



SMITH + CROWN

ORIGINAL RESEARCH

# Security Token Overview Series

## PART I: INTRODUCTION

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This Smith + Crown research series intends to explore the contexts, structures, possibilities, and limitations of security tokens, through an extended series of research memos and commentaries that both analyzes existing arguments relating to securities tokens and introduces key elements of Smith + Crown's own views of securities tokens, including the potential for them to emerge as a novel type of 'securities plus' vehicle able to bridge the gulf between traditional securities markets and emerging cryptocurrency markets.



## Overview

The well-known decline in token sales during the second half of 2018 has been attributed to the volatile and generally declining prices for major cryptocurrencies throughout the year, as well as emerging fundamental questions and regulatory concerns related to the then-prevailing 'utility token' model employed by most projects in the cryptocurrency sector. Many expectations for an increase in overall market activity, enthusiasm, and token sales during 2019 are based upon the widely anticipated emergence of security tokens as the vehicle of choice for project-focused fundraisings.

Existing discussions of security tokens, however, often vacillate between overenthusiastic, vague, and myopic and accordingly fail to provide a full overview of, or accurately contextualize, security tokens. That said, this Smith + Crown research series intends to explore the contexts, structures, possibilities, and limitations of security tokens more extensively,

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through an extended series of research memos and commentaries that both analyzes existing arguments relating to securities tokens and introduces key elements of Smith + Crown's own views of securities tokens, including the potential for them to emerge as a novel type of 'securities plus' vehicle able to bridge the gulf between traditional securities markets and emerging cryptocurrency markets. This initial entry is a high-level overview of the emerging security token landscape and an introduction to the pieces to follow.

# What is a Security Token?

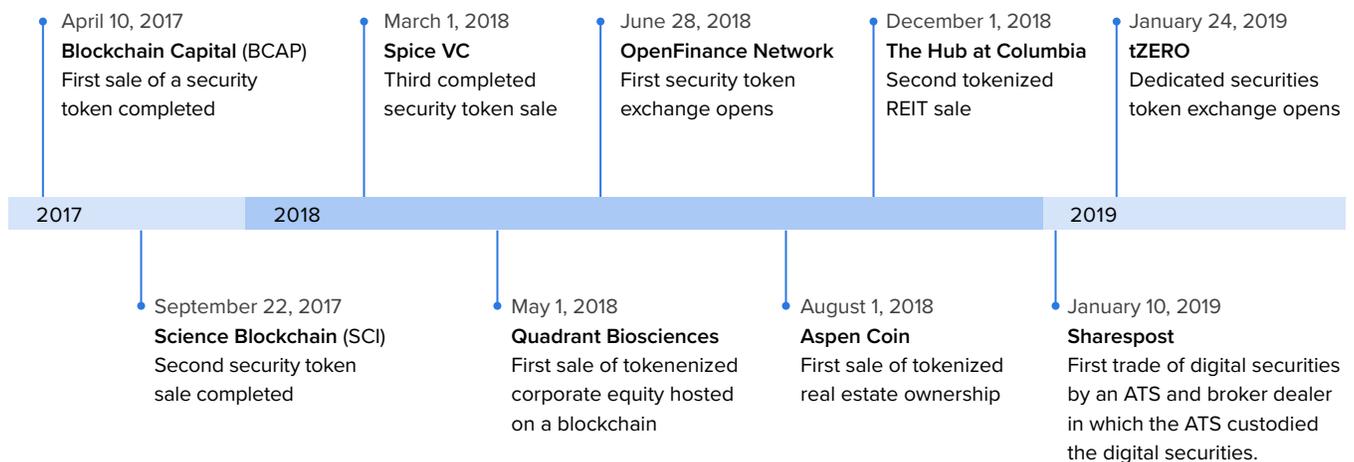
2017 and much of 2018 were, by all accounts, the era of what are commonly referred to as 'utility tokens.' These tokens ostensibly provided access to different projects and their services, were presented as being without economic rights or value, and were generally sold to the public without regard for existing securities laws. While regulators were initially slow to react, their threatened or actual responses eventually became important elements in the decline in token sales that marked the second half of 2018 as new projects hesitated in coming to market while investors stepped back in light of the regulatory uncertainty.

Aiming to address this uncertainty, security tokens are intended to create a regulatory compliant vehicle that, at least implicitly or in the words of particularly

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thoughtful observers, equally addresses what many perceive as core structural weaknesses in the once prevailing 'utility token' and ICO model. As self-declared investment vehicles conforming to securities regulations throughout the entire life of a token, from issuance to trading, security tokens enable a number of structures and innovations. Perhaps most importantly, developing a security token frees issuers from the need to proclaim

## Brief History of Security Tokens



## Security Tokens Seek to Address:

Flaws in 'Utility Tokens'	Flaws in Traditional Securities
<ul style="list-style-type: none"> <li>• Compliance issues for 'utility token' issuances / sales</li> <li>• Lack of legal protections for purchasers, holders, and users</li> <li>• Articulating a recognizable investment thesis or value proposition can be challenging</li> </ul>	<ul style="list-style-type: none"> <li>• High friction and costs of existing trading venues</li> <li>• Lack of transparency when unregulated exchanges and dark pools have an outsized influence in setting market prices</li> <li>• Illiquidity of various assets within existing financial structures and vehicles</li> <li>• Illegal lending of securities by prime brokers</li> <li>• Illiquid nature of many fund vehicles such as VC and PE</li> </ul>

the tokens as being without economic value, and this in turn unlocks a wide range of design choices including the possibility of attaching defined revenue streams or dividend rights. This option holds considerable promise in bringing a new wave of possibilities to the token space, including unique corporate structures offering both compelling business models and/or unique revenue sharing approaches. In addition, the security token structure may catalyze the creation of a new set of stakeholders that include novel permutations of debt/equity/contributor roles. Finally, the declaration of a token as a security by design substantially clarifies the sales, issuance, and secondary trading obligations of issuers, purchasers, and token holders.

## What Problems do Security Tokens Solve?

As suggested above, the arguments for security tokens have two overlapping lineages. One emerges from frequently perceived weaknesses in the 'utility

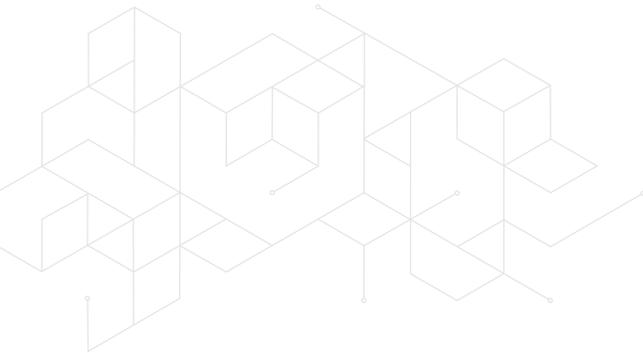
"Addressing the shortcomings of both 'utility tokens' and traditional securities promises both to improve the regulatory and compliance contexts of the cryptocurrency markets and establish them as appealing alternatives to traditional securities markets."

token' model. The second is associated with critiques of the current state of established securities markets, some of which have existed for decades, others that are more closely related to the current state of capital markets. The nature of these dual influences can be appreciated in the table below describing some of the perceived weaknesses in each of the above.

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## What Lends Itself to a Security Token?

Security Token Target Markets	Aggregate Value	Commentary
Arts / Entertainment Funding	\$1,900,000,000,000 <sup>1</sup>	Most funding is via non-standard contracts open only to insiders base require updating
Professionally Managed US Real Estate	\$2,900,000,000,000 <sup>2</sup>	Property value held in massive index funds and REITs
US VC-Backed Private Companies	\$315,800,000,000 <sup>3</sup>	Trading early stage startups is done rarely, with high friction and high costs
Art	\$63,000,000,000 <sup>4</sup>	Fractionalizing Art could open a luxury market to millions of small investors
Capital-backed Network Protocols	\$7,910,000,000 <sup>5</sup>	Some historic funding for protocols was an intended investment by another name



<sup>1</sup> <https://www.pwc.com/gx/en/entertainment-media/outlook/perspectives-from-the-global-entertainment-and-media-outlook-2018-2022.pdf>

<sup>2</sup> <https://www.msci.com/documents/10199/6fdca931-3405-1073-e7fa-1672aa66f4c2>

<sup>3</sup> Based on Top 25 most valuable VC backed companies. <https://pitchbook.com/news/articles/the-25-most-valuable-vc-backed-companies-in-the-us>

<sup>4</sup> [https://d2u3kfw92fzu7.cloudfront.net/Art%20Basel%20and%20UBS\\_The%20Art%20Market\\_2018\\_2.pdf](https://d2u3kfw92fzu7.cloudfront.net/Art%20Basel%20and%20UBS_The%20Art%20Market_2018_2.pdf)

<sup>5</sup> Based on amount raised in an ICO in 2017 and 2018 with a 30% discount due to returned cash, scams, etc. <https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017>

# Beyond Tokenizing Traditional Assets

While the tokenization of existing assets, in effect their conversion into digital securities, offers a number of interesting possibilities to streamline the functioning of existing capital markets, an even more transformative potential exists at the core of the security token genre. This is best captured by the concept of creating new vehicles perhaps best termed 'securities plus,' insofar as the potential exists to create structures with both dedicated claims on future cash flows, as traditional equities have, alongside novel participatory and governance elements that draw inspiration from many of the central ideas underlying 'utility tokens.'

# Key Challenges Security Tokens Need to Overcome

## ECONOMIC CONSIDERATIONS

The appropriate benchmark for security tokens is not the established 'utility token' model, which frankly isn't difficult to improve upon. Rather, the market for security tokens is most commonly described as comprised of buyers of traditional securities, so any security token design needs to be both legible to traditional investors and attractive relative to alternatives.

## REGULATORY CONSIDERATIONS

Launching security tokens involves complying with a number of regulatory regimes that are relatively ambiguous for 'utility tokens' and cryptocurrencies but crystal clear for securities. These include rules around

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issuance and sale, new requirements for tracking and controlling token holders, rules around legal custody, and heavy restrictions on trading. A distributed ledger does not magically solve these, and each must be thought through with a qualified legal counsel.

## DESIGN CONSIDERATIONS

Tokenizing investment vehicles is an opportunity to rethink the fundamental assumptions of both 'utility tokens' and prevailing traditional securities. Smith + Crown believes there are opportunities to layer on utility-like features to traditional securities that would expand the pool of potential investors and deepen the relationship with traditional capital providers.

In addition, not all STO issuers are traditional companies: projects are developing completely new legal vehicles for the issuance of security tokens and even integrating security features into protocol networks. Such projects are particularly reliant upon the development of a well-studied token design that incorporates insights from a wide range of fields to develop bespoke token economies that best support the project's ambitions.

# Conclusion

## **REALIZING THE PROMISE OF SECURITY TOKENS WILL TAKE WORK**

In looking across the range of attributes and possibilities associated with security tokens what becomes clear is that the security token universe, while currently nascent and untested, exists as a realm of considerable opportunity and promise, both to improve upon the operations and functioning of existing vehicles and to establish novel ones thoughtfully and judiciously exploiting the promise of this new model. Nonetheless, the industry is currently beset by a number of misconceptions about securities, the functioning of existing security markets, and even token protocols that deserve further scrutiny and discussion, and which will have to be consciously overcome.

Ultimately, this series hopes to explore and inform broader discussions related to security tokens and to locate them within more extended discussions about the functioning of existing economic and financial models while considering who these markets will serve, what improvements can reasonably be expected, and what might be the implications of a world where security tokens and digital securities become widespread.

