

Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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For more information,
contact:

J.C. Boggs
+1 202 626 2383
jboggs@kslaw.com

Jen DePalma
+1 650 422 6703
jdepalma@kslaw.com

Matthew Hanson
+1 202 626 2904
mhanson@kslaw.com

Ana Buling
+1 212 556 2140
abuling@kslaw.com

King & Spalding
Washington D.C.
1700 Pennsylvania Avenue NW
Suite 200
Washington, D.C. 20006
Tel: +1 202 737 0500

Silicon Valley
601 South California Avenue
Palo Alto, CA 94304
Tel: +1 650 422 6700

New York
1185 Avenue of the Americas,
35th Floor
New York, NY 10036
Tel: +1 212 556 2100

Congress and Cryptocurrency: The Elephant in the Room

In the ancient parable of the Blind Men and the Elephant, a group of blind men who had never come across an elephant before were asked to describe it. Each blind man felt a different part of the elephant's body, but only one part, such as the side or the tusk. Each described the elephant based on his limited experience, resulting in each man's description of the elephant being different from that of the others.¹

Like the men in this story, U.S. regulators have taken different positions on how crypto tokens² should be treated, each based on the particular perspective of the regulator and the types of crypto tokens on which it is focused. The Securities and Exchange Commission (SEC) says tokens issued in initial coin offerings, or ICOs, are probably securities.³ The Commodity Futures Trading Commission (CFTC) views certain virtual currencies as commodities.⁴ The Internal Revenue Service (IRS) says that convertible virtual currencies are property.⁵ And the U.S. Treasury Department's Financial Crimes Enforcement Network says administrators and exchangers of virtual currency are money transmitters.⁶

Given the diverse regulatory perspectives and significant differences in what any given crypto token represents, it would be difficult, if not impossible, to agree on a consensus definition of a term like cryptocurrency or virtual currency. To subject all crypto tokens to a one-size-fits-all legislative or regulatory regime would miss the point that, unlike the men in the parable, regulators are encountering truly distinct digital objects with little more in common than a U.S. dollar has to a share of stock, a derivative security has to a debt instrument, or a loyalty point has to a token used in an arcade.

For crypto tokens, the commonality is that each represents value—or a financial instrument or another asset with value—on a blockchain. That means of representation is new, but each crypto token is a representation of a type of asset or financial instrument that existed before the blockchain. Most derive their value from an asset or other reference in the “real” world.⁷ Tokens can represent a currency, a security, a tangible asset, an intellectual property right, a real estate interest, a loyalty point, or another



asset or financial instrument. Given this breadth, it is little wonder that multiple federal regulators from the SEC, to the IRS, to the CFTC, to the Federal Trade Commission have taken an interest.

REGULATORY TIPTOEING AND AMBIGUITY

To date, U.S. regulators mostly have focused their crypto-related enforcement actions on clear frauds and have been reluctant to create new regulations or to publish official guidance in the area, perhaps wisely so. As some members of Congress and regulators have noted, rushing to legislate could result in ill-fitting laws that potentially slow down innovation and drive industry participants overseas. Under existing guidance, however, it is often difficult to determine whether regulators would classify a particular crypto token as a commodity, a security, another form of financial instrument, or perhaps all of the above.

For companies with crypto-related business plans, the resulting inconsistencies and ambiguity leave them guessing about what exactly is required under the law. What an entrepreneur might view today as a novel step into an area lacking official guidance may later be seen in hindsight as an obvious step onto the wrong side of the law. For example, by the time the SEC brought a case to stop an unregistered ICO in mid-December 2017, there had already been billions of dollars' worth of tokens sold in ICOs, none of them registered as securities.⁸

In the absence of new legislation, the regulators in charge of day-to-day oversight of U.S. financial markets and transactions have been working through how to apply existing rules and regulations, including how to determine where each regulator's authority begins, ends, and overlaps with others.⁹ But regulators have faced similar judgment calls in the past when new asset classes or means of communication, such as those enabled by the internet, emerged. For example, the SEC and the CFTC ultimately sorted through how to address stock indexes (generally, narrow-based indexes are securities, while broad-based indexes are commodities, with a mathematical way to make the determination)¹⁰ and swaps (generally, the SEC has jurisdiction over swaps with securities as the underlying asset, and the CFTC retains jurisdiction over all other swaps).¹¹

BEGINNINGS OF CONGRESSIONAL ACTION

While regulators will no doubt continue evaluating how to apply existing rules and regulations, both the crypto community and U.S. financial regulators have been waiting to see if Congress will act to provide clarity. In the past, Congress has stepped in to clarify or align various regulations with the new ways of doing business enabled by the internet. Similarly, the representation of financial instruments on a blockchain, and the technological ease of trading digital assets, may require Congress to set ground rules through new legislation.

The U.S. Congress has gotten into the action, studying reports and new developments, and hosting meetings with industry players and regulators alike. Committees in both the U.S. House of Representatives and the Senate have held multiple public hearings to solicit views on where legislative action might be best focused and prioritized. With those hearings having produced a substantial record, it appears some members of Congress are now ready to frame some initial legislation.

Pending Legislation

In prior years, much of the proposed legislation related to virtual currency and blockchain technology focused on their potential use in illicit finance and terrorism funding. While some members have continued focusing on that angle, several new pieces of legislation hope to facilitate the use of crypto tokens through clarifications in the law.

Two separate House resolutions introduced on September 28, 2018 — H. Res. 1108, sponsored by Rep. David Schweikert (R-AZ), and H. Res. 1102, sponsored by Rep. Tom Emmer (R-MN) — express support for the new industry. Reps. Schweikert and Emmer co-chair the Congressional Blockchain Caucus, along with fellow co-chairs Reps. Jared



Polis (D-CO) and Bill Foster (D-IL), and are sponsoring more than half of the legislation proposed in recent months.

Recently introduced bills would address:

- Exempting de minimis transactions in cryptocurrencies (initially those under \$600, tied to inflation going forward) from IRS reporting requirements. (H.R. 3708 – Rep. Schweikert (R-AZ)).¹²
- Introducing a pilot program for hospital data security relating to certain categories of medical research—a sign that blockchain is starting to work into legislative thinking outside of the finance sector. (H.R. 6562 – Kevin McCarthy (R-CA)).¹³
- Ensuring that FinCEN has the necessary technology to monitor cryptocurrencies and other emerging financial technologies. (H.R. 6721 – Rep. Ted Budd (R-NC)).
- Setting standard definitions for terms like “blockchain” in order to facilitate a cohesive regulatory scheme and promoting adoption of the technology. One bill would direct the Department of Commerce to convene a working group of federal government and industry stakeholders to develop a consensus-based, agreed upon definition of blockchain, as well as to consider recommending that the National Telecommunications and Information Administration (NTIA) and Federal Communications Commission (FCC) undertake a study to examine the potential impact of blockchain on spectrum policy and opportunities for the adoption of blockchain to promote efficiencies within the federal government. (H.R. 6913 – Rep. Doris Matsui (D-CA) and Rep. Brett Guthrie (R-KY)).¹⁴
- In the absence of administrative guidance, providing a temporary safe harbor for the tax treatment of convertible virtual currency received when a blockchain forks. The bill would insulate taxpayers from potential liabilities stemming from the present lack of clear IRS guidance on forks. (H.R. 6973 – Rep. Emmer).
- Providing a safe harbor from money transmitter licensing and registration for certain blockchain developers and providers of blockchain services that do not, in the regular course of business, “control” crypto tokens of users of the service or software created, maintained, or disseminated. The bill defines the term “control” as “the legal right, authority, or ability to obtain upon demand data sufficient to initiate transactions spending an amount of digital currency.” (H.R. 6974 – Rep. Emmer).
- Amending the Electronic Signatures in Global and National Commerce Act to clarify that it applies to electronic records, signatures, and smart contracts created, stored, or secured on or through a blockchain. (H.R. 7002 – Rep. Schweikert).

All of these resolutions and bills remain in committee at this point, and it is not clear whether any will be voted on before the end of this Congress. With these bills now formally introduced and available for review and discussion, it is likely we will see variations on some or all of them when the 116th Congress convenes in 2019.

Legislative Discussion and Commentary

Outside of formal hearings, members of Congress have held roundtables, formed caucuses, and participated in industry group events to learn about the technology and solicit perspectives on appropriate legislative action. For instance, a recent Library of Congress roundtable event entitled “Legislating Certainty for Cryptocurrencies,” allowed legislators an opportunity to solicit industry input outside of the context of a formal hearing from more than 80 leaders from the crypto token and traditional finance industries. The September 2018 event discussed optimal ways to move forward with crypto token policy-making and regulation.



Remarks by Rep. Warren Davidson (R-OH) at the Library of Congress event expressed a preference for preempting a “heavy-handed regulatory approach that could stall innovation and kill the U.S. ICO market.” This light touch approach is preferred by many, though it is balanced against an understood need to provide the industry with regulatory certainty.

The Congressional Blockchain Caucus has underscored that, while states have shown particular interest in using blockchain for asset tracking, land titles, and smart contracts using eSign technology, the technology could easily become fragmented without federal guidance and standardization.¹⁵ In addition, the National Institute of Standards and Technology’s Information Security and Privacy Advisory Board has called for greater federal guidance and standardization in blockchain to minimize the potential for a patchwork to develop as states pass laws with different approaches to the technology.¹⁶ That concern is timely, as most states have considered some sort of crypto-related legislation in the past year.¹⁷ A fractured system arguably would undermine the utility of blockchain by making it more difficult to conduct business across state lines.

RECOGNIZING THE ELEPHANT IN THE ROOM

Investment and interest in crypto tokens of all forms (from cryptocurrencies, to securities tokens, to other virtual assets) and other blockchain-related technologies have exploded over the past few years. Yet, as the number of asset classes represented as “crypto” has expanded, regulatory, legal, and risk-management constructs have not kept pace and remain in flux. All stakeholders—businesses, regulators, and investors—are facing the growing pains of this new technology in an uncertain, volatile environment.

Rep. Emmer’s and Rep. Davidson’s advocacy for a light touch approach seems to be emblematic of the balancing act Congress is trying to strike between regulating crypto tokens and blockchain technology, while not restricting their utility or hampering innovation. Before this balance can be struck, legislators and regulators must focus on furthering their understanding of, and developing their perspectives on, these new technologies. The path to smart public policy, as applied to crypto tokens, begins with a clear understanding that each crypto token is not merely a different view of the same elephant, but a representation of a distinct financial instrument or asset. As lawmakers and financial regulators work to better understand blockchain technology and crypto tokens, it is critical that industry participants share their knowledge and perspectives with policymakers on Capitol Hill and within the Trump Administration.

KING & SPALDING’S FINTECH, BLOCKCHAIN, AND CRYPTOCURRENCY PRACTICE

King & Spalding is uniquely positioned to assist clients with the risks, challenges, and opportunities associated with crypto tokens and blockchain technologies. The firm’s global FinTech practice allows for seamless coordination across countries and jurisdictions and is a one-stop shop for FinTech clients pursuing strategic transactions, regulatory compliance, and litigation matters. Our attorneys are experienced at working with FinTech companies across a variety of industry segments, including peer-to-peer and alternative lending, digital currency and blockchain technology, and mobile and online payments.



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¹ The Blind Men and the Elephant, Peace Corps, available at <https://www.peacecorps.gov/educators/resources/story-blind-men-and-elephant/>.

² In this article, we use the term crypto token to refer to the wide array of digital representations of value found on the blockchain (whether such token represents a currency, a security, a tangible asset, an intellectual property right, a loyalty point, or another asset or financial instrument).

³ See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>; Munchee Inc., Securities Act Release No. 10445 (ALJ Dec. 11, 2017) (order), available at <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>; Alexander Osipovich, *Judge Lets Cryptocurrency Fraud Case Go Forward, In Win for SEC*, Wall Street Journal (Sept. 11, 2018), available at <https://www.wsj.com/articles/judge-lets-cryptocurrency-fraud-case-go-forward-in-win-for-sec-1536704792>

⁴ See Press Release No. 7774-18, *CFTC Wins Trial Against Virtual Currency Fraudster*, CFTC (Aug. 24, 2018), available at <https://www.cftc.gov/PressRoom/PressReleases/7774-18>; Michelle Price, *U.S. Judge Sides with CFTC on Virtual Currency Oversight*, Reuters (Sept. 26, 2018), available at <https://www.reuters.com/article/us-usa-cftc-bitcoin/u-s-judge-sides-with-cftc-on-virtual-currency-oversight-idUSKCN1M62Z0>.

⁵ IRS Notice 2014-21, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

⁶ FinCEN Guidance, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies" (March 18, 2013), available at <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>

⁷ A token that represents a security derives its value in relation to the issuer of the security. A token that represents a means of exchange for the future purchase of goods or services (e.g., can be used to pay a fee on a protocol or platform, such as Ethereum, or purchase a good or service off of a blockchain) derives its value from the dollar value of the goods or services that can be purchased with such token.

⁸ CoinSchedule Cryptocurrency ICO Stats 2017, available at <https://www.coinschedule.com/stats.html?year=2017>.

⁹ This past February, in a watershed moment for the crypto community, the chairmen of both the SEC and the CFTC testified in a hearing on crypto tokens before the U.S. Senate Committee on Banking, Housing, and Urban Affairs. In one comment that drew headlines, Chairman Jay Clayton suggested that the two may very well be back to Congress with colleagues from other financial regulators to seek crypto-specific legislation. While that has yet to occur, there have been more bills introduced this year than there were in the entire preceding Congress.

¹⁰ See Release No. 34-49469, *Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934*, CFTC/SEC (March 25, 2004), available at https://www.sec.gov/rules/exorders/34-49469.htm#P33_2425.

¹¹ *Id.*

¹² To amend the Internal Revenue Code of 1986 to exclude from gross income de minimis gains from certain sales or exchanges of virtual currency, and for other purposes, H.R. 3708, 115th Cong. (2017).

¹³ FORWARD Act of 2018, H.R. 6562 Sponsored by Rep. Kevin McCarthy, Introduced in House on July 26, 2018 and referred to House Committee on Energy and Commerce (includes a section for a "Blockchain pilot program for hospital data security for coccidioidomycosis research").

¹⁴ Press Release, "Matsui, Guthrie Introduce H.R. 6913, the Blockchain Promotion Act of 2018" (Oct. 1, 2018), available at <https://matsui.house.gov/news/documentsingle.aspx?DocumentID=1819>.

¹⁵ *States Leading on Blockchain, But Is That the Best Route?*, MeriTalk.com (June 25, 2018), available at <https://www.meritalk.com/articles/states-leading-on-blockchain-but-is-that-the-best-route/>.

¹⁶ ISPAB, Final Minutes from June 21 and 22, 2018 meeting, at 15–16, <https://csrc.nist.gov/CSRC/media//Projects/ISPAB/documents/minutes/ispab-june-2018-meeting-minutes.pdf>.

¹⁷ See Cryptocurrency 2018 Legislation, National Conference of State Legislatures (July 5, 2018), available at <http://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2018-legislation.aspx>.