

Goodman's^{LLP} Update

What Makes a “Utility Token”? - SEC Delivers Rare No-Action Letter to Token Issuer

Last month, the U.S. Securities Exchange Commission (SEC) issued a no-action letter to Pocketful of Quarters, Inc. (PoQ), a Connecticut-based gaming start-up looking to issue tokens on the Ethereum blockchain. The no-action letter paves the way for PoQ to legally sell its tokens (called “Quarters”) to the public on an exempt basis, sparing PoQ from the requirement to file a registration statement. The no-action letter is only the second ever issued by the SEC to a cryptocurrency company looking to launch a token sale, and the first in respect of an ERC-20 token.¹ The no-action letter, which distinguishes PoQ’s Quarters from securities, offers fresh insight into the qualities that characterize a true “utility token” - i.e., one that will not fall under the umbrella of securities regulation.

Background

The question of whether cryptocurrencies offered to the public are securities that should be subject to securities laws has recently been a subject of focus amongst regulatory bodies, and a point of interest for market participants and observers. In order to avoid the application of securities laws to their tokens, issuers have often attempted to classify their cryptocurrencies as “utility tokens”, a term often applied in the cryptocurrency sector to tokens that are tied to a certain function, such as allowing the holder to purchase particular services using the token.

To date, regulators have been unwilling to accept as a rule that tokens characterized by issuers as “utility tokens” are not securities. The SEC in the U.S. and the Ontario Securities Commission (OSC) and Canadian Securities Administrators (CSA) in Canada have taken the approach of considering cryptocurrency offerings on a case-by-case basis, considering each token in the context of its particular facts and circumstances to determine whether it constitutes a security for securities law purposes.

In 2018, the CSA issued a staff notice stating that characterizing a token as a “utility token” will not in itself rule out the application of securities laws to the offering of such token. Instead, regulators in Canada will consider the characteristics of each offering of tokens to determine whether such offering involves the distribution of an “investment contract”², or if the tokens offered can otherwise be characterized as securities. For more information on the CSA staff notice, see our June 12, 2018 update *Focus on Substance over Form – CSA Provides Further Guidance on Token Offerings*.

¹ Quarters are built according to the ERC-20 standard, a technical standard applied to most tokens on the Ethereum blockchain.

² Case law in both Canada and the U.S. has identified that the four elements of an “investment contract” are: (i) an investment in money, (ii) in a common enterprise, (iii) with the expectation of profit, (iv) to come significantly from the efforts of others.

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The PoQ No-Action Letter

PoQ's Quarters, the brainchild of the company's 12-year old CEO, are intended to function as a "universal gaming token" that can be utilized by video gamers to make in-game purchases across multiple platforms and games. PoQ will function as an exchange for the cryptocurrency, selling the Quarters on its website, and allowing Quarters holders to store the tokens in online "wallets".

On July 25, 2019, PoQ's legal counsel submitted a letter to the SEC's Division of Corporate Finance seeking confirmation that the regulatory body would not take enforcement action against PoQ if the company sold Quarters to the public without filing a registration statement for the tokens. On the same day, the SEC issued a no-action letter confirming that, based on the representations made in PoQ's submission, no enforcement action would be pursued.

The letter noted the following considerations in reaching the position that no action would be taken:

Immediate functionality. The SEC noted that the Quarters platform has been fully developed and PoQ will be fully operational prior to the sale of any tokens. Thus, the Quarters will be fully useable for their intended function as a universal gaming token at the time they are sold to purchasers. This is in stark contrast to many other sales of utility tokens, in which the proceeds of the offering were stated to be used to fund the development of a platform or service in respect of which the tokens would have functionality at some future date.

No secondary market. As part of the offering of Quarters, PoQ implemented technological and contractual provisions to restrict the transfer of Quarters. Specifically, Quarters holders will only be able to transfer the tokens to game developers and influencers who have opened approved accounts with POQ, and to PoQ in connection with participation in e-sports competitions. Developers and influencers who receive Quarters will be able to exchange them for "Ether" tokens at pre-determined exchange rates. These rules function to restrict secondary trading of the Quarters for investment purposes, which is one of the important indicia of a security token.

No profit potential. The Quarters are a "stablecoin", meaning that PoQ sets the price of the tokens as the only sellers thereof and the price will not fluctuate, removing the possibility of purchasers acquiring tokens for speculative investment purposes.

Implications

POQ's Quarters, and the SEC's no-action letter regarding the offering of the tokens, help to clarify the relatively narrow circumstances in which securities regulators will accept that "utility tokens" are not securities.

Though the SEC noted the functionality of the tokens was a factor in issuing the no-action letter, its comments regarding the lack of a secondary market, and the stable pricing of the Quarters, highlight other important considerations regarding the application of securities laws to cryptocurrencies, especially when the Quarters are compared against other purported "utility tokens" making recent news.

In particular, the SEC's treatment of PoQ's Quarters stands in sharp contrast with the ongoing case relating to the "Kin" tokens offered by Kik Interactive Inc. (Kik). Though Kin tokens possess functionality tied to a messaging app developed by Kik, the SEC has taken the view that the Kin tokens are in fact securities, and that Kik's ICO of the tokens amounted to an illegal offering of securities. Importantly, Kik purportedly represented to investors that rising demand for Kin would drive up the value for the tokens and that Kik's future business activities would spur this increased value, paving the way for token holders to turn a profit by trading the tokens on secondary markets. For further background on the SEC's lawsuit against Kik, refer to our June 5, 2019 update, SEC Sues Canadian Company for Conducting Illegal Token Offering.

The PoQ no-action letter, combined with the SEC's arguments in the ongoing Kik litigation, highlight the relatively narrow circumstances in which the SEC will accept that a "utility token" should not be treated as a security.

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