
THE ACCREDITED INVESTOR TOKEN

This document should not be used as legal or financial advice.

I. Introduction

This memorandum is intended to explain a plausible method for Ethereum-based corporations to sell securities in compliance with U.S. law. The explanation involves the corporation selling tokenized equity only to accredited investors. Part II explains how these sales can be permissible under U.S. securities law, what conditions must be met in order for an investor to be considered accredited, and how sellers are permitted to confirm that an investor is accredited. Part III proposes the issuance of an Accredited Investor Token (“AIT”) that acts to whitelist Ethereum addresses so that they may participate in these securities offerings. The AIT will be issued by licensed attorneys, who are themselves verified by LexDAO, which is an Aragon-based group of attorneys and DAO experts.

II. Background

(a) Blockchain Distributed Ledger Technology

Corporations must produce a stock ledger that contains the name and mailing address¹ of each stockholder entitled to vote.² The stock ledger is the official record of the stock of the corporation. In 2017, the Delaware General Assembly passed legislation amending § 224 to explicitly allow the stock ledger to be in the form of a distributed electronic network or database.³ This legislation opened up the *technical* possibility of corporations trading equity on the blockchain.⁴ However, there are prohibitions on the Federal level, which will be discussed in the next subsection, along with the 506(c) exemption to these prohibitions.

(b) SEC Rule 506(c)

In the U.S., the sale of unregistered securities⁵ is generally prohibited, unless an exemption exists specifically articulated by legislation or agency rule. In 2017, the Securities and Exchange Commission (“SEC”)—which is the federal agency primarily responsible for enforcing

¹ Stockholders probably don’t want their residential addresses made public. Perhaps we could list the mailing address of an agent, like the lawyer who issued the AIT, who accepts service of process and notifies the stockholder either through mail or email.

² Del. Code tit. 8, § 219, 224.

³ John Williams, *Stock Ledgers Revolutionized With Delaware Corporate Blockchain Legislation*, Delaware Business Times (June 28, 2017) <https://www.delawarebusinesstimes.com/stock-ledgers-revolutionized-delaware-corporate-blockchain-legislation/>.

⁴ Id.

⁵ Securities are tradable financial assets, such as equity in a company, that are bought and held as investments.

securities violations—issued a report finding that certain blockchain-based tokens are securities that must be registered.⁶ In the years since, the SEC has shut down a number of token sales, called “Initial Coin Offerings” or “ICOs”, and sought hefty civil penalties for a number of violations. This enforcement has led to a sharp decline in the number of ICOs, with companies and investors looking for a compliant method of selling blockchain-based tokens through a legally authorized registration exemption.

One exemption, Rule 506(c), permits companies to sell restricted securities⁷ to accredited investors under certain conditions.⁸⁹ The condition most relevant to this project is that the issuer takes reasonable steps to verify purchasers’ accredited investor status. The issuer is deemed to have taken reasonable steps if it obtains an attorney’s written confirmation that a purchaser is accredited, as long as the issuer doesn’t have actual knowledge that the purchaser doesn’t in fact meet the qualifications.¹⁰ For example, Company A can sell to Alice if her attorney, Bob, writes an email stating that Alice meets the qualifications of being an accredited investor. But if Company A knows that Alice doesn’t actually have much money and that Bob is mistaken or acting in bad faith, then Company A can’t just rely on Bob’s confirmation.

In order to be qualified, a purchaser must meet the definition of accredited investor as stated in Rule 501.¹¹ Generally this includes various organizations with assets in excess of \$5 million, and—important for this project—people with individual net worth, or joint net worth with a spouse, that exceeds \$1 million in non-residential assets, or people with an individual income greater than \$200,000, or joint income with a spouse greater than \$300,000, within the past two years.

The following Section explains how the written confirmation of accreditation can be issued on the Ethereum blockchain.

III. Proposal

⁶ <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁷ Restricted securities must meet certain conditions in order for them to be re-sold. For non-affiliated sellers (an affiliate is a person, such as an executive officer, a director, or large shareholder) the securities can be sold after a holding period of 1 year for non-reporting (non-public) companies from the time the securities were bought and paid for. This will become important when designing the security token standard, likely requiring the token to be non-transferable for a year.

⁸ A condition not otherwise mentioned in this document is the “bad actor disqualification”, which prohibits the issuer from involving certain people with the sale, namely ones convicted of fraud and the like. The issuer is also required to file a notice with the SEC on Form D within 15 days after the first sale of securities in the offering. These condition will be more fully discussed in a separate legal memorandum.

⁹ 17 CFR § 230.506 (<https://www.law.cornell.edu/cfr/text/17/230.506>).

¹⁰ Rule 506(c)(2)(ii) states that “[t]he issuer shall be deemed to take reasonable steps” if the issuer obtains “a written confirmation” from “[a] licensed attorney who is in good standing under the laws of the jurisdiction in which he or she is admitted to practice law” that the purchaser is an accredited investor within the prior three months, as long as the issuer doesn’t have knowledge that the purchaser is not accredited.

¹¹ 17 CFR § 230.501 (<https://www.law.cornell.edu/cfr/text/17/230.501>).

Because issuers under Rule 506(c) are permitted to rely on written confirmation from an attorney that a purchaser is accredited, we propose putting that confirmation on the Ethereum blockchain in the form of a non-fungible token ("NFT"). The NFT will contain each shareholder's name and mailing address, which can be easily accessible so that corporations can comply with Del. tit 8, § 219 and 224. If the shareholder is uncomfortable with making his or her mailing address public, the AIT issuing attorney could accept mail on the shareholder's behalf in exchange for a small fee.

The issuing attorney will use the OpenLaw platform to electronically sign a document that states (1) that an investor is accredited; and (2) that the investor is the sole owner of the Ethereum address that will receive the Accredited Investor Token (AIT). OpenEsquire has already created a working model for this template, which is located at <https://lib.openlaw.io/web/default/template/Accredited%20Investor%20Token%20Certification>. Currently the model reads as follows:

CERTIFICATION FOR ACCREDITATION

This document is a written confirmation that [[Attorney Name]], a licensed attorney in good standing under the laws of the jurisdiction in which they are admitted to practice law, has taken reasonable steps to confirm, and does so verify and certify hereby, that [[Investor Name]], a(n) individual located at [[Investor Address]] ("Investor"), meets the qualifications for an "Accredited investor" as defined in 17 § CFR 230.501 (the "Regulation"), and further certifies that they have reviewed and determined that Investor satisfies one or more of the following criteria (this "Certification") within the prior three (3) months:

— a natural person whose individual "net worth," or joint net worth with Investor's spouse, exceeds \$1,000,000 (USD);

— a natural person who had an individual income in excess of \$200,000 in each of the two most-recent years or joint income with Investor's spouse in excess of \$300,000 in each of those years.

In connection with this Certification, the undersigned has reviewed the original or photocopies of the following documents as supplied by Investor (the "Client Materials"):

— Form 1040 filed with the Internal Revenue Service by Investor and/or their spouse for the two most recent years;

— Form 1099 filed with the Internal Revenue Service by Investor and/or their spouse for the two most recent years;

— Schedule K-1 of Form 1065 filed with the Internal Revenue Service by Investor and/or their spouse for the two most recent-years;

— Form W-2 issued by the Internal Revenue Service to Investor and/or their spouse for the two most recent-years;

or similar references sufficient for purposes of the Regulation.

Once this document is signed electronically by [[Attorney Name]], [[Investor Name]] shall be issued a non-transferable Accredited Investor Token ("AIT") to the following Ethereum account:

0x[[Investor ETH Address]]

The AIT serves to "whitelist" Ethereum accounts so that such accounts may participate in sales of securities that are only available to accredited investors.

AITs shall at all times be revocable upon the determination by lexDAO cooperative members (0x97103fda00a2b47eac669568063c00e65866a633) that this certification is in violation of, or an associated Ethereum account shall no longer qualify for, accredited investor treatment under applicable rules and regulations.

[[Investor Name]] has made previous representation regarding the above Ethereum address, including representing that [[Investor Name]] is the sole owner of that address and all of the assets associated thereby.

Confirming that the above is true and correct,

[[Attorney Name]]
[[Attorney Address]]
Bar Number: [[Attorney Bar Number]]
0x[[Attorney ETH Address]]

For convenience, attorneys can sign this confirmation and issue an NFT through the OpenLaw platform. As some attorneys have difficulty with technology, the process of AIT issuance should be made as easy as possible. It will require a MetaMask (or equivalent), an OpenLaw template, and enough ETH for gas. In order to facilitate the issuing attorney's usage of these requirements, a tutorial, perhaps in the form of a flowchart, should be produced and made available.

Ideally once an Ethereum address holds the NFT, the address will be whitelisted to allow it to purchase securities tokens. The AIT must be nontransferable so that the information stays with the specific purchaser, and it needs to be revocable in case of fraud, court order, or some SEC-related problem. For example, if it turns out the investor is laundering money, we'd want a way to stop him/her from trading. The AIT also must be burnable so that the investor must re-apply for accreditation. Just because an investor meets the criteria for accreditation for one year doesn't mean he/she meets it for subsequent years. Likely this re-application will have to be done quarterly because of the wording of Rule 506(c)(2)(ii)(C), which states that the confirmation must be "within the prior three months." This would give the AIT a three month expiration date from the time an attorney issues it.

LexDAO will vote to whitelist any licensed attorney as an issuer of AIT. The attorney will need to submit to LexDAO proof of (1) active bar license; and (2) proof of identity (e.g. email from official law firm account). In order to encourage LexDAO members to investigate and vote on applicants, a small administrative fee (\$30?) should be charged. The voting members should share in this fee, whether they voted "yes" or "no", in order to compensate for investigative time and burned Ethereum gas.

In terms of percentage of votes to approve, it should be 100% in agreement, with a single vote having the power to blackball an applicant. If there's any question as to whether the applicant

is a licensed attorney in good standing, s/he should not be whitelisted to issue AIT. In addition, LexDAO must retain the power to remove attorneys from the whitelist in case of fraud, abuse, or court orders. Similarly, LexDAO should retain the power to burn any AIT at anytime for any reason. The reason is to not draw the ire of government agencies if a hostile foreign power misuses the token to funnel money into illegal or otherwise malevolent activities. For example, if a suspected agent of North Korea is using an AIT to launder money for the sale of weapons, and LexDAO is informed of this from the FBI, the token should be burned and the account blacklisted until the situation resolves. Otherwise, AIT issuance will likely become illegal, either through legislation or agency rule making.

The reason we whitelist to any licensed attorney and only charge a small fee is because we want the AIT to be a universal indicator that developers and businesses can use to recognize accredited investors. Competition in this case would be inefficient, as these developers and businesses would need to add multiple versions AIT to their platforms, or investors would need to apply multiple times for different tokens. We also want the project to scale with as many issuers as possible.

An attorney's whitelist status should be renewed every year in order for LexDAO to ensure the issuer has successfully renewed his/her license to practice law.

The AIT issuing attorney shall take reasonable steps to validate that the investor meets the qualifications of "accredited investor" as per Rule 501. This investigation is conducted independently according to the issuing attorney's own professional judgment. The attorney is also responsible for charging the investor an investigation fee, perhaps a subscription since the AIT must be renewed quarterly. Advertisement of the attorney's status as an authorized AIT issuer should be done in accordance with the attorney's local rules of professional conduct.

Current development of the AIT can be found on Github at <https://github.com/lexDAO/AIT/tree/master/contracts>. The following is a chart representing the AIT issuance process:



