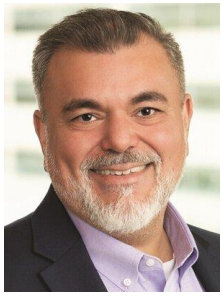
Balancing The Promises And Perils Of Tokenizing Securities

By **Ignacio Sandoval, Joseph Perkins and Nathaniel Reisenburg** (July 25, 2025)



Ignacio Sandoval

Joseph Perkins

Nathaniel Reisenburg

The securities market may be entering uncertain territory as blockchain tokenization matures from digitizing collectibles and other real-world assets to the digitization of securities. Although digitized initial offerings of securities may not be novel, tokenizing existing securities is still evolving and presents several promises — but also potential legal perils.

These perils were alluded to by SEC Commissioner Hester Peirce in a statement on July 9 addressing tokenized securities.[1]

In that statement, Peirce emphasized that while blockchain technology enables new ways to distribute and trade securities through tokenization, these tokenized assets remain subject to federal securities laws. She noted that both new and established firms are exploring on-chain products, but cautioned that tokenized securities do not change the legal nature of the underlying asset.

Peirce also highlighted the importance of understanding disclosure obligations and the potential risks, especially when third parties issue tokens tied to assets they hold. She encouraged market participants to engage with the U.S. Securities and Exchange Commission when developing tokenization products, and signaled the commission's willingness to modernize rules as technology evolves.

As market participants consider whether to issue or transact in tokenized versions of existing shares, they should be mindful of how existing law may affect the classification of the final token and collateral issues, such as reporting, corporate actions and leverage.

Further Efficiencies and Democratization of Trading

At its core, a tokenized security is a digital representation of a traditional asset, recorded on a blockchain or distributed ledger. When it comes to the securities markets, tokenization offers many potential benefits.

First, tokenization can make markets more accessible. Blockchain technology can enable fractional ownership of securities at levels far beyond what traditional systems currently allow.

For instance, while some broker-dealers currently support fractionalization to nine decimal places, blockchain networks can extend this to 18 decimal places or more. This means that even high-priced securities, like shares of Berkshire Hathaway, could become even more accessible to a broader range of investors.[2]

Second, tokenizing securities can also improve transaction settlement efficiency. Traditional securities markets have fixed trading hours, closing on weekends and holidays to allow time for trade processing, calculating net receivables or payables, and settling transactions.

While this process has been shortened from T+5 in the 1990s to T+1 today,[3] tokenization could enable T+0 or even real-time settlement, eliminating the need for market closures and further streamlining the trading process.

Third, trading tokenized securities could allow for 24/7 market access, so participants in Asia, for example, would no longer need to align their trading with London or New York market hours. While some U.S. intermediaries now offer extended trading hours, and some exchanges are moving toward nearly 24-hour trading,[4] tokenized securities can speed up this shift. This continuous trading could improve market transparency, price discovery and liquidity.

Legal Complexity and Regulatory Uncertainty

Despite these potential benefits, tokenized securities introduce new legal and regulatory challenges. The first is classification: What, exactly, is a tokenized security? The answer is rarely straightforward.

Federal securities laws define a "security" broadly to include such things as stocks, security futures, security-based swaps, collateral-trust certificates, transferable shares, certificates of deposit for a security, options, and various certificates or receipts related to these instruments.[5] An "equity security" is similarly expansive, covering such things as stocks, futures, convertible securities, and any warrants or rights to purchase such securities.[6]

The complexity of what tokenized securities represent and how they operate makes it difficult to fit tokenized securities neatly into the existing categories.

In her statement, Peirce noted that a tokenized security may function as a "receipt for a security," making it a security in its own right that is distinct from the underlying asset. Depending on the rights attached, a tokenized security could also qualify as a security-based swap, an option or a convertible security. In some cases, a tokenized share structured like an option or convertible security — especially one that is always deep in the money — could be economically equivalent to a future.

Regardless of classification, offering and selling tokenized shares of existing securities — particularly to retail investors — triggers legal requirements that existing exemptions may not fully address. For example, exchange-listed options on securities are exempt from registration because they are listed.[7] Security futures must trade on a national securities exchange,[8] and some may fall solely under the U.S. Commodity Futures Trading Commission's jurisdiction.

Efforts to bypass intermediaries face another hurdle: Only registered broker-dealers can be members of securities exchanges. Issuing tokens offshore does not solve the problem for U.S. investors, as regulatory relief for offshore products is highly conditioned, often limiting the types of U.S. persons who can transact in them and generally prohibiting U.S. securities from being an underlying reference asset.

If regulators classify a tokenized security as a security-based swap, the challenges grow. Only a limited group of U.S. persons — eligible contract participants — can trade these products. And such products may face mandatory central clearing and execution facility requirements.

Compliance, Reporting and Operational Risks

No matter how regulators ultimately classify tokenized securities, market participants must comply with existing rules — especially when tokenized securities qualify as equity securities.

For example, Financial Industry Regulatory Authority rules require reporting of short interests in equity securities,[9] and Rule 13f-2 under the Securities Exchange Act, adopted in 2023, also mandates periodic reporting of short interests.[10] Regulation SHO's short-selling provisions apply to tokenized equity securities, including requirements to properly mark short sales and meet locate obligations.[11] Uncertainty may arise over whether a tokenized security qualifies as a valid locate for a short position in the underlying asset.

Long sales of tokenized securities are also subject to regulatory reporting requirements. If a tokenized security represents ownership in a publicly traded company and qualifies as a "voting equity security" for purposes of Section 12 of the Exchange Act, investors who beneficially own more than 5% must file a Schedule 13D or 13G, just as they would for traditional shares.[12]

Section 16(b) of the Exchange Act — the short-swing profit rule — applies if a tokenized security represents an equity security of a company registered under Section 12. Insiders must return any profits from buying and selling, or selling and buying, the company's equity securities within a six-month period.

Continuous trading also complicates corporate actions such as stock splits, dividends and mergers. Traditional markets use opening and closing times to set record and ex-dividend dates.

Without clear market hours, issuers may need to adapt or risk undermining investor rights. Alternatively, issuers could design tokenized securities without these rights, but this could trigger classification as a more complex and heavily regulated instrument.

Margin regulations present further challenges when registered broker-dealers handle tokenized securities. Broker-dealers must determine what margin value, if any, to assign to tokenized securities. In a 24-hour trading environment, issues like free-riding — using proceeds from a sale to pay for a purchase — will likely arise, even with real-time settlement.[13]

Opportunity and Responsibility

Tokenizing listed securities offers the promise of greater efficiency, accessibility and innovation. However, the SEC's message is clear — tokenized securities are still securities, and the federal securities laws continue to apply.

As markets move toward 24-hour global trading, regulators, financial institutions and technology developers must work together to create clear rules, robust infrastructure and flexible operations. This collaboration is essential to realize the benefits of tokenization while protecting investors and maintaining market integrity.

With regulators now actively seeking dialogue, tokenization developers should seize the opportunity to engage. Proactive participation will help shape the future of digital markets — and ensure that innovation does not outpace investor protection.

Ignacio Sandoval is a partner at Orrick Herrington & Sutcliffe LLP. He previously served as special counsel in the Office of Chief Counsel in the U.S. Securities and Exchange Commission's Division of Trading and Markets.

Joseph Perkins is a partner at Orrick.

Nathaniel Reisenburg is a managing associate at the firm.

[1] Enchanting, but Not Magical: A Statement on the Tokenization of Securities, Commissioner Hester M. Peirce (July 9, 2025) at https://www.sec.gov/newsroom/speeches-statements/peirce-statement-tokenized-securities-070925.

[2] As of the date of publication, class A shares of Berkshire Hathaway traded at above $700,000 per share. Class B shares trade significantly lower, but still in the hundreds of dollars per share.

[3] Over Memorial Day weekend in 2024, the U.S. securities markets transitioned to a T+1 settlement cycle for most securities. See Shortening the Securities Transaction Settlement Cycle, Securities Exchange Act Release No. 396930 (Feb. 15, 2023), 88 Fed. Reg. 13872 (Mar. 6, 2023).

[4] See, e.g., In the Matter of the Application of 24X National Exchange LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission, Securities Exchange Act Release No. 101777 (Nov. 27, 2024), 89 Fed. Reg. 97092 (Dec. 6, 2024).

[5] See, e.g. Section 3(a)(10) of the Securities Exchange Act of 1934.

[6] See, e.g. Section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1 thereunder.

[7] See 17 CFR § 230.238 (Exemption for standardized options).

[8] See Section 6(h)(1) of the Securities Exchange Act of 1934 ("It shall be unlawful for any person to effect transactions in security futures products that are not listed on a national securities exchange or a national securities association registered pursuant to section 78o–3(a) of this title").

[9] FINRA Rule 4560 (Short-Interest Reporting).

[10] See Short Position and Short Activity Reporting by Institutional Investment Managers, Exchange Act Release No. 98738 (Oct. 13, 2023), 88 Fed. Reg 75100 (Nov. 1, 2023). The rule is currently subject to litigation. As of the date of this writing, no final court decision has been issued in that litigation.

[11] 17 CFR § 242.200 through 204. Among other things, Regulation SHO requires broker-

dealers to locate, borrow, or have a reasonable belief they can borrow securities before executing a short sale. This is meant to ensure they can deliver the borrowed shares on the settlement date.

[12] See 17 CFR 240.13d-1 through 240.13f-1.

[13] See, e.g., 12 C.F.R. Part 220 (Regulation T); FINRA Rule 4210.