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ROB LONG AND ROSS WILLIAMS EXPLORE CRYPTOCURRENCY UTILITY TOKENS

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Partners Robert Long and Ross A. Williams authored the *Texas Lawyer* article titled, "Ready Player One? Avoid Getting Played on Utility Tokens." The piece explores "utility tokens" – cryptocurrencies that provide users with access, now or in the future, to specific goods and services. Long and Williams note that utility tokens have come under increased scrutiny by state and federal regulators – including the U.S. Securities and Exchange Commission (SEC) – as the question of whether they should be treated as securities is actively debated. Unlike the limited use arcade tokens – generally good only for one "turn" or "game" – utility tokens have value both in access to developing technologies and in terms of scarcity: this value raises the question of whether they are securities, and thus subject to a host of regulations and restrictions. Long and Williams consider both the risks for holders of utility tokens and what the future may hold for the cryptocurrency offshoot, as regulators and legislators work to issue guidance.

Full text of the article is below and is available on *Texas Lawyer*'s website, by clicking here.

Ready Player One? Avoid Getting Played on Utility Tokens

If you have ever been to an arcade, you know what a utility token is. You put your dollars in the change machine and you get out those brass coins that are somewhere between a nickel and a quarter in size. Their only use is for playing the games at the arcade. You do not buy them in hopes of reselling them for a profit in a secondary market. You buy them so that you can access certain goods or services. These are tokens with a specific use, also known as utility tokens.

But what if the arcade's founders encouraged you to buy their tokens not only for the special goods and services they can access, but also by enticing you with their potential resale value? What if they told you that they had not built the arcade yet, but that you can put in money to help them do so, that you will receive their tokens in return, and that those tokens can be used to play the arcade games, but they might also appreciate to be worth significantly more on the secondary market than what you paid to get them? Are these really still just utility tokens, or are they also securities? What regulations govern them? And what risks might they pose? These are essentially the puzzles created by the advent of utility tokens in the world of digital currency (or cryptocurrency).

Utility tokens have been "hot commodities" in the cryptocurrency world. Some think the classification provides legal protection from regulatory schemes. Others see them as a mere stepping stone in the evolution of blockchain technology. A few folks might even use them for their ostensible special purpose, which can be any number of things depending on the coin. What is clear, though, is that they have led to some eye-opening initial raises: Factom ($8 million), Filecoin ($257 million), and Telegram ($850 million).

With the potential for high returns comes, you guessed it, high risk. You could very well buy $1,000 worth of utility tokens in an ICO this week, only to find them virtually worthless the next week. Regardless of whether your tokens increase in value, you could lose them forever (e.g., your digital wallet or the exchange could get hacked, or you could lose your private key).

For those looking to get into this space, there are a minefield of regulatory regimes to sweep.

For instance, recent statements by the Securities and Exchange Commission indicate that virtually all cryptocurrencies (with some notable exceptions, bitcoin chief among them) are securities. So if a utility token offering is not registered with the SEC, or the offering is not exempt from SEC registration, and the tokens are offered for sale in the United States, then the issuer may be offering unregistered securities in violation of Section 5 of the Securities Act of 1933. And if the utility tokens are securities, purchasers of the tokens may be subject to resale restrictions and "exchanges" that effect transactions in them needing to be registered with the SEC as a national securities exchange or alternative trading system.

Why is bitcoin special? In short, bitcoin was developed organically and capital was not raised from investors—there was no ICO, for instance. Accordingly, bitcoin fails the Howey test for an "investment contract" because there was no investment of money in a common enterprise with the reasonable expectation of profit to be derived from the entrepreneurial and managerial efforts of others. Similarly, bitcoin is not considered to be a "note," because investors neither loaned money to nor invested money with bitcoin developers in exchange for a fixed amount of periodic income. This oversimplified analysis identifies two key questions a utility token developer needs to consider: (1) are the tokens investment contracts; or (2) are the tokens notes. Indeed, the SEC has launched enforcement actions against developers and issuers of coins and tokens that it considered securities.

Anyone seeking to avoid the federal securities laws and long-arm of the SEC should take cold comfort in the suggestion that a coin is not a security if it has a special purpose or utility. The SEC will look at the *economic realities of the matter, and will ignore window-dressing designations of "utility" or "special purpose" when the underlying facts show the token is a security under the Howey test or a note analysis.*

Aside from SEC regulations, state securities boards and commissions have launched administrative actions and sent cease and desist orders where they suspect fraudulent, noncompliant, or materially misrepresented ICOs, or coin programs that functioned like multi-level marketing organizations. The Texas State Securities Board has been particularly active in this arena.

Regardless of whether the utility tokens are considered securities, they are almost certainly subject to at least some of the Commodity Futures Trading Commission's regulations. The CFTC has announced that it considers all virtual currencies to be commodities. A virtual currency is a "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction." CFTC regulations typically do not apply to "spot" or cash transactions, but the CFTC has authority to police the spot markets for fraud and manipulation involving commodities, including virtual currencies, traded in interstate commerce.

Furthermore, businesses that offer utility tokens may be subject to the Financial Crimes Enforcement Network's "Know Your Customer" and anti-money laundering requirements. So if you are hoping for truly anonymous transactions, utility tokens may not be the way to go. Depending on the facts and circumstances, FinCEN may require the businesses offering these tokens to be registered as "money services businesses" and comply with the attendant regulations.

All that said, there are some encouraging reasons to navigate the maze of potential regulations. There is the opportunity to be a part of a cutting-edge disruptive technology and we all have heard stories of astronomical profits in the area. The SEC chairman has made clear that while regulations need to apply, he recognizes that blockchain technology may prove to be transformative and efficiency-enhancing.

Perhaps even more encouraging, moves are being made to create statutory and legislative exemptions for utility tokens. Wyoming, for instance, has passed a statute providing for specific circumstances under which a utility token will not be deemed a security, at least at the Wyoming state level. Even more recently, in March several big-money cryptocurrency backers met with SEC officials to ask that blockchain-based tokens be exempt from SEC regulation—a long shot.

What's clear is that this space is still evolving. For those willing to change their dollars (or bitcoin or Ether) for utility tokens, drop them in the slot, and play by the rules, though, they might just win enough tickets to buy a rainbow-colored pencil eraser. Or a small country.

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