Securities Regulation Daily Wrap Up, TOP STORY—Commissioner Peirce lays out safe harbor for network developers and tokens, (Feb. 7, 2020)

Securities Regulation Daily Wrap Up

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To address the difficulties of distributing tokens without implicating the federal securities laws, the safe harbor would allow a three-year registration exemption for network development.

In a recent speech, SEC Commissioner Hester Peirce considered the issues associated with crypto entrepreneurs building decentralized networks while attempting to ensure that their token distributions do not fall under the federal securities laws. According to Peirce, the Commission's approach has made it difficult for a company to distribute a token without running into the question of whether it is engaged in a securities offering requiring SEC registration. As such, the commissioner proposed a safe harbor to address the uncertainty of the application of the securities laws to tokens while still protecting investors.

Ongoing concerns. Peirce noted that crypto entrepreneurs are seeking to build decentralized networks in which a token serves as a means of exchange or a function on the network and that they need to get the tokens out to others. However, as the SEC applies the *Howey* test to determine whether a security is involved in a transaction, the distinction between the token and a potential investment contract gets blurred. It can be difficult for a company to distribute tokens, which typically includes planning for the future of the network and talking about success without potentially implicating the existence of an investment contract. Some participants proceed with their token offerings and hope to convince the Commission that their networks are functional enough to avoid having their tokens deemed "securities" and others specifically rely on exemptions from registration.

"We have created a regulatory Catch 22," Peirce opined. Networks cannot get their tokens to others because they may be deemed securities, but they cannot mature into functional, decentralized networks efforts unless the tokens are distributed and transferable, the commissioner stated.

Safe harbor. According to Peirce, a safe harbor for networks would address the uncertainty of the application of the securities laws to tokens and achieve investor protection while still providing sufficient regulatory flexibility to support innovation. The safe harbor would provide network developers with a three-year grace period during which they could facilitate the development of a network while exempt from registration, subject to certain conditions. The developers would be required undertake good faith efforts to reach network maturity and would have to disclose key information on a freely accessible website, Peirce noted. The safe harbor requires source code and transaction history to be publicly available, she said, and the development team would have to describe the number of tokens to be issued in the initial allocation and the total number created and/or outstanding, as well as the token release schedule. Another key disclosure would be the development plan for the network, which would include information regarding the initial development team, she explained.

A token would need to be offered and sold for the purpose of providing for access to, participation on, the network to clarify that the safe harbor is not appropriate for debt or equity securities, the commissioner stated. Under the safe harbor, the development team would have to engage in efforts to create liquidity for users; this requirement recognizes that secondary trading is necessary to get tokens into the hands of users and to offer developers and service providers a means by which to exchange their tokens for fiat or other crypto currencies, according to Peirce. The team would also need to file a notice of reliance on EDGAR within 15 days of the first token sale in reliance on the safe harbor attesting to the fact that all the conditions of the safe harbor have been satisfied.

Bad actor disqualifications and the antifraud provisions would still apply, according to Peirce.

"Once the network cannot be controlled or unilaterally changed by any single person, entity, or group of persons or entities under common control, the token that operates on that network will not look like a security," she explained.

Peirce urged industry participants and the public to provide feedback on the proposed safe harbor framework.

"It is important to write rules that well-intentioned people can follow," she concluded.

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