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Legal Guide to Decentralizing Blockchain Networks and Governance

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Legal Guide to Decentralizing Blockchain Networks and Governance ■

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The idea around blockchain has always been the decentralization and democratization of systems and networks that central authority has typically controlled. Implicitly, however, every blockchain project or network must start with a central party. This ultimately begs the question: how does a centralized network become sufficiently decentralized?

The Securities and Exchange Commission's ("SEC" or "Commission") recent complaint against Ripple Labs and its co-founders, Bradley Garlinghouse and Christian Larsen, sheds light on the SEC's analysis for answering the decentralization question. The Commission relied on the infamous Howey Test in concluding that Ripple's native tokens, XRPs, are investment contracts and, as such, Ripple and its co-founders had engaged in the unregistered sale of securities. While the lawsuit is ongoing, the complaint is a useful tool for gaining insight on what the SEC views as important factors for analyzing whether a network is adequately decentralized or not.

What we see in today's marketplace are projects that begin as networks with a centralized authority—one that is responsible for the entrepreneurial and managerial efforts required to make the project a success—which eventually becomes sufficiently decentralized so that no one single person or entity can control or influence the network or its protocols. These projects typically undergo several phases, which can be described as (1) research and development; (2) building and deploying the public infrastructure; and (3) increased decentralization. The decentralization process involves, among other things, the creation of a non-profit Foundation, the decentralization of corporate governance, and the overall reduction of the founding team's role in developing, maintaining, and marketing the particular ecosystem.

Decentralization Process ■

Decentralization is not binary. There is no magical threshold to cross or bright-line rule to follow for a network to become decentralized. To achieve it, networks must develop over time so that no single person or entity can control, maintain, or influence the network or control the network's token supply. This endeavor involves, among other things, creating a non-profit foundation to oversee the network, dividing the founding team into separate entities who have no more influence than any other individual participating in the network, and granting the ability to independent miners to mine tokens on the platform and implement hard forks. The following is a proposed framework for achieving this ambitious goal.

1. Initially, most projects will require fundraising for research and development and promoting and launching their networks. That being the case, these projects generally begin by issuing their tokens as securities—typically under one of the SEC's exemptions from registration. A centralized team works on the initial research and development of the network. Once the R&D is complete, the team can deploy the network, along with a protocol for proposing improvements to the network.
2. Next, the team can launch a program to incentivize developers to build apps on its blockchain, accelerating the growth of the user-owned network.
3. Once the network is sufficiently developed, the team can then release an updated blockchain protocol that grants independent miners the ability to mine tokens on the platform and implement hard forks to the network's protocol. This is essential to the decentralization process because it transfers the governance of the network to individuals in the ecosystem rather than a single entity. Moreover, it ensures that the network's success is not dependent on any single party and that no single party can be deemed the issuer of the network's particular token.
4. The founding team can further decentralize the ecosystem by dividing it into their own separate entities, participating in the ecosystem as individuals just as anyone else. This eliminates any “identifiable entity” that is in control of the distribution of the network's tokens or promoting and marketing the network itself—a factor that the SEC gave considerable weight to in its complaint against Ripple.



5. The next step in decentralizing the network is forming an independent non-profit foundation—one that is unrelated to the founding team. The foundation will oversee the development of the network and is meant to reduce the scope of the founding team that spearheads the initial development of the network. To that end, the foundation should be comprised primarily of individuals who were not a part of the founding team. Additionally, establishing an independent technical advisory committee that can weigh in on future proposals and help determine the future of the network promotes an open and transparent development process. By creating a non-profit foundation to oversee the network, composed in part by an independent advisory committee, no one single entity can be held responsible for driving the future value of the token or success of the ecosystem.

6. What results is a network in which the operation and governance of the blockchain will be so diffuse or decentralized that no one single party can be deemed as providing, or having the ability to provide, the types of essential managerial services that would satisfy the Howey Test. Moreover, the founding team will play such a minor role in the ecosystem that it cannot provide the essential and managerial services of the Howey Test. Accordingly, the tokens will no longer be deemed investment contracts subject to federal securities laws.

The decentralization of a network is a prolonged, systematic process. It requires, at minimum, a community of miners; developers; service, wallet, and custody providers; independent entities devoted to the ecosystem; and thousands of token holders and individuals participating in the consensus mechanism. Altogether, this community will develop and govern the network, which will ultimately impact the value of the network's native token.

The SEC's Views ■

The Ripple Complaint

To better understand the factors involved in the Howey Test, one needs to look no further than the SEC's complaint against Ripple Labs and its co-founders, Bradley Garlinghouse and Christian Larsen. In the complaint, the SEC alleged that Ripple Labs and its co-founders had engaged in the unregistered sale of securities when selling approximately \$1.4 billion of the digital asset XRP. Relying on the Howey Test, the SEC argued that the sale of XRP constitutes an investment contract because (a) Ripple led investors to reasonably expect that Ripple's and its agents' entrepreneurial and managerial efforts would drive the success or failure of Ripple's XRP projects; (b) purchasers of XRP invested into a common enterprise; and (c) Ripple led investors to reasonably expect to profit from their investments derived from Ripple's efforts.

Ripple Led Investors to Reasonably Expect that Ripple's and its Agent's Entrepreneurial and Managerial Efforts would Drive the Success or Failure of Ripple's XRP projects:

The SEC pointed to five factors in arguing that Ripple led investors to reasonably expect that Ripple and its agent's entrepreneurial and managerial efforts would drive the success or failure of Ripple's XRP projects. First, Ripple promised to undertake significant efforts to build value for XRP. Ripple created "The Ripple Protocol" and stated in a 2014 Promotional Document that "Ripple Labs' business model predicated on a belief that demand for XRP will increase (resulting in price appreciation) if the Ripple protocol becomes widely adopted." Moreover, Ripple held itself out as the critical party who would make these efforts concerning XRP and The Ripple Protocol. Ripple even promised to distribute certain XRP to incentivize market makers, gateways, and consumers to utilize the protocol. On numerous occasions, Ripple highlighted its business development efforts, including the company's efforts to increase XRP's liquidity and price through XRP Escrow. Although Ripple's goal was to provide utility to XRP as a "new intermediary asset," it tied those efforts to a potential for an increase in XRP price and thus led investors to reasonably expect Ripple's entrepreneurial and managerial efforts would drive the success or failure of their investment in XRP.

Second, Ripple promised to undertake significant efforts to develop and maintain a public market for XRP investors to resell XRP. A statement on Ripple's website read: "We will engage in distribution strategies that we expect will result in a stable or strengthening XRP exchange rate against other currencies." Further, in a public interview, Ripple co-founder, Larson, explained that one of the company's "key roles" was to ensure that it could distribute XRP as broadly as possible to add as much utility and liquidity as possible. And in a 2017 article posted on Ripple's website, Garlinghouse reminded investors that, "[t]o build XRP liquidity, [Ripple has] been mindful over the years about how [Ripple] distribute[s] XRP. [Ripple's] goal in distributing XRP is to incentivize actions that build trust, utility, and liquidity." Finally, in a 2020 Markets Report, Ripple explained that it had begun purchasing XRP in the secondary market to ensure a "healthy, orderly XRP market."

Third, Ripple "touted" the ability of its team to succeed in its promised efforts. Ripple highlighted the experience, expertise, and ability of the team it had assembled. In one Ripple forum, a Ripple agent explained that Ripple's fundraising efforts through selling XRP "allows Ripple Labs to have a spectacularly skilled team to develop and promote the Ripple protocol and network."

Fourth, Ripple publicly promoted the efforts that it did, in fact, undertake. For example, the co-founders made many statements in connection with the announcement of XRP Escrow, claiming that Ripple had been a good "steward" of XRP. In a 2018 interview with CNBC, Garlinghouse stated that Ripple had "invested in venture funds . . . in hedge funds . . . in companies, [and] . . . partnered with payment providers [and] . . . market makers, in order to make sure that XRP is the most useful asset out there for solving a cross border payments problem."

Fifth, and finally, the SEC argued that the economic reality dictates that XRP purchasers have no choice but to rely on Ripple's efforts for the success or failure of their investment. The economic reality of the situation is such that reasonable investors are speculating that Ripple has the incentive and potential to create demand for XRP. The investors are speculating that Ripple will solve the "trillion-dollar" cross-border payments problem, and the investors will profit as a result. On the other hand, XRP investors lack both the expertise and resources to take most or any of the steps that Ripple has taken to grow the XRP ecosystem and increase demand for XRP.

Purchasers of XRP Invested in a Common Enterprise



According to the SEC, because XRP is fungible, the “fortunes of XRP purchasers are tied to one another, and each depend on the success of Ripple’s XRP strategy.” Ripple’s ability to drive trading of XRP in turn drives demand for XRP, which will dictate investors’ profits or losses. Ripple pooled the funds it raised in the Offering and used them to fund its operations, including to finance building out potential “use” cases for XRP, paying others to assist in developing a “use” case, constructing the digital platform it promoted, and compensating executives recruited for these purposes. Furthermore, Ripple repeatedly emphasized these common interests to prospective investors and made publicly clear that Ripple would sell XRP to raise funds for one common enterprise: to fund its operations.

Moreover, in the legal memos the Ripple team received after meeting with lawyers early in the venture, the focus was on the very fact that there was the existence of an identifiable actor who held itself out as responsible for making efforts with respect to XRP, which distinguished XRP from bitcoin. At all times Ripple was responsible for the distribution of XRP and the promotion and marketing functions of the Ripple ecosystem.

Finally, Ripple held a large sum of XRP supports the notion that a common enterprise exists because Ripple’s incentives are aligned with those of the users of its network. In 2018, Garlinghouse publicly stated: “There’s no party more interested in the success of the XRP ecosystem than Ripple. We want that to be massively successful because we own a lot of XRP.”

Ripple led investors to reasonably expect to profit from their investments derived from Ripple's efforts:

As an initial matter, Ripple's publicly stated goal was to increase demand for XRP through their entrepreneurial and managerial efforts, repeatedly telling investors that Ripple's XRP related efforts were meant to spur demand for XRP. It follows, the SEC reasoned, that a reasonable investor would understand an increase in demand to lead to an increase in XRP market price. Ripple and its co-founders also assured investors Ripple would protect the trading market for XRP. In fact, Ripple repeatedly stated that it expected its XRP distribution strategies to strengthen the price of XRP against other currencies and told investors that Ripple was establishing the XRP Escrow to remove uncertainty over the supply of XRP in the market.

Co-founder Garlinghouse was a particularly persistent spokesperson for Ripple's efforts to market XRP as an investment from which investors could potentially profit. While he was selling millions of XRP, Garlinghouse frequently told investors that he was invested in XRP and bullish on the investment. In response to a question about the extreme volatility in cryptocurrency markets, Garlinghouse answered: "For XRPs specifically . . . as Ripple has done well in announcing customers—that has driven market interest in buying XRP as a speculative investment. Ripple explicitly stated these goals internally, including in documents describing one of the reasons to establish the XRP Escrow as securing speculative liquidity, with the hopes that it would lead to "immediate increase in volume and price appreciation."

In sum and in short, according to the SEC, Ripple's alleged conduct supports the conclusion that XRPs are investment contracts and are therefore subject to federal securities laws. From promising to undertake significant efforts to develop and maintain a public market for XRP investors to resell XRP to touting its team's abilities to succeed in its promised efforts to publicly stating its goal to increase demand for XRP through Ripple's own entrepreneurial and managerial efforts, the facts and economic reality suggest XRPs are securities in the eyes of the SEC. And, unlike bitcoin, Ripple took extensive efforts to develop its network and is an identifiable entity which is responsible for the distribution of XRP and the promotion and marketing functions of the Ripple Network.

Whether or not a court will agree with the SEC remains up in the air. Nevertheless, the complaint outlines a myriad of factors to take into consideration when analyzing the decentralization of a network.

Furthermore, in his 2018 speech at the Yahoo Finance All Markets Summit, former Director of Corporation Finance at the SEC, William Hinman, discussed the security token analysis. Hinman explained that tokens, standing alone, are not securities. Rather, “[c]entral to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers.” Hinman went on to say:

The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract.

On the other hand, “[i]f the network on which the token or coin is to function is sufficiently decentralized[,]” Hinman reasoned, “where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract.” Hinman distinguished the Bitcoin and Ethereum networks as being sufficiently decentralized because there are no identifiable central parties whose entrepreneurial or managerial efforts are key to the success of the respective networks. In Ethereum's case, although the initial fundraising used to create Ether may have constituted the sale of securities at the time, “the present state of Ether, the Ethereum network, and its decentralized structure, current offers, and sales of Ether are not securities transactions.” This reasoning remains true today.

Proposed Token Safe Harbor

On April 13, 2021, Commissioner Hester Pierce of the SEC released a Public Statement addressing an updated version of the Token Safe Harbor Proposal originally proposed in February of 2020. The proposal also provides insight into the analysis of whether a digital asset is offered or sold as a security. According to Commissioner Pierce, for a network to mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts, the tokens must be distributed to and freely tradeable by potential users, programmers, and participants in the network. If implemented, the safe harbor would provide network developers with a vehicle to achieve sufficient decentralization or functionality without risking liability for violation of US securities laws.

The Proposal

The proposed safe harbor would grant network developers a three-year grace period within which they can facilitate participation in and the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws provided that certain conditions are met. Under the safe harbor proposal, the SEC would exempt the offer and sale of tokens from the provisions of the Securities Act of 1933, other than the antifraud provisions; the tokens from registration under the Securities Exchange Act of 1934; and persons engaged in certain token transactions from the definitions of “exchange,” “broker,” and “dealer” under the 1934 Act.

Moreover, under the safe harbor, the Securities Exchange Act of 1934 would not apply to any offer, sale, or transaction involving a Token if the following conditions are met by the initial development team: (1) the team intends for the network to reach Network Maturity within three years of the date of the first sale of the tokens; (2) disclosures by the team are made available on a freely accessible public website; (3) the tokens are offered and sold for the purpose of facilitating access to, participation on, or the development of the network; (4) the team files a notice of reliance; and (5) the team files an exit report, which would include either an analysis by outside counsel explaining why the network is decentralized or functional, or an announcement that the tokens will be registered under the Securities Exchange Act of 1934.

Commissioner Pierce further explained that token transactions would not be considered securities transactions if the network has matured into a decentralized or functioning network on which the token is in active use for the exchange of goods and services. In assessing decentralization, the initial development team must take into consideration whether the network is controlled and is reasonably likely to be controlled, or unilaterally changed, by any single person, group of persons, or entities under common control. In assessing functionality, the team must consider whether token holders can use the tokens in a manner consistent with the utility of the network.

Additionally, Commissioner Pierce explained that the disclosure requirement of the proposed safe harbor is meant to protect token purchasers by addressing information asymmetry and mandating that certain information be made available on a freely accessible public website. These disclosures include: the source code of the network; the transaction history; the purpose of the network, the protocol, and its operation, which includes, among others, information about how tokens are generated or mined, the process for burning tokens and validating transactions, the consensus mechanism, and the governance mechanisms for implementing changes to the protocol; the plan of development; prior token sales; information regarding the initial development team and certain token holders; the number of tokens owned by each member of the initial development team; a description of any limitations or restrictions on the transferability of tokens held by such persons; a description of the team members' rights to receive tokens in the future; identifying secondary trading platforms on which the tokens trade; the disclosure of any time that a team member sells five percent or more of his or her originally held tokens over any period of time; and a statement that the purchase of the network tokens involves a high degree of risk and the potential loss of money.

Network Maturity Analysis

The definitions section of the proposed safe harbor rule describes “Network Maturity” as being achieved when the network is either: (1) not economically or operationally controlled and is not reasonably likely to be economically or operationally controlled or unilaterally changed by any single person, entity, or group of persons or entities under common control, except that networks for which the initial development team owns more than 20% of the tokens or owns more than 20% of the means of determining network consensus cannot satisfy this condition; or (2) functional, as demonstrated by 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.

In regard to the exit report requirement, Commissioner Pierce detailed what should be included in analyzing a particular network’s Network Maturity. For a network that has reached Network Maturity for a decentralized network, an analysis by outside counsel must be provided. First, the analysis should include a description of the extent to which decentralization has been reached across a number of dimensions, including voting power, development efforts, and network participation. The description should include, if applicable, examples of material engagement on network development and governance matters by parties unaffiliated with the initial development team and explanations of quantitative measures of decentralization. Second, the Network Maturity analysis should include an explanation of how the initial development team’s pre-Network Maturity activities are distinguishable from their ongoing involvement in the network. This explanation should discuss the extent to which the initial development team’s continuing activities are more limited in nature and cannot reasonably be expected to uniquely drive an increase in the value of the tokens; confirm that the initial development team has no material information about the network that is not publicly available; and describe the steps taken to communicate to the network the nature and scope of the initial development team’s continuing activities.

On the other hand, for a network that has reached Network Maturity for a functional network, the analysis by outside counsel should describe the holders’ use 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. Additionally, the analysis should 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.

Finally, if the initial development team determines that Network Maturity has not been reached, the exit report must include the following information: the status of the project and the next steps the initial development team intends to take; contact information for token holders to communicate with the initial development team; and a statement acknowledging that the initial development team will file a Form 10 to register under Section 12(g) of the Securities Exchange Act of 1934 the tokens as a class of securities within 120 days of filing the exit report.

Factors to Consider ■

Below is a non-exhaustive but illustrative list of factors for your team to consider when determining if your network is sufficiently decentralized –

1. Has your team led investors to reasonably expect that your entrepreneurial and managerial efforts will drive the future success or failure of your token?
 - Has your team promised to undertake significant efforts to build the value of the token?
 - Has your team attempted to incentivize participants in the ecosystem to utilize the protocol?
 - Has your team undertaken efforts to increase liquidity and price of the token?
 - Has your team tied the utility of the token to a potential increase in the price of the token, therefore leading investors to reasonably expect to profit?
 - Has your team worked towards developing and maintaining a market for investors to resell the tokens?
 - Has your team publicly endorsed its abilities to deliver on its promises?
 - Has your team publicly endorsed the efforts it has, in fact, taken to succeed in its promised efforts?
 - Does the economic reality dictate that investors have no choice but to rely on the entrepreneurial and managerial efforts of your team for the success or failure of their investment?

2. Is your project a “common enterprise”?

- Are your tokens fungible? That is, are the fortunes of the purchasers of your tokens tied together, each depending on the success of your team’s strategy?
- Have you fundraised specifically to fund your operations?
 - Have you used the funds to build out potential “use” cases for your tokens or for research and development?
 - Have you used the funds to pay others to assist in developing “use” cases for your tokens?
- Is your team an identifiable actor who has held itself out as responsible for the distribution of your tokens and the promotion and marketing functions of your network?
- Does your team hold a large sum of the tokens, supporting the notion that a common enterprise exists because your team’s incentives are aligned with those of the participants in the network?

3. Has your team led investors to reasonably expect to profit from their investments derived from your team’s efforts?

- Has your team publicly stated a goal to increase demand for your tokens through its entrepreneurial and managerial efforts?
- Has your team told investors that its token-related efforts were meant to spur demand for the token?
- Has your team assured investors that it would take efforts to protect your token’s market?
- Has your team utilized token distribution strategies to strengthen the price of your token against other currencies?
- Has your team undertaken efforts, such as creating an escrow for your token, to remove uncertainty over the token supply in the market?
- Has your team communicated internally its goals to increase speculative liquidity, thereby leading to an increase in volume and price appreciation?

Determining whether a project is sufficiently decentralized to avoid scrutiny from the SEC for the unregistered sale of securities is a highly nuanced and complex process. No single factor controls, and the SEC will look at the totality of the circumstances in making this determination. Therefore, we strongly encourage developers to reach out to the SEC's FinHub for guidance on launching their respective projects in compliance with US securities laws and achieving sufficient decentralization. Our lawyers are well-versed in US securities laws and will also work together with our clients to ensure compliance with US securities laws and provide them with a roadmap for achieving true decentralization of their network

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