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Locke Lord QuickStudy: Token Taxonomy Act – Exempting Digital Tokens from U.S. Securities Laws

WRITTEN BY

William D. Foley, Jr.

On April 10, 2019, U.S. Representatives Warren Davidson (R-OH) and Darren Soto (D-FL) ?reintroduced the Token Taxonomy Act[1?] ("TTA") in the effort to amend the Securities Act of ??1933 and the Securities Exchange Act of 1934 to exclude "digital tokens" from the definition of ?a security and provide tax certainty on such assets. As currently drafted, "digital tokens" under ?the TTA are fundamentally digital units on a distributed blockchain that do not represent "a ?financial interest in a company or partnership".[2]? ? Reps. Davidson and Soto first introduced the ?TTA in December 2018; however, this previous attempt to pass the bill was unsuccessful because ?the 115th Congress failed to make a decision prior to the end of its session. ?Reps. Davidson and ?Soto, along with other proponents, hope that the passage of the TTA will provide legal and ?regulatory clarity for businesses, entrepreneurs, and regulators alike with respect to digital tokens.?

While interest in blockchain, distributed ledger technologies, and cryptocurrencies has ?grown exponentially in the last several years—both nationally and globally—regulators, including ?the U.S. Securities and Exchange Commission ("SEC"), have encountered challenges keeping ?pace with the rapidly growing industry.? [3?] This is particularly pressing for digital tokens designed ?for end-use as a medium of exchange or store of value. For example, if a digital token sale ?and/or the method of token distribution is undertaken with an expectation profit or growth in ?value of the token, according to recent SEC guidance (see below), such sale would generally be ?deemed as a sale of a security. As a result, the token issuer would be subject to prescribed ?requirements promulgated by the SEC for such transactions, raising compliance costs and ?undercutting the transferability of the underlying asset. As a result, there is an open debate on ?whether it is best for regulators to treat digital tokens, such as cryptocurrencies, as securities, or ?rather consider them as another type of asset, such as a currency, a commodity, or a newly ?created class. The TTA seeks to slot digital tokens into a new class. ?

On April 3, 2019, the SEC's Division of Corporation Finance issued a Statement with a ??"Framework for 'Investment Contract' Analysis of Digital Assets"[4?] ?(the "Framework") to ?provide guidance on how the SEC plans to determine whether a digital asset is a security.[5]? ? The ?Framework, while not a formal rule, goes a step further from the SEC's prior statements that the ?*Howey* test ? for investment contracts should be applied to sales or offerings of digital tokens, ?coins, or other assets. Under the *Howey* test[6], an "investment contract" exists when there is the (1) ?investment of money in a (2) common enterprise (3) with a reasonable expectation of profits to be ?derived from the efforts of others.?

The Framework provides that the "first prong of the *Howey* test is typically satisfied in an ?offer and sale of a digital assert because the digital asset is purchased or otherwise acquired in ?exchange for value, whether in the form of

real (or fiat) currency, another digital asset, or other ?type of consideration," and that the second "common enterprise" prong "typically exists." ?According to the SEC, the main issue is generally with the final prong, "whether a purchaser has ?a reasonable expectation of profits (or other financial returns) derived from the efforts of others." ?In short, the Framework provides that the SEC will generally find a "reliance on the efforts of ?others" if the blockchain has any feature that is centrally controlled by the entity offering or ?selling the digital asset (or by a group of third parties affiliated with that entity). ?

Accordingly, it is no surprise that the question of whether or not a digital token is deemed a ?security has tremendous implications on any issuer of digital tokens, particularly ones aiming to ?create a functioning cryptocurrency. To this end, the TTA would provide clarity to some of ?currently open-ended questions. ?

Excludes "Digital Tokens" from the Definition of a Security

The TTA amends Section 2(a)(1) of the Security Act of 1933 to expressly exclude ??"digital tokens" from the definition of a "security." Additionally, "digital token" would mean a ??"digital unit," which is a representation of economic, proprietary, or access rights that is stored in ?a computer-readable format.?

U.S. Federal Income Tax Implications

The TTA would also allow the sale of digital assets to qualify for the benefits of Internal ?Revenue Code Section 1031 "like-kind exchange" provision. This provision provides a limited ?exclusion of capital gains of up to $600 from a sale or exchange of virtual currency from an ?individual's gross income so long as the sale or exchange is not for cash or cash equivalents.[7]?

Jurisdiction & Federal Preemption ?

Finally, the TTA further clarifies jurisdictional parameters in its effort to streamline ?federal enforcement. For example, Section 6 of the TTA provides that "[n]othing this Act or the ?amendments made by this Act shall be construed to limit the application of the Commodity ?Exchange Act or the Federal Trade Commission Act." More notably, to clarify any conflicting ?state initiatives and regulatory rulings, the TTA preempts any state laws which would otherwise ?overlap with TTA.?

Conclusion

As businesses and investors continue to enter the crypto ecosystem, the need to establish ?clear and comprehensive laws with respect to digital tokens is crucial. Rep. Soto noted in his ?press release,[8]? ? "[t]his is an important first-step to promoting innovation and maximizing the ?potential of virtual currencies for the U.S. economy, all while protecting customers and the ?financial well-being of investors." ?

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1. *?See* H.R. 2144 – Token Taxonomy Act of 2019 found here.?
2. ?Under the TTA, the term 'digital token' means "a digital unit— "(A) that is created— "(i) in response to the ?verification or collection of proposed transactions;"(ii) pursuant to rules for the digital unit's creation and supply

?that cannot be altered by any single person or persons under common control; or“(iii) as an initial allocation of ?digital units that will otherwise be created in accordance with clause (i) or (ii);“(B) that has a transaction history ?that— “(i) is recorded in a distributed, digital ledger or digital data structure in which consensus is achieved through ?a mathematically verifiable process; and“(ii) after consensus is reached, resists modification or tampering by any ?single person or group of persons under common control;“(C) that is capable of being transferred between persons ?without an intermediate custodian; and“(D) that is not a representation of a financial interest in a company or ?partnership, including an ownership interest or revenue share.” *Id.?*

3. For a more thorough discussion surrounding the issue of what constitutes a “security,” please refer to Locke Lord ?QuickStudy: Staking its Claim: SEC Provides Comprehensive Guide for Blockchain, Digital Asset Securities.?

4. *See* Framework for “Investment Contract” Analysis of Digital Assets. The Framework can be found here.?

5. *See* SEC Clarifies How to Tell When a Token is a Security – A New Framework found here. ?

6. *See SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946). ?

7. *See* 26 U.S.C. § 1031 found here.?

8. *See* Rep. Darren Soto’s Press Release entitled “Soto, Davidson Introduce Digital Token Taxonomy Package to ?Address Blockchain Innovation Flight in America.” The Press Release can be found here.?

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