (as defined in Section 1a of the Commodity Exchange Act of 1936, as amended) and is based on: (1) an index that is a narrow-based security index, including any interest therein or on the value thereof; (2) a single security or loan, including any interest therein or on the value thereof; or (3) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

## Contacts

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