
Don't Be Cryptic When Talking About Crypto – A Beginner's Guide to Digital Assets

Description

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Within the past few weeks, the Securities and Exchange Commission (SEC) has settled two enforcement actions against companies engaged in the sale of digital assets. It also separately settled actions against DJ Khaled and Floyd Mayweather for their failure to disclose payments they received in relation to promoting the sale of digital assets. Subsequent headlines have been filled with terms like “coins,” “cryptocurrency,” “blockchain,” “ICO,” and “tokens.” What does this all mean?

Although the terms “cryptocurrency” and “coin” are typically used as catchall terms to refer to both coins and tokens that rely upon blockchain technology (a public, distributed ledger), digital assets are typically grouped into one of three categories: coins, security tokens, and utility tokens. The terminology related to the three types of digital assets is often used interchangeably and imprecisely, but there are important differences.

The best known form of digital asset is cryptocurrency, or “coin.” Bitcoin is the best known coin, although there are many others (such as Ethereum). Coins are similar in concept to physical currency, in that they are fungible, can be used to buy and sell goods and services, and are primarily intended as a medium of exchange. However, whereas standard currency is typically centralized (think of the government's role in producing the dollar and overseeing monetary policy) coins use cryptography and blockchain technology to create a decentralized ledger that allows the virtual currency to exist in a purely digital environment. The SEC has stated that Bitcoin and Ethereum are not securities, but that other coins could be (not very clear, we know).

Security tokens are typically used to represent an investment in an enterprise, like purchasing equity in a company. A token will be deemed a security when it meets the four part “investment contract” test established in the seminal case of SEC v. Howey. Namely, the token is granted in exchange for an investment of money, the investment of money is in a common enterprise, there is an expectation of profits from the investment, and any profit comes from the efforts of others. It is beyond the scope of this article to discuss the intricacies of the Howey test, and how it may or may not apply to digital assets in particular instances, but suffice it to say that certain digital assets are undoubtedly securities. As of now, the SEC and the courts have yet to provide firm guidance as to the exact scenarios in which a digital asset will be deemed a security token, but it is safe to assume that any given token is a security token unless you have good reason to believe the token fails the Howey test. If a token is a security, then the promotion, issuance, and sale of that token is subject to the same securities laws that apply to any other security, such as stock in a company. Failure to comply with applicable securities laws is what led to the SEC enforcement actions mentioned in the first paragraph of this article. Companies who issue, promote, or sell security tokens and fail to comply with securities laws do so at their own peril.

In contrast, a utility token is a digital asset that is intended for consumption (i.e., to participate in a project's ecosystem) but that is not a currency. Whereas selling a security token is similar to selling shares of stock in a company, selling a utility token is like selling a gift card to purchase goods or services from a company. Digital assets that are sold by companies for customers to use in exchange for goods or services from the company may be more likely to fail the Howey test (and not be a security) because arguably, (i) people may not buy such tokens with an expectation of profit, or (ii) profits may be unrelated to the efforts of others. Because utility tokens may not be securities, companies may be able to avoid needing to comply with securities laws when offering or selling utility tokens.

As you can see, the three types of digital assets have different purposes and legal implications, but they can be used in ways that interact with one another. By way of example, imagine a scenario where a friend is starting a new restaurant. You could use cash to purchase coins. Then, you could invest the coins in the business (just like a cash investment) and, in exchange, receive security tokens entitling you to a percentage of the ownership in the restaurant. Your restaurateur friend could then use the coins to pay the restaurant's builders and vendors instead of using cash. Finally, once the restaurant opens, it could sell utility tokens entitling the owner of the utility token to a free pizza upon redemption. In this scenario, you could simultaneously own security tokens entitling you to ownership in the restaurant, utility tokens entitling you to free food at the restaurant, and coins that could be used in lieu of paying cash at the restaurant.

The analysis of whether a digital asset is a coin, security token, or utility token is nothing short of grey and very fact intensive. You should definitely consult with your legal advisor when making this determination, as it has a huge impact on regulatory implications.

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