SEC Commissioner Proposes Securities Laws "Safe Harbor" for Crypto Tokens

Over the past few years, significant excitement has surrounded the innovative promise associated with the development of blockchain networks and the crypto tokens most often used on them. However, the SEC has sent mixed messages to developers of such technologies about whether crypto tokens used on those networks will be deemed securities subject to onerous SEC regulation and oversight. This uncertainty has caused some to move development efforts outside the United States, and many others to bemoan what is viewed as yet another instance of regulators stifling innovation.

Last week, SEC Commissioner Hester Peirce fired a welcome shot in the debate, by releasing a proposed rule that would provide crypto token issuers with a three-year exemption from federal securities laws to allow them time to bring the underlying token networks to maturity. The proposed rule is intended to allow token issuers building decentralized networks to issue tokens in furtherance of such development without risk that the tokens will immediately become subject to certain securities laws.

Many in the cryptocurrency community have welcomed the proposed rule as a step in the right direction for the U.S. But Commissioner Peirce has yet to secure agreement from her four fellow commissioners, and it remains to be seen whether any can be convinced by her approach. Furthermore, while the proposal would assist new token issuers, it may not apply to the many more advanced token projects currently in operation, or to other actors in the cryptocurrency industry, who continue to face potential SEC enforcement actions related to past token issuances or activities relating to the trading, investment, and storage of existing tokens.

I. The "Regulatory Catch 22" for Issuers of Digital Tokens

Speaking at the International Blockchain Congress in Chicago on Thursday, February 6, 2019, Commissioner Peirce described the problem that her Proposed Securities Act Rule 195 seeks to tackle as follows:

> Many crypto entrepreneurs are seeking to build decentralized networks in which a token serves as a means of exchange on, or provides access to a function of the network. In the course of building out the network, they need to get the tokens into the hands of other people. But these efforts can be stymied by concerns that such efforts may fall within the ambit of federal securities laws.

The result, Commissioner Peirce noted, is a "regulatory Catch 22" where "the fear of running afoul of the securities laws is real."[1]

At the heart of the nettlesome issue of application of securities laws to digital tokens is the *Howey* test, which comes from the 1946 U.S. Supreme Court case *SEC v. Howey Co.*, 328 U.S. 293 (1946). In *Howey,* the Supreme Court interpreted the 1933 Securities Act's undefined term "investment contract" as a "scheme [that] involves an investment of money in a common enterprise with profits to come solely from the efforts of others." If a financial investment is deemed an "investment contract," then its issuance must comply with the 1933 Securities Act, including that the issuer provide extensive information about the issuance in a registration statement. As Commissioner Peirce notes, the threat of failing the *Howey* test has created significant uncertainty

[1] Hester Peirce, "Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization," February 6, 2020, U.S. Securities and Exchange Commission Speeches, available at https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06 ("Pierce February 6, 2020 Speech.")

and imposed stifling disincentives on decentralized network development: "would-be [token] networks cannot mature into a functional or decentralized network that is not dependent upon a single person or group," which, in turn, "has made it extremely difficult for a company to distribute a token."[2] Moreover, it is not only token issuers who have had to grapple with these concerns, but also custody providers, exchanges, and other services involved in the handling and transfer of digital tokens.

II. Inconsistent Enforcement of the *Howey* Test

The SEC's inconsistent application of the *Howey* test to digital tokens in recent years confirms the need for a more reasoned and consistent approach—be it some form of Commissioner Peirce's proposal or another one. The SEC has applied the test to bring dozens of enforcement actions against token issuers,[3] including the prominent cases of *SEC v. Kik Interactive*, No. 19-cv-5244 (S.D.N.Y., filed June 4, 2018),[4] and *SEC v. Telegram Group Inc. et al.*, No. 1:19-cv-09439 (S.D.N.Y., filed October 11, 2019).[5] In *Kik* and *Telegram*, as in other cases, the SEC has argued that the tokens qualify as securities under the *Howey* test, and are therefore subject to federal securities law and within the SEC's jurisdiction. In *Kik*, the SEC alleges that Kik's digital tokens, called Kin, are securities because Kik marketed Kin tokens as instruments that would gain value predominantly thanks to Kik's efforts to create, develop, and support the "Kin Ecosystem," which eventually would facilitate a marketplace where Kin could be used to buy goods and services. *Kik* Complaint at 3. Similarly, in *Telegram*, the SEC alleges that Telegram and a subsidiary marketed tokens called Grams to investors as instruments that would gain value thanks to Telegram's efforts to develop a TON "ecosystem" and implement a new TON Blockchain, and caused investors to expect to profit from Telegram's efforts to build the promised products. *Telegram* Complaint at 2.

Despite the SEC's arguments in *Kik* and *Telegram*, the SEC has simultaneously concluded that older projects that have already developed network ecosystems—ecosystems that share some similarities with the intended Kin and Gram networks—should be spared SEC enforcement actions. In particular, the SEC's Director of the Division of Corporation Finance, William Hinman, announced in a 2018 speech that the SEC does not view Ether, one of the very first digital tokens, as a security: "[P]utting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions."[6] Of course, that the SEC is now willing to "put[] aside the fundraising that accompanied the creation of Ether" is small comfort to issuers like Kik and Telegram that seek to raise funds in a similar manner to develop networks they hope will ultimately function independently, like Ethereum.

III. Commissioner Peirce's Safe Harbor Proposal

Commissioner Peirce opened her speech by offering a general view that "[i]t is important to write rules that well-intentioned people can follow."[7] She continued, "[w]hen we see people struggling to find a way both to comply with the law and accomplish their laudable objectives, we need to ask ourselves whether the law

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[2] *Id.*

[3] For a complete list, see "Cyber Enforcement Actions," U.S. Securities and Exchange Commission, available at https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

[4] Complaint, *U.S. Securities and Exchange Commission v. Kik Interactive*, available at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf ("Kik Complaint").

[5] Complaint, *U.S. Securities and Exchange Commission v. Telegram Group Inc. and Ton Issuer Inc.*, available at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf.

[6] William Hinman, "Digital Asset Transactions: When Howey Met Gary (Plastic)," June 14, 2018, U.S. Securities and Exchange Commission Speeches, available at https://www.sec.gov/news/speech/speech-hinman-061418.

[7] Pierce February 6, 2020 Speech.

should change to enable them to pursue their efforts in confidence that they are doing so legally."[8] As we recently wrote in a Law360 publication, the problem of regulatory uncertainty is well-recognized in the cryptocurrency industry.[9]

The proposed safe harbor will apply to the developers of digital token networks if they can meet five conditions: *First*, developers must intend for their network to reach maturity (defined as either decentralization or token functionality) within three years. This condition seeks to provide developers with a sufficient—but not unduly long—period in which to develop their network in a manner that ensures the tokens will not be deemed securities. *Second,* developers will not be completely immune to disclosure requirements, and will need to publicize key pieces of information, including the token source code and transaction history, as well as details regarding the number of tokens to be released and a schedule for their release. Developers will also be required to disclose any sale of five percent or more of their originally-held tokens. This condition seeks to ensure that tokens, while not subject to the full disclosure requirements of the securities laws, will be accompanied by sufficient information to educate would-be investors as to the nature and risks of investing. *Third,* the tokens must be offered and sold for the purpose of accessing, participating in, or developing a decentralized network. According to Commissioner Peirce, this requirement "is meant to clarify that the safe harbor is not appropriate for debt or equity securities masquerading as tokens."[10] *Fourth,* developers must make an effort to create liquidity for the tokens. This condition intends to ensure that the tokens will spread to users and be used to achieve the purposes of the network. *Finally,* developers must file a notice of reliance on the EDGAR website within fifteen days of the date the first token sale under the safe harbor, to memorialize their intention to rely upon the proposed rule.

While token developers meeting all five conditions would fall within the safe harbor, Commissioner Peirce's proposal would not provide complete immunity from regulatory oversight. For example, Commissioner Peirce has proposed that the SEC's antifraud authority would still apply (although as discussed below, this would be subject to the SEC satisfying the *Howey* test as to a given token), as would state fraud laws. Commission Peirce noted that the rule is attempting to balance "the need to achieve the investor protection objectives of the securities laws, as well as the need to provide the regulatory flexibility that allows innovation to flourish."[11]

IV. Industry Reception, and Concluding Thoughts

In effect, Commissioner Peirce's proposal would offer newer token issuances the same opportunity that Ether received, simply by virtue of its being issued before the SEC was focused on cryptocurrency. Many in the industry have welcomed this return to a time when valuable and innovative crypto projects were allowed more room to develop. J. Christopher Giancarlo, for example, a former Commissioner of the Commodities Future Trading Commission, has opined that "Commissioner Peirce deserves credit for not only advocating a path forward for decentralized token development, [but also] putting forth a specific framework meant to encourage innovation while maintaining the integrity of U.S. securities law and regulation."[12] Giancarlo noted that the proposed rule "would help promote investment in distributed ledger technology and its wider growth

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[8] *Id.*

[9] Michael Liftik, Dave Grable, and Heather Christenson, "The Pitfalls of SEC's Crypto Regulation by Enforcement," January 10, 2020, Law360, available at https://www.law360.com/articles/1231846/the-pitfalls-of-sec-s-crypto-regulation-by-enforcement.

[10] Pierce February 6, 2020 Speech.

[11] *Id.*

[12] Philip Rosenstein, "SEC's Peirce Proposes 3-Year Crypto Safe Harbor," Law360, available at https://www.law360.com/fintech/articles/1241490/sec-s-peirce-proposes-3-year-crypto-safe-harbor

and adoption in the United States, while still protecting investors by providing them with the information they need to make an informed decision."[13]

Several obstacles remain, however. As Commissioner Peirce herself noted in an interview after the speech, she is "just one person at the commission," and has not spent a lot of time "shopping" the proposed rule with her SEC colleagues.[14] Moreover, even if implemented, the proposal is unclear in some respects, and limited in others. It is not clear, for example, what treatment the SEC would apply to a development team that tried—but failed—to bring a network to maturity by the time its three-year period expired. The prospect of retroactive liability for conduct during the development period could dampen much of the encouragement the rule is intended to provide. Similarly, the rule's intended reservation of the SEC's antifraud powers means the SEC could still invoke the *Howey* test (with all its attendant uncertainty) anytime it took the view that "anyone [had] lied in connection with selling tokens pursuant to the safe harbor."[15] This reservation would continue to loom over developers, even where they were confident of meeting the conditions of the proposed rule.

Further, the proposal may prove too rigid or unattractive for some network developers. For example, the "Token Economics" disclosures—which are to include "information . . . explaining the release schedule for tokens"—may not appeal to developers who do not wish to lock in such matters at the outset of the development process, before the network has had the chance to grow following initial issuance. And future disputes over whether "Network Maturity" has been reached at the end of a given token's three-year grace period could become a significant new battleground—essentially kicking the dispute can down the road.

Commissioner Peirce also admits that the proposal would address only one set of legal issues facing many in the crypto industry. Industry participants besides token issuers have also been struggling to follow unclear SEC guidance on other issues, including those seeking to launch cryptocurrency-based exchange traded funds; to provide secure custody solutions for digital assets; and to offer different kinds of trading platforms for digital assets (including many issued without the benefit of Commissioner Peirce's proposal). Commissioner Peirce's potential rule change would not solve the problems these projects are facing.[16]

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to us:

Dave Grable (Los Angeles) Email: davegrable@quinnemanuel.com Phone: 213-443-3669	**Emily Kapur (Silicon Valley)** Email: emilykapur@quinnemanuel.com Phone: 650-801-5122
Michael Liftik (Washington D.C.) Email: michaelliftik@quinnemanuel.com Phone: 202-538-8141	**Toby Futter (New York)** Email: tobyfutter@quinnemanuel.com Phone: 212-849-7431

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[13] *Id.*
[14] *Id.*
[15] Pierce February 6, 2020 Speech.
[16] *Id.*