We Should Support the Proposed Blockchain Token Safe Harbor

By Lee A. Schneider[1]

The application of the US federal securities laws to blockchain tokens has been a controversial subject, with the Securities and Exchange Commission (SEC) taking an aggressive posture. On February 6, 2020, SEC Commissioner Hester Peirce proposed a non-exclusive safe harbor from certain of those laws for sales and other distributions of certain blockchain tokens (sometimes called token generation events, airdrops, SAFTs, ICOs or IEOs), as well as secondary trading in such tokens. Token sales became a popular tool in 2016-17 for blockchain projects to seek to gain initial traction for their network or platform by selling the digital item native to the platform (colloquially known as a "token"). Projects sold tokens to achieve the primary benefits of jump-starting usage of their platform by putting tokens in users' hands and providing a source of revenue or funding for the continued development of the platform. A vibrant secondary trading market in tokens has developed through "exchanges" and peer-to-peer.

Despite good intentions, token sales also were a vehicle for the unscrupulous. Bad actors did what they always do: they exploited people by fraudulently stealing their money with extravagant promises they had no intention of fulfilling. This unfortunate situation was the cause of great distress for the many good actors in the blockchain community but, more importantly, it quite rightly raised the hackles of regulators such as the SEC. The SEC's response, some have argued, went overboard in seeming to characterize virtually all token sales as the offer and sale of a security. On the other hand, the SEC wanted to stop fraudulent activity, so they began a tough campaign of public statements and enforcement activities for the right reason: investor protection.

The result of the SEC's actions has been confusion as to the US securities law analysis, particularly with respect to the definition of the term "investment contract," an asset listed as a type of security under the federal securities laws. The term received its first definitive treatment in the so-called *Howey* case, an opinion by the Supreme Court in 1946 that created the test for when a "contract, transaction or scheme" is an investment contract and therefore subject to the full slate of securities laws around their offer, sale and secondary trading. Everyone in the blockchain space knows the test and *Howey* is arguably the most well-known Supreme Court case amongst the tech community, which no law student from 1946 to 2016 ever would have predicted.

As everyone has sought to hash out what *Howey* means and when the securities laws apply to tokens, token sales and secondary trading, there has been much more confusion and uncertainty than clarity and unity. This unfortunate situation has hindered the development of blockchain projects and related technologies, a source of tremendous innovative potential. Some key questions that are leaving the community perplexed include: (1) when must a token sale comply with public offering rules; (2) must miners register as broker-dealers because they record transactions in the token on the blockchain; (3) is every movement of a token on a blockchain a securities transaction subject to

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securities fraud claims, even if for blockchain operational purposes; (4) what disclosures are required, by whom and in connection with which sales or movements of tokens; and (5) must you have certain licenses to hold tokens and/or transact on behalf of another person?

Boldly stepping into the breach is Commissioner Peirce, who should be roundly applauded for her capacity to listen to all sides of the debate and come up with an excellent proposal. As the proposal of a single Commissioner, her draft safe harbor would require action by the full SEC. Hopefully that will occur in the form of a permanent rule that adds this safe harbor to the many others already in existence for a variety of situations that arise under the securities laws. Here are five non-partisan reasons everyone should support Commissioner Peirce's proposed non-exclusive safe harbor and the SEC should promulgate a rule to adopt it.

1. Just because something is an investment, does not mean it is an investment contract or other type of security.

This basic notion has been lost as a result of the token sale craze, and the law in the United States is the poorer for it. How do we know that under US law not all investments are securities? We just need to look at the Commodity Exchange Act and the rules promulgated thereunder. Congress has made a clear delineation between securities and commodities and created two different sets of laws enforced by two entirely separate commissions (the SEC for securities and the CFTC for commodity futures and derivatives). This distinction survived Gramm-Leach-Bliley, it survived Sarbanes Oxley and it survived Dodd Frank. Courts have also been clear on the demarcation.

It also survives because of common sense. It would strain credulity (to use a phrase litigators are fond of) to consider investments in works of art, in collectibles and in rare books to fall within the definition of security. The SEC has never argued differently.

Moreover, many types of blockchain tokens are not even an investment. As highlighted in the next point, a blockchain token can be anything. Since not everything in the world is an investment, there will be blockchain tokens that exist for entirely other purposes.

The safe harbor proposal recognizes that there are other types of investments beyond securities, and indeed items that are not an investment at all, while also recognizing that sometimes it is hard to tell. Rather than seek to draw ever finer distinctions that cannot provide the basis for realistic application of the federal securities laws, much less their enforcement, the proposal creates a middle way. Similar motivations were behind the creation of the safe harbor in Rule 144 around when a seller of securities will not be considered an underwriter due to the lapse of time, the creation of Regulation ATS concerning when a trading system is not an exchange, and the promulgation of Regulation D for determining when a securities offering constitutes a private sale not subject to registration.

2. A blockchain token can be anything because it is digital.

The importance of this foundational notion cannot be overstated, and it makes attempts to create "one size fits all" regulation or policy futile if not counterproductive. The core of this idea stems from the digital world itself and is one reason blockchain is powerful. In the virtual world, everything is digital, which means that everything is a digital representation of either a tangible item (something from the physical world like gold or coffee mugs or an automobile) or an intangible item (the product of human imagination like stock in a company or a software license or user search history).

Intangible items are easier to create digitally because it is just a new technology used to represent something that might previously have existed on paper. Tangible items need to be linked to their digital representation through some sort of promise to hold or deliver the physical thing. But in all cases, the representation can exist digitally on any type of database, including a blockchain ledger. Proponents view blockchain ledgers or databases as inherently superior to other forms of databases due to their ability to create digital uniqueness, which prevents forgery of digital items.

For our purposes, the key point is that if we do not understand the functions and features of the digital item, then we cannot understand its utilization, valuation, legal classification or regulatory status. The safe harbor allows us to simplify the regulatory approach when it comes to securities laws. It does not prevent anyone from saying that their token is not a security based on the token's functions and features, but it does allow both regulators and participants get a project moving while still providing protections (through disclosure requirements and anti-fraud provisions) for purchasers of tokens.

3. Too much of the terminology people seek to use in their investment contract analyses is not subject to easy or consistent definition.

From the latter half of 2016 to the present, there have been several fads in terminology as people argued about when a token or a token sale does not meet the *Howey* test. Perhaps most popular has been the concept of "sufficient decentralization." The idea was that a sufficiently decentralized blockchain did not meet the "efforts of others" prong of *Howey* by virtue of the fact that there was no central authority whose efforts were responsible for the expectation of profits. Exactly what constitutes sufficient decentralization has never been made clear by the proponents of this idea and there is no generally accepted definition in the technology sphere, much less among blockchain experts. Moreover, it seems to imply that all tokens created by centralized blockchains would be securities, which defied logic for reasons stated above and from the simple concept that all other database technologies were centralized and no one argued that the assets sitting on them, like bank loans, books and music, or hospital records, were by definition securities because of the manner in which they were sold.

Another problematic definitional attempt was the idea that any "fundraising" was a securities offering and because token sales raised funds for the seller, the tokens were securities. Note that the proponents here did not use "capital raising" but the more generic fundraising. A capital raising is much clearer as it requires that the asset sold is part of the legal entity's capital stack. A fundraising could mean anything, including sales of goods or services that raised revenue for the company. As with sufficient decentralization, fundraising left too much uncertainty.

A final example of a troublesome term is "Initial Coin Offering" itself. "Initial" seemed to imply "first" but often the term ICO was used to refer to a second, third or fourth sale or generation of tokens. "Coin" seemed to imply some type of currency functionality to the digital item but many of the tokens did not have any currency-like function, or the currency aspect was fairly limited to a particular context or purpose and the token also provided other benefits. Finally, "offering" suggested the sale of tokens when many times the tokens were being generated without a sale or pursuant to a sale in the past.

Once again, Commissioner Peirce's drafting saves the day with solid definitions that are generally easy to understand and apply.

4. Blockchain technology may change the world but that doesn't mean it should change the law.

Blockchain is a database technology that allows for digital uniqueness. This simple idea has powerful implications for the digital realm by creating certainty around ownership and transfer of digital assets. Among other things, it secures the internet, ushering in new possibilities for digital commerce, communications and identity.

All of this potential does not mean that the law needs to change. While there may be impacts on concepts in law and regulation from digital uniqueness and the flexibility it allows, we should not suspend well-known legal constructs. A pair of shoes on blockchain is still a pair of shoes. A stock on blockchain is still a stock. A blockchain-based crowd-sourcing campaign on Kickstarter, Indie Go-Go or GoFundMe is no different from one relying on a traditional database technology. The laws of physics are not suspended and nor should our utilization of most other laws.

This article is not the place to delve into the arguments around when tokens are securities and when their manner of sale creates an investment contract, most especially because the proposed safe harbor is not asking us to suspend existing laws. Rather, it takes on the hard problem of how different constituencies interpret those laws and finds common ground through a clear compliance framework. It leverages several time-tested mechanisms of investor protection (a disclosure regime and liability for fraud). It creates a path for new projects and tokens while allowing existing projects and tokens to become compliant through the same series of steps. It brings the rigor and standardization we expect from securities laws without undue complexity or stifling innovation.

5. The safe harbor provides certainty and ease of application, which should never be underestimated, but it also does not allow for fraud.

In light of the general uncertainty described above and experienced in much greater variety and detail by the blockchain and regulatory communities, the safe harbor proposal puts everyone on much more solid footing. We now have definitions for key terms, clear time frames for action, comprehensible disclosure and filing requirements, and investor protection both from the disclosures and the threat of securities fraud regulatory enforcement and private class actions.

One should not let perfection be the enemy of the good and there is a lot that is good about providing certainty, understandability and ease of use, while preserving flexibility to proceed with other structures (the safe harbor is non-exclusive) and enforcement against fraudulent activity.

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After the turmoil of the past several years, Commissioner Peirce's safe harbor gives everyone hope for a brighter future. It won't cure the coronavirus or solve world hunger but it will improve the blockchain corner of the digital world. Let's get behind the effort and adopt the safe harbor as a rule.