Published on *The National Law Review* https://natlawreview.com

Bridging the Week by Gary DeWaal: February 3 to 7, and February 10, 2020 (Potential Crypto Certainty; Market Disruption; ADRs; Block Trades)

Article By:

Gary De Waal

Last week, a commissioner at the Securities and Exchange Commission proposed a rule that would provide a bright line when a digital asset initially issued to raise funds to help develop a new network might later be regarded as a non-security. As proposed, network developers and the digital token would not be subject to registration requirements for three years after issuance of the asset, provided certain conditions were satisfied. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- SEC Crypto Mom Cooks Up Tasty Three-Year Safe Harbor Proposal for New Digital Token Sales ; and more.

Article Version:

Briefly:

- **SEC Crypto Mom Cooks Up Tasty Three-Year Safe Harbor Proposal for New Digital Token Sales**: Hester Peirce, a commissioner of the Securities and Exchange Commission, offered language for a potential SEC rule that would grant developers of digital networks, such as a blockchain or distributed ledger, a three-year grace period to develop the functionality or decentralization of the platform without implicating registration requirements of securities laws, provided certain conditions were satisfied.

Speaking before the International Blockchain Congress in Chicago on February 6, 2020, Ms. Peirce said she was introducing her ideas as "a way to address the uncertainty of the application of the securities laws to [digital] tokens."

Under Ms. Peirce's proposal, an initial development team would have to meet five requirements to qualify for the grace period's safe harbor. They would have to:

1. intend that the relevant network become decentralized or functional within three years of the

first token sale and take reasonable steps to achieve such “network maturity”;

2. disclose certain enumerated information on a “freely accessible public website”;

3. ensure digital tokens are offered and sold to enable development of, access to, or participation on the network;

4. take reasonable steps to develop liquidity for users; and

5. file a notice of reliance with the SEC.

The information that the initial development team would be required to publicize includes source code; narrative descriptions of how transaction history would be independently accessed, searched and verified as well as the purpose of the network; launch plans; and how the network would operate and be governed. Also required to be disclosed would be information regarding prior token sales and about the members of the initial development team, including the number or rights to tokens each member owns and may be eligible to acquire.

If all five conditions were met, token transactions after three years would not be regarded as securities transactions if the network was decentralized or functioning (i.e., the token was being actively used on the network in transactions for goods and services). During the three-year safe harbor, token offers and sales in reliance on the safe harbor would be exempt from registration and related provision of securities laws (but not antifraud provisions) and persons involved in certain token transactions would not be regarded as exchanges, brokers or dealers.

Digital tokens previously sold under other lawful exemptions from securities laws are contemplated to be eligible for the proposed new safe harbor. No tokens would be eligible for relief if the initial development team or any of its members previously committed any serious regulatory breaches or if the tokens were of the nature of equity or debt securities.

The preamble to the proposed rule expressly acknowledged that a digital token might be initially offered and sold as a security because it is intertwined in a transaction involving an investment contract but later sold on its own as a non-security because purchasers are not “reasonably” relying on a single person or persons to perform “essential” management or related functions.

Ms. Peirce made clear that, at this time, her proposal was solely her own and had not been approved as a formal rule proposal of the SEC.

Ms. Peirce has often been referred to as “Crypto Mom” by many persons in the digital asset space for her outspoken advocacy of government agencies not impeding responsible innovation (click here for Ms. Peirce’s acknowledgement of this naming).

My View: Purportedly relying on public statements by SEC staff, as well as the agency’s chairman, regarding the potential morphing characteristic of digital tokens from securities to non-securities, and staff’s published guidance regarding qualities of tokens and offering transactions that might render the instruments as securities or not, Telegram Group Inc. and TON Issuer Inc. conducted a private offering of investment contracts involving a virtual currency labelled “TON” during the first quarter of 2018. As part of their plan, they intended to make TON tokens publicly available as non-securities when the TON network became operational in October 2019.

However, the SEC brought an action to enjoin the October 2019 offering and claimed that TON digital assets were securities when first offered in 2018 and would continue to be securities when made more widely available in October 2019. In part, the SEC claimed this was because (1) initial purchasers of the investment contracts always anticipated making money on the resale of their TON digital tokens (and not to use them to facilitate transactions), and (2) although the TON blockchain was to be operational by October 2019, very few applications would be available on the network by that time. The defendants denied the SEC's allegations and legal theories; both the SEC and defendants sought summary judgment based on their respective legal views last month. (Click here for background in the article "Security or Virtual Currency?: Online Messaging Company and SEC File Competing Motions to Resolve ICO Enforcement Action Based on Different View of Same Cryptoasset" in the January 19, 2020 edition of *Bridging the Week*.)

SEC staff has routinely acknowledged the chameleon nature of certain financial instruments. They may be securities one day but not the next, and depending on facts and circumstances, could be securities again. They have done so recently in public statements about the cryptoasset ether and previously about futures based on stock indices.

Indeed, in 2013, the SEC issued a 21(a) Order involving EUREX Deutschland in which it reiterated existing law that a futures contract based on a stock index constituted a securities futures contract under its jurisdiction when the stock index was narrow-based and pure futures under the exclusive oversight of the Commodity Futures Trading Commission when the stock index was broad-based. The order made clear what the bright line was when discerning whether an index was broad-versus narrow-based and warned futures exchanges going forward of the consequences of sliding into SEC-oversight land without complying with securities law requirements. (Click here for background in the My View section of the article "Messaging Service Company Denies SEC's Claim That Sale and Issuance of Cryptocurrency Constitutes Unlawful Security Offering" in the November 17, 2019 edition of *Bridging the Week.*)

Even if adopted, Commissioner's Peirce's proposed route to a safe harbor regarding digital tokens would likely be too late to help Telegram and TON Issuer in their current enforcement action. However, it would create a safe harbor and bright line that formally reflects the potential evolving qualities of digital tokens and transactions and provide a safe path for network developers going forward. That would be a very good development and Ms. Peirce's proposal should be considered sooner not later by all SEC commissioners.

More Briefly:

- **Testing Market Depth Results in Sanction for CBOT Trader**. Paul Dow, a non-member agreed to pay a fine of US $10,000 and be prohibited for 25 business days from accessing any CME Group exchanges' market to settle a disciplinary action brought by the Chicago Board of Trade that charged him with disruptive trading. According to a panel of the business conduct committee of the CBOT, on multiple occasions from May 8, 2017, through July 30, 2018, Mr. Dow entered orders in various agricultural futures contracts during pre-opening sessions to assess the depth of the order book or the prior day's settlement price, and not to execute bona fide transactions. The panel said that Mr. Dow's placement and cancellation of his orders "caused fluctuations in the publicly displayed indicate opening price."

- **One More Time – SEC Names Broker-Dealer in Enforcement Action for Purportedly Mishandling ADRs**: ABN AMRO Clearing Chicago LLC agreed to pay almost US $600,000 in sanctions to settle charges by the Securities and Exchange Commission related to its purported mishandling of "pre-released" American Depositary Receipts.

According to the SEC, from at least January 2013 through approximately December 2015, ABN received pre-released ADRs from certain brokers that had themselves not taken reasonable steps to satisfy obligations they had under pre-release agreements with depositaries. Under these agreements, the pre-release brokers had to represent that they beneficially owned the ordinary shares represented by the ADRs and assigned all their rights to the relevant depositary while the pre-release transactions were outstanding. The SEC claimed that, during the relevant time, ABN brokers who obtained pre-released ADRs from certain brokers were on notice that the brokers were likely not complying or had no reasonable basis to believe the brokers could comply with their pre-release agreements. As a result, charged the SEC, ABN failed to supervise its brokers.

ADRs are negotiable instruments that represent interest in foreign securities on deposit with a depositary. Pre-released ADRs are meant to accommodate ADRs on newly issued securities when it may be impossible because of settlement delays to deposit the newly issued foreign securities.

ABN agreed to disgorge US $328,000 of gains in connection with these transactions and pay a penalty and interest of approximately US $260,000. The SEC said that its ADR enforcement action against ABN was its 15th enforcement action against a bank or broker involving problematic ADR practices since January 2017

- **CME Group Amends Block Trade Information Disclosure Restrictions**: CME Group exchanges proposed to amend a Market Regulation Advisory Notice to make clear that the consent required from a customer by a broker or counterparty to disclose the identity of the customer in a proposed block trade must be "express" consent only. This may be evidenced by a letter, email, instant message, or recorded phone line and such evidence must be provided to Market Regulation upon request. Consent is not required trade-by-trade but must be obtained no less than annually. ICE Futures U.S. also proposed similar amendments to its block trade rule and associated guidance that were effective on January 27, 2020. (Click here for background in the article "IFUS Authorizes More Types of Three-Party EFRPs and Proposes Modifications to Clearing Brokers' Block Trades Obligations" in the January 12, 2020 edition of *Bridging the Week*.)

- **US Department of Treasury Issues Report on Terrorist and Illicit Financing – Cash Is Still King**: The US Department of Treasury announced its 2020 strategy to enhance its anti-money laundering and countering the financing of terrorism regime. Among other things, Treasury said it would prioritize increasing transparency and closing gaps in the US AML/CFT legal framework; enhancing "the efficiency and effectiveness" of the AML/CFT regime for financial institutions; improving current AML/CFT operational frameworks by enhancing communication of illicit finance threats, vulnerabilities and risks; expanding the use of artificial intelligence and data analytics; and employing creative measures to disrupt illicit finance activity. Among "significant" vulnerabilities within the United States that facilitate money laundering and illicit financing activities, said Treasury, are the lack of any requirement to collect beneficial ownership information at the time of company creation or change of ownership; the "ubiquitous and anonymous" use of US physical currency both stateside and abroad; compliance weaknesses; "complicit actors" within financial institutions and other businesses; and the increasing "misuse" of digital assets and the failure of at least some foreign jurisdictions to police digital asset activity.

Video Version:

For further information:

CME Group Amends Block Trade Information Disclosure Restrictions:
https://www.cmegroup.com/content/dam/cmegroup/market-regulation/rule-filings/2020/2/20-095_1.pdf

One More Time – SEC Names Broker-Dealer in Enforcement Action for Purportedly Mishandling ADRs:
https://www.sec.gov/litigation/admin/2020/34-88139.pdf

SEC Crypto Mom Cooks Up Tasty Three-Year Safe Harbor Proposal for New Digital Token Sales:
https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06

Testing Market Depth Results in Sanction for CBOT Trader:
https://www.cmegroup.com/notices/disciplinary/2020/02/CBOT-18-1029-BC-PAUL-DOW.html#pageNumber=1

US Department of Treasury Issues Report on Terrorist and Illicit Financing – Cash Is Still King:
https://home.treasury.gov/system/files/136/National-Strategy-to-Counter-Illicit-Financev2.pdf

National Law Review, Volume X, Number 41