

The Need for a California Taxonomy

What's at Stake: Public Blockchain Networks are the Future

Public blockchain networks allow for the exchange of value without an intermediary. Although this technology is perhaps best known for facilitating the movement of digital money, it also has the potential to enable the rapid and encrypted transfer of data, identity information, and other information that traditionally has been recorded in a database controlled by a single corporation or government. This matters because today, much of our personal data is held by a handful of large entities who use it primarily for profit-generating purposes, which makes it susceptible to hacking and manipulation.

We are still in the early days of blockchain technology, but innovators, entrepreneurs, developers, and investors all over the world are thinking creatively and working to develop new decentralized systems using this technology. Just as the Internet revolutionized the way in which we communicate, public blockchains have the potential to revolutionize the way we transact with one another.

The Issue: Regulatory Uncertainty is Stifling Innovation

The cornerstone of public blockchain networks are digital tokens, which serve as a unit of account and are used to verify transactions within the network. To date, neither Congress nor our federal regulatory agencies have established a clear framework for digital tokens. This space is thus ripe for leading states, like California, to set out a workable policy that would provide an example for other lawmakers and regulators to follow. Any framework should start with a clear token taxonomy -- meaning a clear and simple categorization of tokens defining whether a token is, for example, a security token (does the token represent a share of a company), a utility token (does the token represent access to a particular service or reward), or a payments token that helps bridge payments and remittances.

With that clear token taxonomy as a foundation, the industry, the public, and the regulators would then know which digital assets fall inside which "regulatory perimeter" -- meaning, which existing laws apply to which token asset class. For example, which tokens are regulated under security laws and which under money transmitter laws, and how do privacy regulations and consumer protection laws apply? Any taxonomy should also retain some flexibility in recognition of the fact that digital assets can (and do) move between classifications over time as the technology and use cases evolve.

Below are some examples of what other states have done to attract blockchain technology based businesses as well as proposed bipartisan federal legislation that aims at providing regulatory clarity.

State Leadership: Wyoming and Colorado

Wyoming Looking to Lead the United States in Blockchain

Since 2017, Wyoming has sought to attract blockchain business to the state by passing several pieces of legislation intended to provide regulatory clarity and oversight of open blockchain networks. Colorado has followed suit and enacted many similar proposals that Wyoming has led on. Governor Polis (D-CO) was a blockchain advocate and leader of the Blockchain Caucus during his time in the U.S. House of Representatives.

Holistic Regulatory Framework

Wyoming has established the first holistic legal framework for fintech and digital assets in the United States, resolving legal questions which previously contributed to market uncertainty and risk. Wyoming has also imposed consumer protection and market fairness rules for digital assets. The Wyoming Division of Banking is charged with implementing the regulatory framework outlined in the several bills passed by the state legislature.

Legal Nature of Digital Assets - Wyoming SF 125 (signed into law 2019)

- Created three new forms of intangible personal property - virtual currencies, digital securities, and utility tokens
- Integrated these asset classes into the Uniform Commercial Code (UCC). UCC additions include:
 - a. Establishing "control" of a digital asset
 - b. Possessory security interest
 - c. Lending
 - d. Priorities of creditors/liens
 - e. Consumer remedies

Special Depository Purpose Institution (SPDI) - Wyoming HB 74 (signed into law 2019)

- New bank charter to provide banking, fiduciary, and custodial services for digital assets.
- A bank (instead of a limited-purpose trust company) under banking, commodities and securities laws that 1) receives deposits and 2) exercises actual fiduciary powers similar to national banks.
- 100% reserve requirement for general deposits with lending of deposits prohibited. Consequently, FDIC insurance is authorized, but not required.
- Likely exempt from money transmission laws and similar licensure requirements in most states as a bank.
- Kraken and Avanti applied for SPDI charters in 2020.

Regulatory Sandbox - Wyoming HB 57 (signed into law 2019)

- Controlled regulatory space for innovators to test new financial products and services, including those utilizing blockchain technology, in the marketplace.

- Time-limited to three years and new products/service must not be permitted under existing law.
- Consumer protection bond required and broad supervisory powers for Wyoming regulators.
- Provides Wyoming officials with authority to enter into reciprocity and other agreements with outside jurisdictions (state, federal and foreign).

Utility Tokens - Wyoming HB 70 (signed into law 2018)

- First statute to create a new asset class for digital assets with a predominant consumptive/utility-based purpose. Mirrored language from Switzerland and the UK.¹
- Separate virtual currency and digital securities as a distinct digital asset class.

Cryptocurrency Exemption Colorado Digital Token Act - SB 23

- The act provides limited exemptions from securities registration and securities broker-dealer and salesperson licensing requirements for persons dealing in digital tokens.
- "Digital token" is defined as a digital unit with specified characteristics, secured through a decentralized ledger or database, exchangeable for goods or services, and capable of being traded or transferred between persons without an intermediary or custodian of value.

Federal Legislation: H.R. 2144 - The Token Taxonomy Act

Leaders Behind the Legislation:

- **Sponsors:** Rep. Darren Soto (D-FL), Rep. Warren Davidson (R-OH)
- **Co-Sponsors:** Rep. Eric Swalwell (D-CA), Rep. Ted Budd (R-NC), Rep. Josh Gottheimer (D-NJ), Rep. John Rose (R-TN), Rep. Tulsi Gabbard (D-HI), Rep. Anthony Gonzalez (R-OH), Rep. Scott Perry (R-PA)
- **Supporting Organizations:** US Chamber of Commerce, Blockchain Association, National Venture Capitalist Association, Coincenter, Engine Advocacy, NASDAQ, IBM, Andreessen Horowitz, Gemini, RSM International, Coinlist, Circle, Paul Hastings

What the The Token Taxonomy Act Accomplishes:

- Clearly defines "digital token" and exempts these functioning and decentralized tokens from securities law;
- Amends the tax code to facilitate transactions using virtual currencies by allowing for like-kind exchanges and de minimis tax-free transactions; and
- Does not disturb SEC authority over tokens issued for the purpose of capital formation.

¹ See <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>; <https://www.fca.org.uk/publication/policy/ps19-22.pdf>.

What is a digital token?

A digital token is a token that is exchangeable for goods or services, and is used in a decentralized blockchain network (i.e., not controlled by one or a small number of entities). Participants in the network can use digital tokens for different purposes based on the nature of the network. For instance, a participant could use the digital token to purchase storage space from other stakeholders in the network.

Is bitcoin a digital token?

Yes. Bitcoin meets the requirements of a digital token because it is decentralized (i.e., not controlled by one or more entities) and can be exchanged for goods or services.

Can projects use digital token to raise capital?

No. If an entity issues tokens to investors with the promise to build out a system in which their tokens can be used in the future, this would still be a security token and not a digital token. However, projects can issue securities that promise to deliver digital tokens in the future once the network is up and running. The promise to deliver the tokens is a security, but the tokens themselves are not.

How will this legislation protect consumers?

This legislation provides clarity on which blockchain tokens are securities and which are not. Such a distinction will assist regulators in determining which projects are not complying with securities regulations meant to protect consumers, and which are not.

This bill reaffirms that tokenized securities are regulated by the SEC. These tokenized securities are required to follow consumer protection laws that are already on the books and currently monitored by the SEC. Digital tokens are regulated by other consumer protection laws, such as the Federal Trade Commission's fraud statutes. These tokens are not securities and therefore not under the purview of the SEC.

The bill also strictly outlines that only those with a Bank, Fintech or State Trust Charter can be a qualified custodian for tokens. Charter holders must comply with strict consumer protection, anti-money laundering and "Know Your Customer" regulations. By holding banks, wallets and exchanges to the same rules as current custodians, the Token Taxonomy Act seeks to create parity with the current market participants.

The legislation also provides a specific recourse in case a project's tokens are deemed securities by the SEC. In such a case, the project may have to cease all sales and return remaining funds to consumers.

International Approaches

In addition to domestic efforts, several international jurisdictions have adopted frameworks that we believe provide helpful models as California considers its own taxonomy.

Switzerland

In 2018, the Swiss Financial Market Supervisory Authority FINMA issued guidance setting forth how it intends to treat inquiries from ICO organizers. FINMA and the Swiss National Bank (SNB) are positive on digital assets and have moved quickly to provide regulatory clarity. Additionally, FINMA was one of the first regulators to classify token ICOs

In assessing ICOs, FINMA focuses on the economic function and purpose of the tokens (i.e. the blockchain-based units) issued by the ICO organiser. This analysis is conducted on a case-by-case basis.

- **Payment ICOs:** Where the token is intended to function as a means of payment and can already be transferred, FINMA requires compliance with AML regulations. These tokens, however, are not treated as securities.
- **Utility ICOs:** These tokens do not qualify as securities if their sole purpose is to confer digital access rights to an application or service and if the utility token can already be used in this way at the point of issue. If a utility token functions solely or partially as an investment in economic terms, however, the token is treated as a security.
- **Asset ICOs:** FINMA regards asset tokens as securities, which means that there are securities law requirements for trading in such tokens, as well as civil law requirements under the Swiss Code of Obligations (e.g. prospectus requirements).

United Kingdom

Last year, the UK's Financial Conduct Authority (FCA) issued guidance that sought to classify digital assets as security tokens, utility tokens, or exchange tokens and indicated that utility and exchange tokens would usually fall outside the regulatory perimeter.

Their categorizations include:

- **Exchange tokens:** These are not issued or backed by any central authority and are intended and designed to be used as a means of exchange (typically for buying and selling goods and services). These tokens are generally considered outside the regulatory perimeter.
- **Utility tokens:** These tokens grant holders access to a current or prospective product or service but do not grant holders rights that are the same as those granted by specified investments. They are generally considered outside the regulatory perimeter (though they may meet the definition of e-money in some circumstances, in which case activities involving them may be regulated).
- **Security tokens:** These are tokens with specific characteristics that mean they provide rights and obligations akin to specified investments. These tokens fall within the regulatory perimeter.

The FCA has also found that tokens not subject to financial service regulation might nonetheless be subject to other consumer protections including the Advertising Codes, consumer law, general common law, criminal law, and the General Data Protection Regulation.