O'Melveny

MEMORANDUM

PRIVILEGED & CONFIDENTIAL
ATTORNEY WORK PRODUCT

TO: Daisy Tian and Waykichain Foundation

FROM: O'Melveny & Myers LLP

DATE: February 19, 2019

SUBJECT: **Token Status Memorandum**

This memorandum addresses certain factors which may be relevant in considering whether WICC tokens could be deemed a "security" under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"). The scope of this memorandum is limited to this law and does not address any other laws or regulations. We have not undertaken any analysis under any other body of law or legal construct or the laws of any other jurisdiction, including state law. Whether a token constitutes a security has important implications, including how a token should be marketed and whether a token offering must be registered under the Securities Act of 1933, as amended (the "**Securities Act**"), or is exempt therefrom, whether a person involved in transactions relating to the tokens is required to register as a broker-dealer or otherwise under the Exchange Act,[1] whether an issuer of tokens has reporting obligations under the Exchange Act, and whether purchasers of tokens may assert securities law-based and antifraud claims against token issuers. Statements made by the Chairman of the Securities and Exchange Commission (the "**SEC**") indicate that the SEC holds a broad interpretation of what constitutes a "security." The SEC Chairman stated that every initial coin offering ("**ICO**") he has seen to date is a security while conceding that some cryptocurrencies, likely only bitcoin and ether, fall outside of the definition of security.[2] Though the ultimate decision on a given token's status is highly fact dependent and would be decided by a court, rather than the SEC, it is important to keep the SEC's position in mind while considering this memorandum.

I. BACKGROUND

Our understanding of WICC tokens and Waykichain (the "**Company**") is based on information available on Waykichain's current website, blogs and social media accounts. We understand that features of the WICC token, Waykichain and the process of distributing tokens are likely to continue to evolve. As a result, any changes, including changes in our understanding of existing or proposed facts, could affect our analysis of WICC tokens.

[1] We are not generally addressing broker-dealer and Exchange Act registration requirements in this memorandum.

[2] *Virtual Currencies*: *Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115 Cong. (Feb. 6, 2018) (audio statement of Jay Clayton, Chair, Securities and Exchange Commission), *available at* https://www.c-span.org/video/?440770-1/jay-clayton-christopher-giancarlo-testify-hearing-virtual-currencies&start=1.

We have not previously been engaged to provide legal services to the Company. Moreover, we have not conducted or commissioned anyone to conduct any independent review or analysis of the technical aspects of Waykichain, the WICC token or any other matter described herein. For example, we have not reviewed the code used for the Waykichain blockchain and have not confirmed the accuracy or completeness of any statements regarding the rights associated with, or the functionality or operation of the WICC token. We have not made any independent review or investigation: (a) of any orders, judgments or decrees by which the Company or any of its affiliates may be bound, (b) as to the existence of any actions, suits, investigations or proceedings that may be pending or threatened against the Company or any of its affiliates, or (c) with respect to the Company or any of its affiliates' compliance or noncompliance with any foreign or state laws (including any securities laws or the anti-fraud provisions thereof, and any applicable franchise laws).

As part of our analysis we have reviewed some but not all publicly available materials distributed by the Company. Due to the quantity of public marketing and communications materials made by the Company, including web pages, social media posts, videos, seminars, conferences and other forms of communication, we are unable to review all content the Company has distributed, including some which may have been deleted following its dissemination but prior to our review.

We have assumed, without independent confirmation or verification, that each copy that we have examined of each of the reviewed materials is complete and accurate in all respects and conforms entirely to the original thereof, and there are no other documents, communications or understandings of any nature whatsoever that qualify, amend or otherwise alter the content, scope or effect of such reviewed document. We have also assumed, without independent confirmation or verification, each statement of fact regarding the WICC token and the Company set forth in this memorandum is true and accurate in all respects, and there is no additional information pertaining to the substance of such statement which, if known to us at the time of preparation of this memorandum, would have caused us to change in any respect the formulation of such statement herein, to omit such statement from this memorandum or to assess differently in any respect the relative weight of such statement in the context of our analysis and conclusions.

In particular, for purposes of providing our analysis, we understand the following to be true with respect to the Company and the WICC tokens:

The Waykichain Network and WICC Use

- Waykichain is a blockchain that allows for smart contract programming, decentralized application (or "dApp") development and decentralization computational task management. The Waykichain token, or WICC token, is used as the native currency of this blockchain.
- The Company initially focused the blockchain's development on blockchain services and applications relating to computer gaming, sports betting and prediction markets, but has

since expanded the target audience of Waykichain to include a variety of industries and sectors.

- WICC tokens are used to pay gas costs on the platform, e.g. smart contract execution and data and transaction fees associated with dApp operations.
- Token holders have voting rights in node campaigns (selection of 11 accounting node operators) but do not have voting rights pertaining to governance, overall operation of Waykichain or any equity rights generally.
- Node operators receive handling fees as remuneration for operating nodes and verifying transactions and data blocks.
- Waykichain launched their platform on May 5, 2017, though usage at the time was limited to developers.
- The mainnet launch of Waykichain took place on May 13, 2018.
- The smart contract programming features of the blockchain are currently available to all WICC token holders, and WICC is used as the gas token for smart contracts and associated dApps built on the Waykichain.
- As of February 6, 2019, there are sixteen smart contracts and dApps that are being built on the Waykichain blockchain, including wallets, browsers, games, payment systems and other features. Four of these smart contracts and dApps are built by Waykichain itself, while the other twelve are being developed by third-parties.
- Development of Waykichain is open-sourced.

WICC Distribution

- The Company created a total of 210,000,000 WICC tokens.
- WICC is currently listed on Huobi, Lbank and AEX.
- The Company conducted its private sale period from December 20th to December 25th, 2017, selling tokens for 0.315 USD, or 2 RMB, each.
- Although the Company had planned to host an ICO from December 25th, 2017 to January 5th, 2018, again selling tokens for 0.315 USD, or 2 RMB, each, all tokens that had been allocated to token sales were already sold in the private sale period. No additionals token transactions took place during the ICO period.
- The Company sold 126,000,000 tokens and raised 252,000,000 RMB, then roughly equivalent to $39 million USD.
- Chinese and US purchasers were excluded from the token sales.
- Waykichain implemented KYC/AML procedures for all participants in the token sales.
- The Company did not use any paid promoters in marketing or distributing the token.
- 60% of all tokens were allocated to purchase in the token sale.
- 10% of tokens were allocated to purchase in a presale.
- 15% of tokens were allocated to independent contractor compensation.
- 15% of tokens were allocated to employee compensation (these tokens were subject to a 6 month lock-up period).

II. GENERAL LEGAL ANALYSIS

The term "security" is defined under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act to include certain enumerated instruments (e.g. stocks, bonds, etc.) as well as more broadly "investment contracts."[3]

However, neither of the definitions in the Exchange Act or the Securities Act include the term "currency" as an enumerated instrument defined as a security. In fact, as per 15 U.S.C. § 78c(a)(10), the term "security" is defined to include numerous instruments "but shall not include currency."

In addition to the usage of the term "cryptocurrency" in common parlance, courts and federal agencies have consistently characterized cryptocurrencies as "currencies." A federal court explained that "[v]irtual currencies are generally defined as 'digital assets used as a medium of exchange.'"[4] This interpretation is consistent with enforcement actions and guidance issued by the United States Financial Crimes Network, the Internal Revenue Service, and OFAC, which describe virtual currencies as "a medium of exchange, a unit of account, and/or a store of value."[5]

If a token were not considered to be a currency excluded from the definition of a security, evaluating whether such a token is a security requires analysis to determine if the token resembles an "investment contract" or enumerated instruments.

The *Howey* Test

The US Supreme Court case SEC v. Howey, 328 U.S. 293 (1946) is the leading case for determining if an instrument is a security for the purposes of federal securities regulation. Under *Howey*, an instrument is an "investment contract" and thus a security if all of the following elements are met:

(i) an investment of money;
(ii) in a common enterprise;
(iii) with an expectation of profits;
(iv) solely from the efforts of others (e.g., a promoter or third-party), "regardless of whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets used by the enterprise."[6]

Interpretation and application of elements have been developed by case law.

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[3] The US Supreme Court has consistently taken the position that the definition of a security in the Securities Act and the Exchange Act are virtually identical to each other. See e.g., Reves v. Ernst & Young 494 U.S. 56, 61 n.1 (1990), reaffirming the principle that "[t]he definition of a security in § 3(a)(10) of the 1934 Act, ... is virtually identical [to the definition in the Securities Act of 1933] and, for present purposes, the coverage of the two Acts may be considered the same."

[4] *Commodity Futures Trading Comm'n v. McDonnell*, 287 F. Supp. 3d 213, 218 (E.D.N.Y. 2018); see also *Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc. et al*, 2018 WL 4621727, at *5 (D. Mass. Sept. 26, 2018) (Memorandum of Decision) (quoting *In re BFXNA Inc.*, CFTC Docket 16–19, at 5–6 (June 2, 2016)) ("[V]irtual currencies are . . . properly defined as commodities.").

[5] See FIN-2013-16 G0001, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013); IRS Notice 2014-21; *FinCen Fines Ripple Labs, Inc. in First Civil Enforcement Action Against a Currency Exchanger*, FinCEN (May 5, 2015); OFAC Frequently Asked Questions (2018-11-28).

[6] Howey, 328 U.S. at 298-99.

Investment of Money

We do not address the application of the first prong of the *Howey* test, because both "security tokens" and "utility tokens" generally involve an investment of money, as money is interpreted quite broadly. The "investment of money" prong does not require a transfer of fiat currency, but can be satisfied by consideration other than money,[7] including virtual currency.[8]

A significant expenditure is not required for an issuance to be a "sale" of securities. In a series of actions targeting giveaways of "free stock," the SEC determined that even minimal consideration (such as signing-up to a website and disclosing personal information, soliciting investors or purchasing services) could constitute an investment of money.[9]

Other inducements associated with token purchase or retention, such as bounties and airdrops, may be considered an investment of money if analyzed by the SEC.

For instance, on August 14, 2018, the SEC issued a cease and desist order against Tomahawk Exploration LLC. Tomahawk issued tokens in the forms of bounties, rewarding users that either provided their information or helped the online marketing and promotional efforts of the Tomahawk token. The SEC determined that these tokens were considered securities because they were investment contracts as per the *Howey* Test.[10] Specifically, the SEC stated that

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[7] *Int'l Bhd. of Teamsters v. Daniel* , 439 U.S. 551, 560 n.12 (1979) (citing *Forman* , 421 U.S. at 852 n. 16).

[8] *The DAO* (investment of virtual currency ether created investment contract under Howey); *SEC v. Shavers* , No. 4:13-CV-416, 2014 WL 465212, at 1 (E.D. Tex. Sept. 18, 2014) (holding that investment of virtual currency bitcoin meets first prong of Howey), available at https://www.sec.gov/litigation/investreport/34-81207.pdf .

[9] *SEC Brings First Actions To Halt Unregistered Online Offerings of So-Called "Free Stock"* ("*SEC 'Free Stock' Release* ") (citing *In the Matter of Joe Loofbourrow* , Securities Act Release No. 7700 (July 21, 1999); *In the Matter of Web Works Marketing.com, Inc. and Trace D. Cornell* , Securities Act Release No. 7703 (July 21, 1999); *In the Matter of WowAuction.com Inc. and Steven M. Gaddis, Sr.* , Securities Act Release No. 7702 (July 21, 1999); *In the Matter of Theodore Sotirakis* , Securities Act Release No. 7701 (July 21, 1999)), (available at https://www.sec.gov/news/headlines/webstock.htm). To obtain the "free stock," investors were required to sign up on a website and disclose valuable personal information, solicit other investors, or purchase services. The issuers received value in the form of a public market for the shares, increased business, publicity, increased website traffic, and potential interest in a future IPO. The "free stock" offerings therefore were offerings of securities despite minimal investments.

[10] On November 27, 2018, U.S. District Judge Gonzalo Curiel of the Southern District of California initially denied a motion seeking a preliminary injunction by the SEC against the backers of Blockvest, LLC ("Blockvest") to stop the offer and sale of BLV tokens, stating that the SEC had not shown that BLV tokens were securities. *SEC v. Blockvest, LLC and Reginald Buddy Ringgold, III a/k/a/ Rasool Abdul Rahim El,* Order Denying Plaintiff's Motion For Preliminary Injunction, Case No.: 18CV2287-GPB(BLM) (S.D. Cal. 2018).

Applying the Howey Test to examine if BLV tokens were securities, the court initially determined that the SEC had not provided evidence that there was an investment of money and expectation of profits. Analyzing the first "investment of money" prong of the Howey test, the court focused its inquiry on what the purchasers were offered or promised rather than the subjective intent of the purchasers. The court also indicated that an investment of money "requires that the investor 'commit his assets to the enterprise in such a manner as to subject himself to financial loss.'" *SEC v. Rubera*, 350 F.3d 1084, 1090 (9th Cir. 2003) (quoting *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976) (per curiam)).

However, on February 14, 2019 Judge Curiel reversed his initial position and granted the preliminary injunction, following the provision of additional briefing by the SEC. Judge Curiel indicated that reconsideration of the initial

regardless of the absence of monetary consideration for the "free" tokens, the bounty program constituted a "sale" pursuant to the Securities Act.[11]

Common Enterprise

A "common enterprise" may be "horizontal," "narrowly vertical," or "broadly vertical." A horizontal common enterprise is where multiple investors pool funds and the profits of each investor correlate with those of the other investors.[12] A narrow vertical common enterprise is identified when an investor's profits are tied to a promoter.[13] A broad vertical common enterprise may be found where profits depend on the promoter's expertise.[14] Another common enterprise test is the "risk capital test" that considers (1) if funds are being raised for a business venture, (2) if the transaction is presented to the public at large, (3) if investors are substantially powerless to influence the success of the venture, and (4) if the investors' money is at risk because it is not sufficiently secured.[15]

Although there may be an argument that investment in certain tokens would not constitute a common enterprise (which may be the case for certain decentralized platforms), we do not address this argument as a common enterprise would likely be found for most tokens under at least one or more of these tests.

Expectation of Profits from the Efforts of Others

For a token, the definitive prongs of the *Howey* test are generally the "expectation of profits" prong and the "solely from the efforts of others" prong. Both prongs should be read together, because the expectation of profits alone does not define a security, but the passive expectation of profits from the efforts of others is a defining feature of a security. 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.[16] This was a key part of the SEC's analysis of The DAO, as discussed below.

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denial of the preliminary injunction was warranted "based upon a prima facie showing of Defendants' past securities violation [of Section 17(a) of the Securities Act] and newly developed evidence which supports the conclusion that there is a reasonable likelihood of future violations." *SEC v. Blockvest, LLC and Reginald Buddy Ringgold, III a/k/a/ Rasool Abdul Rahim El,* Order Granting Plaintiff's Motion For Partial Reconsideration, Case No.: 18CV2287-GPB(BLM) (S.D. Cal. 2018). Judge Curiel reasoned that the materials offered to the investors, including the Blockvest Whitepaper and statements made on the Blockvest website, constituted an offer of unregistered securities and created an objective basis for purchasers to have expectations of profits.

[11] *In the Matter of Tomahawk Exploration LLC and David Thompson Laurance*, Securities Act Rel. No. 33-10530, Exchange Act Rel. No. 34-83839, Admin. Proc. File No. 3-18641 (Aug. 14, 2018).

[12] See e.g., Curran v. Merrill Lynch, 622 F.2d 216 (6th Cir. 1980).

[13] See SEC v. Eurobond Exchange Ltd., 13 F.3d 1334 (9th Cir. 1994).

[14] See e.g., SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

[15] See Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961).

[16] 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).

Market Forces

An important consideration in assessing "the efforts of others" is whether and to what extent market forces play a role in an expectation of profits. When market forces, such as fluctuating prices on a token trading platform, determine token prices, an expectation of profit would likely not result "solely" from the efforts of others. The Ninth Circuit has found that profit expectations did not result solely from the efforts of others as required by the *Howey* test in the case of sales of silver and gold by promoters when the expectations were primarily due to fluctuations in precious metals markets.[17] Although the defendant promoter in *Noa v. Key Futures* used high-pressure sales efforts to sell silver, the court found that no investment contract was created since the buyer's profits depended on fluctuations in the silver market, rather than the managerial efforts of the promotor, and because the promoter did not perform any additional activities that would cause the buyer to rely on the promoter's expertise.[18] The Ninth Circuit further found in *SEC v. Belmont Reid & Co.* that a plan to prepay for gold at fixed prices did not create an expectation of profit solely from the efforts of the seller since the buyer's predominant driver in pre-purchasing such gold was to profit from anticipated increases in gold's value.[19]

Effect of Speculation on Securities Classification

Notwithstanding the intended utility of a token, many purchasers (both sophisticated and unsophisticated) appear to buy tokens without a bonafide intent to use the token on the associated platform, but rather with an intent to profit from the potential appreciation of the token's relative value compared to the value of cryptocurrencies, fiat currencies or other assets. The rapid appreciation of cryptocurrencies and interest in initial coin offerings could color the views of the SEC and expectations of investors. Token purchasers with speculative investment expectations could influence the SEC's "core analysis" and cause the SEC to deem certain tokens securities despite the intentions of the token issuer. Unfortunately, this is likely to be judged in hindsight and the token issuer may not be able to fully control the expectations of potential purchasers.

Decentralization

The level of decentralization of a network or platform is also relevant in analyzing whether the efforts of others give rise to an expectation of profits. Decentralized digital currencies, such as bitcoin and ether, may be sufficiently decentralized so that any expectation of profits are not due to the managerial efforts of a promoter or enterprise, but rather due to the joint efforts of distributed network participants such as nodes.[20] The use of proceeds from a token sale is also relevant to assessing whether an expectation of profits arises from "the efforts of others" due to network decentralization. If token sale proceeds are used to further develop a company's network or platform in which the token will be used, this could indicate that a third party promoter or

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[17] *See Noa v. Key Futures, Inc.*, 638 F.2d. 77 (9th Cir. 1980); *SEC v. Belmont Reid & Co.*, 794 F.2d 1388 (9th Cir. 1986).

[18] *Noa*, 638 F.2d at 79-80.

[19] *Belmont*, 794 F.2d at 1391.

[20] CNBC, *SEC Chairman Jay Clayton on Cryptocurrencies and Investing* (Jun. 6, 2018), *available at* https://www.youtube.com/watch?v=wFr1ooaVPjY&feature=youtu.be. *Digital Asset Transactions: When Howey Met Gary (Plastic)*, (Jun. 14, 2018 (oral statement of Will Hinman, Director, Division of Corporation Finance, Securities and Exchange Commission), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.

enterprise has the ability to directly influence the ability to use the token and therefore the token's value.

Further, the type of governance structure used by a network or organization is also relevant to the level of decentralization of a token project. If a network's governance structure is decentralized, network decisions that could influence the token's value would be decided by network participants or token holders rather than a centralized management group. However, because voting rights are commonly associated with equity securities, a decentralized governance scheme could simultaneously point toward a finding that a token is a security.

Resemblance to Commonly Understood Securities

In addition to the "investment contract" test provided by *Howey*, it is also necessary to determine whether a token has attributes commonly associated with or otherwise resembles things commonly understood to be securities. The US Supreme Court case Reves v. Ernst & Young, 494 U.S. 56 (1990) elaborated on the classification of instruments which would typically be seen as "notes" and securities by adopting the "family resemblance test." Under the "family resemblance test" from *Reves*, a court presumes that an instrument resembling a note is a security. However, this presumption can be rebutted if the instrument bears a resemblance to an item on the following list of certain judicially-exempted categories of notes:

- a note delivered in consumer financing;
- a note secured by a mortgage on a home;
- a short-term note secured by a lien on a small business or some of its assets;
- a note evidencing a character loan to a bank customer;
- a short-term note secured by an assignment of accounts receivable;
- a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized); or
- a note evidencing loans by commercial banks for current operations.[21]

In assessing the resemblance of an instrument to one of these categories, a court considers the following factors:

- motivations that would prompt a reasonable seller and buyer to trade the note;
- whether the plan of distribution of the note results in "common trading for speculation or investment";
- the reasonable expectations of the investing public; and
- whether other factors (such as regulation by an agency other than the SEC) reduce the risk of the note, so the application of the federal securities laws would be unnecessary.[22]

Application of the Securities Definition by the SEC to The DAO

On July 25, 2017, the SEC issued *Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*. The report concluded that DAO

[21] Reves, 494 U.S. at 65.
[22] Reves, 494 U.S. at 66-67.

tokens were securities under the Securities Act and the Exchange Act. Some important guidance from the report includes:

- *Marketing*—The DAO was promoted as a for-profit entity whose objective was to fund projects in exchange for a return on investment for token holders;
- *Investor expectations*—Despite the fact that projects approved by The DAO could encompass services or the creation of goods for use by token holders, the SEC found this did not change the "core analysis" that "investors purchased DAO tokens with the expectation of earning profits from the efforts of others.";
- *Efforts of others*—The creators of The DAO held themselves, and their selected curators, out to investors as experts in Ethereum, leading investors to believe that they could be relied on to provide significant managerial experience. The curators of the DAO whitelisted investment projects before they could be voted on by investors, thus exercising indispensable control and significant efforts that investors relied on for obtaining profits;
- *Pooling*—Ether contributed by DAO token holders was pooled and available for The DAO to fund projects, and, depending on the terms of the project, token holders stood to share in potential profits;
- *Investor vetting*—There was no investor vetting and anyone was allowed to purchase tokens;
- *Transfer restrictions*—DAO token holders were not restricted from re-selling or transferring their tokens; and
- *Secondary market trading*—Promotional materials represented that the tokens would be available for secondary market trading and prior to the token sale the founders of The DAO solicited at least one exchange to trade DAO tokens on their system at the time of the sale.

Features of Tokens that May be Indicia of a Security

The presence of the following features may be indicia that a token is a security under *Howey*, as elaborated by *Reves*:[23]

- any equity interest in the token issuer;
- ownership in any legal entity (where token holders are essentially shareholders or partners);
- any voting rights in the token issuer, the system or any other entity;
- any right to repayment (where token holders are like creditors or lenders);
- any sharing of profits or losses (e.g., a dividend or distribution or other return);
- any sharing of liabilities of the token issuer;
- any sharing of assets of the token issuer or another entity;
- any conversion rights (where token holders can exchange a token into a right listed above);
- an expectation among the public of trading the token or holding it for speculation or investment; or
- a heightened risk of loss to the holder of the token.
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Features of a Token Marketing and Other Considerations Which May be Indicia of a Security

[23] This list is not exhaustive and is not ordered by importance or relevance, because any one element could be determinative in its own right.

Munchee Factors

On December 11, 2017, the SEC issued a Cease-and-Desist Order announcing its determination that MUN tokens (a cryptocurrency created by app-developer Munchee Inc.) were securities pursuant to Section 2(a)(1) of the Securities Act (the "**Munchee Order**").[24]

The Munchee Order represents a departure from prior SEC regulatory efforts pertaining to cryptocurrency, as the SEC concluded that the marketing efforts of, and statements made by, Munchee and the promise of profits from the potential appreciation in the value of its digital tokens were sufficient to characterize the tokens as investment contracts under the *Howey* test. No issues of fraud were present, which had been a major component of the SEC's decision to regulate

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[24] If a token were deemed a security, any offering or sale of such token would have to either be registered under the Securities Act or qualify for an exemption from those registration requirements. Offers and sales of securities are also subject to the antifraud provisions of the Securities Act. Violations of the Securities Act could subject the issuer of the token, and others, to civil and criminal enforcement action, private suits, and other remedies, including a right of rescission for the purchasers of the tokens. Violations of state securities laws could similarly subject the issuer and others to fines or a right of rescission. A number of class action lawsuits have been initiated against token issuers alleging that the issued tokens are securities.

In addition, the SEC noted in its report on The DAO that any entity or person engaging in the activities of an exchange with respect to such tokens deemed securities must register as a "national securities exchange" or qualify for an exemption to such registration.

The Exchange Act, among other things, regulates securities exchanges and broker-dealers. Among other things, it establishes minimum requirements for how the exchanges function, how they regulate themselves, and how they manage their relationships with their members. Section 5 of the Exchange Act makes it illegal for brokers, dealers or exchange platforms to effect transactions in a security, or to report on that security, unless the transaction is effected on a registered national securities exchange. If an unregistered exchange or broker-dealer facilitates transactions for a token that is deemed a security, such an exchange or broker-dealer would violate Section 5 of the Exchange Act be subject to rescission and could be subject to criminal and SEC enforcement actions, including for violations of Section 15(a)(1) of the Exchange Act for acting as an unregistered securities broker-dealer. The financial remedies in civil and administrative actions could include disgorgement of profits and civil penalties. On September 11, 2018, the SEC announced cease-and-desist proceedings against TokenLot LLC, a digital cryptographic token promoter and secondary trading platform, and its owners for failing to register as broker-dealers under the Securities Exchange Act of 1934 and facilitating the unregistered sale of securities in violation of Section 5 of the Securities Act of 1933. The TokenLot action did not include any allegations of fraudulent conduct by the defendants; the enforcement action and settlement relate solely to securities and broker-dealer registration violations.

In *U.S. v. Zaslavskiy*, No. 1:17-cr-00647-RJD-RER, Dkt. No. 37 (E.D.N.Y. Sept. 11, 2018), a New York federal judge ruled that U.S. securities law can be used to prosecute fraud cases over cryptocurrency offerings. Judge Raymond J. Dearie denied a motion to dismiss the government's criminal indictment, which alleged that a token offering was a security under the Securities Act, on the grounds that cryptocurrencies were not "securities" and thus were beyond the reach of federal securities laws, opining instead that federal securities law must be interpreted "flexibly". Judge Dearie further indicated that whether a token offering is a security under *Howey* is factual question to be decided by a jury.

There also may be implications under the Investment Company Act of 1940 (the "Investment Company Act"). The SEC's investigative report concerning The DAO states that it does not analyze whether The DAO met the definition of an investment company under Section 3(a) of the Investment Company Act.

cryptocurrency in previous instances. Hence, we now consider how the SEC interprets the *Howey* and *Reves* tests in light of its recent decisions with MUN and The DAO[25].

The following actions may serve as indicia that a token is a security, according to the Munchee Order:[26]

- *Public Solicitation Efforts* - Offering tokens to the general public, posting information about the tokens on web pages, blogs, social media (such as Telegram, Slack, Facebook, Twitter), and cryptocurrency forums;
- *Statements Regarding Appreciation in Value* - Asserting (in marketing or communications materials) that the tokens will appreciate in value;
- *Statements Regarding Secondary Trading* - Announcing the proposed creation of secondary markets for token trading;
- *Statements Explaining Potential Profit Realization* - Explaining how the proceeds of the ICO will be used to develop the business of the cryptocurrency developer, and increase the value of the token in turn;
- *Discount Structure* - Offering discounts on the offering price to early purchasers of the token, or bonuses for holding a token for a designated period of time;
- *Absence of Current Utility* - Selling the token before purchasers could actually use the proposed "utility" of the token;
- *Statements Relating to Appreciation through Increased Adoption* - Proposing an "ecosystem" with opportunities for earning and selling tokens, creating value as more users adopt the platform;
- *Statements Relating to Appreciation through Scarcity* - Creating a finite quantity of tokens and the proposal of "burning" or retiring tokens after their usage, creating scarcity to further increase the value of the token;
- *Link Between Token's Appreciation and Managerial Efforts of the Issuer* - Highlighting the credentials, abilities and management skills of agents and employees in its marketing the token;
- *Endorsement of Third-Parties* - Posting links to third-party endorsers of the token;
- *Targeted Investor Base* - Targeting those with an interest in cryptocurrencies and ICOs, rather than those involved in the industry of the cryptocurrency developer; and
- *Incongruence between Marketing Efforts and Opportunities for Use* - Promoting the token on forums like BitcoinTalk.org, which are accessible worldwide, though the app through which the token could be used was only available in the US.

We also note that, in the Munchee Order, promises to provide liquidity for MUN tokens by listing the token on a secondary trading market within 30 days after the token sale was a factor contributing to the SEC's finding that MUN tokens were securities. It is noted that the necessity

[25] Although this memo will address the factors that were considered by the SEC in their analysis of MUN, as well as those previously articulated in their analysis of whether other tokens constituted securities, it is important to note that the SEC has issued no clear guidance or test for whether or not a token is or is not a security. Rather, they have stated that decisions will be made on a case-by-case basis, relating to the specific facts and circumstances related to the cryptocurrency in question.

[26] It is unclear whether each or any of these factors are non-dispositive to classification of a token as a security, and they are not ordered by importance or relevance.

of making the token available may be important in some cases for effectuating the intended functionality of the token. Although exchange listing is one factor the SEC has mentioned, we do not think the mere availability of the token on an exchange for purchase for its intended purpose would cause a token to be a security.

Third Party Sponsorship or Promotion

Speaking at the Yahoo All Markets Summit: Crypto conference in San Francisco on June 14, 2018, William Hinman, head of the Division of Corporation Finance at the SEC, indicated that a primary factor to consider in assessing whether a token is a security is whether an expectation of return is driven by a third party. Hinman provided a non-exhaustive, illustrative list of circumstances where third party involvement may indicate that a token is a security:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

AirFox and Paragon Enforcement Actions

On November 16, 2018, SEC announced two enforcement actions against token sale issuers for violations of the registration provisions of Section 5 of the Securities Act.[27] The settlements are the first Section 5-only cryptocurrency cases where the SEC imposed a civil penalty. The SEC also required the issuers to register the securities under the Exchange Act and to file periodic reports. In an accompanying "Statement on Digital Asset Securities Issuance and

[27] *Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities*, (Nov. 16, 2018), *available at* https://www.sec.gov/news/press-release/2018-264.

Trading" (the "Joint Statement") issued by the SEC's Corporation Finance, Trading and Markets, and Investment Management divisions (the "Divisions"), the SEC noted its efforts to have issuers who offer unregistered digital assets that the SEC believes to be securities provide information comparable to that of a registered offering to investors.[28]

One of the November 16th actions involved Paragon Coin, Inc. ("Paragon"), an online entity established to implement blockchain technology in cannabis businesses.[29] The other action involved CarrierEQ, Inc., doing business as AirFox ("AirFox").[30]

Both cases concern offerings commenced after the SEC issued its July 2017 report of investigation concerning The DAO, and both offerings included tokens that were not yet usable for the contemplated applications and were made available to U.S. persons without any indication as to whether token purchasers were accredited investors. Additionally, both offerings were accompanied by statements that could be viewed as seeking to drive future appreciation of the token through the efforts of the promoter. Finally, both issuers made statements suggesting that token value would increase as a result of the developers' efforts.

The facts highlighted by the SEC in both actions suggest certain criteria the SEC weighs in applying the Howey test in the cryptocurrency context. Many of these factors reiterate criteria the SEC articulated in the Munchee Order:

- *Public Solicitation Efforts* - Both AirFox and Paragon published whitepapers that included details about their planned token sales. Both companies also used numerous webpages, blog pages, social media accounts, and message boards to market their tokens. Paragon also engaged a celebrity rapper to promote its token sale.
- *Absence of Current Utility* - Neither Paragon digital tokens ("PRG") nor AirTokens had a current utility at the time of the respective offerings. Given the lack of utility, the SEC discounted the AirFox token purchasers' representation in the terms of sale that they were buying AirTokens for their utility as a medium of exchange for mobile airtime, and not as an investment or a security.
- *Statements Regarding Application of Proceeds through Managerial Efforts to Develop Platform* - Paragon indicated in its whitepaper that it would use proceeds from the offering for development of the Paragon platform and to build an "ecosystem" around the token. Paragon highlighted the credentials, abilities and management skills of its agents and employees; for instance, its whitepaper noted their "depth of experience across business, technology, blockchain, smart contracts, and the cannabis industry," and warned that the value of PRG was linked to the efforts of the developer. AirFox also indicated that funds would be used to further develop the system and pay for research, as well as sales, legal, administrative and marketing expenses. AirFox told investors that AirTokens would increase in value as a result of its development efforts. AirFox indicated that its new

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[28] *Statement on Digital Asset Securities Issuance and Trading*, (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[29] *In the Matter of CARRIEREQ, INC., D/B/A AIRFOX*, Securities Act Rel. No. 10575, Admin. Proc. File No. 3-18898 (Nov. 16, 2018).

[30] *In the Matter of Paragon Coin, Inc.*, Securities Act Rel. No. 10574, Admin. Proc. File No. 3-18897 (Nov. 16, 2018).

international platform would include the existing airtime and data rewards system along with new features like user-to-user transfer of AirTokens, peer-to-peer lending and microloan features, credit scoring, and eventually commercial and retail usage of AirTokens.

- *Statements Regarding Increased Demand for the Token* - Paragon indicated that it would expend significant efforts to develop an "ecosystem" that would increase the value of the PRG tokens. In one of AirFox's applications to a major digital token trading platform, the company explained that token value would increase over time: "[o]ver the next two years, the utility of the token will expand and therefore, more people across the world will need to have AirTokens in their possession to participate on our platform and ecosystem." AirFox's principals also said that they believed the undeveloped microlending functionality would create demand for AirTokens from large-scale lenders that would be required to purchase AirTokens in the public markets in order to participate.
- *Statements Regarding Efforts to Stabilize or Increase Token Value* - Paragon's whitepaper stated that "PRG is designed to appreciate in value as our solutions are adopted throughout the cannabis industry and around the world. Our model incentivizes PRG owners to hold their tokens as long term growth assets, in addition to spending PRG on any of our platforms." Paragon repeatedly highlighted, including in its whitepaper and marketing materials, a built-in "deflation algorithm" that it designed to decrease supply of PRG tokens and increase the value of PRG tokens. Paragon also described a "Controlled Reserve Fund" which would "intervene by buying back PRG in an effort to stabilize the market price" if value of the PRG tokens dropped significantly. According to AirFox's whitepaper, the company would maintain the value of AirTokens by purchasing mobile data and other goods and services with fiat currency that could be then purchased by holders of AirTokens. AirFox also said in the whitepaper that the company would buy and sell AirTokens as needed to facilitate the purchase and sale of goods and services with AirTokens.
- *Statements Relating to Appreciation through Scarcity* - Paragon represented that only 200 million PRG tokens would be generated, and that "over time, the tokens in circulation shall reduce in number and increase demand." AirFox announced that it was reducing the contemplated token supply in the initial coin offering from 150 billion to 1.5 billion without changing the anticipated market cap "to alleviate concerns raised by many current and potential token holders and token exchanges who prefer each individual token to be worth more."
- *Statements Regarding Future Secondary Trading and Liquidity* - In its development timeline, Paragon noted "listing" of PRG on "major exchanges" within one month of the close of the offering as milestones for 2017 and 2018. Prior to the initial coin offering, AirFox told prospective investors that it planned to enter into agreements with token exchanges to ensure that the AirToken would be traded on the secondary market.
- *Targeted Investor Base and Incongruence between Marketing Efforts and Opportunities for Use* - Rather than promoting AirToken solely to prospective users of the platform, AirFox also marketed the AirToken to U.S. persons, who were not intended to use the app. AirFox stated that an AirToken presale was directed at "sophisticated crypto investors, angel investors and early backers of the [AirToken] project."

The combination of these factors led the SEC to conclude that PRG and AirTokens were securities under the Howey Test. According to the SEC's orders, both Paragon and AirFox offered and sold unregistered tokens that were securities when no exemption was available.

Under the SEC orders, AirFox and Paragon have agreed to compensate any investor who purchased their tokens in the unregistered offerings if such investor makes a claim. Additionally, AirFox and Paragon must register their tokens as securities under Section 12(g) of the Securities Exchange Act of 1934, and file periodic reports with the SEC. In the Joint Statement, the Divisions noted that these post-sale disclosure measures are aimed at helping holders of PRG and AirToken "make a more informed decision as to whether to seek reimbursement or continue to hold their tokens."[31]

Features of Tokens that May Not Be Indicia of a Security

The risk of a token being classified as a security or being deemed purchased with an expectation of profits may be reduced if it is reasonable that purchasers are acquiring the token with an intent to use the token for a purpose other than to profit from mere ownership of the token. Features associated with one or more rights to use the token or an associated system or platform, giving the token an underlying value that is more than merely a store of value, are not generally indicia of a security:

- a right to access a platform or system;
- a right to use a platform or system;
- a right to buy or sell products or services on a platform or system;
- a right to work on or actively contribute to a platform or system; or
- a right to engage with the functionality of a platform or system (such as mining, programming, developing or otherwise extending or modifying a platform or system).

Tokens with these features are often referred to as "utility tokens," but the SEC has noted that whether a utility token is a security is a facts and circumstances determination. Utility tokens are generally not intended to be securities by their issuers, based on the assertion that the token possesses some utility unrelated to the value intrinsic to the token. Hence the motivation to purchase the token stems from its utility to obtain goods and/or services and not its potential value as an investment contract. In a statement warning investors about investing in cryptocurrency, SEC Chairman Jay Clayton provided one example of such a token that could be construed as a non-security due to its utility: a token that represents a participation interest in a book-of-the-month club and that provides a way for the club to fund and facilitate the acquisition and distribution of books.[32] Chairman Clayton provided this example to illustrate that a token used for its current utility may not implicate securities laws when sold to the public. However, in the Munchee Order, the SEC clarified that the existence of a "utility" for a token was inadequate to avoid this determination. The SEC indicated that the "economic realities underlying the transaction" would be analyzed to see if the token constituted an investment

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[31] *Statement on Digital Asset Securities Issuance and Trading*, (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[32] *Statement on Cryptocurrencies and Initial Coin Offerings*, (Dec. 11, 2017) (written statement of Jay Clayton, Chair, Securities and Exchange Commission), *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

contract, and thereby a security. The SEC elaborated that any token, even those with associated utilities, could still be securities depending on the circumstances.

In a statement warning investors about investing in cryptocurrency, SEC Chairman Jay Clayton also addressed cryptocurrencies' usage of the "utility ICO" defense, stating, "Many of these assertions appear to elevate form over substance…Merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security."[33] He added a warning to purveyors of cryptocurrencies, stating "before launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must either (1) be able to demonstrate that the currency or product is not a security or (2) comply with applicable registration and other requirements under our securities laws."

On June 6, 2018, Chairman Clayton provided further detail on his views on the distinction between non-security cryptocurrencies and cryptographic digital assets that he considers securities. "Cryptocurrencies. These are replacements for sovereign currencies—replace the dollar, the yen, the euro with bitcoin. That type of currency is not a security. Let me turn to what is a security. A token, a digital asset where I give you my money and you go off and make a venture. You have some company you want to start or something you want, and in return for me giving you my money you say, 'you know what I'm going to give you a return or you can get a return in the secondary market by selling your token to somebody.' That is a security and we regulate that."[34]

In his June 2018 speech at the Yahoo All Markets Summit: Crypto, William Hinman added some additional clarity as to certain features of tokens that may or may not be indicia of securities. Hinman stated that "[c]entral to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers," referencing the third prong of the *Howey* Test.[35]

In addition to emphasizing the importance of the purchasers' expectation of profits based on the efforts of a third party, specifically whether there was a person or group that sponsored the creation and sale of the asset as referenced above, Hinman emphasized the third party's significant role in development and maintenance. This suggests that when a centralized token developer sells a token while large components of the token system or platform remain under development, there is a greater risk that the token in question would be classified as a security.

"If there is a centralized third party, along with purchasers with an expectation of a return, then it is likely a security," Hinman said.[36] Hinman also gave examples of cryptoassets that would not be considered securities, and hence would not come under the purview of the SEC. Hinman specifically said that bitcoin is not a security because it is decentralized: there is no central party whose efforts are a key determining factor in the enterprise. In addition, he expressed the view that ether is also not currently a security because the Ethereum network is also decentralized.

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[33] *Id.*
[34] CNBC. *SEC Chairman Jay Clayton on Cryptocurrencies and Investing.* (Jun. 6, 2018), *available at* https://www.youtube.com/watch?v=wFr1ooaVPjY&feature=youtu.be.
[35] *Digital Asset Transactions: When Howey Met Gary (Plastic)*, (Jun. 14, 2018) (oral statement of Will Hinman, Director, Division of Corporation Finance, Securities and Exchange Commission), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.
[36] *Id.*

Hinman went on to provide the following non-exhaustive list of factors to consider when structuring digital assets so that they functions more like a consumer item and less like a security:

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

The above list is not binding legal guidance and it is unclear which of these factors, if any, would be dispositive in determining whether a token will be deemed a security. However, Hinman also expressed that he does not believe that each and every one of these factors needs to be present to establish a case that a token is not being offered as a security.

On November 5, 2018, Hinman stated that if token sponsors are uncertain about whether or not their tokens may be classified as securities, the SEC will be available for consultation through their Strategic Hub for Innovation and Financial Technology or "Finhub."[37] Hinman also indicated that the SEC plans to release "plain English" cryptocurrency guidance, and such guidance may be released by the end of 2018 or early 2019.[38]

Expectation of Token Profits from Efforts of Others versus the Token Holder

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

[37] Nikhelish De and Aaron Stanley. *SEC Official Says 'Plain English' Guidance On ICOs is Coming.* (Nov. 5, 2018), *available at* https://www.coindesk.com/sec-official-says-plain-english-guidance-on-icos-is-coming/.
[38] Andrew Romonas. *SEC Plans 'Plain English' Crypto Securities Guide*. (Nov. 5, 2018), *available at* https://biglawbusiness.com/sec-plans-plain-english-crypto-securities-guide.

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.

Token Sales Without Current Token Functionality Increases Risk of Securities Classification

Reliance on the efforts of others is particularly significant for issuances of tokens or rights to tokens made before a platform is actually built and operational.[39] Even in this context, however, the staff of the SEC has provided no action relief in certain circumstances, such as where memberships in a golf or country club are sold in advance of construction of the facilities in order to fund such development if specific conditions are met.[40] Because rights or tokens for a non-operational platform first depend on the token issuer in designing and building the platform, the token issuer should limit token sales to sophisticated accredited investors with transfer restrictions before the token is functional and sold more broadly. Selling and distributing utility tokens as close to the launch of the platform as possible, or after the launch of the platform, may help mitigate this risk.[41]

"*Absence of Current Utility"* is one of the most significant factors of the Munchee analysis discussed above. Selling a token before purchasers could actually use the proposed 'utility' of the token is likely to be highly scrutinized by the SEC. While not definitive, the existence of some token utility plays a role in distinguishing between tokens that would and would likely not be classified as a security by the SEC. Analysis of purchaser motivations includes determining whether the predominant inducement to purchase a token was either a bonafide interest in utilizing the functionality of the token and the platform that it supports, or a speculative profit interest. Similarly, while many token issuers often retain tokens for company founders or advisors as compensation, unless such founders or advisors are able to and intend to use the retained tokens for their intended utility, the argument that the tokens are not held for investment or speculative purposes is lessened. Lack of token functionality at the time of sale strengthens the argument that the true motivation in purchasing the token is to profit passively by treating the token as an

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[39] The sale of non-existent tokens or rights to tokens may implicate the "common enterprise" and "risk of loss" aspects of the Howey test. In Wooldridge Homes, a court found that purchase agreements entered into before the start of construction of a community constituted a "common enterprise" because the pooling of purchaser funds was essential to the completion of the project. See Wooldridge Homes, Inc. v. Bronze Tree, Inc., 558 F. Supp. 1085 (D. Colo 1983).

[40] See e.g., WA Golf Company, L.L.C., SEC No-Action Letter (March 29, 2004); and Olohana Golf Club, Inc., SEC No-Action Letter (July 31, 2003), however, we note that such memberships often have significant transfer restrictions and are marketed in a limited manner.

[41] If an interest or token was initially deemed a security, it is unclear whether it could cease to be deemed a security at a later date based on the existence of a platform or other factors. While public comments of the SEC Chairman do not carry legal authority, it is reported that in public comments in April 2018 Chairman Clayton suggested that a security could become a non-security and vice versa.

investment, given the purchaser cannot currently use the token to obtain the services or goods associated with functionality. Additionally, lack of current token utility increases the risk that purchasers are relying on the efforts of others, namely, the issuer or developers whose efforts are required to obtain the full functionality of the token. Where this reliance is coupled with an expectation of profits, the SEC may conclude that the major elements of the *Howey* test are met.

Because of the concern of tokens being issued without current functionality, many transactions have been structured pursuant to agreements referred to as SAFTs (Simple Agreements for Future Tokens) for the current sale of rights to future tokens. Because the tokens do not exist at the time of the sale, even if designed as utility tokens, purchasers cannot utilize the token or rely on their own efforts to derive any profits, increasing the likelihood that the right to a future token would be viewed as a security. The US Supreme Court noted in *United Housing Foundation, Inc. v. Forman*, "when a purchaser is motivated by a desire to use or consume the item purchased— […] the securities laws do not apply."[42] The Court, restating its decision in *Howey*, contrasted this with circumstances where "investment in a common venture" is "premised on the reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[43] Purchasers of rights to future tokens are buying a right that may have no value at the time of purchase or may never be usable for anything, and are relying on the efforts of the development team, pooling all such purchasers' contributions, to design and build the tokens and platforms that will give utility and value to the tokens. Thus, there is a significant risk that a court or the SEC could construe these managerial and entrepreneurial efforts creating value and utility for token holders as an indication of a security requiring registration under the Securities Act. Additionally, if a SAFT is determined to be a derivative agreement based on an underlying commodity (the token), futures regulations could be implicated.

Many SAFTs or similar pre-sale or other agreements expressly state that the tokens are securities and implement procedures that approximate or meet the requirements of a Regulation D or Regulation S exemption from registration. Others state that the rights or tokens are not intended to be deemed as securities, but take precautions to preserve the availability of securities law exemptions.

Can a Security Become a Non-Security?

The position asserted for some SAFTs is that the right to a future token is a security, but the token issued pursuant to the right, if it is functional, has utility, and is ready for consumptive use upon issuance, is not a security and more public token sales and marketing can be undertaken.

A security could become or be exchanged for something that is not a security (e.g. a security could be exchanged for US currency), and we believe that something that begins as a security can later cease to be a security depending on facts and circumstances, and vice versa. The legal precedent is unclear for the purchase of a security that later transforms into a non-security interest, but we believe that statements from Chairman Clayton and Mr. Hinman recognize this is possible.

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[42] United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852-53 (1975).)
[43] *Id*.

Proposed Legislation: The Token Taxonomy Act

There have been some efforts among US legislators to seek greater clarity from the SEC regarding the status of digital tokens under federal securities laws; these efforts have culminated in the proposal of the Token Taxonomy Act (the "**Token Taxonomy Act**"), a bill introduced by Representatives Warren Davidson and Darren Soto.[44] The Token Taxonomy Act seeks to, *inter alia*, define digital tokens and amend the Exchange Act to include the new digital token definition and presumptively exclude digital tokens that meet that definition from classification as securities.

The Token Taxonomy Act would define a digital token as a digital unit that:

A. is created:
   i. in response to the verification or collection of proposed transactions;
   ii. pursuant to rules for the digital unit's creation and supply that cannot be altered by a single person or group of persons under common control; or
   iii. as an initial allocation of digital units that will otherwise be created in accordance with clause (i) or (ii);
B. has a transaction history that:
   i. is recorded in a distributed, digital ledger or digital data structure in which consensus is achieved through a mathematically verifiable process; and
   ii. after consensus is reached, cannot be materially altered by a single person or group of persons under common control;
C. is capable of being traded or transferred between persons without an intermediate custodian; and
D. is not a representation of a financial interest in a company, including an ownership or debt interest or revenue share.[45]

Although there is a possibility that passage of such legislation could result in different treatment of digital tokens under federal securities laws, there is no guarantee that the Token Taxonomy Act will be passed in its current form (pending possible revision to the proposed legislation), or at all. There is a substantial possibility that the Token Taxonomy Act will not be passed by Congress into effective legislation, and in the case that it is enacted into law, digital tokens will not be unregulated, rather, they will likely fall under the regulatory purview of the Federal Trade Commission or Commodity Futures Trading Commission.

III. ANALYSIS OF WICC TOKENS

As discussed above, most token sales, including the WICC token sale, involve the payment of money that would meet the first prong of the *Howey* test. Even if the initial transaction did not involve the payment of money, if the token is listed on a trading platform, a payment of money is

[44] Token Taxonomy Act of 20189, H.R. 7356, 115th Cong. § 2 (2018).
[45] *Id.*

required to purchase tokens through a trading platform. Similarly, the second *Howey* analysis prong would likely be met under one or more relevant tests.[46] The remainder of this analysis will focus on the third and fourth *Howey* prongs and the SEC's related guidance under The DAO report, the Munchee Order and statements made by the SEC Chairman and the SEC head of the Division of Corporation Finance.

Expectation of Profits

Central to the analysis of whether or not WICC tokens could be viewed as a security is whether participants purchase WICC tokens with an expectation of profits and whether they expect to do so "solely" from the efforts of others. As interpreted by courts, this depends in part on whether token holders are purchasing tokens with an expectation of profits and on the extent to which potential profits could reasonably be expected to result from the actions of others versus the token holders.

Absence of Features Commonly Associated With Securities

WICC tokens do not currently have features commonly associated with securities as described in *Howey*, such as equity or ownership interests, profit shares, dividends or distributions, or rights to interest or repayment. The current absence of these features is consistent with WICC tokens not being a security as of now, but not dispositive alone.

However, WICC tokens allow their holders to vote in node campaigns that select 11 accounting node operators. These node operators, in turn, receive handling fees (in the form of WICC tokens) as remuneration for node operation and transaction verification. While voting rights are limited to accounting node selection campaigns, and do not provide voting rights related to governance or operation of Waykichain itself, the voting rights present some risk of classification as a security for the WICC token.

Existing and Planned Uses for the Token (Utility)

We understand that WICC tokens are intended to be used for smart contract programming, dApp development and decentralization computational task management. The tokens did not have full utility at the time of the private token sale which took place from December 20th to December 25th, 2017. However, Waykichain completed the mainnet launch of the platform on May 13, 2018, and the WICC tokens currently have available their core functionality in their ability to be used to pay gas costs on the platform, such as fees associated with smart contract execution and data and transaction fees associated with dApp operations on Waykichain. As of February 6, 2019, there are sixteen smart contracts and dApps that are being built on the Waykichain blockchain, including wallets, browsers, games, payment systems and other features. Four of these developing smart contracts and dApps are built by Waykichain itself, while the other twelve are being developed by

[46] Note, however, that in *Woodward v. Terraco*r, the court found that no common enterprise existed where plaintiffs bought lots of undeveloped land from Terracor, with no intent to build on the land, but rather to sell the subdivisions for a profit in reliance on the defendant's promotional materials. 574 F.2d 1023, 1025 (10th Cir. 1978). Without additional elements of commonality, purchaser merely owning a common asset that has value that rises and falls depending on market forces does not give rise to a "common enterprise" for purposes of Howey.

third-parties. The availability of the use of the tokens for as the native currency for the smart contract programming and dApp development platform of Waykichain provide a basis for a purchaser to purchase the token for its stated purpose as the Waykichain gas token, rather than for investment or speculative purposes.

Speculation

In light of the rapid appreciation of cryptocurrencies and interest in initial coin offerings there is a global risk that many purchasers (both sophisticated and unsophisticated) purchase WICC and other tokens on cryptocurrency trading platforms without a bonafide intent to use them for their intended purpose for accessing and paying for fees related to smart contract and dApp development and programming services on the Waykichain platform, but rather with an intent to profit from potential appreciation in the relative value of the WICC token compared to other cryptocurrencies, fiat currencies or other assets.

Purchasers with speculative expectations could influence the SEC's "core analysis" and cause the SEC to deem WICC tokens as securities despite the intentions of the Company, especially given that the SEC Chairman stated that the expectation of profits from others is the key determinant in assessing a token's status as a security.[47] Unfortunately, this is likely to be judged in hindsight and the Company may not be able to fully control the expectations of potential purchasers.

While some purchasers may purchase WICC or other cryptocurrencies out of speculation, we believe it is also reasonable that other purchasers acquire WICC for use on the WICC platform, noting in particular the current availability of the WICC token for its stated use case as a payment mechanism of transaction and execution fees associated with accessing smart contract and dApp programming services through the Waykichain platform, currently available on mainnet, and the sixteen smart contracts and dApps currently being built on the Waykichain.

Although "utility token" is not a formal legal classification, and though the SEC indicated in the Munchee Order that a token may be a security even despite the presence of token utility, a token possessing utility that is currently available for token holders makes it more clearly possible for token holders to purchase the token for that utility, rather than for speculation or expectation of profits through the efforts of others.

Marketing

As noted in the discussion of the Munchee Order above, public solicitation efforts, statements regarding appreciation of token value, and statements regarding secondary trading (like the creation of markets or listing on an trading platform for trading purposes) were articulated by the SEC as factors in their determination that the MUN tokens were securities.

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[47] *Virtual Currencies*: *Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115 Cong. (Feb. 6, 2018) (audio statement of Jay Clayton, Chair, Securities and Exchange Commission), *available at* https://www.c-span.org/video/?440770-1/jay-clayton-christopher-giancarlo-testify-hearing-virtual-currencies&start=1.

Most of WICC's public discussions reviewed focus on the use of WICC for paying for gas costs and accessing decentralized smart contract and dApp development services through the Waykichain platform. Almost all of WICC's publicly available marketing and communication materials reviewed discuss the technology behind the platform and intended usage of WICC tokens.

It is also possible that statements were made by the Company which we may not have reviewed or which may have been deleted after they were disseminated. If such statements address or addressed token value appreciation, or discussed WICC tokens as an investment opportunity, such statements could increase the risk that the overall marketing mix employed by the Company could be regarded by the SEC as a basis for classification of the WICC tokens as securities.

Profits "Solely" from the Efforts of Others

If a purchaser is motivated by expectation of profits, any ability to profit from the use of the tokens might depend in part on the efforts of the Company or other promoters, the adoption and success of the token more broadly and how token holders use WICC. The ability to obtain profits by virtue of holding the token will fundamentally depend on the extent to which token holders purchase and utilize WICC for its intended purpose, but will also depend on the efforts of the Company in designing and promoting adoption of the currency.

State of Development and Ongoing Efforts of the Company

WICC tokens did not have utility at the time of the private sale beginning on December 20th, 2017 and concluding on December 25th, 2017. The absence of token utility at the time of the private sale creates an additional risk that the tokens would be considered securities, as per the Munchee Order. The Company has not articulated precise roadmaps or timelines for future development (existing roadmaps only serve as approximate indicators of planned development), but additional developments contemplated by the Company include the release of more games developed on the Waykichain platform, development of a decentralized asset transaction application, and development of a decentralized foreign exchange (or "forex") application. To the extent that a gap exists between the existing state of development and the anticipated development of the system, a risk of classification as a security exists, given the potential for a purchaser of the token to expect appreciation in the tokens' value based on its enhanced future utility due to the development efforts of the Company.

We understand the ongoing primary functions to be performed by the Company include the following:

- Developing additional games, applications and modules on the Waykichain platform;
- Maintaining the Waykichain platform and network to ensure proper functioning and developing extensions that may augment the features of the token;
- Addressing regulatory requirements and considerations including obtaining registrations and licensing as applicable; and
- Changing the functionality of the platform from time to time to address technical issues or expand the types of actions permitted on the platform.

These efforts are important to the success of building a viable blockchain-enabled platform and, by extension, the ability to use the tokens and the value of the tokens.

Token Holders' Consumption of the Token and Potential Self-Realization of Profits

The ongoing efforts of the Company must be weighed against other drivers of potential token value. Following the release of the mainnet version of the Waykichain platform on May 13, 2018, WICC tokens have utility as a payment mechanism for the gas costs and transaction fees associated with smart contract programming and dApp development on the Waykichain, and some token holders may purchase WICC solely with the intent to use the token for that utility and not with an aim toward profiting from holding or selling the token. Given that the Waykichain platform relies significantly upon the development efforts of third parties, if there were many WICC purchasers holding the token as passive investors (rather than as active participants and contributors to the platform) the platform as a whole would be more likely to fail. However, even token holders that do expect profits may not necessarily be relying "solely" on the efforts of others. Whether and the extent to which a token holder may realize a profit may still depend on the efforts and use of the token by the token holders acting individually or collectively, and on market forces generally, rather than on the efforts of the token sponsor alone.

If many token holders use WICC for its intended purpose to create and program games, smart contracts and dApps through the Waykichain platform, the WICC token may gain wider adoption and usage, increasing demand for the token and possibly increasing token value. In effect, token holders may expect their individual and collective participation in the WICC token ecosystem to contribute to WICC appreciation. While the efforts of the Company in further developing and maintaining the token may contribute to such adoption, it is difficult to measure the efficacy of those efforts and whether those interests predominate or the actions of the token holders predominate.

Additionally, some Ninth Circuit rulings have indicated that where expectation of economic profit is based predominately on market forces, rather than the efforts of a promoter, the instrument in question does not satisfy the third prong of the *Howey* test.[48]

The open-source development, design and distribution of WICC as a cryptocurrency meant for consumption in accessing smart contract and dApp programming and development services may provide an additional basis for asserting that WICC is not a security, consistent with the public comments of SEC Chairman Clayton on June 6, 2018,[49] and those of Director Hinman on June 14, 2018.[50] Of the 16 smart contracts and dApps currently being developed on Waykichain, only 4 are built by Waykichain itself, while the remaining 12 are built by third-party developers. To the extent that users of the Waykichain platform may also be involved with its open-source coding and

[48] *See Noa v. Key Futures, Inc.*, 638 F.2d. 77 (9th Cir. 1980); *SEC v. Belmont Reid & Co.*, 794.
[49] CNBC. *SEC Chairman Jay Clayton on Cryptocurrencies and Investing.* (Jun. 6, 2018), *available at* https://www.youtube.com/watch?v=wFr1ooaVPjY&feature=youtu.be.
[50] *Digital Asset Transactions: When Howey Met Gary (Plastic)*, (Jun. 14, 2018 (oral statement of Will Hinman, Director, Division of Corporation Finance, Securities and Exchange Commission), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.

development, in addition to the role that they play in increasing adoption and usage of the token by virtue of their participation in the ecosystem, the third prong of the *Howey* test is more likely to fail in a securities analysis of the token.

Granted, the Company that sponsored and promoted the creation and sale of WICC is a software company and is leading the open-source development of the Waykichain platform to offer smart contract and dApp development functionalities. Additionally, the Company did raise roughly $39,000,000 USD in private token sales. The Company allocated 15% of tokens to employee compensation, though these tokens were locked for a 6-month period. The Company allocated another 15% of tokens to independent contractor compensation. These factors could be used to characterize the development efforts of the Company as centralized, contravening the open-source nature of the Waykichain platform's development.

However, it is worth noting that the efforts of the Company could potentially be viewed as analogous to those of the Ethereum Foundation, which seeks to "promote and support Ethereum platform and base layer research, development and education." As noted above, Hinman indicated that the Ethereum platform is sufficiently decentralized such that it is not considered a security by the SEC.[51] This determination suggests that the existence of some degree of centralization represented by a foundation or entity contributing to development of a platform does not rise to the level of significant entrepreneurial or managerial efforts as required by the fourth prong of *Howey*. Measuring the extent of decentralization is challenging, and it is uncertain what the SEC would view as sufficient decentralization.

The statements by the SEC in both the Munchee Order and the Senate Hearing on Virtual Currencies suggest that the SEC likely considers most tokens, outside of very limited cryptocurrencies, to be securities.[52] In particular, SEC Chairman Clayton indicated that every ICO he has seen is a security.[53] As noted above, the SEC found that MUN tokens were securities in spite of the presence of token utility. In the more recent Senate Hearing, the SEC Chairman gave a simplified definition of a security (without referring to the *Howey* test specifically) suggesting that, anytime someone purchases something with the expectation of profiting solely from the efforts of others, the purchase in question is a security. The Chairman added that anytime the issuer makes the suggestion that a purchaser may reap short term profits from the resale of that purchase, this is an even greater indication that the purchase is a security.[54] To this end, it is integral that purchasers of WICC tokens purchase the tokens for use and not with the expectation that the value of the tokens will appreciate or for speculative investment purposes.

Regardless, the SEC Chairman's sweeping statement that all ICO's he has seen are securities ought to be tempered by his written testimony for the same hearing, in which he claimed that "there are cryptocurrencies that, at least as currently designed, promoted and used, do not

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[51] *Id.*
[52] *Id*. *See also* CNBC. *SEC Chairman Jay Clayton on Cryptocurrencies and Investing.* (Jun. 6, 2018), *available at* https://www.youtube.com/watch?v=wFr1ooaVPjY&feature=youtu.be.
[53] *Id.*
[54] *Id*.

appear to be securities."[55] At present, however, the SEC likely only considers bitcoin and possibly ether to be non-security cryptocurrencies. Additionally, the SEC Chairman has suggested that token issuers are best advised to comply with SEC regulations as though tokens were securities, either conforming to the traditional registration process or qualifying for an exemption like Regulation D.[56] In the case of token sales restricted to non-US persons, the applicable exemption would likely be Regulation S.

IV. CONCLUSION

The application of securities laws to tokens generally and to the facts and circumstances of specific tokens may be subject to different, but reasonable interpretations. Based on the assumptions and subject to the caveats outlined in this memorandum, we believe that it is a reasonable interpretation that WICC tokens, as we understand them, if issued when currently usable for their core intended functionality as a token used for accessing smart contract and dApp development services through the Waykichain platform, would be "utility tokens" when issued. We also believe that it is a reasonable interpretation of US federal securities laws that certain utility tokens are not securities that are required to be registered under the US federal securities laws, which may include WICC tokens if WICC tokens, when issued, are not purchased with an expectation of profiting from the efforts of others. We note, however, that insofar as the Chairman of the SEC has indicated that all ICOs he has seen are securities (even if they have utility), there is a significant risk that the SEC would currently view almost all tokens, including WICC tokens, as securities and a court could similarly determine that such an interpretation is reasonable. While a court may or may not agree with SEC views, it is important to consider the SEC's global views on tokens in assessing and mitigating risks under the US federal securities laws.

This matter is not entirely free from doubt, is highly fact-specific and subject to change in facts or understanding of facts. The SEC, courts, or others could assert a contrary view now or in the future. Moreover, some of the features relevant to the analysis would likely be judged in hindsight. In addition this memorandum speaks only as of the date hereof, and we assume no obligation to update or supplement this memorandum to reflect any changes in facts or circumstances, or changes in law, which may occur hereafter. The views of courts, the SEC, and other regulators will likely evolve over time, particularly given the current pace of developments around cryptographic token sales. As a result, the considerations discussed in this memorandum may become outdated and are subject to change.

* * *

This memorandum is addressed to and has been prepared solely for the Company. This memorandum may not be used or relied upon by any other person. This memorandum should not be viewed as a prediction or guarantee of any particular outcome if the token is evaluated by the SEC or a court. Copies of this memorandum may not be delivered to any other person without in each instance our prior written consent and then only if under the express understanding that the

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[55] *Virtual Currencies*: *Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 115 Cong. (Feb. 6, 2018) (written statement of Jay Clayton, Chair, Securities and Exchange Commission), *available at* https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%202-6-18.pdf.

[56] *Id.*

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