

SECURITIES VS. UTILITY TOKENS

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Abstract

The nomenclature for the term “securities token” is unclear and the term securities token has not been defined. The lack of a clearly delineated nomenclature resulted in various uses and interpretations of the term securities token, especially vis-à-vis the term “utility token.” This article helps clarify the nomenclature by first defining the general characteristics of securities tokens and the general characteristics of utility tokens. Thereafter, the article delineates key distinctions between the two categories.

Key Words: Securities Token, Utility Token, Blockchain, Startup, Decentralized Commerce, Emerging Technology, Equity, Distributed Ledger Technology, Blockchain Technology

JEL Categories: K20, K23, K32, L43, L5, O31, O3

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I. Introduction

The lack of clearly defined technology features pertaining to blockchain technology, distributed ledger, and other associated terms has knock-on effects on other parts of the blockchain ecosystem.

No truly uniform definition exists for blockchain technology. Some refer to it as a giant worldwide, distributed, immutable “google spreadsheet” for transactions.¹ Others define blockchain by focusing on its central elements, e.g., it is a transaction ledger, electronic, decentralized, immutable, and provides cryptographic verification, among several other elements.²

The core distinguishing features of blockchain technology help define the technology generically but provide no specific definitions. For example, the technology’s distributed consensus model makes it much less likely that fraudulent transactions are

¹ Craig Leppan, *Who Is Blockchain Going to Affect the Most*, OVATIONS (July 29, 2015), <http://www.ovationsgroup.com/blockchain/>; Jonathan Shieber, *Colu Aims to Bring Blockchain Technology Everywhere*, TC (Jan. 27, 2015), <https://techcrunch.com/2015/01/27/colu-aims-to-bring-blockchain-technology-everywhere/>;

² See, e.g., DELOITTE, BLOCKCHAIN ENIGMA. PARADOX. OPPORTUNITY 4–7 (2016), <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/Innovation/deloitte-uk-blockchain-full-report.pdf>. ALAN MORRISON, BLOCKCHAIN AND SMART CONTRACT AUTOMATION: BLOCKCHAINS DEFINED, PWC (2016), <http://www.pwc.com/us/en/technology-forecast/2016/blockchain/pwc-smart-contract-automation-definition.pdf>; Alistair Dabbs, *What Is Blockchain, and Why Is It Growing in Popularity?*, ARSTECHNICA (Nov. 6, 2016, 8:00 AM), <https://arstechnica.com/information-technology/2016/11/what-is-blockchain/>; Lee Grant, *Blockchain – Definition, Origin, and History*, TECHBULLION (Sept. 6, 2016), <http://www.techbullion.com/blockchain-definition-origin-history>;

recorded as individual network nodes verify and validate chain transactions before the execution of the transactions.³ The resulting transparency and enhanced accountability are additional key distinguishing features that help protect against fraud.⁴ Disintermediation is another key feature of the technology as the technology incentivizes direct transactions between creators and consumers.⁵ Other key features that are enabled by the technology may include: more connectivity, more freedom of choice, fewer hierarchies, more value and goal focused work, less focus on ownership, less rent seeking behavior, fewer geographical limitations, and less consumerism. These features enhance trust for the users of the technology.⁶

As a result of the lacking clear nomenclature for blockchain technology, many associated fields and parts of the ecosystem

³ See, e.g., Francois Janinotto, *The Blockchain Explained to Web Developers, Part 1: The Theory*, MARMELAB BLOG (Apr. 28, 2016), <https://marmelab.com/blog/2016/04/28/blockchain-for-web-developers-the-theory.html>; Razvan Peteanu, *Fraud Detection in the World of Bitcoin*, BITCOIN MAG. (Mar. 26, 2014, 5:50 AM EST), <https://bitcoinmagazine.com/articles/fraud-detection-world-bitcoin-1395827419/>.

⁴ See, e.g., D'Aliessi, *supra* note 17.

⁵ Rene Bader & Thorsten Deckers, *How Does Blockchain Work? Transactions Without an Intermediary*, ISBUZZNEWS (May 6, 2017), <http://www.informationsecuritybuzz.com/articles/blockchain-work-transactions-without-intermediary/>; Jill Richmond, *How Blockchain Is Transforming the Creative Industry*, NASDAQ (Apr. 26, 2017, 8:25:46 PM EDT), <http://www.nasdaq.com/article/how-blockchain-is-transforming-the-creative-industry-cm780005>.

⁶ See, e.g., Brakeville & Perepa, *supra* note []. For an in-depth, nuanced discussion of this point, see PETER VAN VALKENBURGH, *OPEN MATTERS: WHY PERMISSIONLESS BLOCKCHAINS ARE ESSENTIAL TO THE FUTURE OF THE INTERNET* 3–4, 23–26 (2016), <https://coincenter.org/files/2016-12/openmattersv1-1.pdf>.

experience similarly nebulous terms that often cause confusion among market participants.

The lack of a clearly delineated nomenclature for the term “securities token” resulted in various uses and interpretations of the term securities token, especially vis-à-vis the term “utility token.” This article helps clarify the nomenclature by first defining the general characteristics of securities tokens and the general characteristics of utility tokens. Thereafter, the article delineates key distinctions between the two categories.

II. General Characteristics of Securities Tokens

The nomenclature for the term “securities token” is unclear and the term securities token has not been defined. The lack of a clearly delineated nomenclature resulted in various uses and interpretations of the term securities token. Typically, commentators use the term security token as a synonym for tokens that are treated as investment contracts or stock in a blockchain company.⁷ Securities tokens typically constitute an investment contract, where the primary reason for the token purchase by investors, and main use case of the token, is the anticipation of future profits in the form of price

⁷ [Kenyon Briggs, Taming the Wild West: How the Sec Can Legitimize Initial Coin Offerings \("Icos"\), Protect Consumers from Bad Actors, and Encourage Blockchain Development, 2 Bus. Entrepreneurship & Tax L. Rev. 424, 428 \(2018\).](#)

appreciation, dividends or revenue share.⁸ While the lines between the different types of tokens are blurred regularly,⁹ securities token are typically investment contracts, whereas utility tokens typically provide their users with access to a product or service.¹⁰ In other words, securities tokens involve an underlying interest or function of the token to replace actual financial securities, such as shares or equity in legacy businesses.¹¹

Key commonalities of securities tokens characteristics enable the delineation of securities tokens from other token designs. A key commonality of securities tokens includes its ability to derive their value from an external tradeable asset.¹² The underlying assets for securities tokens can include corporations, earning streams, or entitlements to interest payments or dividends.¹³ These underlying assets of securities tokens are identical to the underlying assets of equities, bonds, and derivatives. In other words, securities tokens are very similar to shares in corporations, giving their owners

⁸ *Taming the Wild West*, p. 429.

⁹ *Taming the Wild West*, p. 428.

¹⁰ *Securities Treatment of Tokenized Offerings Under U.S Law*, p. 431.

¹¹ *Securities Treatment of Tokenized Offerings Under U.S Law*, p. 432.

¹² [Carol Goforth, Securities Treatment of Tokenized Offerings Under U.S. Law, 46 Pepp. L. Rev. 405, 431 \(2019\).](#)

¹³ Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019), <https://www.blockchain-council.org/blockchain/security-tokens-vs-utility-tokens-a-concise-guide/#:~:text=A%20security%20token%20is%20an,economy%20within%20the%20project%27s%20blockchain>

ownership rights in an ecosystem or corporation.¹⁴ Key commonalities in the literature on securities tokens include:

1. that a securities token functions as or is synonymous with traditional security assets,¹⁵ and
2. that securities tokens are subject to traditional securities regulation.¹⁶

The SEC has offered guidance on when a token becomes a security. Under SEC guidance, investment contracts analysis helps determine whether a digital asset has the characteristics of any product that meets the definition of security under the federal securities laws.¹⁷ In *Howey*,¹⁸ the U.S Supreme Court provides a framework for investment contract analysis which can help determine if a digital asset has any of the characteristics of typical securities.¹⁹ Although the *Howey* test has four parts, the SEC notes that main issue in the analysis of digital assets under the *Howey* test is whether a

¹⁴Janine Yorio, *Security Tokens Are Back and This Time It's Real*, CoinDesk (Aug. 24, 2021), <https://www.coindesk.com/business/2021/06/30/security-tokens-are-back-and-this-time-its-real/>

¹⁵Matt Hussey, *Security Token vs Utility Tokens, what is the difference?*, Decrypt (Jan. 16, 2019), <https://decrypt.co/resources/security-token-vs-utility-tokens> (“security tokens are tokens that are tradable. A security token can represent a share in a company, a voting right in how the company operates, a unit of value, or all three.”).

¹⁶Rebecca Clinton-Floyed, *Security Tokens VS Utility Tokens*, Blockchain Expo (May 30, 2019), <https://www.blockchain-expo.com/2019/05/blockchain/security-tokens-vs-utility-tokens/>

¹⁷U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>

¹⁸*S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)

¹⁹U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

purchaser of such a token has a reasonable expectation of profits derived from others.²⁰ This issue is divided into two sub-elements:

1. Reliance on the efforts of others and,
2. Reasonable expectation of profits. In determining whether there is reliance on the efforts of others the SEC focuses on two key issues: - “[1] Does the purchaser reasonably expect to rely on the efforts of an active participant? [2] Are those efforts the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise as opposed to efforts that are more ministerial in nature?”²¹

Within their framework for analyzing digital assets, the SEC notes many characteristics that would likely determine the purchaser of a digital asset to be relying on the efforts of others. None of these factors are necessarily determinative, but the stronger their presence the more likely the element is met.²² In determining whether there is a reasonable expectation of profits, profits can be, among other things, participation in earnings resulting from the use of purchasers’ funds or capital appreciation resulting from the

²⁰ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

²¹ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

²² U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

development of the initial investment or business enterprise.²³ The SEC also provides a list of characteristics that can determine if there is a reasonable expectation of profit from the purchase of a digital asset.²⁴

III. General Characteristics of Utility Tokens

The term utility token is used to identify tokens that have an intrinsic utility for a good or service. Utility tokens emphasize the uses of the token and typically give their users access to a product or service or give rewards to incentivize desirable behavior on the respective platform.²⁵ In order to interact with a given platform or use case, users are incentivized to acquire access rights to the product or service through the acquisition of the utility token. Utility tokens may also take the form of a digital coupon that can be redeemed in the future for discounted fees.

What makes a utility token unique is the utility its users derive through the creation of a digital coupon²⁶ or an app coin.²⁷ For example, one could compare utility tokens to chips in a casino. Whereas chips in a casino do not convey ownership rights to a stake

²³ U.S. Securities and Exchange Commission, *Framework for "Investment Contract" Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

²⁴ U.S. Securities and Exchange Commission, *Framework for "Investment Contract" Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

²⁵ Matt Hussey, *Security Token vs Utility Tokens, what is the difference?*, Decrypt (Jan. 16, 2019).

²⁶ Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019).

²⁷ Rebecca Clinton-Floyed, *Security Tokens VS Utility Tokens*, Blockchain Expo (May 30, 2019).

in the casino or entitlement to a share of the casino's winnings or profits, chips can be used as a currency to purchase access rights to play games, purchase services etc. within only that one casino that issued the chips.²⁸ Rather than replacing legacy financial services like securities tokens, utility tokens are designed to provide users with future access to a product or service that may or may not exist at the time of the utility token issuance.²⁹ Examples of recognized utility tokens include Filecoin, Siacoin, Civic, among others.

Another consideration for the classification of utility tokens is their investment status. Unlike securities tokens, many commentators do not classify a utility token as an investment or investment contract. Utility tokens are not investment contracts and are not investments because are meant for a good or service³⁰ and they are typically exempted from federal securities laws if they are properly set up.³¹ Companies that issue utility tokens do not create them for

²⁸ Janine Yorio, *Security Tokens Are Back and This Time It's Real*, CoinDesk (Aug. 24, 2021). Comparing an Uber token that could only be used to pay for Uber rides - *Token Classes Explained: Coin vs. Utility Token vs. Security Token*, Invao (Date unavailable; Accessed on Aug. 3, 2021), <https://invao.org/token-classes-explained-coin-vs-utility-token-vs-security-token/>

²⁹ *Securities Treatment of Tokenized Offerings Under U.S Law*, p. 429.

³⁰ Rebecca Clinton-Floyed, *Security Tokens VS Utility Tokens*, Blockchain Expo (May 30, 2019).

³¹ Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019).

investment purposes.³² They are designed to be used for their specific utility in a given context.³³

From a regulatory perspective, merely calling a token a utility token or structuring it to provide some utility does not prevent the token from being characterized as a security.³⁴ According to SEC guidance, if a token is sold for use or consumption by purchasers it may not be classified as a security for regulatory purposes. The SEC provided a list of characteristics where, the stronger their presence,³⁵ the less likely a token is to be considered a security.

These characteristics include:³⁶

- The distributed ledger network and digital asset are fully developed
- Holders of the digital asset are immediately able to use it for its intended functionality, particularly where there are built-in incentives to encourage such use

³² Phemex Contributing Writer, *Security Token vs. Utility Token in Crypto: What are The Differences?*, Phemex (Aug. 5, 2021), <https://phemex.com/academy/crypto-security-token-vs-utility-token>

³³ Rebecca Clinton-Floyed, *Security Tokens VS Utility Tokens*, Blockchain Expo (May 30, 2019).

³⁴ Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), (available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>).

³⁵ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

³⁶ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

- The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development
- Prospects for appreciation in the value of the digital asset are limited
- Any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.³⁷

IV. Distinction between Utility Token and Securities Token

Utility tokens can be distinguished from securities tokens based on several core factors, including but not limited to the following: the purpose of the token, associated valuation, associated rights, user expectations, and regulatory status.³⁸ The purpose of securities tokens is typically to serve as investment contracts that represent the legal ownership of a physical or digital asset. By contrast, the purpose of utility tokens is typically to help create an internal economy within a given project's ecosystem, granting users access

³⁷ U.S. Securities and Exchange Commission, *Framework for "Investment Contract" Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

³⁸ Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019). Rajarshi Mitra, *Utility Tokens vs Security Tokens: Learn the Difference – Ultimate Guide*, Blockgeeks (May 13, 2020), <https://blockgeeks.com/guides/utility-tokens-vs-security-tokens/>

to services, voting, and governance rights within a specific project's ecosystem.³⁹

As it relates to token valuation, utility token's value often depends on their functions, correlating value to actual demand for the utility token. That is, a scaled-up project with a high number of users usually result in increased utility token value. By contrast, the value of securities tokens is often correlated to the value of the token issuing company.⁴⁰ In terms of rights that are associated with a utility token versus rights that are associated with a securities token, a securities token often gives a right or promises to deliver profit to investors by the means of work or advertising performed exclusively by a third party.

By contrast, a utility token typically gives its users rights to use a service or product created by the utility token issuer.⁴¹ Users of securities tokens typically expect that the value of the issuing company is directly tied to the value of the securities token. By contrast, users of utility tokens typically expect no relation between the current valuation of the issuing company and the value of the utility token.⁴² Furthermore, securities tokens users often expect to

³⁹ Phemex Contributing Writer, *Security Token vs. Utility Token in Crypto: What are The Differences?*, Phemex (Aug. 5, 2021).

⁴⁰ Phemex Contributing Writer, *Security Token vs. Utility Token in Crypto: What are The Differences?*, Phemex (Aug. 5, 2021).

⁴¹ Dany Chetverikov, *Utility Tokens vs. Security Tokens: a Comprehensive Guide*, Nimera (Nov. 26, 2019), <https://www.nimera.io/blog/utility-tokens-vs-security-tokens>

⁴² Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019).

trade securities tokens with an expectation of directly associated profit from the securities tokens. By contrast, users of utility tokens typically trade utility tokens with an expectation to derive a utility from the use of the token.⁴³ The regulatory status for a securities tokens is rather well established. By contrast, the regulatory status for utility tokens is unclear.⁴⁴

Utility tokens can also be distinguished from securities tokens through the *Howey* test. While a token that passes the *Howey* test is deemed a security token, a token that does not qualify under the *Howey* test is often classified as a utility token.⁴⁵ The SEC provides an extensive list of characteristics that can be used to determine whether a digital asset will meet the *Howey* test, i.e., whether it will be considered a security token.⁴⁶ The SEC also provides a list of characteristics to determine if a digital asset does not meet the *Howey* test, i.e., whether it will be considered a utility token.⁴⁷

⁴³ Martin Thomas, *The 7 Types of Cryptocurrencies You Must Know*, gitconnected (Apr. 21, 2021), <https://levelup.gitconnected.com/the-7-types-of-cryptocurrencies-you-must-know-3b26b2ce0eb8>

⁴⁴ Toshendra Kumar Sharma, *Security Tokens vs. Utility Tokens: A Concise Guide*, Blockchain Council (Sep. 6, 2019).

⁴⁵ Rajarshi Mitra, *Utility Tokens vs Security Tokens: Learn the Difference – Ultimate Guide*, Blockgeeks (May 13, 2020).

⁴⁶ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

⁴⁷ U.S. Securities and Exchange Commission, *Framework for “Investment Contract” Analysis of Digital Assets*, sec.gov (Apr. 3, 2019).

V. Conclusion

The digital asset industry will continue to refine the terms that apply to its key projects and features. The term securities token is fairly well defined in 2022 and any additional regulatory guidance will continue to delineate its central features and distinguishing characteristics. Utility tokens can be distinguished from securities tokens. As the industry matures, the distinguishing features and associated case law will likely increase and provide more guidance to market participants.