Legal Landscapes Governing Digital Tokens in the United States

Prepared by the Token Alliance – an industry initiative of the Chamber of Digital Commerce

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CHAMBER OF DIGITAL COMMERCE

The Chamber of Digital Commerce is the world’s largest trade association representing the blockchain industry. Our mission is to promote the acceptance and use of digital assets and blockchain technology. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop a pro-growth legal environment that fosters innovation, jobs, and investment.

TOKEN ALLIANCE

The Token Alliance is an industry-led initiative of the Chamber of Digital Commerce, developed to be a key resource for the emerging industry surrounding the generation and distribution of tokens using blockchain technology. Comprised of more than 400 industry participants, the Alliance includes blockchain and token and legal experts, technologists, economists, former regulators, and practitioners from around the globe. The Token Alliance develops community-driven guidelines for the responsible development of tokens.

CHAMBER OF DIGITAL COMMERCE INDUSTRY INITIATIVES & WORKING GROUPS

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I. ACKNOWLEDGEMENTS

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II. PART 1: REGULATORY OVERVIEW OF DIGITAL TOKEN MARKETS

SECTION 1: UNITED STATES

I. INTRODUCTION

This Section provides an overview of United States rules and regulations applicable to digital tokens, primarily focusing on the distinct regulatory frameworks for digital tokens that are commodities, versus those that are securities. In doing so, this Section sets forth criteria used by regulators to assess whether a digital token meets either regulatory classification. It also provides a summary of various regulatory considerations related to consumer protection, state money transmission laws, and federal money laundering rules. Subsequent parts present overviews of the regulatory environment in Canada, the United Kingdom, Australia, and Gibraltar for digital tokens.

In the regulatory sense, digital tokens largely, though not exclusively, fall into two broad categories: 1) commodities; and 2) tokenized securities. Each category brings about important regulatory considerations, although some digital tokens likely fall into neither regulatory category.

United States Securities and Exchange Commission (“SEC”) Chairman Jay Clayton has stated publicly that he does not view virtual currencies to be securities\(^1\) and SEC Director of Corporation Finance William Hinman has stated publicly that bitcoin and ether are not securities;\(^2\) however, to date, the SEC has not formally determined that virtual currencies are not securities. Meanwhile, the United States Commodity Futures Trading Commission (“CFTC”) has determined that virtual currencies like bitcoin are commodities,\(^3\) and at least one court has upheld that view.\(^4\) Tokenized securities, like other securities,

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3. See infra note 8 and accompanying text.
are subject to SEC jurisdiction, but are different than other securities in that they may apply blockchain technology to raise funds, track ownership, and deliver value to owners. “Utility tokens” (also known as “app-coins”) – which, as SEC Commissioner Hester Peirce recently remarked, can “function as a means of executing a transaction, as a way to get access to a product or service or participate in a community, or in any number of ways that have yet to be dreamed up”⁵ – may be commodities, or may be neither securities nor commodities. Tokens that are neither securities nor commodities are presumably regulated under the Federal Trade Commission’s (“FTC”) anti-fraud and other consumer protection authorities, as well as other regulatory regimes. Unfortunately, some distributions of tokenized securities have characterized or claimed the offered assets as “utility tokens,” to steer clear of securities-registration requirements. These tokens are not “utility tokens.”

Broadly, state attorneys general and the FTC have the authority within their jurisdictions to enforce a variety of anti-fraud and consumer protection laws in markets for all types of digital tokens, while the United States Treasury Department has a range of anti-money laundering and sanctions enforcement powers. Additionally, markets for digital tokens are subject to a number of tax law implications.

II. LEGAL CLASSIFICATIONS & RELATED REGULATORY CONSIDERATIONS

A. VIRTUAL CURRENCIES AND MANY APP-COINS – Commodities, Not Securities

The term “commodity,” as defined in the Commodity Exchange Act (“CEA”), is very broad, and includes “all services, rights, and interests… in which contracts for future delivery are presently or in the future dealt in.”⁶ Only onions and box office receipts are expressly excluded from the definition.

The CFTC, in prior enforcement actions, has determined that “bitcoin and other virtual currencies” are a type of “commodity,”⁷ and as mentioned above, a federal court has likewise ruled that the term “‘commodity’ encompasses virtual currency both in economic function and in the language of the statute.”⁸ While no statutory definition for the term virtual currency exists, in December 2017, the CFTC stated in a proposed regulatory interpretation that it interprets the terms “virtual currency” and “digital currency” to encompass:

> any digital representation of value (a “digital asset”) that functions as a medium of exchange, and

> any other digital unit of account that:

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⁶ The term “commodity” is defined in the Commodity Exchange Act (“CEA”) as “wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13–1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.”


• is used as a form of a currency (i.e., transferred from one party to another as a medium of exchange);

• may be manifested through units, tokens, or coins, among other things; and

• may be distributed by way of digital “smart contracts,” among other structures.9

On the other hand, bitcoin and other similarly designed digital tokens do not appear to be securities, as that term has been interpreted under the United States Supreme Court’s holding in SEC v. W.J. Howey Co.,10 subject to SEC regulation. Indeed, SEC Chairman Jay Clayton recently noted that bitcoin “has been determined by most people to not be a security.”11 His colleague SEC Commissioner Hester Peirce similarly remarked in May 2018 that she is not yet “willing to make a blanket statement that everything other than bitcoin is a security,”12 and in April 2017, SEC’s Division of Corporate Finance Director Bill Hinman noted that “it is certainly possible that there are tokens that would not have the hallmarks of a security.”13 Regarding the features of non-security digital tokens, Mr. Hinman noted that such tokens would include those for which the token holder is buying a token “for its utility rather than investment, especially if it’s a decentralized network in which it’s used with no central actors.”

The SEC’s recent interpretations of the Howey Test with regards to digital tokens, and regulatory considerations associated with tokenized securities, are described in greater detail below.

Clearly, the range of digital tokens that are not deemed by United States regulators to be securities may be quite broad. For example, Filecoin is a so-called “utility token” according to CFTC Commissioner Brian Quintenz.14 Commissioner Quintenz recently drew a distinction between virtual currencies and “utility tokens” in a speech before the Chamber of Digital Commerce,15 and in more recent remarks, noted that a motivation for creating digital token markets “is to utilize the transferability of tokens to create a secondary market for... non-tangible things.”16 He also expressed his belief that “[e]mpowering a secondary market’s price discovery and valuation functions for products that were previously untransferable – such as extra storage space on a home computer – is a fascinating development.”

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15 Id.
If the CFTC determines that a digital token is a “commodity,” then it may exercise general anti-fraud and anti-manipulation authority over “spot transactions” in that digital token. The CFTC defines spot transactions as those involving the exchange of a commodity for payment where immediate delivery and payment for the commodity is typically expected to occur on or within a few days of the transaction date. In determining whether transfer of possession and control of the commodity has been made to the buyer, the CFTC considers: (i) “how the agreement, contract, or transaction is marketed, managed, and performed” and (ii) the facts regarding “[o]wnership, possession, title, and physical location,” as well as the “relationship[s] between the buyer, seller, and possessor of the commodity… and the manner in which the… sale is recorded and completed.”

The CFTC’s general anti-fraud and anti-manipulation rule (“Rule 180.1”), which was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to expand CFTC authority over spot transactions, prohibits persons “in connection with any… contract of sale of any commodity in interstate commerce” from:

» using or employing a manipulative device or scheme to defraud;

» engaging in or attempting to engage in market manipulation or fraud;

» making or attempting to make untrue or misleading statements of a material fact or omitting to state a material fact necessary in order to make statements made not untrue or misleading; and

» delivering false or misleading or inaccurate reports concerning market information or conditions that affect or tend to affect the price of a commodity.

In a recent virtual currency-related regulatory action, the CFTC stated that Rule 180.1 grants it the “ability to bring enforcement actions for fraud or manipulation in connection with… contracts of sale of any commodity in interstate commerce.” Previously, the CFTC has relied upon Rule 180.1 to assert its jurisdiction over interstate trading in spot markets for commodities such as silver. In September 2017, the CFTC cited Rule 180.1 in a complaint against a pooled fund operator for fraudulently inducing persons to invest in his bitcoin trading operation. Commentators note that in this complaint, the CFTC “took a step beyond [its] traditional limit” of intervening in commodity spot markets only when “manipulative trading in the spot market affected the associated derivatives market.” At the time of the action, no Bitcoin futures market existed.

20 Actual Delivery Proposed Interpretation, supra note 11 at fn 6.
More recently, a March 2018 court ruling regarding a January 2018 CFTC complaint against market participants engaged in the non-leveraged purchase and sale of virtual currencies on behalf of retail customers found that the “CFTC may exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce.” Notably, Litecoin, for which no futures market exists, was one of the virtual currencies traded on behalf of investors by the defendants in the complaint.

According to the CFTC, “a key component” of its “ability to effectively regulate [virtual currency] markets” is this ability to “assert legal authority over virtual currency derivatives in support of the CFTC’s anti-fraud and manipulation efforts, including in underlying spot markets.” Thus the creation by the Chicago Mercantile Exchange (“CME”) and Chicago Board Options Exchange (“CBOE”) of futures markets for virtual currencies (limited to bitcoin futures to date) will likely lead to heightened CFTC scrutiny over the underlying spot markets for virtual currencies for which a corresponding, CFTC-regulated futures market exists.

Numerous retail customer-oriented spot markets have emerged through which market participants can convert virtual currency, fiat currency, or other digital tokens into other virtual currency, fiat currency, or other digital tokens. Entities that host these markets and that are neither (a) registered with the SEC pursuant to the Exchange Act as a “national securities exchange” or an “alternative trading system” nor (b) registered with the CFTC pursuant to the CEA as a “registered entity,” are referred to in this report as “Token Trading Platforms.” In some cases, as the CFTC recently noted, “[t]hese platforms provide a place to immediately exchange one commodity for another ‘on the spot.’” There are a number of regulatory implications for these “centralized platforms” if a non-security digital token (being converted on a Token Trading Platform into another non-security digital token or into fiat currency) is deemed to be a virtual currency and thus a commodity by the CFTC. One important issue relates to “actual delivery” – a customer using a Token Trading Platform must, according to the CFTC’s interpretation of CEA rules, receive “actual delivery” of that virtual currency within 28 days of sale in order for the sales contract offered by the Token Trading Platform to be excluded from the definition of a futures contract, thus requiring it to be traded on a CFTC-regulated entity.

The CFTC has characterized virtual currencies as intangible commodities capable of actual delivery. In an enforcement action involving Bitfinex, a Token Trading Platform, the CFTC found that actual delivery did not occur in that case because Bitfinex held customers’ bitcoin in an omnibus settlement wallet in its own database rather than having transferred possession and control of the bitcoin to the customers. The CFTC interpreted “actual delivery” to mean the delivery to a consumer of the

26 See Actual Delivery Proposed Interpretation, supra note II at 60.337.
27 BFXNA INC. d/b/a Bitfinex, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the CEA, as Amended, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 16-19 (June 2, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lenforcementactions/documents/legalpleading/enbfxxaorder060216.pdf.
purchased bitcoins’ “private key” – the “secret number...associated with a deposit wallet that allows
[the bitcoin] in that wallet to be spent.”28 That stance was challenged through a petition that noted:

“[M]aking control of private keys a prerequisite to having ownership and control of a cryptocurrency
would be artificial and harmful to [cryptocurrency] markets because private keys have no innate legal
significance with regard to the transfer, control, and possession of cryptocurrency on the blockchain...
Rather, private keys are a modality to effectuate the parties’ contractual agreements...and the
significance or lack of significance of private keys...is determined entirely by the transacting parties.”29

In December 2017, the CFTC issued a proposed interpretation regarding actual delivery of virtual
currency, which notes that for actual delivery to occur, (1) a customer must have the ability to (i)
“take possession and control” of the virtual currency, and (ii) “use it freely in commerce ... no later
than 28 days from the date of the transaction,” and (2) the offeror or counterparty must not retain
“any interest in or control over any of the [virtual currency].” Examples of actual delivery provided by
the CFTC note that “title may be reflected by linking an individual purchaser with proof of ownership
of the particular wallet to wallets that contain the purchased virtual currency.”30 A March 2018 court
ruling calls the CFTC’s stance into question, however, noting that “actual delivery” “does not require
that a buyer take actual possession and control of the purchased commodities; it requires instead that
the possession and control of commodities that exist in fact be transferred from the seller.”31

Because the CFTC has deemed “virtual currency”32 not to fall under the definition of “currency,” it is
not subject to a 2-day actual delivery requirement for retail foreign currency transactions. The agency,
however, has requested public comment on whether a shortened actual delivery requirement would
be appropriate for virtual currencies, and whether Congress should act to shorten the actual delivery
requirement for these instruments.33

Regardless, in its Actual Delivery Proposed Interpretation, the CFTC noted that “depending on
their use,” tokens “may be commodities, commodity options, derivatives, or otherwise fall within
the Commission’s virtual currency definition described in this interpretation.”34 Indeed, agreements
for the future delivery of digital tokens may qualify as derivatives contracts (futures or swaps)
for an underlying commodity if the agreement includes optionality and/or does not provide for
physical delivery. Such agreements can be thought of as commonplace commodity market forward
agreements that provide for future delivery in instances where the commodity has not yet been

28 See Letter, “Petition for Rulemaking Concerning the Requirements of ‘Actual Delivery’ and the Transfer of Ownership under the
Commodity Exchange Act in the Context of Cryptocurrency Markets Utilizing Blockchain for Executing Transactions” from Michael
Dunn & Micah Green, Steptoe & Johnson LLP, to Chris Kirkpatrick, Secretary, CFTC (July 1, 2016), https://poloniex.com/press-
29 Id.
30 Tentative Order Regarding Motion to Dismiss, Motion for Preliminary Injunction, and Motion to Exclude, CFTC v. Monex Deposit Co., et al.,
SACV 17-1868 JVS (DFM) (2018), (citing CFTC v. Hunter Wise Commodities, LLC, 749 F.3d 967, 970 (11th Cir. 2014)).
31 The CFTC has drawn a distinction between “real currency” – which it defined in the action as “the coin and paper money of the United
States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange
in the country of issuance” – and “virtual currency.” Coinflip Order supra note 9 at fn 2.
32 Actual Delivery Proposed Interpretation, supra note 11 at 60,335.
33 Id. at 60,341.
harvested or extracted for delivery. Such digital tokens would be subject to a variety of futures and swaps regulations as “CFTC Regulated Instruments” which, for purposes of this report, means any arrangement involving a digital token that would be subject to regulation by the CFTC as a future, swap, option or retail commodity transaction – as opposed to spot market transactions.

The likelihood that any arrangement involving a digital token may constitute a CFTC Regulated Instrument from the perspective of the CFTC is higher if the arrangement involves optionality, does not provide for immediate delivery of the token to the purchaser, the offer or sale of a commodity on a margined or financed basis where actual delivery does not occur within 28 days, or the exchange of one or more payments based on the value of one or more rates for, or prices of, intangible or tangible commodities.

B. TOKENIZED SECURITIES

The SEC and its staff have historically interpreted the definition of “security” under the Securities Act of 1933 (the “1933 Act” or the “Securities Act”) and the Securities Exchange Act of 1934 (the “1934 Act” or the “Securities Exchange Act”) broadly. In addition to enumerating specific types of securities, such as stock and bonds, the 1933 Act definition of security also includes an “investment contract,” which is essentially a catchall for securities that are not otherwise set out in Section 2(a)(1) of the 1933 Act. In the seminal 1946 case SEC v. Howey, noted above, interpreting the scope of the term “investment contract,” the Supreme Court held that the term encompasses “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Under the Howey Test, an investment contract exists if there is: (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) to be derived from the entrepreneurial or managerial efforts of others.

In July 2017, the SEC considered whether so-called “initial coin offerings” involve, or could involve, the issuance of securities. It issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 in which it concluded, based on an investigation by its Division of Enforcement, that the digital tokens issued by the Decentralized Autonomous Organization (the “DAO”) were securities (the “DAO Report”) within the meaning of the 1933 Act and 1934 Act. As described in the DAO Report, the DAO, an unincorporated association, issued tokens (the “DAO Tokens”) via a website. Investors purchased DAO Tokens with ether. The DAO intended to use the funds it raised through the sale of DAO Tokens to fund “projects.” DAO Token holders stood to share in the anticipated earnings from these projects as a return on their investment. After the initial issuance of the DAO Tokens, a secondary market for trading the DAO Tokens developed.

36 W.J. Howey and Co., 328 U.S. at 298-299.
37 Id. at 291.
In the DAO Report, the SEC analyzed whether the DAO Token was a security. Because a digital token such as the DAO Token is not a specifically enumerated type of security under the 1933 Act, such as a stock or a bond, the SEC considered whether the DAO Token was an “investment contract.”

To answer that question, the SEC applied the *Howey* Test and concluded that the DAO Tokens qualified as investment contracts and thus were securities for purposes of the Securities Act and the Exchange Act. Specifically, the SEC found that:

- the purchase of DAO Tokens with ether was an “investment of money,” noting that “money” need not take the form of cash;
- investors in DAO Tokens were investing in a common enterprise, *i.e.*, the DAO, which was created to pool resources and invest in a variety of projects;
- investors reasonably expected to earn profits by sharing in the return on projects that the DAO would fund from the proceeds of the DAO Token sales; and
- DAO Token holders’ profits were to be derived from the managerial efforts of others, namely the founders and other key personnel associated with the DAO who would direct investments in projects.

Accordingly, the SEC concluded that DAO Tokens were securities that were issued without being registered under the Securities Act.

After publishing the DAO Report, the SEC brought a number of enforcement actions related to so-called ICOs. Most of those actions, however, were brought against persons who launched Ponzi schemes or other outright frauds. Yet in the December 2017 *Munchee* Order, the SEC took the...
opportunity to expand upon the DAO Report.\footnote{41} Munchee involved the creator of a restaurant review smartphone application, Munchee, that wanted to raise capital through the sale of digital tokens to expand its business. Munchee issued a white paper describing its proposed business expansion and plan to raise $15 million by issuing so-called “MUN tokens” in exchange for bitcoin and ether. Munchee characterized the MUN tokens as “utility tokens” and promised they could be used in the future to purchase goods and services in the ecosystem that Munchee would create. Munchee also stated that as use of its app increased, the value of MUN tokens would increase. Moreover, it promised to help increase the value of MUN tokens by “burning” tokens in the future, i.e., taking tokens out of circulation, and by working to ensure that the tokens would trade on a number of trading platforms.

The SEC’s Division of Enforcement contacted Munchee and communicated its view that Munchee was engaged in an unregistered offering of securities in violation of the federal securities laws. Munchee terminated its offering, did not deliver any MUN tokens, and returned all proceeds it received from investors. In its cease-and-desist order concluding that MUN tokens were securities under the \textit{Howey} Test, the SEC took the position that “[p]urchasers reasonably would have viewed the MUN token offering as an opportunity to profit... whether or not they ever used the Munchee App or otherwise participated in the MUN ‘ecosystem.’”\footnote{42} Specifically, the SEC referenced online and social media statements made by Munchee in which, as the SEC notes, MUN token holders were told they “could count on the ‘burning’ of MUN tokens to raise the value of remaining MUN tokens.” The order also highlights that Munchee promised to take action to increase the value of MUN tokens by expanding its business and agreed to use its efforts to allow investors to take advantage of the increased value of MUN tokens by helping to establish a secondary market that would allow holders to sell their tokens. That profit, moreover, would derive from the entrepreneurial efforts of Munchee and its agents, who were working to build out Munchee. The SEC also emphasized that characterizing a digital token as a “utility token” was not in and of itself sufficient to take MUN tokens outside of the definition of a security, even if the tokens had practical use. Rather, the key was the economic reality underlying a
token sale; yet the Munchee Order made clear that MUN tokens had no utility at the time of issuance outside of their potential to trade on the secondary market, given that Munchee had not yet built out its ecosystem.

Since Munchee, the SEC has continued to urge caution with respect to digital token distributions. Chairman Clayton remarked during a February 2018 United States Senate hearing that he views many new digital tokens to be securities,43 although more recently, he noted that it is “absolutely not” the case that all digital tokens are securities.44 Yet, as Chairman Clayton explained during his February testimony, and as noted in the DAO Report, whether a digital token distribution involves a security is a facts-and-circumstances determination.

Of course, as explained above, SEC officials appear to recognize that some digital tokens are not securities.45 Notably, the SEC did not deem ether to be a security in its DAO Report, and both the SEC and Chairman Clayton seemingly draw a distinction between “coins” (such as virtual currencies, which are commodities) and “virtual tokens.”46 With regard to the distinction between securitized tokens and other digital tokens, Chairman Clayton remarked in 2017,

“A key question for all ICO market participants is, ‘Is the coin or token a security?’”
- Chairman Jay Clayton, U.S. Securities and Exchange Commission

“A key question for all ICO market participants: ‘Is the coin or token a security?’ As securities law practitioners know well, the answer depends on the facts. For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws and may well be an efficient way for the club’s operators to fund the future acquisition of books and facilitate the distribution of those books to token holders.”47

45 See supra notes 13 to 15 and accompanying text.
Furthermore, in April 2018, he stated that digital tokens can evolve from being securities into non-securities, using the example of a laundry token:

“If I have a laundry token for washing my clothes, that’s not a security. But if I have a set of 10 laundry tokens and the laundromats are to be developed and those are offered to me as something I can use for the future and I’m buying them because I can sell them to next year’s incoming class, that’s a security... What we find in the regulatory world [is that] the use of a laundry token evolves over time... [and] [t]he use can evolve toward or away from a security.”

No formal SEC statement exists listing the criteria under which the SEC would determine that a particular digital token is or is not a security. As explained above, the SEC relies upon facts and circumstances using the Howey Test and has provided insights into its digital token-specific considerations in these matters through the DAO Report and the Munchee enforcement action. If the SEC does determine that a particular digital token is a security, then a panoply of federal securities laws applies to the distribution and trading of that token, as outlined below.

1. REGISTRATION OF OFFERS AND SALES

Section 5 of the Securities Act prohibits the sale of securities to the public unless a registration statement for such securities has been filed with the SEC and is in effect, and the issuer has delivered a prospectus to investors. The SEC’s DAO Report observes that the term “issuer” is flexibly construed, and, therefore, that The DAO was an issuer required to provide needed information material to the investors in deciding whether to purchase the DAO Tokens.

Section 12(a)(1) of the Securities Act imposes liability on persons who offer or sell securities in violation of Section 5. Under limited circumstances, offers to sell securities can be made prior to the filing of a registration statement (pre-filing period). There is no defined period as to when the pre-filing period commences; therefore, token issuers should consider whether publishing of white papers on websites could be construed as an offer to sell.

There are several potential exemptions from the registration requirements, including:

» Section 4 of the Securities Act permits sales of securities without registration with the SEC under specified circumstances:

• Section 4(a)(2) Non-public offerings – Issuers must limit sales to so-called “sophisticated investors” who have sufficient knowledge and experience in finance and business to evaluate the risks and merits of investment, or who have the ability to bear the risk of loss associated with the investment.

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48 De and Gnanaseharan, supra note 46.
49 Violations of securities laws are subject to civil and criminal penalties.
• Section 4(a)(5) – This paragraph permits non-public offers and sales made solely to accredited investors (a term discussed below), up to a maximum issuance of $5 million.

• Section 4(a)(6) – This paragraph provides a crowdfunding exemption that permits the issuance of securities that does not exceed $1 million in value. It also imposes maximum amounts that individual investors may invest in a given crowdfunding offering.

• Section 4(a)(7) – This paragraph provides that sales of securities are permitted where, among other things, issuers have limited sales to accredited investors; have not engaged in general solicitation or general advertising, and make specified information available to prospective purchasers, including the issuer’s most recent balance sheet and profits and loss statement, as well as similar financial statements.

Rules 504 and 506 of Regulation D under the Securities Act\(^\text{50}\) – Regulation D is intended to clarify the scope and requirements of certain securities offering exemptions under Section 4 of the Securities Act. The rules permit issuance of securities without SEC registration. Securities offerings under Rule 504 are open both to accredited and non-accredited investors,\(^\text{51}\) but general solicitation of investors is prohibited. Offerings under Rule 506 are limited to accredited investors, but general solicitation is permitted for offerings conducted under paragraph (c) of Rule 506 (intended to allow access to the capital markets for small companies unable to bear costs of normal registration. Sales are generally limited to accredited investors.)

Regulation A under the Securities Act – allows companies to raise money under two different tiers:

• Tier 1 – eligible up to $20 million in a 12-month period; requires an offering circular to be filed with and qualified by the SEC as well as relevant state regulators; submission of unaudited financial statements; no ongoing reporting obligations.

• Tier 2 – eligible up to $50 million in a 12-month period; requires an offering circular to be filed with and qualified by the SEC; submission of audited financial statements; and ongoing reporting obligations.

Issuers also need to be aware of potential state law securities registration requirements.

\(^{50}\) 17 C.F.R. § 230.500 \textit{et seq.} (2018).

\(^{51}\) Under Rule 501 of Regulation D, the term “accredited investor” includes, among others, certain financial institutions, such as broker-dealers, registered investment companies and insurance companies. It also includes natural persons whose net worth, or joint net worth with that person’s spouse, exceeds $1 million (excluding the value of the person’s residence). The term also includes natural persons whose income in each of the two most recent years was in excess of $200,000 or jointly with that person’s spouse was in excess of $300,000.
2. SECONDARY MARKET TRADING

Investors can resell securities that they acquire in private and public offerings in private transactions, on registered securities exchanges or in over-the-counter ("OTC") transactions. Each type of resale transaction is subject to certain requirements and considerations. This report focuses on secondary market transactions on exchanges and OTC markets.

Both the exchanges and the securities that trade on them are subject to requirements under the Exchange Act. Section 5 of the Exchange Act makes it unlawful to effect any transaction in a security on an exchange unless it is registered as a national securities exchange under Section 6 of the Exchange Act or exempted from such registration. An exchange is defined as "a marketplace or facilities for bringing together purchasers and sellers of securities." In the DAO Report, the SEC concluded that the platforms that permitted secondary market trading in DAO Tokens were unregistered exchanges not exempt from registration and, thus, their trading of DAO Tokens, which were securities, violated Section 5 of the Exchange Act.

Securities that trade on an exchange are either listed to trade on that exchange, or entitled to unlisted trading privileges on that exchange (a security may obtain unlisted trading privileges on an exchange only if it is listed on another exchange). Section 12 of the Exchange Act prohibits a security from trading on a national securities exchange unless there is in place an effective registration with respect to that security for the exchange. Exchanges display quotations in securities in accordance with applicable securities laws, regulations and rules, such as Regulation NMS.

Securities can also trade on an OTC basis, typically on alternative trading systems ("ATS"). An ATS is a marketplace that provides for secondary market trading of securities. Instead of registering as a national securities exchange, however, an ATS registers as a broker-dealer and files Form ATS with the SEC in accordance with the requirements of Regulation ATS. An ATS does not list securities. Rather, an ATS typically displays quotations in securities that broker-dealer subscribers to the ATS provide in compliance with Rule 15c2-11 under the Exchange Act. Rule 15c2-11 requires a broker-dealer wishing to publish any quotation for a security in a "quotation medium" (which includes an ATS) to gather specified information regarding the issuer. Securities issued in a private placement, however, are not freely tradeable and, thus, cannot be subject to quoting on an ATS unless and until they have met certain requirements, such as a six-month or one-year restricted period, i.e., a period during which the security may not be traded, as set out in Rule 144 under the Securities Act.

3. ANTI-FRAUD, ANTI-MANIPULATION, AND RELATED RULES

Federal securities laws, rules, and regulations (e.g., Rule 10b-5 under the Exchange Act) prohibit, directly or indirectly, fraud and manipulation in connection with the purchase or sale of any security as well as with security-based swap transactions. Such behavior includes: (a) fraudulent or deceitful devices and schemes; and (b) material misstatements or omissions.

Separately, Section 11(a) of the Securities Act imposes liability for untrue statements of material facts in registration statements, or omissions of material facts that are needed to make statements in registration statements not misleading. Furthermore, Section 12(a)(2) of the Securities Act allows for the rescission of securities purchases (or a suit for damages) if the offer/sale was made using a prospectus or oral communication containing material misstatements or omissions.

Additionally, there are a number of state laws, such as the Martin Act of New York State, related to fraud and manipulation in securities markets.

4. OTHER ISSUES

If a derivatives market emerges for which the underlying asset is a tokenized security, either the SEC or the CFTC would regulate the derivatives. Options, swaps on single names or narrow indexes, or futures on single names would be subject to the SEC’s jurisdiction. Swaps on broad-based indices and futures on other than single names would be subject to CFTC jurisdiction.

A person that “engages on behalf of an issuer of securities or on behalf of itself in... transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates” would fall within the definition of “transfer agent” in the Exchange Act. Unless exempted, a transfer agent that makes use of the jurisdictional means to perform that function with respect to a security registered under Exchange Act Section 12 must register as such with the SEC. Therefore, a system that uses distributed ledger technology to electronically transfer record ownership of securities as or on behalf of an issuer may be subject to the registration requirements of Section 17A of the Exchange Act.

C. WHEN DIGITAL TOKENS ARE NEITHER SECURITIES NOR COMMODITIES

As suggested earlier, it is possible – and perhaps appropriate – for some digital tokens to be viewed as neither a security nor a commodity by regulators. In these instances, digital tokens can bear a closer resemblance to participatory rights in channels of communication, collaboration, and commerce, rather than as an intangible commodity or security that is bought and sold.

57 15 U.S.C. § 78c(a)(25)(E) (2012). Other provisions of the definition also may be relevant to this discussion. See, e.g., § 78c(a)(25)(B) and (C) (2012).
For example, airline miles and other loyalty and rewards points programs constitute neither securities nor commodities. Yet points in many such programs can oftentimes be purchased for fiat currency and even transferred for cash. Of course, these instruments are not generated using blockchain technology, but nonetheless illustrate that in the United States regulatory context it is plausible that cash conversion markets for particular tokens could exist, even though tokens do not constitute securities or commodities, but rather, participatory rights in a system of communication or commerce.

Federal and state consumer protection laws and escheat laws apply to gift cards, gift certificates, and similar kinds of property, and presumably would apply to tokens that are neither securities nor commodities. Indeed, the broader regulatory considerations set forth below apply not just to tokens that are neither securities nor commodities, but also to all other digital tokens, broadly defined.

III. BROADER REGULATORY CONSIDERATIONS

A. CONSUMER PROTECTION ISSUES

Regardless of the legal category (security versus commodity versus neither) of a particular digital token, state attorneys general ("AG") would have jurisdiction to enforce their states’ consumer protection and anti-fraud statutes as those laws relate to the purchase and sale of tokens. AG offices would likely have jurisdiction to bring enforcement actions if residents of their states were affected, or if bad actors conducted business in their state. The FTC is also charged with protecting consumers from unfair or deceptive acts and practices that affect commerce. The FTC has authority to conduct investigations, issue subpoenas, and file enforcement actions in administrative tribunals or in federal court. If securities laws do not apply, it is likely that the FTC would have jurisdiction to bring antifraud claims against bad actors. In 2014, the Consumer Financial Protection Bureau ("CFPB") issued a statement regarding virtual currency products and services, noting that it will use complaints it receives from consumers regarding bitcoin and other virtual currencies to “help enforce federal consumer financial laws and, if appropriate, take consumer protection policy steps.” So far, the agency has yet to take any enforcement actions related to virtual currencies or digital tokens. Notably, in 2016, the Bureau’s final prepaid card rule was issued without referring to virtual currency products within its “prepaid access” definition, and the agency stated that the “application of Regulation E and this final rule to [virtual currency] products and services” was “outside of the scope” of its rulemaking. It also noted that, “as part of its broader administration and enforcement of the enumerated consumer financial protection statutes and Title X of the Dodd-Frank Act, the Bureau continues to analyze the nature of products or services tied to virtual currencies.”

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64 Id.
B. STATE MONEY TRANSMISSION LAWS

Trading Platforms that receive for transmission or transmit U.S. dollars in exchange for virtual currency are regulated as money transmitters in many U.S. states in which they operate or have customers. Money transmitter regulatory regimes entail a variety of regulations aimed primarily at protecting consumers, which often include regular examinations, minimum net worth standards, disclosures of key employee criminal convictions, descriptions of the organization’s structure, and a copy of recent audited financial statements. Some state regulatory regimes may entail particularly stringent obligations and/or may be geared particularly towards firms engaged in the purchase, sale, generation, or distribution of convertible virtual currencies. For example, the New York Department of Financial Services “BitLicense” requirements are triggered when a company engages in a “virtual currency business activity.” All holders of a BitLicense must maintain a written anti-fraud policy as well as other enumerated policies. Further, federal law makes it a crime to fail to obtain state money transmitter licenses when required to do so.

C. ANTI-MONEY LAUNDERING AND SANCTIONS REGULATIONS

Anti-money laundering (“AML”) regulations and associated requirements are significantly important to how digital tokens can be distributed and purchased. The relevant AML rules relate to the Bank Secrecy Act (“BSA”), which requires financial institutions to comply with recordkeeping and reporting requirements, and to develop and implement AML compliance regimes. Similar requirements exist for asset management firms and broker-dealers, including under FINRA Rule 3310. Money transmitters must also register as money services businesses (“MSBs”) with the United States Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”).

The sanctions programs maintained by the Office of Foreign Assets Control (“OFAC”) also apply to digital token market participants.

Companies engaged in financial transactions are advised to maintain both AML and OFAC compliance programs to ensure they do not run afoul of these obligations and restrictions. To maintain compliance with both of these regimes, companies must have some understanding of persons with whom they interact.

1. BANK SECRECY ACT & RELATED REGULATORY REQUIREMENTS

In 1970, the United States Congress passed the Currency and Foreign Transactions Reporting Act, commonly known as the BSA, which established requirements for recordkeeping and reporting by private individuals, banks, and other financial institutions. The BSA was designed to help identify the source, volume, movement of currency and other monetary instruments.

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transported or transmitted into or out of the United States or deposited in financial institutions. The statute requires individuals, banks, and other financial institutions to file reports with the United States Department of the Treasury, properly identify persons conducting transactions, and maintain appropriate records of financial transactions. These reports and records enable law enforcement and regulatory agencies to pursue investigations of criminal, tax, and regulatory violations, and provide evidence useful in prosecuting money laundering and other financial crimes.


Pursuant to guidance published on March 18, 2013 by the FinCEN, the Treasury agency charged with administering and enforcing the BSA, “administrators” and “exchangers” of convertible virtual currency are treated as money transmitters under the BSA and are thus subject to its AML requirements. 68

Specifically, money transmitters – such as certain Trading Platforms – must develop, implement, and maintain effective AML programs that address the ever-changing strategies of money launderers and terrorists who attempt to gain access to the United States financial system.

### Anti-Money Laundering Compliance Program

**Minimum Elements**

1. **A System of Policies, Procedures, and Internal Controls**
2. **A Designated BSA Officer**
3. **Training for Appropriate Personnel**
4. **Independent Testing**

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At a minimum, an AML compliance program must contain the following elements:

1. A system of policies, procedures, and internal controls to ensure compliance with the BSA;
2. A designated BSA Officer who is responsible for ensuring the Company’s compliance with the BSA and Office of Foreign Assets Control (“OFAC”) requirements;
3. Training for appropriate personnel; and
4. Independent testing of the program.

The program must also address specific recordkeeping and reporting obligations, such as filing suspicious activity reports (“SARs”) and currency transaction reports (“CTRs”).

Similar requirements apply to broker-dealers, mutual funds, and futures commission merchants and introducing commodity brokers. Broker-dealers also must comply with FINRA’s AML compliance rule, FINRA Rule 3310. Further, general prohibitions against promoting or conducting a transaction knowing the proceeds facilitate money laundering or other crimes, whether or not a company is a “financial institution” under the BSA, apply to all persons.

Appropriate procedures for KYC at customer onboarding and then monitoring the customer’s ongoing transactions are essential to determining whether suspicious activity is occurring.

It is also worth noting that various state regulatory regimes may entail additional AML standards. For example, holders of New York’s “BitLicense” must, among other things:

» Conduct AML risk assessments, and maintain and enforce an AML program very similar in structure to that required by FINRA Rule 3310;
» Verify customer identities at account opening and maintain transaction records that reflect the identity and physical addresses of customers and other parties to the transaction to the extent practicable;
» File SARs as required under federal law, and make certain SAR-like filings to NY state if not required to make such filings to federal regulators; and
» Maintain a written anti-fraud policy.

2. OFFICE OF FOREIGN ASSETS CONTROL REQUIREMENTS

The Office of Foreign Assets Control (“OFAC”) administers and enforces both comprehensive and targeted economic and trade sanctions to further United States foreign policy and

72 FINRA Rule 3310.
national security goals against certain foreign countries and regimes, nationals of certain of those countries, designated terrorists, foreign terrorist organizations, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy, or the economy of the United States. OFAC acts under Presidential national emergency powers, as well as authority granted by specific legislation, to impose controls on transactions and freeze assets under United States jurisdiction.

OFAC requirements apply to all “U.S. persons” or “Persons subject to U.S. jurisdiction”, including United States incorporated companies and their foreign branches, persons and companies located or physically in the United States, and United States citizens and permanent resident aliens wherever located. In certain sanctions programs, foreign subsidiaries owned or controlled by United States companies must also comply.

The specific prohibitions vary depending on the program; however, OFAC sanctions generally prohibit transactions or dealings with a person or entity identified on the OFAC list of Specially Designated Nationals and Blocked Persons (the “SDN List”) or the assets of a SDN, as well as certain transactions and activities with countries or sectors subject to economic sanctions. OFAC regulations maintain specific instructions on what to do if such a transaction or dealing is attempted, including “blocking” (freezing) of accounts or property, or prohibiting or rejecting the transaction.

3. EXECUTIVE ORDER 13827 AND VENEZUELA-RELATED SANCTIONS

On January 19, 2018, OFAC published FAQ 551 stating that United States persons who engage in purchasing or otherwise dealing with the Venezuelan petro (a state-sponsored virtual currency backed by oil) may violate United States sanctions imposed against Venezuela because of rights attached to it to receive commodities, such as oil, in a specified quantity at a later date. This right to receive commodities would violate Executive Order 13808, issued on August, 24, 2017, which, among other things, prohibits transactions, financing, and other dealings regarding “new debt with a maturity of greater than 30 days, or new equity, of the Government of Venezuela.”

On March 19, 2018, President Trump signed Executive Order 13827, Taking Additional Steps to Address the Situation in Venezuela and memorializing the policy position taken in FAQ 551. This Executive Order provides that United States persons may not transact, deal, or provide financing related to any digital currency, digital coin, or digital token that was issued by, or on behalf of the Government of Venezuela on or after January 9, 2018. Executive Order 13827 also

75 id.
covers the broad concepts of “digital currency,” “digital coin,” and “digital token,” which are undefined in the Order but are explained in OFAC FAQs 564-566.

Following the issuance of Executive Order 13827, OFAC amended its list of FAQs related to sanctions imposed against Venezuela to add FAQs 564-66. FAQ 564 clarifies that for the purposes of Executive Order 13827, Venezuela’s petro and petro-gold are considered to be a digital currency, digital coin, or digital token issued by the Government of Venezuela on or after January 9, 2018; thereby prohibiting transactions by United States persons related to the petro and petro-gold.77 FAQ 565 clarifies that Venezuela’s fiat currency, the bolivar fuerte, does not constitute a digital currency, digital coin, or digital token. Finally, FAQ 566 provides that OFAC would consider license applications related to digital currencies, digital coins, or digital tokens issued by the Government of Venezuela on a case-by-case basis, but generally, absent OFAC’s authorization, United States persons may not “engag[e] in transactions related to, provid[e] financing for, and otherwise deal” in Venezuelan-issued digital currencies, digital coins, or digital tokens.

On March 19, 2018, OFAC amended its FAQs to clarify its policy position on virtual currencies generally.78 FAQ 559 defines “virtual currency,” “digital currency,” “digital currency wallet,” and “digital currency address.”79

FAQ 560 states that OFAC compliance obligations are the same for United States persons whether transactions are denominated in a digital currency or a traditional fiat currency. Further, OFAC specifically notes that the compliance obligations extend to firms that are using

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79 Id.
digital currency when facilitating or engaging in online commerce or processing transactions, as well as trading platforms and others. In addition, the FAQ states that technology companies, digital currency users, digital currency trading platforms, digital currency administrators, and other payment processors, among others, should develop tailored, risk-based compliance programs that include sanctions list screening.

FAQ 561 explains that OFAC will use pre-existing government strategies designed to combat illicit use of digital currencies in order to sanction perpetrators. In addition, OFAC reserved the right to amend its SDN list to include specific digital currency addresses that are associated with blocked persons or entities that appear on the list.

FAQ 562 explains that OFAC may also add digital currency addresses associated with blocked persons to the SDN list, and reminds companies that any such digital currency must be blocked and to file a blocking report with OFAC.

FAQ 563 states that the format in which a digital currency address is included on the SDN list will include its corresponding digital currency.

D. FEDERAL INCOME TAX TREATMENT

The federal income tax consequences of transactions involving digital tokens is a developing area of law. The IRS has issued some guidance in Notice 2014-21, which generally treats convertible virtual currencies as property for United States tax purposes, rather than, for example, as foreign currency. However, Notice 2014-21 does not cover all of the terrain, and there are a number of areas of remaining uncertainty.

1. TREATMENT OF CONVERTIBLE VIRTUAL CURRENCIES UNDER NOTICE 2014-21

In April 2014, the IRS issued Notice 2014-21, which explains, in question and answer format, the application of existing general tax principles to transactions using virtual currency.

The guidance in the Notice only applies to “convertible virtual currency,” defined as “[v]irtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency.” The Notice cited bitcoin as one example of a convertible virtual currency, noting that it “can be digitally traded between users and can be purchased for, or exchanged into, United States dollars, Euros, and other real or virtual currencies.”

The Notice provides that, in general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. The Notice provides that virtual currency is treated as property for tax purposes and that “[g]eneral tax principles applicable to property transactions” apply to transactions using virtual currency.
The Notice provides that virtual currency is not treated as currency that could generate foreign currency gain or loss for tax purposes.

The Notice describes some of the tax consequences of mining virtual currency. The Notice provides that when a taxpayer successfully mines virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. The Notice further provides that if a taxpayer’s mining of virtual currency constitutes a trade or business, and the mining activity is not undertaken by the taxpayer as an employee, the net earnings resulting from those activities constitute self-employment income and are subject to the self-employment tax.

The Notice also describes some of the tax consequences of exchanging virtual currency for other property. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. The Notice provides that the basis of virtual currency is generally equal to the fair market value of the virtual currency in United States dollars as of the date of receipt. The Notice also provides that if a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into United States dollars (or into another real currency which in turn can be converted into United States dollars) at the exchange rate, in a reasonable manner that is consistently applied.

The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Virtual currency held for investment typically should be treated as a capital asset. Virtual currency held mainly for sale to customers in a trade or business typically should not be treated as a capital asset. In general, gain on the sale or exchange of a capital asset is treated as long-term capital gain (taxed at preferential rates) when the capital asset has been held for longer than one year. When a capital asset has been held for less than one year, gain generally is treated as short-term capital gain (taxed at ordinary income rates). Gain on the sale or exchange of a non-capital asset generally is treated as ordinary income.

The Notice provides that payments made using virtual currency are subject to information reporting to the same extent as any other payment made in property. The fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (“FICA”) tax, and Federal Unemployment Tax Act (“FUTA”) tax and must be reported on Form W-2. Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC. A third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization that is required to report payments made to a merchant on a Form 1099-K.
Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (“TIN”) from the payee. The payor must backup withholding from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required.

2. OTHER TAX ISSUES INVOLVING VIRTUAL CURRENCIES

Notice 2014-21 does not provide guidance on certain issues relating to the tax treatment of virtual currencies, including: (i) whether and how virtual currency brokers or dealers must report transactions involving virtual currency on Form 1099-B; (ii) whether holders of virtual currency should report their holdings on FinCEN Form 114 (FBAR reporting) or Form 8938 (FATCA reporting); (iii) the circumstances under which two different kinds of virtual currency may be regarded as like kind property for purposes of Section 1031 of the Internal Revenue Code; and (iv) the treatment of a “hard fork” in the blockchain of a virtual currency or of an “airdrop” of virtual currency.

In general, a broker or dealer that effects the sale of certain securities, commodities, options, regulated futures contracts, securities futures contracts, or forward contracts by a customer in the ordinary course of a trade or business must report information concerning its customer’s name, address, and TIN, the property sold, the gross proceeds of the sale, the sale date, and other information required by Form 1099-B. In addition, with respect to certain “covered securities,” the broker or dealer must report the adjusted basis of the security sold and whether any gain or loss with respect to the security sold is long-term or short-term. If reportable sales are not reported on a Form 1099-B, then the broker or dealer generally is subject to backup withholding. Treasury and the IRS have not produced guidance on whether or how brokers or dealers should comply with Form 1099-B reporting with respect to virtual currency.

In general, United States persons that have a financial interest in or signature authority over foreign financial accounts that exceed specified value thresholds must file a Report of Foreign Bank and Financial Accounts (“FBAR”), Form 114, through the e-filing system of FinCEN. In addition, under the Foreign Account Tax Compliance Act (“FATCA”), certain taxpayers that have an interest in specified foreign financial assets that exceed specified value thresholds must report those assets on a Statement of Specified Foreign Financial Assets, Form 8938, filed with their annual tax return. Treasury, the IRS, and FinCEN have not produced any guidance on whether virtual currency accounts could be subject to these reporting requirements.

Prior to 2018, under Section 1031 gain or loss generally was not recognized on the sale or exchange of property held for productive use in a trade or business or for investment if such property was exchanged solely for property of like kind which was to be held either for productive use in a trade or business or for investment. Whether intangible personal property
was of a like kind to other intangible personal property generally depended on the nature and character of the rights involved and on the nature or character of any underlying property. Treasury and the IRS have not issued guidance on the circumstances under which two different kinds of virtual currency may be regarded as like kind property for purposes of Section 1031. The IRS has historically taken a narrow view of the type of property that can qualify as like-kind (for example, treating gold and silver bullion or gold numismatic and gold bullion coins as not like-kind but treating gold bullion for Canadian Maple Leaf gold coins or Mexican and Austrian noncurrency bullion coins as like-kind). Nonetheless, it may be possible to argue that two cryptocurrencies are similar enough to qualify as like-kind (for example, two mined cryptocurrencies on the same blockchain as opposed to a digital currency and a smart contract based token). As a result of the 2017 tax reform legislation, however, Section 1031 can only apply to exchanges of real property, so like-kind exchanges of virtual currencies are no longer possible after 2017.

Treasury and the IRS have also not released guidance on the treatment of so-called “airdrops” of virtual currency or tokens—where holders of one digital token are given other digital tokens for free. The timing of income recognition in an airdrop is unclear, and airdrops may present valuation issues as well.

3. TAX TREATMENT OF TOKEN DISTRIBUTIONS AND SAFTS

Treasury and the IRS have not issued any guidance concerning the tax treatment of token distributions. In general, the facts and circumstances of a particular token distribution, including the nature of any rights associated with a token, must be analyzed to determine the appropriate characterization of the tokens for tax purposes. Depending on these facts, a token might properly be treated as convertible virtual currency under Notice 2014-21, as debt.

or equity interests in an entity established by the issuer, as equity in a de facto partnership among holders of the tokens, as a prepayment for goods and services, or as some other type of property. The tax consequences to issuers and holders of a particular token will depend upon this characterization of the token. In addition, token issuers may be subject to barter exchange reporting rules if the tokens are properly characterized as “scrip” through which clients of the issuer exchange property or services.

Some Token Sponsors pre-sell some amount of the digital tokens that the sponsor intends to distribute through a Simple Agreement for Future Tokens (“SAFT”). Under this model, the SAFT holder typically pays a fixed amount (usually in fiat currency or in a virtual currency) for the right to receive a determinable amount of tokens upon the occurrence of a “launch event,” at which point the Token Sponsor distributes tokens. SAFTs typically provide that the intended tax treatment of the SAFT is as a forward contract. If this treatment is respected, then the issuance of the SAFT generally should not be a taxable event, and taxation of the purchase amount under the SAFT should be deferred until delivery of the tokens to the SAFT holder.

However, the characterization of a SAFT as a forward contract may not necessarily be respected by the IRS. For example, depending on the facts and circumstances, the IRS may seek to re-characterize a SAFT as a debt instrument or to distinguish a SAFT from a traditional prepaid forward contract and tax the proceeds upon receipt. The efficacy of the SAFT approach to token generation remains controversial, and is not a settled regulatory matter.
UNDERSTANDING DIGITAL TOKENS

Legal Landscapes Governing Digital Tokens in the United States