

Colorado Could Carve Smoother Path For Digital Tokens

By Tom Zanki

Law360 (February 1, 2019, 6:10 PM EST) -- The Colorado Senate's recent passage of a law that exempts digital tokens that are sold to consumers rather than investors from being deemed securities could bode well for certain blockchain technology startups seeking clearer regulatory paths elsewhere.

The Colorado Digital Token Act is billed as an effort to reduce legal uncertainty for cryptocurrency companies who fear getting snared by complex securities regulations by providing a safe harbor from state securities laws under limited and specified conditions.

Namely, businesses seeking an exemption must target the sale of their digital tokens to likely consumers of its product and not market the tokens for speculative or investment purposes. The idea, supporters say, is to address risks that digital token offerings can be vehicles for fraud without strangling the ability of fledgling startups to raise capital.

"We have tried to put in guardrails that we feel will balance the needs of consumer protection, as well as the desires of this growing community and companies that are trying to innovate in this space," said Snell & Wilmer LLP partner Eric Kintner, a member of Colorado's Council for the Advance of Blockchain Technology, which helped craft the bill.

The bill, which unanimously passed the Colorado Senate on Jan. 28 and now heads to the state's House of Representatives, follows similar legislation enacted last year in Wyoming.

The Colorado legislation also comes at a time when lawmakers, regulators and industry players are debating how to regulate the nascent but growing market for digital tokens. Congress has yet to act, though a bill exempting digital tokens from being deemed securities was introduced at the end of last session.

Startups that specialize in blockchain technology, which provides the basis for digital currency but can potentially be applied to additional uses, often rely on digital token sales to fund projects. These cryptocurrency instruments can resemble a security, commodity or currency, depending on the context, and remain subject to an evolving regulatory environment.

At the federal level, the Securities and Exchange Commission has taken the position that most initial coin offerings, as token sales are often called, should be regulated as security offerings. The SEC has targeted several token sales in the past two years on grounds that the tokens were marketed on their

potential to rise in investment value and be sold at a profit through a secondary platform — qualities that the SEC says contain the hallmarks of a security.

The SEC has also cracked down on many token sales, alleging they were frauds that fleeced investors on false premises for products that do not exist. Conscious of the SEC's outlook, Kintner said framers of the Colorado bill consulted with the state's securities division and attorney general to develop a narrow approach that would stay out of government crosshairs.

The Colorado proposal specifies that, in order to be eligible for exemption, a digital token must have a "primarily consumptive purpose" — meaning the token is used in exchange for a good or service — and not "be used for a speculative or investment purpose."

Colorado's proposal, like laws passed in Wyoming, is limited in scope because it only applies to intrastate offerings. But some lawyers say the legislations are notable because they contain thoughtful approaches designed to pass legal muster and could spur proposals elsewhere.

"The significance lies in the potential for others to follow suit," said Stephen Wink, a partner in Latham & Watkins LLP's fintech industry group, noting that other state and federal legislators are following legal developments involving the nascent cryptocurrency industry.

Colorado is also moving ahead some six weeks after U.S. Rep. Warren Davidson, R-Ohio, and Darren Soto, D-Fla., introduced the Token Taxonomy Act, which represents a broader attempt to exclude certain digital tokens from SEC jurisdiction. Davidson has argued his bill would provide regulatory clarity so that the U.S. could better compete with countries with friendlier policies toward blockchain technology.

The prospects for that legislation are not clear since it has yet to be reintroduced in the current Congress and Democrats are now the majority. But some lawyers say the fact that states are seeking regulatory clarity on cryptocurrency and blockchain matters could eventually prompt Congress to act.

"It's going to be a while until we actually see something come out of the federal government but the more that state governments push ahead with this, the more that could potentially prod the Senate and House to put something together," Mayer Brown LLP partner Jennifer Carlson said.

While several cases are making their way through the courts that could resolve ambiguities governing the cryptocurrency industry, federal and state regulators have taken the lead in policing token sales.

The SEC defines a security based on whether it meets the "Howey test," named after a 1946 U.S. Supreme Court ruling. The Howey test broadly concludes that an instrument is considered an "investment contract" — meaning a security — if an individual invests money in a common enterprise, expecting a profit based on the efforts of others. SEC Chairman Jay Clayton has said most ICOs he has seen fit that description.

Complying with a full gamut of securities regulations, which require licensed intermediaries and trading platforms, can be costly for startups. The Colorado bill says that the "costs and complexities of state securities registration can outweigh the benefits" to businesses trying to raise capital to develop blockchain platforms.

Kintner said the Colorado bill could benefit startups that need additional growth capital to develop a non-finished product, but don't want to raise equity and dilute the stakes of its founders. The bill states that, for a company to qualify for an exemption from securities law, the consumptive purpose of the digital tokens must be available within 180 days of the sale.

Kintner said framers of the Colorado bill carefully considered SEC pronouncements regarding the Howey test and other statements and enforcement actions that have defined federal regulatory policy to date.

For instance, the SEC halted an ICO in late 2017 of restaurant review app developer Munchee Inc. on grounds that the company marketed the tokens it sold on their potential to appreciate in investment value. The agency concluded that Munchee's sale should have thus been registered as a securities offering, even though Munchee described its token as a "utility token" rather than a security because it was sold to potential users of its app.

Kintner believes the Colorado bill is on firm ground because it expressly prohibits a business from obtaining an exemption from securities law if its tokens are marketed as investments. He also referred to the Supreme Court's *United Housing Foundation Inc. v. Forman* case in 1975 — nearly three decades after the Howey ruling — that determined if someone is purchasing an asset for consumption only, it is likely not a security.

SEC Division of Corporation of Finance Director Bill Hinman acknowledged as much in a speech last June and he listed several scenarios under which the SEC may conclude that an asset is a consumer good and not a security. Attorneys say that's a critical distinction.

Blockchain and cryptocurrency lawyer Joshua Ashley Klayman of Klayman LLC noted that not all tokens are alike, and that many are rightly considered securities because they represent an equity interest in a company.

"We are seeing that there is a strong view by some in the market and some in government that it's important to distinguish between different types of tokens," Klayman said. "States like Colorado and Wyoming are trying to provide clarity."

Kintner said he is not aware how many companies would benefit from the Colorado proposal, acknowledging that it only applies to one state. Many companies that would likely benefit are still in the research and development or pilot stages of their operation, he said.

"We feel that it's good thought leadership at the very least," Kintner said, adding that the legislation shows that lawyers, regulators, entrepreneurs and others with a stake in this matter can collaborate and "come out with a well-reasoned process" that improves current policy.

--Editing by Pamela Wilkinson and Michael Watanabe.