Cooley

Commissioner Peirce Proposes Token Safe Harbor for SEC and Industry Review

February 19, 2020

A way out of the 'regulatory Catch-22' for launching distributed networks?

In a February 6 speech at the International Blockchain Congress in Chicago, Securities and Exchange Commission Commissioner Hester Peirce introduced a proposed safe harbor designed to replace the existing uncertain and fraught regulatory landscape with a framework that offers token-based distributed networks some of the needed clarity and flexibility to launch a network, distribute tokens and support a network to maturity.[1]

The safe harbor attempts to address what Peirce and other industry commentators have diagnosed as a "regulatory Catch-22" with regard to the application of securities laws to the development of distributed networks. Peirce described this problem as follows: "would-be networks cannot get their tokens out into people's hands because their tokens are potentially subject to the securities laws. However, would-be networks cannot mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts unless the tokens are distributed to and freely transferable among potential users, developers, and participants of the network."[2]

As we describe more specifically below, the safe harbor provides for a three-year "grace period" during which the Initial Development Team[3] can distribute tokens, fully participate in and support the development of a functional or decentralized network and actively seek secondary market liquidity, recognized by Peirce as "necessary both to get tokens into the hands of people that will use them and offer developers and people who provide services on the network a way to exchange their tokens for fiat or crypto currency."[4] To do so, the safe harbor: (1) exempts the offer and sale of tokens from the application of the Securities Act of 1933, as amended, other than the antifraud provisions; (2) exempts tokens from registration under the Securities Exchange Act of 1934, as amended, and (3) exempts other network participants from being regulated as exchanges, brokers or dealers under the Exchange Act, allowing for the full and free operation of secondary trading platforms.

Peirce noted in her speech that she is "one of five commissioners [and she] cannot write the rules unilaterally" and emphasized that her proposal remained "a work in progress."[5] The proposed safe harbor presumably would need to garner sufficient support among her fellow commissioners, primarily from SEC Chairman Jay Clayton, to be added to the SEC's rulemaking agenda.[6] Unfortunately, this promises a long road ahead amid an agency that has shown little interest in adopting new rules to address this new technology and its uses, as demonstrated by the passage of nearly three years since Clayton labeled all tokens as securities with no subsequent meaningful helpful guidance from the SEC or its staff during that period.

Importantly, Peirce's speech and the safe harbor proposal make clear that at least one person at the SEC is listening and appreciates the "regulatory difficulties faced by people who want to build functioning token networks"[7] in compliance with law and regulation. Peirce clearly and concisely summarizes the limited options currently available to those seeking to launch a token network in light of the regulatory uncertainty her speech also outlines. The proposal is a promising development that demonstrates the limitations of the existing regulatory regime while articulating a potential framework for SEC oversight that balances the SEC's investor protection mission with a solution thoughtfully crafted to encourage rather than impede innovation.

Requirements of the proposed safe harbor

To qualify for the safe harbor, the project would need to meet the following five conditions:

1) Initial Development Team must intend the network to be fully decentralized or functional within three years and take reasonable efforts to achieve that end

The safe harbor requires that the Initial Development Team intend that the network reach Network Maturity[8] within three years of the first token distributions, and the Initial Development Team must make good faith and reasonable efforts designed to achieve Network Maturity, which Peirce believes can be achieved at the point of decentralization *or* functionality.

This first requirement, with its three-year transition period and clearly defined measures of Network Maturity appears intended to focus Initial Development Teams on achieving decentralization or functionality efficiently and effectively within the grace period. This builds off the SEC staff's prior guidance on the "mutability" of tokens, or the ability for token transactions to morph from regulated securities transactions to transactions that are outside the jurisdiction of securities laws once underlying networks become "sufficiently decentralized."[9] As the SEC staff has done on previous occasions, the proposed safe harbor focuses primarily on decentralization as the point at which transactions in a network's tokens should no longer implicate the securities laws, on the basis that a purchaser's "reliance on the efforts of others" as required by the *Howey* test is no longer present.[10] In her proposed rule, Peirce defines "decentralization" as the point at which "the network is not controlled and is not reasonably likely to be controlled, or unilaterally changed, by any single person, group of persons, or entities under common control."[11]

Peirce also presents "functionality" or "whether holders can use the tokens in a manner consistent with the utility of the network," as another path to Network Maturity.[12] Her speech reiterates her previously expressed view[13] that the tokens described in the two no-action letters submitted by TurnKey Jet and Pocketful of Quarters[14] relating to centralized networks and businesses are unlikely to implicate securities laws at all, yet the existence of these no-action letters could be interpreted to suggest otherwise. Accordingly, to clarify the regulatory landscape, the safe harbor proposes to extend the three-year grace period to those projects that may achieve functionality "as demonstrated by the ability of holders to use tokens for the transmission and storage of value, to prove control over the tokens, to participate in an application running on the network, or in a manner consistent with the utility of the network."[15]

2) Public disclosure of key information

The proposed safe harbor also requires specific disclosures intended to protect token purchasers and address information asymmetries. Importantly, because the Securities Act antifraud provisions remain applicable, these disclosure requirements also have some "teeth." To comply with the requirements of the proposed safe harbor, the Initial Development Team must disclose a range of information on a freely accessible public website, as well as commit to provide any subsequent material updates.[16]

This list of disclosures is notable for a few reasons. This is a clear acknowledgment that the disclosures that are likely to be material to a developer purchasing a token to build upon a particular network, or a user purchasing a token to participate in staking or to utilize the network's services, are significantly different and unique from the disclosures required by Regulation S-K and typical of a traditional registered securities offering. This list appears to be thoughtfully crafted to address the material information for a distributed network, and also acknowledges that those responsible for disclosures at launch may not be in a position to provide those same disclosures forever, once Network Maturity has been achieved at the point of decentralization.

Additionally, the safe harbor process does not require that the disclosures be submitted to the SEC's review and comment process typical of a registered offering. This has the effect of streamlining the launch process and also recognizes that much of the material disclosure relating to a distributed network project is objective, programmed into immutable code, and capable of review and audit.

3) Token must be sold for the purpose of facilitating access to, participation on or the development of the network

Peirce notes that this condition is "meant to clarify that the safe harbor is not appropriate for debt or equity securities masquerading as tokens."[17] This appears to reflect an intent to ensure that this safe harbor is designed for those launching a distributed network rather than selling digital assets that are simply digital representations of certain enumerated securities.

4) Initial Development Team must undertake good faith and reasonable efforts to create secondary market liquidity

The fourth requirement for the proposed safe harbor is that the Initial Development Team make efforts to foster secondary market liquidity and, to the extent these efforts result in the tokens being listed on trading platforms, that the Initial Development Team seeks out platforms that can demonstrate compliance with applicable federal and state law. Peirce's proposal again attempts a balancing act: allowing for liquidity and a broader distribution of tokens, while urging issuers to be diligent in selecting exchanges that implement meaningful compliance procedures that help guard against potential manipulative trading practices or unlawful activity.

The SEC staff has previously expressed a view that an issuer's promises or efforts to create secondary market liquidity are indicative of creating an expectation of profits under the *Howey* test.[18] As Peirce more accurately points out, however, liquidity is necessary to attempt to successfully overcome the regulatory Catch-22 discussed earlier and viewed by Peirce as important to aiding the development of these distributed networks. Accordingly, she has proposed secondary market liquidity as a requirement for reliance on the safe harbor. Users must have a safe and trusted means to obtain tokens. Developers must also be able to exchange one token for another to allow them to offer solutions or applications across multiple networks and to monetize their earnings to fund ongoing development, and to allow users or developers to migrate to platforms with better services, security or governance protocols, among other things. As recognized in traditional securities exchanges, secondary market liquidity with meaningful price discovery, engaged market makers and trusted technology results in reduced price volatility and may limit opportunities to market manipulation with higher volume markets, in each case, for the benefit of participants in those markets.

5) File a notice of reliance

The Initial Development Team must file with the SEC a notice of reliance on the safe harbor no later than 15 calendar days after the date of the first token sold in reliance of the safe harbor. Such notice shall contain:

- The names of the member of the Initial Development Team
- Date on which the first token was sold in reliance to the safe harbor
- Attestation by a duly authorized Initial Development Team member that the safe harbor conditions have been met
- Publicly available website where disclosures are available

Under Peirce's proposal, "a member of the team would have to attest that all the conditions of the safe harbor are satisfied," which, along with the continuing application of the antifraud protections of the Securities Act, could result in potential liability for material omissions or misstatements in the disclosure.

Who can take advantage of the proposed safe harbor?

The proposed safe harbor would be available for tokens that were previously sold in a registered offering or pursuant to an exemption under the Securities Act. While to date there have been no SEC-registered token offerings, projects which have previously issued tokens under exemptions, such as Reg D or even Reg A, would be able to take advantage of this safe harbor. For those that previously sold tokens, convertible instruments or instruments that would deliver tokens in the future pursuant to an exemption, Section (f) of the proposed rule appears to provide the full three-year grace period for the tokens previously sold and for future sales of tokens, on condition that public disclosures are provided and proper notice is filed as soon as practicable.

As currently proposed, tokens previously sold in offerings other than pursuant to an exemption would be unable to rely on this safe harbor, meaning that certain tokens sold generally to the public may still be subject to SEC enforcement actions and would not have the benefit of retroactive application to prior sales. Additionally, Initial Development Teams that include any individual subject to the bad actor disqualifications under SEC Rule 506(d) would also be unable to utilize the proposed safe harbor.

Projects must register if Network Maturity not achieved

Peirce states that the tests laid out in the safe harbor are meant as proxies for the considerations raised in the SEC's *Howey* analysis, such as those articulated in the Framework, and attempt to bring clarity on when a token transaction should not be considered a securities transaction by adopting clearer thresholds for Network Maturity and allowing for the tests to be applied after three years rather than when a network is first launched. If Network Maturity is not reached within three years, then the safe harbor is no longer available and all sales of tokens must be registered under the Securities Act and the class of tokens must be registered under the Exchange Act.

Notes

1. Hester M. Peirce, Commissioner, SEC, ***Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization*** (Feb. 6, 2020), (the "*Safe Harbor Proposal*").
2. The Safe Harbor Proposal.
3. "*Initial Development Team*" is defined in the Safe Harbor Proposal as "Any person, group of persons, or entity that provides the essential managerial efforts for the development of the network prior to reaching Network Maturity."
4. The Safe Harbor Proposal.
5. The Safe Harbor Proposal.
6. The safe harbor proposes a rule that could be adopted by the SEC, or Peirce suggests that it could be implemented through one or more no-action positions from SEC staff. As Peirce states, "a no-action position may be preferable to a rule because it would not concede that the token sales it covers fall within or outside of the securities laws… a rule-based approach would be more durable and would make clear that state laws do not apply." The Safe Harbor Proposal.
7. The Safe Harbor Proposal.
8. "*Network Maturity*" is defined in the Safe Harbor Proposal as "the status of decentralized or functional network that is achieved when the network is either: (i) not controlled and is not reasonably likely to be controlled or unilaterally changed by any single person, entity, or group of persons or entities under common control; or (ii) functional, as demonstrated by the ability of holders to use tokens for the transmission and storage of value, to prove control over the tokens, to participate in an application running on the network, or in a matter consistent with the utility of the network."
9. The SEC staff's view was first announced by SEC Corporation Finance Division Director William Hinman. William Hinman, ***Digital Asset Transactions: When Howey Met Gary (Plastic)***, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018). ("*When Howey Met Gary*").
10. See, e.g., When Howey Met Gary; SEC FinHUB, ***Framework for 'Investment Contract' Analysis of Digital Assets*** (April 3, 2019). ("*Framework*").
11. The Safe Harbor Proposal.
12. The Safe Harbor Proposal.

13. Hester M. Peirce, Commissioner, SEC, ***How We Howey*** (May 16, 2019). In discussing the TurnKey Jet no-action letter, Peirce commented: "This transaction is so clearly *not* an offer of securities that I worry the staff's issuance of a digital token no-action letter – the first and so far only such letter – may in fact have the effect of broadening the perceived reach of our securities laws. …I do not believe there was anything gray about the area in which TurnKey planned to operate, but issuing this letter may give the false impression that there was."
14. *See* **Turnkey Jet, Inc.**, SEC No-Action Letter (Apr. 3, 2019); **Pocketful of Quarters, Inc.**, SEC No-Action Letter (July 25, 2019).
15. The Safe Harbor Proposal.
16. The Initial Development Team must disclose:
    A. source code;
    B. a description of how to independently verify the transaction history of the network;
    C. a description of the token economics of the network, including information relating to:
        i. the supply of the tokens;
        ii. creating tokens, destroying tokens, validating transactions and the protocol's consensus mechanism;
        iii. governance mechanism for implementing changes to the protocol; and
        iv. information to create a tool for verifying the network's transaction history ("block explorer").
    D. the current state of development and timeline to achieve Network Maturity; and
    E. description of prior token sales.
    F. description of the Initial Development Team, including their background, tokens held by each team member, terms applicable to those tokens, and any rights to future tokens.
    G. the trading platforms on which the token trades; and
    H. description of any sale of more than 5% of the tokens held by each member of the Initial Development Team.
17. The Safe Harbor Proposal.
18. See, e.g., Framework (noting that one of the characteristics that made it more likely a purchase was relying on the "efforts of others" was when an Active Participant "has arranged, or promised to arrange for, the trading of the digital asset on a secondary market or platform.")

Key Contacts

Nancy Wojtas Palo Alto	nwojtas@cooley.com +1 650 843 5819
Alfred Browne Boston	abrowne@cooley.com +1 617 937 2310
Luke Cadigan Boston	lcadigan@cooley.com +1 617 937 2480
Patrick Gibbs Palo Alto	pgibbs@cooley.com +1 650 843 5535
Rodrigo Seira Seattle	rseira@cooley.com +1 206 452 8832