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Colorado Digital Token Act Exempts Certain Cryptocurrency Transactions From Colorado Securities Laws

Colorado recently passed legislation that will facilitate the sale and transfer of digital tokens in Colorado. Upon the governor's signature, which is expected by March 8, 2019[1], the Colorado Digital Token Act (Digital Token Act) will become law, but will not become effective until Aug. 2, 2019. Under the Digital Token Act, Colorado businesses will be permitted to effect transactions involving the sale and transfer between certain persons of digital tokens secured through a decentralized ledger or database, with a focus on the production, distribution, and consumption of goods (also known as a "cryptoeconomic system"), as opposed to the current centralized internet platforms and applications that serve as intermediaries of such transactions in cryptocurrencies. Not only will these transactions be exempt from the securities registration requirements under the Colorado Securities Act (CSA), but persons dealing in these digital tokens will be exempt from the securities broker-dealer and salesperson licensing requirements under the CSA. However, the exemption will not be self-executing; it will require a notice filing with the Colorado Securities Commissioner prior to any offer, sale, or transfer of the qualifying digital token to satisfy the exemption.

[1] Senate Bill 19-023 was introduced in January 2019 as a proposal to amend the Colorado Revised Statutes and add a new exemption from the securities registration requirements. The Digital Token Act, dated Feb. 26, 2019, can be found at: https://leg.colorado.gov/sites/default/files/documents/2019A/bills/2019a_023_enr.pdf

The Digital Token Act defines the term "digital token" and (i) exempts the offer or sale of "digital tokens" from state securities registration as long as certain transactional conditions are met; and (ii) exempts the issuer and those persons acting on behalf of the issuer from the broker-dealer and salesperson licensing requirements if effecting or attempting to effect the purchase, sale, or transfer of a digital token.

First, the proposed digital unit must meet the definition of a "digital token" as defined in Section 11-51-308.7(4). A "digital token" is defined as a digital unit that is:

1. created by deploying computer code to a blockchain network and/or in response to verification or collection of transactions relating to a digital ledger or blockchain;

2. recorded in a digital ledger or database that is chronological, consensus-based, decentralized, and mathematically verified in nature; and

3. capable of being traded or transferred between persons without an intermediary or custodian of value.

Second, the offer and sale of a "digital token" must *primarily* have a "consumptive purpose" at the time of issuance or within 180 days after sale, and not be offered or sold for speculative or investment purposes. "Consumptive purpose" is defined to mean providing or receiving goods, services, or content, including access to such goods, services, or content. More specifically, the offer and sale of the digital token will be exempt from the registration requirements of the CSA if the following conditions are satisfied:

1. the offer or sale occurs after the Securities Commissioner promulgates rules to implement the Digital Token Act;

2. the offer or sale complies with the registration exemption requirements and any rules promulgated to implement the Digital Token Act;

3. the issuer files a notice of intent with the Securities Commissioner prior to an offer;

4. the primary purpose of the digital token is a consumptive purpose;

5. the issuer markets the digital token for consumptive purposes and not investment purposes; and either:

    a. the consumptive purpose can be realized at the time of sale; *or*,

    b. all of the following are met:

        i. the consumptive purpose will be available within 180 days of sale or transfer of the digital token;

        ii. the initial buyer is prohibited from reselling or transferring the digital token until the consumptive purpose of the digital token is available; and

        iii. the initial buyer provides a clear acknowledgement that the primary intent of its purchase is to use the digital token for a consumptive purpose.

In addition, any person that engages in the business of effecting or attempting to effect the purchase, sale, or transfer of a digital token will be exempt from the licensing requirements if:

1. the person effects or attempts to effect such transactions after the Securities Commissioner initially promulgates rules to implement the Digital Token Act;

2. the person complies with the licensing exemption requirements and the rules promulgated to implement the Digital Token Act;

3. such person files a notice of intent with the Securities Commissioner prior to an offer;

4. the digital token can be used for a consumptive purpose at the time the person effects the purchase, sale, or transfer of the digital token; and

5. the person takes reasonably prompt action to cease effecting the transaction if not in compliance with the licensing exemption requirements.

Unlike the Securities Act of 1933 (Securities Act), the CSA through the Digital Token Act now explicitly addresses digital tokens and provides a securities registration exemption for transactions involving qualifying digital tokens. However, the transaction will remain subject to the state's antifraud provisions under the CSA. It is noteworthy that under the Digital Token Act, there is no presumption of a violation of the CSA solely due to the digital unit failing to meet the definition of a "digital token" or the transaction failing to otherwise qualify for the exemption under the Digital Token Act. The Digital Token Act further provides that there will not be a presumption that digital token offerings will be integrated. As a condition to the implementation of the Digital Token Act, the Securities Commissioner must adopt rules as necessary to implement the provisions of this new section of the CSA.

Impact

In the last year, despite the uptick in enforcement among the collective states against transactions involving different digital tokens (including initial coin offerings), we have now seen two states in particular – Colorado and Wyoming – pursue a legal definition of specific types of tokens or other cryptocurrencies for state law purposes. Unlike in Colorado, where the transaction in a digital token would be a transactional exemption from the securities registration requirements under the CSA and not an exemption under its Money Transmitter Act, Wyoming has focused on the exemptions from its Money Transmitter Act. Wyoming's Utility Token Bill (HB-70, March 2018) was designed to exempt "utility tokens" (also known as "open blockchain tokens") from the state money transmission laws provided (i) the token must not be offered as an investment; (ii) the token must be exchangeable for services and goods; and (iii) the token issuer or developer must not deliberately make efforts to find a secondary market for the token. Under this new bill, (i) an "open blockchain token" is excluded from the definition of a "security"; (ii) developers or sellers of the digital tokens will not be deemed an "issuer"; and (iii) the digital token will not be subject to securities registration provided it meets the qualifying provisions of the exemption (*see* Section 17-4-206 of the Wyoming Securities Act). In a similar way, by Wyoming's House Bill No. 19, the state amended its Money Transmitter Act to provide an exemption for "virtual currency" and defined the term under Section 40-22-102(a)(xxii) as "any type of digital representation of value that: (A) Is used as a medium of exchange, unit of account or store of value; and (B) Is not recognized as legal tender by the United States government."

In an area still generally unregulated at the state level and where the SEC has taken a more measured approach, the Digital Token Act, which highlights Colorado's influence as a "hub for companies and entrepreneurs that seek to utilize cryptoeconomic systems to power blockchain technology-based business

models," has the potential to at least encourage other states, including foreign jurisdictions, to address digital tokens for purposes of their securities laws. While the Digital Token Act applies only to intrastate digital token offerings, it does permit the Colorado Securities Commissioner to enter into agreements with federal, state, or foreign regulators "to allow digital tokens issued, purchased, sold, or transferred in this state to be issued, purchased, sold, or transferred in another jurisdiction and any digital tokens issued, purchased, sold, or transferred in another jurisdiction to be issued, purchased, sold, or transferred in this state." It is unclear what steps the Colorado Securities Commissioner may propose in influencing other states' treatment of digital token offerings, especially if and when an offering crosses into other states, or whether any other state would necessarily follow Colorado's lead. In the absence of current federal guidance, the Digital Token Act is at least a step towards providing some clarity in this area and hopefully less state enforcement.

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