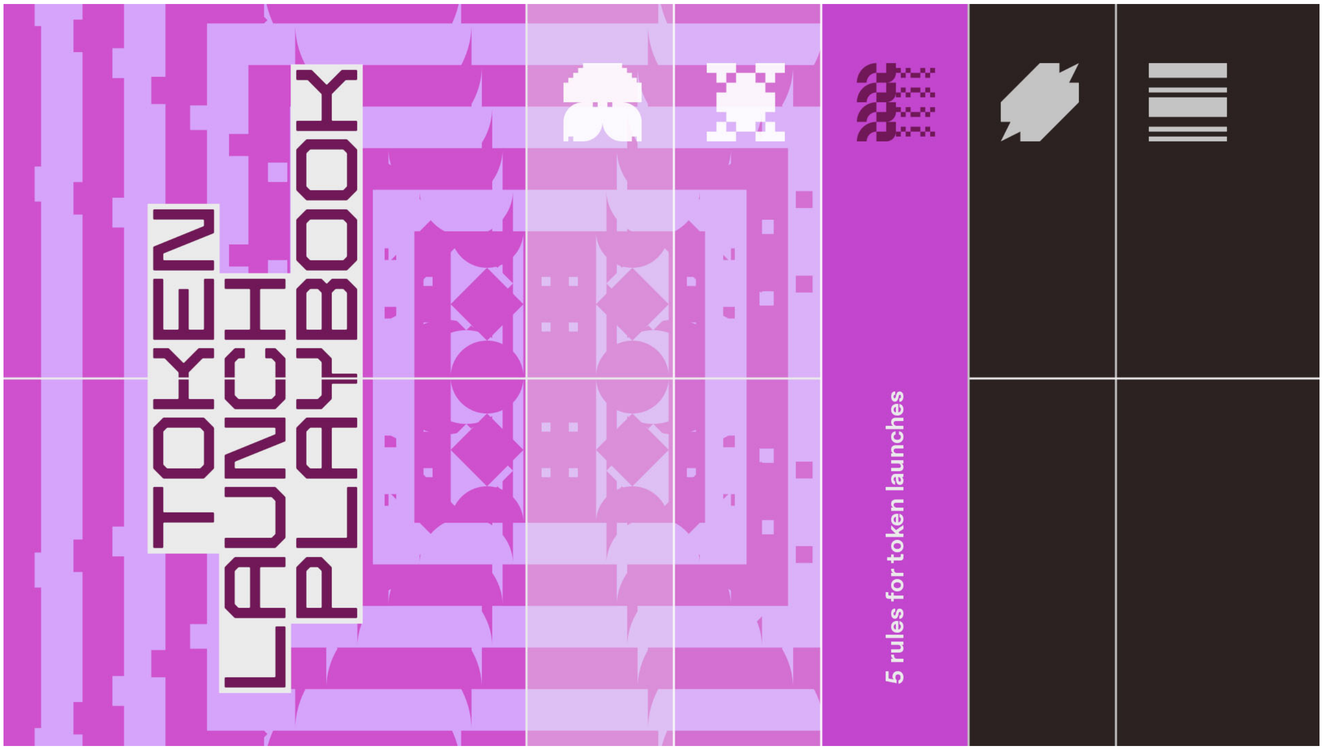
# 5 rules for token launches

a16zcrypto.com/posts/article/5-rules-for-token-launches

April 25, 2024




To an onlooker the tension between blockchain builders and the U.S. Securities and Exchange Commission (SEC) might seem overwrought. The SEC argues that nearly every token should be registered under U.S. securities laws. Builders argue that this is nonsensical. Despite this difference of opinion, the fundamental goal of the SEC and builders is aligned – to create a level playing field.

Tension exists because these two sides approach the same challenge from completely different perspectives. Securities laws seek to level the playing field among investors by applying disclosure requirements designed to eliminate asymmetric information to companies with publicly traded securities. Blockchain systems seek to level the playing field among a wider array of participants (developers, investors, users, etc.) through decentralization, which uses transparent ledgers, eliminates concentrated control, and reduces reliance on managerial efforts. Although builders have a wider audience to address, they too want to eliminate asymmetric information about systems and their native assets, tokens.

It is no surprise that regulators view the latter approach with skepticism. This type of decentralization does not have an analog in the corporate world; it leaves regulators without a party to hold accountable; and, because decentralization is difficult to establish and measure, it's easy to fake.

For better or worse, the burden is on web3 builders to prove that the blockchain industry's approach works and is worthy of consideration. While it's true this task would be easier if the SEC were a constructive partner, the industry cannot allow the failures of the SEC to become its own. Web3 projects must try to work within the bounds of the guidance they have, from the SEC's framework for digital assets released in April 2019 to the most recent ruling in its enforcement action against Coinbase.

So, where should projects start? After determining when and how to launch a token, projects can start with these five rules for token launches:

**Note**: These rules are not intended as a map for evading U.S. securities laws. Instead, they are designed to inform projects about how to conduct themselves, so that the risks associated with holding their tokens depart significantly from those associated with investing in securities. All of these guidelines depend on the specific facts and circumstances of a project's structure and conduct. Discuss them with counsel before following through with a plan.

## Rule 1: Never publicly sell tokens in the U.S. for fundraising purposes

In 2017, initial coin offerings (ICOs) boomed as dozens of projects sought to raise funds based on promises they would achieve important technological breakthroughs. While many did (Ethereum included), significantly more did not. At the time, the SEC's response was both forceful and justified. The commission sought to apply securities laws to ICOs, which often met all of the conditions of the Howey Test – a contract, scheme or transaction in which there is an investment of money in a common enterprise with a reasonable expectation of profits based on the managerial or entrepreneurial efforts of others.

Nowhere is the application of the Howey Test easier than with respect to primary transactions (i.e., token sales to investors by token issuers). In many ICOs, token issuers made clear representations and promises to investors that they were going to fund their operations with the proceeds from the token sale and deliver a future return to investors. Those cases were securities transactions regardless of whether the instruments being sold were digital assets or shares of stock. Case closed.

The industry has evolved since 2017, breaking away from fundraising based on public U.S. token sales. We're in a different era. ICOs are nowhere to be seen. Instead, tokens allow holders to govern networks, join games, or build communities.

The application of the Howey Test to tokens is now much more difficult – airdrops don't involve an investment of money, decentralized projects don't depend on managerial efforts, many secondary token transactions don't obviously satisfy Howey's conditions, and, absent public marketing, secondary buyers may not rely on the efforts of others for profit.

Despite the progress made over the last seven years, ICOs re-emerge in new forms with each new cycle, and seem to rebuff U.S securities laws. This happens for a number of reasons:

- Some industry participants argue that U.S. securities laws are ineffective or inequitable, so the violation of securities laws is therefore justified – a convenient ideological stance for anyone who stands to profit from it.
- Some invent new schemes, hoping that a slight change in facts warrants a different outcome. “Protocol Owned Liquidity” (indirect token sales by decentralized autonomous organizations, or DAOs, who then control the resulting proceeds via decentralized governance) and “Liquidity Bootstrapping Pools” (indirect token sales via liquidity pools on a decentralized exchange) come to mind.
- Some want to capitalize on the uncertainty created by the SEC’s insistence on regulating by enforcement, which has resulted in a number of inconsistent and irreconcilable rulings (see: Telegram, Ripple, Terraform Labs, and Coinbase).

Projects need to be careful to avoid these schemes. None are sufficient grounds for ignoring or violating U.S. securities laws.

The only legitimate way for projects to avoid the application of securities laws to their tokens is to mitigate the risks these laws are intended to address (e.g., reliance on managerial efforts and information asymmetries). Engaging in public token sales to U.S. persons for fundraising purposes is antithetical to these efforts, which is why there is almost no issue in crypto that regulators have been more focused on over the years than fundraising (and slight variations thereof).

The good news is that it is easy to avoid the legal fallout of selling tokens publicly in the U.S. to raise capital. One can simply not do it – and it’s still possible to fundraise by other means. Public sales of equity and tokens outside the U.S. and private sales of equity and tokens can all be done in a compliant manner without being subject to the registration requirements of securities laws.

**The sum up**
Public sales in the U.S. are an own-goal. Avoid at all costs.

## Rule 2: Make decentralization the North Star

There are a number of different token launch strategies builders can use. They can decentralize their project ahead of launch, launch outside of the U.S., or restrict transferability of their tokens to prevent secondary markets in the U.S.

I discuss all of this in greater detail in this post, using the **DXR (Decentralize, X-clude, Restrict) token launch framework**, which maps out how each strategy can mitigate risk.

Both the **X-clude** and **Restrict** strategies can help projects comply with U.S. securities laws at launch if they have not yet achieved "sufficient decentralization." But, crucially, neither are substitutes for decentralization. Decentralization is the only path projects can take to help eliminate the risks securities laws were intended to address, and therefore make their application unnecessary.

So, no matter which strategies projects choose at the outset, those intending to use tokens to convey broad rights (economic, governance, etc.) should always set decentralization as their North Star. Other strategies are only a stopgap.

How does this work in practice? No matter how a project evolves over time, it should always seek to make progress towards greater decentralization. Some examples:

- A founding team of a Layer 1 blockchain may want to invest significant development effort into several technological milestones after mainnet launch. To reduce risk related to "reliance on managerial efforts," they could exclude the U.S. from the launch at first, and then only make their token available here once they've achieved progress towards decentralization. These milestones might include making the validator set or smart contract deployment permissionless, increasing the total number of independent builders building on top of the network, or reducing the concentration of tokenholdings.
- A web3 gaming project may want to use restricted tokens in the U.S. to incentivize economic activity within the game. The project may lift restrictions on the tokens over time as more user-generated content is created, as more gameplay becomes dependent on independent third-parties, or as more independent servers are brought online.

Mapping out each of these steps in a plan for decentralization is arguably the most important work leading up to a token launch. The strategies a project chooses will significantly impact how it operates and communicates, both at launch and into the future.

**The sum up**
Decentralization matters. Pursue it in every endeavor.

## Rule 3: Communication is everything. Govern yourself accordingly

**I can't emphasize this enough: Communications, regardless of how inconsequential or innocuous they may appear, can make or break a project.** A single errant statement by a CEO can put an entire project at risk.

Projects should tailor strict communications policies to the nuances of their token launch strategy. So let's break this down using strategies from the token launch framework:

### Decentralize

This strategy is all about ensuring that purchasers of a project's tokens do not have a "reasonable expectation of profits based on the managerial or entrepreneurial efforts of others" (as outlined in the Howey Test). In a decentralized project, tokenholders would not expect a managerial team to deliver profits, because no single group or individual has this power. Founding teams must not indicate otherwise, or risk implicating securities laws.

So what is a "reasonable expectation?" This is shaped, in large part, by how a project or token issuer talks (and tweets, texts, and emails) about a token. Courts have repeatedly found that when projects announce that their core team is driving progress and economic value, investors are reasonable in relying on the efforts of that core team for investment returns. This finding can then be used to justify the application of securities laws.

When it comes to decentralization, a strict communications policy isn't a cheap ploy to evade U.S. securities laws – it's a way to legitimately decrease the likelihood that token purchasers are relying on managerial or entrepreneurial efforts for profits, which helps protect web3 projects *and* their users. The fact is that, by refusing to establish constructive rules and by weaponizing communications against builders, the SEC has created incentives that are diametrically opposed to their own mission. Web3 builders are actually incentivized to disclose less about their project and their activities to the public.

So what would this strategy look like in practice?

**First**, **projects should not discuss or reference their own tokens before launching the token.** This includes potential airdrops, token distributions, or token economics. The consequences of doing so can be severe – the SEC has successfully stopped companies from issuing tokens, and they could try this again. Don't give them the opportunity.

**Second**, **following a token launch, projects should refrain from discussing the price or potential value of a token, or framing it as an investment opportunity**. This includes mentioning any mechanisms that could cause the token to appreciate in value; as well as any commitments to use private capital to continue to fund the development and success of the project. All of these actions increase the likelihood that tokenholders could be found to have a reasonable expectation of profits.

After a project decentralizes, how members of the project's ecosystem – including founders, development companies, foundations, and the DAO – speak about their roles is critically important. It's easy for founding teams to slip into language that frames things as centralized, even if the project is extremely decentralized, especially when they are used to talking about achievements, milestones, and other launches in the first person.

A few ways to avoid this pitfall:

- Refrain from referring to oneself in a way that inaccurately connotes ownership of or control over the protocol or DAO (e.g., “As CEO of the protocol…”, “Today, we turned on X functionality of the protocol…”).
- Avoid forward-looking statements where possible, particularly with respect to mechanisms like programmatic “burning” of tokens to achieve pricing targets or stability.
- Avoid committing to or guaranteeing ongoing efforts, and refrain from referring to ongoing efforts as having outsized importance to the project’s ecosystem (for example, use “initial development team” rather than “core development team” or “main development team” where appropriate, and do not refer to individual contributors as “managers”).
- Emphasize efforts that have facilitated or will foster greater decentralization, like contributions from third-party developers or app operators.
- Give the project’s DAO or foundation its own voice to avoid confusion with the DevCo or founders that started the project. Even better: Avoid confusing third-parties, and rename or rebrand the original DevCo so that it does not share a name with the protocol.

Ultimately, what anyone communicates should reflect the principles of decentralization, particularly in public contexts. Communications need to be open and designed to prevent significant asymmetrical information accruing to any one individual or group.

For more on the practical implications of decentralization, see here and here.

**The sum up**
Once decentralized, no individual or company is the voice of the project. The project’s ecosystem is its own living system, separate and distinct. Making just one mistake can be catastrophic.

## X-clude

When launching outside of the U.S., projects can take inspiration from the traditional finance world, and adopt strict communications policies that follow the requirements of Regulation S, which provides an exclusion from certain registration requirements under U.S. securities laws for offerings made outside the U.S.

The goal of the strategy is to prevent tokens from flowing back into the U.S., so communications should avoid “Directed Selling Efforts” that promote or advertise the token in the U.S. and risk “conditioning the U.S. market” for the tokens (i.e., creating demand for the token in the U.S.). Ultimately, the strictness of these policies will depend on whether there is “substantial U.S. market interest” (SUSMI) for the tokens (i.e., significant market demand for the token in the U.S.).

**The sum up**
If you aren't offering tokens in the U.S., don't communicate as though you are. Any statements you make on social media about a project's tokens should specifically highlight that the tokens aren't available in the U.S.

### Restrict

Restricting a token launch to transfer-restricted tokens or "off-chain" points can allow for a more flexible communications policy. Thoughtfully executed projects are insulated from legal risk, because individuals can't make an "investment of money" to acquire tokens under the Howey Test.

Still, this insulation can quickly disintegrate if projects encourage participants to view their transfer-restricted tokens or points as an investment product. These statements can significantly undermine the legal basis for restricting a token at all.

**The sum up**
Restrictions don't absolve builders of legal consequences. Careless statements can haunt a project for years to come, preventing it from ever being able to shift launch strategies, or even decentralize.

## Rule 4: Be careful about secondary market listings and liquidity

Secondary market listings and liquidity are another area where the SEC's regulation-by-enforcement has created incentives that run counter to its own mission.

Projects often seek to establish listings on secondary trading platforms so that more people can access their tokens and use them to access blockchain-based products (for instance, you need to own ETH to use the Ethereum blockchain). This typically involves ensuring there is sufficient liquidity available on trading platforms; a lack of liquidity can lead to price volatility and increase risk to both the project and its users. Why? In the early days of a token's launch, larger purchases or sales on a given platform can dramatically move the token's price. When the price goes down, everyone can lose money. When the price goes up, FOMO-driven investors can push prices to unsustainable levels – and risk losing even more when prices stabilize.

Increasing access and ensuring that sufficient liquidity is available (typically through market makers) is better for web3 users. It also helps make markets more fair, orderly, and efficient. Even though this is a stated mission of the SEC, it has used announcements that projects have made about the availability of their tokens on secondary trading platforms against those same projects in court. It's also sought to treat liquidity provisioning on secondary markets the same as an ordinary token sale. No good deed goes unpunished.

Projects that aren't initially using the decentralize token launch strategy have greater flexibility regarding secondary market listings and liquidity, as both of the alternative strategies delay the availability of fully transferable tokens in the U.S. This can buy projects time to address liquidity issues by increasing the public float of their token (the number of tokens in circulation) before the token becomes broadly available in the U.S., and, as a result, reduce the need for token issuers to deal with secondary market listings and liquidity issues in the U.S.

**The sum up**

Projects need to approach these listings and liquidity with extreme caution. The risk/benefit analysis often isn't worth it. At a minimum, projects that are unsure about whether they've achieved "sufficient decentralization" shouldn't post about their token being listed on an exchange, and likely shouldn't engage in any market making activities within the U.S.

## Rule 5: Always make token lockups apply for at least one year from token launch

This is critical. Projects should apply transfer restrictions to all of the tokens issued to insiders (employees, investors, advisors, partners, etc.), affiliates and anyone that may be involved with the distribution of tokens. These restrictions should apply for **at least one year from the token launch**.

The SEC has successfully used the absence of a one-year lockup to literally prevent a token issuer from issuing a token. It will likely seek to do this again. Even worse, the SEC's precedent gives the plaintiff's attorneys a roadmap for bringing class action lawsuits against companies that fail in this regard. That's free money for them, and a world a pain for projects.

Ideally, lockups and other appropriate transfer restrictions should only begin to be released at the end of a one-year period, starting with the token launch and following a linear release from that point through the following three years, for a total lockup period of four years. This approach can help mitigate the legal risk described above. It can also position a project to succeed over the long term by reducing downward price pressure on a their token and signaling confidence in its long-term viability.

That's win-win.

Given these clear benefits, projects should also be wary of investors trying to press for shorter lockups. This type of demand can signal that the investor does not have regard for securities laws, and is likely to sell the token at the first opportunity.

For projects launching tokens outside of the U.S., any tokens issued to U.S. employees, investors, and other insiders should follow this guideline. Teams should discuss with their counsel whether it is necessary to apply lockups more broadly in order to preserve the exemption under Regulation S.

And finally, anyone using transfer-restricted tokens or points as part of their token launch strategy should modify this approach so that any transfer restrictions are not released until **one year from the point when the project's tokens become transferable in the U.S.**

**The sum up**

Applying transfer restrictions for one year from token launch is mandatory. Release schedules that extend at least two or three years after that are good for a project's insiders, its users, and its future. Anyone who says otherwise may have questionable intentions.

—

As we've mentioned throughout this series, every token launch is different. But there are a few guidelines that hold true for most projects. Avoiding public fundraising, making a plan for decentralization, enforcing strict communication guidelines, thinking carefully about secondary markets, and waiting at least a year to release token lockups can help projects navigate the most common pitfalls of token launches. Not only that, but sticking to these general guidelines can also help builders reinforce legitimacy, innovate safely, and move the industry forward.

***

*will have similar characteristics or results. A list of investments made by funds managed by Andreessen Horowitz (excluding investments for which the issuer has not provided permission for a16z to disclose publicly as well as unannounced investments in publicly traded digital assets) is available at https://a16z.com/investments/.*

*Charts and graphs provided within are for informational purposes solely and should not be relied upon when making any investment decision. Past performance is not indicative of future results. The content speaks only as of the date indicated. Any projections, estimates, forecasts, targets, prospects, and/or opinions expressed in these materials are subject to change without notice and may differ or be contrary to opinions expressed by others. Please see https://a16z.com/disclosures for additional important information.*