Digital Token Sales Potentially Find Safe Harbor: SEC Commissioner Takes First Steps to Bridge Token Network Regulatory Gap

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On February 6, 2020, SEC Commissioner Hester M. Peirce delivered a speech [1] where she announced her plans to address the regulatory gaps that prohibit properly functioning token networks. Peirce noted that crypto entrepreneurs have tried building decentralized token networks where tokens can trade hands without ever going through a central authority. However, current securities laws potentially cover these token network transactions, and the lack of clarity (coupled with the SEC's aggressive enforcement) have chilled innovation in the token network space. The SEC has argued that tokens have the same characteristics as a traditional security and should be regulated as such, even if they lack the features of a typical investment contract. As a result, crypto entrepreneurs who offer tokens may unwittingly be engaging in what the SEC determines is an offering of securities, and potentially run afoul of any number of rules.

Peirce noted that there have been a number of solutions to address this problem. Entrepreneurs could: (1) release a white paper detailing the open-source code, mine the genesis block of tokens, and allow the network to grow on its own; (2) provide a formal offering of the tokens pursuant to current SEC rules or utilize an exemption; or (3) sever all ties with the U.S. to avoid the reach of the SEC and hope to avoid any unintentional investment activity within U.S. jurisdiction.

Peirce offered a new solution: create a safe harbor for token networks. The safe harbor would provide network developers with a three-year grace period within which they could facilitate participation in and the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws. The safe harbor would exempt (1) the offer and sale of tokens from the provisions of the Securities Act of 1933, other than the antifraud provisions; (2) the tokens from registration under the Securities Exchange Act of 1934; and (3) persons engaged in certain token transactions from the definitions of "exchange," "broker," and "dealer" under the 1934 Act. However, companies seeking to take advantage of the safe harbor would be required to (1) intend for the network on which the token functions to reach network maturity—defined as either decentralization or token functionality—within three years of the date of the first token sale, and undertake good faith and reasonable efforts to achieve that goal; (2) disclose key information on a freely accessible public website; (3) create tokens that must be offered and sold for the purpose of facilitating access to, participation on, or the development of the network; (4) undertake good faith and reasonable efforts to create liquidity for users; and (5) file a notice of reliance. However, Peirce commented that the safe harbor would not provide immunity from antifraud provisions found in federal and state law, and said her proposal includes a provision "designed to ensure that the SEC can bring suit against a team

that sets out to defraud token purchasers by materially misrepresenting or omitting key information. We all know that there are plenty of those kinds of 'projects' polluting the crypto space."

She also noted that, ideally, the safe harbor should be a part of a "no-action" position from the SEC, instead of a formal rule, so that the SEC would not be forced to admit that tokens are or are not securities and would give the industry time to further develop.

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[1] The speech was entitled "Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization."

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