LOGIN

Contents

Navigation

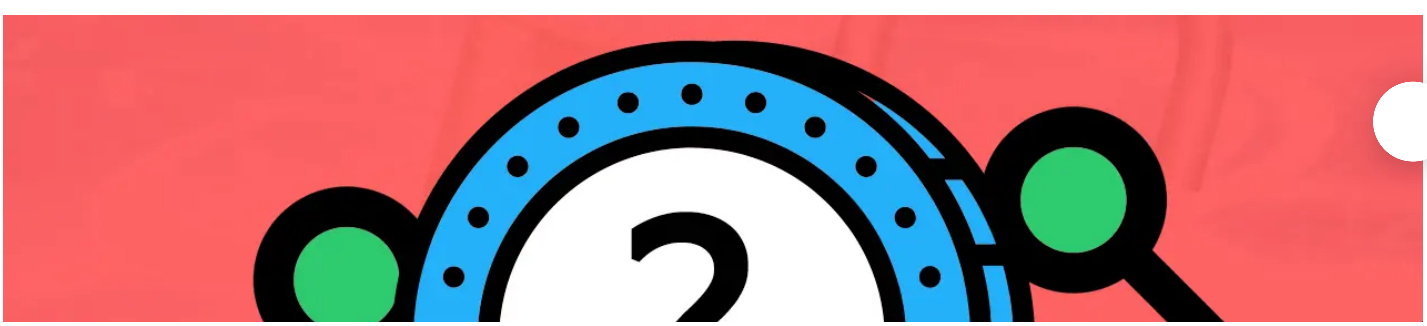
What Are Security Tokens? [The Most Comprehensive Guide]

#Blockchain for Business #Blockchain for Investors #Security Token

Home » Guides » Blockchain for Investors

Rajarshi Mitra

Updated on: May 13th, 2020
This content has been Fact-Checked.



EN AR FR DE KO PT

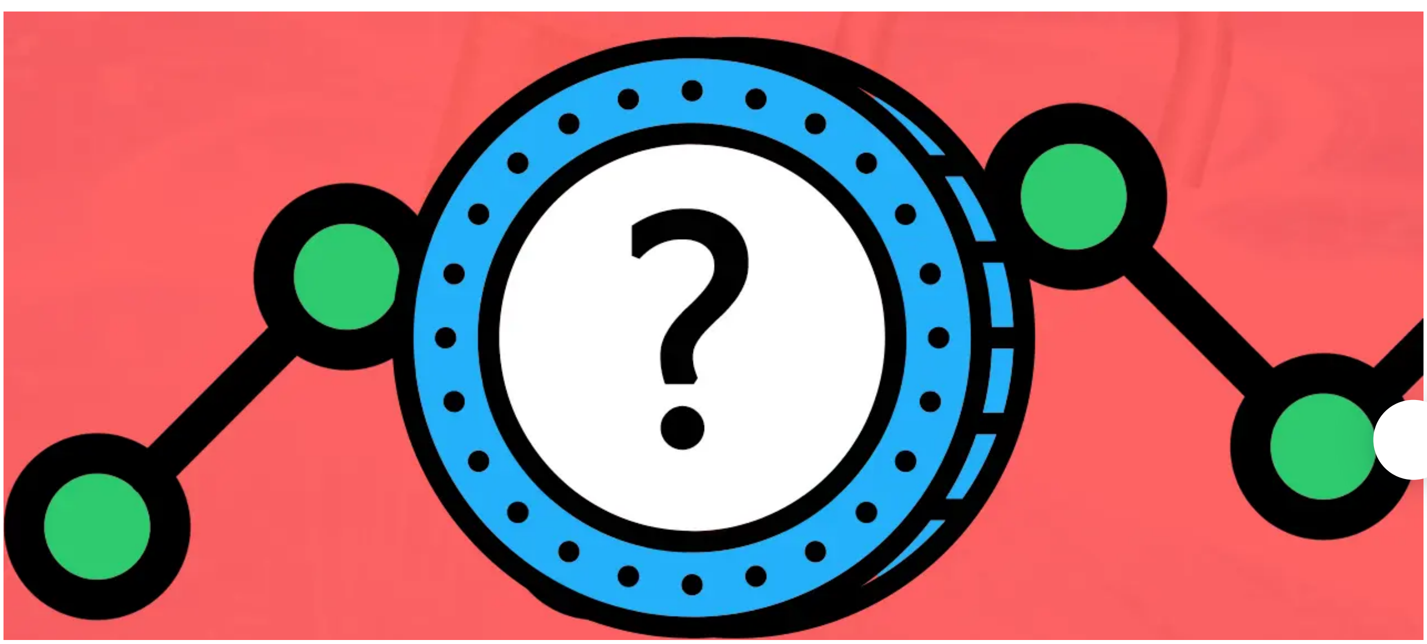
0:00 / 0:00

Go on YouTube right now and search for Security Tokens.

You will probably get results like:

- *Why are Security Tokens the future?*
- *Are Security Tokens the next big thing?*

So, it seems like there is a lot of hype behind security tokens nowadays. In this guide, we are going to learn everything about security tokens and see if they are worth your time or not.



What are Security Tokens?

Firstly, let's briefly define security tokens. In a traditional sense, securities can represent an ownership position in a publicly-traded corporation, a creditor relationship with a governmental body/corporation, or rights to ownership as represented by an option. A security token is a tokenized, digital form of these traditional securities. Before we go any deeper, let's revisit the basics.

What are Tokens?

It can be a little complicated to pinpoint on an exact definition of a "token". To give you a very wide, non-generalized definition, a token is a representation of something in its particular ecosystem. It could value, stake, voting right, or anything. A token is not limited to one particular role; it can fulfill a lot of roles in its native ecosystem.

Before we go any further, however, we must make one more difference clear. The difference between a cryptocurrency coin and a token.

A cryptocurrency coin, like Bitcoin, Bitcoin Cash, Ethereum, etc. can be is independent of a platform. They can be used as a form of currency outside their native environment. Basically, these are the "cryptocurrencies" that we are all familiar with.

However, on the other hand, OmiseGO, Golem, etc. are examples of tokens which exist on a particular platform, in this case, Ethereum.

A token, represent an asset or utility that a company has and they usually give it away to their investors during a public sale called ICO (Initial Coin Offering).'

What Are ICOs?

ICOs or Initial Coin Offerings are basically crowd sales, the cryptocurrency version of crowdfunding. The ICOs have been truly revolutionary and have managed to accomplish amazing tasks:

- They have provided the simplest path by which DAPP developers can get the required funding for their project.
- Anyone can become invested in a project they are interested in by purchasing the tokens of that particular DAPP and become a part of the project themselves. (We are talking about Work Tokens here).

So, how does an ICO work?

Firstly, the developer issues a limited amount of tokens. By keeping a limited amount of tokens they are ensuring that the tokens itself have a value and the ICO has a goal to aim for. The tokens can either have a static pre-determined price or it may increase or decrease depending on how the crowd sale is going.

The transaction is a pretty simple one. If someone wants to buy the tokens they send a particular amount of ether to the crowd-sale address. When the contract acknowledges that this transaction is done, they receive their corresponding amount of tokens. Since everything on ethereum is decentralized, an ICO is considered a success if it is properly well-distributed and a majority of its chunk is not owned by one entity.

The recently concluded EOS ICO which raised a whopping 4 billion dollars in a year is till date the biggest ICO ever.

Also, as TechCrunch points out, ICOs delivered at least 3.5x more capital to blockchain startups than Venture Capitals since 2017

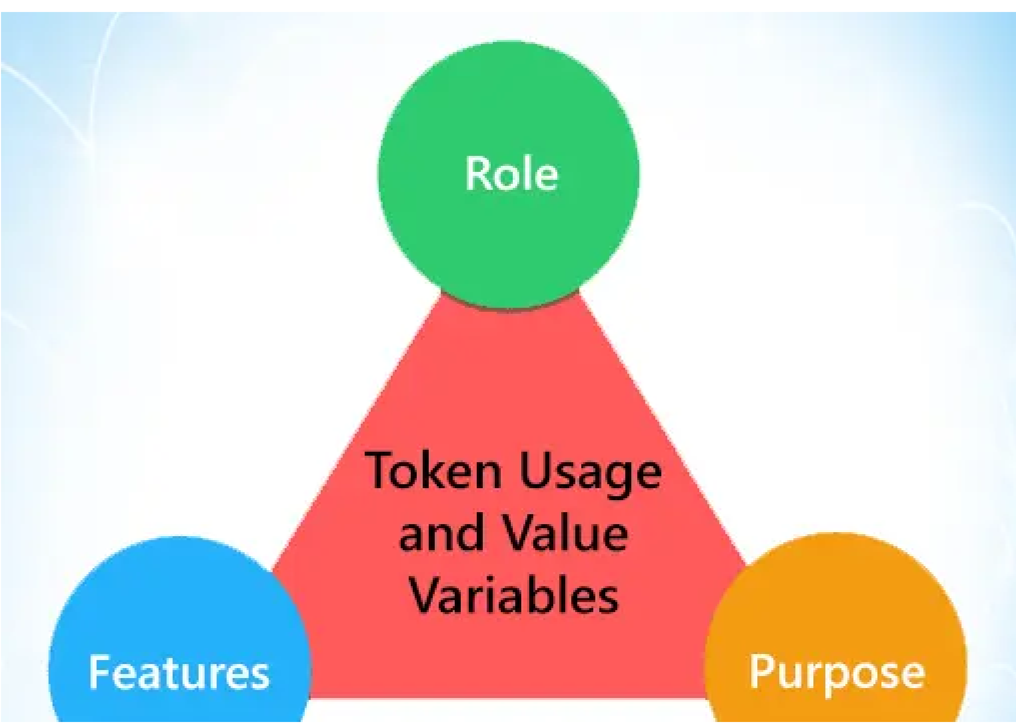
How Does a Token Gain Value?

So, before we continue and classify our tokens, let's look at what functions a token can serve in order to gain value.

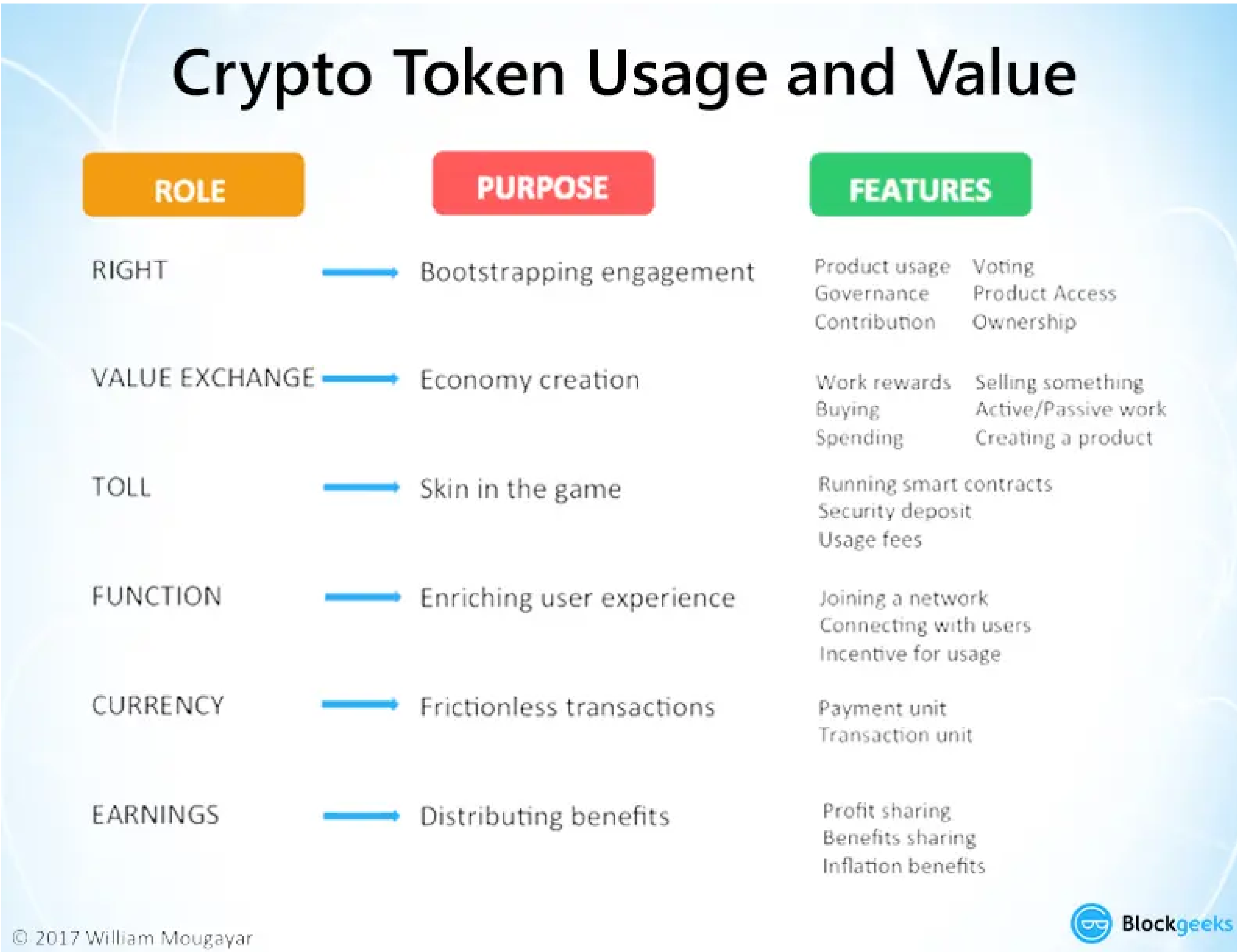
As William Mougayar points out in his Medium article, there are three tenets to token value and they are:

- Role.
- Features.
- Purpose.

These three are locked up in a triangle and they look like this:



Each token role has its own set of features and purpose which are detailed in the following table:



Crypto Token Usage and Value

ROLE	PURPOSE	FEATURES
RIGHT	Bootstrapping engagement	Product usage, Governance, Contribution, Voting, Product Access, Ownership
VALUE EXCHANGE	Economy creation	Work rewards, Buying, Spending, Selling something, Active/Passive work, Creating a product
TOLL	Skin in the game	Running smart contracts, Security deposit, Usage fees
FUNCTION	Enriching user experience	Joining a network, Connecting with users, Incentive for usage
CURRENCY	Frictionless transactions	Payment unit, Transaction unit
EARNINGS	Distributing benefits	Profit sharing, Benefits sharing, Inflation benefits

© 2017 William Mougayar
Blockgeeks

Let’s examine each of the roles that a token can take up:

Right

By taking possession of a particular token, the holder gets a certain amount of rights within the ecosystem. Eg. by having DAO coins in your possession, you could have had voting rights inside the DAO to decide which projects get funding and which don’t.

Value Exchange

The tokens create an internal economic system within the confines of the project itself. The tokens can help the buyers and sellers trade value within the ecosystem. This helps people gain rewards upon completion of particular tasks. This creation and maintenance of individual, internal economies are one of the most important tasks of Tokens.

Toll

It can also act as a toll gateway in order for you to use certain functionalities of a particular system. Eg. in Golem, you need to have GNT (golem tokens) to gain access to the benefits of the Golem supercomputer.

Function

The token can also enable the holders to enrich the user experience inside the confines of the particular environment. Eg. In Brave (a web browser), holders of BAT (tokens used in Brave) will get the rights to enrich customer experience by using their tokens to add advertisements or other attention based services on the Brave platform.

Currency

Can be used as a store of value which can be used to conduct transactions both inside and outside the given ecosystem.

Earnings

Helps in the equitable distribution of profits or other related financial benefits among investors in a particular project.

So, how does this all help in token valuation?

In order to become more valuable, a token must fulfill more than one of these properties. In fact, more properties that a token can have, higher its valuation

Alright, so now we know what a token is, how a company distributes token and where a token can gain value from.

Before we go any further, it is important to know what the Howey test is.

What is a security token: The Howey Test

In 1946, the Supreme Court handled a monumental case. The case was SEC vs Howey which would lay down the foundation for the, now infamous Howey Test. The case was about establishing a test of whether a particular arrangement involves an investment contract or not.

To keep a long story short, two Florida-based corporate defendants offered real estate contracts for tracts of land with citrus groves. The defendants offered buyers the option of leasing any purchased land back to the defendants, who would then tend to the land, and harvest, pool, and market the citrus. As most of the buyers were not farmers and did not have the agricultural expertise, they were happy to lease the land back to the defendants.

However, this was deemed illegal by the U.S. Securities and Exchange Commission (SEC) and the defendants were promptly sued.

According to the SEC, the defendants broke the law by not filing a securities registration statement. Upon investigating the defendant’s leaseback and finding that it was indeed a security, the Supreme Court made a true landmark decision.

They developed a test which will be used to determine whether a certain transaction is an investment contract or not. If it is, then it will be subject to securities registration requirement.

The said transaction will be called an investment contract if it fulfills the following criteria:

- **It is an investment of money**
- **The investment is in a common enterprise**
- **There is an expectation of profit from the work of the promoters or the third party.**

The term “common enterprise” is open to interpretation. However, many federal courts have defined a common enterprise as a horizontal enterprise where the investors pool in their money and assets to invest in a project.

Even though the original Howey Tests used the term “money”, later cases expanded that to include other investments and assets other than money.

Plus, there is another important thing to consider while determining securities. The profits that come from the investment, is it in the investor’s control or is it completely out of it? If it is not in the investor’s control, then the asset has usually declared a security.

So, how is this relevant for ICO and tokens? If the token meets all the three aforementioned criteria, then it is regarded as a security.

All these three elements have to be met for a coin to classify as security.

Other Alternative Tests

Turns out that the Howey Test is not the only test that courts can use to find out whether a given investment is a security or not.

In 1990, the Supreme Court developed a family resemblance test which provided a way for contract creators to show that their contract has a “family resemblance” to other investments and hence cannot be called securities.

Certain states have their own securities registration requirements which are sometimes called "Blue Sky" laws.

According to Wikipedia,

> ***"The first blue sky law was enacted in Kansas in 1911 at the urging of its banking commissioner, Joseph Norman Dolley, and served as a model for similar statutes in other states. Between 1911 and 1933, 47 states adopted blue-sky statutes (Nevada was the lone holdout). Today, the blue sky laws of 40 of the 50 states are patterned after the Uniform Securities Act of 1956. Historically, the federal securities laws and the state blue sky laws complemented and often duplicated one another."***

The DAO and SEC

The Howey Test and securities have become a source of intense debate in the crypto-community after the DAO tokens failed to pass the Howey Test and were deemed securities by the SEC.

This article by Ash Bennington for Coindesk, breaks down why the Dao was deemed a security in the form of a tale:

"Not so long ago, a group of developers started a DAO.

The DAO developers said:

> ***"There are all these decentralized projects and there's no way for them to get funding – because they need money to make money."***

Tell you what. We're going to write code and sell a token and, in exchange, people who buy the token will get whatever profits are made from those projects.

We'll work the code. They'll pick the projects. The projects will flourish and everyone will profit.

The SEC said: "That's a security."

The DAO developers said: "No, no. That's just selling tokens."

Ultimately, the SEC said: "That's a security" – because of the application of the Howey Test: There was an investment of money. And a common enterprise. With the expectation of profit, primarily from the efforts of others."

So, why was this investigation and ruling done in the first place?

Well, it was because of the infamous DAO hack. We have covered this in detail before, but just to give you an overview:

- There was a flaw in the Dao smart contract
- The hacker exploited that flaw to execute a re-entrancy attack.
- Over $!50 million worth of ether was siphoned away.

Because a lot of people invested and got back nothing in return, the SEC intervened to "protect" the interest of the investors and deemed the tokens a security.

As SEC CEO Jay Clayton puts it, "The SEC is studying the effects of the distributed ledger and other innovative technologies and encourages market participants to engage with us. We seek to foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected."

This decision was met with mixed reception in the Crypto community:

Brad Garlinghouse, Ripple Ceo, said,

> *"Regulators aren't going away – and shouldn't. For generations, they have protected from fraud (some is happening w/ the ICO market)."*

Roger Ver, bitcoin.com founder, however, disagreed with the decision,

> ***"Call this what it is: A bunch of strangers in a far-off land threatening peaceful people all over the world with violence if they don't obey."***

Ok, so till now we know what tokens are and what the Howey Testis. So, now let's get into the two major classifications of tokens.

Types of Tokens

The SEC and FINMA have broken down tokens into two broad categories:

- Utility Tokens
- Security Tokens

Utility Tokens

Because most of the ICOs are investment opportunities in the company itself, most tokens qualify as securities. However, if the token doesn't qualify according to the Howey test, then it classifies as utility tokens. These tokens simply provide users with a product and/or service. Think of them like gateway tokens.

As Jeremy Epstein, the CEO of Never Stop Marketing, explains, Utility tokens can:

- Give holders a right to use the network
- Give holders a right to take advantage of the network by voting

Since there is an upper cap on the maximum token availability, the value of the tokens may go up because of the supply-demand equation.

Security Tokens Crypto

Finally, we come to security tokens.

So what exactly are they?

A crypto token that passes the Howey Test is deemed a security token. These usually derive their value from an external, tradable asset. Because the tokens are deemed a security, they are subject to federal securities and regulations. If the ICO doesn't follow the regulations, then they could be subject to penalties.

However, if all the regulations are properly met, then these tokens have immensely powerful use-cases.

What Regulations Are Security Tokens Subjected to?

Anthony Pompliano does an admirable job of explaining the kind of regulations that security tokens will be subjected to in this article.

According to him, because Security Tokens are subject to federal security regulations, they are compliant from the first day itself. So, in USA, security tokens need to follow these regulations:

- Regulation D
- Regulation A+
- Regulation S

Regulation D

Regulation D will allow a particular offering to avoid being registered by the SEC provided "Form D" has been filled by the creators after the securities have been provided "Form D" has been filed by the creators after the securities have been sold. The individual who is offering this security may solicit offerings from investors in compliance with Section 506C.

So what does Section 506C require?

It requires a verification that the investors are indeed accredited and the information which has been providing during the solicitation is "free from false or misleading statements.

Regulation A+

This exemption will allow the creator to offer SEC-approved security to non-accredited investors through a general solicitation for up to $50 million in investment.

In order for the requirement to register the security, the issuance of Regulation A+ can take a lot more time compared to other options. For the same reason, Regulation A+ issuance will be more expensive than any other option.

Regulation S

This happens when a security offering is executed in a country apart from the US and is therefore not subjected to the registration requirement under section 5 of the 1993 Act. The creators are still required to follow the security regulations of the country where they are supposed to be executed.

NOTE: As Anthony Pompliano notes in his article, the above summaries are merely his interpretation. They should not be construed as legal or investment advice and you should consult a lawyer for any and all questions you have.

Why are Security Tokens Important?

Since the assets which are represented by the security tokens already exist in the "real world", they act like a bridge between legacy finance and the blockchain world. So what are the exact changes that security tokens are bringing along with them?

#1 Bringing Credibility Back

As of right now, the ICO space is a little dicey, to say the least. There is a real deficit of accountability in the space because of a lack of regulation for utility tokens. In order for the ICO space to regain some credibility, it should make sense to somehow amalgamate the crypto space and the legacy finance space together.

#2 Improving Traditional Finance

Traditional financial transactions can be a little expensive because of all the fees associated with the middlemen like bankers. Security tokens remove the need for middlemen which reduces fees. In the future, smart contracts may reduce the complexity, costs, and paper works.

#3 Speeding up Execution

Traditional financial institutions have a lot of middlemen involved which simply increases the execution time. By removing these middlemen, securities allow for faster execution time for the successful issuance of security tokens. Because of this increased speed, the security tokens are bound to become attractive investments.

#4 Exposure to Free Market

Investment transactions today are extremely localized.

What do we mean by that?

Chinese investors find it extremely hard to invest in private US companies and vice-versa. So, how are security tokens going to help here?

Well, by using security tokens, creators can market their deals to anyone on the internet. This exposure to the free market helps in increasing asset valuation. Also, this increased exposure leads to….

#5 Huge Number of Investors

Since creators can now present their deals to anyone on the internet, the investor base increases exponentially.

This is another huge incentive for creators.

#6 Reducing Lawyer Service

In the future, there security token projects will use smart contracts which will automate service provider functions through software. These functions are currently provided by players such as lawyers which add on to the potential middlemen involved in the project.

#7 Lack of Institution Manipulation

Because the number of middlemen decreases drastically, the chances of corruption and manipulation by financial institutions decrease drastically and may even be removed from the investment process.

#8 Easier Liquidation

Secondary trading on security tokens will be made simple through licensed security token trading platforms and it will be extremely easy for investors to liquidate security tokens.

Having said that, not everything is sunshine and rainbows, there are some disadvantages of security tokens.

Do Security Tokens have a Weakness?

The removal of the middlemen is usually seen as a huge advantage. However, you can’t have your cake and eat it as well. There are some disadvantages which will invariably come along with security tokens. Removal of middlemen leads to the shifting of responsibilities onto the buyer or the seller in the transaction.

These middlemen i.e. financial institutions serve a lot of important functions in the ecosystem such deal underwriting, preparation of marketing materials, solicitation of investor interest, insurance of high levels of security, and compliance regulation.

Many critics feel that the creators won’t be able to successfully execute these functions without traditional financial institutions. We need to wait and watch if these fears have any basis or not.

Conclusion: Security Tokens?

The crypto community breath a sigh of relief when SEC has ruled Bitcoin and Ethereum to not be securities. As of right now, security tokens have a far less share of the market as compared to utility tokens, however, security tokens are something which can become huge in 2018 and needs to be embraced by everyone soon. It is believed that tons of capital is going to flow from Wall Street to security tokens instead of utility tokens.

This shift is happening because security tokens are considered to be safer because of the strict regulations.

SPICE Venture Capital founder Carlos Domingo expertly summarized his thoughts of the potential size of the security token market:

> ***“It’s inevitable that security tokens will transform equity just a*** *bitcoin* ***has transformed currency, because they afford the owner a direct, liquid economic interest and the expedited***

> ***delivery of proceeds. Every type of ownership can be tokenized, which is a massive multi-trillion dollar addressable market."***

Rajarshi Mitra

Rajarshi started writing in the blockchain space after listening to Andreas Antonopoulos' podcast with Joe Rogan. A content generating machine, Rajarshi has been consistently producing high-quality guides and articles for us since late 2016. His articles have been shared extensively in social media and several start-ups have used his guide as learning material for their staff. He is continuously invited all over his country to give talks in various crypto seminars and conferences. He has gained a solid reputation as a speaker/educator on top of being one of the most promising writers in the crypto space. When he is not busy nerding out over the latest in the blockchain/crypto space, he is usually busy watching re-runs of top gear and MMA.

ASK COMMUNITY

1) Q: What are tokens?

A: a token is a representation of something in its particular ecosystem. It could value, stake, voting rights, or anything. A token is not limited to one particular role; it can fulfill a lot of roles in its native ecosystem.

2) Q: What is a security?

A: In a traditional sense, securities can represent an ownership position in a publicly-traded corporation, a creditor relationship with a governmental body/corporation, or rights to ownership as represented by an option.

3) Q: What is a security token?

A: A security token is a tokenized, digital form of these traditional securities

RELATED GUIDES

Matthew Baggetta

Best Bitcoin Wallets of 2021

0

Matthew Baggetta

Disruptive Blockchain Technology Use Cases 2021

0

Rajarshi Mitra

Enterprise Blockchain Solutions - Overview, Opportunities and Challenges

0

Rajarshi Mitra

Blockchain Supply Chain - Who, What, Where, How?

0

Nalia Khan

3 Reasons Why Blockchain Security Matters to Enterprises

11