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Overview of Cryptocurrencies as Regulated Securities under Federal Securities Laws - Emerging Regulatory Regime

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Overview of Cryptocurrencies as Regulated Securities under Federal Securities Laws - Emerging Regulatory Regime

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Preliminary Question - Why bother with Cryptocurrency?

- **Cryptocurrency is now a major factor in finance and commerce and an alternative universe to traditional nation-state monetary systems.** "The digital assets market has grown significantly in recent years. Millions of people globally, including 16% of adult Americans, have purchased digital assets—which reached a market capitalization of $3 trillion globally last November. Digital assets present potential opportunities to reinforce U.S. leadership in the global financial system and remain at the technological frontier. But they also pose real risks as evidenced by recent events in crypto markets. The May crash of a so-called stablecoin and the subsequent wave of insolvencies wiped out over $600 billion of investor and consumer funds." White House Fact Sheet, Sept. 16, 2022.

- **Fraud is rampant in Cryptocurrencies. Organized crime and terrorist organizations favor Cryptocurrencies.** FTX, a $32 billion dollar exchange collapses and files for bankruptcy protection in November 2022 – **"**Collapsed cryptocurrency trading firm FTX confirmed there was "unauthorized access" to its accounts, hours after the company filed for Chapter 11 bankruptcy protection Friday. The embattled company's new CEO John Ray III said Saturday that FTX is switching off the ability to trade or withdraw funds and taking steps to secure customers' assets, according to a tweet by FTX's general counsel Ryne Miller. FTX is also coordinating with law enforcement and regulators, the company said. Exactly how much money is involved is unclear, but analytics firm Elliptic estimated Saturday that $477 million was missing from the exchange. Another $186 million was moved out of FTX's accounts, but that may have been FTX moving assets to storage, said Elliptic's co-founder and chief scientist Tom Robinson." "Probe underway after funds vanish from bankrupt crypto exchange FTX," by Cathy Bussewitz, AP News, posted on www.pbs.org, Nov. 12, 2022.

"The Justice Department has tapped more than 150 federal prosecutors across the country to bolster law enforcement's efforts to combat the rise in crime linked to the use of cryptocurrencies such as bitcoin, officials said." **"**Justice Department Forms National Network of Prosecutors Focused on Crypto Crime," by Dustin Volz, Wall Street Journal, posted on www.wsj.com, Sept. 16, 2022.

Preliminary Question - Why bother with Cryptocurrency? (cont.)

Terrorists - "The Justice Department today announced the dismantling of three terrorist financing cyber-enabled campaigns, involving the al-Qassam Brigades, Hamas's military wing, al-Qaeda, and Islamic State of Iraq and the Levant (ISIS). This coordinated operation is detailed in three forfeiture complaints and a criminal complaint unsealed today in the District of Columbia. These actions represent the government's largest-ever seizure of cryptocurrency in the terrorism context. These three terror finance campaigns all relied on sophisticated cyber-tools, including the solicitation of cryptocurrency donations from around the world. The action demonstrates how different terrorist groups have similarly adapted their terror finance activities to the cyber age. Each group used cryptocurrency and social media to garner attention and raise funds for their terror campaigns. Pursuant to judicially-authorized warrants, U.S. authorities seized millions of dollars, over 300 cryptocurrency accounts, four websites, and four Facebook pages all related to the criminal enterprise." Global Disruption of Three Terror Finance Cyber-Enabled Campaigns, DOJ Press Release, Aug. 13, 2020, posted at URL: https://www.justice.gov/opa/pr/global-disruption-three-terror-finance-cyber-enabled-campaigns

- **Lawyers are accepting cryptocurrency for payment of legal fees – NOTE: Check your State Bar Ethical Code and Opinions (*evolving area*) –** Some state bars allow Cryptocurrency as payment of legal fee. You may have to convert to cash. See Virginia State Bar Legal Opinion No. 1898, Feb. 2, 2022, URL:

https://www.vsb.org/docs/1898_pub_cmnt_3.25.22.pdf

If you are lawyer – regardless of your practice area –

crypto will be knocking on your door.

Profile of Speaker

Law Practice Focus: Securities, Corporate and M&A Law. Practicing law since 1985 (I was at JFK's Inaugural speech – that old). Experience includes being the former General Counsel/Director/VP of NASDAQ quoted public company; service as an outside director to two public companies; and handling the reorganization and sale of operations in U.S. and in Montreal, Canada. I was an associate lawyer with a business and real estate law firm prior to joining the NASDAQ company. Since 2001, I have had my own law practice that acts as outside SEC-Corporate legal counsel to public and private companies in a variety of industries, including representation of Hong Kong SAR companies on U.S. legal matters. Licensed in Virginia. L.LM. in Securities Regulation from Georgetown U. Law and J.D. from George Mason U. Law.

I originated and authored the first few editions of *Corporate Anti-Takeover Defenses: The Poison Pill Device*, which has been published annually since 1988, and I originated and authored the initial edition of The *Proxy Contest Handbook*, published by Clark Boardman Co., New York City (acquired by West Publishing). I currently update 7 nationally published law books covering M&A, securities offerings and corporate compliance programs written by other lawyers and published by Thomson Reuters West.

Before becoming a lawyer and before everything was available on the Internet (long, long ago), I was manager/researcher for a firm that did research and document retrieval for Wall Street investment banking and brokerage firms, national law firms, major accounting firms, public companies and foreign embassies at Securities and Exchange Commission and other federal regulatory agencies in Washington, D.C.

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Introduction: Scope and Focus of Presentation

Scope: This is an introduction to the regulation of cryptocurrencies as "securities" under U.S. federal securities laws by the U.S. Securities and Exchange Commission or "SEC." It does not cover anti-money laundering regulation of cryptocurrencies, which is an important, evolving and global regulatory regime of cryptocurrencies; or the regulation of futures contracts for cryptocurrencies (that is the regulated by the Commodities Futures Trading Commission or "CFTC"); or state regulation of cryptocurrencies (although I make a few points about state regulation). Since US Dept. of Justice ("DOJ") handles criminal violations of federal securities laws, I am including DOJ enforcement actions under "SEC Regulation".

Cryptocurrencies are digital assets – also known as 'virtual assets'. They only exist electronically – often as software code. They rely on cryptography/encryption for security and blockchain software program online open ledger system for administration. As noted: "Virtual currencies are digital, equal and decentralized. Decentralization lies in the fact that, unlike all traditional currencies, cryptocurrencies do not have a central body that deals with their issue, there is no Central Bank that controls its value and no intermediaries that are required for the validation of transactions. Cryptocurrencies use cryptographic principles for the validation of operations, and for the creation of the [cryptocurrency] itself..." - Blockchain Technology explained 2022, by Warren Larsen. Central to all cryptocurrencies is cartography/encryption and block chain software online open ledger system.

Cryptocurrencies are an emerging, expanding and evolving galaxy in the universe of digital assets – marked by growing variations and complexities and wild fluctuations in market value. The regulation of cryptocurrencies is likewise emerging, expanding and evolving. Congress is likely to impose a regulatory regime in 2023 rather than allow the SEC and CFTC to argue over jurisdiction under dated statutes designed for other financial instruments.

Beginning of Cryptocurrency as a Major Force in Global Finance

SEC Chair Gary Gensler nicely recounted the launch of Cryptocurrency as a major force in global finance:

"It was Halloween night 2008, in the middle of the financial crisis, when Satoshi Nakamoto published an eight-page paper1 on a cypherpunk mailing list that'd been run by cryptographers since 1992. [2] Nakamoto — we still don't know who she, he, or they were — wrote, "I've been working on a new electronic cash system that's fully peer-to-peer, with no trusted third party."[3] Nakamoto had solved two riddles that had dogged these cryptographers and other technology experts for a couple of decades: first, how to move something of value on the internet without a central intermediary; and relatedly, how to prevent the "double-spending" of that valuable digital token. Subsequently, his innovation spurred the development of crypto assets and the underlying blockchain technology. Based upon Nakamoto's innovation, about a dozen years later, the crypto asset class has ballooned. As of Monday [Aug. 2021], this asset class purportedly is worth about $1.6 trillion, with 77 tokens worth at least $1 billion each and 1,600 with at least a $1 million market capitalization.[4] …. At its core, Nakamoto was trying to create a private form of money with no central intermediary, such as a central bank or commercial banks." - Remarks of Gary Gensler Chair of the Securities and Exchange Commission Before the Aspen Security Forum, August 3, 2021.

Footnotes: 2 See Haseeb Qureshi "The Cypherpunks" (Dec. 29, 2019), available at https://nakamoto.com/the-cypherpunks/.
3 See "Bitcoin P2P e-cash paper" (Oct. 31, 2008), available at https://satoshi.nakamotoinstitute.org/emails/cryptography/1/.
4 Numbers as of Aug. 2, 2021. See CoinMarketCap, available at www.coinmarketcap.com. Crypto asset figures are not audited or reported to regulatory authorities.

The double spending referenced above was solved by blockchain software and cryptography/encryption. One motivation of the founders of cryptocurrencies in 2008 was to remove Big Brother Government and Banks from money and commerce as a first step in reducing the power and control of government.

SEC Chair Gensler – Reveals Attitude of SEC towards Cryptocurrency

SEC Chair Gensler said recently: “No single crypto asset, though, broadly fulfills all the functions of money. Primarily, crypto assets provide digital, scarce vehicles for speculative investment. Thus, in that sense, one can say they are highly speculative stores of value. These assets haven’t been used much as a unit of account. We also haven’t seen crypto used much as a medium of exchange. To the extent that it is used as such, it’s often to skirt our laws with respect to anti-money laundering, sanctions, and tax collection. It also can enable extortion via ransomware, as we recently saw with Colonial Pipeline. With the advent of the internet age and the movement from physical money to digital money several decades ago, nations around the globe layered various public policy goals over our digital public money system.

The SEC has a three-part mission — to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets in between them. We focus on financial stability as well. But at our core, we’re about investor protection. If you want to invest in a digital, scarce, speculative store of value, that’s fine. Good-faith actors have been speculating on the value of gold and silver for thousands of years. Right now, we just don’t have enough investor protection in crypto. Frankly, at this time, it’s more like the Wild West.

This asset class is rife with fraud, scams, and abuse in certain applications. There’s a great deal of hype and spin about how crypto assets work. In many cases, investors aren’t able to get rigorous, balanced, and complete information. If we don’t address these issues, I worry a lot of people will be hurt.

(Quote continued next slide…..)

SEC Chair Gensler – Reveals Attitude of SEC towards Cryptocurrency (cont.)

"First, many of these tokens are offered and sold as securities. There's actually a lot of clarity on that front. In the 1930s, Congress established the definition of a security, which included about 20 items, like stock, bonds, and notes. One of the items is an investment contract. The following decade, the Supreme Court took up the definition of an investment contract. This case said an investment contract exists when "a person invests his money is a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[6] The Supreme Court has repeatedly reaffirmed this Howey Test. Further, this is but one of many ways we determine whether tokens must comply with the federal securities laws. I think former SEC Chairman Jay Clayton said it well when he testified in 2018: "To the extent that digital assets like [initial coin offerings, or ICOs] are securities — and I believe every ICO I have seen is a security — we have jurisdiction, and our federal securities laws apply."[7] I find myself agreeing with Chairman Clayton. You see, generally, folks buying these tokens are anticipating profits, and there's a small group of entrepreneurs and technologists standing up and nurturing the projects. I believe we have a crypto market now where many tokens may be unregistered securities, without required disclosures or market oversight."

- Remarks of Gary Gensler Chair of the Securities and Exchange Commission Before the Aspen Security Forum, August 3, 2021.

Footnotes: 6 See SEC v. Howey Co., 328 U.S. 293 (1946), "Framework for 'Investment Contract' Analysis of Digital Assets," available at https://supreme.justia.com/cases/federal/us/328/293/.
7 See Jay Clayton, Testimony United States Senate Committee on Banking, Housing, And Urban Affairs, "Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission" (Feb. 6, 2018), available at https://www.banking.senate.gov/hearings/virtual-currencies-the-oversight-role-of-the-us-securities-and-exchange-commission-and-the-us-commodity-futures-trading-commission (see approx. 32:00 mark)

Practice Point One: Cryptocurrency is the Wild, Wild, Crazy West

In the world of Cryptocurrency, there are: insane amounts of money invested, made and lost; unpredictable market price fluctuations – people go from super wealthy to broke to super wealthy and then so on and so on in a matter of weeks; uncertain, unsettled, evolving, complex regulation and legal parameters; the full spectrum of investors – from the a lone individual to powerhouse investment banks, major banks and private funds to nation states; and fraudsters aplenty – from Joe Loser Hacker in Grandma's basement with a hi-end iMac, big bag of Cheetos and a 24 pack of Mountain Dew Voltage to Lagos or Moscow café Internet gangs to sophisticated, well funded techie fraudsters to major criminal organizations to terrorist organizations. Also, regulators who are operating in uncertain, new areas of regulation without a clear, modern legislative framework can be unpredictable. In such a world, a practitioner must, more than in other instances, exercise following care:

(1) Know who you are dealing with – vet the participants and prospective clients (e.g. Internet check; SEC litigation/order check (see https://www.sec.gov/litigations/sec-action-look-up); reference checks). Use attested questionnaires to collect background information about participants/prospective clients and check any "dubious" or "red flag" responses.

(2) All transaction, offering and promotional materials are produced by client and client reviews and approves all transaction, offering and promotional materials for completeness and accuracy --- that review and approval is evidenced by signed attestations to you.

(3) Document all important communications, guidance, and instructions and use representation and instruction lawyer letters in excess to client in order to PRECISELY state scope and limitations of your representation or role and the client's and client affiliates' legal duties and other responsibilities; Keep accurate journal of all work and interactions with client and affiliates – notarize or attest key important communications, guidance, and instructions.

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Practice Point One: Cryptocurrency is the Wild, Wild, Crazy West (cont.)

(4) If outside legal counsel - **NEVER, EVER** be a promoter director/officer/employee or sign any documents or filings by crypto client – remain an arm's length legal counsel. **DO NOT ATTEND** pitches to investors – this group of potential plaintiffs will view you as a "promoter" even if they are noticed of your limited role. **DO NOT BE LISTED AS AN EXPERT IN ANY DOCUMENTS**. **DO NOT SIGN ANY FILINGS, CHECKS OR TAX FILINGS BY CLIENT**. Your name should never appear anywhere except in a legal opinion rendered as part of representation or simple reference on your representation (and fees paid if required by legal requirements – like an SEC filing or CFTC filing). ***Paranoia will not destroy you in crypto.***

(5) **DOES YOUR PROFESSIONAL INSURANCE COVERAGE COVER WORK IN CRYPTO?** – Make sure.

(6) **DO NOT ACCEPT CRYPTO FOR LEGAL FEES**. Accepting "equity" may affect professional insurance coverage, may create **conflicts of interest** (Are you a lawyer or an investor or promoter? Was your legal advice affected by your investment in the client? Does your acceptance of crypto make you a part of a conspiracy to illegally distribute crypto?) and makes it harder to represent that you are not a promoter. Park the greed. Like a drug defense with a chronic sinus problem – accepting crypto from a crypto client makes you "of interest" to regulators and plaintiffs' lawyers.

(7) **PAPER TRAIL** everything and keep paper trial secure and with a back up copy. Do not rely only on digital – keep a paper copy off site – the tree will forgive you.

Recent Events: Forbes.com, Nov. 8, 2022**:** 'Mass Panic' Triggers $1 Trillion Crypto Price Crash And 'Short Squeeze' Warning As FTX's FTT Goes Into Freefall—Dragging Down Bitcoin, Ethereum, BNB, XRP, Solana, Cardano and Dogecoin" – by Billy Bambrugh. FTX was the second largest Cryptocurrency online exchange and its $32 Billion valuation vanished in a week amid an investor panic prompted by reports of serious liquidity concerns and misuse of investor funds. A proposed bail-out merger failed to happen and FTX filed for Chapter 11 reorganization on November 11, 2022. Reports indicate the SEC and CFTC are or have been investigating FTX. FTX collapse will only prompt Congress to adopt a comprehensive regulatory scheme tailored to cryptocurrency - currently, the SEC, CFTC and DOJ rely on laws enacted for securities or commodities futures regulation to regulate cryptocurrencies – treating cryptocurrencies as "securities" and "commodities" instruments.

Practice Point Two: Stay out of Jail

In law school, a law professor stood before the class and, obviously enjoying one too many beers before class, bellowed out: “First Rule of being a Lawyer: if anyone goes to jail, make sure it is your client. Not you!” He added: “Bad clients and bad deals get good lawyers in trouble. Better to lose a legal fee or a client than lose your license or, worse, your freedom.” The following practice points apply ‘in spades’ to cryptocurrency (also consult applicable state bar ethical code/cannons):

(1) Whenever things “don’t seem right” or interactions with prospective participants in a proposed transaction raises “red flags” – when your “moral antenna” are twitching wildly -- then consult more experienced lawyers about your concerns and, if not then completely resolved or such consult in not available, decline representation (in compliance with applicable state bar ethics and guidelines).

(2) Don’t become a “securities” or “commodities” lawyer through on the job training – either decline representation in the matter and refer the matter to experienced counsel or get help from an experienced lawyer at the very start – preferably as a co-counsel.

(3) Understand the special role of a lawyer under federal securities laws as a “compliance gatekeeper” under SEC policies – it conflicts in some respects with state bar ethical cannons for attorney client relationship and a lawyer’s duties to client. *See*: Section 307 of Sarbanes Oxley Act of 2002 on SEC rules imposing standards for lawyers practicing before SEC and *Implementation of Standards of Professional Conduct for Attorneys,* SEC Release No. 33-8185 (Sept. 26, 2003) (adopting final rules implementing the so-called “up-the-ladder” requirement pursuant to Section 307 of the Sarbanes-Oxley Act) and also *see* 17 C.F.R. §§205.1-205.7. If you are legal counsel to a company or person subject to SEC regulation or making filing with SEC – you could be “practicing” before the SEC. Check SEC Rules of Practice – 17 C.F.R. Part 205; https://www.sec.gov/rulesprac072003htm

All of this common sense, but I have witnessed in my own practice, and I have seen in the downfall of better lawyers than me, that things are not so simple when a big fee, new major client or your standing at a firm are the realities at hand. Sometimes: “Things fall apart ….The ceremony of innocence is drowned; The best lack all conviction, while the worst are full of passionate intensity” – WB Yeats. Don’t be a passive victim of others’ folly.

Practice Point Three: Teach your Clients Well

SEC is the federal agency that enforces the federal securities laws and regulations – See Slide 22.

I have dealt with SEC Staff Lawyers (enforcement and examination divisions), Assistant US District Attorneys, FBI and state securities agencies (enforcement and examination divisions). I represented one of only two legitimate public companies represented by Stratton Oakmont – the *Wolf of Wall Street*. Lesson learned:

- Train your client to first consult competent legal counsel (hopefully you) about any communication from SEC or state securities regulator – no matter how routine or even if seemingly nothing more than a request for information – before responding or speaking to the SEC or state securities regulator. Why? Reasons: (a) your client, no matter how bright, does not understand the perspective and "red buttons" of the regulator attorney or the law in question and may make a seemingly innocent or flippant statement that prompts a heightened scrutiny from the regulator or a more intrusive inquiry (including an informal or formal investigation). Examination staff attorneys are well trained to alert Enforcement lawyers at the agency about any responses from companies or persons that raise "concerns" or "suspicions" – evidence of violations is not required for the referral to Enforcement; and (b) If the SEC or state securities agency conducts an inquiry or investigation, it: (i) requires expenditure of time and money to properly respond - can involve large legal fees; (ii) it is a huge distraction for the client; (iii) existence of inquiry or investigation may require disclosures to others or even a public disclosure, which public disclosure may adversely impact publicly traded stock of a corporate client, or result in shareholder or third party lawsuits; (iv) may be a material fact requiring disclosure to others and may undermine proposed corporate transactions – like securities offerings or other fundings, loans, and mergers – or violate existing contractual covenants; (v) regulator may pass on any information discovered about subject of inquiry or investigation to other regulators – like IRS, DOJ, CFTC, state securities agencies, state attorneys general or prosecutors; (vi) no matter how well run a company is or how proper a person's personal affairs are conducted, a regulator looking into the "closets" may discover unintentional violations of law; and (vi) even if the regulator finds no violations or further reason for inquiry, you do not get a "All OK" letter – you simply get "We have no further inquiries."

Clarification –E-Money vs. Virtual Assets

- “E-Money” is “‘stored value or prepaid payment mechanisms for executing payments [of nation state issued money]] via point-of-sale terminals, direct transfers between two devices, or even open computer networks such as the internet’. Electronic money is a floating claim that is not linked to any particular account. Examples of e-money are bank deposits, electronic funds transfers, payment processors. E-money can also be stored on (and used via) mobile phones or in a payment account on the internet. The fast introduction of e-money has led to governmental regulatory activities. Hong Kong was among the first jurisdictions to regulate e-money, allowing only licensed banks to issue stored-value cards.” Bank of International Settlements, Quoted in “History of Digital Currency,” Digital Watch, Geneva Internet Platform, 2022. Electronic money is when you wire or make online payment of cash – money issued by a nation-state. Like the U.S. Dollar. The transfer of value is done electronically – from one account to another account. That is not an instance of ”virtual asset” because the money has physical form – it is paper money – and transaction is merely an accounting change.

- Virtual currencies [includes Cryptocurrencies] are “a digital representation of value that is neither issued by [or regulated and controlled by] a central bank or a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically” (European Banking Authority, 2014) and is administered and tracked on the blockchain software program online open ledger system, which employs cryptography/encryption for security. Virtual currencies have no physical form. They are denominated in units called “Coins” or “Tokens” or customized names like Bitcoin, Litecoin, Dogecoin – but there is nothing to put under your mattress.

Basics of Federal Securities Regulation: What is a Security?

Federal securities laws regulate" investment" securities – not all kinds of securities are regulated. Securities Act of 1933 ("1933 Act") and Securities Exchange Act of 1934 ("1934 Act") contain definitions of regulated securities (the two statutory definitions are substantially the same) – but these statutory definitions are merely the identification of securities that have been traditionally regulated under English and U.S. state laws and are commonly understood in commerce to be regulated securities (e.g. common and preferred stock, bonds, debentures, and certain 'investment contracts'). There is no bright line", universal statutory definition of "securities" in statutes – statutory definitions are merely the start point of determining what is a "security" regulated under the 1933 Act and 1934 Act.

U.S. courts have developed "tests" to determine whether an instrument is a regulated security – especially helpful since Wall Street keeps investing new kinds of securities and financial instruments. The first and still primary court developed test after 76 years is the ***Howey Test*** – which held that an investment contract and regulated security exists when there is a: "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." SEC v. Howey, 328 U.S. 293 (1946). Note that 'solely' has been morphed into 'meaningful' by the courts and 'common enterprise' has a very, very broad meaning. 'Scheme' is also very broad in meaning.

As noted by an expert: "Each type of financial instruments listed in the statutory definition of security is susceptible to a separate analysis, employing separate analytical concepts. There is no universal or generic test of the terms. This point was particularly emphasized in the 1985 *Landreth Timber* [471 U.S. 681] decision when the Supreme Court noted "that the Howey economic test was designed to determine whether a particular instrument is an 'investment contract', not whether it fits under any of the examples listed in the statutory definition of security' [*Landreth Timber*, at 691]. As the Court explained "applying the *Howey test* to traditional stock and all other instruments listed in the statutory definition would make the Acts' [1933 Act and 1934 Act] enumeration of many types of instruments superfluous" [*Landreth Timber*, at 692]." – Fundamentals of Securities Regulation, 4th Ed.," by Louis Loss and Joel Seligman, Aspen Publishers, 2004, pg. 231.

Basics of Federal Securities Regulation: What is a Security? (cont.)

One the point about statutory construction in federal securities laws' definition of 'security' – the statutory definition of 'security' in the 1933 Act is preceded by "when used in this subchapter, unless the context otherwise requires" – "Congress itself has cautioned that the same words may take on a different coloration in different of the securities laws" [*SEC v. National Sec., Inc.,* 393 U.S. 453, 465-466, (1969)]…There is also support in the legislative history of the Securities Act for the view that 'context' refers more broadly to the surrounding factual circumstances of a transaction alleged to involve a security. …. All nine justices, for. significant example, agreed in *Reves v. Ernst & Young,* [10] that the "phrase 'any note' should not be interpreted to literally mean 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Act.… At the same time, the "context" phrase will not always direct a court to an examination of the surrounding factual circumstances. The Supreme Court's admonition in its 1985 *Landreth Timber* decision that "[u]nder the circumstances of this case, the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts" [11 forecloses the inevitability of the inquiry into the transactional context. Judicial analysis of factual context will be appropriate on a financial-instrument-by-financial-instrument basis." - Fundamentals of Securities Regulation, 4th Ed., by Louis Loss and Joel Seligman, 2004, pp. 232-233.

Footnotes: [10] 494 U.S. 56, 63 (1990); [11] 471 U.S. at 687.

Basics of Federal Securities Regulation – Primary Laws

Primary Federal Securities Laws. 1933 Act. SEC Summary of Securities Act of 1933: “Securities Act of 1933. Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities.

Purpose of Registration: A primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities. While the SEC requires that the information provided be accurate, it does not guarantee it. Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.

The Registration Process: In general, securities sold in the U.S. must be registered. The registration forms companies file provide essential facts while minimizing the burden and expense of complying with the law. In general, registration forms call for: a description of the company's properties and business; a description of the security to be offered for sale; information about the management of the company; and financial statements certified by independent accountants.

Registration statements and prospectuses become public shortly after filing with the SEC. If filed by U.S. domestic companies, the statements are available on the EDGAR database accessible at www.sec.gov. Registration statements are subject to examination for compliance with disclosure requirements. Not all offerings of securities must be registered with the Commission. Some exemptions from the registration requirement include: private offerings to a limited number of persons or institutions; offerings of limited size; intrastate offerings; and securities of municipal, state, and federal governments.

By exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering the cost of offering securities to the public.” – SEC.gov, URL: https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry

Basics of Federal Securities Regulation – Primary Laws (cont.)

Primary Federal Securities Laws: 1934 Act. Securities Exchange Act of 1934. "With this Act, Congress created the Securities and Exchange Commission. The Act empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs). The various securities exchanges, such as the New York Stock Exchange, the NASDAQ Stock Market, and the Chicago Board of Options are SROs. The Financial Industry Regulatory Authority (FINRA) is also an SRO.

The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them. The Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

Corporate Reporting: Companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. These reports are available to the public through the SEC's EDGAR database.

Proxy Solicitations: The Securities Exchange Act also governs the disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action. This information, contained in proxy materials, must be filed with the Commission in advance of any solicitation to ensure compliance with the disclosure rules. Solicitations, whether by management or shareholder groups, must disclose all important facts concerning the issues on which holders are asked to vote.

Tender Offers: The Securities Exchange Act requires disclosure of important information by anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer. Such an offer often is extended in an effort to gain control of the company. As with the proxy rules, this allows shareholders to make informed decisions on these critical corporate events.

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Basics of Federal Securities Regulation – Primary Laws (cont.)

Insider Trading: The securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase, or sale of securities. These provisions are the basis for many types of disciplinary actions, including actions against fraudulent insider trading. Insider trading is illegal when a person trades a security while in possession of material nonpublic information in violation of a duty to withhold the information or refrain from trading.

Registration of Exchanges, Associations, and Others: The Act requires a variety of market participants to register with the Commission, including exchanges, brokers and dealers, transfer agents, and clearing agencies. Registration for these organizations involves filing disclosure documents that are updated on a regular basis.

The exchanges and the Financial Industry Regulatory Authority (FINRA) are identified as self-regulatory organizations (SRO). SROs must create rules that allow for disciplining members for improper conduct and for establishing measures to ensure market integrity and investor protection. SRO proposed rules are subject to SEC review and published to solicit public comment. While many SRO proposed rules are effective upon filing, some are subject to SEC approval before they can go into effect."

- SEC.gov, URL: https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry

Basics of Federal Securities Regulation – Public & Private Offer and Sale

Offer and Sale of Securities to Investors - Under federal securities laws, an offering of regulated securities must be either registered under Section 5 of the 1933 Act or exempt from registration. Section 5 makes "public" offerings of regulated securities that are not registered illegal.

"Public offering" has no bright line definition as Congress did not want to be trapped by a static definition. Obviously, a registered offering under Section 5 is a public offering, but there is a gray area beyond registered public offerings and supposedly private offerings exempt from registration. This is partly resolved by court decisions, SEC rules and guidance (especially safe harbor rules for private or "exempt" offerings of securities). Some securities offerings are exempt from registration as "limited offerings" under Section 3(b) of 1933 Act (e.g. Regulation A offerings). With respect to registered public offerings under the 1933 Act: "The registration provisions of the 1933 Act contemplate that the offer or sale of securities to the public must be accompanied by the "full and fair disclosure" afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed "information about the issuer's financial condition, the identity and background of management, and the price and amount of securities to be offered ...." SEC v. Cavanagh, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), aff'd, 155 F.3d 129 (2d Cir. 1998). "The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors." SEC v. Aaron, 605 F.2d 612, 618 (2d Cir. 1979) (citing SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953)), vacated on other grounds, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. §77e(a) and (c). Violations of Section 5 do not require scienter. SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1047 (2d Cir. 1976)." SEC Release #34-81207, July 25, 2017, The DAO Report, pg. 11.

Basics of Federal Securities Regulation Public & Private Offer and Sale (cont.)

Public securities offerings are registered with the SEC by filing a registration statement that is subject to SEC staff review and approval prior to the commencement of the offering. The registration statement is composed of a cover/Part 1 section with info required by SEC rules; Prospectus – the selling document received by investors and providing information on the issuer, its business and financials, securities being offered, manner of offering and risks of investing; Part II – more info required by SEC rules, including list of offering expenses and exhibit list; and Exhibits – charter documents and other documents that are material to investment decision. Issuer company cannot make a public offering and start selling until SEC declares the registration statement "Effective." Form S-1 is general registration form. Filings with the SEC are made online through EDGAR. The public section of EDGAR displays companies' filings with the SEC (www.sec.gov). A sample of a registration statement for an initial public offering of securities or "IPO" can be seen at URL:

https://www.sec.gov/edgar/browse/?CIK=1886894&owner=exclude\

SEC describes the registration of securities for public offerings at URL:

- SEC Review Process of Registration Statement

https://www.sec.gov/divisions/corpfin/cffilingreview

- Draft Registration Review:

https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded

- Q&A for Draft Registration Review:

https://www.sec.gov/corpfin/voluntary-submission-draft-registration-statements-faqs

The Regulator - SEC

Federal Regulator: SEC is the independent regulatory agency formed in 1934 (not 1933) to enforce federal securities regulation – it is deemed an aggressive, competent regulator. SEC has HQ in DC and regional offices around the U.S. – Note: the regional offices conduct investigations as well as SEC HQ. SEC Division of Enforcement is devoted to investigations and enforcement actions and the Cyber Unit with that division was expanded and renamed “Crypto assets and Cyber Unit [in 2022]. This unit: “Since its creation in 2017, the unit has brought more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms, resulting in monetary relief totaling more than $2 billion. The expanded Crypto Assets and Cyber Unit will leverage the agency’s expertise to ensure investors are protected in the crypto markets, with a focus on investigating securities law violations related to:

- Crypto asset offerings;
- Crypto asset exchanges;
- Crypto asset lending and staking products;
- Decentralized finance ("DeFi") platforms;
- Non-fungible tokens ("NFTs"); and
- Stablecoins.

In addition, the unit has brought numerous actions against SEC registrants and public companies for failing to maintain adequate cybersecurity controls and for failing to appropriately disclose cyber-related risks and incidents. The Crypto Assets and Cyber Unit will continue to tackle the omnipresent cyber-related threats to the nation’s markets. "Crypto markets have exploded in recent years, with retail investors bearing the brunt of abuses in this space. Meanwhile, cyber-related threats continue to pose existential risks to our financial markets and participants," said Gurbir S. Grewal, Director of the SEC’s Division of Enforcement. "The bolstered Crypto Assets and Cyber Unit will be at the forefront of protecting investors and ensuring fair and orderly markets in the face of these critical challenges.” SEC Press Release 2022-78, May 3, 2022.

The Regulator – SEC (cont.)

- The SEC is an aggressive regulator with some of the best trained lawyers in the U.S. Government – including staff members who came from medium or large law firms for a brief stint at the SEC (usually as for resume polishing). While due respect is due all state securities regulators, some states are deemed more aggressive that others – the Texas Securities Board being the first in mind.

- SEC handles civil violations of federal securities laws and U.S. Department of Justice ("DOJ") handles criminal violations of federal securities laws. SEC and DOJ work hand in hand on investigations and sharing information (with each other and other government agencies (e.g. IRS, state securities regulators)). US Postal Inspector often joins the SEC and DOJ (as in the movie *Wall Street* when broker Charlie Sheen is arrested by SEC Enforcement/US District Attorney (DOJ)/Postal inspector/NYPD) because mail fraud is a common offense when a person violates criminal fraud provisions of the securities laws.

- Conduct that violates the anti-fraud securities laws often involves other laws – e.g. wire and mail fraud laws (which have severe criminal penalties), tax evasion laws, state anti-fraud laws and common law fraud.

- SEC relies on public complaints, information from other regulatory agencies and from stock exchanges, computer analysis of stock trading, staff review of Internet and press articles, and referrals from SEC Examination Staff Attorneys (who review public company filings with the SEC) for most of their investigations and enforcement actions.

- SEC Division of Enforcement handles SEC investigations and enforcement actions – SEC Commissioners must authorize enforcement actions. SEC can sue in federal courts or bring an administrative enforcement action before SEC Administrative Judges.

- Created in October 2018, SEC's Strategic Hub for Innovation and Financial Technology ("FinHub") is SEC's technology resource for distributed ledger technology, digital assets and digital marketplace financing. See:

https://www.sec.gov/finhub

The Regulator – SEC (cont.)

SEC investigations and inquiries are almost always not publicly disclosed by SEC while in process. Sometimes the SEC will publish results of an investigation in order to inform the public about important enforcement developments – like investigation of crypto in the DAO Report (included to this presentation). SEC investigations can be informal inquiries or formal investigations with subpoena power.

Whether the subject of an SEC inquiry or investigation discloses existence of an SEC inquiry or investigation is for the target to decide – the decision is tricky for a public company due to requirement to disclose "material information" in SEC filings. Example of public disclosure of SEC investigation by a public company: "The Company has received investigative subpoenas and requests from the SEC for documents and information about certain customer programs, operations, and existing and intended future products, including the Company's processes for listing assets, the classification of certain listed assets, its staking programs, and its stablecoin and yield-generating products. Based on the ongoing nature of these matters, the outcomes remain uncertain and the Company cannot estimate the potential impact, if any, on its business or financial statements at this time.

The Company believes the ultimate resolution of existing legal and regulatory investigation matters will not have a material adverse effect on the financial condition, results of operations, or cash flows of the Company. However, in light of the uncertainties inherent in these matters, it is possible that the ultimate resolution of one or more of these matters may have a material adverse effect on the Company's results of operations for a particular period, and future changes in circumstances or additional information could result in additional accruals or resolution in excess of established accruals, which could adversely affect the Company's results of operations, potentially materially." – Coinbase Global, Inc., Form 10-Q for fiscal quarter ended June 30, 2022, SEC File #001-04321, filed with SEC on Aug. 9, 2022, pg. 49.

The Regulator – SEC (Useful Reference Sources) (cont.)

Some useful reference sources on SEC as a regulator:

1) SEC Website: https://www.sec.gov.

2) SEC summary of how SEC investigations work:

URL https://www.sec.gov/enforce/how-investigations-work.html

3) SEC litigation and administrative proceeding releases and orders – always instructive to read about actual enforcement and lawsuit cases:

URL https://www.sec.gov/page/litigation

4) SEC Enforcement Manual – Internal agency guidance on enforcement

URL https://www.sec.gov/divisions/enforce/enforcementmanual.pdf

5) SEC Enforcement Cooperation Program - offenders can get lighter punishment or escape serious consequences by self reporting violations and cooperation with SEC investigations – BUT NEVER DO SO WITHOUT FIRST CONSULTING COMPETENT SEC LEGAL COUNSEL. DOJ has similar program.

URL https://www.sec.gov/spotlight/enforcement-cooperation-initiative

6) Description of SEC Division of Enforcement and organization

URL https://www.sec.gov/page/enforcement-section-landing

7) SEC Whistleblower Office (SEC pays millions of dollars to Whistleblowers)

URL https://www.sec.gov/whistleblower

The Regulator – SEC (Useful Reference Sources) (cont.)

8) File a complaint with SEC about securities violations (separate from whistleblower complaint).

URL https://www.sec.gov/complaint/select

9) SEC Litigation and Administrative Proceeding Releases – detail summary of SEC actions

URL https://www.sec.gov/litigation/litreleases.htm

URL https://www.sec.gov/litigation/admin.htm

10) SEC Rule Making – proposed and adopted rules

URL https://www.sec.gov/page/regulation

11) SEC Press Releases – includes first public announcements about enforcement actions and related matters as well as rule making notices and speeches and statements by SEC officials.

URL https://www.sec.gov/page/news

Securities Law Books

1A) Fundamentals of Securities Regulation, 7th Edition, by Louis Loss, Joel Seligman and Troy Paredes

2A) Civil Liabilities: Enforcement and Litigation under the 1933 Act (vol. 17, Securities Law Series) J. William Hicks, Thomson Reuters.

3A) Securities Crimes, 2d. Ed., by Marvin Pickholz, Peter Henning and Jason Pickholz, Thomson Reuters.

4A) Bromberg and Lowenfels on Securities Fraud, by Alan Bromberg and Lewis Lowenfels, Thomson Reuters.

The Other Regulator - CFTC

- **CFTC says:**
- Virtual currencies, such as Bitcoin, have been determined to be commodities under the Commodity Exchange Act (CEA).
- Does the CFTC oversee Bitcoin? The U.S. Commodity Futures Trading Commission's (CFTC) jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.

- **Above from - https://www.cftc.gov/sites/default/files/2019-12/oceo_bitcoinbasics0218.pdf**

CFTC has regulatory authority over derivatives transactions, that includes swaps, futures, and options, and certain acts of fraud and manipulation in commodities markets.

CFTC Enforcement. CFTC Chair Christy Romero: "Crypto companies seeking to come within the CFTC-regulated derivatives markets should expect the application of our existing regulatory framework because it has a proven record of reducing financial stability risk." **Remarks of CFTC Commissioner Christy Goldsmith Romero before the International Swaps and Derivatives Association's Crypto Forum 2022, New York, Oct. 26, 2022.**

CFTC enforces civil violations of CEA and DOJ handles criminal violations of CEA. For instance of CFTC enforcement against cryptocurrencies for violations of CEA, see:

https://www.cftc.gov/PressRoom/PressReleases/8498-22

CFTC vs SEC in Crypto Regulation

There is a turf battle between the SEC and CFTC

CFTC Commissioner Brian Quintenz said on Twitter:

Just so we're all clear here, the SEC has no authority over pure commodities or their trading venues, whether those commodities are wheat, gold, oil….or #crypto assets. –

https://twitter.com/cftcquintenz/status/1422912721637580803?lang=en.

Note: CFTC talks about regulating "commodities" – CTFC actually regulates futures/future contracts and similar instruments backed by commodities.

SEC Chair Gary Gensler has stated: "As Justice Thurgood Marshall put it in describing the scope of the securities laws, Congress painted the definition of a security "with a broad brush." He further stated, "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called….My predecessor Jay Clayton said it, and I will reiterate it: Without prejudging any one token, most crypto tokens are investment contracts under the Howey Test." – Kennedy and Crypto – SEC Speaks, SEC Chair Gary Gensler, Sept. 8, 2022.

SEC regulates securities. CFTC regulates commodities futures/futures contracts. There are some instruments that can be deemed securities as well as futures/futures contracts – esp. derivatives.

Congress is currently trying to adopt a regulatory scheme for crypto – and the roles of the SEC and CFTC in that scheme – see later slide on Congressional Bills.

The SEC is the larger, greater resource and more aggressive regulator.

Congress favors the CFTC as the lead regulator – which is Congress placating large donors who do not want the more aggressive SEC as a regulator.

The Other Regulator – State Securities Agencies

State Agencies are also active in regulation of cryptocurrencies, tokens and NFT's. For instance, from the Texas Securities Board, October 20, 2022:

"State securities regulators have taken the lead in warning investors about emerging investment schemes tied to the metaverse. Although blockchain technology, digital assets, and metaverses are generating widespread public interest, bad actors are now leveraging their interests to perpetrate fraudulent schemes. State securities regulators recently filed enforcement actions to stop similar illegal offerings promoted by Flamingo Casino Club and Sand Vegas Casino Club. These recent enforcement actions also involved organizations illegally raising capital for online and metaverse casinos.

State securities regulators filed coordinated enforcement actions to stop sales of NFTs by an organization in the country of Georgia. The actions accuse Slotie NFT ("Slotie") of illegally and fraudulently selling nonfungible tokens, often referred to as NFTs, to raise capital for online and metaverse casinos. The actions were filed by the Alabama Securities Commission, Kentucky Department of Financial Institutions, and the Texas State Securities Board.

The actions accuse Slotie of issuing 10,000 Slotie NFTs that are similar to stock and other equities. The Slotie NFTs purportedly provide investors with ownership interests in the casinos and the right to passively share in the profits of the casinos. The rarity of each Slotie NFT, however, purportedly determines the amount of passive income payable to the owner. Slotie NFTs that contain rarer traits allegedly provide more passive income than NFTs consisting of more common traits."

Basics of Cryptocurrencies - Definitions

Before we discuss SEC regulation of cryptocurrencies, as few basic technology concepts.

Digital assets (also called “virtual assets’) are forms of value or utility or both that exist in electronic form - there is no tangible form. Cryptocurrency is a subset of digital assets.

A Digital Asset is “a medium of exchange, for which generation or ownership records are supported through a distributed ledger technology that relies on cryptography, such as a blockchain.” US President Exec. Order No. 14067, 87 Fed. Reg. 14143, 14151-152 (Sec. 9(d)) (Mar. 14, 2022).

CFTC defines ”digital assets” as: “Anything that can be stored and transmitted electronically and has associated ownership or use rights. A digital asset can represent physical or virtual assets, a value, or a use right/service (e.g., computer storage space). Digital assets may take many forms and may utilize various underlying technologies, including distributed ledger technology (DLT). Digital assets have a varied set of features and applications that touch a range of regulatory domains. Digital assets are created and maintained with software (code), and exist as data on a network. The software and network together enable digital asset transactions. Depending on its design, function, and use, a digital asset may be characterized differently, including as a commodity, swap or other derivative.” “Digital Assets Primer 2020,” by CFTC/LabCFTC, 2020, pp. 5-6.

US Dept. of Justice or “DOJ” Definition: “Digital Assets refers to all [Central Bank Digital Currencies (CBDCs)], regardless of the technology used, and to other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology. For example, digital assets include cryptocurrencies, stable coins, and CBDCs. Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchanged across digital asset trading platforms, including centralized and so-called decentralized finance platforms, or through peer-to-peer technologies.”).” Footnote 8, U.S. Dept of Justice, Report of the Attorney General’s Cyber-Digital Task Force (2018) [hereinafter “2018 Cyber-Digital Task Force Report”].

Basics of Cryptocurrencies - Definitions (cont.)

IRS Definition of "Virtual Currencies". IRS defines virtual currency as: "Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction…Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date, see Financial Crimes Enforcement Network (FinCEN) Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (FIN-2013-G001, March 18, 2013)." IRS Notice 2014-21, pg. 1.

Cryptocurrencies are a form of Virtual Currencies.

Basics of Cryptocurrencies – Definitions (cont.)

SEC Definition of Cryptocurrencies. The SEC defines cryptocurrencies as: "Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions. They are intended to provide many of the same functions as long-established currencies such as the U.S. dollar, Euro or Japanese yen but do not have the backing of a government or other body. Although the design and maintenance of cryptocurrencies differ, proponents of cryptocurrencies highlight various potential benefits and features of them, including (1) the ability to make transfers without an intermediary and without geographic limitation, (2) finality of settlement, (3) lower transaction costs compared to other forms of payment and (4) the ability to publicly verify transactions. Other often-touted features of cryptocurrencies include personal anonymity and the absence of government regulation or oversight. Critics of cryptocurrencies note that these features may facilitate illicit trading and financial transactions, and that some of the purported beneficial features may not prove to be available in practice." See: "Statement on Cryptocurrencies and Initial Coin Offerings," Public Statement by SEC Chairman Jay Clayton, SEC Website, view at URL;
https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11, Dec. 11, 2017.

SEC Maintains an useful Webpage on Cryptocurrencies – see URL:

https://www.sec.gov/ICO

Basics of Cryptocurrencies – Definitions (cont.)

- **SEC Chair Gary Gensler on Cryptocurrencies:**
- -"First, it is a highly volatile, speculative investment class.
- Second, this market isn't so decentralized. Now, we see this industry populated by large, concentrated intermediaries, which often are an amalgam of services that typically are separated from each other in the rest of the securities markets.
- Third, crypto cannot exist outside of our public policy frameworks, regardless of what the crypto industry initially expected or what certain market participants might say today. The policy frameworks include protecting investors and consumers, guarding against illicit activity, and supporting financial stability. Whether you call something a crypto token, stablecoin, or decentralized finance platform (DeFi), those public policy goals remain the same."
- "Frankly, though, in the crypto market there is a lot of noncompliance with the securities laws…Thus, SEC staff is working with market participants to help ensure that investors in the crypto market get time-tested protections that exist in other securities markets and that all market participants have a fair playing field."

See: "Statement on Financial Stability Oversight Council's Report on Digital Asset Financial Stability Risks and Regulation Before the Financial Stability Oversight Council Open Meeting," by SEC Chair Gary Gensler, Oct. 3, 2022.

Basics of Cryptocurrencies – Definitions (cont.)

- **Coins vs Tokens**: While often used as interchangeable terms – there is a difference between Coins and Tokens: "A coin is a unit of value native to a blockchain. It is a means of exchange within the blockchain to incentivize the network of participants to use the blockchain." Cryptocurrencies Bitcoin, Ether, Ripple, and Litecoin are all examples of native coins. The sole purpose of a coin is to exchange value, and it has limited functionality beyond that." "Initial Coin Offering – new paradigm," by Rob Massey and Eric Piscini, Deloitte Tax LLP and Deloitte Consulting LLP, 2017. Coins exist within the blockchain – tokens do not exist only within the blockchain.

- **Tokens** are software code, downloadable, that represent more than a monetary value – they represent a specified asset or functionality and they are not captives of a specific blockchain technology – they exist or can exist outside of a blockchain technology based on "Smart contracts" – more downloadable software code created by a sponsor/developer of cryptocurrencies. Tokens are exchangeable and provide the right and ability to receive some asset or consummate some act or function – like entry into a secure website providing certain info or benefits; membership in a club; an object of value.

Coins and tokens can be called by other names – e.g. Bitcoin, Gramm, and Hydro.

Basics of Cryptocurrencies – Definitions (cont.)

- **Cryptography and "Keys"**: "Cryptography is the study of secure communications techniques that allow only the sender and intended recipient of a message to view its contents. The term is derived from the Greek word *kryptos,* which means hidden. It is closely associated to encryption, which is the act of scrambling ordinary text into what's known as ciphertext and then back again upon arrival. In addition, cryptography also covers the obfuscation of information in images using techniques such as microdots or merging. Ancient Egyptians were known to use these methods in complex hieroglyphics, and Roman Emperor Julius Caesar is credited with using one of the first modern ciphers. When transmitting electronic data, the most common use of cryptography is to encrypt and decrypt email and other plain-text messages. The simplest method uses the symmetric or "secret key" system. Here, data is encrypted using a secret key, and then both the encoded message and secret key are sent to the recipient for decryption. The problem? If the message is intercepted, a third party has everything they need to decrypt and read the message. To address this issue, cryptologists devised the asymmetric or "public key" system. In this case, every user has two keys: one public and one private. Senders request the public key of their intended recipient, encrypt the message and send it along. When the message arrives, only the recipient's private key will decode it — meaning theft is of no use without the corresponding private key." From AO Kaspersky Lab – www.Kaspersky.com
- "There are five primary functions of cryptography:

1. Privacy/confidentiality: Ensuring that no one can read the message except the intended receiver.
2. Authentication: The process of proving one's identity.
3. Integrity: Assuring the receiver that the received message has not been altered in any way from the original.
4. Non-repudiation: A mechanism to prove that the sender really sent this message.
5. Key exchange: The method by which crypto keys are shared between sender and receiver." See: ""An Overview of Cryptography," by Gary Gensler, Nov. 2, 2022, URL: https://www.garykessler.net/library/crypto.html#purpose

Basics of Cryptocurrencies – Definitions (cont.)

Blockchain Technology: Blockchain enables cryptocurrencies by creating the online, peer-to-peer, private ledger system that chronologically records "Blocks" – which are bits of information or formulas or code or keys to access tangible/intangible assets (like Coins and Tokens). Any change in the Block generates a connected new Block. Blockchain can be used for a lot more than cryptocurrency. A county in Nevada actually voted to replace the county government with a Blockchain system (did not pass). Some techies believe that Blockchain, not cryptocurrencies, are the real evolutionary gem.

IBM says: "Blockchain is a shared, immutable ledger that facilitates the process of recording transactions and tracking assets in a business network. An *asset* can be tangible (a house, car, cash, land) or intangible (intellectual property, patents, copyrights, branding). Virtually anything of value can be tracked and traded on a blockchain network, reducing risk and cutting costs for all involved." Key elements of Blockchain are:

- "**Distributed ledger technology** All network participants have access to the distributed ledger and its immutable record of transactions. With this shared ledger, transactions are recorded only once, eliminating the duplication of effort that's typical of traditional business networks.
- **Immutable records** No participant can change or tamper with a transaction after it's been recorded to the shared ledger. If a transaction record includes an error, a new transaction must be added to reverse the error, and both transactions are then visible.
- **Smart contracts** To speed transactions, a set of rules — called a smart contract — is stored on the blockchain and executed automatically. A smart contract can define conditions for corporate bond transfers, include terms for travel insurance to be paid and much more." IBM, Blockchain Overview, 2022. "Smart contracts" are further defined below.

Basics of Cryptocurrencies – Definitions (cont.)

Hash and Hashing: A hash is a "function [that] creates a mathematical algorithm that maps data of any size to a bit string of a fixed size. A bit string is usually 32 characters long, which then represents the data that was hashed…. For practical purposes, think of a hash as a digital fingerprint of data that is used to lock it in placed within the blockchain. "Blockchain for Dummies, 2nd Edition," by Tianna Laurence, New York City: John Wiley & Sons, 2019, pg. 11.

Hashing is creating a hash – which transform data of any size into a a short, fixed length data bit – which cannot be hacked to discover the original data.

BLOCKCHAIN – CRYPTOCURRENCY'S LEDGER

Blockchain Defined: "A blockchain is a [public] decentralized [electronic] ledger [computer program] of all transactions across a peer-to-peer network. Using this technology, participants can confirm transactions without a need for a central clearing authority. Potential applications can include fund transfers, settling trades, voting and many other issues." See: "Making sense of bitcoin, cryptocurrency and blockchain," by PrinceWaterhouseCoopers ("PwC"), 2022.

"Node" on Blockchain is a computer that is entering a transaction in a Coin (a "block") on the Blockchain ledger. "Procotols" are the rules governing a blockchain network for a specific Coin. When a block is created and entered, all viewers of the chain of transactions see the new transaction in the chain of transactions for that Coin.

Why is Blockchain so "special"? Blockchains are revolutionary because they rely on a decentralized and secure open system, not a single Big Brother, to provide a secure network allowing and recording peer-to-peer transactions. Other networks rely on a central authority providing a secure connection.

Basics of Cryptocurrencies – Definitions (cont.)

- Public Key and Private Key in Blockchain.

Blockchain.com describes Public Key and Private Keys as: "Major cryptocurrencies like Bitcoin, Ethereum, and Bitcoin Cash function using three fundamental pieces of information: the address, associated with a balance and used for sending and receiving funds, and the address' corresponding public and private keys. The generation of a bitcoin address begins with the generation of a private key. From there, its corresponding public key can be derived using a known algorithm. The address, which can then be used in transactions, is a shorter, representative form of the public key.

The private key is what grants a cryptocurrency user ownership of the funds on a given address. The Blockchain wallet automatically generates and stores private keys for you. When you send from a Blockchain wallet, the software signs the transaction with your private key (without actually disclosing it), which indicates to the entire network that you have the authority to transfer the funds on the address you're sending from.

The security of this system comes from the one-way street that is getting from the private key to the public address. It is not possible to derive the public key from the address; likewise, it is impossible to derive the private key from the public key. In the Blockchain.com Wallet, your 12-word Secret Private Key Recovery Phrase is a seed of all the private keys of all the addresses generated within the wallet. This is what allows you to restore access to your funds even if you lose access to your original wallet. Using recovery phrase will allow you to recover your crypto." See URL: https://support.blockchain.com/hc/en-us/articles/360000951966-What-are-public-and-private-keys-in-crypto-

Basics of Cryptocurrencies - Definitions (cont.)

- **Protocols - Smart Contracts:**

IBM says: "Smart contracts are simply programs stored on a blockchain that run when predetermined conditions are met. They typically are used to automate the execution of an agreement so that all participants can be immediately certain of the outcome, without any intermediary's involvement or time loss. They can also automate a workflow, triggering the next action when conditions are met.… Smart contracts work by following simple "if/when…then…" statements that are written into code on a blockchain. A network of computers executes the actions when predetermined conditions have been met and verified. These actions could include releasing funds to the appropriate parties, registering a vehicle, sending notifications, or issuing a ticket. The blockchain is then updated when the transaction is completed. That means the transaction cannot be changed, and only parties who have been granted permission can see the results."

- IBM, URL: https://www.ibm.com/topics/smart-contracts, 2022.

SEC says: "Smart contracts" are defined by SEC as: "a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs." Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The SEC DAO," SEC Release No. 34-81207, July 25, 2017.

Basics of Cryptocurrencies - Definitions (cont.)

- **Coins and Tokens were defined in Slide 10. Special variants of Coins and Tokens are Stable Coins and NFTs:**
- **Stable Coins**: Stable coins are coins backed or redeemable for a nation-state currency. This feature is designed to reassure investors about coins by providing the "security" of being able to exchange or redeem the Stable Coin for paper currency.
- **Non Fungible Tokens or "NFTs":** "An NFT is a unit of data stored on a digital ledger or blockchain that certifies a digital asset as unique and not interchangeable. An NFT is a digital representation of a work of art or music or a photograph that can be separated from and sold separately from the original work. Hence, at first glance, NFTs appear akin to artworks or collectibles…. The stupendous rise of this market and vast sums of dollars being paid for NFTs has raised alarm bells at the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Treasury Department, and Congress. Congress and regulators fear NFTs are being used as lures to raise capital without fulfilling any of the legal requirements that promoters of such investment vehicles are required to fulfill. They fear the lack of regulation or the circumvention of existing securities laws (that regulate capital raise or issuance of securities) puts consumers at grave risk." – "What are NFT and Why are they so Controversial?" by Aarthi Anand, Cahill Gordon & Reindel, LLP, posted on The CLS Blue Sky Blog, Columbia Law School, June 9, 2022.

NFTs were a rage for a period in 2022 – but the hack and theft of NFTs online sites (like Bored Ape Yaht Club NFTs and hack of Bill Murray's wallet after NFT charity auction) has cooled some of the passion for NFTs.

Basics of Cryptocurrencies – Definitions (cont.)

NFTs as Regulated Securities. One commentator noted about NFT's: "Some commentators have begun to draw parallels between NFTs and initial coin offerings (ICOs). The Securities and Exchange Commission has been scrutinizing ICOs and token offerings for years now. Depending on the specific characteristics of the NFT and offers and sales, certain NFTs could also be classified as securities, triggering regulatory and filing requirements and potential liabilities. Like most other digital assets, the primary test relevant to whether an NFT would be a security is the Howey Test, under which a transaction is deemed an investment contract if "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." S.E.C. v. W.J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244, 163 A.L.R. 1043 (1946). The non-fungible nature of many NFTs and association with assets not commonly understood to be securities like art or digital collectibles often may clearly distinguish NFTs from securities, but depending on the specific design of the NFT and associated bundle of rights, as well as how it sold and promoted and other factors, there is the potential for it to be deemed a security." "O'Melveny & Myers Discusses Challenges of NFT's," by Heather J,. Meeker, Laurel Loomis Rimon, Eric Sibbitt and Braddock Stevenson, O'Melveny & Myers, LLP, CLS Blue Sky Blog, April 14, 2021, view at URL: https://clsbluesky.law.columbia.edu 2021/04/14/omelveny-myers-discusses-the-legal-challenges-of-nfts

Basics of Cryptocurrencies – Definitions (cont.)

Creation of Coins. Virtual organization or other capital raising entity – called "sponsors" and usually private (although some governments are contemplating issuing coins) – start the creation of coins by issuing a white paper describing the coin and its purpose and uses.

"Coins" are created and distributed initially by "mining." Special peer-to-peer, private connected computers compete to solve a mathematical problem based on finding a 64 digit hexadecimal number (called a "hash"). It takes tremendous computing power to compete – which prevents small hackers and competitors from competing. The winner of the competition is awarded coins and then posts the transaction on the public and decentralized ledger as a "block" (a record of all transactions in for the coins in play). The "block" has an attached "hash" code to verify the transaction – like a digital signature. This winning process is validated by all participating computer systems as a security measure.

In the transactions in the available coins, a public and private encryption "keys" (software code to encrypt and decrypt information) are used by the owner – the private key is needed to decrypt the keys. The buyer receives the private key to decrypt the keys and effect a transaction in the coins. Hashing is using an algorithm that converts data in a key to a fixed value and protects the original data in the key from being publicly known and blocking any effort to calculate the original data in the key – which is important to protecting transactions or "blocks" and the integrity of the ledger for those transactions.

Basics of Cryptocurrencies – Definitions (cont.)

Owners of coins are anonymous and the coin is only identified by the encryption key code. There is no bank or government entity that issues, controls, monitors and knows the identity of the owners of coins and knows the parties to transactions in coins. Although some coins have "curators" that monitor the coins and issuance and coins have sponsors who create the coins, and other than initial validation of the coin/token and transactions in coins by the linked computers displaying the shared, linked ledger, the transactions in coins are designed to be private, peer-to-peer on the blockchain ledger. The ledger is public – so anyone can see the chain of title of the coin or coins – the privacy data of the owners and buyers is shielded. The Keys are used as identifiers.

This privacy and lack of a central administrator/regulator appeals to many – unfortunately, criminals are especially fond of the privacy and lack of government control over coins.

Helpful Reference Sources:

- **Mastering Bitcoin: Unlocking Digital Cryptocurrencies by Andreas M. Antonopoulos, O'Reilly Media, 2014.**
- **The Age of Cryptocurrency: How Bitcoin and Digital Money Are Challenging the Global Economic Order by Paul Vigna and Michael Casey, St. Martin's Press, 2015.**
- **Crypto-Finance, Law and Regulation. Governing an Emerging Ecosystem by Joseph Lee, Routledge, 2022.**
- **The Truth About Crypto: A Practical, Easy-to-Understand Guide to Bitcoin, Blockchain, NFTs, and Other Digital Assets by Ric Edelman, Simon & Schuster, 2022.**

Court Developed Tests - What is a Security?

General. Whether a financial or investment interest or contract is a regulated security and, thereby, subject to federal and state securities laws and regulations and the extensive, burdensome compliance regime often imposed by those laws and regulations, is the initial assessment made by an issuer company seeking to raise money by the sale of the securities and issuer company counsel. Since the statutory definition of a "security" is only a list of recognized, traditional regulated securities and not the "universe" of regulated securities, issuer company and its counsel often need to consider court created tests of what is a regulated security. The primary court created tests are:

- **Howey Test**: An instrument or interest is an investment contract or regulated security if: (1) an investment of money is made by an investor; (2) in a common enterprise or business; (3) with an expectation of profit by the investor; and (4) the profit is to be derived solely from the efforts of others. Do not get fixated on "solely" – courts have held that "solely" is really "primarily." In *Howey*, a company was selling interests in orange groves and the investments met all requirements of the test. Interests in orange groves can be regulated securities – yet, not statute lists such interests as regulated securities. The lesson is that a company or person has to look at statutory definitions, court cases, regulatory enforcement cases and regulatory guidance to determine whether a financial instrument or interest or contract is a regulated securities and, as such, any offer of that security must be registered under federal and applicable state securities laws or must qualify for an exemption from registration – otherwise the offer and sale is likely illegal.
- *PRACTICE POINT*: Even if a financial interest is not an "regulated security" – an investigation by the SEC or a state securities regulator based on a offering of securities can be very expensive to handle, can take months or longer to resolve, and can underline working capital funding (existence of an investigation is "material" to any investor or lender and would have to be disclosed to that investor or lender). A deal killer is "Oh, by-the-way, the SEC is investigating us for securities law violations."
- **Other Court Created Tests**: *State v. Hawaii Market Center, Inc.*, 485 P.2d. 105 (1971). Some courts have been dissatisfied with Howey Test as an adequate test in all situations. The *Hawaii Market* Test finds a regulated security when:

Court Developed Tests – What is a security? (cont.)

(**Hawaii Market Test** cont.): "(1) An offeree furnishes initial value to an offeror and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise." - *State v. Hawaii Market Center*, 485 P.2d 105 (1971), pg. 649.

For the Hawaii Market Test, the focus was on risk capital nature of the investment – "This subjection of the investor's money to the risks of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction." *State by Comm'r of Sec. v. Hawaii Mkt. Ctr., Inc.,* 52 Haw. 642, 648, 485 P.2d 105, 109 (1971).

The Court in this case added: "The primary weakness of the Howey formula is that it has led courts to analyze investment projects mechanically, based on a narrow concept of investor participation. See Gallion v. Alabama Market Centers, Inc., supra; Emery v. So-Soft of Ohio, Inc., supra. Thus courts become entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business.4 In fulfilling the remedial purposes of our state act, we believe a sounder approach to securities regulation requires that courts focus their attention on the economic realities of security transactions: that is, '(t)he placing of capital or laying out of money in a way intended to secure income or profit from its employment' in an enterprise. State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)…. The salient feature of securities sales is the public solicitation of venture capital to be used in a business enterprise. Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 815, 13 Cal.Rptr. 186, 188, 361 P.2d 906, 908 (1961); Goodwin, Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations, 24 Business Lawyer 1311, 1320-21 (1969)." State by Comm'r of Sec. v. Hawaii Mkt. Ctr., Inc., 52 Haw. 642, 647–48, 485 P.2d 105, 108–09 (1971) [Footnotes in quote not reproduced here]

SEC Analysis Investment Contracts and Cryptocurrencies under Howey Test

SEC issued guidance on when Coins and Tokens are regulated securities with the 2019 Framework for "Investment Contract" Analysis of Digital Assets (quotes below are from this guidance – footnotes deleted from quotes). Guidance does not have the force of law or a rule and is subject to change by SEC.

Relying on the Howey Test – this SEC Guidance highlighted following key points about each requirement of Howey Test and how digital assets can satisfy each requirement:

- **"The Investment of Money -** The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration." Cash is not a requirement of the investment.
- **Common Enterprise**. "Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts. See SEC v. Int'l Loan Network, Inc., 968 F.2d 1304, 1307 (D.C. Cir. 1992)." SEC has no trouble finding common enterprise in Coins/Tokens realm.
- **Reasonable Expectation of Profits Derived from Efforts of Others. "**When a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. Relevant to this inquiry is the "economic reality" of the transaction and "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." The inquiry, therefore, is an objective one, focused on the transaction itself and the manner in which the digital asset is offered and sold."

SEC Analysis Investment Contracts and Cryptocurrencies under Howey Test (cont.)

- One commentator's summary of the SEC Analysis: "Recently, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) attempted to provide some clarity by issuing a "Framework for 'Investment Contract' Analysis of Digital Assets," which provides a toolkit to apply the *Howey* test to digital assets. The guidance quickly dispenses with the first and second prongs of the *Howey* test, stating that the requirements for an "investment of money" in a "common enterprise" are "typically satisfied" in a digital asset transaction. FinHub focuses on the third prong of the *Howey* test and provides an exhausting, but "not intended to be an exhaustive," list of over thirty factors to help determine if an investor has a reasonable expectation of profits derived from the efforts of others. For instance, the guidance suggests looking at an active participant's managerial role, the functionality and progress of the project, and the quantity of the funds raised…. In conjunction with the framework, the SEC's Division of Corporation Finance issued a no-action letter stating that tokens issued by TurnKey Jet (TKJ), an on-demand air charter service, were not securities. TKJ members purchase blockchain-based tokens, which "decreases the settlement time and improves the efficiencies of paying for and obtaining air charter services." In deciding not to bring an enforcement action, the SEC relied on, inter alia, findings that the project was "fully developed and operational," the tokens were "immediately usable for their intended functionality," and the tokens were "marketed in a manner that emphasize[d] the functionality of the [t]oken, and not the potential for the increase in [its] market value." …. The framework and no-action letter indicate that the SEC is open to excluding some blockchain-based digital assets from securities regulations. This development is meaningful because it marks a shift away from the former uncertainty, which was likely a function of the SEC's desire to promote innovation. Though the new framework is helpful, it is not binding and is not an adequate substitute for clear rules upon which market participants could rely. Through selective enforcement of the most egregious fraud cases, the SEC has prevented judges from interpreting the application of securities laws to digital assets, leading to vague and nebulous regulation. As a result, some market participants are calling for judicial intervention, and the framework may be geared more toward guiding judges' analyses in inevitable litigation than equipping citizens to navigate ICOs."
- **- "SEC, Framework for "Investment Contract" Analysis of Digital Assets (2019), Harvard Law Review, 132 Harvard L. Rev. 2418,**

SEC Analysis Investment Contracts and Cryptocurrencies under Howey Test (cont.)

- Another commentator noted: “The Framework explains that when assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction, and in so doing, the courts have considered whether the instrument is offered and sold for use or consumption by purchasers. The stronger the presence of the following factors, the ***less likely*** it is that the digital asset is an investment contract.

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.
- Prospects for appreciation in the value of the digital asset are limited.
- With respect to a digital asset referred to as a virtual currency, it can be immediately used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.
- With respect to a digital asset that represents a right to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services.
- The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset. –

”SEC Publishes Framework for Investment Contract Analysis of Digital Assets and Issues First No-Action Letter for a Token Sale,” Keith F. Higgins, Thomas Holden and Edward Baer, Ropes & Gray, LLP, April 30, 2019

SEC Analysis Investment Contracts and Cryptocurrencies under Howey Test (cont.)

Ropes & Gray LLP added: “The Framework is not intended to be an exhaustive overview of the law and, in some respects, reiterates positions that the SEC has taken or expressed through past investigative reports, enforcement actions or speeches. The Framework should provide market participants with a helpful tool in evaluating whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset. Significantly, in its discussion of the inquiries pertaining to the reliance on the efforts of others and the reasonable expectation of profits, the Framework also confirms that a digital asset that was part of an offering of securities may become, over time, something other than a security and identifies certain considerations to be examined when reevaluating the status of the digital asset at the time of later offers and sales. Where there is a fully functioning network and no transferability of tokens except within the network, the inquiry is relatively straightforward and the TKJ Letter provides relevant guidance. In contrast, the Framework will be most helpful when the current facts are subject to interpretation. The Framework provides a useful outline of the various factors that token issuers should weigh in reaching the appropriate conclusion regarding whether or not it will be necessary to register the tokens as securities.” - ”SEC Publishes Framework for Investment Contract Analysis of Digital Assets and Issues First No-Action Letter for a Token Sale,” Keith F. Higgins, Thomas Holden and Edward Baer, Ropes & Gray, LLP, April 30, 2019.

Beginning of SEC Regulation

The start of extensive SEC regulation of cryptocurrencies starts with the Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Release #33-81207, July 25, 2017 ("DAO Report"). DAO Report is included in presentation materials.

The DAO Report stated the findings of the SEC on whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation, and it's co-founders and intermediaries may have violated the U.S. federal securities laws by issuing DAO Tokens to investors. The DAO Report is a cornerstone of SEC's assertion that coins and tokens can be regulated securities and sets forth the SEC analysis supporting the assertion that Coins and Tokens can be regulated securities.

The DAO ("DAO" stands for "Decentralized Autonomous Organization") "offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether ("ETH"), a virtual currency used on the Ethereum Blockchain. As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars ("USD") at approximately $150 million." DAO Report, pp. 2-3. The offering was made through a website supplemented by public announcements - in short, by general solicitation.

The DAO Tokens were not restricted in terms of resale and could be resold in secondary online markets. Thus, monetizing the DAO Tokens. Further, DAO Tokens could be transferred through the Blockchain system that generated to DAO Tokens.

Ponzi Schemes

- SEC defines a Ponzi Scheme – which is a concern of SEC in cryptocurrencies – as follows:

Ponzi Schemes Generally

"A Ponzi scheme is an investment scam that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, rather than engaging in any legitimate investment activity, the fraudulent actors focus on attracting new money to make promised payments to earlier investors as well as to divert some of these "invested" funds for personal use. the SEC investigates and prosecutes many Ponzi scheme cases each year to prevent new victims from being harmed and to maximize recovery of assets to investors.

Bitcoin Ponzi Scheme. In a recent case, SEC v. Shavers, the organizer of an alleged Ponzi scheme advertised a Bitcoin "investment opportunity" in an online Bitcoin forum. Investors were allegedly promised up to 7% interest per week and that the invested funds would be used for Bitcoin arbitrage activities in order to generate the returns. Instead, invested Bitcoins were allegedly used to pay existing investors and exchanged into U.S. dollars to pay the organizer's personal expenses."

- From SEC Investor Alert - Investor Alert Ponzi schemes Using virtual Currencies , July 2013 – URL:

https://www.sec.gov/files/ia_virtualcurrencies.pdf

SEC Enforcement Focus on Crypto

- SEC has repeatedly said Crypto is a Focus on Enforcement – **SEE:**

See: SEC Chair Jay Clayton, Testimony United States Senate Committee on Banking, Housing, And Urban Affairs, "Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission" (Feb. 6, 2018), available at URL: https://www.banking.senate.gov/hearings/virtual-currencies-the-oversight-role-of-the-us-securities-and-exchange-commission-and-the-us-commodity-futures-trading-commission (see approx. 32:00 mark).

See: New SEC Chair Cary Gensler at Aspen Security Forum, *The View from the SEC: Cryptocurrencies and National Security with Speaker: Gary Gensler, Chairman, Securities and Exchange Commission*, transcript available at https://www.aspensecurityforum.org/asf-transcript-library.

SEC has commenced several Enforcement Actions against Crypto ICOs, Exchanges and Sponsors:

See: Press Release, *SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange* (Aug. 9, 2021), https://www.sec.gov/news/press-release/2021-147?utm_medium=email&utm_source=govdelivery.

See: In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree, *Order Instituting Cease-and-Desist Proceedings* (Aug. 6, 2021), https://www.sec.gov/litigation/admin/2021/33-10961.pdf.

See: [Alleged insider trading] *SEC v. Ishan Wahi et al., Case No. 2:22 cv-01009, USDC WDWA, July 21, 2022.*

See: *SEC v. MCC International Corp. (DBA "Mining Capital Coin Corp."), et al.,* Case No. 2:22-cv-14129-KMM, USDC SDFL, April 7, 2022. Alleged unregistered offerings and fraudulent sales of investment plans called mining packages.

SEC Enforcement Focus on Crypto (cont.)

See: In the Matter of NVDIA Corporation, SEC Releases 34-94859 and 33-11060, SEC Admin. Pro. Number 3-20844, May 6, 2022, Cease and Desist Order, Settled – alleged failure to disclose impact of crypto-mining on revenues.

See: SEC v. John Barksdale and Jonatina Barksdale, USDC SDNY, Case #1:22-cv-01933, March 8, 2022. Alleged illegal sale of cryptocurrency to retail investors.

See: SEC v. Vladimir Okhotnikov, et al. Case No. 1:22-cv-03879, USDC NDIL, August 1, 2022. Alleged fraudulent crypto pyramid and Ponzi scheme that raised more than $300 million from millions of retail investors worldwide, including in the United States.

See: SEC v. Chicago Crypto Capital LLC, et al. Case No. 1:22-cv-04975, USDC NDIL, Sept. 14, 2022. Alleged unregistered tokens.

See: *Securities and Exchange Commission v. Arbitrade Ltd., et al.*, Civil Action No. 1:22-cv-23171 (S.D. Fla. filed September 29, 2022). Alleged pump and dump.

SEC Enforcement Actions in 2021 involving crypto were 20 --- Of the 20 enforcement actions brought in 2021, 65% alleged fraud, 80% alleged an unregistered securities offering violation, and 55% alleged both. “SEC Cryptocurrency Enforcement – 2021 Update,” by Simona Nola, Cornerstone Research, 2022, pg. 4.

DOJ Enforcement Actions: DOJ filed actions in four cases of alleged criminal fraud involving, including a NFT case – See: Justice Department Announces Enforcement Action Charging Six Individuals with Cryptocurrency Fraud Offenses in Cases Involving Over $100 Million in Intended Losses, DOJ Press Release, June 30, 2022, URL: https://www.justice.gov/opa/pr/justice-department-announces-enforcement-action-charging-six-individuals-cryptocurrency-fraud

SEC/DOJ Enforcement – Crypto Cases

DOJ - United States v. Zaslavskiy, No. 17 CR 647 (RJD), 2018 WL 4346339, at *1 (E.D.N.Y. Sept. 11, 2018). DOJ filed criminal securities fraud claims for two separate ICOs offerings were no coins were actually issued – remember that the offer can violate federal securities laws as well as the sale or issuance.

DOJ alleged in an indictment that the defendants, a person and two companies that he controlled, offered two classes of coins in separate ICOs: one offering of coins backed by and producing returns from real estate projects and another backed and producing returns from a diamond business. DOJ alleges the two businesses were never started or existed and no coins were ever actually issued to investors. DOJ filed 3 count indictment for Conspiracy to Commit Securities Fraud in violation of 18 U.S.C. §371, and Securities Fraud, in connection with real estate coins offering and Securities Fraud in connection with diamond coins in violation of 15 U.S.C. §§78j(b) and 78ff.

This case presents a common defense claims - Defendants moved to dismiss the Indictment arguing that coins did not involve securities and are beyond the reach of the federal securities laws; that the securities laws are unconstitutionality vague as applied to crypto. DOJ asserted that the investments made in coins were "investment contracts" under SEC v. W.J. Howey Co., 328 U.S. 293 (1946), and thus "securities," as defined by both Section 3(a)(10) of the Securities Exchange Act of 1933 and Section 2(a)(1) of the Securities Act of 1933 and that these laws are not unconstitutionally vague.

Court held the Indictment was constitutionally sufficient and meets the pleading requirements set forth in the Federal Rules of Criminal Procedure and the Exchange Act and SEC Rule 10b-5, under which Defendants were charged, are not unconstitutionally vague as applied to crypto – Zaslavskiy, pg. 1 of memorandum order.

SEC/DOJ Enforcement – Crypto Cases (cont.)

- DOJ - **United States v. Zaslavskiy (cont.).**

With respect to defense that coins were not securities subject to federal securities laws but were "currency" (excluded from definition of "securities" - "See 15 U.S.C § 78c(a)(10) (security does not include "currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited") - 2018 WL 4346339 (E.D.N.Y.), 7., the Court held, as some courts do, that the finder of fact would have to determine whether the coins were "securities" but the DOJ has met the pleading requirements by pleading facts sufficient to defeat a motion to dismiss – in particular:

(1) "a reasonable jury could conclude that, if proven at trial, the facts alleged in the Indictment demonstrate that individuals invested money (and other forms of payment) in order to participate in Zaslavskiy's schemes. Id. ¶¶ 10, 12-13, 17-20, 24: see Howey, 328 U.S. at 299-300. They did so in exchange for investments in what they were told were investment-backed virtual tokens or coins. Id. ¶10-11, 18-19: see also SEC v. SG Ltd., 265 F.3d 42, 48 (1st Cir. 2001) ("[t]he determining factor [for the first Howey prong] is whether an investor 'chose to give up specific consideration in return for a separable financial interest with the characteristics of a security.'") - 2018 WL 4346339 (E.D.N.Y.), 5.

(2) facts plead "would allow a reasonable jury to find that both REcoin [real estate coin] and Diamond [coin] constituted a "common enterprise." See Howey, 328 U.S. at 298-300; see also Daniel, 439 U.S. at 561 ("the 'touchstone' of the Howey test 'is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.' ") (quoting Forman, 421 U.S. at 852). To allege a common enterprise, the Indictment must establish that "commonality" existed between the investors in Recoin [real estate coin] , and, separately, between the investors in Diamond [coins]. In this Circuit, "horizontal commonality" is sufficient to establish a common enterprise.[7] Revak, 18 F.3d at 87." - Horizontal commonality "is characterized as the tying of each individual investor's fortunes to the fortunes of [ ] other investors by the pooling of assets, *usually* combined with the pro-rata distribution of profits." In re J.P. Jeanneret, 769 F. Supp. 2d at 359." 2018 WL 4346339 (E.D.N.Y.), 5-6.

SEC/DOJ Enforcement – Crypto Cases (cont.)

- DOJ - **United States v. Zaslavskiy (cont.):**

(3) the facts alleged, if proven, would enable a jury to conclude that investors were led to expect profits in REcoin and Diamond to be derived solely from the managerial efforts of Zaslavaskiy and his co-conspirators, not any efforts of the investors themselves. See Howey, 328 U.S. at 300 ("[a] common enterprise managed by respondents or third parties with adequate personnel and equipment is [ ] essential if [ ] investors are to achieve their paramount aim of a return on their investments."); see also Edwards, 540 U.S. at 396 (a "touchstone" of an investment contract is "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); see also Leonard, 529 F.3d at 88 (the Second Circuit does not interpret "solely" literally, "rather, we 'consider whether, under the all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money, and the promoter's contribution in a meaningful way.' ") (quoting SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir. 1982))…. REcoin and Diamond investors undoubtedly expected to receive profits on their investments. See Indictment ¶¶ 11, 14, 21-22; see also Howey, 328 U.S. at 298-300; Edwards, 540 U.S. at 390, 396 (profits refer to "simpl[e] financial returns on ... investments" and may "include, for example, dividends, other periodic payments, or the increased value of the investment.") (internal quotation marks and citations omitted); Forman, 421 U.S. at 852 (profits include "capital appreciation resulting from the development of the initial investment" or "a participation in earnings resulting from the use of the investors' funds.")." - 2018 WL 4346339 (E.D.N.Y.), 6.

SEC/DOJ Enforcement – Crypto Cases (cont.)

- **DOJ - United States v. Zaslavskiy (cont.):**

With respect to Defendants' argument that securities laws were constitutionally vague, the Court brushed that 'everything and the kitchen sink defense' aside with "securities laws are meant to be interpreted 'flexibly to effectuate [their] remedial purpose" and Howey Test has provided "clear guidance to courts and litigants as to the definition of 'investment contract' under the securities laws." - 2018 WL 4346339 (E.D.N.Y.), pg. 9.

Commentator on *Zaslavskiy*: "The court's decision in *Zaslavskiy* suggests that general allegations that a cryptocurrency instrument satisfies the *Howey* test may be sufficient to fulfill requirements for indictments at the motion to dismiss stage. This relieves the government of a potentially significant pleading burden when bringing similar actions, but does not encourage clarification of clear standards for application of the *Howey* test and may create a risk of inconsistent determinations since the ultimate decision will be left to a jury. Nor is this unique to the criminal context – civil courts have made similar sweeping findings in preliminary stages of litigation that certain cryptocurrencies may be securities, but have yet to issue final rulings based on specific factual findings. Similarly, the SEC's summary conclusion in *Token Lot* that the tokens at issue "included securities," without even identifying those tokens, is in line with SEC Chairman Jay Clayton's previous suggestions that most ICOs are securities, but does not explain the particular facts and circumstances that transformed those cryptocurrencies into securities." – "Federal Court, SEC, and FINRA Scrutinize Cryptocurrencies and ICOs," by Alexis Collins, Grace Kurland, ,& Adam Motiwala, Cleary Gottlieb Steen & Hamilton , LLP, September 17, 2018.

SEC/DOJ Enforcement – Crypto Cases

SEC: Violation with Fraud – In the Matter of Bloom Protocol, LLC, Admin. Proceeding 3-20952, Aug. 9, 2022. This is a case of failing to register an ICO deemed a public offering of securities by SEC without any allegations of fraud. In 2017, Bloom made an ICO offering of Bloom Tokens ("BLTs") to investors and raised $30M among some 7,000 investors. ICO was not registered under 1933 Act and was not qualified under an exemption from registration. Bloom also used general solicitation and advertising to promote ICO. Violates Sections 5(a) and 5(c) of 1933 Act. There is no allegation of fraud in the ICO. BLTs were sold to raise money "to build its lending ecosystem, fund joint ventures with established lenders, and acquire users."

Section 5(a): "states that unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale." In the Matter of Bloom Protocol, LLC, Admin. Proceeding 3-20952, Aug. 9, 2022, pg. 6.

Section 5(c): "states that it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use of medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security." In the Matter of Bloom Protocol, LLC, Admin. Proceeding 3-20952, Aug. 9, 2022, pg. 6.

SEC/DOJ Enforcement – Crypto Cases (cont.)

SEC Recission Offer for Coins - *In the Matter of Bloom Protocol, LLC*, SEC Admin. Proceeding 3-20952, Aug. 9, 2022 (cont.): Bloom consented to SEC imposed remedial actions, which consisted of: (1) Register the BLTs under the 1934 Act (not 1933 Act); (2) implement a claims process – basically, a rescission of the ICO offering – to allow investors to recoup their investment in the BLTs; and (3) pay a $300,000 civil penalty (which "springs up" if Bloom does not meet all requirements of the Settlement). Besides the 'spring up' provision, what is novel about this settlement is the requirement that Bloom notify the SEC if Bloom seeks to terminate BLT's 1934 Act registration under Section 12g-4 of the 1934 Act on the basis that Bloom believes the BLTs are no longer regulated securities (suggesting that tokens can morph into utilities from investment contracts) under Section 3(a)(10) of the 1934 Act. As one commentator noted about this part of the settlement in Bloom: "This appears to be an admission by the SEC of a belief held by many practitioners in the digital asset industry - that a token that was once a security could, under the right circumstances, cease to be a security at some point in the future. It is unclear from the Order what basis the SEC might assent to a digital asset's treatment as a non-security. While in the past, the SEC released guidance on when a digital asset might be an investment contract under *Howey* with a heavy focus on operationality and decentralization of the underlying protocol, the Division of Enforcement has tried to walk this back in its prosecution of the XRP case against Ripple. This language could hint that the SEC may at some point become willing to make determinations that digital assets are not securities beyond the extremely limited three examples where the SEC has granted no-action relief in Turnkey Pocketful of Quarters, and VCOIN." "SEC Hints at Path for Digital Assets to Morph Into Non-Securities," by Daniel McAvoy and Jonathan Schmalfeld, Polsinelli PC, Aug. 18, 2022, Posted on JDSupra.com, see at URL: https://www.jdsupra.com/legalnews/sec-hints-at-path-for-digital-assets-to-5698821/

SEC/DOJ Enforcement – Crypto Cases (cont.)

SEC Suspension of Trading of Stock of Crypto Companies. One of the SEC's enforcement powers is the ability to temporarily suspend trading in a company's stock under Section 12(k) of the 1934 Act without proof of any violation of federal securities laws. The usual explanation for the suspension in trading is unexplained market activity in the stock and questions about accuracy of statements in filings with the SEC or in public communications. After termination of the suspension, pursuant to Rule 15c2-11 under the 1934 Act, no quotation for the suspended securities may be entered by a broker unless and until the broker has strictly complied with all of the provisions of Rule 15c2-11. The net impact of a trading suspension is to place a Scarlet A on the stock – depressing future trading in the stock. Examples of SEC suspension of trading of stock of companies engaged in cryptocurrencies can be found at URL:

https://www.sec.gov/litigation/suspensions/2018/34-84063.pdf

SEC – PONIZ SCHEME - *SEC v. Okhotnikov et al*. Action to enjoin Ponzi Scheme in Crypto. SEC commenced litigation against foreign and U.S. nationals for allegedly establishing a website (called Forsage) that, according to the SEC complaint, operated as a " textbook pyramid and Ponzi scheme. It did not sell or purport to sell any actual, consumable product to bona fide retail customers during the relevant time period and had no apparent source of revenue other than funds received from investors. The primary way for investors to make money from Forsage was to recruit others into the scheme. To participate, an investor created a crypto-asset wallet and then purchased "slots" in Forsage's smart contracts, which gave the investor the right to earn compensation from others whom the investor recruited into the scheme (the "downlines") and compensation from the larger Forsage community of investors in the form of profit sharing of payments known as "spillovers." When an investor purchased a slot, a portion of that investment was directed to the persons who recruited the investor (the "uplines") and the investor in turn became an upline to whomever the investor recruited. Thus, all payouts to earlier investors were made using funds received from later investors." Complaint, *SEC v. Okhotnikov* et al., Case: 1:22-cv-03978, USDC ND IL, pg. 4.

SEC/DOJ Enforcement – Crypto Cases (cont.)

(cont.) - *SEC v. Okhotnikov et al*. SEC seeks to enjoin alleged violations of Section 5 of the 1933 Act, 15 U.S.C. § 77e; Section 17(a) of the Securities Act, 15 U.S.C. §77q(a); and Section 10(b) and Rule 10b-5 of the 1934 Act, 15 U.S.C. §78j(b), 17 C.F.R. §240.10b-5. SEC of the Philippines and Montana state securities agency are also involved in the case. This case is presented to show the complexity and global scope of crypto cases.

SEC: Celebrity Touting Coins - *In the Matter of Kimberly Kardashian*, Admin. Proceeding 3-21197, Oct. 3, 2022. Anti-Touting Case. Ms. Kardashian consent to pay $1.26 million in penalties, disgorgement, and interest, and cooperate with the SEC's ongoing investigation – she "failed to disclose that she was paid $250,000 to publish a post on her Instagram account about EMAX tokens, the crypto asset security being offered by EthereumMax. Kardashian's post contained a link to the EthereumMax website, which provided instructions for potential investors to purchase EMAX tokens." SEC Press Release No. 2022-183, Oct. 3, 2022.

Failing to disclose compensation as a promoter violates Section 17(b) of the 1933 Act, which makes it unlawful for any person to promote a security without fully disclosing the receipt and amount of such consideration from an issuer.

SEC issued a public statement warning celebrities not to tout crypto without disclosing compensation as a promoter: "Celebrities and others are using social media networks to encourage the public to purchase stocks and other investments. These endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement. The SEC's Enforcement Division and Office of Compliance Inspections and Examinations encourage investors to be wary of investment opportunities that sound too good to be true. We encourage investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons." SEC Statement Urging Caution Around Celebrity Backed ICOs, SEC Division of Enforcement, Nov. 1, 2017, URL: https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos

SEC/DOJ Enforcement – Crypto Cases (cont.)

DOJ Criminal Action NFTs: Justice Department Announces Enforcement Action Charging Six Individuals with Cryptocurrency Fraud Offenses in Cases Involving Over $100 Million in Intended Losses, U.S. Attorney's Office, Central District of California, U.S. Department of Justice, Press Release, June 30, 2022. DOJ is actively pursuing NFT cases – as summarized below. Quotes are from this release.

-***U.S. v. Le Ahn Tuan*** filed in Central District of California U.S. District Court. Indictment alleges: "shortly after the first day Baller Ape Club NFTs were publicly sold, Tuan and his co-conspirators engaged in what is known as a "rug pull," ending the purported investment project, deleting its website, and stealing the investors' money. Based on blockchain analytics, shortly after the rug pull, Tuan and his co-conspirators laundered investors' funds through "chain-hopping," a form of money laundering in which one type of coin is converted to another type and funds are moved across multiple cryptocurrency blockchains, and used decentralized cryptocurrency swap services to obscure the trail of Baller Ape investors' stolen funds. In total, Tuan and his co-conspirators obtained approximately $2.6 million from investors."

-***U.S. v. Emerson Pires, Flavio Goncalves, and Joshua David Nicholas*** filed in Southern District of Florida U.S. District Court. Indictment alleges: "Pires and Goncalves, both founders of EmpiresX, along with Nicholas, the so-called "Head Trader" for EmpiresX, fraudulently promoted EmpiresX, a cryptocurrency investment platform and unregistered securities offering, by making numerous misrepresentations regarding, among other things, a purported proprietary trading bot and fraudulently guaranteeing returns to investors and prospective investors in EmpiresX. As alleged in the indictment, blockchain analytics shows that Pires and Goncalves then laundered investors' funds through a foreign-based cryptocurrency exchange and operated a Ponzi scheme by paying earlier investors with money obtained from later EmpiresX investors."

SEC/DOJ Enforcement – Crypto Cases (cont.)

DOJ Criminal Actions NFTs (cont.):

-***United States v. Michael Alan Stollery*** filed in Central District of California U.S. District Court. Allegations are: "Stollery falsified TBIS white papers (a document for prospective investors that typically explains how the technology underlying the cryptocurrency works and the purpose of the cryptocurrency project), planted fake testimonials on TBIS's website, and fabricated purported business relationships with the U.S. Federal Reserve Board and dozens of prominent companies, including Apple Inc., Pfizer Inc., and The Walt Disney Company, to create the appearance of legitimacy."

-***United States v. David Saffron*** filed in Central District of California U.S. District Court. Indictment alleges: "Saffron falsely represented to investors that he traded investors' funds to earn profits using a trading bot that could execute over 17,000 transactions per hour on various cryptocurrency exchanges. Saffron falsely represented that his trading bot would generate between 500% to 600% returns on the amount invested. To entice investors to invest, Saffron allegedly led investor meetings at luxury homes in the Hollywood Hills and elsewhere, and traveled with a team of armed security guards in order to create the false appearance of wealth and success. In total, Saffron fraudulently raised approximately $12 million from investors."

SEC: Unregistered Offering and Failure to Register as an Investment Company. *In the Matter of BlockFi Lending LLC*, SEC Admin. Proceeding No. 3-20758, Feb. 14, 2022. According to SEC: "BlockFi offered and sold BIAs [BlockFi Interest Accounts] to the public. Through BIAs, investors lent crypto assets to BlockFi in exchange for the company's promise to provide a variable monthly interest payment. The order finds that BIAs are securities under applicable law, and the company therefore was required to register its offers and sales of BIAs but failed to do so or to qualify for an exemption from SEC registration. Additionally, the order finds that BlockFi operated for more than 18 months as an unregistered investment company because it issued securities and also held more than 40 percent of its total assets, excluding cash, in investment securities, including loans of crypto assets to institutional borrowers. SEC also alleged that "BlockFi made a false and misleading statement for more than two years on its website concerning the level of risk in its loan portfolio and lending activity. Without admitting or denying the SEC's findings, BlockFi agreed to a cease-and-desist order prohibiting it from violating the registration and antifraud provisions of the Securities Act and the registration provisions of the Investment Company Act. BlockFi also agreed to cease offering or selling BIAs in the United States" and paid a $50 million penalty.

SEC/DOJ Enforcement – Crypto Cases (cont.)

SEC: Online Trading Platform - Failure to Register as a Broker Dealer and Register as a Stock Exchange. *In the Matter of BTG Trading Corp*. and Ethan Burnside, SEC Admin. Proceeding 3-16307, Dec. 18, 2014. SEC sanctioned computer programmer for allegedly operating online trading platforms providing "account holders the ability to use Bitcoin or Litecoin to buy, sell, and trade securities of businesses (primarily virtual currency-related entities) listed on the exchanges' websites. The venues [exchanges] weren't registered as broker-dealers despite soliciting the public to open accounts and trade securities. The venues weren't registered as stock exchanges despite enlisting issuers to offer securities for the public to buy and sell… Without admitting or denying the SEC's findings, Burnside and BTC Trading Corp. consented to cease and desist from committing or causing any future violations of the registration provisions. Burnside agreed to be barred from the securities industry with the right to reapply after two years, and he must pay $58,387.07 in disgorgement and prejudgment interest plus a penalty of $10,000. The penalty amount reflects prompt remedial acts taken by Burnside as he cooperated with the SEC's investigation." – SEC Press Release No.2014-273, Dec. 8, 2014.

SEC: Enjoined Unregistered ICO by a "Crypto Bank". *SEC v. Arisebank et al.,* USDC NDTX, Slip Opinion, 2018 WL 10419828, 2018**.** SEC obtained court order halting defendants from allegedly offering and selling "unregistered investments in their purported "AriseCoin" cryptocurrency" depicted as "a first-of-its-kind decentralized bank offering a variety of consumer-facing banking products and services using more than 700 different virtual currencies. AriseBank's sales pitch claimed that it developed an algorithmic trading application that automatically trades in various cryptocurrencies." SEC Press Release No. 2018-8, Jan. 30, 2018.

SEC/DOJ Enforcement – Crypto Cases (cont.)

SEC – Halt ICO*. SEC v. Plexcorps et al*., USDC EDNY, 2017. SEC "obtained an emergency asset freeze to halt a fast-moving Initial Coin Offering (ICO) fraud that raised up to $15 million from thousands of investors since August by falsely promising a 13-fold profit in less than a month. The SEC filed charges against a recidivist Quebec securities law violator, Dominic Lacroix, and his company, PlexCorps. The Commission's complaint, filed in federal court in Brooklyn, New York, alleges that Lacroix and PlexCorps marketed and sold securities called PlexCoin on the internet to investors in the U.S. and elsewhere, claiming that investments in PlexCoin would yield a 1,354 percent profit in less than 29 days. The SEC also charged Lacroix's partner, Sabrina Paradis-Royer, in connection with the scheme." Case is SEC's new Cyber Unit first enforcement action, which unit focuses the "Enforcement Division's cyber-related expertise on misconduct involving distributed ledger technology and initial coin offerings, the spread of false information through electronic and social media, hacking and threats to trading platforms. – SEC Press Release No. 2017-219, Dec. 4, 2017. "This first Cyber Unit case hits all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing," said Robert Cohen, Chief of the Cyber Unit. "We acted quickly to protect retail investors from this initial coin offering's false promises."Based on its filing, the SEC obtained an emergency court order to freeze the assets of PlexCorps, Lacroix, and Paradis-Royer." - SEC Press Release No. 2017-219, Dec. 4, 2017

SEC Inquiry Ends ICO. ***In the Matter of Munchee Inc***., SEC Admin. Proceeding 3-18304, Dec. 11, 2017. "Munchee Inc. refunded investor proceeds after the SEC intervened. Munchee was seeking $15 million in capital to improve an existing iPhone app centered on restaurant meal reviews and create an "ecosystem" in which Munchee and others would buy and sell goods and services using the tokens. The company communicated through its website, a white paper, and other means that it would use the proceeds to create the ecosystem, including eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and "in-app" purchases to app users in exchange for tokens." SEC Press Release No. 2017-227, Dec. 11, 2017.

Future of SEC Regulation of Cryptocurrencies

- According to Wilson Sonsini, the future of SEC Regulation of Crypto is predicted to be (and I agree with this analysis):

"* A reiteration of the SEC's position that virtually all tokens are securities (with the exception of perhaps Bitcoin, Ether, and maybe a few others);[15]

* A requirement that the sponsors of many tokens, and perhaps especially tokens trading on significant crypto exchanges, register those tokens under the Securities Exchange Act of 1934 (the "**1934 Act**"), which would result in the sponsors becoming public reporting companies that must file annual and quarterly reports, and become subject to the proxy, tender offer, Sarbanes-Oxley, and other rules. The SEC may also, as part of the Statement or in a subsequent rulemaking, develop new disclosure requirements specifically tailored for digital assets;

* A requirement that the sponsors of most tokens must register or qualify tokens sold to the public in the United States, either through a Regulation A offering or a public offering on Form S-1 or Form F-1 (for foreign sponsors); and

* A requirement that crypto exchanges and perhaps other trading platforms that permit U.S. persons to participate must register as a broker-dealer and/or as some form of alternative trading system ("**ATS**"), perhaps subject to new and enhanced requirements tailored to retail participation in the crypto markets." Reading the Not-So-Subtle Tea Leaves: What the SEC Is Likely to Do Next in Crypto, and How Crypto Participants Should Prepare," by Rob Rosenblum, Esq., Wilson Sonsini Goodrich & Rosati, July 26, 2022.

Congress Crypto Legislation

Preliminary Comments: #1) SEC and Congress have an often tense relationship – in part, because the SEC vexes wealthy campaign contributors (e.g. Wall Street, Big Business, Wealthy People). This tension is also the result of SEC dragging its feet in implementing legislation that is unpopular at the SEC – example: JOBS Act of 2012 rule making. Congressional displeasure with the SEC is often cloaked in "unnecessary regulation" mantra. When SEC asked Congress for $ for a new HQ building in DC - Congress tried to fund a new SEC HQ building that overlooked a gravel pit in a remote part of DC near the DC sewage treatment plant. Who said that legislators do not have a sense of humor? #2) Whenever you see congressional legislation where the subject being regulated can logically be handled by either the CFTC or the SEC, and the legislation makes the CFTC the lead regulator – that legislation is trying to "soft pedal" regulatory reform. In general, the CFTC is a Golden Retriever regulator and the SEC is more like a pit bull regulator in comparison.

CFTC wants to Regulate Crypto: "On June 14, CFTC Commissioner Christy Goldsmith Romero discussed cryptocurrency regulation, rejecting suggestions that the agency would take a relaxed approach toward regulating cryptocurrency and affirming that the CFTC is positioned to protect consumers if given more authority. Romero said she welcomed efforts to close regulatory gaps through the recent Responsible Financial Innovation Act (RFIA) that was introduced in the Senate earlier this month and another similar bill that will be introduced by Senators Stabenow (D-MI) and Bozeman (R-AR) that would designate the CFTC as crypto's top regulator. When asked about the possibility of regulation slowing the crypto market, Romero responded that "companies can't scale up the way they need to without a lot of the financial institutions investments," and that "regulation is needed." - "CFTC: Agency Prepared to Regulate Crypto," by Moorari Shah, A.J. S. Dhaliwa and Gabriel Khoury, Sheppard, Mullin, Richter & Hampton LLP, Posted on National Law Review, June 27, 2022, view at URL: https://www.natlawreview.com/article/cftc-agency-prepared-to-regulate-crypto

Congress Crypto Legislation (cont.)

- **Status of Congressional Bills Summarized Below for Crypto Regulation**: "US lawmakers' efforts to pass significant crypto legislation by the end of the year are on life support, leaving in place Washington's scattershot approach to digital coins." – "Crypto Overhaul Fizzles in Congress, Leaving Industry and Investors in Limbo," by Allyson Versprille, Bloomberg.com, Oct. 5, 2022.
- **Senate Bill**: **Responsible Financial Innovation Act** – sponsored by Senator K. Gillibrand (D-NY) and Senator C. Lummins (R-WY) – introduced June 2022. Bill seeks to: (1) define crypto that is securities and that is commodities – but assumes most crypto are commodities under CFTC authority; (2) Makes CFTC lead regulator in crypto; (3) for stablecoins: "establishes 100% reserve, asset type and detailed disclosure requirements for all payment stablecoin issuers"; (4) "authorizes a special depository institution charter under both state law and the *National Bank Act* for payment stablecoin issuance, with tailored capital requirements and holding company supervision. The bill does not require all payment stablecoin issuers to become depository institutions"; (5) "Directs the CFTC and the SEC to study and report on the development of a self-regulatory organization (SRO) and develop a proposal for its creation" Note: SRO is an entity often used in securities realm to create a quasi governmental organization to regulate certain aspects of an industry – for instance, NASDAQ, New York Stock Exchange and FINRA are SRO's; (6) "The bill creates a *de minimis* exemption so that people can make purchases with virtual currency without having to account for and report income. The bill also clarifies the tax treatments of different actors and actions in the digital asset industry, including that miners and other validators are not "brokers" for income tax purposes and that their rewards shall not be income until redeemed for cash"; (7)" Imposes disclosure requirements on digital asset service providers to ensure that consumers understand the product and can make informed decisions when engaging with digital assets". – Senator K. Gillibrand Press Release, June 7, 2022.

Congress Crypto Legislation (cont.)

- **Digital Commodities Consumer Protection Act of 2022, sponsored by Senators Stabenow (D-MI), Thune (R-SD), Booker (D-NJ), Boozman (R-AZ), Aug.2022.** Bill would: (1) makes CFTC the lead regulator of "digital commodities" (making crypto a "commodity" foremost and not a security – but does not completely shut out the SEC from regulation); (2) require trading exchanges to register with the CFTC and pay fees to CFTC; (3) "Requires digital commodity platforms to prohibit abusive trading practices, eliminate or disclose conflicts of interest, maintain sufficient financial resources, have strong cybersecurity programs, protect customer assets, and report suspicious transactions"; (4) "Requires digital commodity platforms to adhere to advertising standards and disclose information about digital commodities and their risks, bringing greater transparency and accountability to the marketplace"; (5) Directs the CFTC to examine racial, ethnic, and gender demographics of customers participating in digital commodity markets and use that information to inform its rulemaking and provide outreach to customers" - The Digital Commodities Consumer Protection Act Closes Regulatory Gaps, Senate Agriculture Committee Summary, Aug. 2022.
- **Digital Trading Clarity Act of 2022 - S 5030, sponsored by Senator Bill Hagerty (R-TN), Sept. 2022.** Bill would: (1) create a safe harbor for digital asset exchange from SEC regulation; and (2) bill would set out that a digital asset not subject to a determination by the SEC or a federal court, and listed through an intermediary that meets certain requirements related to custody, disclosure and other investor protections, would not be considered a security" – "Senate Bill Establish Temporary SEC Safe Harbor for Crypto Exchanges," by Bill Flook**,** Editor, Accounting and Compliance Alert, October 7, 2022, posted on Thomson Reuters Tax and Accounting website. Comment: In November 2022, FTX, a major $32B crypto exchange, collapsed and some traders may be unable to retrieve cash in their accounts – "See no evil, hear no evil" on this Bill.

Other threats to Cryptocurrency's Decentralized Utopia

- Governments and Big Business and Big Banks are getting into Cryptocurrency – the fear is that this development will ensure that cryptocurrency becomes enslaved in regulation and dominated by large corporations – ending the dream of blockchain and cryptocurrency allowing DAO's as the basis of a decentralized world of financial and non-financial affairs.
- "We are constantly hearing about CBDCs [central bank created digital currency]. It's apparent, especially in certain countries that are trying to come out with their own central bank digital currencies, that they are often instituting laws that either ban or greatly restrict the private crypto sector, in order to take out the competition on a national level," says David Dobrovitsky, CEO of Glitter Finance, without mentioning the obvious here — China is doing precisely that. They are constantly talking up their pilot project in a digital renminbi [Chinese state money], and have been busy cracking down in Bitcoin for at least two years." - Imagining A Central Bank Wipeout Of Bitcoin In 2022, by Kenneth Rapoza, Senior Contributor, Forbes.com, Dec. 21, 2021.
- "Cryptocurrencies and DeFi [decentralized finance using crypto] aim to replicate money, payments, and a range of financial services. They build on permissionless distributed ledger technology such as blockchain. This technology allows for technical functions that can adapt to new demands as they arise, as well as for openness across borders. Yet crypto suffers from serious structural flaws that prevent it from serving as a sound basis for the monetary system…. First, crypto lacks a sound nominal anchor. The system relies on volatile cryptocurrencies and so-called stablecoins that seek such an anchor by maintaining a fixed value to a sovereign currency, such as the US dollar. But cryptocurrencies are not currencies, and stablecoins are not stable. This was underscored by the implosion of TerraUSD in May 2022 and persistent doubts about the actual assets that back the largest stablecoin, Tether. In other words, stablecoins seek to "borrow" credibility from real money issued by central banks. This shows that if central bank money did not exist, it would be necessary to invent it…. (cont. next slide]

Other threats to Cryptocurrency's Decentralized Utopia (cont.)

- Second, crypto induces fragmentation. Money is a social convention, characterized by network effects—the more people use a given type of money, the more attractive it becomes to others. These network effects are anchored in a trusted institution—the central bank—that guarantees the stability of the currency as well as the safety and finality (settlement and irreversibility) of transactions…. Because of these flaws, crypto is neither stable nor efficient. It is a largely unregulated sector, and its participants are not accountable to society. Frequent fraud, theft, and scams have raised serious concerns about market integrity." – "A New Era of Money," by Eswar Prasad, Finance and Development, Sept. 2022, pp. 8-9.

SEC Anti-Fraud Statutes/Rules Summary

- Section 10(b)/Rule 10b-5 under Exchange Act: A civil and criminal law, this is the "catch-all" fraud provision in federal securities laws. It makes fraudulent any untrue statement of a material fact (or omission thereof) in connection with the sale or purchase of a security and is used in insider trading cases as well as fraudulent statements of material facts in offering documents or communications. Supreme Court has held that Section 10(b)/Rule 10b-5 implies a private right of action – private plaintiffs can sue under Section 10(b)/Rule 10b-5. See: ***Ernst & Ernst v. Hochfelder***, 425 U.S. 185 (1976).

Scienter. The big obstacle in pleading Section 10(b)/Rule 10b-5 claims is pleading and proving the required element of "Scienter" – that defendant acted with the required ''intent to deceive, manipulate, or defraud.'' Private Securities Litigation Reform Act of 1995 or "PSLRA" stated: "[I]n any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2)(A).

- Section 17(a) of Securities Act: Like Section 10(b), Section 17(a) provides for civil and criminal penalties for a broad scope of fraud: "It shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement (as defined in section 78c(a)(78) [1] of this title) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud, or(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." A violation of (1), or (2) or (3) produces liability.

Civil Liability under Section 17(a) DOES NOT require a showing of Scienter – Criminal liability does require a showing of Scienter. Most jurisdictions do not allow a private right of action under Section 17(a) – but it is primarily used by SEC and DOJ for fraud claims.

SEC Anti-Fraud Statutes/Rules Summary (cont.)

- Section 11 of the Securities Act. It makes an issuer strictly liable for any untrue statement of material fact in a registration statement under Securities Act. “Directors of the issuer as well as every person who signs the registration statement, every expert (e. g., an accountant) and every underwriter are also liable, though all persons other than the issuer have a so-called “due diligence” defense if they can establish that they had reasonable grounds for belief in the truth of the alleged misstatements or omissions.” - Litigation Risks Remain for Private Equity Sponsors Even After Janus, by Julie H. Jones, Peter L. Welsh and Rodman K. Forter, Jr., INSIGHTS, Vol. 25, No. 11, Nov. 2011. Section 11 is a favored claim for private litigants when applicable due to strict liability.

- Section 12(a)(2) of Securities Act. “Section 12(a)(2) creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission. A defendant who violates Section 12(a)(2) is liable to the purchaser for either rescission of the purchase or damages, provided that the purchaser did not know about the misstatement or omission at the time of the purchase.” Litigation Risks Remain for Private Equity Sponsors Even After Janus, by Julie H. Jones, Peter L. Welsh and Rodman K. Forter, Jr., INSIGHTS, Vol. 25, No. 11, Nov. 2011.

- **Section 15(a) of Securities Act – Control Person Liability**. Section 15(a) imposes liability for: “Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections [15 U.S.C. §] 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.”

- Section 20(a) of the Exchange Act – “Control Person.” Section 20(a) imposes liability on a “control person” for any violation of the Exchange Act to the same extent as the primary violator of the Exchange Act. Liability as a “control person” can be avoided if the “control person” establishes that the person acted in good faith and did not directly or indirectly induce the violation of the Exchange Act. Private right of action is possible under Section 20(a).

SEC Anti-Fraud Statutes/Rules Summary (cont.)

- Section 20(b) of Exchange Act. "Control person" liability recently asserted by SEC in enforcement cases in order to skirt limitations imposed in *Janus* case. Courts have not established a private right of action under Section 20(b) – See: *Janus Capital Group v. First Derivative Trader*s, 564 U.S. 135 (2011).

Section 20(b) provides that "[i]t shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person." A critical difference between Section 20(b) and the control person provisions of Section 20(a) is that Section 20(b) does not appear to require a shareholder plaintiff to demonstrate "control" of the primary violator; rather, it only requires the defendant to have taken some "unlawful" action through another entity. In Janus, the Supreme Court expressly declined to address whether Section 20(b) gives rise to a private right of action, noting "[w]e do not address whether Congress created liability of entities that act through innocent intermediaries in [Section 20(b)]."4 So far, no other court has held that Section 20(b) provides a private remedy, though given the Supreme Court's acknowledgement that the issue is at least unsettled, shareholder plaintiffs may try to bring such a claim in the future against third party actors." Litigation Risks Remain for Private Equity Sponsors Even After Janus, by Julie H. Jones, Peter L. Welsh and Rodman K. Forter, Jr., INSIGHTS, Vol. 25, No. 11, Nov. 2011.

Other Issues: Taxes

IRS Notice 2014-21 [Select] Q&A: This IRS Notice was one of the first statements of policy by IRS on cryptocurrencies under federal tax law.

*"Q-1: How is virtual currency treated for federal tax purposes?
A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.
* Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?
A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.
* Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?
A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, Taxable and Nontaxable Income, for more information on miscellaneous income from exchanges involving property or services.
* Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?
A-4: The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, Basis of Assets, for more information on the computation of basis when property is received for goods or services." See remainder of Q&A in IRS Notice 2014-21 at URL: https://www.irs.gov/pub/irs-drop/n-14-21.pdf

Other Issues: Anti-Money Laundering Regulation

- For information on anti-money laundering regulation of cryptocurrencies – see:

- The Report of the Attorney General Pursuant to Section 8(b)(iv) of Executive Order 14067: How To Strengthen International Law Enforcement Cooperation For Detecting, Investigating, And Prosecuting Criminal Activity Related To Digital, DOJ, June 6, 2022. URL: https://www.justice.gov/ag/page/file/1510931/download
- The Report of the Attorney General Pursuant to Section 5(b)(iii) of Executive Order 14067: The Role Of Law Enforcement In Detecting, Investigating, And Prosecuting Criminal Activity Related To Digital Asset, DOJ, Sept. 6, 2022. URL: https://www.justice.gov/ag/page/file/1535236/download
- FACT SHEET: White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets, White House, September 16,2022. URL:

https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/

Investor Alert: Public Companies Making ICO-Related Claims

Aug. 28, 2017

The SEC's Office of Investor Education and Advocacy is warning investors about potential scams involving stock of companies claiming to be related to, or asserting they are engaging in, Initial Coin Offerings (or ICOs). Fraudsters often try to use the lure of new and emerging technologies to convince potential victims to invest their money in scams. These frauds include "pump-and-dump" and market manipulation schemes involving publicly traded companies that claim to provide exposure to these new technologies.

Recent Trading Suspensions

Developers, businesses, and individuals increasingly are using ICOs – also called coin or token launches or sales – to raise capital. There has been media attention regarding this form of capital raising. While these activities may provide fair and lawful investment opportunities, there may be situations in which companies are publicly announcing ICO or coin/token related events to affect the price of the company's common stock.

The SEC may suspend trading in a stock when the SEC is of the opinion that a suspension is required to protect investors and the public interest. Circumstances that might lead to a trading suspension include:

- A lack of current, accurate, or adequate information about the company – for example, when a company has not filed any periodic reports for an extended period;
- Questions about the accuracy of publicly available information, including in company press releases and reports, about the company's current operational status and financial condition; or
- Questions about trading in the stock, including trading by insiders, potential market manipulation, and the ability to clear and settle transactions in the stock.

The SEC recently issued several trading suspensions on the common stock of certain issuers who made claims regarding their investments in ICOs or touted coin/token related news. The companies affected by trading suspensions include First Bitcoin Capital Corp., CIAO Group, Strategic Global, and Sunshine Capital.
Investors should be very cautious in considering an investment in a stock following a trading suspension. A trading suspension is one warning sign of possible microcap fraud (microcap stocks, some of which are penny stocks and/or nanocap stocks, tend to be low priced and trade in low volumes). If current, reliable information about a company and its stock is not available, investors should consider seriously the risk of making an investment in the company's stock. *For more on trading suspensions, see our Investor Bulletin: Trading in Stock after an SEC Trading Suspension – Be Aware of the Risks.*

Pump-and-Dump and Market Manipulations

One way fraudsters seek to profit is by engaging in market manipulation, such as by spreading false and misleading information about a company (typically microcap stocks) to affect the stock's share price. They may spread stock rumors in different ways, including on company websites, press releases, email spam, and posts on social media, online bulletin boards, and chat rooms. The false or misleading rumors may be positive or negative.
For example, "pump-and-dump" schemes involve the effort to manipulate a stock's share price or trading volume by touting the company's stock through false and misleading statements to the marketplace. Pump-and-dump schemes often occur on the Internet where it is common to see messages posted that urge readers to buy a stock quickly or to sell before the price goes down, or a promoter will call using the same sort of pitch. In reality, the author of the messages may be a company insider or paid promoter who stands to gain by selling their shares after the stock price is "pumped" up by the buying frenzy they create. Once these fraudsters "dump" their shares for a profit and stop hyping the stock, the price typically falls, and investors lose their money. *Learn more about these schemes in our Updated Investor Alert: Fraudulent Stock Promotions.*

Tips for Investors

- Always research a company before buying its stock, especially following a trading suspension. Consider the company's finances, organization, and business prospects. This type of information often

is included in filings that a company makes with the SEC, which are available for free and can be found in the Commission's EDGAR filing system.

- Some companies are not required to file reports with the SEC. These are known as "non-reporting" companies. Investors should be aware of the risks of trading the stock of such companies, as there may not be current and accurate information that would allow investors to make an informed investment decision.
- Investors should also do their own research and be aware that information from online blogs, social networking sites, and even a company's own website may be inaccurate and potentially intentionally misleading.
- Be especially cautious regarding stock promotions, including related to new technologies such as ICOs. Look out for these warning signs of possible ICO-related fraud:
    - Company that has common stock trading claims that its ICO is "SEC-compliant" without explaining how the offering is in compliance with the securities laws; or
    - Company that has common stock trading also purports to raise capital through an ICO or take on ICO-related business described in vague or nonsensical terms or using undefined technical or legal jargon.
- Look out for these warning signs of possible microcap fraud:
    - SEC suspended public trading of the security or other securities promoted by the same promoter;
    - Increase in stock price or trading volume happening at the same time as the promotional activity;
    - Press releases or promotional activity announcing events that ultimately do not happen (*e.g.*, multiple announcements of preliminary deals or agreements; announcements of deals with unnamed partners; announcements using hyperbolic language);
    - Company has no real business operations (few assets, or minimal gross revenues);
    - Company issues a lot of shares without a corresponding increase in the company's assets; and
    - Frequent changes in company name, management, or type of business.

SEC - Framework for "Investment Contract" Analysis of Digital Assets [1]

I. Introduction

If you are considering an Initial Coin Offering, sometimes referred to as an "ICO," or otherwise engaging in the offer, sale, or distribution of a digital asset,[2] you need to consider whether the U.S. federal securities laws apply. A threshold issue is whether the digital asset is a "security" under those laws.[3] The term "security" includes an "investment contract," as well as other instruments such as stocks, bonds, and transferable shares. A digital asset should be analyzed to determine whether it has the characteristics of any product that meets the definition of "security" under the federal securities laws. In this guidance, we provide a framework for analyzing whether a digital asset has the characteristics of one particular type of security – an "investment contract."[4] Both the Commission and the federal courts frequently use the "investment contract" analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[5] The so-called "*Howey* test" applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of typical securities.[6] The focus of the *Howey* analysis is not only on the form and terms of the instrument itself (in this case, the digital asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales). Therefore, issuers and other persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset will need to analyze the relevant transactions to determine if the federal securities laws apply.

The federal securities laws require all offers and sales of securities, including those involving a digital asset, to either be registered under its provisions or to qualify for an exemption from registration. The registration provisions require persons to disclose certain information to investors, and that information must be complete and not materially misleading. This requirement for disclosure furthers the federal securities laws' goal of providing investors with the information necessary to make informed investment decisions. Among the information that must be disclosed is information relating to the essential managerial efforts that affect the success of the enterprise.[7] This is true in the case of a corporation, for example, but also may be true for other types of enterprises regardless of their organizational structure or form.[8] Absent the disclosures required by law about those efforts and the progress and prospects of the enterprise, significant informational asymmetries may exist between the management and promoters of the enterprise on the one hand, and investors and prospective investors on the other hand. The reduction of these information asymmetries through required disclosures protects investors and is one of the primary purposes of the federal securities laws.

II. Application of *Howey* to Digital Assets

In this guidance, we provide a framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions. As noted above, under the *Howey* test, an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Whether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances. We address each of the elements of the *Howey* test below.

A. The Investment of Money

The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.[9]

B. Common Enterprise

Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract.[10] In evaluating digital assets, we have found that a "common enterprise" typically exists.[11]

C. Reasonable Expectation of Profits Derived from Efforts of Others

Usually, the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others. A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. When a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. Relevant to this inquiry is the "economic reality"[12] of the transaction and "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[13] The inquiry, therefore, is an objective one, focused on the transaction itself and the manner in which the digital asset is offered and sold.

The following characteristics are especially relevant in an analysis of whether the third prong of the *Howey* test is satisfied.

1. Reliance on the Efforts of Others

The inquiry into whether a purchaser is relying on the efforts of others focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an AP?
- Are those efforts "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,"[14] as opposed to efforts that are more ministerial in nature?

Although no one of the following characteristics is necessarily determinative, the stronger their presence, the more likely it is that a purchaser of a digital asset is relying on the "efforts of others":

- An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network,[15] particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.[16]
    - Where the network or the digital asset is still in development and the network or digital asset is not fully functional at the time of the offer or sale, purchasers would reasonably expect an AP to further develop the functionality of the network or digital asset (directly or indirectly). This particularly would be the case where an AP promises further developmental efforts in order for the digital asset to attain or grow in value.
- There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a "decentralized" network).
- An AP creates or supports a market for,[17] or the price of, the digital asset. This can include, for example, an AP that: (1) controls the creation and issuance of the digital asset; or (2) takes other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity, through, for example, buybacks, "burning," or other activities.
- An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset. In particular, an AP plays a lead or central role in deciding governance issues, code updates, or how third parties participate in the validation of transactions that occur with respect to the digital asset.
- An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents including, for example:
    - Determining whether and how to compensate persons providing services to the network or to the entity or entities charged with oversight of the network.

    - Determining whether and where the digital asset will trade. For example, purchasers may reasonably rely on an AP for liquidity, such as where the AP has arranged, or promised to arrange for, the trading of the digital asset on a secondary market or platform.
    - Determining who will receive additional digital assets and under what conditions.
    - Making or contributing to managerial level business decisions, such as how to deploy funds raised from sales of the digital asset.
    - Playing a leading role in the validation or confirmation of transactions on the network, or in some other way having responsibility for the ongoing security of the network.
    - Making other managerial judgements or decisions that will directly or indirectly impact the success of the network or the value of the digital asset generally.
- Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where:
    - The AP has the ability to realize capital appreciation from the value of the digital asset. This can be demonstrated, for example, if the AP retains a stake or interest in the digital asset. In these instances, purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset.
    - The AP distributes the digital asset as compensation to management or the AP's compensation is tied to the price of the digital asset in the secondary market. To the extent these facts are present, the compensated individuals can be expected to take steps to build the value of the digital asset.
    - The AP owns or controls ownership of intellectual property rights of the network or digital asset, directly or indirectly.
    - The AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "efforts of others," including but not limited to:

- Whether or not the efforts of an AP, including any successor AP, continue to be important to the value of an investment in the digital asset.
- Whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts.
- Whether the efforts of an AP are no longer affecting the enterprise's success.

2. Reasonable Expectation of Profits

An evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. Profits can be, among other things, capital appreciation resulting from the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchasers' funds.[18] Price appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered "profit" under the *Howey* test.

The more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

- The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset.
    - The opportunity may result from appreciation in the value of the digital asset that comes, at least in part, from the operation, promotion, improvement, or other positive developments in the network, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains.
    - This also can be the case where the digital asset gives the holder rights to dividends or distributions.
- The digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future.[19]

- Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase.
- The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.
    - The digital asset is offered and purchased in quantities indicative of investment intent instead of quantities indicative of a user of the network. For example, it is offered and purchased in quantities significantly greater than any likely user would reasonably need, or so small as to make actual use of the asset in the network impractical.
- There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.
- There is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption.
- The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset.
- The AP is able to benefit from its efforts as a result of holding the same class of digital assets as those being distributed to the public.
- The AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset.
- The digital asset is marketed, directly or indirectly, using any of the following:
    - The expertise of an AP or its ability to build or grow the value of the network or digital asset.
    - The digital asset is marketed in terms that indicate it is an investment or that the solicited holders are investors.
    - The intended use of the proceeds from the sale of the digital asset is to develop the network or digital asset.
    - The future (and not present) functionality of the network or digital asset, and the prospect that an AP will deliver that functionality.
    - The promise (implied or explicit) to build a business or operation as opposed to delivering currently available goods or services for use on an existing network.
    - The ready transferability of the digital asset is a key selling feature.
    - The potential profitability of the operations of the network, or the potential appreciation in the value of the digital asset, is emphasized in marketing or other promotional materials.
    - The availability of a market for the trading of the digital asset, particularly where the AP implicitly or explicitly promises to create or otherwise support a trading market for the digital asset.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "reasonable expectation of profits," including but not limited to:

- Purchasers of the digital asset no longer reasonably expect that continued development efforts of an AP will be a key factor for determining the value of the digital asset.
- The value of the digital asset has shown a direct and stable correlation to the value of the good or service for which it may be exchanged or redeemed.
- The trading volume for the digital asset corresponds to the level of demand for the good or service for which it may be exchanged or redeemed.
- Whether holders are then able to use the digital asset for its intended functionality, such as to acquire goods and services on or through the network or platform.
- Whether any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- No AP has access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.

3. Other Relevant Considerations

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction.[20] In doing so, the courts also have considered whether the instrument is offered and sold for use or consumption by purchasers.[21]

Although no one of the following characteristics of use or consumption is necessarily determinative, the stronger their presence, the less likely the *Howey* test is met:

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.
- The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network. For example, the digital asset can only be used on the network and generally can be held or transferred only in amounts that correspond to a purchaser's expected use.
- Prospects for appreciation in the value of the digital asset are limited. For example, the design of the digital asset provides that its value will remain constant or even degrade over time, and, therefore, a reasonable purchaser would not be expected to hold the digital asset for extended periods as an investment.
- With respect to a digital asset referred to as a virtual currency, it can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.
    - This means that it is possible to pay for goods or services with the digital asset without first having to convert it to another digital asset or real currency.
    - If it is characterized as a virtual currency, the digital asset actually operates as a store of value that can be saved, retrieved, and exchanged for something of value at a later time.
- With respect to a digital asset that represents rights to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services. Relevant factors may include:
    - There is a correlation between the purchase price of the digital asset and a market price of the particular good or service for which it may be redeemed or exchanged.
    - The digital asset is available in increments that correlate with a consumptive intent versus an investment or speculative purpose.
    - An intent to consume the digital asset may also be more evident if the good or service underlying the digital asset can only be acquired, or more efficiently acquired, through the use of the digital asset on the network.
- Any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset.
- Potential purchasers have the ability to use the network and use (or have used) the digital asset for its intended functionality.
- Restrictions on the transferability of the digital asset are consistent with the asset's use and not facilitating a speculative market.
- If the AP facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

Digital assets with these types of use or consumption characteristics are less likely to be investment contracts. For example, take the case of an online retailer with a fully-developed operating business. The retailer creates a digital asset to be used by consumers to purchase products only on the retailer's network, offers the digital asset for sale in exchange for real currency, and the digital asset is redeemable for products commensurately priced in that real currency. The retailer continues to market its products to its existing customer base, advertises its digital asset payment method as part of those efforts, and may "reward" customers with digital assets based on product purchases. Upon receipt of the digital asset, consumers immediately are able to purchase products on the network using the digital asset. The digital assets are not transferable; rather, consumers can only use them to purchase products from the retailer or sell them back to the retailer at a discount to the original purchase price. Under these facts, the digital asset would not be an investment contract.

Even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, there may be securities transactions if, among other factors, the following is present: the digital asset is offered or sold to purchasers at a discount to the value of the goods or services; the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or there are limited or no restrictions on reselling those digital assets, particularly where an AP is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.

III. Conclusion

The discussion above identifies some of the factors market participants should consider in assessing whether a digital asset is offered or sold as an investment contract and, therefore, is a security. It also identifies some of the factors to be considered in determining whether and when a digital asset may no longer be a security. These factors are not intended to be exhaustive in evaluating whether a digital asset is an investment contract or any other type of security, and no single factor is determinative; rather, we are providing them to assist those engaging in the offer, sale, or distribution of a digital asset, and their counsel, as they consider these issues. We encourage market participants to seek the advice of securities counsel and engage with the Staff through www.sec.gov/finhub.

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[1] This framework represents the views of the Strategic Hub for Innovation and Financial Technology ("FinHub," the "Staff," or "we") of the Securities and Exchange Commission (the "Commission"). It is not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved its content. Further, this framework does not replace or supersede existing case law, legal requirements, or statements or guidance from the Commission or Staff. Rather, the framework provides additional guidance in the areas that the Commission or Staff has previously addressed. *See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017) ("*The DAO Report*"); William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

[2] The term "digital asset," as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

[3] The term "security" is defined in Section 2(a)(1) of the Securities Act of 1933 (the "Securities Act"), Section 3(a)(10) of the Securities Exchange Act of 1934, Section 2(a)(36) of the Investment Company Act of 1940, and Section 202(a)(18) of the Investment Advisers Act of 1940.

[4] This framework is intended to be instructive and is based on the Staff's experiences to date and relevant law and legal precedent. It is not an exhaustive treatment of the legal and regulatory issues relevant to conducting an analysis of whether a product is a security, including an investment contract analysis with respect to digital assets generally. We expect that analysis concerning digital assets as securities may evolve over time as the digital asset market matures. Also, no one factor is necessarily dispositive as to whether or not an investment contract exists.

[5] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*"). *See also United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975) ("*Forman*"); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) ("*Tcherepnin*"); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) ("*Joiner*").

[6] Whether a contract, scheme, or transaction is an investment contract is a matter of federal, not state, law and does not turn on whether there is a formal contract between parties. Rather, under the *Howey* test, "form [is] disregarded for substance and the emphasis [is] on economic reality." *Howey*, 328 U.S. at 298. The Supreme Court has further explained that that the term security "embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

[7] Issuers of digital assets, like all issuers, must provide full and fair disclosure of material information consistent with the requirements of the federal securities laws. Issuers of digital assets should be guided by the regulatory framework and concepts of materiality. What is material depends upon the nature and structure of the issuer's particular network and circumstances. *See TSC Industries v. Northway*, 426 U.S. 438, 449 (1976) (a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the shareholder).

[8] *See The DAO Report*.

[9] The lack of monetary consideration for digital assets, such as those distributed via a so-called "bounty program" does not mean that the investment of money prong is not satisfied. As the Commission explained in *The DAO Report*, "[i]n determining whether an investment contract exists, the investment of 'money' need not take the form of cash" and "in spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract." *The DAO Report* at 11 (citation omitted). *See In re Tomahawk Exploration LLC*, Securities Act Rel. 10530 (Aug. 14, 2018) (issuance of tokens under a so-called "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its securities). Further, the lack of monetary consideration for digital assets, such as those distributed via a so-called "air drop," does not mean that the investment of money prong is not satisfied; therefore, an airdrop may constitute a sale or distribution of securities. In a so-called "airdrop," a digital asset is distributed to holders of another digital asset, typically to promote its circulation.

[10] In order to satisfy the "common enterprise" aspect of the *Howey* test, federal courts require that there be either "horizontal commonality" or "vertical commonality." *See Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits" and two variants of vertical commonality, which focus "on the relationship between the promoter and the body of investors"). The Commission, on the other hand, does not require vertical or horizontal commonality *per se*, nor does it view a "common enterprise" as a distinct element of the term "investment contract." *In re Barkate*, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004); *see also* the Commission's Supplemental Brief at 14 in *SEC v. Edwards*, 540 U.S. 389 (2004) (on remand to the 11th Circuit).

[11] Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts. *See SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1307 (D.C. Cir. 1992).

[12] *Howey*, 328 U.S. at 298. *See also Tcherepnin*, 389 U.S. at 336 ("in searching for the meaning and scope of the word 'security' in the [Acts], form should be disregarded for substance and the emphasis should be on economic reality.")

[13] *Joiner*, 320 U.S. at 352-53.

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

[15] In this guidance, we are using the term "network" broadly to encompass the various elements that comprise a digital asset's network, enterprise, platform, or application.

[16] We recognize that holders of digital assets may put forth some effort in the operations of the network, but those efforts do not negate the fact that the holders of digital assets are relying on the efforts of the AP. That a scheme assigns "nominal or limited responsibilities to the [investor] does not negate the existence of an investment contract." *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n.15 (5th Cir. 1974) (citation and quotation marks omitted). If the AP provides efforts that are "the undeniably significant ones, those essential managerial efforts

which affect the failure or success of the enterprise," and the AP is not merely performing ministerial or routine tasks, then there likely is an investment contract. *See Turner*, 474 U.S. at 482; *see also The DAO Report* (although DAO token holders had certain voting rights, they nonetheless reasonably relied on the managerial efforts of others). Managerial and entrepreneurial efforts typically are characterized as involving expertise and decision-making that impacts the success of the business or enterprise through the application of skill and judgment.

[17] *See, e.g.*, *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985).

[18] *See Forman*, 421 U.S. at 852.

[19] Situations where the digital asset is exchangeable or redeemable solely for goods or services within the network or on a platform, and may not otherwise be transferred or sold, may more likely be a payment for a good or service in which the purchaser is motivated to use or consume the digital asset. *See* discussion of "Other Relevant Considerations."

[20] As noted above, under *Howey*, courts conduct an objective inquiry focused on the transaction itself and the manner in which it is offered.

[21] *See Forman*, 421 U.S. at 852-53 (where a purchaser is not "'attracted solely by the prospects of a return' on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.").

Modified: April 3, 2019

SEC DAO REPORT

SECURITIES AND EXCHANGE COMMISSION
SECURITIES EXCHANGE ACT OF 1934
Release No. 81207 / July 25, 2017
Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:
The DAO
I. Introduction and Summary

The United States Securities and Exchange Commission's ("Commission") Division of Enforcement ("Division") has investigated whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation; Slock.it's co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it's co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary
trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO's code to steal approximately one-third of The DAO's assets. Slock.it's co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").1 The Commission deems it appropriate and in the public interest to issue this report of investigation ("Report") pursuant to Section 21(a) of the Exchange Act2 to advise those who would use a Decentralized Autonomous Organization ("DAO Entity"), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to

1 This Report does not analyze the question whether The DAO was an "investment company," as defined under Section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.

ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, "smart contracts,"3 or computer code, does not remove conduct from the purview of the U.S. federal securities laws.4 This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

II. Facts
A. Background

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether ("ETH"), a virtual currency5 used on the Ethereum Blockchain.6 As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars ("USD") at approximately $150 million

2 Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." This Report does not constitute an adjudication of any fact or issue addressed herein, nor does it make any findings of violations by any individual or entity. The facts discussed in Section II, infra, are matters of public record or based on documentary records. We are publishing this Report on the Commission's website to ensure that all market participants have concurrent and equal access to the information contained herein.
3 Computer scientist Nick Szabo described a "smart contract" as: a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs. See Nick Szabo, Smart Contracts, 1994, http://www.virtualschool.edu/mon/Economics/SmartContracts.html.
4 See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security'."); see also Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.").

The concept of a DAO Entity is memorialized in a document (the "White Paper"), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a "Blockchain and IoT [(internet-of-things)] solution company," incorporated in Germany and co-founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch's brother), and Stephan Tual ("Tual").7 The White Paper purports to describe "the first implementation of a [DAO Entity] code to automate organizational governance and decision making."8 The White Paper posits that a DAO Entity "can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law." The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations.9 As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are "formalized, automated and enforced using software."10

5 The Financial Action Task Force defines "virtual currency" as: a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. "real currency," "real money," or "national currency"), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks, FINANCIAL A CTION T ASK F ORCE (June 2014), http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf.
6 Ethereum, developed by the Ethereum Foundation, a Swiss nonprofit organization, is a decentralized platform that

runs smart contracts on a blockchain known as the Ethereum Blockchain.
7 Christoph Jentzsch released the final draft of the White Paper on or around March 23, 2016. He introduced his concept of a DAO Entity as early as November 2015 at an Ethereum Developer Conference in London, as a medium to raise funds for Slock.it, a German start-up he co-founded in September 2015. Slock.it purports to create technology that embeds smart contracts that run on the Ethereum Blockchain into real-world devices and, as a result, for example, permits anyone to rent, sell or share physical objects in a decentralized way. See S LOCK. IT, https://slock.it/.
8 Christoph Jentzsch, Decentralized Autonomous Organization to Automate Governance Final Draft – Under Review, https://download.slock.it/public/DAO/WhitePaper.pdf.
9 Id.
10 Id. The White Paper contained the following statement: A word of caution, at the outset: the legal status of [DAO Entities] remains the subject of active and vigorous debate and discussion. Not everyone shares the same definition. Some have said that [DAO Entities] are autonomous code and can operate independently of legal systems; others have said that [DAO Entities] must be owned or operate[d] by humans or human created entities. There will be many use cases, and the DAO [Entity] code will develop over time. Ultimately, how a DAO [Entity] functions and its legal status will depend on many factors, including how DAO [Entity] code is used, where it is used, and who uses it. This paper does not speculate about the legal status of [DAO Entities] worldwide. This paper is not intended to offer legal advice or conclusions. Anyone who uses DAO [Entity] code will do so at their own risk.
Id.

B. The DAO

"The DAO" is the "first generation" implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a "crowdfunding contract" to raise "funds to grow [a] company in the crypto space."11 In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a "for-profit DAO [Entity]," where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to "rewards."12 Christoph Jentzsch likened this to "buying shares in a company and getting ... dividends."13 The DAO was to be "decentralized" in that it would allow for voting by investors holding DAO Tokens.14 All funds raised were to be held at an Ethereum Blockchain "address" associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO's anticipated earnings from the projects it funded.15 The DAO was intended to be "autonomous" in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.16

11 Christoph Jentzsch, The History of the DAO and Lessons Learned, S LOCK. IT BLOG (Aug. 24, 2016), https://blog.slock.it/the-history-of-the-dao-and-lessons-learned-d06740f8cfa5#.5o62zo8uv. Although The DAO has been described as a "crowdfunding contract," The DAO would not have met the requirements of Regulation Crowdfunding, adopted under Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 (providing an exemption from registration for certain crowdfunding), because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority ("FINRA"). See Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers, SEC (Apr. 5, 2017), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm; Updated Investor Bulletin: Crowdfunding for Investors, SEC (May 10, 2017), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html.
12 See Slockit, Slock.it DAO demo at Devcon1: IoT + Blockchain, Y OUTUBE (Nov. 13, 2015), https://www.youtube.com/watch?v=49wHQoJxYPo.
13 Id.
14 See Jentzsch, supra note 8.
15 Id. In theory, there was no limitation on the type of project that could be proposed. For example, proposed "projects" could include, among other things, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.
16 Id.

On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions.17 This code was to govern how The DAO was to operate.

To promote The DAO, Slock. it's co-founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO's intended purpose: "To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code."18 The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity's structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis."19

Slock.it's co-founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO's status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it's co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered "The DAO Slack" channel, an online messaging platform in which over 5,000 invited "team members" could discuss and exchange ideas about The DAO in real time.

1. DAO Tokens

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects

17 According to the White Paper, a DAO Entity is "activated by deployment on the Ethereum [B]lockchain. Once deployed, a [DAO Entity's] code requires 'ether' [ETH] to engage in transactions on Ethereum. Ether is the digital fuel that powers the Ethereum Network." The only way to update or alter The DAO's code is to submit a new proposal for voting and achieve a majority consensus on that proposal. See Jentzsch, supra note 8. According to Slock. it's website, Slock.it gave The DAO code to the Ethereum community, noting that: The DAO framework is [a] side project of Slock.it UG and a gift to the Ethereum community. It consisted of a definitive whitepaper, smart contract code audited by one of the best security companies in the world and soon, a complete frontend interface. All free and open source for anyone to re-use, it is our way to say 'thank you' to the community.
S LOCK. IT, https://slock.it. The DAO code is publicly-available on GitHub, a host of source code. See The Standard DAO Framework, Inc., Whitepaper, G ITH UB , https://github.com/slockit/DAO.
18 The DAO Website was available at https://daohub.org.
19 Stephen Tual, Deja Vu DAO Smart Contracts Audit Results, S LOCK. IT BLOG (Apr. 5, 2016), https://blog.slock.it/deja-vu-dai-smart-contracts-audit-results-d26bc088e32e.

that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock. it's co-founders touted that DAO Token holders would receive "rewards," which the White Paper defined as, "any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded." DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the "Offering Period"), The DAO offered and sold DAO Tokens. Investments in The DAO were made "pseudonymously" (i.e., an individual's or entity's pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO's Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to

purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.20

In addition to secondary market trading on the Platforms, after the Offering Period, DAO

Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity "split."21

2. Participants in The DAO

According to the White Paper, in order for a project to be considered for funding with "a DAO [Entity]'s [ETH]," a "Contractor" first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.22

20 The Platforms are registered with FinCEN as "Money Services Businesses" and provide systems whereby customers may exchange virtual currencies for other virtual currencies or fiat currencies.
21 According to the White Paper, the primary purpose of a split is to protect minority shareholders and prevent what is commonly referred to as a "51% Attack," whereby an attacker holding 51% of a DAO Entity's Tokens could create a proposal to send all of the DAO Entity's funds to himself or herself.

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders.23 DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. Specifically, as noted in a May 27, 2016 blog post by a group of computer security researchers, The DAO's structure included a "strong positive bias to vote YES on proposals and to suppress NO votes as a side effect of the way in which it restricts users' range of options following the casting of a vote."24

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO's "Curators." At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it.25 According to the White Paper, the Curators of a DAO Entity had "considerable power." The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for "failsafe protection" and for protecting The DAO from "malicous [sic] actors." Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2) confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the "whitelist," which was a

list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

22 It was stated on The DAO Website and elsewhere that Slock.it anticipated that it would be the first to submit a proposal for funding. In fact, a draft of Slock.it's proposal for funding for an "Ethereum Computer and Universal Sharing Network" was publicly-available online during the Offering Period.
23 DAO Token holders could vote on proposals, either by direct interaction with the Ethereum Blockchain or by using an application that interfaces with the Ethereum Blockchain. It was generally acknowledged that DAO Token holders needed some technical knowledge in order to submit a vote, and The DAO Website included a link to a step-by-step tutorial describing how to vote on proposals.
24 By voting on a proposal, DAO Token holders would "tie up" their tokens until the end of the voting cycle. See Jentzsch, supra note 8 at 8 ("The tokens used to vote will be blocked, meaning they can not [sic] be transferred until the proposal is closed."). If, however, a DAO Token holder abstained from voting, the DAO Token holder could avoid these restrictions; any DAO Tokens not submitted for a vote could be withdrawn or transferred at any time. As a result, DAO Token holders were incentivized either to vote yes or to abstain from voting. See Dino Mark et al., A Call for a Temporary Moratorium on The DAO, H ACKING, D ISTRIBUTED (May 27, 2016, 1:35 PM), http://hackingdistributed.com/2016/05/27/dao-call-for-moratorium/.
25 At the time of The DAO's launch, The DAO Website identified eleven "high profile" individuals as holders of The DAO's Curator "Multisig" (or "private key"). These individuals all appear to live outside of the United States. Many of them were associated with the Ethereum Foundation, and The DAO Website touted the qualifications and trustworthiness of these individuals.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had "complete control over the whitelist ... the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhite listed ... [and] clear ability to control the order and frequency of proposals," noting that "curators have tremendous power."26 Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics.27 Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.

3. Secondary Market Trading on the Platforms

During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform's system, which would then match with orders from other customers residing on the system. Each Platform's system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers' orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.

26 Epicenter, EB134 – Emin Gün Sirer And Vlad Zamfir: On A Rocky DAO, Y OUTUBE (June 6, 2016), https://www.youtube.com/watch?v=ON5GhIQdFU8.
27 Andrew Quentson, Are the DAO Curators Masters or Janitors?, THE COIN TELEGRAPH (June 12, 2016), https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors.

4. Security Concerns, The "Attack" on The DAO, and The Hard Fork

In late May 2016, just prior to the expiration of the Offering Period, concerns about the safety and security of The DAO's funds began to surface due to vulnerabilities in The DAO'scode. On May 26, 2016, in response to these concerns, Slock.it submitted a "DAO Security Proposal" that called for the development of certain updates to The DAO's code and the appointment of a security expert.28 Further, on June 3, 2016, Christoph Jentzsch, on behalf of Slock.it, proposed a moratorium on all proposals until alterations to The DAO's code to fix vulnerabilities in The DAO's code had been implemented.29

On June 17, 2016, an unknown individual or group (the "Attacker") began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO's Ethereum Blockchain address to an Ethereum Blockchain address controlled by the Attacker (the "Attack").30 Although the diverted ETH was then held in an address controlled by the Attacker, the Attacker was prevented by The DAO's code from moving the ETH from that address for 27 days.31

In order to secure the diverted ETH and return it to DAO Token holders, Slock.it's co-founders and others endorsed a "Hard Fork" to the Ethereum Blockchain. The "Hard Fork," called for a change in the Ethereum protocol on a going forward basis that would restore the DAO Token holders' investments as if the Attack had not occurred. On July 20, 2016, after a majority of the Ethereum network adopted the necessary software updates, the new, forked Ethereum Blockchain became active.32 The Hard Fork had the effect of transferring all of the funds raised (including those held by the Attacker) from The DAO to a recovery address, where DAO Token holders could exchange their DAO Tokens for ETH.33 All DAO Token holders

28 See Stephan Tual, Proposal #1-DAO Security, Redux, S LOCK. IT B LOG (May 26, 2016), https://blog.slock.it/both-our-proposals-are-now-out-voting-starts-saturday-morning-ba322d6d3aea. The unnamed security expert would "act as the first point of contact for security disclosures, and continually monitor, pre-empt and avert any potential attack vectors The DAO may face, including social, technical and economic attacks." Id. Slock.it initially proposed a much broader security proposal that included the formation of a "DAO Security" group, the establishment of a "Bug Bounty Program," and routine external audits of The DAO's code. However, the cost of the proposal (125,000 ETH), which would be paid from The DAO's funds, was immediately criticized as too high and Slock.it decided instead to submit the revised proposal described above. See Stephan Tual, DAO.Security, a Proposal to guarantee the integrity of The DAO, S LOCK. IT B LOG (May 25, 2016), https://blog.slock.it/dao-security-a-proposal-to-guarantee-the-integrity-of-the-dao-3473899ace9d.
29 See The DAO Proposal ID 5, ETHERSCAN, https://etherscan.io/token/thedao-proposal/5.
30 See Stephan Tual, DAO Security Advisory: live updates, SLOCK. IT BLOG (June 17, 2016), https://blog.slock.it/dao-security-advisory-live-updates-2a0a42a2d07b.
31 Id.
32 A minority group, however, elected not to adopt the new Ethereum Blockchain created by the Hard Fork because to do so would run counter to the concept that a blockchain is immutable. Instead they continued to use the former version of the blockchain, which is now known as "Ethereum Classic."
33 See Christoph Jentzsch, What the 'Fork' Really Means, S LOCK. IT B LOG (July 18, 2016), https://blog.slock.it/what-the-fork-really-means-6fe573ac31dd.
34 Id.

who adopted the Hard Fork could exchange their DAO Tokens for ETH, and avoid any loss of the ETH they had invested.34

III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as "Initial Coin Offerings" or "Token Sales." Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular

offer or sale. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the "full and fair disclosure" afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed "information about the issuer's financial condition, the identity and background of management, and the price and amount of securities to be offered ...." SEC v. Cavanagh, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), aff'd, 155 F.3d 129 (2d Cir. 1998). "The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors." SEC v. Aaron, 605 F.2d 612, 618 (2d Cir. 1979) (citing SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953)), vacated on other grounds, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed.

Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1047 (2d Cir. 1976).

B. DAO Tokens Are Securities

1. Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes "an investment contract." See 15 U.S.C. §§ 77b-77c. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. See SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); see also United Housing Found., Inc. v. Forman, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."). This definition embodies a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." Howey, 328 U.S. at 299 (emphasis added). The test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" Id. In analyzing whether something is a security, "form should be disregarded for substance," Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), "and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto." United Housing Found., 421 U.S. at 849.

2. Investors in The DAO Invested Money

In determining whether an investment contract exists, the investment of "money" need not take the form of cash. See, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of Howey's reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an "investment contract").

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under Howey. See SEC v. Shavers, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of Howey); Uselton, 940 F.2d at 574 ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value'.") (citations omitted).

3. With a Reasonable Expectation of Profits

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO's Ethereum Blockchain address in exchange for DAO Tokens. "[P]rofits" include "dividends, other periodic payments, or the increased value of the investment." Edwards, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.35 The ETH was pooled and available to The DAO to fund projects. The projects (or "contracts") would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. Derived from the Managerial Efforts of Others

a. The Efforts of Slock.it, Slock.it's Co-Founders, and The DAO's Curators Were Essential to the Enterprise

Investors' profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO's Curators. The central issue is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973). The DAO's investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO's Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO's investors. Investors' expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO's Curators, to provide significant managerial efforts after The DAO's launch. The expertise of The DAO's creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO's protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.36

35 That the "projects" could encompass services and the creation of goods for use by DAO Token holders does not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others.

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

b. DAO Token Holders' Voting Rights Were Limited

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators.37 Even if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise. See, e.g., Glenn W. Turner, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter's managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); Long v. Shultz, 881 F.2d 129, 137 (5th Cir. 1989) ("An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not pay off."). See also generally SEC v. Merchant Capital, LLC, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators.38 And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. Indeed, based on the particular facts concerning The DAO and the few draft proposals discussed in online forums, there are indications that contract proposals would not have necessarily provide enough information for investors to make an informed voting decision, affording them less meaningful control. For example, the sample contract proposal attached to the White Paper included little information concerning the terms of the contract. Also, the Slock.it co-founders put forth a draft of their own contract proposal and, in response to questions and requests to negotiate the terms of the proposal (posted to a DAO forum), a Slock.it founder explained that the proposal was intentionally vague and that it was, in essence, a take it or leave it proposition not subject to negotiation or feedback. See, e.g., SEC v. Shields, 744 F.3d 633, 643-45 (10th Cir. 2014) (in assessing whether agreements were investment contracts, court looked to whether "the investors actually had the type of control reserved under the agreements to obtain access to information necessary to protect, manage, and control their investments at the time they purchased their interests.").

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market—an arrangement that bears little resemblance to that of a genuine general partnership. Cf. Williamson v. Tucker, 645 F.2d 404, 422-24 (5th Cir. 1981) ("[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many [limited] partners that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation.").39 Slock.it did create and maintain online forums on which investors could submit posts regarding contract proposals, which were not limited to use by DAO Token holders (anyone was permitted to post). However, DAO Token holders were pseudonymous, as were their posts to

the forums. Those facts, combined with the sheer number of DAO Token holders, potentially made the forums of limited use if investors hoped to consolidate their votes into blocs powerful enough to assert actual control. This was later demonstrated through the fact that DAO Token holders were unable to effectively address the Attack without the assistance of Slock.it and others. The DAO Token holders' pseudonymity and dispersion diluted their control over The DAO. See Merchant Capital, 483 F.3d at 758 (finding geographic dispersion of investors weighing against investor control).

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. Steinhardt Group, Inc. v. Citicorp., 126 F.3d 144, 152 (3d Cir. 1997) ("It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action ... a security may be found to exist ... . [The] emphasis must be placed on economic reality.") (citing SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 n. 14 (5th Cir. 1974)). By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO. See Glenn W. Turner, 474 F.2d at 482.

C. Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security" and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). The term "issuer" is flexibly construed in the Section 5 context "as issuers devise new ways to issue their securities and the definition of a security itself expands." Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 909 (5th Cir. 1977); accord SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980) ("[W]hen a person [or entity] organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer ... .").

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was "crucial" to the DAO Token holders' investment decision. See Murphy, 626 F.2d at 643 ("Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.") (citation omitted). The DAO was "responsible for the success or failure of the enterprise," and accordingly was the entity about which the investors needed information material to their investment decision. Id. at 643-44.

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately $150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. See, e.g., Murphy, 626 F.2d at 650-51 ("[T]hose who ha[ve] a necessary role in the transaction are held liable as participants.") (citing SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 81 (2d Cir. 1970); SEC v. Culpepper, 270 F.2d 241, 247 (2d Cir. 1959); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 28 (10th Cir. 1972); Pennaluna & Co. v. SEC, 410 F.2d 861, 864 n.1, 868 (9th Cir. 1969)); SEC v. Softpoint, Inc., 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) ("The prohibitions of Section 5 ... sweep[] broadly to encompass 'any person' who participates in the offer or sale of an unregistered, non-exempt security."); SEC v. Chinese Consol. Benevolent Ass'n., 120 F.2d 738, 740-41 (2d Cir. 1941) (defendant violated Section 5(a) "because it engaged in selling unregistered securities" issued by a third party "when it solicited offers to buy the securities 'for value'").

D. A System that Meets the Definition of an Exchange Must Register as a National

Securities Exchange or Operate Pursuant to an Exemption from Such Registration Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. See 15 U.S.C. §78e. Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ... ." 15 U.S.C. § 78c(a)(1).

Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange under Section 3(a)(1). Under Exchange Act Rule 3b-16(a), an organization, association, or group of persons shall be considered to constitute, maintain, or provide "a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.40

A system that meets the criteria of Rule 3b-16(a), and is not excluded under Rule 3b-16(b), must register as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act41 or operate pursuant to an appropriate exemption. One frequently used exemption is for alternative trading systems ("ATS").42 Rule 3a1-1(a)(2) exempts from the definition of "exchange" under Section 3(a)(1) an ATS that complies with Regulation ATS,43 which includes, among other things, the requirement to register as a broker-dealer and file a Form ATS with the Commission to provide notice of the ATS's operations. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

IV. Conclusion and References for Additional Guidance

Whether or not a particular transaction involves the offer and sale of a security— regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

To learn more about registration requirements under the Securities Act, please visit the Commission's website here. To learn more about the Commission's registration requirements for investment companies, please visit the Commission's website here. To learn more about the Commission's registration requirements for national securities exchanges, please visit the Commission's website here. To learn more about alternative trading systems, please see the Regulation ATS adopting release here.

36 DAO Token holders could put forth a proposal to split from The DAO, which would result in the creation of a

new DAO Entity with a new Curator. Other DAO Token holders would be allowed to join the new DAO Entity as long as they voted yes to the original "split" proposal. Unlike all other contract proposals, a proposal to split did not require a deposit or a quorum, and it required a seven-day debating period instead of the minimum two-week debating period required for other proposals.

37 Because, as described above, DAO Token holders were incentivized either to vote yes or to abstain from voting, the results of DAO Token holder voting would not necessarily reflect the actual view of a majority of DAO Token holders.

38 Because, in part, The DAO never commenced its business operations funding projects, this Report does not analyze the question whether anyone associated with The DAO was an "[i]nvestment adviser" under Section 202(a)(11) of the Investment Advisers Act of 1940 ("Advisers Act"). See 15 U.S.C. § 80b-2(a)(11). Those who would use virtual organizations should consider their obligations under the Advisers Act.

39 The Fifth Circuit in Williamson stated that: A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. Williamson, 645 F.2d at 424 & n.15 (court also noting that, "this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.").

For additional guidance, please see the following Commission enforcement actions involving virtual currencies:

• SEC v. Trendon T. Shavers and Bitcoin Savings and Trust, Civil Action No. 4:13-CV-416 (E.D. Tex., complaint filed July 23, 2013)
• In re Erik T. Voorhees, Rel. No. 33-9592 (June 3, 2014)
• In re BTC Trading, Corp. and Ethan Burnside, Rel. No. 33-9685 (Dec. 8, 2014)
• SEC v. Homero Joshua Garza, Gaw Miners, LLC, and ZenMiner, LLC (d/b/a Zen Cloud), Civil Action No. 3:15-CV-01760 (D. Conn., complaint filed Dec. 1, 2015)
• In re Bitcoin Investment Trust and SecondMarket, Inc., Rel. No. 34-78282 (July 11, 2016)
• In re Sunshine Capital, Inc., File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

• Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014)
• Ponzi Schemes Using Virtual Currencies (July 2013)

By the Commission.

40 See 17 C.F.R. § 240.3b-16(a). The Commission adopted Rule 3b-16(b) to exclude explicitly certain systems that the Commission believed did not meet the exchange definition. These systems include systems that merely route orders to other execution facilities and systems that allow persons to enter orders for execution against the bids and offers of a single dealer system. See Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) ("Regulation ATS"), 70852.

41 15 U.S.C. § 78e. A "national securities exchange" is an exchange registered as such under Section 6 of the Exchange Act. 15 U.S.C. § 78f.

42 Rule 300(a) of Regulation ATS promulgated under the Exchange Act provides that an ATS is: any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers' trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading. Regulation ATS, supra note 40, Rule 300(a).

43 See 17 C.F.R. § 240.3a1-1(a)(2). Rule 3a1-1 also provides two other exemptions from the definition of "exchange" for any ATS operated by a national securities association, and any ATS not required to comply with Regulation ATS pursuant to Rule 301(a) of Regulation ATS. See 17 C.F.R. §§ 240.3a1-1(a)(1) and (3)

SEC NO ACTION LETTER – TURNKEY JET INC.

Securities Act of 1933
Section 2(a)(1)

April 3, 2019

Response of the Division of Corporation Finance

Re: TurnKey Jet, Inc.
Incoming letter dated April 2, 2019

Based on the facts presented, the Division will not recommend enforcement action to the Commission if, in reliance on your opinion as counsel that the Tokens are not securities, TKJ offers and sells the Tokens without registration under the Securities Act and the Exchange Act. Capitalized terms have the same meanings as defined in your letter.

In reaching this position, we particularly note that:

- TKJ will not use any funds from Token sales to develop the TKJ Platform, Network, or App, and each of these will be fully developed and operational at the time any Tokens are sold;
- the Tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
- TKJ will restrict transfers of Tokens to TKJ Wallets only, and not to wallets external to the Platform;
- TKJ will sell Tokens at a price of one USD per Token throughout the life of the Program, and each Token will represent a TKJ obligation to supply air charter services at a value of one USD per Token;
- If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens (one USD per Token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the Tokens; and
- The Token is marketed in a manner that emphasizes the functionality of the Token, and not the potential for the increase in the market value of the Token.

This position is based on the representations made to the Division in your letter. Any different facts or conditions might require the Division to reach a different conclusion. Further, this response expresses the Division's position on enforcement action only and does not express any legal conclusion on the question presented.

Sincerely,

Jonathan A. Ingram
Chief Legal Advisor, FinHub
Division of Corporation Finance

INCOMING LETTER:

[LETTERHEAD –

Securities Act of 1933 Section 2(a)(1) and Section 5
Securities Exchange Act of 1934 Section 3(a)(10) and Section 12(g)

April 2, 2019

VIA ELECTRONIC SUBMISSION

Office of Chief Counsel
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: TurnKey Jet, Inc.

Dear Sir or Madam:

TurnKey Jet, Inc., a Delaware corporation ("TKJ"), with its principal business location in West Palm Beach, Florida, proposes to offer and sell blockchain-based digital assets in the form of "tokenized" jet cards ("Tokens"). On behalf of TKJ, I respectfully request that the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") confirm that it will not recommend that the Commission take any enforcement action against TKJ if TKJ offers and sells Tokens in the manner and under the circumstances described below without registration under Section 5 of the Securities Act of 1933, as amended (the "Securities Act") and Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act," and together with the Securities Act, the "Securities Acts").

I. FACTUAL BACKGROUND

A. About TurnKey Jet, Inc. and the Proposed Token Program

TurnKey Jet, Inc. provides interstate air charter services as a licensed United States air carrier and air taxi operator. TKJ currently operates two business jets and is in the process of acquiring a third business jet. TKJ has successfully and profitably conducted flight operations since 2012. In the last two years, TKJ has operated its aircraft for at least 899 flight hours and conducted at least 643 landings for 141 customers. In that time, TKJ has had zero FAA violations or incidents and is accident-free. As discussed in more detail below, TKJ proposes to launch a Token membership program ("Program") and develop a Token platform ("Platform") to facilitate Token sales for air charter services via a private blockchain network ("Network"). TKJ will manage the Program as program manager ("Program

Manager"). Operating the Platform and Network would be within TKJ's economic authority as a federally-licensed air carrier and air taxi operator. Each user will access and use the Platform via an application ("App") that includes a wallet ("Wallet"). There will be three types of users of the Platform, depending on their role in the delivery of air charter services. Users who buy Tokens to consume air charter services are consumers ("Consumers"). Users who take part on the Platform by brokering charter flights between Consumers and carriers are brokers ("Brokers"). Users who deliver charter flights directly to Consumers via the Platform with their own fleet of planes are carriers ("Carriers"). Each type of user will have a distinct membership agreement and collectively the users of all types are members of the Program

("Members"). All Members will be required to pay membership subscription fees to take part in the Program and purchase Tokens. Consumers may be individuals or business entities. Brokers and Carriers are business entities and cannot be Consumers. Consumers will buy Tokens which TKJ will sell only at a price of one United States Dollar ("USD") per Token throughout the life of the Program. A typical transaction will involve a Consumer redeeming bought Tokens for air charter services.

B. Blockchain Technology Solves Air Charter Services Payment Settlement Problems

In supplying air charter services, TKJ faces significant transactional costs and inefficiencies, including delays, regarding payment settlement and regulatory compliance. From a customer's perspective, the delays and inefficiencies can prevent the customer from travelling. As with accepting credit cards, TKJ faces difficulties at times in accepting wire transfers for payment settlement. Further, TKJ must conduct extensive and time-consuming bookkeeping and operations records management of all transactions to meet its regulatory compliance obligations.

As discussed in more detail below, TKJ's proposed Program and Tokens for prepaid on-demand air charter services allows for settlement via blockchain which decreases the settlement time and improves the efficiencies of paying for and obtaining air charter services for both Consumers and TKJ.

Consumers would be able to obtain the air charter services and leave on their trip much faster than under the current system. The advantages of utilizing blockchain technology for air charter services payment settlement include a significant reduction in financial transaction costs that financial institutions charge in payment settlement for air charter services. Transferring Tokens on the Platform and Network will significantly increase efficiencies in the delivery of air charter services. These improved efficiencies and rapid settlement of large transactions that are typical in the air charter services industry will in turn allow for faster delivery of air charter flights. The Platform will diminish the possibility of fraudulent transactions and potential chargebacks, by relying on transparency and distribution via the Network. The Network is private to TKJ Program Members and mirrored across multiple servers, each of which verifies the validity of each transaction and keeps a copy of the entire ledger. TKJ as Program Manager will be responsible for verifying the validity of the ledger. The Platform will allow for increasing global transparency to Consumers, Brokers and Carriers by relying on the Network that will be used to record the terms of the Token contracts, manage documentation and complete transaction terms with immediate payment. This transparency will in turn provide access and insight into the clearing and settlement of the TKJ financial transactions to

prevent disputes because all participants will be able to inspect their personal Platform and Network activity and monitor settlement of their Token redemptions and delivery of air charter flights. These advantages show the utility of the proposed Tokens as an improvement to the existing air charter travel services payment settlement process.

II. PROPOSED PROGRAM AND TOKEN SALES

A. The Token Infrastructure

(i) Blockchain Platform and Network

The proposed TKJ Tokens will operate and be deployed on the Platform and Network consisting of a private, permissioned, centralized blockchain network and smart contract infrastructure operated by TKJ. TKJ will run the Platform and Network and use third-party service providers, as necessary, to meet operational requirements, including providers of internal tools for developers, user-facing app interfaces, wallets, smart contract infrastructure and private network and token management services.

TKJ will account for each TKJ Member via the Wallet that each Consumer uses to hold their Tokens. Each Wallet is part of the Platform, Network and App. TKJ will provision a Wallet to each Consumer, Broker and Carrier who will use the App and Wallet to send and receive Tokens via the Platform to TKJ, Consumers, Brokers or Carriers who are also TKJ Members on the Platform. TKJ Platform participants will be able to view their Token balance and related Platform and Network activities through a console via the App. The respective Token balances and related activities of each Member will not be public, but private to each individual Member and the TKJ Network administrators.

Consumers will not satisfy the obligation to pay for air charter services. Rather, TKJ will satisfy the obligation by paying the Brokers or Carriers directly using escrow funds, which are comprised of the Token sale proceeds, upon the Consumer's redemption of Tokens. TKJ will manage payment to Brokers or Carriers but will have no contractual obligation to do so until Consumers, Brokers or Carriers transfer Tokens to TKJ for redemption.

TKJ will allow Brokers to be Members of the Platform because of antitrust legal concerns that would arise if TKJ were the sole broker of air charter services on the Platform and the Consumer user base became large. The Program attributes will incentivize Brokers to become Members and join the Platform because they will be able to transact with Consumers outside of banking hours using the Platform and App. Currently, Brokers cannot transact outside of banking hours due to the unavailability of wire transfers. Further, Brokers would need to be participants in the Program because the industry still needs their involvement in processing air charter services transactions via phone, email and fax.

There is currently no automated air charter services scheduling and purchase system in place. In addition, Brokers have recently become regulated entities pursuant to 14 CFR Part 295, governing the brokerage of air charter services, and may provide air charter services as agents of Carriers or as principals with Carriers under contract to them. As such, Brokers (which may also be Carriers), as air charter services providers, Carriers (which may also be Brokers), and TKJ (which may be a Broker or

Carrier), will all be regulated entities on the Platform. TKJ will operate the Program in a manner compliant with applicable federal, state and foreign law including regulations of FinCEN, FAA, DOT and other applicable law governing the handling, custody and transmittal of funds, and other matters within their respective jurisdictions. In short, the Tokens, Platform and Network will simply be an air charter services payment debit/credit system for large financial transactions conducted inside and outside of banking hours.

(ii) The Tokens Will Be Smart Contracts Between TKJ and Token Consumers and Subsequent Holders for Air Charter Services

The proposed Tokens will include smart contract functionality and TKJ will create and deploy them on the Platform and Network. The Tokens will meet a token standard based on the chosen Platform technology and TKJ will develop the code for the Tokens with standard-compliant rules and methods, including transferring Tokens from TKJ to Consumers and between Network Members, reporting the balance of Tokens at a certain address, and reporting the total supply of Tokens. TKJ will be in privity of contract with each first Consumer of Tokens and the later holders of the Tokens via the Program membership agreement and the Token sales agreement embedded in the Tokens. The terms of the TKJ membership agreement will vary depending on whether the user is a Consumer, Broker or Carrier. The terms will obligate TKJ to release Token escrow funds to a Broker or Carrier to pay for the provided air charter services to a TKJ Member and holder of Tokens who exercises their right per the smart contract to redeem the Tokens at their equivalent value for those services on-demand.

TKJ, via the Platform, will update the smart contracts corresponding to each Token after each

transfer of Tokens within the Platform to reflect the current holder of the transferred Tokens. The smart contracts will include the terms of service restricting transfer and setting forth that the Tokens are the prepayment of the future consumption of air charter services and there will be no return of principal or interest on the monies that are prepaid. Further, TKJ will use the smart contracts to execute the consideration for TKJ Token redemptions. Consumers will execute separately the respective TKJ Program membership agreements and Token sales agreements prior to issuance of Tokens. The agreed to terms and conditions will be embedded in the smart contract code. The smart contracts will programmatically acknowledge redemptions on the blockchain and notify TKJ of the redemptions for disbursement of the escrow funds corresponding to the Tokens to Brokers or Carriers for payment of the air charter services.

Redeemable for air charter services, the proposed Tokens in operation will be like the business jet card programs that are common in the aviation industry today. The typical jet card program operator arranges flights on behalf of their jet card clients with Carriers. In supplying the service, the air carriers keep complete operational control of the charter flights. Here, the Program Carriers will be part of the TKJ Platform. TKJ will require that all Carriers meet or exceed all FAA and TKJ safety standards. Token issuances to Consumers will occur after they execute a Program membership agreement and Token sales agreement together with a smart contract issued on the Network that contains legally

binding terms and conditions between the Token holders and TKJ to provide air charter services equal in value to the redemption amount of the Tokens. Only Consumers will be able to buy Tokens. The Tokens will not represent a TKJ obligation to supply a specified number of flight hours regardless of cost. Rather, the Tokens will represent a TKJ obligation to supply air charter services to the Consumer/Token holder at a 1 USD:1 USD value, to allow for the variable costs of charter flights, jet fuel, catering, and other incidental costs related to each charter. When a Token enters circulation, TKJ Consumers may freely trade or exchange the Tokens in their possession between any other Consumer, Broker or Carrier within the Network. Only TKJ has the authority and capability to issue Tokens into circulation, or upon redemption remove them from circulation. In addition to the terms of the smart contracts restricting transfer of the Tokens TKJ will implement technical restrictions via the Platform and Network that restrict transfers of Tokens to TKJ Wallets only, and not to wallets external to the Platform.

A Consumer may redeem Tokens to pay for a flight directly with TKJ, which will arrange the flight using its own fleet of aircraft, a Broker or a Carrier. In that scenario, TKJ, as Program Manager, will transfer the escrow funds corresponding to the retail cost of the flight and the redeemed Tokens to itself as a Broker or Carrier and to its own bank account, deliver the flight and then pay for the costs associated with the flight using the transferred funds. In the alternative, a Consumer may transfer Tokens to a Broker or a Carrier other than TKJ to arrange and deliver the flight. In those types of transactions, the Broker or Carrier will then redeem with TKJ the Tokens that the Consumer transfers to the Broker or Carrier for the retail cost of the flight, and TKJ will then transfer the funds held in escrow directly to the Broker or Carrier for payment of the costs associated with the delivered flight. The terms stated in the Program membership agreement, Token sales agreement and each smart contract corresponding to each

Token will obligate TKJ to disburse the escrow funds for the payment of air charter services when a Consumer redeems them. Further, the terms of the Program membership agreement, Token sales agreement and smart contracts for each Token will expressly state that at no time will TKJ have any discretion to do anything with the escrow funds other than disburse the funds for payment of air charter services upon redemption.

At all times, the identity of each Consumer as a TKJ Program Member will be known to TKJ in

compliance with Transportation Security Administration regulations and federal law regarding TKJ's obligations to know its customers. See, e.g., 49 CFR 1540.107, governing passenger identification, which requires all passengers to provide identification using a valid verifying identity document. In addition, all passengers must provide their full name, date of birth, and gender, which is screened against the travel ban watch list in effect at the time of travel. The Tokens will be transferable only to other TKJ Program Members who are eligible to receive Tokens and become Token holders on the Platform and submit to 49 CFR 1540.107. To become a TKJ Program Member, all users must agree to the representations, terms and conditions regarding disclosure of their identity. In addition, prior to redemption and use of Tokens, all Token transferees must hold a current TKJ jet card Program membership which they can only obtain approval for after going through the TKJ application process which includes stringent KYC/AML background checks and TSA anti-terrorism watch list checks.

Construction of the TKJ Platform, Network, App and Token will be funded by TKJ through its own capital resources. At no time will TKJ utilize funds received for the purchase of Tokens to develop the TKJ Platform, Network, App or Token, and each of these will be fully developed and operational at the time any Tokens are sold. At all times, such funds will be held in escrow until redemption. At the time of their choosing, Consumers may redeem their Tokens into air charter services for the best price of those services correlated with the value of those services in the market offered directly by TKJ or by another verified and authorized Broker or Carrier that is a Program Member on the TKJ Platform. A Consumer will be able to redeem Tokens immediately after issuance for air charter services via TurnKey Jet, Inc. under its economic authority as an air carrier and air taxi operator. In addition, Consumers will be able to redeem their Tokens with any other verified and authorized Broker or Carrier that is a Program Member of the Network.

B. The Proposed Token Lifecycle and Steps of the Ongoing Token Sales

Step 1 – TKJ Consumer agrees to the terms of the Program membership agreement and Token sales agreement and deposits USD into TKJ's bank escrow account. The proceeds will be deposited into the TKJ interest-bearing escrow accounts1 at FDIC-insured depository banks corresponding to the purchaser's Tokens, and any interest in those accounts will not be distributed to Consumers/Token holders but will be retained by TKJ.

Step 2 – TKJ creates TKJ Wallet on Platform and Network for the Consumer and credits the Consumer's Wallet with the number and value of Tokens bought. TKJ creates the smart contract and transfers the Token to the Consumer's Wallet. The Tokens are now in circulation with the Consumer as the first holder of the Tokens. The amount that the Consumer deposits equals the number of Tokens issued to the Consumer at a 1:1 ratio (i.e., 100,000 USD deposited = 100,000 Tokens issued).

Step 3 – TKJ Consumers can transfer and exchange Tokens to other Consumers, Brokers or Carriers exclusively on the TKJ Platform and Network. TKJ Consumers, Brokers and Carriers will be contractually and technically restricted from transferring Tokens outside of the TKJ Platform.

Step 4 – The Consumer deposits/transfers enough Tokens from their Wallet to TKJ, a Broker or Carrier for redemption into air charter services. The terms stated in the Program membership agreement, Token sales agreement and each smart contract corresponding to each Token obligate TKJ to disburse the escrow funds for the payment of air charter services upon redemption and TKJ has no discretion contractually to do anything else with the escrow funds.

Step 5 – TKJ, as Program Manager, will destroy the Tokens that the Consumer, Broker or Carrier redeems. Upon redemption, TKJ, as Program Manager, remits the redeemed escrow funds to itself as

1 While the funds will be held in accounts at FDIC-insured banks, the funds in the bank escrow accounts may not be FDIC-insured in full.

Broker or Carrier, or to another Broker or Carrier. Either TKJ, via its own fleet of aircraft, or the other Broker or Carrier, supplies air charter services in the equivalent value amount of the redeemed Tokens. TKJ plans to hold continuous, open-ended Token sales to meet demand. If a Consumer such as a corporation goes out of business, its Tokens will be assets of that corporation. Consumers may redeem their Tokens at any time of their choosing in the future. There will be no time constraints within which period the Consumers must redeem their Tokens after purchase or acquisition. Consumers will be able to receive offers and select the best offer, whether it is from TKJ directly or from one of the other verified and authorized Brokers and Carriers who are also members of the Network. At no time will Token sales include a rebate program, rewards program, or similar or otherwise allow for the monetization of an economic benefit or bonus for buying Tokens. TKJ does not expect resales of Tokens in a large amount. If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens that the holder looks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the Tokens per a forced liquidation. There should not be Token sales to others at a discount because a purchaser may buy Tokens from TKJ at 1 USD per Token, which will cause the market price to stabilize at one dollar. As a result, Consumers will not have an incentive to buy from other Token holders at a premium above one dollar per Token. In theory, a Consumer may be required to sell their Tokens at a significant discount below face value in order to liquidate its holdings, but TKJ does not anticipate that this will occur frequently because of market forces stabilizing the price near one dollar per Token, contractual and technical restrictions on transfer, and timing of purchase and use not requiring advance purchase since the Tokens are immediately redeemable after purchase.

The Tokens will be nonrefundable. Consumers will only be able to redeem their Tokens for air charter services. They will not be able to redeem their Tokens for USD. When a Consumer remits cash payment for Tokens, TKJ will follow the Patriot Act and report such purchases that are more than $10,000 per occurrence. TKJ will use its regulatory tools to identify bad actors and will reserve the right to refuse a Token sale to any such person who looks to become a Consumer as part of illegal activities such as money laundering. For international transactions, TKJ will adhere to all applicable laws and regulations for the jurisdictions that govern the transaction. Consumers who buy Tokens will be protected and will have minimal risk because TKJ will hold their prepaid funds always in escrow until the Tokens are redeemed. The United States government strictly regulates TKJ via the DOT and FAA, among others, and TKJ will hold the funds received from Token sales in bank escrow accounts at United States FDIC-insured depository banks. Hence, TKJ will hold sales proceeds in escrow as collateral to guarantee TKJ's obligation to supply air charter services in the future.

The Tokens will be distributed to Consumers as purchasers such that they meet their on-demand air charter needs as users of the TKJ Platform. They will receive their Tokens at once after purchase and will be able to redeem their Tokens once received with no delay. Consumers will be able to transfer their Tokens in the amount needed to pay for the offered air charter services corresponding to their expected use.

C. Proof of Reserves and TKJ's Obligations to Consumers, Brokers and Carriers as Token Holders

At all times, the total number of Tokens in circulation, being TKJ liabilities, will be fully backed by an equal amount of USD held in reserve in FDIC-insured financial institution escrow accounts located in the United States. Each Token in circulation will represent one United States Dollar held in TKJ escrow reserves in a one-to-one ratio. To complement disclosure and transparency, TKJ will publish regularly in a private forum to Consumers, Brokers and Carriers an independent professional audit of the total amount of USD held in its escrow account reserves and the total number of Tokens then outstanding.

D. Representations Regarding TKJ Program Memberships and Token Sales

- TKJ will offer Program memberships and Tokens to Consumers solely as an opportunity to obtain prepaid on-demand air charter services. All marketing materials will say clearly that Consumers should buy the TKJ Program memberships and Tokens solely for the purpose of obtaining prepaid on-demand air charter services and not for investment purposes or with an expectation to earn a profit.

- The TKJ Program membership agreement, TKJ Token sale agreement and Platform terms of service will require each Consumer or later transferee holder to agree to represent, warrant and acknowledge the following prior to purchasing the Tokens:

• The Consumer is not acquiring the membership or Tokens as an investment and has no expectation of economic benefit or profit as a TKJ Program Member or TKJ Token holder;
• The Consumer is solely acquiring the TKJ Program membership and Tokens for the right to obtain prepaid on-demand air charter services;
• The Consumer is acquiring the TKJ Program membership and Tokens for the Consumer's own use and not with a view to sell or otherwise distribute the Tokens to anyone else in a secondary market;
• All funds paid to TKJ to buy TKJ Program memberships or TKJ Tokens are nonrefundable;
• The Consumer will not have any equity or other ownership interest in TKJ or any affiliated entities; will not have any rights to dividends, distribution rights, or interest from TKJ or any affiliated entities at any time as a result of being a TKJ Program Member and TKJ Token holder; and will not have any voting rights regarding any matters relating to TKJ or any affiliated entities;
• All transfers of TKJ Tokens will be subject to membership restrictions, TKJ Program memberships will be nontransferable, and there is no guarantee that there will exist in the future a market for the resale of TKJ Tokens, and neither TKJ nor anyone else is

obligated to create such a market. When a TKJ Token holder transfers their Tokens to another TKJ Program member, they will not represent to such prospective transferee that the Tokens or membership is an investment opportunity or an opportunity to obtain an economic benefit or profit; and
• The Consumer and subsequent Token holder will not pledge or hypothecate their Tokens.

- All TKJ Program members must execute the membership agreement providing their personal

identity with proof and TKJ Token sale agreement with express terms and provisions substantially similar to the above-stated terms and conditions.

TKJ, its agents and employees will not make statements in the sales process that are in any way inconsistent with the statements and representations above, or otherwise mention profits or an investment opportunity.

III. LEGAL DISCUSSION

For the reasons set forth below, it is my opinion that the proposed sale of Tokens under the TKJ Program will not involve the sale of a “security” within the meaning of Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, and, therefore, that registration under the Securities Acts is not required. Rather, the interest represented by a Token will be a consumptive right to redeem the escrowed funds to pay for air charter services. As such, neither an “investment contract,” a “note,” an “evidence of indebtedness” nor another form of security is present. There is no reasonable expectation of profit derived from the efforts of others, and the Consumer’s expectation will be to enter into a consumer transaction for prepayment of air charter services.

A. Howey and Forman Analyses: The Proposed TKJ Jet Card Program Tokens Fail to Satisfy the Howey Test and Thus Are Not Investment Contracts

It is my opinion that the Tokens will not be not “investment contracts,” see SEC v. W.J. Howey Co., 328 U.S. 293 (1946). The United States Supreme Court in S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946) articulated the Howey test for determining whether an economic transaction is an investment contract that as such implicates the Securities Acts. The Howey test provides that an “investment contract” is present where there is: (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits to be derived solely from the efforts of the promoters or third parties. All elements of the Howey test must be satisfied for an instrument to be deemed a “contract, transaction or scheme” that is a security. Howey at 298–99. The focus of the Howey analysis here is on how and why the proposed Tokens fail to satisfy the third element regarding expectations of profit.

(i) Investment of Money

Since the purchase of Tokens will require the payment of funds, an investment of money under the Howey test exists here.

(ii) Common Enterprise

Since TKJ will run the Platform and Network for managing the creation and redemption of Tokens and allow for Brokers or Carriers to transfer and redeem Tokens to collectively supply air charter services in addition to TKJ as part of the Network, a common enterprise may exist here as well. Consumers, however, will not be invested in the success or failure of the TKJ Program and Platform. Rather, they are buying as consumers prepaid air charter services. As such, they are relying on TKJ to deliver the services as obligated, not to deliver a capital return or other profit on an investment.

(iii) Expectation of Profits to Be Derived Solely from the Efforts of the Promoters or Third Parties

Regarding “profit” under the Howey test, the Supreme Court means “capital appreciation” resulting from an investment of money or “participation in earnings” resulting from the usage of the

investor's funds. See United Housing Foundation v. Forman, 421 U.S. at 852. While the Howey test is flexible, there must be a reasonable of expectation of profit for there to be a security.

The characteristics of the Tokens and terms and conditions of the Program demonstrate that there is no reasonable expectation of any profit that Howey recognizes on the part of any Member.2 This is because Consumers will have no right to share in any income generated by the operation of TKJ (or any other affiliated entity). TKJ will not pay dividends, rebates, rewards, interest or other distributions to Consumers from the operation of TKJ. TKJ will make no distribution of any kind to any Consumers, other than the non-monetary provision of the air charter services using the prepaid Token sales funds held in escrow corresponding to the specific Consumers. Further, Consumers will have no reasonable expectation of profit based on capital appreciation as explained below.

A Consumer will be motivated to buy Tokens by a desire to obtain on-demand air charter services in a more efficient and faster manner than they are able to do so currently. As in Forman, the characteristics of the instrument and the manner in which they are sold indicate that Members will not buy Tokens with an expectation of profit, but rather solely with a view to use them for air charter services. In Forman, the purchasers were screened and qualified, similar to how the Consumers are

2 In the Tuition Plan Consortium, LLP no-action letter, the Staff said that it will not recommend enforcement action where the proposed instruments represented prepaid tuition certificates, and demonstrated similar characteristics to those in Forman (purchaser received right to fixed amount of prepaid future services; provision of services not dependent on third party efforts of others to offer returns; limited transferability; the return on funds was limited to principal plus treasury rate of accrued interest). In earlier no-action letters the Staff agreed that prepayment was motivated by a desire to obtain future services for consumption and not by a desire for profit where pre-need funeral services contracts were offered. See Fleet National Bank (September 5, 1990); Michigan Funeral Directors Association (September 28, 1987). Similarly, since the TKJ memberships and Tokens do not meet the definition of a security pursuant to the Securities Acts and they will not be marketed to the public as an investment opportunity, but rather are prepayment for future air charter services, have limited transferability, and there will be no refunds, granting the requested no-action relief would be consistent with Tuition Plan Consortium, LLP and the related prepaid tuition and prepaid funeral services no-action letters.

qualified when they apply for membership in the Program (via the KYC/AML background check and TSA anti-terrorism travel ban watch list check) and subsequently execute the membership agreement and Token purchase agreement wherein, they agree to abide by Program rules and acknowledge that they are not purchasing Tokens for financial gain. Further, in Forman a purchaser could not redeem the purchase for more than the sales price, while here TKJ will not provide refunds to Consumers, and the Tokens must be consumed for air charter services within the closed Program environment.

Consumers will be motivated to purchase the Tokens in order to prepay for and consume on-demand air charter services, based on the following attributes of the Program: (i) there will be contractual and technical restrictions on transferability of Tokens, because such transfers will be subject to terms of the Token sales agreement, TKJ Program membership agreement and smart contracts that only Consumers, Brokers or Carriers may acquire and hold Tokens; (ii) the Consumers, Brokers and Carriers as Token holders will be advised that they should not acquire Tokens as an investment for profit; (iii) each prospective Consumer as buyer or holder (including transferees) will be required to represent that they are not acquiring the Tokens as an investment and has no expectation of economic benefit or profit as a Consumer; (iv) the Consumers will acknowledge and agree that they are acquiring the TKJ membership and Tokens for their own use and not with a view to sell or otherwise distribute the Tokens to anyone else in a secondary market; and (v) the Consumers will acknowledge and agree that there is no market for the

Tokens, and neither TKJ nor any other person will create such a market. Hence, reasonable Consumers of the TKJ Program memberships and Tokens will not expect and TKJ will not promise any "return" on their payment, or any other "profit" from TKJ Program membership or ownership of Tokens. Similarly, Carriers' and Brokers' expectations are to receive Tokens as compensation for services rendered through the Program and not to earn "profits" for such work.

The attributes of the Program further include: (i) all marketing materials will state clearly that the TKJ Members should acquire the Tokens solely for the purpose of prepaying for and consuming prepaid on-demand air charter services; (ii) the Token and TKJ membership agreements will require each Consumer or subsequent transferee holder to agree to represent, warrant and acknowledge transfer and redemption restrictions; (iii) TKJ will hold all prepaid funds for the corresponding sold Tokens in escrow accounts; and (iv) upon redemption of Tokens, TKJ will utilize the funds held in escrow to pay for the delivery of air charter services directly to Brokers or Carriers as obligated pursuant to the Token sales agreement, smart contract embedded in each Token and Program membership agreement. Based on these attributes and the others discussed here, there would be no reasonable expectation of profit.

In the LA Fan Club, Inc. Membership Program (June 28, 2017) no-action letter, the Staff provided no-action relief relating to memberships involving personal seat licenses and ticket-related member benefits for a professional sports franchise. The terms of the memberships, among other things, provided that they had significant transfer restrictions, purchasers represented that they were obtaining the memberships for their own use and not as an investment or to profit, and they were not marketed to

the public as investments.3 The crux of these letters is that the primary motivation of the purchasers of the seat licenses was to attend events and consume entertainment, not to profit or resell. In each case, this was demonstrated by various characteristics of the asset and the manner in which the assets were sold. This also is the case with the Tokens and the Program.

Here, TKJ has an even stronger argument since the sole purpose of buying the Tokens is to prepay for and consume air charter services. It will not be technically possible to trade and transfer Tokens from the Platform in a non-Platform secondary market at a premium. Further, it will be economically impractical to trade Tokens within the Platform in a secondary market since TKJ will offer continuous, ongoing Token sales at one USD per Token which should cause the market price of Tokens not to exceed one USD per Token. These restrictions on transfer are indicative of the consumptive nature of the Tokens. The TKJ Program memberships are non-equity memberships and will be non-transferable. The Consumers will represent that they are obtaining the TKJ memberships and Tokens for their own use and not as an investment or to profit. The TKJ memberships and Tokens will not be marketed to the public as investments. The funds that the Consumers prepay for the on-demand air charter services will be nonrefundable and will be immediately redeemable for air charter services, so no Consumer will have a reasonable expectation of profit. Thus, granting the requested no-action relief to TurnKey Jet, Inc. would be consistent with the Staff's earlier position in LA Fan Club, Inc. Membership Program and the related personal seat license no-action letters.

As explained above, it is highly unlikely that a Member would be able to buy Tokens and resell them for a financial gain. While such a financial gain is theoretically possible, it is highly unlikely, given the Program's structure, particularly that Members will be able to purchase Tokens from TKJ at the 1 USD fixed price throughout the life of the Program. Any such gain, however, would not result from the entrepreneurial or managerial efforts of TKJ and, accordingly, would not be "profit" under Howey. 4

B. Reves Analysis: The Proposed Tokens Are Not Notes or Other Evidence of Indebtedness Because They Simply Formalize Using Blockchain Technology Open-Account Debts Incurred in the

Ordinary Course of Business of TKJ

It is my opinion that the Tokens should not be viewed as a "note," as such term is used in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, or other "evidence of indebtedness" as such term is used in Section 2(a)(1) of the Securities Act, because they will bear a strong resemblance to those instruments traditionally excluded from the definition of a security pursuant to Reves v. Ernst & Young, 494 U.S. 56 (1990). The Tokens will simply formalize using blockchain technology an open-account debt incurred in the ordinary course of business of TKJ, that is, the obligation to provide air charter services in exchange for the prepayment of those services. Such an

3 Earlier Staff no-action letters exist involving similar circumstances involving personal seat licenses and member benefits, and non-equity memberships. See San Francisco Baseball Assocs. L.P. (February 24, 2006); Ticket Reserve, Inc. (September 11, 2003); Erica Enders Racing, LLC (November 21, 2006).
4 See, e.g., Community Sun, LLC (August 29, 2011) (no-action recommended where solar panel condominium units could be resold by original purchasers for potential profit based on fluctuations in energy markets).

open-account debt is one of the Reves enumerated categories of instruments which are not securities. 5 Here, since the funds paid for Tokens are held in escrow, and each Token has a corresponding 1 USD in an account at an FDIC-insured financial institution available for payment for services upon redemption by the Member, they represent an open-account debt of TJK. Further, the TJK Program memberships and Tokens will not be marketed to the public as investments that earn a profit. This, under these circumstances, grant the requested no-action relief to Turn-Key, Inc. would be consistent with federal case law and Staff guidance.

Turnkey Jet, Inc. plans to begin offering the TKJ jet card membership Program and Tokens as soon as practical after receiving a response from the Division that grants this request. If you need more information to prepare a response, please call me at [Presenter – phone number deleted] to discuss this matter. Thank you for your assistance.

[Presenter - signature section deleted]

5 See generally S.E.C. v. Thompson, 732 F.3d 1151, 1159 (10th Cir.); Tr. Co. of Louisiana v. N.N.P. Inc., 104 F.3d 1478, 1489 (5th Cir. 1997).
6 See also Poplogix, LLC (November 5, 2010) no-action letter where Staff provided a favorable no-action response to a request arguing that certain loans and notes were not securities because, among other things, the terms of the loans and notes provided no possibility of profit or capital appreciation, and were not marketed to the public as investments.

SEC Statement Urging Caution Around Celebrity Backed ICOs
SEC Division of Enforcement and
SEC Office of Compliance Inspections and Examinations

Nov. 1, 2017

Celebrities and others are using social media networks to encourage the public to purchase stocks and other investments. These endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement. The SEC's Enforcement Division and Office of Compliance Inspections and Examinations encourage investors to be wary of investment opportunities that sound too good to be true. We encourage investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons.

Celebrities and others have recently promoted investments in Initial Coin Offerings (ICOs). In the SEC's Report of Investigation concerning The DAO, the Commission warned that virtual tokens or coins sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws. Any celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion. A failure to disclose this information is a violation of the anti-touting provisions of the federal securities laws. Persons making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as unregistered brokers. The SEC will continue to focus on these types of promotions to protect investors and to ensure compliance with the securities laws.

Investors should note that celebrity endorsements may appear unbiased, but instead may be part of a paid promotion. Investment decisions should not be based solely on an endorsement by a promoter or other individual. Celebrities who endorse an investment often do not have sufficient expertise to ensure that the investment is appropriate and in compliance with federal securities laws. Conduct research before making investments, including in ICOs. If you are relying on a particular endorsement or recommendation, learn more regarding the relationship between the promoter and the company and consider whether the recommendation is truly independent or a paid promotion. For more information, see an Investor Alert that the SEC's Office of Investor Education and Advocacy issued today regarding celebrity endorsements.