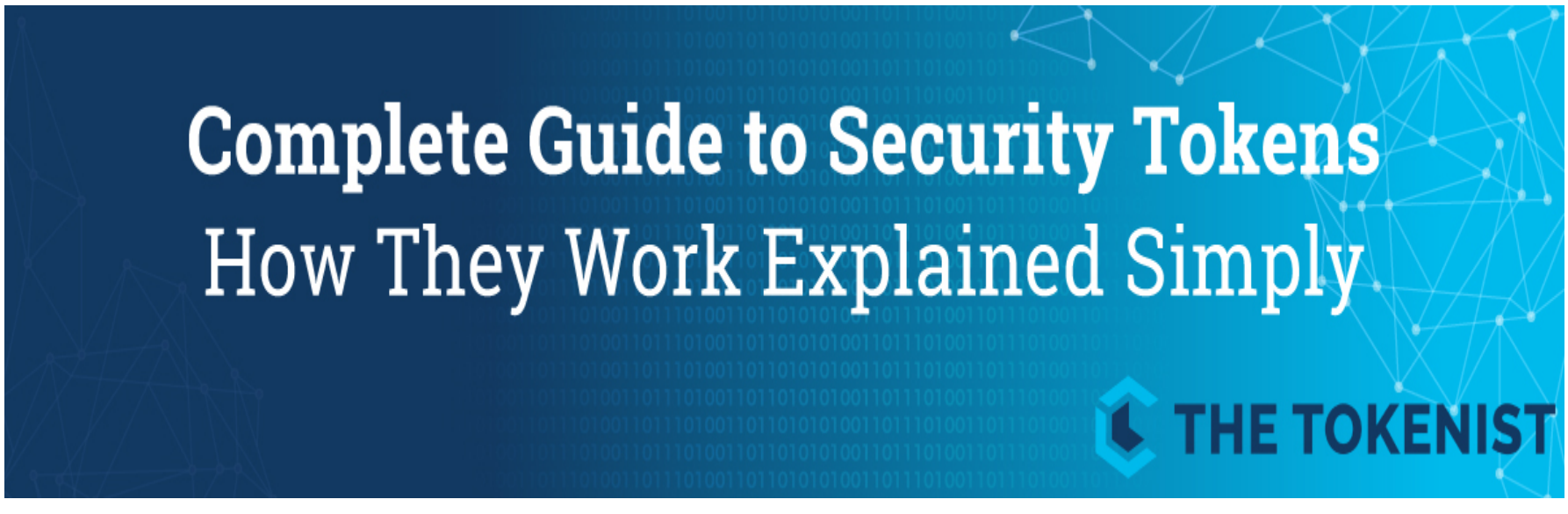

By Tim Fries Reviewed by Shane Neagle Updated March 17, 2022

Does a security token help you feel safer? Find out what security tokens actually are. At the most basic level, tokens can be divided into two types: utility tokens and security tokens. 🛡️

Most people will be more familiar with utility tokens than security tokens, even if we do not often call utility tokens by that name. A **utility token** is a 'coin' backed up by a project, and this is the type of investment most of us are used to making. Usually, utility tokens are Ethereum based, as this is one of the simplest ways of making a new token and programming it so the user is granted access to some utility.

Typically, when a user invests in a utility token, they receive some definable benefit in return. Most commonly, this benefit is access to a particular system, or the receipt of a coin that in turn offers access to some service. This could be access to cloud storage space, for instance, whether now or in the future.

A **security token**, on the other hand, need not have a utility. Rather than conferring a tangible benefit on the investor, a security token typically represents a share in the company who issued it. For this reason, security tokens are also sometimes called equity tokens, and are often compared to the way in which buying shares on the traditional stock market confers partial ownership of a company.

Whilst this may sound like a slightly pedantic distinction to make, in reality, the major difference between utility and security tokens comes down to one major fact: security tokens are much more regulated by the government than utility tokens with new rules on the way.

Whether this is a positive thing or not depends, largely, on your perspective. For those coming from more traditional forms of finance and investing, security tokens offer the speed and ease of blockchain without sacrificing strong legal protection. For those with a

The Howey Test 🧪

In the US, any instrument defined as a 'security' is regulated by the Securities and Exchange Commission (SEC), including security tokens. This sounds straightforward enough, but the legal definition of a security is actually quite complex, and many coins sit uncomfortably between the categories of 'utility' and 'security'.

To understand what the SEC counts as a security, it is necessary to go all the way back to 1946, and all the way to a citrus grove in sunny Florida. At that time, a company called the Howey Company was leasing out part of their orange groves to investors. Investors in this scheme would buy a plot of land, but there was also an explicit promise from the Howey Company that they would work the land, and pay out part of the profit to investors.

The SEC moved to block the sale. From their perspective, the planned scheme was an investment contract, and as such the investors were entitled to protection. The Howey Company disagreed, and argued that the transaction would be no more than a land sale.

The case would eventually be appealed all the way to the US Supreme Court, who contentiously found in favor of the SEC, and thereby created the current definition of what counts as a 'security'.

This is defined by what has become known as the 'Howey Test'. A transaction will be classified as a security if all four of the following requirements are met:

1. ☑️ There is an investment of money.
2. ☑️ There is an expectation of profits.
3. ☑️ The investment of money is in a common enterprise.
4. ☑️ Any profit comes from the efforts of a promoter or third party.

In the court ruling, presiding judge Justice Murphy went further, stating that:

> *If that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether there is a sale of a property with or without intrinsic value.*

What this means, basically, is that if you are investing money, and plan to profit from the efforts of someone else, you are buying a security. If that sounds an awful lot like buying a token, and hoping those behind it succeed, that's because it is.

Blockchain and the SEC 🔗

In fact, for all of the talk about security tokens recently, it is a wonder that more tokens have

At that time, DAO was the largest crowdfunded cryptocurrency in history. Though records were being broken almost every month in 2016 / 17, the $150m raised by DAO is still astounding, particularly given that many were expressing concerns that the system was hackable even whilst more investors were pouring money into the ICO. In response, Stephan Tual, one of DAO's founders, explicitly said that "*no DAO funds [were] at risk*". They were, however, as hackers stole $50m, and the price of Ethereum dropped by 50%.

This made an awful lot of investors awfully angry and was the spark for the SEC to finally concern itself with crypto. Their report on the affair described the application of the 'fundamental principles' of US federal securities law to the 'new paradigm' of crypto, defined as 'virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and the related offer and sale of securities'.

This report stated, in terms that sent shockwaves through the ICO world, that 'the automation of certain functions through this technology, "smart contracts," or computer code, does not remove conduct from the purview of the U.S. federal securities laws'. That is: cryptocurrencies would no longer exist in some unregulated dreamland. DAO was quickly defined as a security, as were a number of smaller coins, and many expect other major players to have their tokens defined as securities in the coming years.

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Regulation vs. Opportunity – Is Regulation Really Bad for Crypto? ⚔️

Many ICOs are scrambling to avoid being defined as security tokens, and in fact, a profitable line of business has opened up advising companies on how to avoid their tokens being classed in this way. The motives behind this are clear enough: with this definition comes the need to make tokens compliant with the SEC's rules, and potential fines if promises are not met.

For some companies, a desire to avoid the oversight of the SEC is undoubtedly a way of avoiding potential legal consequences. For others, however, there is a greater issue at stake: government regulation is simply against the philosophy that underpins blockchain.

The crypto space has historically had something of the Wild West about it – whilst investments are often unsecured, and profits unguaranteed, canny and adaptable investors could make a lot of money very quickly – and many want to keep the market that way.

> 🤡 **Fun Fact:** The best apps for investing have used technology to make a number of assets — stocks, ETFs, mutual funds, IRAs, and more —seamlessly accessible.

Some tokens are more 'vulnerable' to being classed as securities than others. As the definition above makes clear(ish), one critical factor in avoiding the definition is providing a clear utility to investors. Another is the requirement that a security generates profit from the work of others. For this reason, certain tokens will never be classed as securities.

Bitcoin, for instance, is used as a currency by those who hold it, and by investing in bitcoin there is no development team not promise that an investor will profit from buying it. Ethereum is a more complex case, but undoubtedly has utility, and holders of it are not

With some other tokens, the definition is a little hazy. Take, as an example, an ICO that promises a share of profits from a future cloud storage platform, but also provides investors with space on the platform. *Are we to regard the space provided as a utility? Or is the work that the developers will put in to realize the system equivalent to the Howey Company working the orange groves?*

As I've said, the situation is complex, and as such many are paying close attention to the actions of the SEC over the coming months. The legal gray area that the SEC's recent rulings have opened up has, however, already generated some pretty strange outcomes: many teams have added in-app functionality, for instance, as a (totally arbitrary) 'utility' in order to hide their investment instruments from the Commission.

The Promise of Security Tokens – A New World of Finance 💰

Even whilst some teams are desperately trying to avoid their tokens being classed as securities, there is a complementary and opposite shift occurring amongst more traditional investment firms. Many corporate giants have recently announced platforms for trading security tokens, and in doing so hope to offer institutional investors a relatively safe and easy way to begin investing in blockchain.

The founder of the company that owns the NY Stock Exchange, for instance, recently announced a new venture, Bakkt, and the Swiss Exchange also plans to build a regulated exchange for tokenized securities. Both systems aim to bring together the huge amount of capital present in more traditional investment markets with the adaptability, speed, and potential returns, of cryptocurrency.

In fact, this linkage between long-established investment instruments and the dynamic world of crypto is where many see the primary value of security tokens. They potentially offer investors the security of a regulated instrument, combined with the speed of blockchain.

What Does This Mean in Theory? 🧠

This could, theoretically, change the nature of investing forever. Take corporate equity, for instance. Though shares in companies have arguably been available for purchase since the days of ancient Rome, even the most advanced stock exchanges in the world today still typically require 2 days to clear purchases.

Using blockchain, this period could be reduced to minutes. Perhaps the most transformative potential of security tokens, however, and the one that many investors are most excited about, is the application of blockchain to the real estate market.

This shift will not be easy, however. Security tokens are far more complex than the cryptocurrencies on the market today, and therefore require similarly complex systems for trade. Specifically, the need to comply with the SEC's rules on the trading of securities means that any system for trading security tokens needs to incorporate many more legal contracts than a standard purchase of bitcoin. It is for this reason that, although many companies have recently announced security token exchanges, there is no Coinbase or Circle for security token exchange just yet.

On the other hand, the ***rewards for building a dominant system for security token exchange could be massive***. There are over $256 trillion of real-world assets in the world, after all, and connecting this to consumer investors through blockchain could transform the way we understand financial markets. As such, the opportunity for crypto-securities is truly massive, especially with regards to asset classes like real estate and fine art that have historically suffered from limited commerce and liquidity'.

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Hype or Reality? – Let's Look at The Facts 🤔

We shouldn't get carried away, though. Whilst security tokens are generating a huge amount of interest at the moment, this could all be hype. Even a quick search for information on security tokens returns many articles speculating about the possibility of them being the next doomed bubble: see here and here, for example.

At the moment, no-one seems sure where the future of security tokens lies. Whilst the long-prophesied collapse of blockchain itself now seems to have been disproven, the recent history of ICOs perhaps offers some warning signs about security tokens. The huge levels of capital generated by ICOs in 2016 / 17 now seem to be a thing of the past as investors grow more wary of investments backed by nothing more than a white paper and a promise of future utility. In this context, the fact that some are talking about security tokens being 'the next ICO' is less positive than it sounds.

At the center of this issue is a question about what it is, precisely, that investors want. Those who have traditionally invested in ICOs, and in utility tokens, seem content to receive a service in exchange for their capital, and care little about whether their investment is regulated by the government. Indeed, for many of these investors, the idea of regulation of any kind seems to cut against the primary attraction of blockchain: it's independence from more traditional systems of finance.

From the opposing perspective, it also seems unlikely that the bulk of institutional investors have a requirement for the rapidity that blockchain transactions require. Large financial institutions with specialist trading teams are likely to make use of tokenized security trading, but for the majority of more cautious investors, the ability to complete transactions in minutes makes little difference to investment strategies that typically take years to develop.

All this said, it is also clear that security tokens are here to stay, if only because the sheer amount of money invested in building platforms for their exchange gives them a degree of momentum. The best prediction that can be made, therefore, is to remain skeptical about the sometimes grandiose claims of those pushing security tokens, whilst also accepting that they will likely establish their own place within the crypto ecosystem.

7 Ways Security Tokens Can Change The Market 📊

Traditional securities take a long time to settle. Sure, the settling process has sped up over

1. Unlocking Liquidity 🌊

So as it stands now, if you sell a security on a Thursday afternoon, the transaction may not be settled until the following Monday (that's a total of 4 days). With thousands of securities transactions happening constantly, this inefficiency compounds.But when you remove these inefficiencies, trades can settle faster (minutes), and the ***illiquidity discount*** is eliminated.

For example, if you own a piece of real estate and, one day, you suddenly want to sell it, it can take weeks or even months for the deal to close – even if you have the buyer ready! **This drives the price down, because buyers know that it's such a pain to sell.**

For a comparison of just how big this innovation is, consider what email did to snail mail. A few decades ago, you'd have to go through the painstaking process of mailing a fax in order to send written communications. People would think twice before going through that.

But now that email is mainstream, people frequently use it for simple communications like asking coworkers to lunch, keeping in touch, and sending memes – things they never even considered before. And so, the invention and widespread use of email has transformed not just the "how", but the "what" in our written communications – all because of its ease of use.

Security tokens can do the same for finance – and if this is very exciting for the future of both crypto and finance in general.

2. Opening Up Capital to Global Markets 🏛️

Depending on the how the token is set up, it may be eligible for trading in global markets. For example, an investor in Germany could easily buy equity in a cafe in Florida with a few clicks.

Just how much of the global market is possible? CoinList, a leading platform for compliant token sales, conducted a round for Origin Protocol and attracted over 1800+ investors from over 50 countries worldwide to participate in the investment round.

This, again, adds liquidity and provides opportunities for investors to buy shares of assets that were previously much more difficult to attain.

3. 24/7 Trading ⌛

With traditional stocks and securities, the markets are strictly open for 6-7 hours, and on weekdays only (9:30am-4pm EDT from Monday-Friday in US, excluding holidays).

This hinders liquidity, because investors can't trade on news or market developments over the weekend. This could lead to sketchy behavior from companies. For example, they'll often release information after 4pm on Fridays in order to capitalize on this.

However, security tokens **allow for 24/7 markets**, which eliminates the huge inefficiencies of daily market closures.

> 🤓 **Extra Class:** Learn how to trade stocks in our in-depth guide.

4. Asset Interoperability 📊

Stephen McKeon explains what this could mean in his Security Token Thesis:

> "*If the ecosystem for global assets becomes interoperable, it means* ***we can hold ownership claims to a commercial building, early stage equity, corporate bonds, a T-bill, a single family residence, and a decentralized network on the same platform.*** *Further, we could self-custody these types of ownership claims in a single hardware wallet, if so desired. It means these assets to be able to reference each other contractually and interact in an automated way.* ***It could mean global pooled liquidity for all asset classes through a single interface.***"

This would create endless opportunities and new markets from the likes that we've never seen before.

5. Automated Compliance ⚙️

One of the most difficult aspects of trading securities is adhering to regulations. This is because:

- ☑️ Regulations can vary by asset type, investor type, and buyer/seller/issuer jurisdictions.
- ☑️ You typically need to document regulatory compliance through a series of separate ledgers.

But because security tokens are programmable, compliance can be baked right into the token. The hassles of being compliant are greatly reduced, as legally compliant protocols like Polymath and Harbor work together with exchanges like tZERO, 0x, and more.

This allows compliance to become exponentially easier, and just about automatic once the systems are in place.

6. Programmable Assets and Securities 💡

For example, let's say you and your friend, Joe, both own the same amount of Apple stock – but Joe has owned the stock for 5 years, while you just bought it last week.

Dividend Release 🏦

If Apple offers a dividend, you and Joe would both get the same percentage, despite the fact that Joe got in long before you, but if these assets were programmable, like they can be with security tokens, companies could do something more unique. Joe could get a higher dividend because he's held it for so much longer than you. This incentivizes long-term holding, which helps the asset maintain and increase its value over time.

Voting and Governance Rights 🧮

Similar to how dividends and rewards can be programmed, so can voting rights. If Joe has owned Apple for a lot longer than someone who has actively traded in and out of the equity they could theoretically be given special voting or decision-making rights.

While this idea itself isn't new, shareholders are still able to vote (depending on what kind of shares they hold), accomplishing this via tokenized representations of ownership is much

Special Rights and Privileges 💳

Now imagine if our friend Joe was also given a discount based on how long he's held his Apple stock. The longer/more stock he's had the higher his discount tier would be. This could all be accomplished via a generic platform specific ID. This could also even be further built into an affiliate network.

For example, if Joe owned X amount of Y security token he would be able to promote it to his network and be rewarded with more security tokens. This might sound like an MLM in the making, however, companies like UBER and Paypal literally paid people to promote their services for years before they gained mainstream adoption.

These same principles could be applied for tokenized assets but in a much more effective manner – instead of getting a cash payout you're receiving equity in the underlying business.

7. Fractional Ownership and Increased Market Depth 💸

Consider high-priced assets like real estate and artwork. These assets can have huge costs, ranging in the millions to even hundreds of millions of dollars – with minimal market depth.

(Market depth is a property of the orders that are contained in the limit order book at any given time. It lets you know the supply and demand of a particular cryptocurrency or security at different prices. Securities with strong market depth allow traders to place larger orders without significantly affecting the price. See the market depth chart below.)

For example, most investors can't afford to buy a commercial property in the Upper East Side of New York City, and even those investors who CAN afford it may not be able to hedge their bets by also buying real estate in Brooklyn.

But with security tokens, you get the benefits of fractionalized ownership. Instead of spending millions of dollars for an entire property (or even a piece of artwork), you can spend far less and buy a fraction of that property. Then, if you want to hedge your bet, you can buy a fraction of another property in a different part of town or even in a different part of the world.

This also increases market depth, because there will now be more buyers out there who are interested and capable of owning a tokenized version of the asset.

High-priced investment opportunities open up to everyone – not just the super rich – AND give you a chance to not just invest, but diversify your investments in ways you've never been able to. This is truly a groundbreaking evolution.

Security Tokens Are Here to Stay 🏁

In summary, security tokens show a lot of promise, even if at the moment they remain underutilized. The long-term trend is clear: there will undoubtedly be many more security tokens coming to market in the next few years, as the hype that surrounds them continues to build and (possibly) some existing tokens are re-classified.

At the moment, there is no dominant platform for trading security tokens, and the complex compliance issues that they raise means that this seems unlikely to happen in the immediate

matter of attitude: whilst there are certainly profits to be made in getting in early on security tokens, there are certainly risks involved.

Ultimately, and as with most issues when it comes to cryptocurrency, working with security tokens is an area in which a little knowledge goes a long way. Understanding the difference between a utility token and a security token is a great start, as is understanding the reasons why so many investors are getting so hot and bothered about security tokens.

We hope we've provided you with that, at least, in the article today, but stayed tuned to The Tokenist for more information on security tokens as the market inevitably expands!

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