Equity Tokens on the Blockchain

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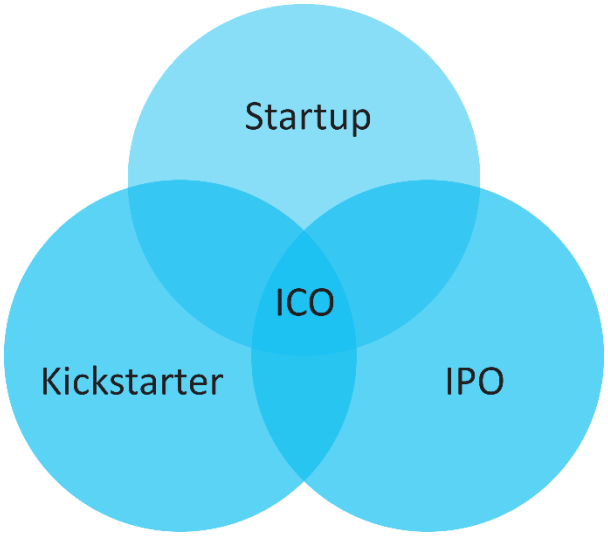
Blockchain technology, as the SEC's William Henman recently pointed out, is "exciting" and holds "real value."[1] One of the primary challenges facing regulators is Initial Coin Offerings, or ICOs.



In brief, an ICO is something of a cross between a startup, a crowdfunded campaign (like Kickstarter or Indiegogo), and an Initial Public Offering. Investors typically buy into a new company with hundreds of other likeminded investors—but instead of equity, they receive blockchain-based "tokens," which function something like shares of stock.

Like stock, these tokens can be traded on digital exchanges (similar to Nasdaq), where investors hope to see the value of these tokens increase over time. Typically, each buy/sell transaction is recorded using blockchain technology, which means no central authority manages the transaction (in the same way no central authority "owns" the Internet).

The debate over whether such tokens are securities is of great interest. In our experience talking with hundreds of blockchain investors, we are convinced that the majority *think* of these tokens like securities. They purchase tokens with the hope of seeing their value appreciate over time, due to the managerial efforts of others.[2]

Blockchain technology is complex and poorly understood by regulators; securities law is complex and poorly understood by blockchain technologists. The purpose of this brief is to bridge the gap, and suggest a path forward, by introducing the concept of **equity tokens**.

How Tokens Work

Blockchain technology is in its infancy. This time is similar to the 1994-1995 period of the Internet, when the World Wide Web was difficult to explain and difficult to use. Much of the Web's success came from the U.S. government's light touch on regulation, which allowed the Internet ecosystem to flourish, and "a thousand flowers to bloom."

While we are still at the mid-1990s period of the adoption curve, we are faced with a different problem: investors are pouring money into new blockchain projects at a rate similar to the late 1990s period of the dot-com boom—about $11 billion in the first half of 2018.[3] So what are these investors buying?

There are innumerable use cases for blockchain-based tokens, just are there are innumerable use cases for the Internet. Tokens come in all shapes and sizes: they can be used for digital payments (like currency), they can track spending (like rewards points), they can monitor usage of a service (like energy metering). One matchmaking application let users earn tokens for setting up a successful date.
Simply put, a **token is a unit of value**. Tokens are stored on the blockchain, instead of through a central bank or regulatory authority. Indeed, the advantage to tokens is they are not subject to a central authority, which can reduce friction and increase liquidity in

[1] Hinman, William. "Digital Asset Transactions: When Howey Met Gary." Remarks given at Yahoo Finance All Markets Summit, San Francisco, CA, June 14, 2018.
[2] SEC v. W. J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244, 1946 U.S. LEXIS 3159, 163 A.L.R. 1043 (U.S. May 27, 1946).
[3] "ICOs Have Raised Billions — But Now VCs Are Swooping In." CBInsights Research Brief. Source: https://www.cbinsights.com/research/blockchain-ico-equity-financing-vc-investments

financial systems. In the same way that cash allows consumers to exchange value without going through a central bank, tokens can allow users to exchange value, peer-to-peer.

In plain English: blockchain is the underlying technology; tokens are the things built on top. Because it is easy to create a new blockchain application, hundreds of new tokens are being created each month. Broadly speaking, we can classify these tokens into three categories:

1. **Payment tokens**, which function like a currency. Bitcoin is the most well-known of these tokens, but there are many others, each offering different features: some are completely private, some have low transaction fees, some are developed for specific industries, and so on.

2. **Security tokens**, which function like a traditional security and derive their value from some external, tradable asset. For example, SPiCE VC is a new type of venture capital fund where investors buy tokens tied to the value of the fund's underlying investments.

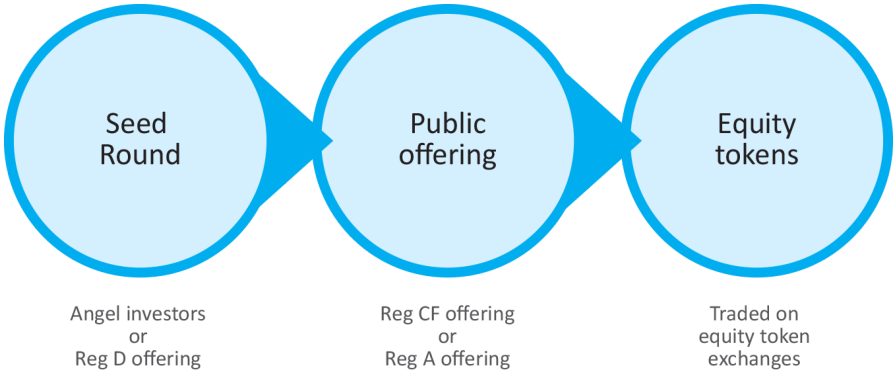
3. **Utility tokens**, which are something like "digital coupons" for a new blockchain service. For example, Filecoin is a decentralized storage service: you earn tokens for "renting out" your excess hard drive space, and companies spend those same tokens to "buy" storage. The Filecoin team raised over $250 million by allowing users to pre-purchase the tokens, like the advance purchase of a videogame.

In practice, our experience is that investors largely think of these tokens like stocks: regardless of their purpose, investors are hoping the tokens will increase in value, and can later be sold at a profit.

It is for this reason that we recommend a simple model we call the **equity token**.

The Equity Token, Explained

The equity token functions just like a traditional security. The blockchain management team offers the token to the public in a crowdfunding event, as a Regulation CF or Regulation A exempt offering. The resulting token functions just like a share of stock, but recorded on the blockchain and traded on **equity token exchanges**.[4]



In the equity token offering process:

- **Seed round:** The management team raises an early "seed round" either through angel investment, or through a Reg D filing. This comes in as a traditional funding round, using fiat currency. With this startup capital, the team funds a working prototype of the token. (Think of this like a traditional early-stage investment.)
- **Public offering:** The team then offers equity to the public, in the form of tokens, through a Reg CF or Reg A+ offering. Funds come in as fiat currency; investors receive equity tokens in return. (Think of this like a "mini-IPO.")
- **Public listing:** The team then lists these tokens on equity token exchanges (like listing a stock on Nasdaq), where token holders can buy, sell, and trade their tokens like traditional securities. (Think of this like the new crop of public stocks.)

This model is good for all parties:

- **Investors** receive equity in the new company, in a way that's compliant with existing securities laws.

[4] Several equity token exchanges are in development, or currently going through SEC approval. We expect they will be live in late 2018. See: https://strategiccoin.com/overstocks-new-ico-market-embraces-sec-regulation/

- **Founders** have a clear model they can use to fund new blockchain companies.
- **Regulators** have a well-understood framework they can use to evaluate new token offerings.

To be clear, not all new tokens will fit into an equity token model. Every day, entrepreneurs and technologists are coming up with new use cases for blockchain tokens. The intent of this working paper is to forge one clear path for funding these tokens, which will kickstart token markets, providing further liquidity and allowing the ecosystem to grow with regulatory confidence.

The Equity Token Ecosystem

For this ecosystem to flourish, each of the three steps in the equity token model require specialized companies and services.

- **Due diligence:** Because of the low barrier to entry, investors need companies providing analysis and due diligence. (For example, our company Media Shower provides such services, employing a team of analysts and a peer-reviewed blockchain valuation model.)

- **Broker-dealers:** Because of the inexperience of blockchain technologists and investors alike, they need broker-dealers to market and sell these securities to qualified investors. (Our company Hamersley Partners provides these services, with deep blockchain expertise.)

- **Crowdfund platforms:** Because many investors want to participate, we need platforms that can sign up both retail and institutional investors with KYC/AML compliance. (Crowdfund sites like Indiegogo provide these services.)

Summary

To quote the SEC's Director Hinman, "it is still early days." Be that as it may, investors, founders, and regulators alike are finding themselves hurtled into a new technology, while the world waits for a regulatory response. To do nothing is the worst solution. Already we are seeing the most promising blockchain companies choose to take their projects offshore, for fear of unforeseen U.S. regulation later coming to bite them. At the same time, to come in too heavily (such as China, which prematurely banned all ICOs[5]) is to permanently move that investment capital offshore—not to mention the blockchain industry itself.

While a "light touch" is needed on the blockchain industry as a whole, our intent is to develop a clear solution for those who wish to use tokens for funding a new company. **Equity tokens** provide that solution.

[5] Russell, Jon. "China has Banned ICOs." TechCrunch, September 4, 2017. Source: https://techcrunch.com/2017/09/04/chinas-central-bank-has-banned-icos/