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The classification of tokens and its regulatory implications

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Motivation

- Growth of the so-called tokenized economy, but…
- … the terminology used is not always uniform
- Need to survey the different types of existing tokens (from a regulatory perspective)
- Search for agreement on the employed categories and working definitions in the field

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Outline

- Different classifications and definitions
- Regulatory consequences
- Final remarks

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A preliminary note: how do we define tokens?

- The result of a process aimed at protecting some important data that is not intended to be disclosed, and implemented through the conversion of such data into a non-significant equivalent that can be transmitted without revealing the original content, typically thanks to cryptography
- Tokenisation in the blockchain environment: the process of converting wealth into digital tokens, which are then issued on platforms based on a blockchain via smart contract

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The existing categories

- The most common classification of tokens divides them into security and utility tokens (with the addition of payment tokens)
- Payment tokens, currency tokens, investment tokens, equity tokens, asset tokens, commodity tokens, exchange tokens…

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The existing categories

- “stable tokens”, “asset tokens”, “social media tokens”, “attention tokens”, “purpose-driven tokens”, “Fractional Ownership Tokens”, “Privacy Tokens”, “Lending Tokens”, on top of Central Bank Digital Currencies (CBDCs) and Facebook’s Libra and Calibra (Voshmgir, 2020)
- Are these categories only relevant marketing-wise or are they actual, self-standing notions from an IT and/or legal perspective?
- What matters is arguably the purpose: currency / investment / benefits-services

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SEC taxonomy

- Common consideration: cryptocurrencies, utility tokens, security tokens. Really?
- SEC *Framework for "Investment Contract" Analysis of Digital Assets* (April 2019) uses different terminology → 'digital assets'
- "The term "digital asset," as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens"" → no mention of security tokens or utility tokens
- Analysis of when the "digital assets" must be considered "securities" (from this, we can derive *a contrario* when a token falls into another category)

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SEC taxonomy

- To determine whether the token in question falls within the notion of security (more precisely, in its subcategory of "investment contract"), the SEC refers to the well-known "*Howey* test"
- Three prongs: the existence of an "investment contract" should be recognized when there is 1) an investment of money, 2) in a common enterprise, 3) with the reasonable expectation of profits derived from the efforts of others
- A token must be qualified as security (hence, as a "security token") if it meets all the three criteria

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SEC taxonomy

- No analysis of utility tokens → their qualification can be obtained in a residual manner (they are unregulated and lawful)
- Apparently they include also cryptocurrencies → to the extent that a virtual currency "can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency", it will tend to fall in the cases of use or consumption purposes, with the consequent exclusion of the application of the rules relating to securities

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FINMA taxonomy

- Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs) (February 2018)
- "There is no generally recognized classification of ICOs and the tokens that result from them […]. FINMA bases its own approach to categorization on the underlying economic function of the token" (cf. third prong of *Howey* test)
- Avoiding the risks of circularity, i.e. defining a token based on its regulatory treatment, which instead is only the consequence of its attribution – based only on its intrinsic characteristics and purpose – to a particular category

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FINMA taxonomy

- The common tripartition: “payment tokens”, “utility tokens”, and “asset tokens”
- Payment tokens = cryptocurrencies, self-standing category: “tokens which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer”
- FINMA “will not treat payment tokens as securities” (contrary to some experts’ view)

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FINMA taxonomy

- Utility tokens "are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure" → not a residual category

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FINMA taxonomy

- Asset tokens "represent assets such as a debt or equity claim on the issuer. Asset tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds or derivatives"
- "[T]okens which enable physical assets to be traded on the blockchain also fall into this category" → also securities resulting for example from the tokenization of real estate, or a work of art, or intellectual property rights, or even a commodity → any asset, no circularity

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FINMA taxonomy

- "The individual token classifications are not mutually exclusive". Right! But… only one case, namely the possibility that utility tokens on the one hand, and asset tokens on the other, are simultaneously classified as payment tokens → term "hybrid tokens" only employed with regard to this case → a bit misleading: how about the overlap between utility and asset/security tokens

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The impact on compliance: payment tokens/cryptocurrencies

- Discrepancy between the position of the SEC, which tends to trace cryptocurrencies back to the securities category (thus blurring the line of the distinction mentioned above), and that of other authorities, such as the Commodities Futures Trading Commission, which instead qualifies them as commodities. On its turn, since 2014, the Internal Revenue Service established that it would tax cryptocurrencies as property and not as commodities

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Some further confusion

- EU Court of Justice, Bitcoin VAT case: the exchange of Bitcoin (and other cryptocurrencies, for that matter) for fiat coins should be considered exempt from VAT, as these transactions should be included in the exemption provided for the exchange of "currency, bank notes and coins used as legal tender"
- Favorable for operators but contrast with cryptocurrencies' nature of an alternative instrument to coins used as legal tender, in competition with them

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FINMA on payment tokens

- A means of payment, and as such, they are essentially subject to the anti-money laundering legislation contained in the Anti-Money Laundering Act
- The most precise and consistent approach

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Utility tokens

- The least regulated category. In most jurisdictions (with some notable exceptions) lawful → more general civil and possibly corporate law rules, but not under the special financial regulations related to the issuance of securities
- Incentive for issuers to qualify their tokens as utility tokens in order to avoid compliance with the obligations in question → utility tokens should be exempt from the need to comply with the rules for securities only "if their *sole* purpose is to confer digital access rights to an application or service"

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Utility tokens

- What must be entirely missing is the "investment purpose", the willingness to "grant the access rights and the connection with capital markets": if this element is even partially present, the token under consideration will have a dual nature of security and utility token, and therefore will still be subject to securities legislation
- → SEC restrictive view → an ICO qualifies for an exemption from securities rules only in limited cases, equivalent to those outlined by FINMA
- "Determining whether a transaction involves a security does not turn on labelling such as characterizing an ICO as involving a 'utility token' - but instead required an assessment of the economic realities underlying transaction" = FINMA

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Security tokens

- need for registration with supervisory authorities, and in some cases licensing requirements, as well as the need to provide several essential pieces of information, typically contained in the prospectus
- several exemptions are possible that make compliance less burdensome
- “Simple Agreement for Future Tokens” (SAFT)
- Enforcement practice of the SEC has shown a considerable severity against what it perceived as attempts by issuers to escape from the securities discipline

Conclusions

- The picture is still somewhat hazy in terms of terminology: many different token qualifications have spread commercially, but they do not correspond to a difference in terms of either substance or law
- Several supervisory authorities have embarked on a path towards the regulation of ICOs, which, however, is not always preceded by an adequate preliminary classification of “coins”, or tokens

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Conclusions

- Many similarities between SEC and FINMA: the most accurate classification is the one that provides for a tripartition between tokens respectively intended as a means of payment, as an instrument to obtain goods or services, or as an investment. Labels may change, but what matters is the economic substance
- Call for caution by operators

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Conclusions

- Some differences:
  - Asset vs security tokens
  - Utility tokens as residual category vs self-standing qualification
  - Crpytocurrencies as securities or commodities (Us) vs means of payment (Switzerland)
- Need for further clarity for operators

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Appendix: MICA Proposed Regulation

- Partial fall in the circularity trap: no definition of security tokens is provided: they appear included in the general definition of 'crypto-assets', and then identified as the ones qualifying as 'financial instruments' under MiFID II
- Not comprehensive, explicitly leaving out (above all) security tokens
- Double negative for e-money: Regulation not applicable to crypto-assets that qualify as e-money, except if they qualify as e-money tokens under the regulation
- Particular, and somewhat questionable, focus on stablecoins, announced multiple times in the Explanatory Memorandum, but then not coherently developed in the proposal

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Definitions in the MICA Proposed Regulation

- 'crypto-asset' as «a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology»
- How about security tokens? They seem covered by the definition but fall outside the scope of the regulation
- How about cryptocurrencies? They seem covered but are subject to a specific regime

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Three subcategories

- ‘asset-referenced token’, ‘electronic money token’ or ‘e-money token’, and ‘utility token’
- But not the only existing ones: how about security tokens?
- «‘Crypto-assets’ and ‘distributed ledger technology’ should […] be defined as widely as possible to capture all types of crypto-assets which currently fall outside the scope of Union legislation on financial services». Missed opportunity

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Some other problems

- 'asset-referenced tokens' do not appear to correspond to the 'asset tokens' → "a type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets"
- 'e-money token' is «a type of crypto-asset the main purpose of which is to be used as a means of exchange and that purports to maintain a stable value by referring to the value of a fiat currency that is legal tender»
- a 'utility token' is «a type of crypto-asset which is intended to provide digital access to a good or service, available on DLT, and is only accepted by the issuer of that token»
- Where are stablecoins?

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Utility tokens

- They appear a residual category, but the expression 'utility token' only appears four other times in the draft, and most importantly Title II is not dedicated to them, but rather to 'Crypto-Assets, other than asset-referenced tokens or e-money tokens' → are there tokens in this category that are not utility tokens?

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Thank you!

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