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What “Cryptos” Can Expect from Congress in 2019

Faced with falling prices and tepid investor demand, digital token companies may have one bright spot in 2019: regulatory clarity. Prior to the holiday break and largely eclipsed by the looming government shutdown, Reps. Warren Davidson (OH-8) and Darren Soto (FL-9) introduced H.R. 7356, the Token Taxonomy Act. Months in the making, the bipartisan bill proposed exempting certain digital tokens from securities registration. Recently, Rep. Davidson signaled plans to re-introduce the act in February with slight modifications, though the crux of the bill will likely remain the same.

To understand the significance of this bill, it is worth looking at the regulatory history of digital tokens.

We **wrote previously** about the U.S. Securities and Exchange Commission’s (SEC) position that most digital tokens are securities under the *Howey* test, and thus must be registered under the Securities Act of 1933. Digital tokens are also referred to as virtual currencies, crypto currencies and digital assets depending on preference and product features.

The now infamous *Howey* test, named for the 70-year-old case *SEC v. W. J. Howey Co.*, has been the SEC’s main source of regulatory authority. In that case, the U.S. Supreme Court held that an investment contract is a “security” if it involves “an investment of money in a common enterprise with profits to come ***solely from the efforts of others***.”

In applying the *Howey* test, the SEC’s position has evolved over the past two years to clarify that most tokens must be registered under the Securities Act or offered pursuant to a specific exemption. As a result, many companies went from cavalierly offering unregistered tokens or Initial Coin Offerings (ICO) without proper anti-money laundering (AML) and know-your-customer (KYC) protocols to ensuring all offerings fit within a registration exemption and meet other anti-fraud compliance requirements.

On the heels of the SEC, states have introduced legislation that would exempt certain token offerings from registering with state securities regulators. Wyoming, also now dubbed “Crypto Capital USA,” is one of the leading states in this area. States like Colorado, Delaware and Ohio have also offered crypto-friendly laws and regulations.

For those states that have yet to provide specific exemptions, the biggest question facing the industry is whether a token that is deemed a security is always a security? This question is a product of the unique features of the crypto industry, in which developers sell tokens to raise funds to build platforms where the token will eventually be operational. In other words, while the profitability of a token may rely on the efforts of others at an initial stage, once operational, its value may be entirely independent. Considering this question, William Hinman, the director of the Division of Corporate Finance at the SEC, suggested in a **June 2018 speech** that the answer is, it depends:

> In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely “no”. In these cases, calling the transaction an initial coin offering, or “ICO”, or a sale of a “token”, will not take it out of the purview of the U.S. securities laws.

> But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified “yes.”

An example may help bear this distinction out: imagine a developer creates an ice cream token that allows its members to purchase ice cream delivery services on its platform. The developer raises funds to create the platform by selling tokens with the expectation that the platform would go live six months later. Investors who purchased the ice cream tokens would thus be relying on the developer to operationalize the ice cream platform in order for their tokens to have any underlying value. This has the hallmarks of a *Howey* security.

Once the platform is operational, however, and users can buy coco banana sundae and cookie dream ice cream from various vendors who service the platform and pay for the delivery with the ice cream tokens, the value of the token becomes more dependent on supply-and-demand market dynamics. Thus, it is no longer tied to the performance of a third party. The question then becomes, given the ice cream token’s evolution, should the developer have registered it as a security even though eventually it took on the characteristics of a currency and transitioned away from the security construct?

Enter the Token Taxonomy Act, which could answer for the first time under what circumstances a digital token that is intended to function as a currency or a “utility token” can escape the federal securities laws registration requirements. To do so, the act defined “digital token” and in turn, exempted “digital tokens” from the definition of “security.” Thus, so long as a token meets the requirements specified in the act, even in the development stage, a developer would not need to register the token or find an exemption under the Securities Act.

Expecting the bill’s re-introduction, we would note that it still faces a difficult pathway to enactment. Indeed, even though the former version of the bill had bipartisan support, many members of Congress remain skeptical of the cryptocurrency industry and are unlikely to move quickly in providing any significant regulatory relief (or clarity). This is reflected in recent legislation that easily passed the House in late January, including:

- **H.R. 428 - Homeland Security Assessment of Terrorists’ Use of Virtual Currencies Act:** The U.S. Department of Homeland Security would be required to develop and disseminate to state and local law enforcement officials a threat assessment regarding the actual and potential risks posed by individuals using virtual currencies to support terrorism.

- **H.R. 56 - Financial Technology Protection Act:** The U.S. Department of the Treasury would be given new tools to combat the use of digital currencies in evading sanctions and financing terrorism (e.g., grants for new technologies and rewards for tips leading to convictions). Treasury would also establish a new task force to study terrorist and illicit use of digital currencies and to recommend legislative and regulatory counter measures.

- **H.R. 502 - Fight Illicit Networks and Detect (FIND) Trafficking Act of 2019:** The Government Accountability Office would be required to study and submit to Congress a report on how virtual currencies and online marketplaces are used to facilitate sex and drug trafficking, including recommending legislative and regulatory counter measures.

Reps. Davidson and Soto face the difficult task of first needing to persuade many of their colleagues that digital currencies are not (simply by their nature) nefarious tools and that without regulatory clarity the U.S. risks losing out on the potential economic benefits of innovation in this sector. That said, congressional proponents do seem to be taking a measured approach. They chose to tackle the question of what constitutes a security in lieu of introducing a sweeping cryptocurrency package.

Still, the Token Taxonomy Act in and of itself is an important benchmark for other regulators to follow. Indeed, the bill serves as a model for other states looking to exempt utility tokens from their state registration requirements. It also will be useful as Congress continues to debate what exceptions, if any, this industry should be given from complying with an 86-year-old securities registration process.

Emily R. Garnett
Associate
egarnett@bhfs.com
303.223.1171

John Sonsalla
Senior Policy Advisor
jsonsalla@bhfs.com
202.652.2357

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