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Re: Datamall Coin *Howey* Test Opinion Memorandum

I. Introduction and Synopsis

This memorandum addresses your request for a formal review of the U.S. regulated security or non-security status of a blockchain-based digital asset called Datamall Coin ("DMC," the "Token," or the "DMC Token") by Dmctech Foundation Ltd, also known as Datamall Foundation (the "Foundation" or "DMC Foundation"). This memorandum is intended only to address the question of whether DMC is a utility token or a security, as is understood by Section 5 of the Securities Act of 1933, as amended (the "Securities Act") and Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act," and together with the Securities Act, the "Securities Acts"); supplemented by the guidance last amended by the Securities Exchange Commission ("SEC") on April 3, 2019 and titled Framework for "Investment Contract" Analysis of Digital Assets (the "SEC Guidance").

The facts of this memorandum are based on my review of (1) technical and corporate documentation, (2) written communication with the Foundation and its authorized representatives, (3) applicable federal laws and secondary sources, and (4) information publicly available on the internet. Accordingly, the accuracy of the opinions and conclusions herein are materially dependent on information provided by the Foundation and the Foundation's representations.

The primary conclusion, based on the review of the provided information, applicable law and generally accepted facts, the legal status of DMC under U.S. securities law should be considered to be that of a non-security, that is, a utility token. More specifically, DMC is not an investment contract. In the event of a listing or trading activity on an exchange faces a U.S. legal inquiry or challenge based on DMC constituting an unregistered security under United States law, I find that the Foundation should sustain against such scrutiny due to its being, on the merits, a non-security instrument.

This memorandum uses the phrase "non-security" to indicate my opinion that DMC does not need to be registered as a security, and that the Foundation, as its creator, do not need to register a public security offering to offer DMC for sale or use. If you engage in other fundraising activities, however, including traditional private equity raises or public offerings, such activities will require separate analysis. The scope of this memorandum is limited exclusively to the initial offering of DMC and does not address any other offerings that the Foundation may make.

Further, this memorandum is not a guarantee of any results, including the avoidance of action by the SEC or any other government or regulatory authority, nor is it a promise to represent or indemnify the Foundation from any such action. The law, as it pertains to blockchain, distributed ledger technology, and associated token sales and offerings, is in a state of rapid change, both in terms of codified law and in the law as applied to particular scenarios and practices.[1] Additionally, the SEC has taken an aggressive regulation-by-enforcement approach for digital assts and decentralized finance ("DeFi") providers, and creators bear the burden of demonstrating the applicability of an exemption from registration with the SEC as described in detail below.

The limited scope of this memorandum does not purport to reach a formal legal view as to whether the Foundation would need to register with any governmental or regulatory authority as a broker-dealer, investment advisor, money transmitter, exchange, or other financial entity, nor does it address any issue related to state laws on securities, also known as "Blue Sky Laws", address compliance with the U.S. economic sanctions program administered by the Office of Foreign Assets Control of the U.S. Department of the Treasury (OFAC), anti-money laundering, money transmitter, or money service business rules and regulations administered by the Treasury Department Financial Crimes Enforcement Network (FinCEN), or Commodity Future Trading Commission (CFTC) rules and regulations on digital assets. You are advised to seek additional counsel to ensure compliance with these issues.

Finally, this memorandum does not provide an opinion in regards to any non-U.S. law, rather, it is necessary to retain local counsel in those other foreign jurisdictions to determine the applicability of

[1] The level of persuasion of this memorandum is not necessarily that which would convince the SEC, but would convince a hypothetical, rational, and fair U.S. court tasked with applying the Securities Act of 1933 to the issuance of DMC. This is an appropriate benchmark because the SEC relies on the U.S. Supreme Court's interpretation of an "investment contract" and applies the Supreme Court's *Howey* test (as described in further detail below) in its own administrative and civil enforcement actions. *See Morrison v. National Australia Bank LTD*., 561 U.S. 247, 273 (2010) (noting that the "significant and material conduct" test the SEC employed was not based on its own interpretation of the statute, but on decisions of federal courts. The Supreme Court noted that it owed them no deference based upon the circumstances in that case stating that "[w]e need 'accept only those agency interpretations that are reasonable in light of the principles of construction courts normally employ.'") *See also United Housing Found, Inc. v. Forman*, 421 U.S. 837, 848-49 (1975) (noting that Congress defined "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our world fall within the ordinary concept of a security" and that the task has fallen to the SEC and "ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.").

those jurisdiction's laws or the conclusions of this memorandum.[2] In addition, the laws that are discussed herein are constantly evolving. While this office makes every reasonable effort to keep clients appraised of relevant new developments in the law, I cannot guarantee that future changes to will not alter some or all of the conclusions made in this memorandum.

II. Factual Background

The contents of this section summarize the background facts of the project along with bona fide statements of intent and future plans represented to us by the client (including through emails, synchronous conversations, as well as public and private documents). This opinion therefore assumes, and its validity is absolutely conditioned upon, the accuracy of this material, along with other representations made to us by the project principals and other authorized agents upon which we have expressly or implicitly relied.[3] The presentation of facts below draws upon the materials variously, except where express citations are provided.

A. DMC Foundation

The Foundation is a non-profit foundation, created in Q4 of 2020 and incorporated in Singapore in February 2022 with the purpose of furthering the development and standardization of decentralized storage. It aims to provide the fundamental decentralized storage technology underlying third-party Web3 services and dApps. The foundation seeks to encourage the development and adoption of decentralized storage with the inclusion of incentives native to the chain. More specifically, the Foundation has created the Datamall Chain and its native token, the Datamall Coin.

Currently, the Foundation is primarily working on the development of the Datamall Chain and issuing DMC. It issued a Technical Yellowpaper on the Datamall Chain and the second version of the DMC Whitepaper in August 2022. It plans to expand offerings by allowing interoperability with existing decentralized storage, including IPFS, Filecoin, StorJ, and ARweave, and may create an entire ecosystem of associated storage applications and dApps. It also features a marketplace where buyers and sellers of decentralized storage can form storage deals, perform off-chain verification, and have on-chain arbitration and penalties.

Decentralization of data storage will solve a monopolistic system of data storage; a handful of large companies store the majority of all data stored on the internet, making it susceptible to vulnerabilities, including data loss. Decentralized storage takes advantage of the underlying blockchain technology to ensure high availability and security of the stored data. However, technology to store data

[2] This is exceptionally important in regards to Singaporean law. Specifically, certain terms of significance in Singaporean law, such as "debenture," "security," and "capital market product" may have superficial analogies in U.S. law, but those terms may not have the same legal definition. Accordingly, while on its surface, this memorandum may appear to conclude using terminology that would apply in Singaporean law, it is not applicable to Singaporean law without further guidance. Singaporean counsel will be needed to address the applicability of these conclusions to activities in Singapore.

[3] Informational materials received by us in the formulation of this memorandum have been examined to a degree governed by their perceived significance to us in the overall legal analysis. Our proper goal in this endeavor is not to achieve exhaustive "verification" of all facts and constituent materials, but to attain a reasonable level of confidence that the assumptions herein and otherwise underlying this memorandum are likely to substantially hold true and accurate

in a decentralized manner is necessary but not alone sufficient to encourage adoption: a marketplace to match the open orders and open bids for decentralized storage is also needed. This marketplace must also provide incentives for both sides of each transaction after successful completion of the storage contract. Further, this marketplace needs to have operability to scale rapidly when demand spikes. The Foundation has adopted a ten-year plan of operations that includes such scalability.

B. Datamall Chain

The Datamall Chain (the "Chain") is an open source blockchain platform. It is engineered to provide stable and reliable decentralized storage services for Web3 and dApps and is compatible with both CYFS and IPFS storage protocols, but is still in the Testnet phase. The Mainnet is expected to launch this year. The Chain is used as the decentralized storage market, representing real storage verified by smart contracts. For example, after a storage holder and a customer come to an agreement, they transmit the data in a peer-to-peer manner. The customer can challenge the storage holder to verify the actual possession of the data, encouraging and incentivizing real storage capacity and development of a healthy ecosystem.

The Chain uses a Proof a Storage Service ("PoSS") algorithm for consensus. Miner nodes are ranked according to storage delivery capability to entice miners with the ability to provides secure and reliable storage service.

C. Datamall Coin

The Datamall Coin is the native governance token of the Chain. DMC represents the actual data storage capability to match supply and demand for storage needs; it is used to purchase and offer for sale storage services. It is obtainable through "mining" which, unlike cryptocurrencies, is performed by providing and consuming storage space. There is a total supply of one billion DMC, with up to four decimal spaces. DMC can be traded on public marketplaces.

The Foundation has not allocated any DMC for itself; however, the Foundation is expected to hold 5% of the total issued DMC. DMC will be released in stages between January 2022 and June 2032. The first release was issued immediately prior to the finalizing of this Memo. DMC must be mined in order to be fully released; providing storage space will release DMC on the marketplace. That DMC can then be purchased and exchanged for the storage space.

The Foundation has also created auxiliary tokens, the Proof of Service Token ("PST") and Real Storage Incentive ("RSI"). PST is generated by the PoSS consensus based on the quantity of staked DMC to allocate voting power. RSI is a reward for use of storage; the consumer parallel to PST. Both PST and RSI are only useable withing the Chain and do not circulate in the marketplace. This memo does not address whether PST or RSI are securities.

III. Legal Background

A. U.S. Securities Laws

All offers and sales of securities in the U.S. must be registered with the SEC or conducted pursuant to a federal exemption from registration. These offerings are also subject to the SEC's

antifraud provisions under the Securities Acts[4] and bad actor disqualifications.[5] The term "offer" in Section 2(a)(3) of the Securities Act is broadly defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[6] The threshold question is whether or not a transaction falls within the definition of "security" as defined in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act.[7] The list includes financial instruments commonly associated with securities, such as notes, stocks ,and bonds, but also investment contracts that reach novel, uncommon instruments or arrangements.[8]

An "investment contract" is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[9] In *SEC v. W.J. Howey* ("*Howey*"), the Supreme Court developed the authoritative set of criteria for determine whether the representation of an interest constitutes an investment contract. The *Howey* test, as it is commonly known, requires the presence of each of the following conditions for an interest to be considered and investment contract: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profits; (4) derived from the efforts of others.[10] These conditions, or elements, of the *Howey* test are functional, that is, they are concerned with the substance of the actions being taken, not the names or labels placed on those actions. This is sometimes called the "economic reality" of the interest.[11]

This memorandum focuses on whether or not the digital assets known as DMC are being offered and sold as investment contracts and therefore securities. The *Howey* test framework is consistently

[4] Specifically, Section 17 of the Securities Act, Section 10(b) of the Exchange Act, and SEC Rule 10b-5
[5] Bad actor disqualifications are disqualifying events that include criminal and civil actions which prohibit an individual from accepting a security in certain transactions, or require registration of those securities.
[6] 15 U.S.C. §77b(a).
[7] *See* 15 U.S.C. §§77b and 78c.
[8] *See e.g.,* SEC v. C.M. Joiner Leasing Corp, 320 U.S. 344, 351 (1943).
[9] *See United Housing Found, Inc. v. Forman,* 421 U.S. 837, 852-53 (1975), citing *SEC v. W.J. Howey Co*., 328 U.S. 293, 301 (1946); *see also SEC v. Edwards,* 540 U.S. 389,393 (2004).
[10] Different courts divide the elements of *Howey* differently; most commonly, it other than the four- prong test is (1) an investment of money; (2) in a common enterprise; (3) with the reasonable expectation of profits derived from the efforts of others. *See , e.g., AFFCO Invs. 2001, L.L.C. v. Proskauer Rose, L.L.P*., 625 F. 3d 185, 190 (5th Cir. 2010); *Cameron v. Outdoor Resorts of Am., Inc.,* 608 F. 2d 187, 192 (5th Cir. 1979); *Hodges v. Harrison*, 372 F. Supp. 3d 1342, 1348 (S.D. Fla. 2019); *Rocky Aspen Mgmt. 204 LLC v. Hanford Holdings LLC,* 230 F. Supp. 3d 159, 164-65 (S.D.N.Y 2017); *SEC v. Cooper*, 142 F. Supp. 3d 302, 314 (D. N.J. 2015); *Rossi v. Quarmley*, 7 F. Supp. 3d 502, 507-8 (E.D. Pa. 2014); *In Re Gables Mgmt., LLC,* 473 B.R. 352, 360 (Bkrtcy. D. Idaho 2012); *SEC v. Infinity Group Co.,* 993 F. Supp. 321, 322-4 (E.D. Pa. 1998); *Copeland v. Hill,* 680 F. Supp. 466, 467 (D. Mass. 1988); *Seale v. Miller*, 698 F. Supp. 883, 891 (N.D. Ga. 1988); *Waterman v. Alta Verde Indus., Inc*., 643 F. Supp. 797, 802-3 (E.D.N.C. 1986), *aff'd*, 883 F. 2d 1006 (4th Cir. 1987).
[11] *Howey* at 298; *see also Tcherepnin v. Knight,* 389 U.S. 322, 383 (1967) ("Congress did not intend to adopt a narrow or restrictive concept of security in defining [investment contract]… [Rather, a] security embodies a flexible rather than static principle…") (internal quotation marks and cite to *Howey* omitted).

applied to determine whether or not a digital asset is a security in the SEC's own guidance,[12] in SEC enforcement actions,[13] and by the courts.[14]

1. Investment of Money

The "investment of money" need for the purposes of determining an investment contract under *Howey* need not be fiat currency; anything of value is sufficient to be considered "money."[15] The phrase "investment of money" is broadly construed to include not only the provision of capital, assets, and cash, but also goods, services, and promissory notes.[16] Courts consider the means of acquiring the interest or asset, specifically if those means include an exchange of consideration.[17] The issue of whether virtual currency paid-in as investment consideration constitutes an "investment of money" has already been visited by the courts and regulators, and has been decided affirmatively.[18]

2. Common Enterprise

[12] *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Re. No. 81207) (July 25, 2017) (the "*DAO Report*"); *see also Framework for 'Investment Contract' Analysis of Digital Assets,* Securities Exchange Commission, April 3, 2019 ("*SEC Guidance*").
[13] *See e.g., In the Matter of Block.one*, SEC Release No. 10714 (September 30, 2019) ("Based on the facts and circumstances set forth below, the ERC-20 Tokens were securities under the federal securities laws pursuant to [*Howey*] and its progeny, including the cases discussed by the Commission in its Report of Investigation Pursuant to Section 21(a) of [the *DAO Report*]; *In the Matter of Blockchain of Things, Inc.*, SEC Release No. 10736 (December 18, 2019); *In the matter of Enigma MPC*, SEC Release No. 10755 (February 19, 2020); *In the Matter of Kelvin Boon, LLC and Rajesh Pavithran*, SEC Release No. 10807 (August 13, 2020); *in the Matter of Unikrn, Inc.,* SEC Release No. 10840 (Sept. 15, 2020); *In the Matter of Wireline, Inc.,* SEC Release No. 10920 (January, 15, 2021), *In the Matter of Loci, Inc. and John Wise, Inc.,* SEC Release No. 10950 (June 22, 2021).
[14] *See e.g., SEC v. Telegram Group, Inc.,* 448 F. Supp. 3d 352, 370 (S.D.N.Y. 2020); *U.S. v. Kik Interactive Inc.,* 492 F. Supp. 3d 169 (S.D.N.Y. 2020).
[15] *See e.g., Uselton v. Comm. Lovelace Motor Freight, Inc.,* 940 F.2d 564, 574 (10th Cir. 1991) (noting "[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."); *Glenn W. Turner Enters.,* 474 F.2d at 476,482 (9th Cir. 1973) (even an "investment" of labor can qualify).
[16] *See Int'l Bhd. of Teamsters v. Daniel,* 439 U.S. 551 (1079); *Hector v. Wiens,* 533 F.2d 429, 432-33 (9th Cir. 1976); *Sandusky Land, Ltd. v. Uniplan Groups, Inc.,* 400 F. Supp. 440, 445 (N.D. Ohio 1975).
[17] Consideration, in a legal context, can itself be the subject of an entire legal memorandum, but it need not be addressed here; the analysis of an "investment of money" for the purposes necessitated by the circumstances herein do not require an in-depth understanding or analysis of the legal concept of consideration. It is sufficient to say that any exchange of money or things of value are consideration enough to satisfy this prong of the *Howey* test. *See Int'l Bhd. of Teamsters v. Daniel,* 439 U.S. 551 (1079); *see also SEC v. United Benefit Life Ins. Co.,* 389 U.S. 202 (1967); *Variable Annuity Life Ins. Co.,* 359 U.S. 65 (1959); *SEC v. C.M. Joiner Leasing Corp.,* 320 U.S. 344 (1944).
[18] *See SEC v. Shavers,* No. 4:13-CV-416 (E.D. Tex. Aug. 6, 2013). (finding where investors paid-in bitcoin for promised returns (also in bitcoin), the arrangement was deemed to constitute an "investment of money" and securities status overall was found. Note, however, that this is not quite an "ICO case," because, while it address ethe question of whether the investment contract was that of a security, the contract was in the form of a *conventional agreement* rather than constituted by *the issuance of a novel token* (i.e., there was no question of the extent and role of the utility of a newly-issued token on offer to the buyers in effecting securities status).

To satisfy to a court the "common enterprise" aspect of the *Howey* test, there must be either "horizontal commonality" or "vertical commonality."[19] Horizontal commonality exists when each individual investor's fortunes is tied to the fortunes of the other investors by a pooling of the assets, usually combined with the pro-rata distribution of profits.[20] Vertical commonality focuses on the relationship between the promoter on the body of investors; when the investor's fortunes are tied to the fortunes or efforts of the promoter.[21] Fortunes need not be *profits*, but common losses, risks, and stability satisfy both horizontal and vertical commonality as well.[22] In contrast, the SEC does not require horizontal nor vertical commonality *per se*, nor does it view a "common enterprise" as a distinct element of the term "investment contract."[23]

3. Reasonable Expectation of Profits

As stated above, *profits* need not be interpreted literally; profits for the purpose of the third element of the *Howey* test may be capital appreciation resulting form the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchaser's funds.[24] This element is objective, rather than subjective; the mere fact that an individual believes they are making an "investment" is not sufficient to prove the existence of an "investment contract;" rather, the efforts utilized by the promoter to lead a reasonable person to believe they are making an investment contract is the determinant.

Incidental market gains alone, or the hope thereof, are not determinative of the establishment of an investment contract, absent affirmative conduct or representations of the promoter.[25] Even where promises and inducements, such as a statement extolling "effort-free profit," are made, the actual agreement of the parties may, in some instances, be more persuasive than prior oral representations.[26] These types of gains are *not* due to the efforts of the promoter, that is, the "others" referred to in the fourth element of the *Howey* test. Courts have found that the sale of certain fungible commodities were

[19] *See Revack v. SEC Realty Corp.,* 18 F.3d. 81 (2d Cir. 1994) ("*Revack*").
[20] *Id*. at 87-88.
[21] *Id.*; *see also SEC v. Telegram Grp., Inc,* 448 F. Supp. 3d 352, 369 (S.D.N.Y 2020) (citing *Revack*); A broad vertical commonality approach is the easiest to satisfy. However, it is also not the appropriate approach as it is duplicative of the efforts of others prong, which the SEC itself has previously expressly acknowledged. *See* e.g., Brief of Appellant at 28 n. 11, *SG Ltd.,* 365 F.3d at 42 (stating that "[t]he commission has also long taken the position that broad vertical commonality is not an appropriate test because it collapses the second prong of the *Howey* test into the third prong.") "Broad vertical commonality" is the tying of the fortunes of investors to the *efforts* of the promoter; conversely, some courts recognize "strict vertical commonality," where fortunes of investors are tied to *fortunes* of the promoter. *See Long v. Shultz Cattle Co., Inc*., 881 F.2d 129, 140-41 (5th Cir. 1989).
[22] *See e.g., SG Ltd.,* 235 F.3d at 49-50. *See also Brodt v. Bache & Co., Inc.,* 595 F.2d 459, 461 (9th Cir. 1978) ("'Strict vertical commonality' requires that the fortunes of investors be tied to the fortunes of the promoter")
[23] *See In re Barkate,* 57 SEC 488, 493 n. 13 (April 8, 2004); *see also* the Commission's Supplemental Brief at 14 in *SEC v. Edwards,* 540 U.S. 389 (2004) (on remand to the 11th Circuit).
[24] *See Forman*, 421 U.S. at 852. *See also, Aldrich v. McCulloch Props., Inc*., 627 F. 2d 1036, 1039 (10th Cir. 1980); *Cameron v. Outdoor Resorts of Am., Inc.,* 608 F. 2d 187, 193 (5th Cir. 1979); *Timmreck v. Munn,* 433 F. Supp. 396, 402 n.3 (N.D. Ill. 1977).
[25] See *Woodward v. Terracor,* 574 F.2d. 1023, 1025; *see also Warfield v. Alaniz*, 569 F.3d 1015, 1021 (9th Cir. 2009) ("[W]hile the subjective intent of the purchasers may have some bearing on the issue of whether they entered into investment contracts, we must focus our inquiry on what the purchasers were offered or promised.")
[26] *Alumni v. Dev. Res. Group,* 445 Fed. Appx. 288, 298 (11th Cir. 2011).

not investment contracts because the expected profits came from market fluctuations rather than the efforts of others.[27]

4. From Efforts of Others

The final element of *Howey* requires the profit-making efforts of concern in the issuance be predominantly the efforts of others; specifically, that "the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[28]

Where an investor of money in a common enterprise expects profits from their investment, the promoter of the security or a third party, not the investor, must be the one to perform the significant or essential managerial or other efforts necessary for the success of the investment.[29] The investor must expect that profits be derived "solely through the efforts of the promoter or of someone other than themselves." In the case of digital assets, informal guidance from SEC leadership has reflected the interpretation that a security is at issue if the investor expects the efforts of the person or group sponsoring or promoting the creation and sale of a token to "play a significant role in the development and maintenance of the asset and its potential increase in value" by exercising "governance rights" and "meaningful influence" over the common enterprise to the degree that the investor would tend to rely on that sponsor or promoter's profit-generating efforts.[30] The foregoing establishes an apparent logical gulf-between a standard embodied by language like "a significant role," as related recently by SEC staff, and "sole," "essential," or "undeniably significant" efforts. This language that has emerged over the decades from black-letter securities case law. It is our opinion that it makes fundamental sense and best in keeping with the remedial purposes of the Securities Act to draw this line somewhere in the middle, specifically that is should be less reasonable for an investment contract to be found when reasonable reliance on the promoters has fallen below the middle of this range. The analysis that follows is in keeping with this view.

B. SEC Guidance

For a token, the definitive prongs of the Howey test are generally the "expectation of profits" and the "solely from the efforts of others" prongs. Both prongs should be read together, because the expectation of profits alone does not define a security. Profits can be expected from investments in money in many things which are not securities. However, the passive expectation of profits from the efforts of others is a defining feature of a security. This interpretation was affirmed by the *SEC Guidance*.

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[27] *Id.*

[28] *See, e.g., Glenn W. Turner,* 474 F.2d at 482. Note that *Howey* itself stated that the efforts should be *solely* those other than the investors'; an effective standard deemed too absolute and declined by subsequent courts. The court in *Glenn W. Turner* states that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities."

[29] *Id.*

[30] *See* William Hinman, "*Digital Asset Transactions: When Howey Met Gary (Plastic)*," Securities Exchange Commission, June 14, 2018 (hereinafter, *Hinman Speech*), https://www.sec.gov/news/speech/speech-hinman-061418; *See also SEC Guidance* at 3 (noting that where inquiry into reliance on Efforts of Others focuses on purchasers reasonable expectation of reliance on efforts of an Active Participant and that are not ministerial but "undeniably significant ones").

Courts have expanded the understanding of the fourth prong to include instances where the expectation of profits is largely dependent on the efforts or expertise of others (i.e. not literally "solely"), even if the investors have some involvement, such as voting.[31]

In April 2019 the SEC's Strategic Hub for Innovation and Financial Technology ("FinHub") published the *SEC Guidance* which provides a legal framework for analyzing whether a digital asset has the characteristic of an investment contract and whether an offer or sales of digital assets are securities transactions. The Framework serves only as informal guidance and is not binding on SEC itself.[32] Nonetheless, it sets forth a wide range of factors (generally of the nature of being pro-security indicators) that provide issuers the opportunity to assess whether, under certain facts and circumstances, the Howey test is satisfied vis-à-vis their assets. However, the SEC expressly did not provide any rule or weighting scheme, instead, explicitly reiterating that a full facts-and-circumstances analysis was called for. Thus, the *SEC Guidance* is more of a laundry list, and, as such, it is largely incumbent upon the good-faith judgment of an issuer's counsel to determine whether, weighing all of the factors (and any others that might be relevant), a digital asset or token is, as offered, an investment contract and, thus, a security.

Notably, the *SEC Guidance* focuses on the third prong (and fourth, in our delineation) of the *Howey* test, whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others and where a purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. The prong is met when a "promoter, sponsor, or other third parties (or affiliated group of third parties, each, an 'Active Participant' or 'AP') provides essential managerial efforts that affect the success of the enterprise, those efforts being "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[33]

The presence of the following features may be indicia that a purchaser of a digital asset would have "expectations of profits" as per *Howey*, as elaborated by the *SEC Guidance*:

- the digital asset gives the purchaser rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset;

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[31] *See e.g., SEC v. Glenn W. Turner Enters*., 474 F.2d 476, 482-83 (9th Cir. 1973); *SEC v. Koscot Interplanetary, Inc*., 497 F.2d 473 (5th Cir. 1974).

[32] *See SEC Public Statement, Statement Regarding SEC Staff View* (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-clayton-091318 ("The Commission's longstanding position is that all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties. Statements issued by SEC staff frequently include a disclaimer underscoring the important distinction between the Commission's rules and regulations, on the one hand, and staff views on the other."). Courts will also not defer to agency that disclaims the use of such regulatory guides as authoritative. *See e.g., Kiso v Wilkie*, 139 S. Ct. 2400, 2416, 2019 U.S. Lexis 4397, at 29 (2019)(noting that the regulatory interpretation must be agency's "'authoritative'" or "'official position'" and citing with approval *Exelon Generation Co. v Local 15, Int'l Brotherhood of Elec. Workers,* where the Seventh Circuit declined to defer to the agency which had itself 'disclaimed the use of regulatory guides as authoritative.' *AFL-CIO*, 676 F.3d 566, 576-578 (7th Cir. 2012).

[33] Quoting *SEC v. Glenn W. Turner Enter., Inc.,* 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973) ("Turner").

- the digital asset is transferable or traded on a digital asset trading platform, or expected to be traded on such a platform in the future;
- the purchaser reasonably expects that the token developer's efforts will result in appreciation in the value of the digital asset;
- the digital asset is offered broadly to purchasers rather than targeted to those likely to utilize the digital asset for its intended purpose on the network;
- the digital asset is sold in quantities indicative of investment rather than intended usage, for instance, in quantities so high that usage of that quantity of tokens on the network would be impractical;
- there is limited correlation between the initial purchase price of the digital asset in the initial digital asset sale and the market price of the goods or services that may be obtained in exchange for the digital asset;
- there is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption;
- the token developer raised funds in excess of the amount needed to develop a functioning network;
- the token developer may benefit from holding the same digital assets as those being distributed to the public;
- the token developer uses funds from proceeds of token sales or operations to enhance the functionality or value of the network or digital asset; or
- the token developer markets the digital asset in any of the following manners:
    - highlighting the expertise of the token developer or their ability to add value to the network;
    - the digital asset is described with investment-like terms, or solicited purchasers are referred to as "investors";
    - the use of the proceeds from the sale of digital assets is used to develop the network or digital asset;
    - promotion of the future or contemplated, yet-undeveloped functionality of a network or digital asset still under development;
    - promotion of the transferability or liquidity of the digital asset; o discussing potential profitability of the network or digital asset; or o highlighting the availability of a secondary market for the digital asset, particularly where the token developer promises to create a trading market for that asset.

The presence of the following features may be indicia that a purchaser of a digital asset would be acting in "reliance on the efforts of others" as per *Howey*, as elaborated by the *SEC Guidance*:

- the token developer is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly such tasks that are necessary for the network to achieve its full or primary functionality;
- the token developer is responsible for essential tasks for the completion of the network, rather than an unaffiliated, dispersed or decentralized group of users being responsible for such tasks;

- the token developer creates a market for the token, including controlling the creation and issuance of the asset, limiting supply of the asset or ensuring scarcity
- through mechanisms like buybacks or token burning;
- the token developer plays a central role in determining the future development of the network, governance, updates, validation, compensation of persons providing services to the network, or allocation of funds from a token sale;
- the token developer determines where the asset will be traded, for instance, when the token developer has arranged for or promised the listing of the token on a digital asset trading platform;
- the token developer retains a stake of the digital asset for itself, giving it the opportunity to realize capital appreciation;
- the token developer distributes the digital asset to its management team;
- the token developer controls the intellectual property rights of the technology fueling the network or token; or
- the token developer monetizes the digital asset, particularly when the digital asset has limited functionality.

However, the *SEC Guidance* also articulated factors that would make it more likely that a given digital asset is intended to be used in a consumptive process rather than held for investment purposes, and therefore less likely to be deemed a security under the *Howey* test:

- the network and digital asset are fully developed and operational;
- purchasers of the digital asset are able to use it for its intended usage on the network immediately, particularly when there are incentives to encourage such use (such as devaluation of idle digital assets);
- the creation and structure of the digital asset are tailored to meet users' needs on the network, and are distributed in amounts proportional to anticipated usage on the network;
- likelihood of appreciation in the value of the digital asset is limited, for instance, where the asset's value is tracking a set value or will degrade over time;
- for digital assets intended to be used as "virtual currency", there are existing opportunities to such currency for payment, without conversion into other forms of cryptocurrency or fiat;
- for digital assets that represent rights to a good or service, additional factors may include:
    - there is a correlation between the purchase price of the digital asset and a market price of the particular good or service for which it may be redeemed or exchanged;
    - the digital asset is available in increments that correlate with a consumptive intent versus an investment or speculative purpose; or
    - the good or service underlying the digital asset can only be acquired, or more efficiently acquired, through the use of the digital asset on the network.
- any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality;
- the digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset;
- potential purchasers have the ability to use the network and use (or have used) the digital asset for its intended functionality;

- restrictions on the transferability of the digital asset are consistent with the asset's use and not facilitating a speculative market; or
- if the token developer facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

The list of factors articulated under the *SEC Guidance* is not binding legal guidance. Nor is it an exhaustive list of all factors considered in evaluating whether a digital asset is a security. It is unclear which of these factors, if any, would be dispositive in determining whether a token will be deemed a security.

Assuming a purchaser acquires a token with an expectation of profits, it generally must also expect that profit "solely" from the efforts of others to be classified as an investment contract. As interpreted by courts, this depends in part on the extent to which potential profits result from the actions of the token holders versus others. Often tokens are intended to be used to access and use a system or platform, but any ability to profit from the use of the tokens will necessarily depend on the creation and success of the platform to enhance the utility of the token.

The efforts of the token issuer are often important to the success of building a viable platform and, by extension, the ability to use the tokens and the value of the tokens. Determining the relative importance of the efforts of the token issuer versus the efforts of token holders is somewhat subjective. Promoting the knowledge and expertise of the agents or employees of the token developer could increase the perceived importance of the issuer's efforts in such a determination.

C. Enforcement

1. DAO/Slock.it UG

In 2016, the Decentralized Autonomous Organization (the "DAO") offered and sold DAO Tokens in exchange for Ether raising approximately $150 million dollars in what is described as an Initial Coin Offering or ICO. It achieved particular notoriety for its being disastrously hacked, requiring the Ethereum blockchain network to be completely reset (or "forked") to effectively unwind the hack's effects. The SEC investigated the DAO ICO and issued a Report of Investigation that set forth an SEC view of the general applicability of securities law to the ICO sector.[34]

In the DAO Report, the SEC determined that the issuance (sale) of the DAO tokens constituted the issuance of a security, building on its predicate conclusion that the Howey test generally applies to blockchain-based token purchases. It further concluded that, whether a token is a security is based on the facts and circumstances of each issuance scenario (i.e., each ICO), explicitly following the "economic reality" test.

2. Telegram Group Inc.

[34] The Securities Exchange Commission, "*Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*" (Release No. 81207), July 25, 2017, https://www.sec.gov/litigation/investreport/34-81207.pdf (the "DAO Report").

Another noteworthy case is the SEC civil action against Telegram Group Inc. The case was originally filed on October 11, 2019, and ultimately settled on June 26, 2020.[35] Telegram is the originator of one of the most popular online messaging apps in the world and planned to build a connected blockchain ecosystem called the TON blockchain (centered on the TON token) by raising funds in a token sale (spearheaded by Telegram Group, Inc., and TON Issuer, Inc., a pair of British Virgin Islands companies created by founder NAME and associates). They succeeded in raising about $1.7 billion worldwide from March 2018 to October 2021, with $424.5 million raised from 39 purchasers in the U.S. under Regulation D, but the SEC claimed major violations in the offering concerning United States purchasers.

Telegram's token sale took the form of SAFTs, and the agreement called for the TON token to be distributed on October 31st 2021. However (as appears key), Telegram apparently under-delivered on its network and token utility promises by a longshot concerning the promised delivery date, leaving itself open to SEC claims that the public token distribution would necessarily be in violation of the Securities Act and Exchange Act. Amidst the litigation, Telegram reportedly refunded seventy-two percent (72%) of its raised funds to investors (at their behest, pursuant to a contractual right provided in the SAFTs), and on June 26, 2020, agreed to an $18.5 million fine by the SEC and agreed to permanently call off its planned TON distribution (the SEC also ordered disgorgement in about the amount Telegram investors had recalled). Due to the settlement (and, thus, a lack of adjudication on the merits), this major ostensible blockchain utility token sale case has yielded only broad outlines of what might constitute an "allowable" utility token issuance.

3. Kik Interactive Inc.

On June 4, 2019, the SEC brought suit against Kik Interactive, alleging that its "KIN" token, claimed by Kik to be a utility token, was a security.[36] Kik, based in Ontario, Canada conducted a "private" sale of SAFTs from May 2017 to September 2017, spanning the release of the DAO Report. While Kik only sold SAFTs to U.S. investors (representing about $39 million out of $49.5 million total) in putative compliance with Regulation D, Rule 506(c) (restricting sales to accredited investors, among other requirements), Kik nevertheless proceeded to a "public" sale (open to all purchasers) immediately after the cessation of its "private sale." The court granted summary judgment against Kik for violation of Section 5(a) and 5(c) of the Securities Act, finding that the public and private sales of KIN tokens were securities subject to registration.[37] Kik had argued that the SAFTs it sold to accredited investors were

[35] The case is *SEC v. Telegram Group Inc. and TON Issuer Inc.,* No. 1:19-cv-09439 (PKC) (S.D.N.Y. October 11, 2019). The complaint is available at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf. The motion for a preliminary injunction was granted in March 2020. *SEC v. Telegram Grp. Inc.,* 448 F. Supp. 3d 352 (S.D.N.Y. 2020).

[36] Case 1:19-cv-05244-AKH, United States District Court for the Southern District of New York; *complaint available at* https://www.courtlistener.com/docket/15722539/1/us-securities-and-exchange-commission-v-kik-interactive-inc/; for corresponding SEC press release, see Sec. Exch. Comm'n "SEC Charges Issuer with Conducting $100 Million Unregistered ICO" (June 4, 2019), https://www.sec.gov/news/press-release/2019-87.

[37] The case is *SEC v. Kik Interactive, Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. DATE). The original complaint is *available at* https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf.

subject to an exemption. However, because the court found that the public sale and private placement were an integrated offering, the sale of SAFTs was not eligible for such an exemption.[38]

4. Block.one

The SEC also settled an enforcement action against Block.one, a Cayman Islands company with operations in Virginia and Hong Kong. Between June 2017 and June 2018, Block.one conducted an ICO on its flagship product, EOSIO; the offering eventually raised several billion dollars in digital assets in part from U.S. purchasers.[39] Block.one instituted certain measures to prevent U.S. purchasers from participating in the offering. First, Block.one instituted an IP-blocking mechanism that prevented U.S. persons from accessing the token sale page on the EOS website. Second, it required all purchasers to execute a "token purchase agreement," according to which U.S. persons were prohibited from purchasing the tokens and that any purchase by a U.S. person was deemed unlawful as well as null and void.

However, Block.one also made certain decisions that rendered the ICO more susceptible to regulation. First, Block.one did not ascertain from purchasers whether they were based in the U.S. or not. As a result, notwithstanding the token purchase agreement and IP block, several U.S. persons were able to purchase tokens directly through the EOSIO website.[40] Second, Block.one participated in several U.S.-based blockchain conferences and ancillary meetings wherein it promoted EOSIO as well as the ICO. Third, the EOSIO website (barring the token purchase page), Whitepaper, and associated promotional statements were available to U.S. persons. Finally, the token was available for trading on several exchanges which were open to U.S. persons. On September 30, 2019, the SEC announced a settlement action regarding Block.one, wherein the company was fined $24,000,000.

5. LBRY, Inc.

In the final noteworthy case, the SEC filed a civil suit on March 29, 2021, against LBRY, Inc. (LBRY), alleging the company issued an offering of unregistered securities.[41] LBRY is an open-source public proof-of-work blockchain video file-sharing/payment network focused on digital content. The platform launched in June 2016. The blockchain portion is based on BTC and uses a network of servers to host an index of content, transaction ledger, and published identities of creators. The platform works in conjunction with Bittorrent for content distribution.

The SEC alleges that LBRY pre-mined and took control of forty percent (40%) of the total supply of the LBRY digital asset (LBC), totaling 400 million tokens. The SEC further alleges that LBRY pooled the $11 million it raised from the sale of LBC such that the successes of LBC holders were inextricably intertwined with other holders of LBC – including LBRY, the asset's largest holder. LBRY sold more than 13 million LBC directly to the general public through accounts it controlled through two online digital

[38] Kik, 492 F. Supp. at 181.
[39] *In the matter of Block.one*, Securities Act Rel No. 10714 (Sept. 30, 2019), https://www.sec.gov/litigation/admin/2019/33-10714.pdf (Block.one Order); for the corresponding SEC press release, see Press Release, Sec. Exch. Comm'n "SEC Orders Blockchain Company to Pay $24 Million Penalty for Unregistered ICO" (Sep. 30, 2019), https://www.sec.gov/news/press-release/2019-202.
[40] *See* Block.one Order at 4.
[41] The case is *SEC v. LBRY, Inc.*, No. 1:21-cv-00260 (D. N.H. 2021) The complaint is available at https://www.sec.gov/litigation/complaints/2021/comp25060.pdf.

asset trading platforms. These LBC sales to secondary market purchasers yielded bitcoin valued at more than $5 million in proceeds and sold to institutional investors at a discount to secondary market trading prices. LBRY engaged an agent and market maker to use 40 million LBC from LBRY's holdings to stabilize short-term prices and provide liquidity. It also engaged in other distributions of LBC from its holdings including compensation for employees and an employee purchase program. The SEC alleges that LBRY makes unilateral strategic and managerial decisions as well as decisions about the allocation of capital and resources pooled from investors. Finally, the SEC noted that, notwithstanding the platform's focus on digital content distribution, trading in LBC dwarfs any use of the platform's applications.

On November 7, 2022, Judge Peter Barbadoro of the United States District Court for the District of New Hampshire granted the SEC's motion for summary judgment against LBRY, Inc. The Court held that LBRY offered and sold LBC as a security in violation of the registration provisions of the federal securities laws, and that LBRY did not have a defense that it lacked fair notice of the application of those laws to its offer and sale. Based on the parties' stipulations, only the third element of Howey was in dispute, so the issue before the Court was whether "the economic realities surrounding LBRY's offerings of LBC led investors to have a reasonable expectation of profits derived from the entrepreneurial or managerial efforts of LBRY."[42] In ruling for the SEC, the Court reasoned that statements by LBRY and its employees in blog posts and interviews signaled to investors that LBC would appreciate in value through LBRY's efforts. For example, in a blog post following a large increase in LBC's market cap, the LBRY team stated that "the long-term value proposition of LBRY is tremendous, but also dependent on our team staying focused on the task at hand: building this thing."[43] Further, in an email to a potential investor, LBRY stated, "[i]f our product has the utility we plan, the credits should appreciate accordingly."[44] The Court rejected the significance of LBC's consumptive uses and of disclaimers by LBRY that LBC was not offered as an investment, holding that such a disclaimer was contrary to the objective economic realities of LBC purchases. Notably, the Court found that, even ignoring such LBRY statements, LBRY's decision to reserve or "pre-mine" hundreds of millions of coins for itself led purchasers of LBC "to expect that they too would profit from their holdings of LBC as a result of LBRY's assiduous efforts."

D. No Action Relief

The SEC staff has granted a small number of no action letters for specific digital assets. The facts and circumstances of these no action letters are very limited and not of much use for most digital assets but do indicate fact patterns which the SEC considers to be clearly safe.

On April 3, 2019, the SEC issued a no-action letter to TurnKey Jet, Inc. ("TurnKey"), a blockchain developer that plans to sell tokenized "jet cards" used by consumers, brokers, and carriers that utilize or provide private jet leasing services.[45] In the no-action letter, the SEC indicated that it would not recommend enforcement action against TurnKey in reliance on a legal opinion that TurnKey's counsel provided, indicating the TurnKey tokens were not securities, and numerous factors specific to TurnKey's development and prospective token sale, including: (i) token sales will not be used to fund development of the TurnKey platform, and the platform, tokens, application and network will be fully developed by

[42] *Order, SEC v. LBRY, Inc*., No. 21-CV-260-PB, Dkt. No. 86 at 8.
[43] *Id*. at 10.
[44] *Id*. at 11.
[45] *See TurnKey Jet, Inc.,* SEC No-Action Letter (April 3, 2019)

the time of the token sale, (ii) the token will be immediately available for its intended function when sold, (iii) TurnKey will restrict token transfers to users of the TurnKey platform only, and restrict transfers to wallets external to TurnKey, (iv) TurnKey will sell tokens at a fixed price of $1 USD, and such tokens will represent that same price when redeemed for private jet leasing services at the same price, (v) if TurnKey offers to repurchase tokens, it will only do so at a discount to the face value of the Tokens ($1 USD) that the holder seeks to resell to TKJ, unless a court within the United States orders TurnKey to liquidate the tokens, and (vi) TurnKey markets the token emphasizing its functionality and not potential price appreciation.

In 2020, the SEC granted a no-action letter to IMVU, Inc. ("IMVU"), a software development company that builds virtual world platforms and sells its Ethereum-based token, VCOIN. The relief provided that the SEC will not recommend enforcement action to the Commission if IMVU offers and sells VCOIN, which is transferable both on and off of IMVU's platform, without registration under Section 5 of the Securities Act, and does not register VCOIN as a class of equity securities under Section 12(g) of the Exchange Act. The no-action letter for IMVU was notable in that previous no-action letters only addressed digital assets that could not be sold or transferred outside of the platform in question, but VCOINs are transferable generally.

The no-action letter also emphasized certain factors addressed in previous no-action guidance, specifically that current token functionality at the point of token sale and marketing of the token exclusively as a consumptive mechanism for goods and services, and not an investment, were key issues in determining that the digital asset in question was not a security. The SEC also noted the importance of the digital asset issuer not using funds from the sale of tokens to develop an incomplete platform or network. The SEC also established requirements for the digital asset issuer to subject token holders to ongoing KYC/AML measures.

While the scope of the IMVU no-action letter is limited, the SEC noted new factors not addressed in previous no-action letters, such as requiring purchasers to affirm their intention of buying the token for consumptive use and not for speculative purposes, placing additional purchase, conversion, and transfer limits, and representing that IMVU will not promote or support listing or trading of the token on any third-party trading platform.

There are many common factors that the SEC considered in the IMVU no-action letter which it previously also considered in no-action letters to TurnKey and Pocketful of Quarters ("PoQ") to TurnKey, but in the case of PoQ and TKJ, the SEC seemed to place importance on the fact that users could not buy, sell, or trade either PoQ's Quarters or Turnkey tokens or generally transfer them to outside wallets. This was similar to no-action relief the SEC provided to various golf clubs in connection with selling equity memberships in the clubs, where the equity membership was only transferable to the club.[46] In PoQ, developers and influencers with approved accounts were also able to exchange their PoQ Quarters for ETH at pre-determined rates, and IMVU incrementally broadens interaction outside of a closed system by generally permitting all VCOIN users, subject to certain restrictions, to transfer their VCOIN to a digital wallet that would allow them to conduct transactions off the platform in addition to selling them to IMVU for fiat currency. Furthermore, while the scope of the IMVU no-action letter is still very

[46] *See, e.g., Olahana Golf Club, Inc*. No-Action Letter (July 31, 2003).

limited, the SEC noted new factors, such as requiring purchasers to affirm their intention of buying the token for consumptive use and not for speculative purposes, placing additional purchase, conversion, and transfer limits, and representing that IMVU will not promote or support listing or trading of the token on any third-party trading platform. SEC no-action letters are fact-specific and may not necessarily be relied on by others, and thus far, no-action letters have been extremely narrow in the blockchain area.

E. Private Placement and Sale

Based on the information and facts above, at least some DMC were issued to individuals and entities prior to the public sale and token listings. It is also possible that fundraising activities may have implicated US Securities laws, to the extent that an exemption from registration would be required if such an analysis were complete. Based on our review of that information, even if those Token offerings were to qualify as securities, they would fall into the exemption provided by the SEC's Rule 701 for offerings made subject to employment compensation arrangement[47] and the general exemption of Section 4(a)(2) of the Securities Act.

Section 4(a)(2) of the Securities Act provides an exemption for transactions by an issuer "not involving any public offering."[48] Any general advertisement or general solicitation is not allowed under that statutory exemption.[49] As a general matter, employers which make such offerings to employees are not subject to registration in reliance upon the exemptions recited above; however, where such securities are offered as part of a deferred-compensation plan (or retirement plan) for employees, there may be unrelated requirements under the Employee Retirement Income Security Act ("ERISA"). This memorandum does not address potential risks related to ERISA.

We have also had the opportunity to review the private placements that you made through the Token Warrants, as described in greater detail above. These, too, we understand were not made coincident with, or incidental to, an otherwise registration-subject public offering. Historically, Rule 506 under Regulation D provided a safe harbor that could be relied on to satisfy the Section 4(a)(2) statutory exemption. This safe harbor permits issuers to raise unlimited capital from an unlimited number of accredited investors[50] and up to 35 non-accredited investors but prohibited general solicitation or general advertising.

The Jumpstart Our Business Startups Act (JOBS Act) of 2012, lifted the ban on general advertising and general solicitation where the offering is restricted to accredited investors, and reasonable steps are taken to verify such status. This resulted in a new Rule 506(c) safe harbor allowing such communications in offerings with only accredited investors and concurrently preserving the existing safe harbor as Rule 506(b), which retained the continued prohibition on general solicitation and

[47] *See SEC Final Rule: S7-5-98*, Release No. 33-7645.
[48] 15 U.S.C. § 77d(a)(2).
[49] Issuers relying on Section 4(a)(2) are restricted in their ability to make public communications or attract investors for offerings as such public advertising would be incompatible with the exemption covering transactions "not involving any public offering." *See Non-public Offering Exemption*, SEC Release No. 33-4552, 27 Fed. Reg. 113163 (Nov. 6, 1962).
[50] 17 C.F.R. § 230.501(a)(defining the term accredited investor).

general advertising. The JOBS Act did not disturb the prohibition on general advertisement and general solicitation for the statutory Section 4(a)(2) exemption.

Compliance with Rule 506(c) of Regulation D allows the Foundation and the Platform to raise a more-or-less unlimited amount of capital through a private offering to an unlimited number of accredited investors. This is important given the onerous communications restrictions under Rule 506(b) or the Section 4(a)(2) statutory exemption that prohibits general solicitation and general advertisement, which are broadly construed. The terms "general solicitation" and "general advertisement" are not defined in the Securities Act, but Regulation D does provide examples including advertising published in newspapers, magazines, communication broadcast over television and radio, and seminars who attendees have been invited by such general solicitation or general advertising.[51] The SEC has further interpreted this to also include other uses of publicly available media, such as unrestricted websites.[52]

Based upon our review of documents that formed the basis for your relationship with Fog Works, Inc., in addition to the accreditation status of such investors and the non-US domicile of parties involved in those transactions, if any securities were required as part of the Token Warrants or other transactions, they would remain eligible for exemption under the Securities Act.

The Rule 506(c) safe harbor exemption allows for general solicitation and imposes no specific disclosure requirements, although reasonable steps must be taken to verify the accredited investor status of each purchaser. Issuers must comply with the "bad actor" rule in Rule 506(d)(1) and exercise reasonable care to identify and avoid having placement agents and certain controlling persons, officers, and affiliates involved who were subject to any "disqualifying events."[53] The offering remains subject to the SEC's antifraud provision and bad actor disqualification and limitations on resale.[54]

It should be noted that issuers relying on this exemption must file SEC Form D within fifteen (15) calendar days from the date of the first sale of securities in the offering.[55] However, the procedural requirement to comply with Rule 506, and, thus, the availability of the exemption, does not depend on the form, as stated by the SEC itself in Question 257.07 of its Securities Act Rules, Questions, and Answers of General Applicability.[56] While failing to file a Form D is not a condition of a Regulation D exemption, it could subject the issuer to potential penalties such as fines or prohibition on the future use of exemptions, for not filing Form D or for a late filing.

We understand that the Foundation did not generally solicit or advertise in its early private placement rounds and the number of purchasers is limited. As such, it should be in a strong position to rely on this exemption from registration if the transactions are subject to any scrutiny.

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[51] *See* 17 C.F.R. § 230.502(c).
[52] *See Use of Electronic Media for Delivery Purposes*, SEC Release No. 33-7233, 60 Fed. Reg. 53458 (Oct. 6, 1995) at ex 20; see also Use of electronic Media, SEC Release No 33-7856, 65 Fed. Reg. 25843 (Apr. 28, 2000) at n 79-80.
[53] The list of disqualifying events are identified in Rule 506(d) but generally are securities-related bad acts involving criminal convictions, suspensions, expulsions and debarments.
[54] *See* 17 C.F.R. § 230.502(d) ("Limitations on resale. Except as provided in § 230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(a)(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom."
[55] 17 C.F.R. § 230.503(a)(1).
[56] *SEC Compliance & Disclosure Interpretations,* Question 257.07 (Nov. 6, 2017).

F. Public Sale

Regulation S provides an additional exemption from the registration requirements. It specifically states:

> For the purposes only of section 5 of the Act (15 U.S.C. § 77e), the terms *offer, offer to sell, sell, sale,* and *offer to buy* shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States.

Regulation S, Rule 901 (17 CFR §230.901). To provide foreign issuers and resellers of foreign securities with certainty that their transactions will be deemed to occur outside the U.S., Regulation S sets forth two safe harbors with conditions that if met, result in an issuers' exemption from the registration requirement under the Securities Act.[57] Separately, offers or sales conducted "outside of the United States" that do not satisfy either safe harbor may also qualify for exemption under certain circumstances. Separately, offers or sales conducted "outside of the United States" that do not satisfy either safe harbor may also qualify for exemption under certain circumstances.[58]

Transactions are generally not structured around Rule 901 because of the harsh consequences if the SEC finds the compliance measures to fall short. Indeed, even the posting of information about the BURNT offering on a website, alone, may constitute an offer of a security, which would require registration or an exemption.[59] As such, we do not recommend that Regulation S form the basis of any future public issuances of DMC.

The SEC has not issued detailed guidance regarding the requirements needed to satisfy the Regulation S exemption subject to Rule 901.[60] However, we think satisfaction of the two general conditions found in the Rule 903 issuer safe harbor should be sufficient to make a strong case that the offering qualifies for the Regulation S exemption. These two conditions are that (1) the offer or sale is

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[57] As Regulation S is "self-executing," simply meeting its standards amounts to a self-grant of the regulatory exemption.

[58] *See Europe Overseas Commodity Trader S.A. v Banque Paribas London*, 147 F.3d 118, 124 (2d Circ. 1998).

[59] *See e.g., SEC v. Blockvest, LLC*, No. 18CV2287-GPB, 2019 U.S. Dist. LEXIS 24446, at *29-30 (S.D. Cal. 2019) (concluding "that the contents of Defendants' website, the Whitepaper and social media posts concerning the ICO of the BLV tokens to the public at large constitute an "offer" of "securities" under the Securities Act.").

[60] The analysis of the public sale is complicated by the fact that there is a question as to scope and extent of SEC's extraterritorial authority to impose registration requirements under Section 5 for transactions that take place outside of the United States. The SEC in adopting Regulation S stated that "[i]f it can be demonstrated that an offer or sale of securities occurs 'outside the United States,' the registration provisions of the Securities Act will not apply, regardless of whether the conditions of [Regulation S] are met. For a transaction to qualify…both the sale and offer pursuant to which it was made must be outside the United States." *See Regulation S Adopting Release*, SEC Rel. No. 6863 (April 24, 1990), 55 Fed. Reg. 18306 (May 2, 1990)("Reg. S Adopting Release"). The ongoing conflict over whether Section 929P of the Dodd-Frank Act abrogated the U.S. Supreme Court's decision in *Morrison v National Australia Bank Ltd*., 561 U.S. 247 (2010) is limited to antifraud provisions of the U.S. securities law. *See e.g., U.S. v Scoville*, 913 F.3d 1204 (10th Cir. 2019). In contrast the SEC has long had a territorial approach with respect to the imposition of registration requirements for transactions effected offshore. *See Reg. S Adopting Release* (stating that "[i]t is generally accepted that different considerations apply to the extraterritorial application of the antifraud provisions than to the registration provisions of the Securities Act. While it may not be necessary for securities sold in a transaction that occurs outside the United States, but touching this country through conduct or effects, to be registered under United States securities laws, such conduct or effects have been held to provide a basis for jurisdiction under the antifraud provisions of the United States securities laws.").

made in an offshore transaction and (2) that the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf does not engage in any directed selling efforts.[61]

1. Offshore Transaction

DMC will be able to satisfy the offshore transaction condition set forth in the Regulation S safe harbors that its offers were not made to a person in the United States if, at the time the buy order is originated, the buyers were outside of the United States, or that DMC, and any person acting on the Foundation's behalf, reasonably believed that the buyer is outside of the United States. U.S. green card holders are presumed to be U.S. residents for purposes of Regulation S.[62] In addition, DMC could not have targeted any identifiable group of U.S. citizens abroad.

The phrase "offers were not made to a person in the United States" is broadly construed as noted above, as even the posting of information about a token sale could be construed as an offer of a security. However, the SEC has issued guidance clarifying that when such postings constitute an offer or solicitation materials on a website would satisfy this condition.[63]

The SEC Internet Guidance requires that issuers must take commercially reasonable steps to avoid selling any digital assets to anyone based in the United States. These measures will need to comply with the requirements set forth in the SEC's guidance on "Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore (the "internet guidance").[64] The SEC internet guidance takes a facts-and-circumstances-based approach in line with the facts-and-circumstances approach of Regulation S. The guidance requires that offerors implement adequate measures to prevent U.S. persons[65] from participating in an offshore internet offer. Specifically, the guidance states that the SEC generally would not consider an offshore internet offer made by a non-U.S. offeror as targeted at the United States if the following two factors are met: (1) the offeror's website includes a prominent disclaimer making it clear that the offer is directed only to countries other than the United States; and (2) the offeror's website implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering.[66]

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[61] 17 C.F.R. §§ 230.903(a)(1),(2).
[62] *See SEC Compliance and Disclosure Interpretations*, Question 276.01.
[63] *Sec. Exch. Comm'n, Offshore Offers and Sales*, 55 Fed. Reg. 18,306, 18,309 (May 2, 1990).
[64] *See Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, SEC Release No. 33-7516, 63 Fed. Reg. 14806 (March 23, 1998).
[65] Rule 902(k) of Regulation S defines the term "U.S. person" to mean: (i) any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the U.S.; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; and (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the U.S., and (viii) any partnership or corporation if (A) organized or incorporated under the laws of any foreign jurisdiction, and (B) formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a)) who are not natural persons, estates, or trusts.
[66] *Id*. at 14808.

The exemption under Regulation S amounts to an exemption for parties who, not being domiciled in the United States, are not generally subject to the jurisdiction of its securities regulators. However, as noted above, this office cannot comment on U.S.-domiciled persons who may have participated in Token Warrants as members or shareholders of the various applicable parties. If, for example, Fog Works, Inc. engaged in its own fundraising activities involving U.S. persons, that is beyond the scope of this memorandum. This is one of many reasons to recommend that the Foundation continue to employ KYC protocols to ensure that no U.S.-based persons are eligible to invest in DMC in any form until such time as the requisite exemptions can be satisfied. If those entities engaged in other forms of fundraising (such as sales of their own equity for cash), this memorandum cannot comment on those other raises.

Any disclaimers of the sort described above which facially deny access to the raise by U.S.-domiciled persons must be meaningful, meaning it must be displayed prominently on the same page as the offered materials or on a screen that must be viewed by prospective purchasers.

For example, the SEC identified the following disclaimer as being sufficient if the other conditions are met: "This offering is intended only to be available to residents of countries within the European Union."[67] With respect to what constitutes procedures reasonably designed to guard against U.S. persons in offshore offerings, steps may include the prevention of sending materials to U.S. addresses or phones (including by creating a blacklist, or using technology solutions to geo-locate wallets and exclude U.S.-based wallets from such distributions).

2. Compliance with Prohibition against Directed Selling Efforts

There is no specific requirement that issuers seeking to avail themselves of the exemptions recited above not engage in such directed selling efforts. Nevertheless, an issuer's actions and offerings must be consistent with the additional rules in the preliminary notes of Regulation S. Specifically, the preliminary notes state that the exemption is "not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act." Based upon the information we have reviewed, DMC has complied with the prohibition in Regulation S against engaging in directed selling efforts.[68]

Directed selling efforts is defined as "any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S (§230.901 through § 230.905, and Preliminary Notes). Such activity includes placing an advertisement in a publication "with a general circulation in the United States" that refers to the offering of securities being made in reliance upon this Regulation S."[69] Activities undertaken by an issuer for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for the very securities being offering in reliance

[67] *Id.*

[68] For purposes of clarity, the Regulation S discussed here may also be referred to as the Rule 901 exemption. *See* 17 CF §230.901

[69] 17 C.F.R. § 230.902(c)(1). Directed selling efforts may also include placing an advertisement in a publication with a general circulation in the U.S., including traditional solicitation methods such as direct mail, seminars, telephone solicitations, and radio and TV advertisements.

on Regulation S could be viewed as a plan or scheme to evade registration. As such, an activity that could be characterized as directed selling efforts must be closely scrutinized.

Importantly, in our opinion, directed selling efforts would not (or should not) include any internet activities that fail to comply with the SEC's internet guidance and with the plain text of Rule 901. The employment of commonsense technology solutions such as KYC. The purpose of the guidance is to ensure that adequate measures are taken to prevent a U.S. person from participating in an offshore internet offer. An issuer's effort to take such measures to ensure its internet websites do not run afoul of the SEC guidance, should not be viewed as conditioning the market in the United States for any of the securities being offering in reliance on Regulation S and thus directed selling efforts.

For purposes of this memorandum, we have not engaged in any detailed assessment of the Foundation's online media postings, engagements with the public through seminars, webinars, or other unrestricted social media channels. We note that DMC has continuously published information about the developments and details through ordinary social media channels and that you use certain other communications tools such as an internal Discord.

The SEC may take a conservative position that any prior discussion that references the DMC digital assets constituted directed selling efforts. However, as will be detailed below in our view, DMC's digital assets are not intrinsically securities but are only securities when they form part of an investment contract. As such, descriptions and discussions regarding ongoing developments related to the Platform or Protocol outside of the context of any offer or sale of the DMC digital assets should not be viewed as discussion related to a security and thus directed selling efforts. We further note that DMC may yet availed itself of the Regulation D Rule 506(c) exemption which does allow general solicitation and general advertisement and that these private placement sells would have occurred concurrently with the timeframe at issue providing DMC with further protection from any charge of directed selling efforts.

In summary, based upon the information we have reviewed, it is our opinion that the Foundation has not engaged in activities that would run afoul of the directed selling efforts in Regulation S, though it should not be relied upon for reasons related to the domicile of certain interested parties.

IV. Analysis

A. There is Likely an Investment of Money

Where a token is being purchased or exchanged for a thing of value, an investment of money exists. DMC can be purchased and exchanged for fiat and cryptocurrencies on public marketplaces, and therefore an investment of money likely exits.

B. There May Be a Common Enterprise

As the SEC does not require commonality as a requirement to find a "common enterprise" and generally finds that the "fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts."[70] While we believe the Foundation may have an argument that a

[70] *See SEC Guidance,* referencing *SEC v. Int'l Loan Network, Inc*., 968 F.2d 1304, 1307 (D.C. Cir. 1992).

common enterprise does not exist because DMC is used as a representation of data storage and the value of that storage, and therefore the fortunes made by holders of DMC may not be related to one another, it will likely be an unconvincing argument on its own and not determinative. It is therefore not necessary to fully analyze this point at this time.

C. There is No Reasonable Expectation of Profits

As a token that is still in its early stages, including limited listings and current unavailability on exchanges, it is reasonable that there is some reliance on an Active Participant for certain activities, in this case. However, the nature of the Foundation's participation does not cumulate into a reliance on the efforts of others as contemplated by *Howey*.

Specifically, there is no right for DMC holders to share in the Foundation's income or profits, nor realize gain from capital appreciation of DMC. While DMC can me sold from the original purchaser to another individual, it is merely a representation of the right to receive services and therefore the market value of those *services*, not any other value. Any fluctuation in value of DMC would be directly related to the value of the storage services marketplace, and is limited because it is tied to market value of storage space, not inherently of the DMC itself. While the Foundation is expected to encourage adoption and development of the network at such an early stage, it is unrelated to an expectation of an increase in value of DMC. Additionally, the Foundation is a non-profit entity, therefore it has no such profits in which holders of DMC could possibly share, and no incentive to profit from the value of DMC.

Further, DMC has not been marketed in any way that would be indicative of an expectation of profits. The Foundation does not highlight their own expertise, but the potential of third-party adoption for functionality, not that of the Foundation itself. DMC is not marketed with any investment-related terms, nor in a matter discussing potential profitability of the asset, but only its functional aspects as a representative of real storage space. The creation and structure of DMC is tailored to meet purchaser's needs on the network, and only distributed in accordance with actual available storage space, that is, proportional to its anticipated usage.

Therefore, when looked at as a whole, there would be no reasonable expectation of profits from *holding* DMC, only from its transfer. As a newly created token and blockchain, the Foundation is actively developing the network and plans to do so for some time. However, due to the nature of the Foundation and the function of DMC, it is unlikely that this active participation in the adoption of the Chain, and incidentally DMC, is indicative that there is a reasonable expectation of profits from DMC.

D. Any Expectation of Profits is not Derived from the Efforts of Others

It is unlikely that any expectation of profits in DMC, to the extent they exist, are derived from the efforts of the Foundation. Specifically, while DMC at this time may meet a majority of the criteria listed in the *SEC Guidance*, the SEC itself has stated that it is not conclusive. Additionally, the Foundation does not retain DMC for itself, though it may in the future, therefore it will not realize any appreciation of DMC, nor does it monetize the value of DMC. The value of DMC comes from its ability to be exchanged for storage space on the Chain; it is merely the right to receive services in a manner similar to that in TurnKey.

Further, while the Foundation will continue to promote the adoption of the Chain and promote DMC, the promotion of DMC is *merely* to encourage the use of the Chain and development of it. Any efforts at hand are efforts related to the Chain, not DMC. In addition, the Chain, while still under development, is fully operational. Current holders of DMC can exchange it for storage space, assuming there is storage space on the market for them to use.

V. Conclusion

Based on our review of *Howey,* derivative case law, relevant SEC guidance on the subject of cryptocurrencies, and information provided by the Foundation and subject to the qualifications of the preceding sections of this memorandum, our conclusion is that there is a reasonable argument to me bad that transactions made involving DMC, as described above, should not be deemed offerings of securities. Specifically, the Foundation's creation and offering of DMC does not include "an expectations of profits derived from the efforts of others," as further elaborated upon in the *SEC Guidance,* with particular relevance in Section C(3). For the above-mentioned reasons, if Datamall Foundation continues to offer and sell DMC and further operates the Chain in the manner and under the circumstances described above, the Foundation can do so without registration under the Securities Acts.

If you have any further questions or require clarification on any points, please do not hesitate to ask.

Sincerely,

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