

ADDENDUM “A”

Blockchain technology has created whole new asset classes, and H.R. 3633, S. 394, and The Senate Market Structure Bill seek to categorize these as “Digital Assets”. The Clarity Act (H.R. 3633) and The Genius Act (S. 394) divide digital assets into three categories, “Digital Commodities”, “Securities”, and “Stable Coins”. The Senate Market Structure Bill divides digital assets into two categories, “Ancillary Assets” and “Stable Coins”. Unfortunately, neither H.R. 3633 or the Market Structure Bill acknowledge digital assets that already have existing structures in place. “Utility Tokens” fit this later category, with many existing requirements already addressing their regulation.

Definition of Utility Token

To explain our issue, it is important to understand what a “Utility Token” is. It should be stated here, utility tokens can be gifted, earned, purchased, or swapped. They are hybrid instruments that can exhibit characteristics of purchased gift cards, raffle tickets, coupons, loyalty rewards or points. They are meant to flexibly satisfy the needs of the user in ways unavailable individually to the above listed legacy asset classes. This digital utility token creates an asset class that has never existed before, and is made possible by blockchain and distributed ledger technology. It becomes possible to gift utility tokens to a friend as a birthday present, purchase utility tokens similar to a coupon book for discounts, and swap utility tokens with someone else when you both want to change networks.

“Utility Tokens” can be managed by the issuer in such a way as to prevent expiration. Additionally, the utility tokens one receives at Christmas can be combined in the same account with those from a birthday. No longer is it necessary to carry multiple gift cards, nor is it necessary to worry about if they are still good or not. If the holder of a utility token wants to wait on a purchase, there is no rush to meet some arbitrary deadline. Furthermore, their hybrid nature allows utility token issuers to accomplish multiple objectives simultaneously. For charitable efforts an issuer can allow full redemption of a product or service using their utility tokens. For promotional efforts an issuer can receive their “Utility Token” as a coupon for a discount. Instead of needing to support multiple types of gift card, coupon, and promotional items, the issuer can use their “Utility Token” to satisfy all requirements, to all purchasers, simultaneously.

Hybridization of utility tokens allows them to remain useful to a business throughout its life cycle. When a business is determining what new products its customers want, utility tokens allow purchasers to indicate support for products they desire to reach market. The purchaser can then use the tokens for discounts on the new product when it launches. When a business wants to expand its marketing to a larger audience, it can run promotional campaigns centered on its utility token, holiday and birthday gift cards being a prime example. When a business wants to close down operations, its utility token can be used to redeem inventory, similar to a closeout sale. This allows a business to show appreciation to its long-time supporters.

Overview of Problem

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Unfortunately, Congress is making a simplifying assumption that everyone is on the same page in understanding what is and isn't a “Utility Token”. While it should seem straightforward, or even common sense, there are prior enforcement actions that show it to be anything but. Specifically, Congress has granted large interpretive powers to enforcement agencies such as the SEC, CFTC, and Comptroller of the Currency. The SEC in particular has interpreted “Utility Token” classification so rigidly and narrowly, it has effectively prevented utility tokens from achieving the features and benefits discussed earlier. While the Market Structure Bill seeks to place a majority of “Digital Assets” into the “Ancillary Asset” category, and hence under CFTC jurisdiction, it inadvertently includes “Utility Tokens” in this category by not explicitly defining and excluding them. The language used does not sufficiently acknowledge how utility tokens function, nor the existing requirements that regulate them. This keeps utility tokens captive to outdated standards of interpretation meant for legacy asset classes, effectively, opening them to jurisdiction by both SEC and CFTC.

Current Standard of Interpretation

Significant to this discussion, is what standard does the SEC use when determining “Utility Token” Status? That standard would be the, “**Framework for “Investment Contract” Analysis of Digital Assets**”. <https://www.sec.gov/about/divisions-offices/division-corporation-finance/framework-investment-contract-analysis-digital-assets>

The listed standard references the Howey Test which consists of 4 parts in determining if an asset is a “Security”.

- #1. An investment of money
- #2. Into a common enterprise
- #3. With an expectation of profit
- #4. From the effort of others

To restate the point already made, “Utility Tokens” are a new class of “Digital Asset” with hybrid characteristics that do not directly correlate to previous asset classes. Highlighted here is that the “Howey Test” came from litigation to determine the “Security” status of legacy asset classes. “Utility Tokens” fulfill numbers 1, 2, and 4. Number four is of particular note, as it is necessary for many utility token issuers to control their token centrally. This is necessitated by efforts to control the outstanding liabilities of unclaimed rewards, points, discounts, etc... In order to adequately protect both the business and the purchaser, it is often necessary to centrally control the issuance of the utility token. This facilitates knowing how many tokens are outstanding at any given time and allows the issuer to add or subtract tokens for promotions and for controlling token prices. Number three of the “Howey Test” is the only way utility token issuers can attempt to avoid classification as a “Security”.

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Being classified a “Security” essentially prevents all “Utility Token” features and benefits from being offered for direct sale to the majority of U.S. citizens. This stems from the fact that “Securities” can be sold only to “Accredited Investors”. Accredited investors are classified as those who: #1 Have a net worth over a million dollars, excluding primary residence (individually or with spouse or partner). #2 Income over \$200,000 (individually) or \$300,000 (with a spouse or partner) in each of the prior two years, and reasonably expects the same for the current year. <https://www.sec.gov/resources-small-businesses/capital-raising-building-blocks/accredited-investors>

Problems in the Marketplace

Number three of the "Howey Test" involves profit motive on the part of the purchaser. (This is a fundamental misunderstanding of how blockchain transactions function.) Blockchain transactions do not allow the issuer to either assess or prevent “reasonable expectation of profit” on the part of the purchaser. During a blockchain transaction, the two parties do not exchange personally identifiable information. It is not possible for the issuer to know whether the purchaser is a business or an individual. There is no way for the issuer to know the socio-economic status or intentions of the purchaser.

This inability to verify and control profit motive on the part of the purchaser has historically led the SEC to prohibit listing utility tokens on centralized and decentralized crypto exchanges, which effectively removed utility tokens’ opportunity to function in the beneficial ways listed earlier. This legacy method of determining "Security" status does not adequately meet the needs of the modern digital world. As an example, it took two and a half years of litigation for the Judiciary to issue a partial ruling as paraphrased here: trading of utility tokens on exchanges does not make utility tokens into Securities. The case in question is *SEC vs Ripple Labs, Inc.*, heard before the United States Federal District Court for the Southern District of New York. The case, first filed in December of 2020, has not reached settlement at the time of this writing.

Number three of the “Howey Test” is still in effect by the SEC despite the Judiciary ruling that utility tokens can be purchased and swapped on the exchanges. This stems from attribution of profit motive to the purchaser, i.e., an issuer is now allowed to sell their tokens on the digital asset exchanges but could arbitrarily be declared an unregistered security. This would be particularly true, should the SEC find a customer who purchased speculatively. It then becomes a case of being legally allowed, but impossible in implementation.