REIHSEN & ASSOCIATES

SECURITIES LAWS IMPLICATIONS OF DIGITAL CURRENCIES

Blockchain Law Study Group Presentation

July 25, 2017

GERRY REIHSEN

More Than Three Decade Corporate-Securities Attorney

Legal Representation Across Hundreds of Businesses and Industries

Entrepreneur/Founder of Technology and Investment Fund Businesses

Public Company Independent Director & Audit Committee Chair

Non-Profit Founder & Board Member

NOMENCLATURE

Money – a medium of exchange (ex. USD, GBP)

Electronic Money – any money not held in physical form, including representations of sovereign currency (ex. PayPal)

Digital Money – subset of electronic money that has no physical counterpart

Virtual Money – subset of digital currency used for purchasing both digital and non-digital goods

Blockchain – software system that connects blocks of data one to the other (ex. the underlying software that enables virtual currency)

NOMENCLATURE

Coin or Token – a unit of software that is created on blockchain technology that may be "mined", purchased and/or exchanged for other currencies

Distributed Blockchain – software that may be run on multiple computer systems/nodes connected to each node through the internet

Permissionless Blockchain – blockchain software that anyone with the requisite computer systems may run

Open/Transparent Blockchain – blockchain software that is based upon freely available code that anyone on the internet may acquire and use

Mining – The actions of blockchain node parties to create a block in the blockchain, with compensation to the miner for doing so, but sometimes with compensation from the parties with transactions on the block

TYPES OF COINS

Cryptocurrency – A cryptocurrency created with cryptologic software protocol that only produces such currency through that protocol and which beyond currency use has no other functionality. (ex. Bitcoin)

Alt Coins – Coins built off an original cryptocurrency protocol (such as Bitcoin's) that have no functionality beyond this. (ex. Litecoin)

App Coins – A cryptocurrency with an underlying protocol for its creation that also has a functional application on the top of it. For instance, it is used to drive a functional business use for the token.

Platform Coins – A cryptocurrency that is intended to have other coins built on its protocol and/or applications. (ex. Ethereum)

DEFINITION OF SECURITY

[A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement … ***investment contract*** … or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

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

The Securities Act generally applies to the sale of securities, while the Securities Exchange Act of 1934 generally deals with operational matters related to widely held securities. Section 3(a)(10) of the Securities Exchange Act of 1934 also contains a definition of security. The definitions of "security" under the Securities Act and the Exchange Act are treated as being the same, despite some technical differences. (SEC v. Edwards, 540 U.S. 398 (2004) (citing Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990))

TOKEN AS SECURITY – FUNCTIONALITY

With the advent of App Coins tokens can be developed with the same or similar functionality as stocks, bonds and other traditional securities.

Examples of app tokens:

- Entity ownership, equity interest or share of profits and/or losses, or assets and/or liabilities.
- Token to be held as a debt, claim in bankruptcy, repayment obligation.
- Token allowing the holder to convert a non-security token into a token or instrument with one or more investment interests, or granting an option to purchase investment interests.
- Aragon Network/Token (AN) distributed autonomous organization (DAO) designed to act as a digital (non-geographical) jurisdiction for the creation of enterprises much as one would create a Delaware corporation.

TOKEN AS SECURITY – INVESTMENT CONTRACT

SEC v. Howey, 328 U.S. 293 (1946) – interpretation of the term "investment contract" under federal securities laws. When is an orchard not real estate and not trees.

Four/Three part test (escaping any test means no security):

1. **Investment of Money**
2. **Common Enterprise**
3. **Expectation of Profits**
4. **Solely from the Efforts of Others**

Since "expectation of profits" this could refer to any type of return or income which necessarily would be narrowed to the extent it is derived passively (i.e., from the efforts of others) the last two parts are generally analyzed as a unity making this essentially a three part test.

INVESTMENT OF MONEY

"Investment of money includes the **provision of capital, assets, goods, services or a promissory note.** See Int'l Bhd. Of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979); Hector v. Wiens, 533 F.2d 429, 432-33 (9th Cir. 1976); Sandusky Land, Ltd. V. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975).

If a token is not sold by an issuer then this test is not met and therefor no security exists. Bitcoin mining is a good example of this. Persons acquire the protocol software and are allowed to allocate to themselves a prescribed number of Bitcoin for each block in the blockchain they successfully create. (See Teamsters where providing labor in return for possible benefits found akin to obtaining a livelihood rather than making an investment.)

When one acquires a Bitcoin from another (invests in it) does this meet the test? Probably not because the seller is not an "issuer" of the Bitcoin.

Even with this test, it is seen that the tests inform each other, that the "efforts of others" concept essentially requires an issuer.

COMMON ENTERPRISE – HORIZONTAL

Federal circuits have their own pet approaches to "common enterprise"

1. **Horizontal**
2. **Vertical**
3. **Broad Vertical**

Horizontal Approach – Curran v. Merrill Lynch, 622 F.2d 216 (6th Cir. 1980); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101; Wals v. Fox Hills Dev. Corp., 24 F.3d 1016 (7th Cir. 1994)

A common enterprise exists where multiple investors pool funds into an investment and the profits of each investor correlate with those of the other investors.

A token system may be a common enterprise under this analysis where the reward for work (which may be through mining or otherwise) correlates to the reward received by other participants. So if there is an issuer and it retains control over the protocol, the rewards received by the token holders likely seen as correlated. **Giving some or all control over the token protocol may vitiate the common enterprise determination.**

COMMON ENTERPRISE – VERTICAL

The **narrow vertical** approach looks to whether **the profits of an investor are tied to a promoter.** See SEC v. Eurobond Exchange Ltd., 13 F.3d 1334 (9th Cir. 1994).

The **broad vertical** approach finds a common enterprise where **the success of the investor depends on the promoter's expertise.** See e.g., SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

Under either of the vertical approaches a **common enterprise may not exist where a token holder depends on its own efforts (e.g., mining), rather than the issuer's expertise (even if the issuer controls or influences token permissions or protocol management).** The determination is probably around the level of control exerted by the issuer.

The less control/reliance on the issuer for the production of the token, the less likely the existence of a common enterprise.

COMMON ENTERPRISE – START-UP FUNDING

Where the token **payment is used by an issuer to fund its operations unlikely to avoid being found to have created a common enterprise.**

Especially true the earlier in the issuer's prosecution of its business. See Wooldridge Homes, Inc. v. Bronze Tree, Inc., 558 F. Supp. 1085 (D. Colo 1983) where a common enterprise was found in the case of a construction company **pooling presale purchase commitments in order to obtain financing to fund a project** (the completion of the project dependent on generating sufficient investor interest). Very much like the "ICOs" currently in vogue.

The argument against in respect of an App Coin (a token that creates an environment where the token holder can use the system independently for the token holder's own purposes or profit) is that a token's character should not be considered changed because it is sold before the system is constructed or in order to raise funds for construction of the system and should be viewed as the sale of the right to future use of the system in the future and not an investment interest.

This argument is more difficult to carry for a non-functional token.

COMMON ENTERPRISE – RISK CAPITAL

A limited number of jurisdictions have used **the "risk capital test," that can find a common enterprise in the passivity of "investors" where (i) funds are being raised for an enterprise; (ii) the arrangements are offered indiscriminately to the public at large; (iii) the investors must rely on the promoters to effect the success of the enterprise; and (iv) the investors' money is the risk capital.** See Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961).

This test **has been applied in the context of "start-up" capitalization,** particularly where the investment is for club memberships consisting of nothing more than a later right to use facilities. See Jet Set Travels Club v. Corporation Com'r, 21 Or. App. 362 (1975).

This is a significant consideration for pre-platform development ICOs. The finding of the issuance of the token as a security **might be avoided where platform benefits have already been realized by other token holders, e.g., the platform has been fully or partially built.**

PROFITS FROM OTHERS' EFFORTS

As mentioned the Howey tests of an "expectation of profits" and profits derived "solely from the efforts of others" are most meaningfully analyzed together.

These tests **focus on the passivity of the investors and whether the issuer of the alleged security are those responsible for the investors' return.**

Not surprisingly, courts have found ways to read out the word "solely" and generally will find the tests met where **significant or essential managerial or other efforts of the issuer are at the essence of the success of the investment.** See SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482-83 (9th Cir. 1973); and SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

So, **if a token arrangement permits a holder to use, contribute to or license the use of the system or otherwise take an active role essential to the production of profits there would be no passive investment and no security.**

Voting rights or other rights in respect of the token protocol decrease token holder passivity and issuer control/effect on returns and strengthen this result.

INITIAL COIN/TOKEN OFFERINGS

ICOs - used to fund a businesses in the virtual currency ecosystem.

ICO is terrible terminology. Terminology matters. Language used in discussing the sale of tokens may affect the determination the finding of a security, especially the "expectation of profits" analysis. Words like "investment," "returns" or "profits" and other words taken from or analogous to traditional securities investment models will suggest a sale of a token is an investment scheme/security.

Jurisdictions at the forefront of ICOs are Switzerland and Singapore.

Many of the current crop of ICOs prohibit U.S. person purchase. This may derive not only from concerns regarding U.S. securities laws (including the private right of action thereunder) but also from laws requiring FinCEN and state money service business regulation and Anti-Money Laundering and Know Your Customer requirements.

TOKEN ISSUANCE NON-SECURITY ELEMENTS

Lack of Investment of Money

- Avoid issuer compensation (Bitcoin)
- Some try to characterize the transaction akin to a charitable contribution

Lack of Common Enterprise

- Issuance of functional App Coin
- Issue after some of all of the platform developed
- Return not proportional to other holders
- Return dependent on token holder's particular efforts

TOKEN ISSUANCE NON-SECURITY ELEMENTS

Little Expectation of Profits from Others

- Token holder acquired to access a functional purpose rather than profit
- Issuance after token code built or, better, token protocol in place
- Token holders right to affect future of the token/protocol
- Issuer avoids securities offering language and approach
- Token marketed as giving rights to access the network
- No possibility of economic return (may mean prohibition on trading)

REAL WORLD ICO CONSIDERATIONS

ICO purchasers may be highly numerous and anonymous

Securities Laws Issues

- May not be possible to comply with offering registration or exemption requirements
- May not be able to comply with reporting (Exchange Act) requirements
- Securities laws violations consequences – rescission, personal liability, civil and criminal penalties

Business World Issues

- Difficulty complying with other laws
- Probability of exclusion from traditional financing sources
- Anonymous token purchasers may be a risk/liability

FINI

Q&A

Gerald J. (Gerry) Reihsen, III

greihsen@swordshieldlaw.com

214.908.2009