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CryptoMom to the Rescue: SEC Commissioner Peirce Proposes a Crypto Token Offering Safe Harbor

The enforcement offensive of the U.S. Securities and Exchange Commission ("SEC") against initial coin offerings ("ICOs") of digital assets—called coins or tokens—is ongoing. The SEC brought high-profile enforcement actions against Kik Interactive Inc. ("Kik") and Telegram Group Inc. ("Telegram") in 2019. The SEC alleged that the Kik and Telegram tokens were in fact securities within the meaning of the U.S. securities laws and that Kik and Telegram should have registered them under the Securities Act of 1933 ("Securities Act").

The SEC's "regulation by enforcement" approach has been widely criticized, and the attempt to provide more guidance to token issuers in the SEC's *Framework of Investment Contract Analysis of Digital Assets* fell flat. Among the critics of the SEC's approach is SEC Commissioner Hester Peirce, affectionately known as "CryptoMom" to the crypto community. In *How We Howey*, Commissioner Peirce pointed out that the *Framework* lists 38 factors, some with sub-points, that the SEC considers important in evaluating whether a token is a security. Rather than aiding planning and providing a clear road map for the application of the federal securities laws to digital assets, the *Framework* is more likely to frustrate attempts at compliance and stifle innovation, while unjustly enriching securities attorneys.

In an attempt to fill this regulatory void, Commissioner Peirce just proposed a "safe harbor" for token offerings in a February 6, 2020 speech to the International Blockchain Congress in Chicago. If adopted by the SEC, such a safe harbor would go a long way toward addressing the shortcomings of the SEC's current approach by providing some clear guidance and a pathway to compliance that are tailored to the crypto industry.

Commissioner Peirce's proposal for exempting token offerings from registration as an offering of securities includes several components: disclosure, a three-year grace period for network development, liquidity, "bad actor" disqualification, state law preemption, and non-exclusivity.

To recap the federal securities law applied by the SEC to token offerings, a token or other digital asset may be a "security" within the meaning of the Securities Act because of the 1946 Supreme Court Case *SEC v. W.J. Howey Co.* ("*Howey*"). An "investment contract" is included in the Securities Act's definition of a security. In *Howey*, the Supreme Court defined an "investment contract" as an investment of money in a common enterprise with an expectation of profits, derived solely from the entrepreneurial and managerial efforts of others. In the *Framework* and a number of enforcement actions, the SEC has emphasized the "expectation of profits" and "efforts of others" prongs of the *Howey* test. As the latter, a sufficiently developed and decentralized network for the tokens should mean that the purchaser of a token in an offering is not relying on the management efforts of the initial sponsor or issuer of the tokens.

Commissioner Peirce's proposal aims to protect the investing public with extensive disclosure that is tailored for relevance to the digital asset space. To take advantage of the exemption from registration safe harbor, issuers of tokens would be required to disclose: the token project's source code, transaction history, token economics, roadmap and a history of past token sales. In addition, the names and experience, qualifications, attributes or skills of each member of the token development team, as well as their token holdings (and potential awards) would be required to be disclosed. The exemption would apply to the registration requirements of the

Securities Act, but the anti-fraud provisions of the federal securities laws would continue to apply, according to Peirce.

Her proposal would permit the initial issuance of a token that has security-like attributes if a mature network for the functioning of the token is developed within three years. The development team would have three years to achieve "network maturity," such that the token has utility in the network and is no longer a security meeting the *Howey* test. "Network maturity" would mean that the developed network (i) is "not controlled and is not reasonably likely to be controlled" by a single entity or individual, but (ii) is operational.

Peirce also proposes that token liquidity would be an aspect of the exemption, in direct opposition to the SEC's existing position that the ability to trade a token on an exchange is probative of the "expectation of profits" prong of *Howey*. Her reasoning is that secondary trading is "necessary both to get tokens into the hands of people who will use them and offer developers and people who provide services on the network a way to exchange their tokens for fiat or cryptocurrency." Liquidity would require the listing of the token on an online crypto trading platform (colloquially called "exchanges") that is compliant with federal and state money transmission and other laws and regulations.

"Bad actors," as currently defined in Rule 506(d) of SEC Regulation D, would not be permitted to use the exemption for token offerings.

The new safe harbor exemption would preempt state securities laws and would not be exclusive. Projects could still avail themselves of the exemptions under Regulation D, Regulation S or Regulation A. Finally, the exemption would not apply to existing token projects, but only new projects.

Time will tell whether the SEC will adopt Commissioner Peirce's proposal. Adoption of Peirce's safe harbor by the SEC would represent a step in the direction of less "regulation by enforcement" and would update *Howey's* 1946 test for the crypto age. Offering a degree of regulatory certainty for the crypto industry is sure to lead to more innovation and attendant benefits to the U.S. economy.

Additional Information

If you have any questions regarding this Client Alert, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at www.KutakRock.com.

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