Private Equity Regulatory Update

February 28, 2020

Rules and Regulations

Proposed Amendments to the Volcker Rule

On January 30, 2020, the Federal Reserve Board, the OCC, the FDIC, the SEC and the CFTC proposed amendments to the covered fund provisions of the Volcker Rule. The proposed amendments address long-standing concerns with the over-broad definition of covered fund, the treatment of foreign funds (both public and private), and the Super 23A prohibition.

The proposal is relatively short and straightforward. It reflects the approach of Federal Reserve Vice Chair Randal Quarles to simplify the Volcker Rule "in light of our experience with the rule over six years of implementation" and to allow banking entities to conduct "additional fund-related activities, which do not present the risks that the Volcker Rule was intended to address."

Davis Polk has published a **client memorandum** discussing the proposed amendments to the covered fund provisions of the Volcker Rule.

Industry Update

SEC Office of Compliance Inspections and Examinations (OCIE) Issues Observations on Cybersecurity and Resiliency Practices

The SEC Office of Compliance Inspections and Examinations (the "**OCIE**") recently published observations related to cybersecurity and operational resiliency practices observed in its examinations, highlighting seven areas of focus: governance and risk management; access rights and controls; data loss prevention; mobile security; incident response and resiliency; vendor management; and training and awareness.

Davis Polk has published a **client memorandum** discussing the OCIE's observations.

SEC Commissioner Hester M. Peirce Delivers Speech Detailing Her Token Safe Harbor Proposal

On February 6, 2020, SEC Commissioner Hester M. Peirce outlined in a speech the details and rationale behind her Token Safe Harbor Proposal, in which she proposes a new Rule 195 under the Securities Act of 1933 relating to cryptocurrency regulation. Commissioner Peirce clarified that her speech reflected her own “not fully formed” views alone, and welcomed feedback from those with an interest in digital asset regulation.

Commissioner Peirce began by noting that her general approach to regulation is that “[i]t is important to write rules that well-intentioned people can follow.” Currently, she argued, entrepreneurs in the cryptocurrency space are struggling to find a way to both comply with the law and accomplish their “laudable objectives” of developing worthwhile and beneficial products.

As the Commissioner explained, crypto entrepreneurs face a regulatory quagmire when attempting to build “token networks”--decentralized networks where tokens, or units of value tied to an existing blockchain, provide access to functions of these networks. In order to successfully create a token network, an entrepreneur must disseminate those tokens among other actors. However, Peirce argued, these efforts can be stymied by concerns that such dissemination may fall within the scope of federal securities laws.

The *Howey* Analysis and Its Limitations

The Commissioner continued by observing that the SEC has scrutinized whether token sales would be considered “investment contracts” subject to federal securities laws using an analysis under *SEC v. W.J. Howey Co*.[1] Yet while *Howey* concerned the sale of orange grove units, Peirce argued that its application to cryptocurrency has proven more complicated. As she explained, “[t]he ‘contract, transaction or scheme’ by which the token is sold may constitute an investment contract; but, the object of the investment contract—the token—may not bear the hallmarks of a security.”

Peirce also noted that although sellers may suggest that tokens’ value will increase and therefore prompt the conclusion that these assets are sold pursuant to an investment contract, such suggestions often reflect mere hopes that a network will expand and grow to become a widely used network. Peirce instead likened tokens to any other consumer product, and argued that the analysis should “focus on the objective nature” of the item for sale, rather than a purchaser’s “subjective intent.”

Peirce argued that the SEC’s approach has made it difficult for a company to distribute tokens without confronting the risk that it has engaged in a securities offering, even in the case of a token airdrop where tokens may be distributed for free. The Commissioner then outlined certain avenues crypto entrepreneurs have sought in an effort to manage securities regulations, noting that “any route chosen by a team to distribute tokens into the hands of potential users is fraught with uncertainty under the securities laws.”

First, Peirce explained that some entrepreneurs attempt to sufficiently build out their networks prior to distributing tokens, in the hope that these networks will appear functional enough to avoid the securities label altogether. However, she noted that the difficulty of proving that tokens have utility prior to their dissemination makes this strategy risky.

Second, the Commissioner noted that another option is to sell tokens either in a registered offering or pursuant to an exemption from registration. However, she explained that a registered offering of tokens has yet to occur in the United States, and proceeding under an exemption, such as Regulation A, can involve prohibitive costs. Moreover, Peirce highlighted that once this route is taken, the tokens must trade as a security through a registered broker-dealer or registered exchange, which could dampen the development of a thriving decentralized crypto network, whose core benefit “is its non-reliance on intermediaries; people transact directly with one another.”

Finally, Peirce noted that some entrepreneurs choose to elide U.S. securities laws altogether by operating entirely outside the United States. She cautioned, however, that the near-inevitability of U.S. activity

[1] 328 U.S. 293 (1946).

within a token network imbued this strategy with risk, and further raised the issue that this approach would prevent American citizens from participating in the creation of these networks to the detriment of the U.S. economy.

Proposed Rule 195: Token Safe Harbor Proposal

Having discussed her view that the SEC's traditional approach stifles the development of token networks, Peirce transitioned to her proposed "safe harbor" to balance "the need to achieve the investor protection objectives of the securities laws" with "the need to provide the regulatory flexibility that allows innovation to flourish." Peirce noted that she proposed the safe harbor as an SEC rule, as opposed to a no-action position, in order to increase durability and preempt state laws.

The Commissioner explained that the proposed safe harbor "would provide network developers with a three-year grace period within which they could facilitate participation in and the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws." Specifically, Peirce's proposal would exempt during such grace period "(1) the offer and sale of tokens from the provisions of the Securities Act of 1933, other than the antifraud provisions, (2) the tokens from registration under the Securities Exchange Act of 1934 [("**1934 Act**")], and (3) persons engaged in certain token transactions from the definitions of 'exchange,' 'broker,' and 'dealer' under the 1934 Act." She elaborated that this three-year grace period was intended to allow a network to mature into a decentralized or functioning network such that token sales on such network would no longer look like securities transactions under the *Howey* standard.

Peirce also clarified that under her proposal, these exemptions would apply only if five conditions were met:

> First, the team must intend for the network on which the token functions to reach network maturity—defined as either decentralization or token functionality—within three years of the date of the first token sale and undertake good faith and reasonable efforts to achieve that goal. Second, the team would have to disclose key information on a freely accessible public website. Third, the token must be offered and sold for the purpose of facilitating access to, participation on, or the development of the network. Fourth, the team would have to undertake good faith and reasonable efforts to create liquidity for users. Finally, the team would have to file a notice of reliance.

Peirce clarified that the proposed safe harbor would also apply retroactively to tokens already sold in a registered offering or pursuant to a valid exemption from registration. Moreover, she also stressed that the proposed rule would not interfere with SEC or state antifraud actions, citing the need to protect token purchasers alongside token entrepreneurs.

In closing her remarks, the Commissioner underscored that her proposition remains a work in progress and welcomed feedback. Specifically, she stated that she would appreciate advice on improving the proposed rule's definitions to better keep pace with new technology, and appropriately defining the proposed rule's scope.

- **See a transcript of the remarks**

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