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Legislators Seek Clearer Regulatory Path For Digital Tokens

By **Tom Zanki**

Law360 (October 23, 2020, 9:12 PM EDT) -- Two complementary congressional bills recently introduced seek to provide legislative clarity regarding the status of cryptocurrency tokens and their trading platforms, a development some lawyers say is worth watching given regulatory hurdles facing the nascent industry.

The Securities Clarity Act, sponsored by Rep. Tom Emmer, R-Minn., and the Digital Commodity Exchange Act, sponsored by Rep. Michael Conaway, R-Texas, were both introduced in late September and have yet to be assigned to committee. While the bills are still in their early stages, a lawyer said the proposals are notable in that they seek to create paths that would enable digital assets to trade on registered platforms without fear of a regulatory crackdown.

"This is a reaction against the myriad of SEC enforcement actions that has stymied a lot of cutting-edge digital assets projects or, at the very least, has created uncertainty for these projects," said Fenwick & West LLP partner Michael Dicke, a former attorney in the U.S. Securities and Exchange Commission's enforcement division.

The SEC has been wary of digital tokens that were sold as part of capital-raising projects, contending that many such tokens are unregistered securities. The agency's legal strategy has been upheld in court several times, most recently involving cases against messaging apps Kik Interactive Inc. and Telegram Group Inc. Both times, federal judges sided with the SEC's arguments that the companies failed to properly register offerings that funded their projects.

SEC policy is premised on a 1946 Supreme Court decision that concluded an "investment contract" — a catchall term for securities — is defined by a transaction that raises money from investors of a common enterprise who expect to profit based on the efforts of others.

As such, any transaction that fits that criteria — also dubbed the Howey test after the defendant in the 1946 case — should be registered with the SEC unless an exemption applies.

The Emmer bill defines a new entity called an "investment contract asset," which would include a digital asset sold through an investment contract, and states that such assets do not automatically become securities even if they were sold in connection with a regulated offering. By carving out that distinction, the bill purports to provide developers of digital assets clarity needed to move forward on their projects without worrying about further regulatory uncertainty.

The Digital Commodity Exchange Act proposes a framework for governing the subsequent trading of digital assets. The bill treats digital assets as commodities and authorizes the U.S. Commodity Futures Trading Commission to oversee the regulation of such trading platforms. The intention is to provide a single, national framework for trading venues to replace state-by-state money transmitter regulations that now govern trading of digital assets.

Both bills have been endorsed by groups advocating blockchain technology, which underpins cryptocurrency and other digital assets, including Coin Center and Blockchain Association.

Lawyers who advise blockchain companies say it's still too early to determine whether these bills will gain traction and how details may get fleshed out. But they welcomed the attempt of Congress to resolve certain gray areas. Depending on their context, digital assets can be compared to securities, commodities or currencies and come under purview of various federal and state regulators. The Conaway bill would grant the CFTC a clearer leadership position.

"It would be helpful to know who is in charge of the boat," Baker Botts LLP partner Sam Dibble said. "What the crypto industry would like, like any other industry, is to know [who] its regulator is."

If the bills were to gain steam, lawyers also cautioned that the SEC is likely to push back on the Securities Clarity Act since it seeks to legally distinguish digital assets that are issued as part of an investment contract from the contract itself, which is regulated like a securities offering.

In a notable case that **concluded in June**, U.S. District Judge Kevin Castel ruled that encrypted messaging company Telegram's $1.7 billion initial coin offering should be halted, preventing the company's Gram tokens from being distributed to investors. Judge Castel further said that "economic realities" of the Howey test validated the SEC's argument that Telegram's initial offering and its subsequent plans to distribute Gram tokens should be viewed together rather than separately.

Munger Tolles & Olson LLP partner John Berry, a former SEC enforcement lawyer, said the Securities Clarity Act could face an "uphill climb" given potential opposition from the SEC.

"I would imagine the SEC would not be in favor of that bill," Berry said.

The SEC declined to comment.

For its part, current CFTC leadership favorably views the Digital Commodity Exchange Act, which would grant the agency a bigger role. The agency referred to a tweet by chairman Heath Tarbert, who said the "legislation will help advance opportunities for 21st Century commodities."

Battles over how digital assets should be classified are likely to carry over into 2021. Lawyers note that there has long been a push to devise more nuanced regulations than the formula specified in the Howey case, which involved the development and marketing of citrus groves.

SEC Commissioner Hester Peirce, who has criticized some SEC enforcement actions against cryptocurrency developers, has advocated creating a regulatory "safe harbor" that would allow startups to issue digital tokens and build projects without fearing securities law violations.

Previous congressional proposals, including the Token Taxonomy Act, which specified that digital tokens should not be deemed securities for regulatory purposes, have failed to make it past committee. Other bills have languished as well. Some lawyers say Congress needs to continue intelligent discussion in this realm so blockchain companies are not left in limbo.

"We don't want regulations to hinder the progress of new technologies coming to fruition," said Michelle Gitlitz, a partner at Crowell & Moring LLP and global head of the firm's digital assets and blockchain practice. "The people or companies who are facilitating that progress need to raise money."

It's unclear how the coming presidential election will affect the SEC's composition next year, though a victory by Democrat Joe Biden could move the agency toward a more enforcement-minded stance. The majority of the SEC's five commissioners represent the president's party.

Dicke noted that the crypto industry has in the past attempted to beat the SEC in court. But that strategy hasn't yielded results, potentially leaving it to lawmakers to resolve lingering questions.

"Now I think you're seeing a pivot to focusing on legislation," Dicke said.

--Editing by Emily Kokoll and Alanna Weissman.