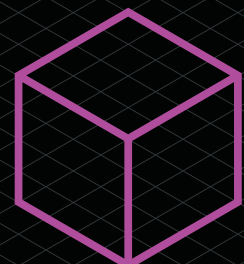
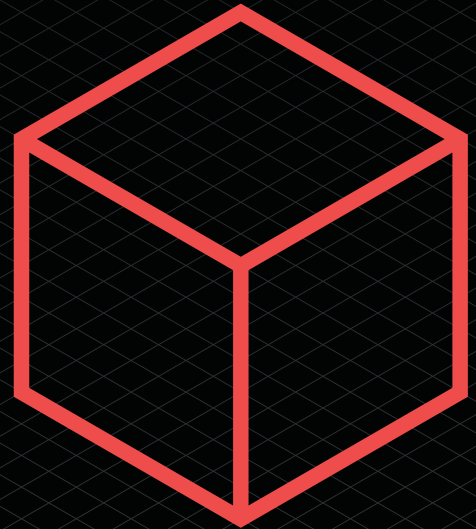


Part 1:
Developing
Technologies
Section 6
Social Tokens



Section 6: Social Tokens

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What are social tokens?

Social tokens (also known as community tokens) are one of the latest innovations in the crypto space and have grown significantly in recent years. They are essentially a new form of cryptocurrency that is linked to a company, organisation or a person. The social token definition covers tokens created by companies, organisations and people across a broad range of sectors, including:

- art;
- content;
- culture;
- design;
- gaming;
- music; and
- sport.

The direct rewards for owning social tokens are generally determined by the token designer or issuer. They vary significantly across the different sectors but can include benefits such as early access to new content, “money can’t buy” experiences, discounts, governance rights and influence on decision making. Token ownership also carries with it other, indirect, benefits such as status within a community and growth in value.

Are there different types of social token?

There are three main classifications of social tokens:

1. personal tokens;
2. community tokens; and
3. social platform tokens.

Personal tokens

Personal tokens, also known as “creator tokens”, are issued and controlled by a primary individual. The creators are often high-profile celebrities, entrepreneurs or artists. Personal tokens generally allow the holders to redeem them against services provided by their creators.

An example of a personal token is the “RAC” token issued by the musician RAC (André Allen Anjos), the DJ and Grammy award-winning artist. The token allows fans to access various perks and exclusive content.

Community tokens

Community tokens are issued and controlled by a group which is often managed by a Decentralised Autonomous Organisation (**DAO**). (For more on DAOs see Section 8.) These tokens generally have all the benefits of personal tokens with added governance rights of the DAO, together with influence and prestige in a niche community. Benefits may also include the right to revenue from assets owned or rented by the community or payments for services provided by the community.

One example of a community token is the “Whale” token. The Whale community is a DAO and is backed by rare and valuable NFTs primarily across the blockchain, gaming, digital art and virtual real estate sectors. It is therefore a community token backed by unique digital assets; or put another way, fungible assets backed by non-fungible ones. The token offers its owners the chance to rent NFTs from the Whale “vault”, buy exclusive NFTs, participate in liquidity mining, purchase exclusive digital products and engage in DAO decision making.

Social platform tokens

Social platform tokens represent control over a platform that facilitates social token issuance and exchange. Token holders can often engage in the governance of the social platform and use the tokens to pay for transaction fees on the platform. Additionally, because the tokens have a money's worth value, they can be held as investments by those speculating that the value will increase. Some tokens can also be staked whereby the token is deployed to validate transactions in a proof-of-stake blockchain. Staking generates rewards for the token holder.

The "Rally" token is one of the main social platform tokens on the market and is the governance token of the Rally network, which backs all "Creator Coins". Creator Coins allow individuals and businesses to receive payment for services and are essentially an individual type of cryptocurrency.

One of the best-known examples of a platform token in the sports sector is the Socios.com fan engagement platform and its "Chiliz" token. Socios allows holders of the Chiliz token to purchase fan tokens related to their favourite football team. The team related tokens are minted and exchanged on a permissioned sidechain to the main Chiliz blockchain and allow holders to engage in official sports team polls (thereby influencing club decision making) and unlock exclusive club rewards. A sidechain is used because it is less intensive in computational terms than the main Ethereum network and also enables Socios to reduce and manage the cost of gas on that network.

Social tokens terms and conditions

Unlike many of the older cryptocurrencies like Bitcoin, social tokens and related platforms generally have an identifiable individual or entity behind them which means it is more likely there will be a set of terms and conditions and/or a white paper governing the use of the platform and the token(s).

The terms and conditions currently in the market tend to exclude liability as far as possible for the token issuer. Participants or token holders should expect to see numerous unfavourable terms including extensive disclaimers for various types of risk (from hacking to lack of liquidity in the market) and uncapped indemnity provisions in favour of the token issuer.

Choice of governing law and jurisdiction is likely to be driven by where the individual, entity or platform is based. HX Entertainment Ltd (the entity behind the Chiliz social platform token) for example is a company registered in Malta and as such the Chiliz token terms and conditions are governed by Maltese Law. Rally Network, Inc on the other hand is a California-based company and has terms governed by the US State of Delaware.

Where English law does apply, the extent to which consumer law will protect the purchasers of cryptoassets such as social tokens is something of a grey area. The FCA's consumer research found that 89% of purchasers of cryptoassets were aware that they were not subject to regulatory protection¹⁷². At present then such purchasers do seem to be relatively sophisticated. The technical challenges for the newcomer in terms of setting up wallets, acquiring cryptocurrencies and acquiring tokens have also helped to ensure a degree of sophistication amongst purchasers. Those technical challenges are quickly being made easier however and that is likely to lead to increased access to the market for less experienced or less knowledgeable individuals. The application of consumer protections will probably therefore become a more prominent topic over time. This issue is of particular relevance in the field of social tokens which are used quite widely in the context of entertainment and celebrity culture.

¹⁷² HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf (publishing.service.gov.uk)

Social tokens interaction with smart contracts

Social tokens are purchased and traded on platforms utilising smart contracts to govern the transaction. These contracts are generally quite simple, prescribing an agreed purchase price for the transfer of the token to a new owner, perhaps together with certain other limited information. Smart contracts that use the ERC-20 standard for example will also include information such as the total number of such tokens in circulation and the current token balance of an account. It is rare to find highly complex smart contracts because, as well as complexity itself making problems with the contracts more likely, the cost in gas of processing them can be prohibitively high.

Most of the functionality of social tokens as perceived by the end user of the token, such as the bestowal of real world benefits, are handled off-chain rather than via smart contracts. By way of example, if an influencer or brand wants to produce a closed Instagram Live session for token holders exclusively, that right to that benefit does not sit on-chain or within the token or any smart contract. Instead it is simply a matter of a real world contract, or arrangement, between the influencer or brand and the token holder.

Regulatory challenges in the UK

As with many digital assets in the blockchain sector, social tokens do not fit neatly into the existing regulatory framework. The FCA has identified two types of regulated token in the UK:

- e-money tokens; and
- security tokens.

Social token issuers who wish to ensure that their tokens are not captured by FCA regulations will be keen for their tokens to avoid any of the attributes of an e-money or security token.

Within the category of unregulated token, the FCA has specifically identified the following two types of token:

- utility tokens; and
- exchange tokens.

Many of the social tokens referenced in this article are likely to be considered “utility tokens” under the current guidance and, as such, would not be caught by the existing FCA regulations. Where tokens are used in the context of payment, they may be exchange tokens. While such tokens are themselves unregulated, certain payment activities in which they may be used could potentially be regulated under payment services regulation.

However, token issuers should be cautious when attaching rights to a token that could be construed as being similar to the characteristics of a share, a debt instrument or other type of financial instrument. Platforms and exchanges should also be cautious that their activities do not constitute “investment activity” on behalf of token holders, potentially opening up a classification of the platform or exchange operating a “collective investment scheme”. This is a particular risk where the token provides holders with a right to revenue from the ownership/management of assets/businesses.

The FCA’s AML/CTF cryptoasset registration regime requires cryptoasset exchange providers and custodian wallet providers to register with the FCA and to meet various anti-money laundering and counter terrorist financing requirements. It is possible that a social token platform or exchange could be captured by these requirements.

Any token issuer or platform/exchange which is considering launching in the UK should seek specialist legal advice in this area as soon as possible.