FinTech Weekly
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Security Tokens: between IPOs and ICOs

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The change is here. While 2017 was the year of the utility token, 2018 is the year of the security token. This is more than just a semantic change; it means that we are going to see less capital raised from the public and more capital from institutional investors; Fewer promises of early stage companies about their future, yet to be developed products, but rather an increase in investment rounds of companies with proven capabilities; No more entities seeking to circumvent regulation, instead, we'll have entrepreneurs seeking regulatory protection.

It didn't take long. A combination of ever-increasing worldwide regulatory vigor, under the lead of the US Security and Exchange Commission (SEC), a more realistic investor approach and the numerous difficulties faced by cryptographic tokens in their endeavors to be accepted by the traditional financial markets, has led entrepreneurs to understand that the window that opened in 2017 is now closing. In accordance, investments in the field have significantly fallen over the past few months. Furthermore, recent studies show that many of the ICOs conducted in 2017 were fraudulent, the underlying products or services were never offered and the tokens sold couldn't be traded. Some of these companies were very short lived. All of these have caused a rapid decrease in the appetite for risky ICOs, especially in light of the sharply declining yields.

But the investment market never rests. Talented entrepreneurs who discovered the world of blockchain and the many advantages it represents have been seeking other investment avenues, and security tokens are now all the rage. The logic is simple: instead of creating a complex business model with currency that represents a product or service (and therefore, pursuant to certain definitions, is not subject to cumbersome securities regulations), let's call a spade a spade—and thus the security token, which is the equivalent of a security, was created. As such, the token is subject to securities regulations from the outset, and will be issued accordingly.

What is the difference, then, between a security tokens offering (STO) and an initial public offering (IPO)? Apparently, the difference is not insignificant, both in terms of the rights attached to the token, and in terms of the relevant market.

Security tokens can generate a range of rights, like ownership, participation in revenues, voting, debt and so on. One interesting possible use case is fractional ownership. The purpose is to break down the rights in valuable tangible or intangible assets into tradable units. Take for example a real estate asset or a valuable work of art. The rights unit is sold to multiple investors, and they can enjoy future returns or operating income on a pro rata basis. It may sound a little like a share, but there are several distinctions. Firstly, performance of the share is linked to that of the entire firm, which may have other business activities while by using security tokens, the economic activity can be linked, through a smart contract, exclusively to the underlying asset, without outside interference. Secondly, a token allows greater liquidity since it can be traded against other tokens; this way, the investors can change and update their portfolios to precisely suit their intentions.

Another advantage of security tokens are the markets. As compared to the securities markets currently in existence, the evolving token exchanges will apparently be global (will enable listing and trading with no geographic barriers), operate around the clock, with fewer intermediaries and with an engrained immediate validation process. Thanks to blockchain technology and smart contracts, validation, listing and clearing of transactions can grant parties certainty with regard to the validity of the transaction and registration of the ancillary rights, both between the seller and buyer, and toward third parties. Some say that transaction costs will also be significantly lower, and that the process would therefore be much more efficient than the sale of securities as is currently carried out.

Sounds great, doesn't it? So why isn't everyone raising money through security tokens? For this to take place, two things need to happen: first, the security token must be issued pursuant to existing securities regulations, which generally means that the offering must be pursuant to one of the exemptions stipulated by law. In this business, everybody is toeing the line with US law, which stipulates several exemptions (such as REG CF, REG D, REG A+). Each contains different conditions, but the overriding principle is that if the offering complies, the issuance is relieved of some of the obligations imposed on ordinary public offerings.

The second condition may seem technical, but will, to a great extent, mark the direction in which this sector will evolve. For security tokens to be truly negotiable, reliable exchanges are needed. Over the last few months, quite a few exchanges have started seeking regulatory approvals. Their final mode of operation is not completely clear yet, but several directions can already be identified.

Not all tokens can be traded on these exchanges. Only security tokens that satisfy the regulations governing their issuance will be authorized for offering. This means a lot of the utility tokens we've seen in the last few years will not be listed on these exchanges. In addition, the trading rules governing the exchanges will require proper reporting and adequate disclosure processes to provide investors with a reliable picture of the underlying business activity. Finally, traditional securities laws, such as fair trading, insider information and market manipulation, will also apply to currency tokens.

The next few months will show if security tokens really are the next big thing. In any case, security token trading is a much safer arena than the wild west of utility tokens, and more "traditional" and institutional investments (which where the big money really is) will likely flow through these transactions. Entrepreneurs that take advantage of these new avenues, comply with the regulation and adjust to market demands, stand to generate significant business advantages.

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