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How Congress Could Change The Game For Digital Tokens

By **Stephen Crimmins and Matthew Comstock** (January 10, 2019, 2:45 PM EST)

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As Washington emptied out for the long holiday weekend on Dec. 20, a bill hit the hopper in the House of Representatives that has the potential to be a total game changer for regulation of digital assets (also referred to broadly as "tokens"). And as it's bipartisan, co-sponsored by Reps. Darren Soto, D-Fla., and Warren Davidson, R-Ohio, it actually stands a realistic chance of passage after it is reintroduced in the new 116th Congress. The bill — dubbed the "Token Taxonomy Act" (H.R. 7356) — has been referred to the Committee on Financial Services and the Committee on Ways and Means.

Some form of relief in this area is long overdue. The crypto industry and regulators have been struggling over the last two years to fit cutting-edge blockchain technology into a securities regulatory framework with its roots solidly planted in the paper-based 1930s. Without clear statutory direction, regulators could only point to the 72-year old Howey test[1] as a lodestar.[2] The challenge has been to maintain core investor protections, while at the same time figuring out a principled way to enable American markets, in the words of the bill's sponsors, "to compete with Singapore, Switzerland, and others who are aggressively growing their blockchain economies."[3]

The bottom-line philosophy of the bill, according to its sponsors, is that once companies using blockchain achieve "a functional network," the "securities laws should not apply." The sponsors suggest that relieving the U.S. Securities and Exchange Commission of an obligation to police digital tokens on functional networks will free it to "perform its vital and much needed consumer protection duties."[4]

Spelling Out When Tokens Are Not Securities

The bill would, among other things, create an asset class defined as a "digital token" that would be exempt from the definition of security under the federal securities laws. The bill would also offer a mechanism for unwinding token offerings when there is a problem.

The new bill begins its work by amending the definitions section of the Securities Act of 1933 with concepts never dreamed of back in the '30s. A new Section 2(a)(21) defines a "digital unit" as "a representation of economic, proprietary, or access rights that is stored in a computer-readable format"

— essentially, property that lives only on a computer server.

The bill then provides a new Section 2(a)(20) to define the bill's core concept of a "digital token." A digital unit qualifies as a digital token if four distinct conditions governing the creation, recordation, transfer and economics of the digital unit are all met. First, the digital unit must be created "in response to the verification or collection of proposed transactions," i.e., mined. Alternatively it can be created pursuant to rules for its "creation and supply that cannot be altered by a single person or group of persons under common control," meaning that the issuer cannot create new digital tokens in a manner not in accordance with the rules. Finally, digital units can be created as an initial allocation of the units through mining or pursuant to inalterable rules.

Second, the digital unit must have real blockchain security and transaction-tracking bona fides. Specifically, it must have a "transaction history" that is "recorded in a distributed, digital ledger or digital data structure," where "consensus" is reached by a "mathematically verifiable process" that cannot be "materially altered" by individuals.

Third, the digital unit must be "capable of being traded or transferred between persons without an intermediate custodian."

Fourth, the digital unit cannot grant the purchaser of the unit any economic interest in the issuer of the unit; it cannot be a form of digital stock or other shared ownership of a business venture. Specifically, it cannot be "a representation of a financial interest in a company, including an ownership or debt interest or revenue share."

Once all four of these conditions are met, the "digital unit" qualifies as a "digital token." And once it is a digital token, the bill takes it out from under the Howey regime. The bill accomplishes this result by amending the Securities Act's definition of a "security" in Section 2(a)(1), obviously at the heart of the Securities Act's regulatory scheme, to provide that the term "security" simply "does not include a digital token."

Interestingly, the creation criteria of the bill's digital token definition seem to allow presales of digital tokens, even in the absence of functioning network built by the token issuer. Provided such tokens otherwise meet the digital token criteria — i.e., are transferable without the use of an intermediate custodian, and do not provide the purchaser with any economic interest in the issuer — such tokens would not be securities.

Moreover, nothing in the bill's definition of digital token prevents secondary market trading of such tokens. Thus, the bill appears to contemplate that purchasers of digital tokens in presales should be free to trade those securities on a secondary market. The issuer arguably could assist with the process of listing a digital token on the secondary market. It is unclear, however, if the bill's sponsors actually intended to allow such trading, at least ahead of a functioning network for the digital token, particularly given the potential for investor losses.

Path Out for Those Who Get It Wrong

The bill offers a lifeline for those who, despite sincere efforts, fail to satisfy the requirements of the new digital token definitional regime. The bill adds Section 4(a)(8) to the Securities Act to provide a new transactional exemption from the registration requirements of Section 5 where the person "developing, offering, or selling the digital unit" can demonstrate a "reasonable and good faith belief" that the digital

unit is a digital token.

If this is the case, the individual gets a 90-day grace period to unwind a token offering following an SEC notice that it has determined the digital unit to be a security. During that 90-day window, the individual must publicly post the SEC's determination, take reasonable steps to cease all sales and return proceeds from past sales. Importantly, the individual need not return funds already spent to develop "technology associated with the digital unit."

Last month, the SEC resolved cases against two companies that sold tokens in ICOs under settlement terms that required the companies to register their tokens as securities under the Securities Exchange Act, to maintain periodic reporting, to offer to return funds to investors and to pay additional civil monetary penalties. At the time, the SEC's Co-Director of Enforcement characterized these settlements as "a model for companies that have issued tokens in ICOs and seek to comply with the federal securities laws."[5] New Section 4(a)(8) would thus provide a considerably softer landing for those who can show they went astray in good faith.

New Clarity for Cryptocurrency Intermediaries

By making similar definitional changes to the Exchange Act, the bill provides considerable clarity for intermediaries dealing with digital assets. It adds Section 3(a)(82) to the Exchange Act to define a "digital token" as having the same meaning as in its new definition in the Securities Act, and it amends the Exchange Act's definition of "security" in Section 3(a)(10) to expressly provide that it "does not include a digital token." With the threshold for what is a security thus clarified, the picture has changed considerably for intermediaries. Intermediaries that are not registered as broker-dealers can transact in digital tokens without running afoul of the federal securities laws.

By comparison, earlier this year, the SEC's Enforcement and Trading & Markets Divisions had issued a joint statement that spelled out a parade of difficult consequences for those handling tokens deemed to be securities.[6] The platform handling the tokens could potentially have to register as an exchange,[7] or seek to operate under Reg ATS. As an exchange and SRO, it would need rules, policies and procedures to prevent fraud, enforce compliance and discipline members. As an ATS, it would file Form ATS with the SEC, register as a broker-dealer, become an SRO member, and need policies and procedures to protect material non-public information, books and records requirements, and financial responsibility rules.

Additionally, by offering digital wallet services or transacting in digital securities, trading platforms could have to register as broker-dealers, transfer agents or clearing agencies. And by offering such securities, the platform could be participating in an unregistered offering.

And just last month, the SEC delivered the same message on the need for exchange registration, ATS exemption and broker-dealer registration in another joint statement, this time by its Corporation Finance, Investment Management and Trading & Markets Divisions.[8] The statement went on to caution funds holding digital assets and advisers to such funds that they would need to comply with registration, regulatory and fiduciary obligations under the Investment Company Act and the Investment Advisers Act. Again, this regulatory regime's applicability hinges on the threshold question whether there is a security — and the new bill relieves digital units that qualify as digital tokens from these SEC requirements.

Custody of Digital Securities

The bill also provides clarity for broker-dealers that wish to maintain custody of their customers' digital securities. SEC Exchange Act Rule 15c3-3 requires broker-dealers to, among other things, "maintain the physical possession or control of" securities they carry for the accounts of customers. Broker-dealers arguably cannot take "physical" possession of their customers' digital securities. To date, however, the SEC has not provided guidance as to how a broker-dealer could maintain "control" of customers' digital securities. Rule 15c3-3 specifies acceptable control locations for customers' securities, and the SEC and its staff have expanded the list of such locations through written guidance. None of these control locations specified to date, however, are workable for digital securities.

Responding to this concern, the bill directs the SEC to amend Rule 15c3-3to provide that its requirement for a "satisfactory control location" is fulfilled by protecting a digital unit "through public key cryptography and following commercially reasonable cybersecurity practices." Unanswered, however, is what types of entities will be permitted to maintain control of digital securities using the cryptographic and cybersecurity means.

Conclusion

Deep in what some have called the "winter of crypto," the Token Taxonomy Act may offer some hope of a crypto spring. There will doubtless be much input from consumers, regulators and industry groups like the Chamber of Digital Commerce before anything close to final emerges. But the present bill tees up the issues for all to consider, and proposes a possible framework for the future of this new asset class.

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[1] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[2] Senior SEC officials had to default to including a wide range of digital currencies within the purview of what they were tasked with regulating. E.g., testimony of SEC Chairman Jay Clayton before U.S. Senate Committee on Banking, Housing and Urban Affairs, Feb. 6, 2018, available here: https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission.

[3] Press release, "Congressmen Warren Davidson, Darren Soto Introduce ICO Fix for Businesses, Consumers" (Dec. 20, 2018). Available here: https://davidson.house.gov/media-center/press-releases/congressmen-warren-davidson-darren-soto-introduce-ico-fix-businesses.

[4] Id.

[5] SEC Press Rel. 2018-264 (Nov. 16, 2018).

[6] “Statement on Potentially Unlawful Online Platforms for Trading Digital Assets” (March 7, 2018). Available here: https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[7] An “exchange” is an entity or group that “constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities,” or that is “otherwise performing” what are “generally understood” as securities exchange functions. Securities Exchange Act §3(a)(1), 15 U.S.C. §78c(a)(1).

[8] “Statement on Digital Asset Securities Issuance and Trading” (Nov. 16, 2018). Available here: https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.