

## I. Introduction

The U.S. Securities and Exchange Commission (“SEC”) should foster financial competition by enacting a safe harbor proposal for blockchain technologies. This paper will argue that the current regulatory approach from the SEC is contradicting the tripart mission of the SEC.<sup>1</sup> That this approach creates, lose-lose situations<sup>2</sup>, and does not incentivize competition<sup>3</sup> or innovation. Next the paper will consider a safe harbor proposal from SEC Commissioner Hester Peirce, and analyze if this safe harbor proposal would or would not support the goals of the SEC. Finally, this paper will argue that Commissioner Peirce’s proposed safe harbor better supports the mission of the SEC than do current enforcement and policy decisions.

Blockchain-based companies envision experimental new ownership structures based upon community involvement and rewarding creators of content and value. It remains to be seen whether such experimental ownership structures such as DAOs (decentralized autonomous organizations) will come to fruition. Regardless, projects have been soliciting capital and investors have been providing it. But the question is often, what are investors buying? Is it a new network that facilitates consumptive value or is it a form of equity that should be regulated as a security?

If you agree that network industries should be regulated differently than the trading of equities, then you might agree that determining if a project is a network or security is important so that the correct regulation can be applied. A network will usually gain efficiency and market power as adoption grows and more people join the network. However, equity works differently—Berle-Means type of problems may develop when ownership and management are separated among a diverse group of owners. Thus, the optimal amount of network users and the optimal amount of stockholders are very different numbers.

This fundamental critique of how many participants or owners are necessary for a successful network goes to the heart of the differences between regulating equity markets and regulating networks. For equity, it makes sense to have relatively few owners. However, a successful network requires many users. Thus, regulating innovative potential networks like equity creates problems.

Lastly, one commentator argues that “[t]he conflicting approaches amongst US regulatory agencies reflects the lack of larger regulatory framework. While permissionless innovation has helped spawn the innovation, regulators left unchecked will seek new things to regulate. In the past the bumbling approach may have mattered less, but today the US faces an existential economic and security crisis with China, which is determined to supersede America. Seeing that the US doesn’t have its crypto act together, China has moved to issue its own digital currency, build a blockchain ledger from it, and pilot the technology’s use in its domestic economy. . . . Congress should step up in 2021 and make the proper framework for cryptocurrency to ensure US leadership and clarify regulatory boundaries.”<sup>4</sup>

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<sup>1</sup> Robert J. Jackson, Jr., *Competition: The Forgotten Fourth Pillar of the SEC’s Mission* U.S. SEC. EXCH. COMM. (Oct. 11, 2018), [https://www.sec.gov/news/speech/speech-jackson-101118#\\_ftn18](https://www.sec.gov/news/speech/speech-jackson-101118#_ftn18).

<sup>2</sup> Rick Steves, *SEC V. RIPPLE LAWSUIT MIGHT PROVE XRP CAN’T BE CONTROLLED, GRUNDFEST INTERVIEW* FINANCE FEEDS (March 10, 2022), <https://financefeeds.com/sec-v-ripple-lawsuit-might-prove-xrp-can-t-be-controlled-grundfest-interview/>.

<sup>3</sup> Robert J. Jackson, Jr., *Competition: The Forgotten Fourth Pillar of the SEC’s Mission* U.S. SEC. EXCH. COMM. (Oct. 11, 2018), [https://www.sec.gov/news/speech/speech-jackson-101118#\\_ftn18](https://www.sec.gov/news/speech/speech-jackson-101118#_ftn18).

<sup>4</sup> Roslyn Layton, *SEC V. Ripple: The Cryptocurrency Trial Of The Century* FORBES (Dec. 29, 2020), <https://www.forbes.com/sites/roslynlayton/2021/12/29/sec-v-ripple-the-cryptocurrency-trial-of-the-century/?sh=19f6fbff5417>.

But, at the inception of either equity or a network it may be incredibly difficult to determine if the instrument or token is equity or a network (or both). That is why some kind of incubation period or separate regime that allows for experimentation could be beneficial in driving innovation and value to consumers. For these reasons, the SEC should foster financial competition by enacting a safe harbor proposal for blockchain technologies.

## II. Introduction To The '33 Act.

The stock market crash in 1929 is often credited as the impetus for federal securities regulation which began with the Securities Act of 1933 (“The '33 Act”).<sup>5</sup> The '33 Act defines “security” inclusively as “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement . . .”<sup>6</sup> This already expansive definition has been further “clarified” and expanded in subsequent case law.<sup>7</sup> However, this test generally boils down to the *Howey* test, especially for digital assets.<sup>8</sup>

The *Howey* test is defined by four elements, if these four elements are met then the asset is considered an “investment contract” and thus a type of “security” per the statutory definition in the '33 Act.<sup>9</sup> Any attempted sale of a security is subject to the “gun jumping” rules in section five of the '33 Act.<sup>10</sup>

The '33 Act section five broadly requires federal registration and mandatory disclosure to sell securities.<sup>11</sup> These mandatory disclosure rules are often referred to as “gun jumping” rules.<sup>12</sup> It should be noted that this is regulation of the “primary” market, as opposed to the “secondary” market.

Generally speaking, the SEC has justified regulation of the primary market on two grounds, 1) so that investors receive significant financial information concerning securities being offered for public sale, and 2) to prohibit deceit, misrepresentations, and other fraud in the sale of securities.<sup>13</sup>

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<sup>5</sup> *A Brief History of Securities Regulation* WIS. DEP'T OF FIN. INST.S, <https://www.wdfi.org/fi/securities/regexemp/history.htm> (last visited Mar. 26, 2022); *see also* 15 U.S.C. § 77(a) (2021).

<sup>6</sup> *See* 15 U.S.C. § 77(b).

<sup>7</sup> *See generally Framework for “Investment Contract” Analysis of Digital Assets* U.S. SEC. EXCH. COMM., <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> (last visited Mar. 26, 2022); *see generally* S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946); *see generally* Reves v. Ernst & Young, 494 U.S. 56 (1990); *see generally* S.E.C. v. Merch. Cap., LLC, 483 F.3d 747 (11th Cir. 2007).

<sup>8</sup> *See generally Framework for “Investment Contract” Analysis of Digital Assets* U.S. SEC. EXCH. COMM., <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> (last visited Mar. 26, 2022); *see generally* S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946).

<sup>9</sup> *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298 (1946); *see* 15 U.S.C. § 77(b).

<sup>10</sup> *See generally* 15 U.S.C. § 77(e).

<sup>11</sup> *Registration Under the Securities Act of 1933* U.S. SEC. EXCH. COMM., <https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933> (last visited Mar. 26, 2022); *see also* 15 U.S.C. § 77(e).

<sup>12</sup> *gun jumping* **LEGAL INFO. INST. CORNELL L. SCH.**, [https://www.law.cornell.edu/wex/gun\\_jumping](https://www.law.cornell.edu/wex/gun_jumping) (last visited Mar. 26, 2022); *see also* *Section 5* **LEGAL INFO. INST. CORNELL L. SCH.**, [https://www.law.cornell.edu/wex/gun\\_jumping](https://www.law.cornell.edu/wex/gun_jumping) (last visited Mar. 26, 2022).

<sup>13</sup> *See Registration Under the Securities Act of 1933* U.S. SEC. EXCH. COMM., <https://www.investor.gov/introduction-investing/investing-basics/glossary/registration-under-securities-act-1933> (last visited Mar. 26, 2022).

### **III. The Tripart Mission of the SEC.**

The '33 Act does not explicitly specify a “mission” for the SEC. The Federal Register website describes the SEC as follows: The SEC “administers Federal securities laws that seek to provide protection for investors; to ensure that securities markets are fair and honest; and, when necessary, to provide the means to enforce securities laws through sanctions.”<sup>14</sup> However, this expression of the “mission” changes over time and is different than SEC “goals.”<sup>15</sup>

The “Our Goals” section of the SEC website includes a three-part mission that is similar to the mission in the Federal Register.<sup>16</sup> The three-part mission in “Our Goals” states the following: 1) “Focus on the long-term interests of our Main Street investors”; 2) “Recognize significant developments and trends in our evolving capital markets and adjust our efforts to ensure we are effectively allocating our resources”; and 3) “Elevate the SEC’s performance by enhancing our analytical capabilities and human capital development.”<sup>17</sup> Older public materials such as the listing in the Federal Register emphasize enforcement while modern materials emphasize the need to recognize “significant developments and trends in our evolving markets[.]”<sup>18</sup>

### **IV. What are Initial Coin Offerings (ICOs)?**

In 2017 and 2018 there was a craze in what was colloquially referred to as Initial Coin Offerings (“ICOs”), due to new technology which allowed for tokens to be easily launched; the term ICO is also nearly synonymous with unregistered securities offerings. It is estimated that nearly \$4 billion was raised by ICO projects between October and November of 2017.<sup>19</sup>

SEC Chairman at the time, Mr. Clayton, responded to the ICO boom in a speech in 2018 where he characterized many of the “cryptocurrencies” for sale as securities: he stated “many products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that rely on the efforts of others, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic.”<sup>20</sup> Chairman Clayton elaborated that “if a cryptocurrency, or a product with its value tied to one or more cryptocurrencies, is a security, its promoters cannot make offers or sales unless they comply with the registration and other requirements under our federal securities laws.”<sup>21</sup> This is standard rhetoric for the SEC in response to the sale of unregistered securities.

### **V. The Forgotten Fourth Pillar of Competition.**

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<sup>14</sup> *Securities and Exchange Commission* FED. REG., <https://www.federalregister.gov/agencies/securities-and-exchange-commission> (last visited Mar. 27, 2022).

<sup>15</sup> See generally *What We Do* SEC. EXCH. COMM., <https://www.sec.gov/about/what-we-do> (last visited Mar. 27, 2022).

<sup>16</sup> *Our Goals* SEC. EXCH. COMM., <https://www.sec.gov/about/what-we-do> (last visited Mar. 27, 2022).

<sup>17</sup> *Our Goals* SEC. EXCH. COMM., <https://www.sec.gov/about/what-we-do> (last visited Mar. 27, 2022).

<sup>18</sup> *Our Goals* SEC. EXCH. COMM., <https://www.sec.gov/about/what-we-do> (last visited Mar. 27, 2022).

<sup>19</sup> EY research: initial coin offerings (ICOs) ERNST & YOUNG 1, 6 (Dec. 2017), [https://assets.ey.com/content/dam/ey-sites/ey-com/en\\_gl/topics/banking-and-capital-markets/ey-research-initial-coin-offerings-icos.pdf](https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/banking-and-capital-markets/ey-research-initial-coin-offerings-icos.pdf).

<sup>20</sup> See generally *Chairman’s Testimony on Virtual Currencies: The Roles of the SEC and CFTC* SEC. EXCH. COMM. (Feb. 6, 2018), [https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission#\\_ftn5](https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission#_ftn5).

<sup>21</sup> *Id.*

Responding to Chairman Jay Clayton’s speech from February 6—fellow Commissioner Robert J. Jackson, Jr. discussed the importance of competition, a “forgotten” fourth pillar of the SEC’s mission.<sup>22</sup> Commissioner Jackson described the competition among the markets that the SEC regulates as lacking due to the highly concentrated nature of the industries, and presumably high barriers to entry which make new entrants unlikely; he stated—“[t]here is a striking lack of competition across crucial areas of our capital markets. . . . [T]he concentration of power in just a few players of enormous size and scope is a potential problem in nearly every area the SEC oversees.”<sup>23</sup> Commissioner Jackson emphasized how competition is often forgotten and pushed into the background on policy decisions.<sup>24</sup> As an anecdotal example, he discussed how the percentage fee charged by investment bankers for a company to go public has not changed in the last 25 years since Commissioner Jackson was working as an investment banker and charged the same rate.<sup>25</sup>

Commissioner Jackson suggested at least three remedies the SEC could take to foster market competition—formally incorporate competition economics into the SEC’s decision making, that the SEC should more closely collaborate with the Federal Trade Commission, and that the SEC should not withdraw from markets in a blind attempt to foster competition.<sup>26</sup> The groundwork for this analysis will be continued by following Jackson’s suggestion to look to competition economics and specifically theories on the regulation of network industries.

## VI. The Modern Goals of the SEC, Lip Service Only?

It is unclear how much Chairman Clayton credited Commissioner Jackson’s critique, but after 2018—the statements from Chairman Clayton and the SEC seem to pay more lip service to an obligation to foster competition than prior statements. For example, statements made by Chairman Clayton in 2019<sup>27</sup> and 2020<sup>28</sup> seem to be concerned with reducing costs and fostering competition and adoption.

Speaking in 2019, Chairman Clayton expounded the importance of making the public markets more accessible.<sup>29</sup> He noted that “our private markets have become increasingly important, and . . . , today outpace the public markets in many measures, including in size[, and] [u]nless one is an accredited investor, the options in the private markets are limited.”<sup>30</sup> Chairman

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<sup>22</sup> Robert J. Jackson, Jr., *Competition: The Forgotten Fourth Pillar of the SEC’s Mission* U.S. SEC. EXCH. COMM. (Oct. 11, 2018), [https://www.sec.gov/news/speech/speech-jackson-101118#\\_ftn18](https://www.sec.gov/news/speech/speech-jackson-101118#_ftn18).

<sup>23</sup> *Id.*

<sup>24</sup> See generally *id.*

<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

<sup>27</sup> See generally *Oversight of the Securities and Exchange Commission: Wall Street’s Cop on the Beat* SEC. EXCH. COMM. (Sept. 24, 2019), <https://www.sec.gov/news/testimony/testimony09-24-2019>.

<sup>28</sup> See generally *Putting Principles into Practice, the SEC from 2017-2020 Remarks to the Economic Club of New York* SEC. EXCH. COMM. (Nov. 19, 2020), <https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19>; see generally *Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework; Benefits to Small and Medium-Sized Business and Their Investors* SEC. EXCH. COMM. (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2>.

<sup>29</sup> See generally *Putting Principles into Practice, the SEC from 2017-2020 Remarks to the Economic Club of New York* SEC. EXCH. COMM. (Nov. 19, 2020), <https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19>; see generally *Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework; Benefits to Small and Medium-Sized Business and Their Investors* SEC. EXCH. COMM. (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2>.

<sup>30</sup> *Id.*

Clayton continued to say that the SEC is attempting to “expand investment opportunities” while “enhancing appropriate investor protections and promoting capital formation.”<sup>31</sup>

When discussing the ability for small and medium sized companies to go public Chairman Clayton conceded that for the “vast majority” of small and medium sized companies—businesses with values between \$50,000 and \$100 million—“raising capital in the public markets is not a practical option.”<sup>32</sup> He elaborated further that the purpose of recent amendments was to reduce costs, that as a “practical matter serve no mission-oriented purpose, and specifically do not enhance investor protection. Many of these costs are the result of rules that were constructed in an age of different communications and other technologies.”<sup>33</sup>

At times Chairman Clayton acknowledged the potential benefits of new technology;<sup>34</sup> however, in usual SEC rhetoric, investor protection was stressed above all else. Yet, these statements were followed with others, that “regardless of the promise of this technology,” that investors “deserve the full protections afforded under those laws.” But, what if investors do not want these protections? For wealthy investors, accredited investor rules allow something similar to opting-out of securities protections—by allowing investors to invest in projects without registering the securities. However, such exemptions are based upon income and assets, so independent of sophistication these exemptions are not available to less wealthy investors.

The number of public reporting companies has decreased 50% from the high-water mark,<sup>35</sup> and going public is not an option for the “vast majority” of companies valued between \$50,000 and \$100 million.<sup>36</sup> This is consistent with reports that show, between 2000 and 2020, the number of IPOs less than \$100 million has been decreasing.<sup>37</sup> Thus, maybe Commissioner Jackson was correct in that there should be a fourth pillar of competition.

The take away is that while the SEC is beginning to pay lip service to the need to consider competition in its decision-making, the current system that faces those wishing to raise capital is impracticable, unless the company is worth in excess of \$100 million.

## VII. Blockchains Are Decentralized Ledgers, Usually Supported Through Encryption and Incentives.

The Merriam-Webster dictionary defines “ledger” as both “a book containing accounts” and as “a digital record that is used similarly to an accounting ledger as for maintaining a list of transactions[.]”<sup>38</sup>

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<sup>31</sup> *Id.*

<sup>32</sup> See Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework; Benefits to Small and Medium-Sized Business and Their Investors SEC. EXCH. COMM. (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2>.

<sup>33</sup> *Id.*

<sup>34</sup> See Putting Principles into Practice, the SEC from 2017-2020 Remarks to the Economic Club of New York SEC. EXCH. COMM. (Nov. 19, 2020), <https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19>.

<sup>35</sup> See Putting Principles into Practice, the SEC from 2017-2020 Remarks to the Economic Club of New York SEC. EXCH. COMM. (Nov. 19, 2020), <https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19>.

<sup>36</sup> Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework; Benefits to Small and Medium-Sized Business and Their Investors SEC. EXCH. COMM. (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2>.

<sup>37</sup> Vartika Gupta et. al, *Reports of corporates’ demise have been greatly exaggerated* MCKINSEY (Oct. 21, 2022), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/reports-of-corporates-demise-have-been-greatly-exaggerated>.

<sup>38</sup> *Ledger* Merriam-Webster, <https://www.merriam-webster.com/dictionary/ledger> (last visited Mar. 28, 2022).

By some accounts, ledgers were one of the earliest forms of human writing.<sup>39</sup> The invention of double entry bookkeeping further popularized the use of ledgers as a form of accounting and finance.<sup>40</sup> For many nations, the central bank maintains the ledger of the nation's monies and debts.<sup>41</sup> Thus, currencies and many economic relations are commonly tracked through ledgers. The key concern being, what entities may amend the ledger, as in add or subtract entries.

Blockchains are simply decentralized ledgers, where there is a complex mechanism that allocates the power of adding entries to the ledger (usually each block is a group of transactions or entries and blocks are issued at various intervals, such as every few minutes or seconds). A technical definition of a blockchain is—an “immutable digital ledger [system] implemented in a distributed fashion (i.e., without a central repository) and usually without a central authority.”<sup>42</sup> This immutable and distributed ledger, or blockchain, allows for “a community of users to record transactions in a ledger that is public to that community, such that no transaction can be changed once published.”<sup>43</sup> To be more specific, “immutable” isn’t entirely correct because the ledger must be changed; the more precise terminology is “append only”—meaning that only new transactions can be added and existing entries (or transactions) cannot be removed, modified, or reordered.<sup>44</sup> But once the ledger is published (with each block) it is generally immutable to most users for most purposes.

The addition of blocks is enabled by aligning incentive structures (arriving at consensus by solving the Byzantine Generals problem<sup>45</sup>) and/or using encryption. The process of disguising a message to hide its substance is “encryption.”<sup>46</sup> A fundamental building block of encryption are one-way functions. One-way functions are usually easy to compute, but significantly harder to reverse. For example, one-way functions can help create puzzles that are hard to solve, but easy to verify.

In 2008 an internet user by the pseudonym Satoshi Nakamoto began discussing a “new electronic cash system.”<sup>47</sup> This bitcoin white paper<sup>48</sup> combined technical components of academic literature which originated in the 1980s and ‘90s to create the bitcoin blockchain, or an electronic-distributed-append-only ledger (that relies on proof-of-work as the solution to the Byzantine Generals problem).<sup>49</sup>

Technological advances in blockchains have been created to maintain a ledger in a decentralized way without a central authority. Due to encryption and incentive structures,

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<sup>39</sup> See LLFOURN *A Brief History of Ledgers* MEDIUM (Feb. 15, 2018), <https://medium.com/unraveling-the-ouroboros/a-brief-history-of-ledgers-b6ab84a7ff41>.

<sup>40</sup> *Id.*

<sup>41</sup> See generally *id.*

<sup>42</sup> Dylan Yaga et. al, *Blockchain Technology Overview* NAT’L INST. STANDARDS & TECH. 1, 4 (Jan. 2018) (available at <https://csrc.nist.gov/CSRC/media/Publications/nistir/8202/draft/documents/nistir8202-draft.pdf>).

<sup>43</sup> *Id.*

<sup>44</sup> Arvind Narayanan & Jeremy Clark, *Bitcoin’s Academic Pedigree* ACM QUEUE (Aug. 29, 2017), <https://queue.acm.org/detail.cfm?id=3136559>.

<sup>45</sup> Arvind Narayanan & Jeremy Clark, *Bitcoin’s Academic Pedigree* ACM QUEUE (Aug. 29, 2017), <https://queue.acm.org/detail.cfm?id=3136559>.

<sup>46</sup> BRUCE SCHNEIER. APPLIED CRYPTOGRAPHY 1, 29 (1996).

<sup>47</sup> Satoshi Nakamoto, *Bitcoin P2P e-cash paper* (Oct. 31, 2008), <https://www.metzdowd.com/pipermail/cryptography/2008-October/014810.html>.

<sup>48</sup> Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System Bitcoin.org, <https://bitcoin.org/bitcoin.pdf> (last visited Mar. 28, 2022).

<sup>49</sup> Arvind Narayanan & Jeremy Clark, *Bitcoin’s Academic Pedigree* ACM QUEUE (Aug. 29, 2017), <https://queue.acm.org/detail.cfm?id=3136559>.

blockchains can provide strong “property like” rights that are sometimes enforced outside of state control. This can present both a danger and a utility (as the networks may be incredibly robust). This has profound implications for how capital is raised and how capital is defined.<sup>50</sup>

Rather than submit to willful ignorance, the U.S. should seek to channel innovation and excitement about blockchains toward positive goals through a rational regulatory scheme, rather than suppress free markets and off-shore innovative projects.

### VIII. Carl Shapiro On The Regulation of Network Industries.

This section will consider Commissioner Jackson’s suggestion to look to the FTC and competition economics on guidance for how to regulate a network industry while also fostering competition. Then, the analysis will conclude that the SEC should seek to regulate blockchain technologies in ways that foster lawful competition rather than force innovative projects to be built in foreign jurisdictions. Although the future of the public markets is uncertain, if the SEC doesn’t create a feasible regulatory regime for blockchain projects it could lose projects to jurisdictions that provide better regulatory clarity and freedom.

In some sense, a blockchain may also be considered and viewed as a network. Carl Shapiro, while Deputy Assistant Attorney General for Economics in the Antitrust Division of the Department of Justice, gave a speech in 1996 summarizing his views on the optimal regulation of network industries and the economic characteristics of network industries.<sup>51</sup> Shapiro described the key economic feature of a network industry as defined by—“positive feedback due to demand-side scale economies: [meaning] large networks are more attractive to buyers, and thus tend to get larger.”<sup>52</sup>

It is important to understand when a market is characterized by network effects, because network industries function very differently than micro-economically efficient markets.<sup>53</sup> Furthermore, it is important for policy because, according to Mr. Shapiro, “sound antitrust policy depends upon a solid understanding of business strategy and economics, as well as the case law.”<sup>54</sup>

It is clear Mr. Shapiro viewed his role as one to foster competition and innovation—“our job is to ensure that incumbent firms do not use their power to block technological progress.”<sup>55</sup> For example, Mr. Shapiro points out that the “positive feedback” nature of network industries means network industries are ripe for monopolization.<sup>56</sup> The fear of monopolization is further exacerbated by network effects because once monopolization is achieved, “the network effects that helped create dominance may make it more difficult for new entrants to dislodge the market leader than in other industries lacking network characteristics.”<sup>57</sup>

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<sup>50</sup> See generally EY research: initial coin offerings (ICOs) ERNST & YOUNG 1, 6 (Dec. 2017), [https://assets.ey.com/content/dam/ey-sites/ey-com/en\\_gl/topics/banking-and-capital-markets/ey-research-initial-coin-offerings-icos.pdf](https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/banking-and-capital-markets/ey-research-initial-coin-offerings-icos.pdf).

<sup>51</sup> Carl Shapiro, ANTITRUST IN NETWORK INDUSTRIES DEP’T JUSTICE (Mar. 7, 1996), <https://www.justice.gov/atr/speech/antitrust-network-industries-speech-american-law-institute-and-american-bar-association>.

<sup>52</sup> *Id.*

<sup>53</sup> See generally *id.* (“Competition in these industries is qualitatively different than it was in the manufacturing industries of yesteryear.”)

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* (“antitrust enforcers must be alert in these industries, because the very nature of the “positive feedback” cycle means that monopolization may be accomplished swiftly.”)

<sup>57</sup> *Id.*

Because of the positive feedback loops, networks usually become more valuable as users are added.<sup>58</sup> However, gaining new users may be difficult due to the switching costs involved.<sup>59</sup> Thus, the key to success in network industries is to build and maintain an installed base of active users—users who consistently use the network.

The takeaway from Mr. Shapiro’s work is that competition among network industries differs from usual micro-economically efficient markets; strategy is defined by building and maintaining the most installed users (as switching costs are high); and, competition and consumer value is driven by technological innovation rather than competition over lower prices.

Markets and many other financial products exhibit features of networks—connecting buyers and sellers, similar to a network, such that theoretically, a market with more buyers and sellers (all else equal) should have greater liquidity and better prices than a market with less buyers and sellers.

However, if the SEC is not careful, its installed users—companies and assets regulated by the SEC—may move to private markets if current trends continue. In which case the SEC would have little power and authority as SEC regulation could be replaced by private market regulatory regimes implemented by code or law.

If financial services are network industries, and we know network industries are characterized by fights for installed users and “creative destruction” and paradigm shifts, the SEC’s power may be decreasing unless it reverses trends by making compliance easier and securities markets more available—this would foster financial competition and bring value to consumers by lowering barriers to entry (the cost of securities compliance) and increasing competitors (the number of entities reporting to the SEC).

As this paper will analyze later, if creating competition among networks is the goal—limiting the number and type of investors, requiring central intermediaries in a space characterized by decentralization, and making the cost of compliance prohibitively expensive for companies worth less than \$100 million does not drive innovation. Given the context of the ICO craze of 2017 there is excess demand for financial products that is not being met through regulated markets. The argument can be made that the SEC’s time can be better spent trying to create a regime that allows for industry compliance rather than forcing these markets away through excessive and unnecessary enforcement. If compliance were more practical, then smaller companies would be able to raise capital and compete, investors in ICOs could get more information and make less risky decisions, and enforcement may be easier (more information about reporting projects, and projects that don’t report are more likely scams). While wealthy investors are legally allowed to invest in risky projects through accredited investor rules, the ability to “opt-out” of SEC protection and invest in risky projects is not available to all investors.

## **IX. How Were 2017 And 2018 ICO Projects Launched?**

The paper will now consider what options are available to those wishing to issue a financial blockchain network and not run afoul of securities laws. A useful starting point for this analysis will be the ICO craze of 2017. Where are those projects today and how successful were they?

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<sup>58</sup> See generally *id.*

<sup>59</sup> See *id.*

It is estimated that more than 2,000 ICO projects raised \$10 billion between 2017 and 2018 combined.<sup>60</sup> The cryptocurrency exchange Gemini explains the usual dynamics of an ICO as follows—"ICOs allow companies in the crypto space to raise capital and fund development without having to go through the arduous and regulation-intensive process of a traditional IPO."<sup>61</sup>

A typical ICO gives buyers "ERC-20" tokens (a standard and function in the Ethereum ecosystem) which are promoted based upon future utility.<sup>62</sup> However, "depending on the specific tokens, the way they were distributed, and the location of their jurisdiction" the tokens may be subject to federal securities laws.<sup>63</sup> The "ERC-20" method of ICO allows for easy deployment, distribution, calculations, and interoperability (or vertical cooperation) which makes it attractive for the purposes of an ICO.<sup>64</sup> However, not all ICOs are conducted this way, and many projects are simply scams.<sup>65</sup>

Yet, there were also projects that raised massive sums of money and thus had definite potential.<sup>66</sup> Block.one raised \$4 billion in 2018 and Telegram raised \$1.7 billion in 2018.<sup>67</sup> Block.one had to pay fines of \$24 million, and Telegram paid \$18.5 million in fines and returned \$1.2 billion to investors.<sup>68</sup> While many projects were facing the regulatory heat from the SEC<sup>69</sup>, one project that raised a significant amount and seems to have complied with SEC regulations was Filecoin in 2017, which used a Simple Agreement for Future Tokens ("SAFT").<sup>70</sup>

The law firm, Anderson Kill paid special attention to complying with SEC mandatory disclosure laws. Partner Stephen Palley elaborated that the SAFT agreement relied primarily on SEC Reg. D, 506(c) and Rule 144 resales. This means that only accredited investors were allowed to invest, and there was a six-month minimum holding period. Notable venture capital funds such as Sequoia and Union Square Ventures contributed a total of \$52 million<sup>71</sup> while accredited investors contributed another \$205.8 million.<sup>72</sup>

Although Filecoin raised \$257 million in 2017 and was not hit with SEC fines, the product and trading did not occur until three years later in 2020.<sup>73</sup> In terms of both regulatory compliance and product success Filecoin seems to be the exception rather than the rule. However, these options are not available for non-accredited investors, as SEC Chairman Clayton previously noted—there are not many options for non-accredited investors in private markets.

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<sup>60</sup> *Ethereum and the ICO Boom* GEMINI (Mar. 10, 2022), <https://www.gemini.com/cryptopedia/initial-coin-offering-explained-ethereum-ico>.

<sup>61</sup> *Id.*

<sup>62</sup> *See id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *See generally id.*

<sup>66</sup> *See generally id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *See generally* Spencer D. Klein, *Do You Want to Launch an ICO? Please, Listen to the SEC*. MORRISON FOERSTER (Feb. 8, 2018), [https://www.mofo.com/resources/insights/180131-ico-sec.html#\\_ftn12](https://www.mofo.com/resources/insights/180131-ico-sec.html#_ftn12).

<sup>70</sup> *See generally* Stephen D. Palley, *FILECOIN LAMENTS SHUTTING OUT CRYPTO SUPPORTERS TO MEET SEC REGULATIONS* ANDERSON KILL (Aug. 4, 2017), <https://www.andersonkill.com/News/Filecoin-laments-shutting-out-crypto-supporters-to-meet-SEC-regulations>.

<sup>71</sup> *Id.*

<sup>72</sup> Stan Higgins, *\$257 Million: Filecoin Breaks All-Time Record for ICO Funding* COINDESK (Sept. 7, 2017), <https://www.coindesk.com/markets/2017/09/07/257-million-filecoin-breaks-all-time-record-for-ico-funding/>.

<sup>73</sup> Brady Dale & Sebastian Sinclair, *Filecoin Launch Finally Brings \$200M ICO to Fruition* NASDAQ (Oct. 15, 2020), <https://www.nasdaq.com/articles/filecoin-launch-finally-brings-%24200m-ico-to-fruition-2020-10-15>.

The Telegram project also tried to use a SAFT, but hoped that the functionality of the token would exempt it from securities law.<sup>74</sup> The court applied the *Howey* test and reasoned that, “reasonable purchasers would not be willing to pay \$1.7 billion” to acquire the security.<sup>75</sup> A preliminary injunction was issued to restrain the project from raising further funds.<sup>76</sup>

Given the current regulatory environment, it seems that one of the only successful ICOs (that was both legally compliant and delivered a product) was issued to wealthy investors through a 506(c) offering and had to raise over \$200 million. This is consistent with the SEC’s analysis that public markets are not practical for companies worth less than \$100 million, and that there are very limited options for non-accredited investors in private markets.

## X. Criticisms of Blockchain Projects Not Complying with Securities Regulations.

Commissioner Crenshaw has in the past criticized blockchain projects for a lack of compliance. Commissioner Crenshaw has contrasted the network effects in social media with those of blockchain projects— “there are many proven ways to achieve network effects that don’t require speculative profit potential[;] [d]evelopers can raise capital in traditional ways and sell or distribute tokens strictly for network use and with no potential for profits, but the vast majority choose not to do so.”<sup>77</sup> However, this overlooks both technical and ownership considerations that make blockchain technology superior to prior technologies. Most existing social media companies do not function like transparent decentralized blockchains. Free speech considerations aside, there are many financial networks that can be turned into effective blockchains of financial products, and because financial products are involved, the tokens or instruments are considered securities.

## XI. What Securities Exemptions Are Available And Why Are They Difficult For Blockchain Projects?

The SEC lists nine exemptions (or methods of compliance) for federal securities laws.<sup>78</sup> None of these exemptions is commercially feasible for a decentralized network with many installed users; almost all of the exemptions have extensive limits on the total number of investors or type of investors. Section 4(a)(2) requires that recipients be insiders of the organization per *SEC v. Ralston Purina Co.* this is not practical that individuals be insiders to build out a network.<sup>79</sup> Section 506(c) requires that all investors be accredited investors, and 506(b) allows for only 35 investors in a 90-day period.<sup>80</sup>

Reg A seems facially promising, but requires that all transactions of interest take place through an SEC registered intermediary which defeats the purpose a decentralized network if transactions must also go through a government central intermediary. Additionally, there are high reporting requirements and low caps on the amount of capital that may be raised. All of

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<sup>74</sup> Stephen Palley, *Court in Telegram case blocks gram token issuance, says token distribution likely violates securities law* THE BLOCK (Mar. 24, 2020), <https://www.theblockcrypto.com/post/59831/court-in-telegram-case-blocks-gram-token-issuance-says-token-distribution-likely-violates-securities-law>.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> Caroline A. Crenshaw, *Digital Asset Securities – Common Goals and a Bridge to Better Outcomes* SEC. EXCH. COMM. (Oct. 12, 2021), <https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012>.

<sup>78</sup> *Overview of Capital-Raising Exemptions* SEC. EXCH. COMM.,

<https://www.sec.gov/smallbusiness/exemptofferings/exemptofferingschart> (last visited Mar. 29, 2022).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

these requirements make Reg. A problematic for launching a decentralized system with no central authority. It seems easier for investors and reporting entities to disseminate this information in other ways than government reporting, and many blockchains are independently verifiable with free “block explorer” websites such as Etherscan<sup>81</sup> and others, which are much easier to corroborate than source code.

Lastly, there are intrastate exemptions,<sup>82</sup> which again do not make much sense to limit the distribution of a network (seeking to gain the most installed users) to a single geographic area, as this would substantially limit the potential for network effects and thus limit the potential efficiency and growth of the network. Given the few paths for compliance, and the prohibitively high cost of going public it is not a surprise that few projects are attempting to comply with SEC rules.

As a solution to the problem of securities laws stifling innovation, SEC Commissioner Hester Peirce has proposed language for a potential safe harbor that would facilitate disclosure and allow projects to be registered with the SEC while a network is built out.

## XII. The Safe Harbor Proposal

The introductory notes to the proposal present the problem the proposal is trying to solve: innovative new financial networks cannot be built if network participants (investors, programmers, and potential users) cannot freely buy, sell, and trade the tokens of the network. Commissioner Peirce stated that federal securities laws “frustrat[e]” the ability of the network to achieve “maturity.”<sup>83</sup> The safe harbor proposal is intended to provide regulatory clarity for “Initial Development Teams”, to have a three-year safe harbor to build a network.<sup>84</sup> During the three-year period there are various disclosure and reporting requirements.<sup>85</sup> Then at the end of the three-year period there will be an assessment to determine if the network has or has not achieved “Network Maturity.”<sup>86</sup> “The definition of Network Maturity is intended to provide clarity as to when a Token transaction should no longer be considered a security transaction but the analysis with respect to any particular network will require an evaluation of the particular facts and circumstances.”<sup>87</sup>

Section (a) of the proposal requires that disclosures in section (b) are freely available on a public website, the distribution is made for the purpose of “facilitating access to, participation on, or the development of the relevant autonomous cryptosystem[,]” the Initial Development Team filed a “notice of reliance[,]” and lastly that the initial development team may not sell any tokens until twelve months after the first distribution.<sup>88</sup>

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<sup>81</sup> See generally ETHERSCAN, <https://etherscan.io/> (last visited Apr. 18, 2022).

<sup>82</sup> Overview of Capital-Raising Exemptions SEC. EXCH. COMM., <https://www.sec.gov/smallbusiness/exemptofferings/exemptofferingschart> (last visited Mar. 29, 2022).

<sup>83</sup> Commissioner Hester M. Peirce, Token Safe Harbor Proposal 2.0 Sec. Exch. Comm. (Apr. 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0>; see also CommissionerPeirce, *SafeHarbor2.0* GITHUB (Apr. 13, 2021), <https://github.com/CommissionerPeirce/SafeHarbor2.0>.

<sup>84</sup> Commissioner Hester M. Peirce, Token Safe Harbor Proposal 2.0 Sec. Exch. Comm. (Apr. 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0>.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

Section (b) is critical in that it defines what disclosures would be required of the Initial Development Team.<sup>89</sup> It requires disclosure of the source code, transaction history, token economics, plan of development, prior token sales, initial development team information, available trading platforms, sales of tokens by the initial development team, related person transactions, warning to token purchasers, and semiannual disclosures.<sup>90</sup> Section (b) represents the main disclosures that the proposal requires.

Section (c) lists what must be included in the notice of reliance, which would then be displayed in the SEC EDGAR reporting system. The notice of reliance would include the names of the executive team, the website where disclosure reporting is satisfied, and an email address to contact the initial development team.

Sections (d) through (k) provide further color with section (f) being of particular importance as this section specifies what must be included in the “exit report” that must be filed at either the end of the three-year exemption or before. The exit report is important because it will specify if the network is sufficiently decentralized to not be regulated as a security, or exchange, or broker, or dealer.

Section (d) specifies limitations of the safe harbor, and what is not covered. The safe harbor does not provide an exemption to ’33 Act section 12(a)(2) liability (for false statements in a prospectus or oral communication), and it does not provide an exemption from ’33 Act section 17 which prohibits fraudulent interstate transactions.

Section (f) is the last major section as it relates important requirements for the exit-report. An exit report must be filed by outside counsel before the expiration of the three-year exemption period. The report must include a description of how decentralized the network has become across voting power, development efforts, and network participation. The report must also explain how the development team’s “pre-Network Maturity activities are distinguishable from their ongoing involvement with the network.” Lastly, the report must include a determination if the network has or has not achieved “Network Maturity.” If the network has not achieved network maturity then the initial development team must register the token per section 12(g) of the ’34 Act within 120 days. It is clear that the exit report must be conducted by outside counsel and that the initial development team or another party may file the exit report.

If the exit report determines that “Network Maturity” has been achieved then the report must show this to be the case. The proposed safe harbor requests that the following evidence and descriptions be provided: “Describe the holders’ use of Tokens for the transmission and storage of value on the network, the participation in an application running on the network, or otherwise in a manner consistent with the utility of the network[;]” and “Detail how the Initial Development Team’s marketing efforts have been, and will be, focused on the Token’s consumptive use, and not on speculative activity.”

“Network Maturity”, defined in section (k), can be achieved in either of two ways, if the network is not controlled by a group with more than 20% of the tokens, or the network is “functional” “as demonstrated by the holders’ use of Tokens for the transmission and storage of value on the network[.]”

The other important definition is that of “token.” A token is defined as “a digital representation of value or rights” that “has a transaction history” which shows an independently verifiable transaction history that cannot be modified; the token is capable of transfer without an intermediary party; the token does not represent a financial interest “in a

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<sup>89</sup> *Id.*

<sup>90</sup> *Id.* (all cites are to the safe harbor proposal until the next footnote).

company, partnership, or fund, including an ownership or debt interest, revenue share, entitlement to any interest or dividend payment[.]”

In summary the safe harbor proposal would allow for a three-year exemption period from most of the federal securities laws. However, there would need to be initial disclosures, disclosures every six months, as well as an exit-report at the end of the three-years to determine the path forward. At the end of the three years, the token will either have achieved “Network Maturity” through decentralization or utility—or, if network maturity is not achieved, then the token must be registered as a security within 120 days of the exit report. Thus, failed projects would need to cease or register as securities.

The proposal has engendered many questions from those in the crypto-industry as well as other regulators. Regulators ask if the proposal goes far enough to protect investors, and those in the crypto-industry worry about over-regulation.

### XIII. Commissioner Crenshaw Criticizes the Safe Harbor Proposal.

SEC Commissioner Caroline A. Crenshaw voiced her criticisms of the safe harbor proposal in a speech on October 12, 2021.<sup>91</sup> While Commissioner Crenshaw mentioned that she thought that blockchain “technology and its potential are positive” but that investors must be protected.<sup>92</sup> Prior to the SEC “retail investors were frequently subject to fraud, undisclosed risks, market manipulation, and, often, lost huge sums of money[.]”<sup>93</sup>

Commissioner Crenshaw notes that many digital assets are not registered as securities and that such a regulatory regime “is not sustainable, particularly as digital asset markets continue to grow and intersect with traditional markets.”<sup>94</sup> She then addresses possible paths forward, and begins with criticisms of Commissioner Peirce’s proposal.<sup>95</sup>

Commissioner Crenshaw stated that, “[r]ather than solving for how to make the use of these digital asset securities compliant from the moment investors put their capital at risk, these proposals would define the tokens as outside our jurisdiction, at least for several years.” Commissioner Crenshaw focuses her critique on two key assumptions which she views as untrue—“[t]he first is the need to achieve network effects, and the second is the project’s choice to use a token . . . instead of giving up equity or taking on loan obligations.”

Commissioner Crenshaw asserted that network effects could be achieved without having investors also serve as the users. She provided the example of social media, which has both separate investors and users. The choice to require that investors also be users, is unnecessary in her mind.

Commissioner Crenshaw’s second criticism, is that granting an exemption to blockchain companies would disadvantage businesses that seek to raise money in public markets. She stated that “granting a special exemption to these projects would provide unfair advantages to blockchain related businesses and disadvantage everyone else: participants who raise capital in compliant ways that support healthy markets and informed investors.” “Whatever we do should result in a more level playing field for everyone, not simply shift the advantages.” In summary, she stated that “I do not think that a safe harbor that permits unlimited capital raising with only limited disclosures, and no registration requirement, is in the best interest of investors. Nor will it

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<sup>91</sup> Caroline A. Crenshaw, *Digital Asset Securities – Common Goals and a Bridge to Better Outcomes* SEC. EXCH. COMM. (Oct. 12, 2021), <https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012>.

<sup>92</sup> See *id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> See *id.*

be effective at preventing a re-run of the excesses and failures of the recent past. And when investors lose, so do issuers and all the other market participants who seek to profit from their capital, transaction flow, liquidity, and enthusiasm.” In her view, “[h]ad a safe harbor been in place during the Initial Coin Offering or ICO boom of 2017 and 2018, . . . the results would have been even worse for investors and the markets.”

To give further context to how this proposal would or would not be effective, a few real-world events could be analyzed to shed light on the potential effectiveness of this proposal in fostering innovation while also protecting investors.

#### **XIV. SEC Trends in Enforcement & Policy—XRP Suit, Proposed Amendment to Regulation ATS, and the Blockchain Caucus.**

On December 23, 2020, the SEC filed suit against Ripple Labs for allegedly selling approximately \$1.3 billion in unregistered securities.<sup>96</sup> Ripple Labs was founded in 2012 and operates RippleNet and the XRP payment system. Some commentators believe it to be “considered superior to bitcoin with its improved ledger, faster settlement speed, and digital wallet for international transactions across 55 countries” and could potentially be a competitor to the SWIFT payment system (Society for Worldwide Interbank Financial Telecommunication).

Past SEC Commissioner Joseph Grundfest commented on the SEC’s choice to sue Ripple Labs—Grundfest suggested the situation presented a lose-lose scenario.<sup>97</sup> Grundfest made the following arguments: “I had questions about the timing, implications, policy. Is this a matter that is best addressed from a social perspective by bringing a lawsuit or by saying ‘let’s look at our regulations’?” “The issue for me is let’s get a system that works and generates compliant crypto, and this lawsuit has a high probability that no matter who wins actually gets us farther away from a good solution.”

Grundfest explained the lose-lose situation as follows: if the SEC wins, “we get a crazy regime where we’ll try to fit square pegs [in] round holes”; if XRP wins, “then arguably one of the very few cops we have on the beat winds up being weakened.” Lastly, there may be jurisdictional flaws in the SEC’s case; Grundfest suggested that “even if it is decided [XRP] is a security, the SEC may not be able to reach transactions unless they can prove [that the transactions] occurred in the US, and given the architecture of the system, they may not be able to do that.”

Looking forward it is clear that the SEC is trying to expand enforcement power rather than find common ground or foster a compliant regulatory regime. For example, the SEC is proposing a new rule that would expand the definition of “exchange” in Regulation ATS (Alternative Trading Systems) so that decentralized exchanges would need to register with the SEC. The proposed language adds the phrase “communication protocol system” to the definition of exchange, and modifies language which emphasizes orders, that is replaced with language that emphasizes bringing together buyers and sellers.<sup>98</sup>

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<sup>96</sup> Roslyn Layton, *SEC V. Ripple: The Cryptocurrency Trial Of The Century* FORBES (Dec. 29, 2020), <https://www.forbes.com/sites/roslynlayton/2021/12/29/sec-v-ripple-the-cryptocurrency-trial-of-the-century/?sh=19f6fbff5417>.

<sup>97</sup> Rick Steves, *SEC V. RIPPLE LAWSUIT MIGHT PROVE XRP CAN’T BE CONTROLLED, GRUNDFEST INTERVIEW* FINANCEFEEDS (Mar. 10, 2022), <https://financefeeds.com/sec-v-ripple-lawsuit-might-prove-xrp-can-t-be-controlled-grundfest-interview/>.

<sup>98</sup> Christopher Grobbel et. al, *SEC Proposes Rules That Could Regulate DeFi, Extend to Aspects of Centralized Crypto Exchanges* JDSUPRA (Jan. 31, 2021), <https://www.jdsupra.com/legalnews/sec-proposes-rules-that-could-regulate-2150663/>.

Commenting on the new proposal, Commissioner Peirce suggested that “[t]he proposal includes very expansive language, which, together with the chair’s apparent interest in regulating all things crypto, suggests that it could be used to regulate crypto platforms[.]”<sup>99</sup> Another legal commentator has attacked the proposal on first amendment grounds, suggesting that the extension of the regulation from “orders” to bringing together buyers and sellers, unconstitutionally infringes on the right to association.<sup>100</sup> Whatever, the legality of the language it is clear that the SEC is attempting to expand its enforcement regulation rather than foster a regime of compliance— “[t]he SEC says that its Jan. 26 rule proposal is meant to close a ‘regulatory gap’ created by market participants using platforms that aren’t registered as exchanges or brokerages to trade all types of securities.”<sup>101</sup>

The last trend in enforcement that I would like to consider are the SEC’s information finding practices and possible suppression of innovation. As an illustrative anecdote I would like to touch on two stories. The first is the attempts by the publicly traded company Coinbase to work with the SEC, and some of the potential congressional blowback that was enraged.

Coinbase alleges that it worked with SEC regulators for over six months, answering diligence requests and trying to gain legal clarity.<sup>102</sup> The product is described as follows, “we’re seeking to allow eligible customers to earn interest on select assets on Coinbase, starting with 4% APY on USD Coin (USDC).”<sup>103</sup> Paul Grewal the Chief Legal Officer of Coinbase, who has served as a magistrate judge for six years and sat on the Northern District’s Technology Practice and Patent Instructions and Rules Committees, continued as follows: “Coinbase’s Lend program doesn’t qualify as a security — or to use more specific legal terms, it’s not an investment contract or a note. Customers won’t be ‘investing’ in the program, but rather lending the USDC they hold on Coinbase’s platform in connection with their existing relationship.” Grewal ended the summary:

“The SEC has repeatedly asked our industry to ‘talk to us, come in.’ We did that here. But today all we know is that we can either keep Lend off the market indefinitely without knowing why or we can be sued. A healthy regulatory relationship should never leave the industry in that kind of bind without explanation. Dialogue is at the heart of good regulation.”<sup>104</sup>

While on the one hand a private company is attempting to offer an interest rate of 4% to nearly all “deposits”—this would be a potentially revolutionary shift in banking dynamics, but instead the SEC is not working in good faith to offer these potentially revolutionary financial products to consumers. Due to actions such as this (or similar actions), which cost public reporting

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<sup>99</sup> Allyson Versprille, *SEC’s Lone Republican Warns of Threat to Crypto DeFi Platforms in New Agency Plan* BLOOMBERG (Feb. 1, 2022), <https://www.bloomberg.com/news/articles/2022-02-01/sec-s-peirce-sees-threat-to-crypto-defi-platforms-in-agency-plan?sref=3REHEaVI>.

<sup>100</sup> Peter Van Valkenburgh, *A new SEC proposal has a serious change hidden within its complex language* COINCENTER (Apr. 14, 2022), <https://www.coincenter.org/a-new-sec-proposal-has-a-serious-change-hidden-within-its-complex-language/>.

<sup>101</sup> Allyson Versprille, *SEC’s Lone Republican Warns of Threat to Crypto DeFi Platforms in New Agency Plan* BLOOMBERG (Feb. 1, 2022), <https://www.bloomberg.com/news/articles/2022-02-01/sec-s-peirce-sees-threat-to-crypto-defi-platforms-in-agency-plan?sref=3REHEaVI>.

<sup>102</sup> Paul Grewal, *The SEC has told us it wants to sue us over Lend. We don’t know why.* COINBASE (Sep. 7, 2021), <https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009>.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

companies hundreds of thousands to comply with, some in Congress have attempted to rally support against this type of behavior from the SEC.<sup>105</sup>

The self-proclaimed “Blockchain Caucus” is composed of a bi-partisan group of eight Congresspeople. Republican Congressman Tom Emmer of Minnesota sent a letter, co-signed by the seven other members of the caucus, to Gary Gensler and the SEC. Congressman Emmer explained that “[i]t appears there has been a recent trend towards employing the Enforcement Division’s investigative functions to gather information from unregulated cryptocurrency and blockchain industry participants in a manner inconsistent with the Commission’s standards for initiating investigations.”<sup>106</sup> The letter alleges violation of the Paperwork Reduction Act (PRA) and that the agency may not “overwhelm” the public with “unnecessary or duplicative requests for information.”<sup>107</sup>

In summary, these are some of the recent policy decisions by the SEC. Cases like Ripple Labs present lose-lose scenarios where either the SEC’s power grows or the SEC is rendered useless. Proposed changes to expand the definition of “exchange” in the ’34 Act show that the SEC is positioning itself not to enhance regulatory clarity, but enhance enforcement power. Lastly, the SEC’s lack of clarity (on products such as Coinbase Lend), and ability to drive away potentially innovative products is a clear outcome of this regulatory structure that is inherently risk adverse. This is why the SEC analysis should focus on providing investors and companies reasonable regulations and consider not only “protecting investors” but more broadly enhancing financial competition and thus delivering consumers more valuable financial products.

## XV. Would The Safe Harbor Have Changed Outcomes?

Commissioner Crenshaw claimed that the ICO craze would have been worse had the safe harbor been implemented at the time. Commissioner Crenshaw elaborated that “ICOs and other digital asset offerings raised billions from investors, but most never delivered on their promises[,] [and] [i]nvestors suffered the losses.”<sup>108</sup> As with many startup businesses, many fail to deliver on their promises. Yet, similar to the venture capital industry, there are projects that become massive successes without regulatory clarity.<sup>109</sup> While investor protection is a laudable goal, it is unclear that investors want to be “protected” from these assets. Rather, it seems that SEC’s enforcement efforts would be aided by a regulatory regime rather than hampered by it.

If the safe harbor proposal had been in place during 2017 and 2018 then what might have happened? First the initial development team would have to file a notice of reliance specifying their reliance on the safe harbor which would then get filed in EDGAR;<sup>110</sup> the initial development team would then have to follow the disclosure rules and post information about the

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<sup>105</sup> Tom Mitchel Hill, *Congresspeople concerned SEC stifling innovation with crypto scrutiny* COINTELEGRAPH (Mar. 17, 2022), <https://cointelegraph.com/news/congress-members-concerned-sec-stifling-innovation-with-crypto-scrutiny>.

<sup>106</sup> Tomm Emmer twitter, [https://twitter.com/RepTomEmmer/status/1504117933395619846?ref\\_src=twsr%5Etfw%7Ctwcamp%5Eweetemb%7Ctwterm%5E1504117933395619846%7Ctwgr%5E%7Ctwcon%5Es1\\_&ref\\_url=https%3A%2F%2Fcointelegraph.com%2Fnews%2Fcongress-members-concerned-sec-stifling-innovation-with-crypto-scrutiny](https://twitter.com/RepTomEmmer/status/1504117933395619846?ref_src=twsr%5Etfw%7Ctwcamp%5Eweetemb%7Ctwterm%5E1504117933395619846%7Ctwgr%5E%7Ctwcon%5Es1_&ref_url=https%3A%2F%2Fcointelegraph.com%2Fnews%2Fcongress-members-concerned-sec-stifling-innovation-with-crypto-scrutiny)

<sup>107</sup> Tom Mitchel Hill, *Congresspeople concerned SEC stifling innovation with crypto scrutiny* COINTELEGRAPH (Mar. 17, 2022), <https://cointelegraph.com/news/congress-members-concerned-sec-stifling-innovation-with-crypto-scrutiny>.

<sup>108</sup> Caroline A. Crenshaw, *Digital Asset Securities – Common Goals and a Bridge to Better Outcomes* SEC. EXCH. COMM. (Oct. 12, 2021), <https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012>.

<sup>109</sup> *Id.*

<sup>110</sup> See the initial disclosures required in the Safe Harbor proposal.

project; lastly, the initial development team would have to warn investors about the risks of the investment. The project would be able to be regulated under these rules for three-years and focus on building a quality project in a legally compliant manner. At the end of the three-year period there would need to be a reckoning if the project would have to register or not. At that point investors would gain regulatory clarity on the next steps for the investment.

Assuming some projects used the safe harbor proposal (otherwise no use would not have made the ICOs worse) it is unclear how investors or the SEC would be worse off. The most predictable conclusion is that projects would have used the safe harbor, raised money, and lost the money by not delivering on projects. However, at that point investors would at least know some information on which to have a follow-up suit. Conversely, the project could either do well and develop a functioning network or register as a security. Thus, the worst outcome would be investors who lose money through projects that participated in the safe harbor. Those investors would have received reasonable disclosures and a similar shot of success as accredited investors, and likely better odds than a casino or lottery.

Crenshaw totally overlooks 1) how the safe harbor could help bolster enforcement and protect investors, and 2) she is not considering the consumer benefits of innovation. Crenshaw, earlier in her speech acknowledges the benefits of having the founders of projects release their identity. Furthermore, the source she cites for the lack of success includes stories on wildly successful projects. As mentioned earlier, the nascent crypto industry is worth trillions of dollars, and adoption is growing and in incredibly early stages. Eventually, the SEC needs to weigh the benefits of its enforcement actions, in cases such as the Ripple Labs suit which setup lose-lose scenarios, and the benefits of providing investors *some* protections for projects where there is clearly a lot of appetite. Because it is almost the norm that projects do not register, this places many projects in the same category of being unregistered. However, if it was feasible for projects to meaningfully differentiate themselves through compliance this could actually reduce and facilitate enforcement efforts.

Commissioner Crenshaw, might respond that there is no reason that users need to be owners. She gives the example of social media companies that thrived off of a small group of investors, but the companies grew large user bases.

This argument implicitly drives to the heart of the discussion. Is this the regulation of equity, or is this the regulation of a network? Commissioner Crenshaw must believe that if it is within the definition of a security then the instrument should be forced to register as such. However, Commissioner Peirce might agree, that the definition of security is overly broad and beginning to inhibit the growth of “networks.” Commissioner Crenshaw’s viewpoint seems to be the usual SEC rhetoric, focused on protecting investors and limiting investor losses. Commissioner Peirce’s view might be characterized as accepting that there is massive demand for these new technological projects, and that finding a new regime that facilitates compliance could foster both investor protection and innovation.

The last piece in this analysis is the seemingly arbitrary definition of “accredited investor.” It is not clear why “accredited investors” should be able to invest in risky projects but that individuals with less money are inherently less sophisticated. Why should there be clear exemptions for a group of 35 “accredited investors” but 35 similarly situated individuals that make less than the accredited investor rules are somehow unable to invest in the same way. Even, if both groups lose all the money invested somehow the investment of the poorer investors was illegal because they were not accredited investors. Additionally, given the prevalence of

casinos and lotteries in the U.S. as well as the allowance of investment from accredited investors, it seems counterintuitive to penalize less wealthy investors.

The counterargument might be that markets need to be healthy and safe for retirement accounts. This is a valid concern. But it does not justify why only accredited investors are allowed to invest in risky projects. It seems the fear is that the SEC does not want investment advisors to place retirement money in risky markets. But shouldn't these professionals choose safe assets regardless what they are able to choose? Thus, it seems that allowing for opt-in based rules similar to "accredited" investor rules could facilitate orderly markets and registration of crypto markets while making sure that only knowledge individuals with high risk tolerances are allowed to invest in such risky projects. For example, combining the safe harbor proposal with rules that only allow certain types of investors that have chosen to opt-in to higher risk investments could make sense. As this facilitates both registration, orderly investment, and would not allow retirement funds to "opt-in" to these projects unless they filed accordingly, which would be a big red flag, or could be made illegal.

While there may be significant investor losses, this would be preferable for a number of reasons. One, investors may still lose money, but the investors are warned about the risks, would opt-in, and could know at least the information that is required in the disclosure. Two, projects that fail, the initial teams could be more easily regulated and pursued. Three, successful projects would be more likely given regulatory clarity. Four, this could be a legitimate alternative to unregistered ICOs and could ease regulatory efforts.

Applying the safe harbor to the facts at issue in the Ripple Labs case, if Ripple Labs had relied on the safe harbor the three-year period would have expired and there would have been an exit report. At which point the project would have undergone scrutiny to determine if it had reached "Network Maturity" (either no party with more than 20% control, or the network is functional and based upon consumptive use) or it would have needed to register as a security within 120 days.

The safe harbor proposal would have somewhat conflicted with the proposed language for Regulation ATS. The safe harbor proposal states that facilitating the trading of tokens provided for in the safe harbor would exempt the party from the definition of "exchange" in Exchange Act Rule 3a1-2 (nearly the same rule as the SEC proposed new language for, Exchange Act Rule 3a1-1). Thus, it is clear the SEC is moving away from allowing exemptions from the definition of "exchange" and moving toward expanding the definition of "exchange."

Lastly, it does not seem that the safe harbor proposal would have allowed Coinbase to issue the Lend product it envisioned.

Thus, it is clear that the safe harbor proposal would be useful to those companies that believe the company can achieve "Network Maturity" within three years. Otherwise, if the company did not have an expectation that it could achieve network maturity, then the company would not want to register as the registration process would place undue scrutiny on the project. These incentives would help filter good projects from bad, as bad projects wouldn't want to take the risk of registration. Additionally, this would help investors by providing ample information and easier recourse. Thus, consumers would be able to choose between regulated safe harbor projects and unregulated projects. This would foster enforcement efforts by identifying the initial development team—a large obstacle in the anonymous and pseudonymous ecosystem. Also, investors would be able to distinguish between projects that are total scams and projects that are willing to register the identities of the development team.

## XVI. What Improvements Could Be Made Of This Proposal?

Two potential improvements that could be added to the proposal would be 1) restricting the group of potential investors possibly through some kind of opt-in program that warns investors of the risks of their investments, and 2) limiting the amount of money that could be raised through the safe harbor.

Restricting the potential group of investors would bar risky investments from retirement funds and similar conservative institutions. However, the safe harbor could serve as an outlet for demand for projects that are attempting to be networks or projects that operate through blockchains. It seems much better that this money be tracked and the failures of projects be studied. Furthermore, the experiences of small-scale opt-in investors could help the SEC craft policy with some experience.

The overall amount of capital that may be raised should be capped around \$300 to \$150 million. Companies that raise more capital than this should go through a formal IPO process. A report cited by Commissioner Crenshaw, which she cited as outlining some of the biggest failures (which it does), also outlines some of the most successful projects of the ICO era.<sup>111</sup> Of the “successful” projects, the most amount of money raised was \$62 million. Additionally, given statements that public markets are not practical for companies worth less than \$100 million, it makes sense that companies raising over that amount of money could afford better compliance and are better able to succeed in the registration process.

Adding these two improvements, restricting the group of potential purchasers and limiting the total amount of money that could be raised, would better align the safe harbor proposal with the SEC’s stated aims.

## XVII. Does This Better Support SEC Mission And Mandatory Disclosure?

Speaking in 2019, then Chairman Clayton expounded three goals for the SEC—focus on the long-term interests of Main Street investors, be innovative and responsive, and elevate the agency’s performance through technology, data analytics and human capital. The safe harbor proposal could protect the interests of Main Street investors by requiring an opt-in system for investors, so that retirement funds are not invested into risky projects. Second, the safe harbor proposal would be innovative and responsive as there is clearly a market demand and need for both regulatory clarity and investor protection. Third, the safe harbor could support efforts to elevate technology and data analytics as the safe harbor proposal “may enable [the SEC] to better monitor transactions, . . . and other activities and characteristics of our markets, thereby facilitating our regulatory mission[.]”

## XVIII. Conclusion.

Given the decline in public reporting companies, the high cost of compliance, and the rise of blockchain technology and private markets—the SEC should seek to attract entities to regulate rather than drive them away. If the SEC has no entities to regulate, then the SEC has no power.

While investor protection is important, at what point does investor protection become paternalism, or worse yet stall innovation? Given the amount of money raised in 2017 and 2018 and the increasing market capitalization of all cryptocurrency, it is clear there is investor demand for these products. Rather than play regulatory whack-a-mole that may present lose-lose

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<sup>111</sup> Andrey Kartsev, *Best and Worst of ICO Gold Rush: How Technology Created a Market and Greed Doomed It* COINMARKETCAP, <https://coinmarketcap.com/alexandria/article/best-and-worst-of-ico-gold-rush-how-technology-created-a-market-and-greed-doomed-it> (last visited Apr. 17, 2022).

situations, the SEC should seek to create a superior regulatory regime that begins with attempting to regulate these projects on a small scale and opening up these opportunities to a small, and willing group of investors. Otherwise, current trends are likely to continue, public companies may slowly die out, while private and international markets gain further power and influence.

However, the SEC could take its goals seriously to help Main Street investors through financial innovation, innovate by adapting to consumer demand and offering a regulatory structure that is helpful to market participants, and increase enforcement efforts by not examining legitimate projects and pursuing the worst offenders. Thus, the SEC should adopt the safe harbor proposal with a cap on the amount of capital that may be raised and opt-in limitations on the potential investors. Doing so, would allow the SEC to remain relevant by regulating more projects, and presents benefits to investors through both potential innovation, regulatory clarity, and respecting investors' preference for technology.