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TO: U.S. House of Representatives
Committee on Agriculture

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RE: **U.S. Regulatory Framework for Digital Assets**

Introduction

We support the regulatory mission of investor protection and full and fair disclosure. We also support aggressively dealing with fraudulent actors in the blockchain technology industry. We believe it is essential to both market participants and the regulatory community that bad actors are dealt with through targeted strikes and regulatory action. We also believe it is equally essential to provide clear guidance beyond enforcement actions to allow continued development and innovation around what many believe to be potentially transformational technology development. It is in that spirit that we welcome this engagement with the regulatory community toward defining a regulatory framework that best addresses market participant protection and continued growth and development of blockchain technologies.

Blockchain technology (also called “distributed ledger technology”) allows the creation of a software ledger that is distributed, meaning many copies of the ledger exist and are automatically kept in sync such that no one actor can alter the ledger without employing a defined consensus mechanism among the actors. This technology allows assets to be traded on a ledger that is not maintained by a centralized “trusted” actor. Blockchain technology allows ledger transactions to occur immediately, immutably and transparently, without the need for reconciliation of multiple proprietary ledgers. This is, arguably, the most fundamental change to ledger technology since double-entry accounting. Double-entry accounting helped trading counterparties trust each other. Blockchain technology removes the need for centralized trusted intermediaries to act as the go between for trading counterparties. While the Internet enables the free flow of information, blockchain technology enables the free flow of value. More specifically, blockchain technology enables the creation of many types of digital assets, including digital currencies, digital goods and services, software tokens and digital securities (*e.g.*, tokenized debt or equity).

This memorandum addresses the regulatory framework for the application of U.S. securities laws and commodities laws to these various types of digital assets, with a focus on the treatment of utility tokens. Tokenized goods and services are non-fungible tokens that are merely intended to represent specific goods or services, so their regulatory status should simply follow from the regulatory status of the good or service they represent. Other digital assets require somewhat more complicated analysis to determine their regulatory status.

Digital Currencies, Digital Securities & Utility Tokens

At one end of the spectrum, digital currencies are fungible tokens that have no other marketed functionality than use as a medium of exchange or stored value. These types of tokens (*e.g.*, Bitcoin) are subject to various U.S. federal and state as well as foreign money transmission laws, are treated as property under U.S. tax laws, and are treated as commodities under U.S. commodities laws. Offers and sales of digital currencies should not be viewed as securities under the *Howey* test, absent unusual facts (such as promising efforts to maintain secondary market liquidity or token architectural features like burning tokens intended to reduce supply and increase the value).

At the other end of the spectrum, digital securities are tokenized traditional securities (*e.g.*, debt or equity) or investment contract type securities that offer a direct financial return from an identifiable issuer. These types of tokens would clearly be securities and would generally not be subject to commodities laws or money transmission laws *per se*.

Utility tokens are intended to be used by users of a software network and do not represent an equity interest (or any other corporate obligation), but they do attract speculative resellers, which implicates the *Howey* test. The *Howey* case law is highly nuanced and, therefore, challenging to interpret, leading to uncertainty. As a general matter, U.S. federal securities laws were developed and have evolved primarily for and around equity securities (and other corporate obligations). There is much less clarity around investment contract type securities, particularly investment contract type securities that offer no direct financial return, but nevertheless enjoy robust secondary markets.

The *Howey* test requires a reasonable expectation of profits. A purchaser may be led to expect profits either from a direct financial return (*e.g.*, an ownership interest in a business or a promise of payment) or from a rising price in secondary markets. Ordinarily, if there is no direct financial return, and the object being sold has never been sold before, there would be no reasonable expectation of profits. This is because a reasonable purchaser would not expect a novel product to have any secondary market liquidity. The fact that every team, every time, seems to be able to general an immediate secondary market for its newly minted utility token, is astonishing, but has become a fact of life. At this point, the expectation of profits from secondary market activity has become a given. It would be difficult to point to another phenomenon where this was the case. This is the first factor in the utility token analysis that is arguably unique.

An expectation of profits is not, however, sufficient to form an investment contract. The expectation of profits must be based on the efforts of others. Most investment contracts, including *Howey* itself, involve the promise of direct financial returns. When a promoter offers a financial return to the purchaser, the efforts of others continue for the life of the financial return, which would mean indefinitely in the case of an ownership interest in a going concern. When no direct financial return is offered, however, and the only expectation of profits comes from the hope of a rise in price in secondary markets, the efforts of the promoter are only relevant so long

as the product is being developed by the promoter. This temporal qualification is the second factor in the utility token analysis that is unique and leads to the concept of mutability, discussed in our memorandum to the SEC dated March 26, 2018 regarding the Investment Contract Analysis of Utility Tokens. As discussed in that memorandum, the token itself is never a security, but the facts and circumstances surrounding the sale of the token likely constitute an investment contract while the token is in the development stage because the buyer's expectation of profits are based on the seller's efforts to complete development of the token. Once the token has been fully developed and the facts and circumstances no longer support an investment contract conclusion, the offer and sale of the token should be treated as the sale of any other commodity trading in spot markets. As a result, under the *Howey* test, token sale agreements could constitute investment contracts under some circumstances but not others.

Some would prefer to resist the implications of mutability by simply treating all tokens as securities forever. Treating all tokens as immutable securities, however, (i) would not be analytically consistent with existing law and (ii) would not allow tokens to be used for their intended purpose -- access to products and services on a network, which would inevitably cause development to relocate abroad.¹ China, whose securities laws arguably are not as nuanced, took a binary approach to regulation and banned all token sales in China instead of adopting tailored protections that would enable the development of the technology to continue in China. We believe the law and guidance around what constitutes an investment contract should be clarified. We believe that the industry's and the regulators' interests are aligned in establishing clear rules and appropriate investor protections so that capital formation in blockchain technology is not derailed and development can continue to flourish in the United States.

Proposed Regulatory Framework for Utility Tokens

To remedy the uncertainty and confusion in this space, we are part of a group of academics, venture capital firms and law firms practicing in this area that has proposed the following regulatory framework to serve as the basis for a more detailed non-exclusive safe harbor that would help provide guidance to the industry on what constitutes an "investment contract" and how the investment contract law and guidance should apply to utility tokens with respect to primary sales, resales and use of the tokens for their intended purposes. Similar to the steps the SEC took by putting in place Regulation D, a non-exclusive safe harbor to address the uncertainty caused by *SEC v. Ralston Purina* in the private placement arena, we believe the proposed framework outlined below could be codified in a no-action letter or series of no-action letters that could ultimately lead to a rulemaking around a safe harbor that will assist in relieving the regulatory uncertainty around utility tokens. The goals of the proposed framework are to (i) establish clarity for the industry, (ii) permit use of tokens for their intended purposes (*i.e.*, on their software platform) and (iii) establish appropriate investor protections for both primary sales and resales of tokens, with emphasis on eliminating trading manipulation.

¹ For example, a social network that uses a token as a micro payment for a micro task like submitting a blog post, would be engaged in the unregistered and, presumably, non-exempt sale of a security if the token were a security.

The industry's need for clarity is obvious. Currently, the vast majority of token sales are smaller token sales that have not been reviewed by counsel or that are merely attempting to follow precedent transactions in a highly nuanced area with varying models and no bright line rules. The regulators would also benefit from clarity. The proposed framework would require affirmative consent to jurisdiction, which has been challenging in light of the global and distributed nature of token sales. The proposed framework allows regulators to (i) define the contours of jurisdiction (and therefore responsibility), (ii) avoid the incongruent result of defining all tokens as securities (while tokens have security-like characteristics at one stage, the regulatory scheme must also permit use of tokens for their intended purposes) and (iii) provide an efficient structure for continued capital formation.

The proposed framework is largely based on the application of existing case law and regulatory principles, such as Rule 144 and Rule 701, to tokens, but proposes bright lines to clarify existing case law and regulation in a way that is practical and useful for all constituents. The proposed framework has been vetted by, and has the support of, many of the key players in the industry. We believe the proposed framework works well from the perspective of both industry and the regulators by balancing market participant protections and capital formation.

In general, offers and sales of tokens meeting the specified conditions would not be deemed securities transactions (except for purposes of application of general anti-fraud and manipulation rules, such as Rule 10b-5) once the tokens have achieved either full functionality or full decentralization (as described below) and may be exchanged as non-securities in secondary markets subject to the general anti-fraud and manipulation rules of each of the CFTC and the SEC. Token sellers would, however, impose certain investor protection requirements tailored to each stage. The no-action letter(s) and any eventual safe harbor would be non-exclusive as there will be tokens clearly purchased for consumptive purposes, such as non-fungible tokenized goods and services. The principles of the proposed framework are as follows:

Pre-Functionality -- Until the token achieves full functionality, offers and sales of tokens would generally constitute investment contract type securities under *Howey*, unless a reasonable purchaser is purchasing with consumptive intent.² In this case, the token should generally be treated as a security unless use of the token (as opposed to resale) is reasonably certain. As such, this stage would include the following features:

Primary sales – Existing securities laws would apply to primary sales of the token. Primary token sale agreements would continue to be generally treated as securities based on the investment contract analysis under *Howey*. Primary sellers of tokens would be able to rely on available exemptions from registration (*e.g.*, Rule 506(b), Rule 506(c), Regulation S, Rule 701) and the SEC would retain full regulatory authority to enforce violations under existing federal securities laws.

² Consumptive intent, as opposed to investment intent, would generally be established if the purchaser is only able to use the token for its intended purpose and is not able to resell the token for profit. The existence of consumptive intent was a key determinant, for example, in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

Resales -- Any resales or assignments of the primary token purchase agreement, which is the security under *Howey*, by purchasers or affiliates of the token creator would also need to rely on existing resale exemptions under the securities laws. Resales of the token would also be subject to the special resale lockup and resale volume restrictions described below.

Use for Intended Purpose -- Tokens would be able to be earned or used as intended through the network, so long as either (i) resale is not possible,³ or (ii) the network on which the tokens can be used will be shut down within some reasonably finite period, say 6 months (*i.e.*, these are testnet tokens that have no resale value).

Full Functionality -- Once the token achieves full functionality, offers and sales of tokens would generally not constitute investment contracts under *Howey*. Software networks, however, generally require ongoing updates and upgrades, so it may be appropriate to create limited but ongoing investor protections.⁴ As such, this stage would include the following features:

Primary Sales -- Primary sales of tokens below the Per Purchaser Limit (described below) would be able to be made without being subject to lockup or volume restrictions. Larger purchasers, however, would need to be accredited investors and are subject to the special resale lockup and resale volume restrictions described below. Tokens would be able to be gifted or otherwise distributed to users, service providers, strategic partners and other participants without an exchange of money, including mining, also without being subject to lockup or volume restrictions.⁵

Resales -- Tokens would be able to be traded on exchanges or resale platforms as non-securities, other than for purposes of the general anti-fraud and manipulation rules, such as Rule 10b-5.⁶

³ During this stage of token development, we believe that resale should either be extremely unlikely (*i.e.*, in the case of testnet tokens) or effectively impossible. More practical (*i.e.*, less stringent) resale lockup mechanics may be more appropriate for tokens that achieve full functionality.

⁴ Ongoing software updates and upgrades constitute ongoing efforts of others under *Howey*, but they are not likely to rise to the requisite level of efforts to form an investment contract. The case law is particularly challenging to apply to the facts in this area, which makes it difficult to determine whether investor protections should apply. Nevertheless, we believe that limited ongoing investor protections, even at this stage of token functionality, are essential in ensuring that capital raising is not derailed in this industry by pump and dump or get rich quick schemes taking advantage of immediate liquidity in secondary trading markets for tokens.

⁵ For equity securities, we would typically consider many of these non-monetary issuances of stock to be “sales.” For tokens, there are strong policy objectives around bolstering the use of the tokens for their intended purposes. As such, non-monetary transfers of tokens for the purpose of seeding potential users to drive network adoption or for purposes otherwise related to the token’s usage should be permitted. To the extent a so-called “airdrop” is announced in advance as a way to drive up the trading price of the token associated with the blockchain on which a new token is being airdropped, we would consider this a marketing practice inconsistent with the safe harbor.

⁶ There are many variations in the market on token trading platforms, from true peer-to-peer to decentralized exchanges that provide information supporting peer-to-peer trading or, in some cases, matching engines, but that do not take custody of tokens, to hosted-wallet exchanges running full services as an exchange. How to handle

Use for Intended Purpose -- The token would be able to be earned or used on the network for its intended purpose (*i.e.*, on their software platform) without being subject to lockup or volume restrictions.

Full Decentralization (Protocol Tokens⁷) -- If a token achieves full decentralization (not all will), the token would fall entirely outside of *Howey* since there is no longer an issuer or promoter delivering ongoing software updates or upgrades that could potentially constitute the requisite efforts of others under *Howey*. As such, a token that achieves full decentralization would be not be deemed a security for any purposes other than the general anti-fraud and manipulation rules, such as Rule 10b-5.

Key Defined Terms --

Full Functionality -- A token achieves full functionality when a token holder can use the token for its intended purpose (marketing test), or a token holder can use the token in some meaningful way (qualitative use test), or the network in which the token is to be used is fully functional in accordance with its whitepaper (operational test), or the token's consensus mechanism is working and blocks are being published (layer 1 protocol token test). The foregoing are examples of functionality criteria, but there may be other indicia of functionality that require further discussion in the context of a specific no-action letter. Protocol tokens (*i.e.*, tokens that allow other developers to build application tokens on top of the protocol token network) should be deemed to have immediate full functionality when the protocol tokens can be used for their intended purpose by developers even if the applications have not been developed yet, while application tokens would require their marketed features to be built before achieving full functionality.

Per Purchaser Limit -- This could be a dollar limit akin to crowdfunding concepts, but would make more sense under *Howey* as a limit that indicates consumptive intent. Each primary token seller could establish a limit based, for example, on the number of tokens a user might use within a given period of time. In some cases, tokens are meant to be purchased by developers who are building other applications that will make use of the tokens and will need a larger quantity of tokens for their separate development project than would a typical user.

Full Decentralization -- A token achieves full decentralization when the token creator no longer has control of the network based on its ability to make unilateral changes to the

exchanges and the mechanics of our proposal will need significant further discussion with the Staff. We do not believe, however, that it would be appropriate to require all exchanges trading fully functional tokens to be registered as Alternative Trading Systems. We believe it is essential to apply general anti-fraud and manipulation rules to these open exchanges, but it would be counterproductive to treat them as ATS's with inapposite rules developed around equity securities and other corporate obligations.

⁷ ETH is a good example of this type of protocol token that has become so decentralized it should not be deemed a security. For clarity, ETH is the protocol token for the Ethereum network, so this safe harbor provision would apply to ETH, but not necessarily to all ERC20 tokens running on top of the Ethereum network unless an ERC20 token is itself a protocol token. Also, for clarity, a protocol token may qualify as a token with full functionality irrespective of whether it has achieved full decentralization.

functionality of the tokens, or based on the number of network nodes controlled by the broader community, or based on the code being forkable and open source, or based on it being a permissionless network (any node can join), or based on affiliated hashpower (proof of work), or based on affiliated holdings (proof of stake). Again, these are just examples of indicia of control criteria that require further discussion in the context of a specific no-action letter.

Primary Token Seller Conditions for Safe Harbor --

Special Resale Lockup and Resale Volume Restrictions -- Primary sales other than for fully decentralized protocol tokens (*i.e.*, for either Pre-Functionality or Full Functionality tokens), would need to include a lockup that permits use but not resale for the period ending on the later of (i) 6 months following purchase, and (ii) achievement of full functionality. In addition, purchasers and affiliates of the token creator would need to agree to resale volume limitations.

Consent to Jurisdiction -- Primary token sellers would need to consent to jurisdiction of the applicable regulators.

Consent to Anti-Fraud Rules -- The primary token seller would need to also agree to the application of the general anti-fraud and manipulation rules, such as Rule 10b-5 under federal securities laws with respect to any tokens sold under all circumstances.

Public Disclosure -- Any information that the primary token seller provides regarding features and use of the network would need to be made publicly available. To achieve full functionality, a white paper, superseding any prior white paper, would need to be published detailing present functionality and would need to focus on present features with only limited and very generalized discussion of future features, if any. Other disclosures may be appropriate and would need to be discussed in the context of a specific no-action letter.

Public Marketing -- The token seller would not be permitted to market the token as an investment, but would be able to provide disclosures consistent with Rule 506(c) and Rule 134. Any marketing materials made public would only be able to relate to the token's functionality, not its resale value.

Legends/Smart Contracts -- Primary token seller would need to enforce lockups.

Token Features -- The tokens would not (i) have one or more features that make them a "security" under one of the other concepts in the definitions under the '33 Act or '34 Act, or (ii) constitute an (a) ownership interest, (b) equity interest, (c) a share of revenue, profit and/or loss, or assets and/or liabilities, (d) status as a creditor or lender, (e) claim in bankruptcy, (f) holders of repayment obligations, or (g) right to convert into an investment interest, all with respect to the token project or network application, or any legal entity.

Exchange Conditions for Safe Harbor --

The conditions for an exchange to list a utility token as a non-security requires further discussion in the context of a specific no-action letter, including with respect to (i) the exchange's role regarding FinCEN KYC/AML regulations; (ii) the exchange's role relating to resale limitations on tokens; and (iii) consent to jurisdiction for enforcement of general anti-fraud and manipulation rules.

Reseller Conditions for Safe Harbor --

Resellers would need to comply with any lockup and volume limitations.

Resellers would need to be subject to the general anti-fraud and manipulation rules, such as Rule 10b-5.

Conclusion

We believe that the above regulatory framework ensures the goals of investor protection, clarity for market participants and support for blockchain technology. While the SEC retains significant jurisdiction under the proposal, the CFTC would also retain the ability to regulate fraud and market manipulation in the token spot markets, in addition to its full authority to regulate any derivative token markets. FinCEN remains the primary regulator with respect to all KYC/AML requirements, and the FTC would also have jurisdiction for any consumer protection actions associated with misleading advertising.