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Industry Update

What Every Public Company Needs to Know About the SEC's New Innovation Exemption: Opportunities and Risks for the SEC's New Tokenization Landscape

By [Daniel Laguardia](#), [Eric Sibbitt](#), [Andrew Nizamian](#) and [Will A. Ostrander](#)

On Sept. 17, the Securities and Exchange Commission (SEC) issued Release No. 34-106402 (the Order), which for the first time creates a pathway for blockchain-based secondary trading of tokenized National Market System (NMS) stock in the United States. For public companies, the Order is significant in that it permits unaffiliated third parties to tokenize an issuer's stock and make those tokens available for trading on qualifying Tokenized Securities Venues (TSVs) without the issuer's participation (subject to certain opt-out rights). The Order is part of the SEC's broader initiative to expand access to tokenized securities and other crypto assets. And although temporary — with a current expiration date of 2031 — it establishes a framework for trading tokenized stocks outside the traditional exchange structure while the SEC considers further regulatory action. Trading in tokenized public securities offers the potential for broadening investor engagement and liquidity on a global 24/7 basis.

At the same time, the Order does not displace the antifraud and antimanipulation provisions of the federal securities laws, including Rule 10b-5. Nor does it establish the robust regulatory framework that governs traditional securities intermediaries and markets, or address situations where tokenized securities are traded outside qualifying TSVs. Many questions, therefore, remain on how markets for tokenized securities will operate, how they will interact with public companies, and what new compliance and liability risks they create. Public companies will need to think critically about how to engage with tokenized securities in order to effectively navigate the opportunities and dilemmas this emerging market presents.

How the Order Reshapes the Market for Tokenized Securities

The Order — branded the Innovation Exemption by the SEC — creates an initial framework for trading tokenized securities by granting two conditional, five-year exemptions under the Securities Exchange Act of 1934 (the Exchange Act). First, the Order exempts qualifying TSVs — permissioned platforms that trade tokenized NMS stock through automated market maker (AMM) liquidity pools — from the definition of “exchange.” Second, it exempts certain liquidity providers that supply tokenized NMS stock to TSV liquidity pools from the definition of “dealer.”

Because qualifying TSVs are not “exchanges” under the Order, they do not need to register as national securities exchanges or with other self-regulatory organizations or comply with Regulation NMS. As a result, the Order makes it significantly easier to establish TSVs for the purposes of facilitating the trade of tokenized securities. The Order also establishes what conditions a TSV must satisfy in order to qualify for the exemption, requiring, among other things:

- **Public, Permissionless Ledgers:** Smart contracts used by the TSV must be auditable, public and deployed on a public, permissionless distributed ledger.
- **U.S. Personhood and Sanctions Compliance:** A TSV must be a U.S. person and, therefore, must comply with the economic and trade sanctions programs administered by the Office of Foreign Assets Control (OFAC), including the prohibition on transacting with persons on the Specially Designated Nationals and Blocked Persons List.
- **Opt-Out:** Before listing a third-party tokenized version of an issuer's stock, a qualifying TSV must give the issuer written notice. The issuer then has 30 calendar days to object. A timely objection bars trading of that token on the TSV.
- **Same Shareholder Rights:** A TSV must verify that each token provides holders the same rights and privileges as traditional stock of the same class — including the same interest in the company and the same dividend, voting and liquidation rights. For tokens created by unaffiliated third parties, proxy materials and other issuer communications must also be passed through to holders at no cost.
- **Limits on Trading Volume:** Tokenized NMS stock is divided into two "tiers," each of which is subject to different daily trading limitations. NMS stock listed on "Tier 1" includes stock in the S&P 500 and Russell 1000 indexes, as well as certain highly traded exchange-traded products; all other stocks fall into "Tier 2." A TSV may trade no more than 75 Tier 1 symbols, and its volume in each Tier 1 stock may not exceed 0.25% of that stock's prior-month average daily share volume. For Tier 2, the limits are 250 symbols and 2.5%. Volume and symbols must be aggregated across affiliated TSVs, but there is no limit on the number of TSVs
- **Stoppages in Trading:** A TSV must stop trading a tokenized NMS stock whenever trading in the underlying stock is halted or suspended on its primary listing exchange — for example, because of a market-wide circuit breaker, pending material news or a regulatory suspension. Coordinated stoppages are designed to prevent price dislocations and the resulting losses to participants. That coordination applies only while the primary market is open. Because a TSV may trade around the clock, it can keep trading while the exchange is closed, so a token's price may diverge from the underlying stock outside of regular trading hours. In addition, prices on automated market maker pools used by TSVs are determined based on the ratio of quantities of the assets in a liquidity pool without direct reference to external pricing, which differ from the quotation and trade through requirements which apply to national securities exchanges.

With a framework under which TSVs can operate, the market for tokenized securities is likely to experience a significant increase in activity. That framework, however, is still in its infancy. The Order represents the first attempt to formally sanction the creation of a TSV through regulatory action and TSVs have already organized to trade NMS stock under the Order, but many aspects of this new market remain untested. As such, even with a formal framework in place, there remain many outstanding questions about how these TSVs will operate and what issues they present for publicly traded companies. Separately, a growing number of public companies have been working with SEC-registered transfer agents to tokenize their own shares, and supporting market infrastructure has continued to develop, including through the SEC staff granting The Depository Trust Company no action relief to pilot the tokenization of securities it custodies. As such, public companies should expect activity in this space to continue to accelerate as the framework matures.

Furthermore, TSVs are not the only path to tokenization, and tokenized securities currently trade outside qualifying TSVs, where the Order's conditions do not apply. For example, third parties unaffiliated with an issuer are already creating tokens which may represent a right to acquire securities held in special purpose vehicles or otherwise create "synthetic" equity or debt tokens whose value tracks an underlying security without conferring ownership or other shareholder rights. Such tokens cannot trade on a

qualifying TSV under the framework above, but may reach investors through other channels. Public companies, too, should be mindful of these markets and the unique issues they present.

Why Tokenized Markets Matter to Public Companies

The creation of TSVs — and the growth of tokenized trading generally — carries significant implications for public companies. Tokenization may broaden an issuer's investor base, increase trading volume and modernize how its shares are held and traded, including through fractional ownership and near-instantaneous settlement. At the same time, it can erode an issuer's control over how its securities trade, expose its securities to more volatile trading patterns and complicate disclosure practices where TSVs permit around-the-clock trading. Public companies will need to decide, on a compressed timeline, how and whether they want to participate in the tokenization of their own securities.

At minimum, public companies should consider:

- **Third-Party Tokenization Without Issuer Participation:** Unaffiliated third parties can tokenize an issuer's stock — for example, by issuing tokens backed by shares held in custody — and sell those tokens to investors. These tokens may affect the trading price of an issuer's securities and may cause investor confusion about whether the issuer sponsors or endorses them. Issuers should strictly monitor whether unaffiliated third parties have disseminated unauthorized tokens and take appropriate action, including, if necessary, exercising opt-out rights under the Order (see below).
- **Issuer Notice and Objection Right:** Qualifying TSVs are required to give issuers the opportunity to object before selling a tokenized version of their security on their platform. In light of this, issuers should designate personnel to monitor for these notices and establish criteria for deciding when and whether to object to those sales.
- **Potential Effects on Trading and Disclosure Practices:** Because tokenized securities on qualifying TSVs may trade around the clock, the traditional distinction between pre-market, regular and after-hours sessions may weaken. Public companies that time material announcements to market closings may need to revisit their disclosure practices, and insiders should be mindful that trading-window and Regulation FD policies were not designed with continuous trading in mind. In addition, because a TSV must make its transaction data public within roughly 10 minutes of each trade, overnight trading on news may generate public price signals before the exchange opens. Public companies may wish to revisit when they release public information and to confirm that their Regulation FD and insider trading preclearance procedures account for continuous trading.

Some Questions That Remain About the Future of Tokenized Securities

Many outstanding questions remain regarding how the market for tokenized securities will operate and what relationship they will have with public companies. Looking forward, these questions include:

- What impact could tokenization have on the value of public companies' stock?
- How can and should public companies comply with their disclosure obligations in light of around-the-clock trading permitted on TSVs?
- What procedures can public companies implement to effectively monitor the market for tokenized securities?
- To what extent should public companies offer tokenized versions of their own stock? What unique advantages does tokenization offer over more traditional offerings?

- To what extent should third parties unaffiliated with an issuer be allowed to offer a tokenized version of that issuer's security to the market? What actions can and should issuers take to prevent the dissemination of such unaffiliated tokens?

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Will Ostrander
+1-213-683-6108
willostrander@paulhastings.com

San Francisco

Daniel H. R. Laguardia
+1-415-856-7055
daniellaguardia@paulhastings.com

Eric C. Sibbitt
+1-415-856-7210
ericsibbitt@paulhastings.com

Andrew Armen Nizamian
+1-415-856-7043
andrewnizamian@paulhastings.com

Paul Hastings LLP

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