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Changing securities laws and regulations for the digital token age

Robert A. Schwinger, *New York Law Journal – March 19, 2019*

In his Blockchain Law column, Robert Schwinger explains how, when it comes to virtual currencies, digital tokens and other blockchain assets, our legal and political systems are still in the earliest stages of grappling with which regulations and structures would be best suited for encouraging financial technology innovation on the one hand, while providing certainty and serving the public interest on the other.

While courts last year recognized that under existing law virtual currencies based on blockchain platforms could qualify as "securities," see *United States v. Zaslavskiy*, No. 17 CR 647, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018), and/or "commodities," see *CFTC v. McDonnell*, 287 F. Supp. 3d 213 (E.D.N.Y. 2018), concern has been growing that these regulatory structures may not be ideal for regulating all digital tokens in all situations. Lawmakers across the country are thus now exploring possible revisions to existing laws and regulations to deal more appropriately with this new asset class.

Background: Securities vs. 'Utility Tokens'

As noted in the January "Blockchain Law" column, the SEC has brought increasing numbers of proceedings in recent months in connection with cryptocurrencies and other digital tokens on the basis that they qualified as "securities" under federal law because they satisfy the "Howey test" for "investment contracts" under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and its progeny.

Although each case is fact-specific, SEC chairman Jay Clayton has taken the view that to date most tokens publicly sold in initial coin offerings (ICOs) have amounted to securities, even if not registered as such. Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC, before the Committee on Banking, Housing, and Urban Affairs United States Senate, Feb. 6, 2018. Supreme Court jurisprudence also establishes, however, that if a person is purchasing an asset for consumption only, it is likely not a security. *United Housing Found. v. Forman*, 421 U.S. 837 (1975).

Accordingly, some scholars have posited a bright-line distinction between investment tokens, which entitle their holders to economic rights like a share of any profits generated by the project, and "utility tokens," which only carry with them the right to use and govern the technology that is being developed with funds generated by the ICO token sale, and argue that the latter is not a security. See Jonathan Rohr and Aaron Wright, Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets, 97 Cardozo Leg. Stud. Res. Paper No. 527 (2018).

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The SEC has contended, though, that even digital assets that provide utility could be a security, depending on how they are packaged and sold. See William Hinman (Director of the SEC's Division of Corporation Finance), Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018).

Legislative Reactions

Facing concerns that uncertainty about the regulatory treatment of digital tokens could stifle innovation, deter entrepreneurism or harm the competitiveness of American businesses operating in a new industry that could have a significant impact on the economy, federal and state legislators have begun addressing such issues and advancing legislative proposals to address such concerns. In May 2018, Rep. Warren Davidson (R-Ohio) called on Congress to pass legislation to address whether digital tokens are securities or commodities and to clarify the role of regulators. 164 Cong. Rec. H3788 (daily ed. May 8, 2018).

Similarly, Rep. Darren Soto (D-Fla.) has advocated for "light-touch regulation" of cryptocurrencies, arguing that "an increasing share of international business will be done using blockchain-based exchanges and that America's leadership on cryptocurrency will be critical to its success in the twenty-first century economy."

In September 2018, a bipartisan group of 15 lawmakers issued a letter to SEC chairman Jay Clayton asking the SEC to clarify the criteria it uses to determine when offers and sales of digital tokens should be classified as securities, asserting that "not all digital tokens are securities" and that "treating all digital tokens as securities would harm American innovation and leadership in the cryptocurrency and financial technology space."

The lawmakers also expressed concern "about the use of enforcement actions alone to clarify policy" and stated that all policymakers should ultimately be working towards formal guidance or legislation. Press release, "Budd Sends Bipartisan Letter to SEC Seeking Token Clarity," Sept. 28, 2018.

Proposed Federal Legislation

Lawmakers have begun to introduce bills to take on these issues. In December 2018, Reps. Davidson and Soto introduced the "Token Taxonomy Act of 2018," H.R. 7356, 115th Cong., 2d Sess. (2018). This bill proposes to amend the definition of a "security" under the four major federal securities statutes to exclude "digital tokens." The bill sets forth specific criteria to define "digital tokens," including that they "cannot be altered by a single person," have "a transaction history that is recorded in a distributed digital ledger or digital data structure in which consensus is achieved through a mathematical verifiable process," and are "capable of being traded or transferred between persons without an intermediate custodian."

The bill further provides that a "digital token" cannot be "a representation of a financial interest in a company, including an ownership or debt interest or revenue share," meaning that the token may not represent an equity interest or other corporate obligation, but must instead have some utility, such as conferring rights to access an online platform.

The bill would exempt from the registration requirements of the Securities Act transactions involving the development, offer or sale of a "digital unit" (defined as "a representation of economic, proprietary, or access rights that is stored in a computer-readable format") if the person developing, offering or selling the digital unit has a "reasonable and good faith belief" that the digital unit is a "digital token." The bill's co-sponsors' press release state that the bill would clarify that the securities laws "do not apply to companies that use blockchain once they reach their goal of becoming a functional network." See Press release, "Congressmen Warren Davidson, Darren Soto Introduce ICO Fix for Businesses, Consumers," Dec. 20, 2018.

While the sponsors of the Token Taxonomy Act in their press release touted their proposed legislation by pointing to the early days of the Internet, when Congress "passed legislation that provided certainty and resisted the temptation to over-regulate the market," the bill does in fact provide significant openings for uncertainty. Most notably under the bill, if the SEC notifies the developer in writing that it considers a digital unit to be a "security" and not a "digital token" notwithstanding the developer's "reasonable and good faith belief" otherwise, then within 90 days the developer must stop selling the tokens and return all proceeds from sales, excluding funds reasonably spent on the development of associated technology.

Rep. Soto also introduced two other proposed bills in the last session of Congress, both of a more general nature. One, the "U.S. Virtual Currency Market and Regulatory Competitiveness Act of 2018," H.R. 7225, 115th Cong., 2d Sess. (2018), directs the Chairman of the Commodity Futures Trading Commission (CFTC), in consultation with the heads of the SEC and other

relevant federal agencies, to submit a report to Congress within one year on the state of virtual markets and ways to promote American competitiveness, including recommendations for any legislative changes needed to do so.

The other, the "Virtual Currency Consumer Protection Act of 2018," H.R. 7224, 115th Cong., 2d Sess. (2018), directs the CFTC chairman (again in consultation with the SEC and other agencies) to prepare and submit within one year a report "to promote fair and transparent virtual currency markets by examining the potential for price manipulation," including an analysis of the powers of the FTC and other federal agencies to address such concerns under existing regulatory structures and recommendations for needed legislative changes.

State Legislation

There also has been activity at the state level to exempt digital tokens from certain state securities laws. In March 2018, Wyoming enacted House Bill 70, commonly known as the Utility Token Bill, which provides that the sale of digital tokens is not subject to securities and money transmission laws. Wyo. Stat. Ann. §17-4-206 (2018). In April 2018, Arizona passed House Bill 2601, exempting virtual coin offerings from securities registration requirements. Ariz. Rev. Stat. Ann. §§44-1801, 44-1844 (2018). Most recently, in February, Colorado passed the Colorado Digital Token Act, exempting the offer and sale of digital tokens from Colorado's securities registration requirements. Colo. S.B. 19-023, 72nd Gen. Assemb., 1st Reg. Sess. (2019).

Under the Wyoming and Colorado laws, a promoter seeking exemption from registration requirements must market the digital tokens primarily for "a consumptive purpose" and not "as a financial investment." The primary purpose of the digital token is a consumptive purpose if the token is "exchangeable for, or provided for the receipt of, goods, services or content, including rights of access to goods, services or content."

Under the Arizona law, the promoter must not have marketed the digital token as "an investment" and the purchaser must be granted, within 90 days after receipt of the digital token, "the right to use, contribute to the development of or license the use of a platform using blockchain technology," including "a license to use a product or service on the platform or a discount against fees for use of the platform."

Requests for New Rulemaking

Not only legislators but also market participants are seeking to modify securities laws and regulations to accommodate digital token transactions. In December 2018, Templum, Inc., whose broker-dealer subsidiary operates an alternative trading system for the secondary trading of digital assets, filed a petition for rulemaking to the SEC requesting that the SEC provide "needed guidance related to post-trade activities in the digital asset space." Petition for Rulemaking, File No. 4-736 (Dec. 12, 2018).

The petition asks the SEC to (1) clearly define when a blockchain technology platform must register as a clearing corporation and define how blockchain technology may be used by such firms, (2) issue guidance as to when a blockchain technology platform must register as a transfer agent and provide guidance to issuers of digital assets as to when they must use a transfer agent, and (3) modernize existing rules that require broker-deals to maintain physical possession or control over customers' securities. The SEC has not yet issued a public response.

Conclusion

Our legal and political systems are still in the earliest stages of grappling with what regulatory tools and structures are best suited to properly serving the public interest and providing certainty while encouraging financial technology innovation when it comes to virtual currencies, digital tokens and other blockchain assets.

While Congress mulls taking legislative action, the examples of Wyoming, Arizona and Colorado suggest that the states may end up being the first laboratories of change. For now, businesses working with these assets will need to monitor a patchwork of developments on both federal and state levels in order to steer their course.

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