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To: Michael Horowitz, General Partner
Chaintech Digital GP Inc.

From: Murphy & McGonigle, P.C.

Subject: Whether Loopring Tokens are Securities within the Meaning of the Securities Act of 1933

Date: [Date]

You have asked us to analyze whether tokens, referred to as LRC, that the Loopring Project Ltd.[1] ("Loopring") issued in an initial coin offering ("ICO")[2] are securities under the Securities Act of 1933 (the "Securities Act") and whether LRC are commodity interests within the meaning of the Commodity Exchange Act ("CEA"). As discussed below, although the matter is not free from doubt, we think the better argument is that LRC is not a security under the test that the Supreme Court set out in *S.E.C. v. W.J. Howey Co.*[3] and guidance from the Division of Enforcement of the U.S. Securities and Exchange Commission (the "SEC"). Further, we do not believe that LRC are commodity interests under the CEA.

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[1] You provided a Certificate of Incorporation, dated July 25, 2017, showing that Loopring is incorporated under the laws of the British Virgin Islands.

[2] The Financial Industry Regulatory Authority, Inc. describes an ICO as follows:

> An ICO involves the creation of a new virtual coin or token by a company looking to raise money. In general, the company announces a specified amount of funds that it wants to raise, and the fundraising continues until that amount is reached. ICOs are conducted online, and purchasers use fiat currency, like the U.S. dollar, or virtual currencies, like bitcoin and ether, to pay for the new tokens.

Initial Coin Offerings: Know Before You Invest, FINRA Investor Alerts (Aug. 31, 2017) *available at* http://www.finra.org/investors/alerts/initial-coin-offerings-know-before-you-invest.

[3] 328 U.S. 293 (1946).

Background

Loopring states that it is an "open, multilateral token exchange protocol"[4] and decentralized automated execution system.[5] It allows system users (members) to trade different types of crypto-tokens across exchanges on the Ethereum blockchain.

Loopring describes LRC as a "cryptographic token that provides membership access and is used to pay trading fees"[6] that is based on the ERC20 Ethereum Token Standard.[7] Members with higher LRC balances will have "access to preferential liquidity treatment and discounted trading."[8] We understand from you that LRC does not confer any ownership rights in Loopring to LRC holders, and LRC holders are not entitled to share in any potential profits of Loopring.

Loopring's website indicates that Loopring sold LRC to investors in a public auction. Investors purchased LRC using Ether. Documentation on the website indicates that the total supply of LRC is nearly 1.4 billion tokens.[9] You have represented that Loopring does not plan to create additional LRC or sell additional LRC to the public. Loopring expects that LRC may trade on the secondary market.[10]

Discussion

We believe that LRC can reasonably be classified as a so-called "utility token." A utility token represents services or units of services that can be purchased.[11] The sale of utility tokens is described as "a way to fund projects of shared infrastructure that couldn't be funded before."[12]

I. LRC under the Securities Act

The threshold question is whether LRC, as a utility token, is a security within the meaning of the federal securities laws. Section 2(a)(1) of the Securities Act of 1933[13] (the "Securities Act") defines a "security" as follows:

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[4] Whitepaper, Loopring Decentralized Token Exchange Protocol v 1.3 (Sept. 26, 2017) *available at* https://loopring.org/en/index.html ("Loopring Whitepaper").
[5] https://loopring.org/en/index.html.
[6] https://loopring.org/en/faq.html.
[7] Loopring Whitepaper at 11.
[8] *Id*.
[9] http://docs.loopring.org/token/#circulating-supply.
[10] *Id*.
[11] https://medium.com/startup-grind/understanding-the-difference-between-coins-utility-tokens-and-tokenized-securities-a6522655fb91.
[12] *Id*. A recently-released whitepaper categorizes tokens as follows: "Tokens leverage computation and cryptography to represent consumptive goods (known as 'utility tokens') or replacements for traditional investments (known as 'securities tokens')." The SAFT Project: Toward a Compliant Token Sale Framework (Oct. 2, 2017) *available at* http://saftproject.com/static/SAFT-Project-Whitepaper.pdf (the "Token Whitepaper"). The Token Whitepaper discusses the uncertainty around the status of token sales under the U.S. securities laws and proposes, among other things, that a company interested in token sales instead raise capital by selling securities to accredited investors with token sales to follow once the issuer has created a functioning service or product.
[13] 15 U.S.C. § 77b(a)(1).

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) or any put, call, straddle, option or privilege entered into on a national securities exchange relating to a foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 5 of the Securities Act prohibits the unregistered offer or sale of securities in interstate commerce, absent an exemption from registration.[14] Violations of Section 5 do not require scienter.[15] Thus, an offering of tokens to the public would violate Section 5 of the Securities Act if such tokens are securities but the offering of such securities is not registered under the Securities Act or exempt from registration.

Case law interpreting what is considered a "security" has focused on the term "investment contract," a catch-all term Congress inserted into the definition of security that is intended to "encompass the range of novel and unusual instruments whose economic realities invite application of the securities laws."[16] The Supreme Court in *Howey* defined an investment contract as "an investment of money in a common enterprise with profits to come solely from the efforts of others." An instrument must meet each of the elements set out in *Howey* to be considered a security.

The staff of the SEC's Division of Enforcement (the "Staff") recently issued the *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (the "Report") in which it analyzed under *Howey* whether tokens ("DAO Tokens") that an organization called The DAO issued in an ICO were securities for purposes of the Securities Act and the Securities Exchange Act of 1934.[17] The Staff described The DAO as follows:

> The DAO was created … with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.[18]

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[14] 15 U.S.C. § 77e.
[15] *SEC v. Universal Major Indus. Corp*., 546 F.2d 1044 (2d Cir. 1976).
[16] *See Robinson v. Glynn*, 349 F.3d 166, 172-73 (4th Cir. 2003).
[17] Securities Exchange Act Release No. 81207 (July 25, 2017) *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.
[18] Report at 1.

The Staff concluded that DAO Tokens were securities under the *Howey* test. In reaching that conclusion, the Staff determined that (1) the purchase of DAO Tokens with Ether ("ETH") was an "investment of money" because the term "money" is broader than cash;[19] (2) investors in DAO Tokens had a reasonable expectation of profits because DAO Token holders were entitled to share in any profits that the projects funded with their investments generated;[20] (3) and DAO Token holders profits were to be derived from the managerial efforts of others, namely the founders and other key personnel associated with The DAO; DAO Token holders' limited voting rights in The DAO did not give them any meaningful managerial power in The DAO.[21]

Although we think the purchase of LRC involved an investment of money and investors will rely on the managerial efforts of Loopring personnel with respect to the build out of Loopring, we do not believe that LRC investors have an expectation of profits.

1. Investors in LRC Invested Money

Investors' purchases of LRC likely would be viewed as an investment of money for purposes of the *Howey* test.[22] As noted in the Report, in determining whether an investment contract exists, the investment of "money" need not take the form of cash. In decisions following *Howey*, courts expanded the scope of investment of money to include the investment of consideration. For instance, the Ninth Circuit held in *Hector v. Wiens* that an investor simply guaranteeing loans met the first test outlined in *Howey*.[23] Investors in LRC used ETH to make their investments, and LRC were received in exchange for ETH. If faced with the question, we believe the Staff would take the position that the purchase of LRC in the auction was an investment of money.[24]

2. LRC Holders Have No Reasonable Expectation of Profits

The Howey test also requires that a transaction be induced by the investor's expectation of receiving a profit; whether or not the investor receives a profit is irrelevant. The Supreme Court has characterized "profits" to mean "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds." "[P]rofits" also include "dividends, other periodic payments, or the increased value of the investment."[25]

Courts have held that there is no expectation of profit if an investor is motivated to consume the thing purchased. Moreover, the profit motive must be the predominant motive. If a person

[19] Report at 11.
[20] *Id*. at 12.
[21] *Id*. at 12-15.
[22] We also believe that because LRC investors would be investing money in the build out of Loopring's exchange protocol, the investment would be in a common enterprise within the meaning of the *Howey* test.
[23] 533 F.2d 429 (9th Cir. 1976). *See also, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc*., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of Howey's reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract").
[24] *See SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of Howey); *Uselton*, 940 F.2d at 574 ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value'") (citations omitted).
[25] *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

invests money with an expectation of profit, but the predominant motive is to consume the thing purchased, the expectation of profit prong of the *Howey* test has not been met.[26]

In our view, investors who purchased LRC have no reasonable expectation of earning profits through Loopring by purchasing LRC. The Report noted that The DAO was "a for-profit entity whose objective was to fund 12 projects in exchange for a return on investment." The DAO pooled the ETH it received in exchange for issuing DAO Tokens, and that ETH was available to The DAO to fund projects. The projects (or "contracts") were to be proposed by specified persons. If a designated group called Curators whitelisted the proposed contracts, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, the Staff concluded that a reasonable investor would have been motivated by the prospect of profits on their investment of ETH in The DAO.

By contrast, we understand that LRC holders do not have any input into if and how Loopring is deployed by exchanges. Moreover, you have represented that LRC holders will not share in any profits that Loopring might earn from exchanges that deploy its protocol. Rather, LRC holders are entitled to benefits for trading on exchanges utilizing Loopring. The holders will receive certain execution priority, lower liquidity costs, higher service levels and will be able to pay trading fees with LRC. The reasonable investor in LRC would be motivated not by the prospect of profits, but by a more favorable exchange trading environment for cryptocurrencies.

The availability of secondary-market trading for LRC arguably could be viewed as a profit motive. An investor might be motivated to purchase LRC if he or she believed that the tokens could be sold in the future at an increased value if Loopring were to become successful.

We do not believe that the existence of a secondary market for LRC indicates a profit motive in purchasing LRC. We understand that LRC does not represent an equity or similar interest in Loopring. If Loopring grows and becomes more profitable, LRC holders will not share in that increased value; thus, there is no reason to believe that the profitability of Loopring should impact the price of LRC on the secondary market. Rather, a secondary market would allow LRC holders to sell all or some of the benefits to which they are entitled with respect to Loopring. If, for example, an LRC holder determined that he no longer needed the higher benefit and service levels commensurate with his LRC holdings, he could liquidate some portion of this holdings, retain a lower level of Loopring benefits, and recoup a portion of his LRC investment through the secondary market. The value of LRC benefits might vary based on a number of factors, such as benefits available to, and costs to, non-LRC holders in using Loopring. It does not appear, however, that such market fluctuation would be tied to the profitability of Loopring. Stated somewhat differently, although an LRC holder might profit on the sale of LRC on the secondary market, his or her primary motive in purchasing LRC is consumption of the trading services and other benefits that LRC provides.

[26] *United Hous. Found. v. Forman*, 421 U.S. 837, 858 (1975).

3. LRC Holders Would Not Earn Profits Derived Solely from the Efforts of Loopring's Founders and Managers

The Howey test requires that the profits "come solely from the efforts of others." In determining whether an investor is deriving profits form the efforts of others, the central issue is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[27] The Staff concluded in the Report that The DAO's investors relied on the managerial and entrepreneurial efforts of specified persons other than the investors "to manage The DAO and put forth project proposals that could generate profits for The DAO's investors." The Staff provided extensive documentation of founders' and managers' efforts to make The DAO successful and profitable.

Although we believe that efforts of Loopring's founders and managers will be essential to the failure or success of the enterprise, we do not believe that LRC holders have a reasonable expectation of earning a profit from such efforts, as discussed above. If investors have no reasonable expectation of profit, then efforts on the part of an enterprise's personnel necessarily are not aimed at creating profits for such investors.

We believe, moreover, that there is a colorable argument that any profit an LRC holder might earn through use of the Loopring platform would derive from the holder's efforts, not from those of the founders/managers of Loopring. If the primary benefit of purchasing and holding LRC is to gain access to preferential trading on exchanges that have implemented Loopring, LRC holders, who may be traders on those exchanges, would earn profits through their trading activities on those exchanges, not through the activities of Loopring. That is, LRC holders are relying on Loopring to build out the Loopring infrastructure so that the holders can derive profits through the holders' trading efforts.

II. LRC under the CEA

With respect to whether LRC is subject to the CEA[28] and the jurisdiction of the Commodity Futures Trading Commission ("CFTC"), the question is whether LRC is a "commodity interest."[29] The CFTC has exclusive jurisdiction over transactions in commodity interests.[30]

The CFTC defines a commodity interest to mean:

(1) Any contract for the purchase or sale of a commodity for future delivery;

(2) Any contract, agreement or transaction subject to a Commission regulation under section 4c or 19 of the Act;

(3) Any contract, agreement or transaction subject to Commission jurisdiction under section 2(c)(2) of the Act; and

[27] *SEC v. Glenn W. Turner Enters*., *Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).
[28] The Commodity Exchange Act of 1936, Pub. L. No. 74-675 49 Stat. 1491.
[29] 17 C.F.R. § 1.3(yy) (2017).
[30] The Commodity Futures Trading Act of 1974, § 101, 7 U.S.C. § 2(a)(1)(A) (2012).

(4) Any swap as defined in the Act, by the Commission, or jointly by the Commission and the Securities and Exchange Commission.[31]

As the definition above demonstrates, whether a particular instrument (other than a swap) is a commodity interest depends, in the first instance, on whether the subject of the relevant contract is a commodity. The CEA defines commodity broadly to include, in addition to agricultural products, "all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in."

The CFTC would likely view LRC as a commodity. The CFTC has taken the position that digital currencies, such as Bitcoin, are commodities.[32] Moreover, a task force within the CFTC, called LabCFTC, recently stated that "virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances."[33] Even if LRC is a commodity however, the CFTC does not have jurisdiction over commodity transactions in the spot market, although it does have non-exclusive jurisdiction over manipulation and fraud involving commodities.[34]

Although LRC might be a commodity, we do not believe that LRC would represent a commodity interest over which the CFTC would have exclusive jurisdiction. Nothing in the Loopring Whitepaper, in the information presented on Loopring's website or in any other documentation or information related to LRC that we have received, indicates that Loopring's issuance of LRC involves a contract for future delivery or other derivative or interest in LRC. In our view, therefore, LRC does not meet the definition of commodity interest under CFTC Rule 1.3(yy).

Conclusion

For the reasons set out in this memorandum, we do not believe that LRC should be viewed as a security for purposes of the Securities Act or as a commodity interest for purposes of CFTC rules. We note that the securities and commodities regulatory regimes governing ICOs are developing and neither the SEC, the CFTC nor their respective staffs have provided guidance on whether tokens similar to LRC are securities under the federal securities laws or commodity interests under the CEA and the regulations and rules adopted thereunder, so we cannot provide assurances that the SEC, CFTC or their staffs would agree with our conclusion.[35] Nevertheless,

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[31] 17 C.F.R. § 1.3(yy) (2017).
[32] *See In re* Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015).
[33] A CFTC Primer on Virtual Currencies at 14 ("Virtual Currency Primer") *available at* http://www.cftc.gov/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.
[34] 17 C.F.R. § 180.1 (2017). *See, e.g., In re* Gelfman Blueprint, Inc., CFTC No. 17-7181 (Sept. 21, 2017) *available* here (Defendants solicited approximately $600,000 from investors, ostensibly to purchase and trade Bitcoin using a trading algorithm. Defendants did not trade Bitcoin, but were running a Ponzi scheme. The CFTC brought a fraud action against the defendants under CFTC Rule 180.1).
[35] The Token Whitepaper, cited in footnote 12 above, assumes that the primary motivation to invest in tokens is to turn a profit and that, therefore, the issuance of tokens before an issuer has a functioning product or service involves the issuance of securities. The authors conclude that assuming that the profit motive predominates, profits are necessarily derived from the managerial efforts of the issuer if the issuer is in the process of creating its product or service. Token Whitepaper at 8.

the SEC and CFTC staffs have taken the position that whether a token is a security or commodity/commodity interest is a facts and circumstances determination, and we believe that LRC, as described above, should not be viewed as either a security under application of the *Howey* test and other relevant case law and guidance, or a commodity interest under CFTC rules. Our position is based solely on the facts set out in this memorandum, and any different or additional facts could affect that position.

Our analysis of LRC in this memorandum is limited to its likely status under the federal securities, commodities and derivatives laws of the United States. We do not consider the status of LRC under the tax code of the United States; under the banking laws, regulations and rules of the United States or any individual state; under any other laws, regulations or rules of the United States or any individual state or subdivision thereof; or under the laws, regulations or rules of any jurisdiction outside of the United States.

Please note that this memorandum is being delivered to the Chaintech Digital GP Inc. ("Chaintech") in its capacity as a representative of Loopring, and should not be distributed to third parties without our prior consent. This memorandum is furnished solely for the benefit of Chaintech and Loopring with respect to the status of LRC under the federal securities, commodities and derivatives laws of the United States and may not, without our prior consent, be relied upon by any other person.