HERBERT SMITH FREEHILLS

CREATING A SAFE HARBOR BEFORE THE DIGITAL TOKEN SHIP SAILS

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Legal Briefings

As regulators wrestle with how to treat the emerging class of post-blockchain digital assets, we assess US proposals for a grace period

As we continue to witness the transformation from tangible to digital assets, countries around the world are grappling with the question of how to regulate these new asset classes and, of course, the platforms and service providers that underpin them.

The issues is that digital assets, particularly smart contracts, can be algorithmically programmed with any number of different features, making it difficult to find neat regulatory classification boxes from the “old world” of financial products and markets. This means that the ability to apply relevant licenses, authorisations, registrations and reporting regimes across to the digital medium is a challenge that currently has no easy answer.

Yet the absence of a simple solution is not an excuse to do nothing. Regulators have, rightly, been clear that digital assets are not exempt from regulatory oversight and will be subject to regulatory action if non-compliant.

Less clear is how to practically license and register digital asset products and services. In many respects we are already witnessing a game of 'regulatory catch up'. This is simply because increasingly complex, new and creative methods of economic interaction, from fractionalised fundraising to yield farming, or from tethering and stable coins to non-fungible token (NFT) trading platforms, are yet to successfully reconcile to the traditional regulatory process. This is especially true in respect of products and services with functionality resembling securitisation. It is also evident amongst an increasingly frustrated cohort of crypto enthusiasts unwilling to become embroiled in regulatory test cases, but crying out for clear direction and legal processes.

Against this backdrop, earlier this year the Commissioner of the US Securities and Exchange Commission ("SEC"), Hester Peirce, announced an update to her proposal for a digital token "safe harbor" period. Peirce's proposal, if adopted, would provide those engaging in token generation events—such as Initial Coin Offerings ("ICOs")—with a three-year grace period during which they are exempt from SEC regulations.

Suffice it to say that regulators across the globe are watching with interest as to whether this approach may be something of a panacea to this digital regulatory maelstrom.

All of this means that over the next 18 months it would be reasonable to expect an uptick in regulatory clarity globally. In the interim, a US Style moratorium on prosecutorial action may be required to alleviate genuine concerns by legitimate digital actors that doing the right thing is easier said than done.

The safe harbor proposal would allow a startup three years to establish a decentralised blockchain network before, for example, needing to evaluate whether it complies with applicable securities laws, or if its token(s) still satisfies the definition of a security. While the approach is not without risk, as it may provide opportunity for scammers to operate during the moratorium period, the attraction of this approach is that it will buy some time for regulators and legislators to get the digital house in order. If other countries chose to follow suit, they may also decide to provide a shorter period of no-action.

To determine whether a network is sufficiently decentralised, Peirce's updated proposal provides for greater transparency to enhance token purchaser protections, and guidance and clarity on how developers can demonstrate their project is operational. Developers must provide semi-annual updates to the development disclosure plan, a block explorer to allow investors to view transactions recorded on the blockchain for financial transparency and an exit report. The exit report must include either (i) analysis by outside counsel explaining why the network is sufficiently decentralised; or (ii) an announcement that the tokens will be registered as securities under the Securities Exchange Act of 1934.

The proposal guides counsel in their analysis of whether the network is decentralised. Rather than a set check list, it balances guidance with flexibility for individual facts and circumstances including voting power, development efforts, and network participation. The exit report must explain how the initial development team's pre-network maturity activities are distinguishable from its ongoing involvement with the network. The initial development team cannot be the unique driver of value, and all material information about the network must be publicly available, and not solely known to the initial development team.

Whatever happens, it is indisputable that the world is undergoing a rapid digital transformation.. The fusing of people, process and technology, on a global scale, is fundamentally changing the way business is done - optimising existing business models and creating new sources of value. The spotlight focusing on how that business is concluded – and regulated – will be shining brightly for some time to come.

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