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SEC Guidance

SEC Issues 'No-Action' Letters Allowing Sales of Utility Tokens

By Rebecca G. DiStefano and Barbara A. Jones

In a significant step forward for the cryptocurrency industry, the U.S. Securities and Exchange Commission (SEC) issued its first "no-action" letter (NAL) to a U.S.-based company using utility tokens created for consumptive use rather than investment. The regulator sent the letter to TurnKey Jet, Inc. (TKJ) on April 3, 2019, agreeing with the Florida-based air charter and air taxi service's interpretation that the tokens it uses in its token membership program for sale of air charter services via a private blockchain network are not securities. Therefore, the SEC noted, TKJ can use them under certain conditions.

These conditions include:

- the tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;

- TKJ will restrict transfers of tokens to TKJ Wallets only, and not to wallets external to the platform;
- TKJ will sell tokens at a price of one USD per token throughout the life of the program, and each token will represent a TKJ obligation to supply air charter services at a value of one USD per token;
- If TKJ offers to repurchase tokens, it will only do so at a discount to the face value of the tokens (one USD per token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the tokens; and
- the token is marketed in a manner that emphasizes its functionality, and not the potential for the increase in market value of the token.

A second NAL was issued by the SEC on July 26, 2019, to Pocketful of Quarters, Inc., an online video gaming company, allowing the company to issue its "Quarters" to video gamers. The Quarters are described as a "universal gaming token" and an in-game currency having an unlimited supply and fixed price. The conditions outlined in the NAL mirrored those in TKJ while also adding an additional condition that the Quarters could only be exchanged by the game's developers and influencers (with approved accounts) for ETH at pre-determined exchange rates. The SEC Division of Corporation Finance's response further provided those developers and influencers with the ability to exchange their Quarters. Developers and influencers must undergo Know Your Customer/Anti-Money Laundering checks on an ongoing basis.

Both NALs indicate that the SEC is willing to allow a token offering to proceed without registration under the Securities Act of 1933, or reliance upon an exemption therefrom, in the narrow circumstances where, among other things, the tokens are limited to use on a particular platform/network/application and have no external transfer capability or trading market.

See the SEC's letters to TurnKey Jet and Pocketful of Quarters **here** and **here**.

SEC Clears First Two Regulated Token Offerings

By Rebecca G. DiStefano and Barbara A. Jones

In July 2019, the SEC qualified the first token offerings under Regulation A+, approving blockchain startup Blockstack's bitcoin-like digital tokens on July 10, and live video streaming platform YouNow's offering of its "Props" tokens on July 11. These decisions will likely serve as new fundraising templates for many blockchain businesses.

Blockstack

Blockstack describes its services as being an open-source decentralized computing platform, whose software libraries enable developers to build decentralized applications, that have no single point of failure or control. The company provides decentralized protocols for authentication, data storage, and software distribution.

According to Blockstack's filings on EDGAR, it intends to conduct a cash offering under the Regulation A+, Tier 2, framework. Unlike traditional registered IPO filings, this framework allows the sale of Blockstack's tokens to retail investors as well as to accredited investors and institutions**.** As part of the offering, an additional supply of tokens is proposed to be allocated to Blockstack's App Mining Program, which rewards developers who create the top-ranked applications within the Blockstack ecosystem.

YouNow

Following on the heels of the Blockstack qualified offering, on July 11, 2019, the SEC approved YouNow's "Props" token offering under the Regulation A+, Tier 2 framework. According to its filings on EDGAR, YouNow has created an Ethereum-based blockchain token, which it intends to distribute to those who create content using its app for activities that "drive community engagement" or as a reward for administration of its own blockchain. The Reg A+ offering also includes a secondary distribution of tokens to be distributed by its affiliated foundation for grants to persons developing key apps or otherwise contributing to the development of the network. The company also said that users will begin to receive tokens for engaging with the platform.

Both offerings are significant in that they establish a basic framework for companies that have sought to issue tokens as rewards for specific platform users and developers. In the past, issuers have attempted to structure such tokens to fall outside the *Howey* test as something other than a security. The Blockstack and YouNow precedents clarify that such attempted structures are unlikely to be acceptable to the SEC in the absence of fact-specific no-action relief. This is not surprising in light of the two recent no-action letters issued by the SEC in TurnKey Jet and Pocketful of Quarters, as highlighted in this newsletter. The SEC draws a clear line between tokens developed for use strictly on a particular platform or "in-app" versus tokens that may be transferred outside the platform or publicly traded on an ATS or other exchange.

The *Howey* test is based on the U.S. Supreme Court's landmark case, *SEC v. W.J. Howey Co.*, setting the standard for what arrangement constitutes an investment contract and is therefore regulated as a security. In the context of blockchain tokens, the *Howey* test asks if a party has invested funds, in a common enterprise, with the expectation of profits, based on the efforts of a third party.

SEC/FINRA Joint Statement on Custody

By Rebecca G. DiStefano

The SEC's Division of Trading and Markets and the Office of the General Counsel of FINRA (Financial Industry Regulatory Authority) published on July 8, 2019, a joint staff statement (Custody Release) on broker-dealer custody of digital assets. The statement has been eagerly awaited by market participants, including broker-dealers, given significant uncertainty in the application of securities laws to novel digital asset transactions.

In the new digital world, broker-dealers currently grapple with possession and control to safeguard customers' digital asset securities and their own duties and responsibilities under Rule 15c3-3 of the Securities Exchange Act of 1934, also known as the Customer Protection Rule. This rule requires broker-dealers to safeguard customer assets and to keep customer assets separate from the broker's assets, thus increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. Digital assets present heightened risk for broker-dealers charged with maintaining custody of the assets. Unlike having possession of a tangible stock certificate stored in a vault, in the digital asset realm, a broker-dealer could be victimized by fraud or theft through the loss of a "private key" necessary for the transfer of the asset, and potentially have no recourse.

The Custody Release additionally addresses financial responsibility rules, the maintenance of books and records, noncustodial broker-dealer models, regulatory approvals needed for existing broker-dealers engaging in digital asset securities for the first time, and limited coverage under SIPA (Securities and Investor Protection Act of 1970) unless the security meets the definition of a "security" under SIPA (which is different than under the Securities Act of 1933 by, in general, limiting it to securities which are subject

to a filed and approved registration statement). If the digital asset security does not meet the definition of "security" under SIPA, protection likely would not apply in the event of failure of the broker-dealer and holders of those digital asset securities would have only unsecured general creditor claims against the failed broker-dealer.

As a practical matter, the Custody Release makes clear that broker-dealers are encouraged to engage with the SEC Staff to discuss solutions for compliance issues. Unregistered broker-dealer entities that intend to engage in broker-dealer activities involving digital assets will be required to submit New Membership Applications to FINRA. Existing registered broker-dealer firms will be wise to now evaluate the need for a Continuing Membership Application (CMA). Under FINRA rules, an existing broker-dealer is prohibited from changing its business operations to incorporate material digital asset securities activities for the first time without FINRA's prior approval of the CMA.

FinCEN Guidance

FinCEN Issues Guidance on Application of Regulations to Certain Business Models Involving Convertible Virtual Currencies

By Carl A. Fornaris, Obiamaka P. Madubuko, William B. Mack, Marina Olman-Pal, Richard Abeeku Mills-Robertson, and Jonathan R. Cyprys

On May 9, 2019, the Financial Crimes Enforcement Network of the U.S. Department of the Treasury (FinCEN) issued "interpretive guidance" addressing how FinCEN's money services business (MSB) regulations apply to a variety of business models that use convertible virtual currency (CVC). This is the first significant guidance FinCEN has issued regarding the regulatory treatment of virtual currency under the Bank Secrecy Act of 1970, as amended, and FinCEN's implementing regulations thereunder, since its landmark 2013 virtual currency guidance. In that 2013 guidance, FinCEN grouped persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies as "users," "administrators," or "exchangers," and concluded (i) a "user" of virtual currency is not an MSB under FinCEN's regulations and therefore not subject to MSB registration, reporting, and recordkeeping regulations, but (ii) an "administrator" or "exchanger" is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition of MSB applies to the person.

Click here to read the complete GT Alert.

Fintech Update

Smart Contracts Lead the Way to Blockchain Implementation

By Jonathan A. Beckham and Maria Sendra

"Smart contracts" constitute a significant component of the blockchain universe. They comprise limited contract terms representing an agreement between two parties and are composed in source code rather than natural language. A smart contract self-executes when conditions to execution that have been included as part of the smart contract code have been fulfilled. Smart contract coding may be correlated with data sets from a blockchain platform and external data sets that deliver data through interfaces referred to as "oracles." As such, the smart contract adds the possibility of attaching customized, automated functions or processes to a blockchain platform.

To learn more about how smart contracts work, how they are being received in the financial and business markets, and how the laws in various states recognize them, read the full article **here**.

Fintech in Focus: Anti-Money Laundering Regulatory Developments for Virtual Currencies and Initial Coin Offerings (Q2, 2019)

By Obiamaka P. Madubuko and Margaret Ukwu

Virtual currencies like Bitcoin and Ether are new entrants into the global financial services industry. ICOs (initial coin offerings) are opening new ways for businesses to access capital using blockchain technology. These new technologies pose real concerns regarding anti-money laundering (AML), fraud and security risks. This article explores AML regulatory developments and enforcement trends for virtual currencies and ICOs in the United States, and offers insights for what fintech companies can do to minimize their AML, fraud and security risks.

Click here to read the full article, originally published by *Thomson Reuters Westlaw*.

Tax Update

IRS Warns Cryptocurrency Investors That They May Owe Tax Money

By Mary F. Voce and Pallav Raghuvanshi

The Internal Revenue Service (IRS) announced on July 26 that it has begun sending letters to taxpayers with virtual currency (also known as cryptocurrency) transactions who potentially failed to report income on them and pay the resulting tax, and/or did not report their transactions properly.

The agency, which plans to reach more than 10,000 cryptocurrency investors by the end of August 2019, says it began notifying these taxpayers the week of July 15.

“Taxpayers should take these letters very seriously by reviewing their tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties,” IRS Commissioner Chuck Rettig said in a statement. “The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations.”

The IRS noted that the warning letter recipients had their names provided via “various ongoing IRS compliance efforts,” and that “virtual currency is an ongoing focus area for IRS Criminal Investigation.”

“The IRS will remain actively engaged in addressing non-compliance related to virtual currency transactions through a variety of efforts, ranging from taxpayer education to audits to criminal investigations,” the agency said in its news release.

To read the full IRS news release, **click here**.

IRS Guidance on Cryptocurrency Tax Issues Expected Soon

By Mary F. Voce and Pallav Raghuvanshi

The IRS may release guidance on virtual currency tax issues within the next few months, according to IRS Commissioner Charles Retting. Speaking at the Federal Bar Association Insurance Tax Seminar in Washington on May 30, Rettig added that the guidance will include a revenue ruling and a revenue procedure, and that "it's going to be helpful for people who might be guessing at ways that digital assets might be nontaxable."

The coming guidance is being issued as part of an effort to make virtual currencies more visible, he said. Rettig's comments came just after he wrote in a May 16 letter to Rep. Tom Emmer (R-Minn.) that the IRS plans to issue guidance on acceptable methods for calculating cost basis and of cost basis assignment, the tax treatment of forks, as well as on other tax issues. This new information will add considerable guidance on virtual currencies, as the agency has to date only issued Notice 2014-21, 2014-16 IRB 938, which says that these currencies are considered property.

Cross-Border Developments

A Global Regulatory Overview of Token Offerings (Q2, 2019)

By Barbara A. Jones

The positions of various countries on token offerings, sales, and issuances range from an official recognition of no interference to a full ban on digital currencies. Many nations are pursuing changes to their regulatory policies to keep pace with broad market interest in cryptocurrencies and other digital assets. This article summarizes recent developments by lawmakers and regulatory authorities in certain key jurisdictions around the globe (other than the United States) and the related impact on the market for cryptocurrencies and other digital assets. The jurisdictions covered include Switzerland, Singapore, Malta, the European Union, the United Kingdom, France, Canada, Australia, Taiwan, the United Arab Emirates, Bahrain, Austria, Russia, Israel, India, and China and other countries that have banned ICO activity.

Click here to read the full article, originally published by *Thomson Reuters Westlaw*.

New Regulations in Japan on Security Token Offerings

By Koichiro Ohashi, Makoto Koinuma, Yukari Sakamoto, and Sayaka Uno

A bill to amend the Act on Settlement of Funds and the Financial Instruments and Exchange Act (FIEA) has passed both the upper and lower houses of Japan's National Diet and was enacted on May 31, 2019. The amendments enhance the regulations on ICOs (initial coin offerings) by applying the securities regulations under the FIEA when an ICO is an investment program, i.e., the investors expect to receive distribution of profits from the issuer. This form of ICO is sometimes referred to as an STO (security token offering), and the tokens or the rights represented on such tokens issued in an STO are called "security tokens." STOs will be subject to disclosure requirements, and the issuers or brokers who deal with STOs will be subject to registration requirements under the amended FIEA.

Click here to read the full GT Alert.

State Law Developments

Rocky Mountain States Make Headway in Blockchain-Related Legislation

By Rebecca G. DiStefano and Michele A. Kulerman

With Wyoming having become the first state to define "utility tokens" as a new asset class (see article in Blockchain & Cryptocurrency's Winter 2019 Issue), Montana and Colorado are following close behind with their own cryptocurrency legislation. Both states have blockchain-related bills going into effect in July and August 2019, respectively.

Four Blockchain Regulations are Now Effective in Wyoming

In 2018, four (4) pro-blockchain regulations were signed into law by the governor. Now all are effective:

- HB 19 and HB 70 amend the Wyoming Money Transmitter Act under Wyoming Stat. Sections 40-22-102 and 40-22-104, and Wyoming Stat. Sections 17-4-206, 17-4-102, 40-22-1094 and 40-22-126, respectively.
  - HB 19 provides an exemption from money transmitter laws and regulations for digital currency transmission. Signed by the governor March 7, 2018.
  - HB 70 provides an exemption from certain securities and money transmission laws for a person who develops, sells, or facilitates the exchange of an open blockchain token (a "consumer" or "utility" token). The Wyoming Uniform Securities Act was amended to provide for the same. Effective July 1, 2019.
- SB 111 exempts digital currencies from property taxation, providing that virtual currency is not "property" for purposes of taxation. Signed by the governor March 12, 2018.
- SF 34, codified at Wyoming Stat. Sections 2-3-1001 to 2-3-1017, regulates fiduciary management of digital assets, including digital currency. Effective July 1, 2019.

In January 2019, the state introduced and passed new legislation. Effective July 1, 2019, (1) House Bill No. HB0185 permits companies to issue digital or "certificate tokens" in lieu of stock certificates, declaring that the words share certificate, share, stock, share of stock, or other similar words also include a certificate token and certificated shares or similar words to include shares represented by certificate tokens; and (2) Senate File No. SF0125 allows for banks to provide custodial services for a range of digital assets, including virtual currencies (such as bitcoin and ether), digital consumer assets (utility tokens, including those used to purchases goods and services), and digital securities.

Montana Cryptocurrency Act Now in Effect

Montana is the third Rocky Mountain state (after Wyoming and Colorado) to pass blockchain-related legislation; House Bill No. 584 went into effect July 1, 2019, and exempts blockchain-based utility tokens from securities laws so long as the tokens have a "primarily consumptive" purpose.

Entitled "Generally Revise Laws Relating to Cryptocurrency," the new Act defines this purpose as having a primary aim to "provide or receive goods, services, or content, including access to goods, services, or content." The issuer of the tokens cannot market them as an investment or for speculation.

The Act provides that tokens that qualify for the exemption (i.e., the consumptive purpose of the utility token) must be available no more than 180 days after their date of sale or transfer, and initial buyers of the tokens are not permitted to transfer the tokens until their consumptive purpose is available. Prior to the tokens being offered for sale, the issuer must file a notice of intent to sell them with the state's securities commissioner.

Additionally, while utility tokens are now exempt from the state's securities law, the issuers of such tokens still have to notify the securities commissioner, and must file certain disclosures in the state in order to sell such tokens. Such notice must be amended within 30 days for any information previously disclosed that becomes inaccurate in any material respect for any reason.

The Act is codified as a transactional exemption under Section 30-10-105(23) of the Montana Securities Act. The Act terminates Sept. 30, 2023.

Colorado Digital Token Act to Take Effect in August 2019

The Colorado Digital Token Act (Colorado Act) is scheduled to become effective August 2019. The Colorado Act permits Colorado businesses to effect transactions involving the purchase, 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.

Under the Colorado Revised Statutes Section 11-51-308.7, transactions meeting certain conditions will be exempt from the securities registration requirements under the Colorado Securities Act (CSA), and those persons dealing in these digital tokens will be exempt from the securities broker-dealer and salesperson licensing requirements under the CSA. This issuer exemption requires the issuer of the digital token, and a person engaged in the business of effecting the purchase, sale, or transfer of a digital token, to file a notice of intent, and the consumptive purpose must be available at the time of sale or within 180 days after the date of sale or transfer of such digital token.

For more on the Colorado Act, click **here**.

Florida Creates Blockchain Task Force to Study Benefits of Blockchain Technology

By Carl A. Fornaris, John B. Hutton III, and Marina Olman-Pal

On May 23, 2019, Florida Gov. Ron DeSantis signed SB 1024 into law to establish the Florida Blockchain Task Force within the Florida Department of Financial Services. The Blockchain Task Force will study if and how Florida's state, county, and municipal governments can benefit from a transition to blockchain-based systems for recordkeeping, data security, financial transactions, and service delivery, and identify ways blockchain technology can be used to improve government interaction with businesses and the public.

Click here to read the full GT Alert.

Nevada Revises Provisions Relating to Technology Used by Certain Business Entities

By Michael J. Bonner and Ed Chansky

Nevada Senate Bill 163, effective Oct. 1, 2019, revises the applicable definition of "electronic transmission" to include any form or process of communication facilitated through the use of a blockchain; revises the definition of "blockchain"; authorizes a corporation, and various other entities, to keep records on a blockchain; and expands the Secretary of State's authority to adopt regulations relating to the use of certain technologies.

Click here for more Nevada 2019 legislative highlights for businesses.

Escheat/Unclaimed Property

Cryptocurrencies and Unclaimed Property: Potential Implications of State Escheat Laws for the Blockchain Technology Industry

By Marc J. Musyl, Steven M. Felsenstein, and Brooke E. Condran

The use of blockchain technology and the issuance of cryptocurrencies have grown considerably in recent years, inviting heightened scrutiny and regulation. While federal securities, tax, and other financial services regulatory agencies, such as the SEC, the IRS, state securities commissioners and others, have begun applying their rules and regulations to cryptocurrency businesses, the cryptocurrency industry has not yet faced significant enforcement from state unclaimed property administrators. This GT Advisory considers the application of state unclaimed property laws to cryptocurrencies, and the potential implications and challenges of such application for both industry participants and state unclaimed property administrators.

Click here for the full GT Advisory.

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