# Security Token Offerings – Outlook 2019

*"[Security tokens are] the future, not share certificates and filing cabinets."* – Trevor Koverko, CEO of Polymath Network.[1]

8 NOVEMBER 2018 – CHRIS HOLLAND

For all of the irrational exuberance that exists in the blockchain industry, Trevor Koverko's quote above rings true. This article will explore certain factors that may facilitate or create issues for the security token market in the near term.

## BACKGROUND

### The wild ride to now

If you look at the price graph of Bitcoin from 1 January 2014 to the end of October 2018, you will see three years of no growth, a 12-month, massive spike and then a correction in excess of 60%. Such volatility is not surprising for an emerging market/asset class, particularly one based on new technologies. For cryptocurrency "investors", timing has been everything.

### Use of proceeds and the treasury management problem

Since March/April 2018, the initial coin offering ("ICO") market for utility token has been in decline. The simplest explanation is that the market correction in cryptocurrency prices has (1) concerned potential cryptocurrency "investors" and (2) made offerings less attractive for prospective issuers. However, investors are also pausing to look at the existing token landscape. Many utility token issuers chose to leave their offering proceeds in cryptocurrencies such as Ethereum rather than convert the proceeds into fiat (the likely denomination of their project expenses). Thus, the downturn in cryptocurrency markets combined with the cash burn of most projects has depleted such issuer's treasuries. As a result, such projects may run out of money over the next 18 months. Investors who wish to litigate may be left suing companies that have no assets and be handicapped by white paper disclosure that clearly disclaimed the fact that investors may lose their entire investment. In addition, such lawsuits could further depress cryptocurrency prices and put additional pressure on the treasuries of issuers struggling to continue.

### Utility tokens

I put the word "investors" in quotation marks because most existing tokens were not marketed as "securities". Having said that, many utility tokens were marketed as compelling investments and used bullish marketing language like "To the Moon!" which (1) would be shocking in a traditional securities offering[2] and (2) likely negates any issuer's claim that the offering was not a securities offering.[3] This disconnect is due to many factors, including token purchasers' delight in the paper increases in their holdings, regulators' desire not to stifle innovation and entrepreneurs who believe that if you wait for lawyers and regulators to bless everything before you do it, you will never achieve anything new.

### Security tokens

This anticipated issuer shakeout arguably will be caused by a lack of issuer governance. In response, the cryptocurrency industry is warming to the idea of improved governance, including having issuers make assurances to investors about how raised funds will be used, the rights of token purchasers and the expectation of a profit. From a legal perspective, these adjustments may result in the offerings being considered offers of securities.[4] The conventional wisdom in the cryptocurrency industry is that this change is a positive development, despite the fact that most issuers to date have taken extensive measures to argue that their tokens were not securities.

According to Eleanor Jones, a Singapore-based Blockchain consultant: "Many people in the blockchain space draw parallels between ICOs and security token offerings ("STOs"). However, most ICOs were designed to fund newly created businesses within blockchain sector. I predict that STOs will largely be offered to capitalize and provide fractional ownership to existing businesses that have an operating history and those businesses that have presence in the physical world."

## THE UPCOMING SECURITY TOKEN MARKET – REASONS FOR OPTIMISM

### The relentless advancement of technology and requirements for efficiency

Blockchain enthusiasts promote security tokens as being a more efficient capital markets product. Blockchain technologies will allow for more efficient custody and transfer solutions than those that operate in today's securities markets. Furthermore, security tokens can potentially be traded globally and 24/7. A number of security token exchanges, including platforms offered by The Gibraltar Stock Exchange, Malta Stock Exchange and Coinbase, are expected to go live by mid-2019.

### Enthusiasm for a new cryptocurrency product

There are still believers in cryptocurrency but only a handful of new offerings. For some this will sound scary, but security tokens may be the cool, new token that crypto enthusiasts will snap up for fear of missing out (FOMO).

### Expansion of the cryptocurrency investor market

Optimists will argue that security tokens could appeal to cryptocurrency investors as well as traditional securities investors, thus increasing overall demand and introducing more old-school investors to the cryptocurrency token markets. Ms. Jones believes: "The next wave of blockchain-related investment will be institutional investors who are looking to place that have a solid business model, proper governance and more investor protections. This makes security tokens very attractive as an emerging asset class."

### Enhanced governance

Conventional investors will expect security tokens to offer substantially similar rights as their corresponding vanilla security. Requiring security tokens to have features such as insider trading restrictions or financial covenants may restore balance to a cryptocurrency market that was historically weighted in favour of issuers.

## THE UPCOMING SECURITY TOKEN MARKET – REASONS FOR PESSIMISM

### Regulation

Utility token offerings have largely operated in an unregulated market. Security token offerings fall within the ambit of securities law and are clearly subject to (often extensive) regulation. Even exempt offers of securities require issuers to satisfy various conditions for exemption, which can vary from jurisdiction to jurisdiction. In the utility token world, issuers typically commissioned legal advice in their home jurisdiction or the jurisdiction of token listing (if any) that the token was not a security in that jurisdiction and extrapolated that analysis to other jurisdictions on a risk-based approach. Moreover, the ebullient marketing and community management approach that utility token issuers often exhibit will be impossible in a compliant security token offering, as such marketing likely would breach private placement exemptions and/or create significant risk for a later suit for securities fraud. Along with additional costs (discussed below) complying with these regulations generally means the offering process will take longer than for a comparable utility token offering.

**Increased immediate costs**

Additional regulatory burdens impose additional costs on issuers. For private placements, issuers likely will hire lawyers to confirm their offering satisfies the relevant exemption requirements. For public offerings, there would be significant additional costs. For example, initial public offerings in larger jurisdictions such as Hong Kong often involve multiple law firms, auditing firm costs, costs to conduct background checks on an issuer's management, and intermediary costs for sponsors/underwriters who will receive a fee equalling a percentage of the total funds raised.

**Uncertain logistics**

How will security tokens trade? To my knowledge, there are no security tokens listed to date. Will the exchanges be regulated? What will the transaction fees be? What will the listing fees and vetting process for listing be? What will the onboarding process be for participants of security token exchanges? How will decentralized securities exchanges conduct transaction monitoring and suspicious transaction reporting? For private placements, how will transfer restrictions work given that tokens are typically freely tradable? Will security token exchanges be required to report on participant's holdings/transactions for compliance with the Common Reporting Standard?[5]

It is easy to pour cold water and raise doubts on new initiatives. Still, utility tokens have had liquid marketplaces on unregulated exchanges.[6] Security token exchanges will have significantly greater operating burdens and requirements, and such costs and complications likely will make the experience of trading security tokens more painful than trading utility tokens.

Ms. Jones elaborates: "The handful of security tokens that have been launched globally have been flawed in the sense that they are trading at a substantial premium to comparable industry financial products, or represent less-investable or distressed assets. For security tokens to be widely adopted, there needs to be a good selection of strong tokens that are fairly priced and easily traded."

## CONCLUSIONS AND QUESTIONS

**Rewards do not come without risks**

For cryptocurrency proponents, the fear, doubt and uncertainty of others will result in lower market prices for security tokens and thus more attractive investments. They will note that investing involves

risk and investors must evaluate each security token on its merits, which is the same process for investments that have nothing to do with blockchain technology. Meanwhile, how will a security token be priced compared to a substantially similar security with no blockchain element? Pricing inequalities could yield significant arbitrage opportunities.

**The hot Christmas toy take**

Some in the market believe that the first security token offerings will be in high demand, almost like a new iPhone… or initial coin offerings at the end of 2017. As the security token market becomes more saturated, the appetite for security tokens will reduce. While I would hope that fundamental securities analysis will rule the day about which security tokens will be popular, I do not discount the likelihood of FOMO running up security token prices at the beginning.

**What will regulators do?**

The regulatory approach to cryptocurrency has varied significantly across jurisdictions. This trend is likely to continue, as regulators balance a desire to regulate markets and prevent fraud against encouraging innovation. Meanwhile, many countries have been considering cryptocurrency regulation over the last 18 months, and as time passes such legislation will be finalized and put into effect. While there are many draft bills and consultation papers published today, the fine print of such bills will be important and affect security token markets.[7]

**There are people who are excited about a blockchain revolution… and there are people who are not**

If you search for articles about how blockchain will change the world, you will find a large number. However, for every way in which blockchain can change the world, there are various existing constituencies which will have opinions on how such changes will be implemented.

One article[8] found has the following take on Bitcoin: “Due to there not being a way for third parties to identify transactions that are made in Bitcoin, an appealing advantage of the currency is that no taxes are added onto any purchase, regardless of how big or small it might be.”

There is a saying that the only certainties in life are death and taxes. I do not expect governments to stand by idly while cryptocurrency supporters develop a world to subvert tax requirements. And I think these high-level debates will impact every specific implementation of blockchain technology, including security token offerings.

**About the Author**

Holland & Marie is a compliance, C-Suite and legal solutions firm based in Singapore. We have extensive experience resolving typical compliance issues including regulatory inspections, satisfying regulatory requirements and maintaining best practices in corporate governance to navigate the rapidly changing regulatory landscape.

**References**

1. https://www.securitytokenacademy.com/info/polymath-ceo-trevor-koverko-security-tokens-are-the-future-1440/

2. Due to the liability risks inherent in suggesting the unlimited potential for the value of the security to increase.

3. Often, utility token issuers paid for legal advice that their token was not a security. However, most legal opinions included assumptions and qualifications regarding the marketing of the offering. If the marketing of a utility token offering is inconsistent with the assumptions or qualifications of a legal opinion, the conclusion of such an opinion (that the utility token is not a security) does not hold. The greater the marketing that a utility token should be considered an "investment", the more likely the token would be considered a security.

4. Although every jurisdiction has its own criteria for what constitutes a security, the Howey test in the United States is the most well-known. Under the Howey test, a token will be considered a security if (1) there is an investment of money, (2) there is an expectation of profits from the investment, (3) the investment of money is in a common enterprise and (4) any profit comes from the efforts of a promoter or third party.

5. See the following article written by Stephan Banfield, a partner at Withers KhattarWong – https://www.withersworldwide.com/en-gb/cryptocurrencies-decrypting-the-past-regulating-the-future.

6. In many jurisdictions, including Singapore, utility token exchanges will be subject to regulation – primarily relating to anti-money laundering and counter terrorism financing requirements.

7. In addition, developments in privacy law and other related fields will affect how blockchain solutions are implemented.

8. https://socialnomics.net/2018/04/18/how-bitcoin-has-the-potential-to-change-the-world/

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