Security Token Models for 2019 and Beyond – A Thought Experiment

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About me

• Gordon Einstein is a California (USA) licensed attorney who specializes in blockchain and crypto law
• Proud to serve as Chief Legal Officer (CLO) of Distributed Lab
• Founder of CryptoLaw Partners
• Happy to share this presentation – please email me (geinstein@cryptolawpartners.com) or message me on LinkedIn or Facebook
• Available to discuss in greater depth during conference breaks
Fast mandatory disclaimers

- I’m a lawyer, but I’m not your lawyer (probably). 😊
- I am approaching this from a US legal perspective, but these ideas and concepts apply globally.
- This presentation is for general discussion purposes only. It is not legal advice.
- Do not rely on this presentation for anything – it has not been tailored to your situation.
- Don’t break the law. Don’t commit crime.
- Most of all - don’t make US regulators and law enforcement agencies angry. They will get you. Just ask Noriega.

ICO drama and security tokens

- **FUD =** Fear, Uncertainty and Doubt. **FOMO =** Fear Of Missing Out.
- There is talk that ICOs are dead and that there is no such thing as a “utility token”. Hence security tokens and “Security Token Offerings” (“STOs”) are the new “cool kids”.
- This business about utility token ICOs being dead is just FUD. And, this interest in STOs is somewhat driven by ICO FOMO.
- BUT, both ICOs and STOs can be legitimate and warranted.
- STOs are new and evolving – how should we think about them?
I invite you to join in this thought experiment

The goal of this talk is to engage in a public thought experiment about securities, tokens, and the future of STOs. What are the possible security token models and how should they evolve?

I assert that the phenomena of tokenization is fundamentally expanding the conceptual coverage of the term “security”.

Back to basics - “security” is a defined term

- “Security” is a defined term under US law – see the Securities Act of 1933 §2(a)(1)
- Most of these enumerated items are traditional “legacy” security types
- Usually some recognized and standardized form of equity (ownership) or debt
Back to basics – the “investment contract”

• Investment contracts are usually “accidental securities”. They do not fit into any of the traditional “legacy” security types, nor are they intended to (but people make mistakes).
• The utility token gray zone relates to “investment contracts”, and these are identified according to the “Howey Test” (from the famous 1946 US Supreme Court case of SEC v. W.J. Howey Co.
• I have long YouTube videos about Howey

Is there:
1. An investment of money (value)
2. With an expectation of profit (“led to”)
3. In a “common enterprise”
4. Primarily through the efforts of others.

“Traditional” conceptual model of securities - §2(a)(1)

<table>
<thead>
<tr>
<th>Traditional “Legacy” Securities Types</th>
<th>Investment Contracts (“Accidental Securities”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>Orange groves</td>
</tr>
<tr>
<td>Shares</td>
<td>Whiskey warehouse receipts</td>
</tr>
<tr>
<td>Notes</td>
<td>Payphone contracts</td>
</tr>
<tr>
<td>Bonds</td>
<td>(Pre-functional utility tokens)</td>
</tr>
<tr>
<td>Etc.</td>
<td>Etc.</td>
</tr>
</tbody>
</table>

So, what happened? Software (tokenization) ate this model!
BEWARE the “pre-functional utility token”

• Even if a token WILL BE a non-security or utility once its platform is working, prior to then it MAY BE a security (why then not Ethereum?)
• This is because of belief that token purchasers are buying with profit expectation as their primary motivation. Does not help that early ICOs encouraged this profit expectation. Like... Munchee (idiots).
• BUT... an SEC Commissioner Hinman recently acknowledged that a token (i.e., Ethereum) can develop and change its legal nature!
• Stretches, but does not break, traditional conceptual model of securities.

“Why SOFTWARE is eating the world” (almost)

• Marc Andreessen is famous for co-founding Netscape and is now a well-regarded VC at Andreessen Horowitz and a16z crypto.
• On August 20, 2011 published “Why software is eating the world” in the Wall Street Journal. Article generated a huge response.
• Explained why the then rocketing valuations of software and web enterprises relative to traditional companies was rational (i.e., the Internet boom was not a bubble).
• “Software is also eating much of the value chain of industries that are widely viewed as primarily existing in the physical world.”
• BUT, Andreessen did not recognize the core “last mile” issue. Namely, how do we “wire up” the entire physical world to the software world and seamlessly merge these two?
“Why TOKENIZATION is eating the world” (really)

• For the software revolution to be complete, every possible physical object (e.g., a diamond) and every possible non-physical object (e.g., a security) in the “real world” must be “wired up” (i.e., be addressable and subject to interrogation and manipulation) by the software world.

• The best way to accomplish this vastly complex task is by tokenizing the world. I.e., by making virtual representations or virtual handles (software tokens) which stand in for the “real things” (the “referents”) to which they refer.

• Tokenized objects can become “smart” and “dynamic”. Meaning, they can adjust their behavior, communicate and coordinate with each other, and evolve over time.

• To really understand tokenization, watch Distributed Lab’s videos and read its upcoming book. 😊

Tokens without “real world” referents

• Keep in mind that not every token or virtual object must refer to an actual “real world” thing (referent). Some tokens and virtual objects exist independently sui generis within a software system.

• Some (non-security) examples:
  • World of Warcraft and other game virtual money, goods and weapons
  • Non-fiat currencies such as Bitcoin and Zcash, and maybe Ethereum and EOS
  • “Bare” utility tokens/platform access tokens/licenses
  • Internal “in system” accounting or record-keeping entries
  • Digital collectibles (e.g., CryptoKitties)

• PREVIEW – You can also create non-referent security tokens!

Borrowed from “The Treasure of the Sierra Madre” (1948)
Reminder! It’s a big world – not everything is a security

- Keep in mind the “traditional” conceptual model of securities – we should be able to agree that not everything on the planet is a security
- There are also commodities, currencies, software licenses, shoes, dogs, houses, membership clubs, nonprofit interests, etc.
- Merely tokenizing a non-security “real word” object does not automatically convert it into a security
- A purely virtual token without a “real world” referent is not automatically a security
- Some things CANNOT be a security – and claiming otherwise is fraud
- *So, why does it seem that everything is a security now?*

Tokenization is expanding the “securities realm”

- Because tokens can be smart and dynamic, they can take on new characteristics which turn them into securities, even if the underlying referent is not a security
- Similarly, “hybrid tokens” can be blend the characteristics of many things – meaning a token might be a security, a commodity, a license, and a currency (for example) all at the same time
- Tokenization allows for traditional economic and legal interests to be sliced up and re-allocated in more targeted ways
- Tokenization is allowing new sorts of economic relationships and opportunities which were not feasible before, and the related liquid markets for those relationships and opportunities organically arise in response
This “everything is a security” tendency is NOT passive - this huge opportunity is propelling events

“Security tokens are going to be revolutionary, they’re going to give birth to a quadrillion dollar market. That’s because we’re seeing the tokenization of the world’s fiat money, debt market, equities, real estate, art...”

Brock Pierce

*** Notice the interesting language choice here? With “fiat money... real estate....art”? Those referents are (usually) NOT viewed as securities, and for good reason. But, most people are now talking like Brock (who is a perceptive guy), as if by instinct. Maybe legal categories are now evolving in response to tokenization, and “securities are eating the world”.

The FOUR levels of security token enlightenment

Let’s put this all together and explore the FOUR levels of security token enlightenment.
Tokenizing legacy securities

- Existing traditional “legacy” security types can be tokenized, with the original security acting as the token's referent. These are “tokenized securities”.
- Will acclimate industry to tokenization.
- Should allow for some increase in liquidity and standardization.
- Good way to start building necessary financial and technological infrastructure for future developments.
- Does not fundamentally change the nature of traditional equity and debt type investments.

Issuing true security tokens

- Enterprises can issue true (or “native”) security tokens which have rights based upon the associated platform’s code and not based upon national securities law and state corporate and contract law.
- Token characteristics can model traditional equity and debt, and can blend them as needed.
- Economic interests in projects (such as real estate) can be divided with more granularity based upon investor needs (e.g., for tax optimization).
- Begins to separate legal status of enterprise from local (state) law and court system.
Innovating new securities models

- Securities become smart (aware) and dynamic (capable of action and change). They begin to react to their environment, and to communicate and collaborate with other network-connected objects.
- Hybrid securities become part of the “Internet of Things” and interact with non-securities in order to optimize results.
- New economic relationships and models beyond the typical “enterprise” become viable. Purely software-based smart contracts, projects and organizations may be individually funded and their profits monetized.

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