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# INSIGHT: Crypto—The Pursuit of Sufficient Decentralization

By Stephen Wink and Shaun Musuka


Stephen Wink
Latham & Watkins LLP


Shaun Musuka
Latham & Watkins LLP

*Recent SEC guidance on digital assets cleared a path for at least certain stable coins or payment tokens to avoid securities regulation. However, Latham & Watkins attorneys say there are still a number of open questions that should be addressed.*

In a welcome step toward clarity, the Securities and Exchange Commission issued guidance in April on the application of the "*Howey* test" to digital assets (also known as tokens).

The *Howey* test is decades-old and is used to determine whether a financial instrument is a security. The framework emerged from a 1946 U.S. Supreme Court decision.

The SEC staff has also issued two no-action letters relating to digital assets. The SEC defines a digital asset as an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

The no-action letters confirm there is now a clear path to avoid securities regulation—for at least certain stable coins or payment tokens. The guidance also reinforces that fundraising activities to build a network platform for a token remains the province of securities regulation.

Furthermore, the role of the token's central enterprise will remain a fundamental part of the SEC's inquiry at each stage of the network's evolution. Finally, the guidance expands on SEC Director William H. Hinman's views on how a network may evolve towards sufficient decentralization, thus preserving the possibility of the transmutation of security tokens to consumer tokens.

**Problems, Questions Still Linger**

Still, the SEC's guidance leaves open a number of questions and reaffirms some problematic regulatory themes. Notably, the guidance is unclear about how to evaluate when a platform becomes sufficiently decentralized and it "doubles-down" on the SEC's focus on marketing, regardless of token design.

In a May 2019 speech, SEC Commissioner Hester Peirce noted that the "SEC has yet to provide guidance to the public or FINRA on any of the core questions" involving market participants in this area, and described the April 2019 guidance as one of "splashing lots of factors on the canvas without any clear message." Peirce challenged the SEC to "tackle the remaining legitimate legal questions in a way that does not throw merit-based obstacles in the way of socially beneficial innovation."

For Peirce, the SEC's continued silence on these key issues risks pushing this "innovation and any attendant economic growth into other jurisdictions that have done their work and provided clear guidelines for the market participants to follow." We could not agree more.

We are of the view that issuers who both operate decentralized networks featuring tokens designed for consumption, and sell such tokens in a manner designed to dissuade purchases for investment, should be allowed to avoid the application of the securities laws to such token sales. This is especially true when we consider that other jurisdictions have been able to create pathways for consumer tokens that do not subject issuers to the compliance burden associated with traditional security issuances.

**Steps to Providing More Clarity**

Although sufficient decentralization is difficult to define precisely, there are potential steps that the SEC can take to provide market participants with greater clarity. As Peirce discussed, while the SEC highlighted a number of factors to consider when judging whether a token-based network is sufficiently decentralized, clarity as to the appropriate weighting of such factors would be helpful to issuers.

We propose that the principle of mitigating information asymmetries that exist between issuers and investors, which Hinman noted as a fundamental driver of the need for regulation, should inform the weighting of the factors used to measure the sufficient decentralization of a network. As a result, the SEC should place greater emphasis on factors that have a clear nexus to the reduction of information asymmetries.

For example, the decentralization of network development and maintenance, as well as distributed network governance, should be among the most heavily weighted factors. If such activity is truly decentralized, information asymmetries between network users and a powerful small group that manages the network will be less likely.

On the other hand, the SEC should give less weight to factors such as the existence of a secondary market for the token or its transferability. There are many commodities for which secondary markets exist and their mere existence does not transmute those commodities into securities.

Many token-based networks are under development for which a large number of active market participants is critical to the success of the network. It is difficult to imagine a scenario in which such networks could achieve the critical mass of network participants necessary if such network participants were restricted from exchanging their tokens in some way with other participants for other digital assets or tokens as a means to continually broaden the universe of token holders.

Thus clear guidance from the SEC regarding potential pathways for achieving sufficient decentralization will be essential to the development of tokens and networks. Currently, developers must be wary that the seeding of their network via token “airdrops” and other distributions to affiliates, strategic partners, vendors and community members could be deemed to be a securities offering, given that the issuer may receive a direct benefit from such distributions.

However, these parties are unlikely to require protection from the information asymmetries Hinman cited as the basis for applying the securities laws in this context. These distributions can be a vital step for many networks to achieve decentralization, as distributions often promote network activity, facilitate the implementation of governance procedures, enable network testing prior to full launch and incentivize third-party development work.

In addition, this seed activity permits the nascent token economy of a network to grow, allowing forces beyond those of the initial promoter to begin to determine the value of the network. Accordingly, developers would greatly benefit from a bright line drawn between the capital formation period of these projects, when the securities laws would apply, and thereafter, when token distributions may be made in pursuit of decentralization.

Finally, the SEC should apply less weighting to whether purchasers might expect to receive potential gains based on the future value of the token. Well-designed token economies encourage the development of so-called “network effects,” and such incentives should be encouraged as they will lead to further decentralization.

The fact that a white paper describes these economic incentives as part of the overall economic design of the network should not, in itself, cause the SEC to view the white paper as promoting the token sale as an investment. These types of design elements are notably distinct from actions taken by a central party to promote an increase in the value of the token.

These recommendations, if adopted and implemented, would go a long way towards providing clarity for market participants that are eager to implement innovation and comply with the law but have yet to be presented with a viable pathway towards sufficient decentralization.

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**Author Information**

Stephen Wink *is a partner in the New York office of Latham & Watkins, member of the firm’s Financial Institutions and FinTech Industry Groups, and Co-Chair of the firm’s Blockchain & Cryptocurrency Task Force.*

Shaun Musuka *is an associate in the London office of Latham & Watkins and a member of the Capital Markets Practice.*

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