Market Trends 2019/20: Blockchain Security Token Offerings (STOs) – Regulations, Risks, Opportunities, and Potential for Riches

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This practice note covers recent market trends in distributed ledger/Blockchain capital funding and regulation. It focuses on the legal framework for capital formation using distributed ledger/Blockchain technology to enable offerings of coins, tokens, and other rights (digital assets) and developments over the past few years. Blockchain technology is a chain of blocks of discrete bit-lengths containing information embedded in computer code, which when connected to other blocks, constitutes a trusted distributed ledger technology application. Blockchain technology can be utilized for technological, financial, social, business, and legal applications through computer code with embedded smart contracts, smart assets, and other features supporting verification, creation, or recording of transactions involving private and/or public parties. This note highlights the state of current regulation in the United States for Blockchain-related offerings of digital assets.

For additional information on different types of securities offerings, see Private Placements Resource Kit, Initial Public Offerings Resource Kit, Follow-On Offerings Resource Kit, and Offering Documents Resource Kit. For other market trends articles covering various capital markets and corporate governance topics, see Market Trends.

In 1778, the most useful chain was one of 35 tons of forged iron, assembled into at least 53 blocks of nine links (plus connector) each. Strategically strung across the Hudson River at West Point, its use blocked British forces and shipments as a key to the creation of a country which later birthed 150 years of rapid world economic growth. Today, though, we face a backdrop of the black swan of COVID-19 and Thomas Piketty's 2013 annual 2% growth forecast for the balance of the 21st century. Crowdfunding in its various iterations, regulatory reductions, and tax and securities law changes offer somewhat better prospects, particularly when coupled with technological innovations and human ingenuity. Among the recent and COVID-19 era's most useful innovations, is a different type of chain, one commonly referred to as Blockchain; one which, through its myriad computer applications and uses has and shall lever the speed of world economic growth. Blockchain, at core, is simply a technological chain used to record, verify, and/or create transactions—one which is distributed in blocks of cryptographically verified computer code—and includes, in our use, other distributed ledger technologies (such as DAG, directed acrylic graphs). Blockchain, including one of its offspring, cryptocurrencies and coin offerings and other uses, are transforming business and consumer beliefs about currency, trade, competition, and market fairness. Blockchain-related innovations hold promise of various emergent behaviors, widely beneficial economic and social effects, and an above-Piketty world GDP average growth rate, and yet—to the frustration of innovators and regulators alike—the Gordian knot of laws, rules, regulations, jurisdictions, policies, bureaucracies, perspectives, and judgments is. A reasoned Hester Pierce sandbox rule would

secure an unraveling or severing of a portion of that knot and spur further economic growth; we would so counsel. This note, though, is meant to inform as to the state of our present.

Blockchain token and other offerings first appeared around 2013 with the staged initial coin offering (ICO) by Mastercoin—an early Blockchain protocol. The year 2017 and early 2018 saw an explosion of Blockchain-related offerings tempered, since then, by the U.S. Securities and Exchange Commission (SEC) and state blue sky and financial regulatory enforcement activity reining in prohibited activities. The year 2019, perhaps ironically, became the year of enterprise endorsement of the technology with major financial institutions and industry players leading the charge—not what early adopters envisioned. Blockchain's promise is the potential for profound economic and social transformation and wealth creation through, among other results, eliminating the need for many trusted third parties and generating emergent behaviors from self-executing smart contracts embedded within the blocks or other distributed ledger technologies (such as the Tangle network which eliminates the need for so-called miners who cryptographically verify individual transactions). For simplicity, Blockchain is used herein to mean all distributed ledger technology; though the capital funding phenomenon is worldwide, this article addresses only the existing U.S. legal framework.

Blockchain – Digital Age Trading and Finance

Blockchain technology has been called a revolution, akin to the development of the internet, with unlimited potential. One such potential is to fundamentally reconstruct the financial services industry by decentralizing, privatizing, and securing confidential data while lowering uncertainties in trade and economic transactions through consolidated and permanent registries and decreasing costs. Blockchain has, in these few short years, become well-established in the global lexicon. While many uses have been adopted and proved, the technology remains, in many niches, in early adoption and proof of concept stages. To date, it is not widely used by individuals as consumers with notable exceptions in the purchasing and trading of digital assets (such as cryptocurrencies).

So, then, what are the legal and business risks of Blockchain transactions? While a disruptive wave of ICOs raised in excess of $31 billion for formative (or fictitious) businesses from January 2016 through June 2019, the bulk was in the first six months of 2018. With a regulatory crackdown beginning in late 2017, 2019's monthly average had been in the $200 million per month range with the exception of Bitfinex's $1 billion private raise in May 2019. Regulatory enforcement activity and legal uncertainty during 2018, which stemmed the free flow of digital-asset-related capital in the U.S., caused many innovators to launch start-ups in non-U.S. jurisdictions. The ICO has since been replaced in the U.S. by the STO (security token offerings), which is conducted primarily in reliance on private offering exemptions not requiring SEC permission or direct involvement; development of a potentially robust primary market for digital assets resulted. What now hinders U.S.-based digital asset capital markets is the continuing legal uncertainty surrounding the viability of secondary trading markets and little precedent guiding fund-raising using the registration and small offering machinery of our securities laws, including Form S-1 registrations and Regulation A+ "mini-registrations" each requiring SEC involvement and qualification. Market participants attempting to break the ice to access the public markets are currently tasked with a lengthy comment process or simply forced to restructure. Blockstack PBC, a Blockchain software platform for which developers can build applications, was qualified in the first Regulation A+, Tier 2, token offering, July 10, 2019, listed $1,500,000 in legal fees in its Form 1-A filed with the SEC; it was qualified following a 10-month process. Blockstack, having initially filed its offering through a different entity, restructured and made its offering through a public benefit corporation. Similarly, YouNow, Inc. qualified its Props Tokens through the Regulation A+, Tier 2 process in July 2019, intending to issue the tokens as rewards to users of its apps, along with a secondary distribution of tokens by Props Public Benefit Corporation as grants to persons who contribute significantly to the development of the network. Legal fees for YouNow were listed as $1,400,000, audit fees as $200,000. Discussed further below, a best efforts registered IPO for INX Limited on Form F-1 was declared effective by the SEC in August 2020, following a two-year regulatory process, disclosing legal fees and expenses of $3,761,000.

What Is a Blockchain?

Blockchain technology in its most distilled form is a type of distributed digital ledger technology or recording of data sets and transactions and the foundation for transfers of value. Blockchain has become a tagline for its use as a digital ledger in which transactions made in bitcoin or other cryptocurrencies (i.e., mediums of exchange that are digital, alternative, or virtual currencies) are recorded chronologically and publicly. According to the SEC, Blockchain is another term for an electronic distributed ledger that is disseminated to participants in a virtual

organization allowing parties (in theory, and to varying degrees in practice) to transact business securely and privately without third-party intermediaries. Blockchain technology, with its use of cryptographically hash-linked blocks in one organizational model, may enable participants in decentralized autonomous organizations (DAOs) to govern and operate without formalized incorporation or organization, functioning through preprogrammed code running on numerous nodes or computers connected and operating in, for such purposes, ad hoc networks. A DAO is online and considered autonomous because the code of the DAO may only be altered if 51% or higher percentage of the members of the DAO agree to the coding change. The DAO is considered decentralized because participants can acquire tokens to participate in these systems and then later sell or exchange their tokens without the need for any trusted third party (such as a bank or other clearing or verifying authority).

A cryptocurrency using Blockchain (such as bitcoin and ether) may be acquired by interested parties by fiat currency and, if applicable to the particular cryptocurrency through a process called mining (though such mining is not needed using DAG technology). Mining is the process of adding a verified transaction block to the distributed ledger. This results in the miner receiving the applicable formula-established amount of tokens (such as bitcoin or ether) in return for providing the verified proof of work. Cryptocurrency may also be purchased directly from the issuer in an initial or subsequent coin offering or, after issuance, directly from their owner or through any cryptocurrency exchange which has agreed to act in such capacity (and which, in today's regulatory regime, may or may not have appropriate licensure to do so).

Regulatory Approaches

In 2019–2020, as the business and consumer markets for cryptocurrencies broadened, taxation of digital assets posed practical problems. Internal Revenue Service (IRS) Regulatory guidance had been limited to the basic rule of Notice 2014-21, issued by the IRS; providing that cryptocurrencies are property for federal income tax purposes and transfers, unless clearly gifts, result in taxable recognition of gain or loss. Guidance from the IRS in Revenue Ruling 2019-24, an IRS FAQ, and subsequent pronouncements clarified that a taxpayer will have gross income, ordinary in character, following a hard fork if the taxpayer receives units of any new cryptocurrency. The IRS also confirmed that taxpayers cannot defer taxes on exchanges of cryptocurrency under the guise of a like-exchange. The subject of taxation of digital assets beyond these comments is beyond the scope of this paper, the authors noting it is necessary to fully understand the technology and structure underlying a transaction involving digital assets in order to determine the tax classification of an asset, determine whether such asset is treated as stock, commodity, or something else, whether any sale, transfer, or determination of worthlessness is eligible for ordinary or long- or short-term capital gain or loss, and whether there may be other surrounding tax implications (e.g., a sale, lease, or service). An update from the IRS is noted below in Other Key 2019–2020 Developments.

In 2019, the SEC's Trading and Markets Division in conjunction with the Office of the General Counsel of FINRA (Financial Industry Regulatory Authority) published a (long-awaited) joint staff statement on broker-dealer custody of digital assets and specifically noting the statement does not change existing law. While noting that they are in the receipt of applications from new market participants to become broker-dealers authorized to trade in digital assets, the statement highlights and discusses many issues relevant to all persons involved or to be involved in digital assets which are, or may be found to be, securities; a thorough reading of this statement is essential. The statement spans a host of issues including the custody and non-custody of digital asset securities, the Consumer Protection Rule, financial responsibility rules, complexities of safeguarding assets, regulatory approvals needed for existing broker-dealers engaging in material digital asset securities for the first time, and the lack of coverage under SIPA (Securities and Investor Protection Act of 1970) unless the security meets the definition of a "security" under SIPA (which is different than under the Securities Act of 1933 by, in general, limiting it to securities which are subject to a filed and approved registration statement). The platforms having to date received regulatory approvals for trading of cryptocurrencies as an ATS are Coinbase, OpenFinance, tZERO, SharesPost, Templum Markets, and North Capital (PPEX ATS).

Limitless Applications for Blockchain?

Applications for Blockchain technology continue to be developed across arrays of industries, financial, and nonfinancial. The years 2018–2020 saw significant enterprise collaborations developing models and standards and lowering risks to individual enterprises; the Hyperledger consortium, Mobility Open Blockchain Initiative (MOBI), and the Enterprise Ethereum Alliance are notable. Selected other collaborations and initiatives have included the following:

- **Facebook.** The social media giant, in association with more than 25 large international corporations, continues to invest substantial resources to develop the digital

currency, Libra, to secure user payments, including through various social media networks. While PayPal, Visa, MasterCard, Stripe, and others withdrew (for various reasons), the collaboration shows significant promise though opposed by some central banks and others and facing regulatory headwinds.

- **JPMorgan Chase (JPM).** Through its Blockchain center, the bank has developed JPM Coin (for institutional clients to reduce settlement time), Dromaius (for use with debt instruments), IIN (for information sharing in real time), and Quorum (to process transactions with permissioned networks), which has been transferred to ConsenSys (though with JPMorgan Chase reportedly retaining an undisclosed interest). ConsenSyn provides an enterprise version of Ethereum available through Microsoft Azure's Marketplace and designed to integrate with Microsoft's cloud platform.
- **Cargill.** Cargill is building a food source tracking system to address food contamination issues and using Blockchain in trade finance.
- **Starbucks.** The coffee giant has rolled out a coffee bean-to-cup tracking system to trace the origins of a customer's coffee and aimed at connecting these coffee drinkers with coffee farmers around the globe.
- **Depository Trust & Clearing Corporation (DTCC).** DTCC is implementing a new system for custodianship, with records for securities accounts to be moved to AxCore, providing access to a single real-time trade ledger, and has launched ION (an alternative settlement proof of concept protocol) and Whitney (a security token ecosystem supporting the issuance, distribution, and exchange of securities through smart contracts).
- **MasterCard.** Having developed a Central Bank Digital Currency Testing Platform, MasterCard is working with several central banks, and promoting its platform to central banks and commercial enterprises for testing.

As enterprise consortia focus on Blockchain solutions to enhance business processes, the technological uses have eclipsed the scale of development of cryptocurrencies.

Original Killer Apps of Blockchain – Bitcoin and Ether (and Other Virtual Currencies)

Blockchain technology entered the public awareness through a burgeoning market for cryptocurrencies. Bitcoin economic transactions, in particular, were called the first "killer app" of Blockchain technology and seemed to be the catalyst for widescale distributed ledger innovation and design. Cryptocurrencies exist in many forms; the earliest cryptocurrencies being virtual currencies purporting to operate like coin and paper legal tender, such as bitcoin (and later ether and ripple). Virtual currencies are, to date, issued (either in a limited or other manner) by five countries with at least five more likely close behind. Japan, in 2018, began to accept bitcoin as legal tender. Virtual currencies are created and memorialized in digital ledger systems and are used by some vendors and consumers for trading goods and services worldwide though initially banned by many countries (including China limiting bitcoin activity).

Bitcoin

The phenomenal growth of the most well-known cryptocurrency, bitcoin, raised awareness of uses of Blockchain technology and fueled its growth. The first bitcoin transaction occurred in January 2009 on the heels of the 2008 financial crisis in part due to distrust of traditional financial authorities and anti-establishment sentiments. Bitcoin was initially designed to act as a secure peer-to-peer decentralized payment system. Despite having no government recognition as fiat capital (except in Japan) and a designed limitation on supply, bitcoin surged with a market capitalization of in excess of $240 billion (i.e., valued as one bitcoin equals as high as $19,783.21) in December 2017 (contrasted with a bit over $200 billion as of September 2020). Bitcoin is a scarce asset due to the finite number of bitcoins that are capable of being created (a maximum of approximately 21 million) under its coding structure (with about 85% mined to date and with all anticipated to be mined by 2140) with somewhat under four million bitcoins believed missing or lost. The speculation is that miners, by being the first to cryptographically hash a block and thereby "minting" a code-fixed number of automatically issued new bitcoins, will no longer be needed after 2140, although verifications will continue through transaction fees to be charged for each transaction. Bitcoin's market correction during 2018—falling below $6,000—and, though always volatile, approximates $11,000 as of September 2020. Bitcoin's market capitalization accounts for over 50% of the total cryptocurrency market (approximately $350 billion in September 2020).

Ethereum

The Ethereum platform market is younger than bitcoin and developed preternaturally after its 2015 live launch. The Ethereum cryptocurrency is called ether and was initiated following an initial offering of 60 million units of ether raising $18.5 million. Ethereum's website describes ether as:

> A necessary element—a fuel—for operating the distributed application platform Ethereum. It is a form of payment made by the clients of the platform to the machines executing the requested operations. To put

it another way, ether is the incentive ensuring that developers write quality applications (wasteful code costs more), and that the network remains healthy (people are compensated for their contributed resources).

This market is considered to have more utility and flexibility of use than bitcoin, allowing the execution of smart contracts and serving as a problem-solving development platform for a range of industries. The Ethereum platform describes itself as focused on the creation of decentralized markets, "store registries of debts and promises," and moving funds in accordance with past instructions, all without an intermediary or counterparty risk. Ether is currently capped at 18 million ether released per year, although the rate of issuance is expected to change over time. In April 2018, the founder of Ethereum proposed capping the maximum supply of ether to 120,204,432 (double the amount of the original issuance) to ensure the economic sustainability of the platform over time.

More recently a crypto finance trend is emerging—bitcoin, ether, and other cryptocurrencies may be deposited by users and speculators to facilitate liquidity or provide loan collateral in exchange for governing tokens of new networks on decentralized finance exchanges or DeFi platforms. (See also "National Bank Custody of Crypto" below.) The earliest use case was the COMP token. The DeFi and related yield farming trend is without question speculative and high risk for users and included here only to illustrate the complex finance trends evolving and supporting early digital networks.

Trends in Blockchain Capital Formation

The ICO disruption in the capital markets slowed in the U.S. mid-year 2018, punctuated by federal and state regulatory pronouncements and enforcement actions focusing primarily on fraud and the failure to register digital asset offerings with the SEC and state securities commissions.

The regulatory climate in 2019–2020 struck a balance between regulators' desire to allow the creative processes necessary to technological innovation and forbearance, though intervening strategically to maintain the integrity of the financial markets. Following July 2019 guidance relative to secondary trading markets (which would allow securities professionals such as broker-dealers, investment advisers, and custodians of digital assets to best comply with the framework of existing securities laws) some additional marketplaces (alternative trading systems of which 55 have been approved by the SEC as of September 2020) exempt from registration as an exchange have emerged, of which some, such as SharesPost and tZERO, permit trading of certain cryptocurrencies. This is progress; however, the aftermarket needs of our growing digital economy remain unmet. The July 8, 2019 SEC/FINRA joint statement noted above, while addressing and providing needed clarity did not, and could not, address many issues and risks. More time—measured in years—will likely be needed before the niche of engaging in digital asset securities is sufficiently refined to provide comfort to many industry participants. And yet, the benefits which the niche portends may be well worth the risk of engagement, a decision which each potential participant will, in conjunction with such person's qualified advisers, need to make.

Other key 2018–2020 securities law guidance and actions include the following some of which are expanded upon further below:

- In the action, In re Tomahawk Exploration, the SEC deemed a token airdrop as a sale of securities.
- William Hinman, the director of the Division of Corporation Finance at the SEC gave the "When Howey Met Gary" speech at the June 2018 Yahoo conference in San Francisco opining, "the economic substance of the [token] transaction always determines the legal analysis, not the labels."
- FinHub was established as a center of contact to allow market participants to interact directly with the SEC Staff.
- Enforcement actions focused on the failure to register an offering or qualify for an exemption in Blockvest, TokenLot, Crypto Asset Management, Longfin, IPro, Nextblock, Pachecko, and Kik Interactive with Kik reported to be contesting the SEC.
- Gladius Network, LLC settlement was reached regarding following an issuer self-reporting and willingness to take remedial steps.
- Framework for "Investment Contract" Analysis of Digital Assets, published by the Division of Corporation Finance of the SEC, in April 2019.
- In April 2019 and July 2019, the SEC Staff issued the first token no-action letters first to TurnKey Jet, a charter jet company, tokenizing redeemable gift cards for charter jet services, and then to Pocketful of Quarters, Inc., an online video gaming company, issuing its "Quarters" as in-game app currency to video gamers, developers, and influencers.
- In March 2020, the Southern District of New York granted, in the action SEC v. Telegram, the SEC's motion for a preliminary injunction blocking the transfer of the network's cryptocurrency called "Grams" based on the

SEC's showing the transfer of Grams to sophisticated accredited investors was, in economic reality, an unregistered public offering of securities for which the initial purchasers for the Grams would be statutory underwriters under the Securities Act.

Blockchain Funding – Trends in Offerings of Digital Assets

Blockchain technology offerings, previously known as ICOs and more recently, STO, emerged as investments or implausibly argued digital currency. They were implausible—even with both bitcoin and Ethereum, insofar as at the outset of each, through the time of a critical decentralized mass:

- A limited group was responsible for distribution.
- There was no (or little in the case of Ethereum) utility or value apart from the prospects of future value.
- There were analogs to the social media donation and charitable crowdfunding popularized by Kickstarter and, for investment contracts, the resulting crowdfunding legislation and SEC rulemaking legally formalized under the JOBS Act.

ICOs were born in 2016 and 2017 as somewhat of an exclusive club for technology investors with specialized training or education, as well as access to information, about building systems, platforms, and applications for relevant markets. Later, in 2017 and early 2018, the ICO phenomenon quickly became the center of attention for speculators with no awareness of, or with a conscious disregard for, securities or other legal requirements (propelled in part by success stories of digitally disruptive companies in taxi services and consumer retail which grew on such a philosophy).

ICOs, Interrupted

This seemingly (to the unknowledgeable) unregulated ICO wild-west slowed following the SEC release of its DAO investigative report warning issuers of cryptocurrencies that offerings may be subject to U.S. federal and state securities laws (The DAO Report). The DAO Report cautioned market participants that the sale of tokens must be analyzed under the test created in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), defining an investment contract as involving the investment of money, in a common enterprise, with an expectation of profits from the efforts of management or other third parties.

2018–2020 Regulatory and Enforcement Trends

In a series of enforcement actions beginning with the Munchee action, the SEC Staff applied the Howey test to offerings of digital assets to determine when an arrangement or instrument may constitute an investment contract and thereby a security.

In the Matter of Munchee, Inc.

In December 2017, having scrutinized an ICO sale of subscriptions for purported utility tokens, the SEC issued a cease-and-desist consent order (the Order) In the Matter of Munchee, Inc., preemptively halting the distribution of tokens to fund a restaurant review app for use with iPhones as an unregistered sale of securities. The SEC observed that Munchee targeted purchasers of digital assets reasonably expecting profits from a rise in value due to the creation of a Munchee ecosystem resulting from Munchee's efforts and those acting on its behalf. The Order held that the sale was of an unregistered security in violation of the Securities Act. The Order notes that even if the so-called MUN tokens had a practical use at the time of the offering, such focus would not preclude a finding that the sale of subscriptions constituted the sale of an unregistered security. The SEC's analysis turned on the classification of MUN tokens as investment contracts, focusing on, among other factors, Munchee's general solicitations touting the opportunity to profit and promising to develop a secondary trading market within 30 days of the conclusion of the offering. While many legal commentators have stressed the need for centralized or directed management (as opposed to a distributed autonomous organization) in order to find an investment contract constituting a security, the Order, perhaps strategically, cites the language of United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (Forman), which does not mandate such a conclusion. The Forman decision holds that it is the entrepreneurial or managerial efforts of others which govern whether something is a security. The holding would not seem to dictate a difference in result dependent upon whether an issuer actively managed or aided in the development of an ecosystem or whether profits emerge from the independent entrepreneurial efforts of others (which is a characteristic of emergent systems) participating in distributed autonomous organizations.

Contemporaneously with the Order, the SEC chairman Jay Clayton issued a statement on cryptocurrencies and ICOs, noting that, no ICOs had been SEC registered and no exchange-traded funds containing cryptocurrencies had been registered, and that offerings of coins or tokens occur outside U.S. borders. He stated he asked the SEC's Division

of Enforcement to police and vigorously enforce violations of the federal securities laws in this arena foreshadowing a handful of enforcement actions in latter 2018 and 2019, some of which are set forth below.

Tokenized Securities

If the token, coin, or other digital asset purchased provides an ownership interest in equity, or a future right or conversion right to own a stake in a common enterprise or receive returns based upon the traditionally defined managerial work of others, the digital asset will generally be considered a security under the traditional Howey test described below.

Regulation D – Primary Exemption for STOs

Tokenized securities are now most often sold in STOs under Regulation D of the Securities Act, and Rule 506, requiring no SEC involvement other than the filing of a Form D report (which report is required though not a condition to the exemption). Issuers must be aware that tokens are not, to date, expressly included in the federal securities law definition of "covered securities" and, thus, are not preempted from state securities registration except to the extent exempted, such as being sold under Regulation D.

Currently, issuers in STOs are required to comply with state securities or blue sky laws in states where the tokenized securities are offered and sold, and secondary (non-issuer) sellers of the tokens must comply with the state blue sky laws in resale transactions to the extent such token constitutes a security.

Howey Factors and the 2019 Framework

The SEC has, in the Hinman speech "When Howey Met Gary" (Hinman Speech) and in other public statements, made it abundantly clear that labeling a digital asset, a token would not take it out of the purview of the U.S. securities laws; perhaps more importantly, it has suggested that a promoters' or third party's efforts driving the expectation of a return is critical to the Howey analysis. As had been anticipated, the FinHub staff of the SEC solidified the Hinman speech by publishing in April 2019, its Framework for "Investment Contract" Analysis of Digital Assets, available here, (2019 Framework) incorporating some of the considerations from the Hinman Speech and moreover, describing features of an offering and factors that could be dispositive that an issuer is offering an investment contract and thus subject to securities laws. The 2019 Framework focuses upon the efforts of others, the expectation of profits, and other relevant factors; a thorough working through its questions and the issues in the context of any particular digital asset is essential to any determination as to whether the digital asset is a security. The authors note that some of the many factors discussed in the framework may be afforded more weight and be more controlling than others and are fact and context specific.

Central to this 2019 Framework is the concept of, need for, and roles of any Active Participant(s) (AP). AP includes one or more of any "promoter, sponsor, or other third party (or affiliated group of third parties)" who or which provide, "those essential managerial efforts which affect the failure or success of the enterprise" especially 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." The presence, role(s), and reliance on any AP seem viewed through the lens of two key issues: management impact and scale of operational functionality. (1) Management impact. Included in this analysis should be such questions as: 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" as opposed to efforts that are more ministerial in nature? The 2019 Framework defines the AP as being "responsible for the development, improvement (or enhancement), operation, or promotion of the network 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." (2) Scale of operational functionality. A central theme of this analysis is a focus on whether the network/enterprise been fully developed and become operational such that its use is meaningful as well as whether the digital asset can now be used and whether a third party would reasonably now use such digital asset on the network at a value roughly corresponding to its proposed sale or purchase price.

A way to think about the digital analysis security analysis is, perhaps, to answer this question: Has the network become, effectively, a functional operating system/network of sufficient critical mass for which the applicable digital assets have a value directly correlated and limited to their current use of, in or on such system/network? If the answer is yes, then it would seem not to be a security. If the answer is no, barring specific SEC pronouncements (such as pertain to bitcoin and ether), it is most likely (given the current state of the market) and should be assumed to be a security.

If the answer is no, yet treatment as other than a security is sought (or need be confirmed), then focus should shift to whether active centralized system/network management

on some intermittent or more frequent basis is required to be fully developed/operational. If such active management is required, then the analysis need specifically focus on the centralized nature of such management as well as what portion of the current non-use value is dependent upon such future management action. The more intense, more frequent, and more centralized the active management coupled with a lower correlation between the digital asset's current use value to future use value, the higher the probability that the digital asset is or would be found to be a security. The outcome of whether the digital asset is, if the network is operational, or will be, at the time of the sale/issuance, a security under the objective economic-reality test set forth in the 2019 Framework becomes a judgment call; all risk, absent a no-action letter issued to the issuer by the SEC, is (whether by SEC or state securities regulators enforcement actions or third-party civil suits) upon the issuer, control party(ies), underwriter(s), and others who participate (e.g., investment adviser, promoter, seller) in the offer, sale, or purchase for whom statutory or other liability may lie. Moreover, in such an analysis, the more facts (e.g., text messages, emails, websites, draft whitepapers, discussions, solicitations, press releases, press articles, interviews, internal, or external non-privileged communications) which skew against current use value in a fully functional/developed network or system by touting, stating or implying the digital asset's future increase in value for its future use, to justify its purchase or holding based upon a probable increase in value, and/or warranting its sale based upon factors other than current use, regardless of how the system/network may have evolved, the seemingly higher the probability that the digital asset's treatment, in connection with its sale, purchase, or holding would be found to be a Howey investment contract—a security.

The 2019 Framework—to be used when making such a detailed analysis—provides, among other listed factors if the below facts are present, the digital asset is likely to be an investment contract under Howey:

- 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 and also the AP promises further developmental efforts in order for the digital asset to attain or grow in value.
- Essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users or decentralized network.
- An AP creates or supports a market for, or the price of, the digital asset.
- AP has a lead or central role in the direction of the ongoing development of the network or the digital asset, and especially where 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.
- Among other factors, 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.

SEC Actions Focus on Failure to Register

From 2018 through 2020, the SEC selectively exercised its powers of enforcement in an evenly measured manner. In August 2018, the Staff sent a message to the market in the action In re Tomahawk Exploration that token airdrops or gifts of tokens may constitute a Section 5 sale of securities under the Securities Act. Here, the SEC affirmed that by gifting tokens to generate interest in the ICO, the issuer Tomahawk received economic value in the form of online marketing and the creation of a public trading market, despite not receiving capital in exchange for the tokens.

In two other actions, the SEC focused on organizations issuing or dealing in digital assets which are clearly securities which have failed to register under the Securities Act. In the Matter of TokenLot, LLC et al., the first SEC order charged an unregistered broker-dealer operating in the cryptocurrency space (TokenLot Order) and In the Matter of Crypto Asset Management, LP, a SEC order was issued against an unregistered hedge fund.

The TokenLot Order involved a platform described as an "ICO Superstore" facilitating the purchases of digital assets in an ICO. The order is an example of the SEC's stated "functional approach" considering the circumstances in assessing unregistered digital activities in whether the definition of broker or dealer is met, regardless of a party's self-description of its activities or the technology used to provide the services. On the same day as the TokenLot Order, the SEC instituted cease-and-desist proceedings against a hedge fund whose primary purpose was investing in digital assets finding the fund and its managers violated Sections 5(a) and 5(c) of the Securities Act for failure to register securities and had improperly failed to register the fund as an investment company under the Investment Company Act of 1940 (ICA), and also finding both respondents had violated the anti-fraud provisions of the Investment Advisers Act of 1940 for untrue statements or omissions to investors or prospective investors in a pooled investment vehicle.

Self-reporting paid off for Gladius Network, LLC, a Blockchain-enabled cybersecurity services firm. In February 2019, the SEC published the order In re Gladius Network, LLC, charging Gladius with a violation of Section 5 involving its failure to register digital assets with the SEC following a capital raise yielding $12.7 million in ether. Demonstrating its willingness in taking prompt remedial steps, Gladius cooperated with the investigation. The SEC's press release stated it did not impose a penalty as part of the cease and desist order because the company self-reported the conduct, agreed to compensate investors, and will register the tokens as a class of securities on Form 10 under the Exchange Act.

Since SEC v. Telegram, referenced below, and among other actions, the SEC has charged a film producer and rapper, among others, for participation in two fraudulent ICO's, civil penalties have issued, and criminal charges are pending in federal court. In a more recent action, the SEC has agreed that the issuer, Unikrn, a sports betting operation, of an unregistered ICO (raising $31 million in Unikoin Gold tokens) will, without agreeing to the allegations, disable the tokens and pay a penalty, all of its remaining assets, $6.1 million, for distribution to the investors through a, "Fair Fund." It is likely that a stream of such SEC and state civil (and DOJ and state criminal) enforcement actions will continue for so long as promoters either or both fail to secure qualified counsel or knowingly engage in unlawful conduct.

Utility Tokens

Certain models of token ICO's are sold or presold with utility or product-like rights and features. These may include rights to vote or contribute labor, as well as rights to access, mine, and license the Blockchain technology at hand. Federal and state regulators, legislative groups, Blockchain industry groups, U.S. law firms, and securities practitioners now generally concede that in some situations, token sales used solely to purchase products, services, or mining rights in enterprises under development—that is, they have a direct utility and the price reflects the utilization price and not an investment, should not (provided they are not directly, indirectly, or implicitly marketed using their potential as investments) be considered securities under U.S. federal laws based on the Howey legal framework. The theory behind this thinking is that the token value is derived from speculations in the token's asset class and consumer uses in the related network, rather than an expectation of future profits from those involved in the management of the enterprise. In the case of utility tokens that are purchased mainly for consumer-like uses (e.g., for bartering, trading, coupons, or in payment for services, products, or network fees), the Howey test profit motive arguably may not exist or may be secondary to the consumptive nature of the transaction. Utility tokens may provide membership rights, loan collateral, or redeemable coupons for goods and services. Utility tokens, in some cases, may act as currencies in a functional network.

The referenced **2019 Framework** provides that if the following characteristics of use or consumption, are present, the more likely the digital asset is a utility token, and the less likely the Howey test is met (having reached or provided what might be viewed as a critical mass):

- 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.
- Prospects for appreciation in the value of the digital asset are limited; its value will remain constant or even degrade over time.
- For 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.

By way of example, bitcoin and ether are generally not considered to be investment contracts or securities based on recent statements of representatives of the SEC given the present decentralized states of these cryptocurrencies. Unfortunately, for many situations there will be no bright-line test, with facts and circumstances overlaid on the 2019 Framework (and any other SEC pronouncements) requiring counsel's judgment (or a no-action letter) required for a determination of whether a security is present.

TurnKey and Pocketful of Quarters No-Action Letters

In April 2019, the SEC Staff publicly acknowledged and granted no-action relief to the first utility token in TurnKey Jet, Inc., SEC No-Action Letter (TKY NAL). TurnKey Jet, Inc. headquartered in West Palm Beach, Florida, proposed to offer and sell Blockchain-based digital assets in the form of "tokenized" jet cards to facilitate air charter payments and travel arrangements efficiently through a Blockchain-based settlement system.

The SEC's response contained the conditions below, which may be seen especially restrictive where the token product in question may not have been ever considered an investment contract, but for its context as a Blockchain-based token:

- TKJ would not be permitted to 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 TKJ tokens are sold.
- The tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold.
- TKJ tokens will restrict transfers of tokens to TKJ wallets only, and not to wallets external to the platform.
- TKJ would only sell its tokens at a price of $1 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 $1 per token.
- If TKJ offers to repurchase tokens, it will only do so at a discount to the face value of the tokens.
- The token would be 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.

The SEC Staff issued a second no-action letter in July 2019 to Pocketful of Quarters, Inc. (POQ NAL), an online video gaming company (POQ), allowing the company to issue its "Quarters" to video gamers as a "universal gaming token" without registration. The Quarters have an unlimited supply and fixed price, and unlike in TKY NAL are also exchangeable by certain developers and influencers for ETH although no exchanges are to occur outside the Quarters platform. The conditions outlined in the POQ NAL mirrored those in TKJ while also adding an additional condition that the Quarters could only be exchanged by the game's developers and influencers (with approved accounts) for ETH at predetermined exchange rates. Additionally, the POQ NAL stipulates developers and influencers with special exchange accounts must undergo Know Your Client / Anti-money Laundering reviews initially and on an ongoing basis.

Fortunately, and in line with the creation of FinHub and helpful to practitioners, the SEC now emphasizes a coordination between the SEC Staff and market innovators to develop solutions to difficult legal questions within the Howey framework that will allow socially beneficial advancements. Practitioners may receive further guidance from the FinHub staff related to structuring the token, features of the digital asset, and operation of the network to determine if seeking a no-action letter may be warranted under the circumstances.

Certainly, this is only the beginning of the utility token story. The TKJ NAL met with some commentary that the staff no-action letter-imposed conditions on what was clearly a non-security. At the least, some experienced securities practitioners may take comfort from TKJ and POQ that the SEC has been willing to exempt stored value digital assets under certain conditions and advise their clients accordingly.

SEC v. Telegram

The SEC's enforcement action against Telegram Group Inc. and its wholly owned subsidiary TON Issuer Inc. (Telegram Entities or Telegram) in October 2019, is an important development in the regulation of digital assets as securities. In its complaint for a temporary restraining order, the SEC alleged the cryptocurrency network engaged in the unregistered sales of securities to finance its business by selling approximately 2.9 billion Grams to 171 initial purchasers worldwide of which 39 were U.S. investors. The Telegram Entities, organized in the British Virgin Islands, created an encrypted messaging application with over 300 million users that developed a following within the cryptocurrency community.

The SEC sought to enjoin the Telegram Entities from delivering the Grams it sold under securities purchase agreements to initial purchasers in 2018, stating it was anticipated that upon distribution, the initial purchasers would act as "underwriters" as defined under Section 2(a)(11) of the Securities Act and resell the Grams into a secondary public market in an unregistered offering of securities. On March 24, 2020, the U.S. District Court for the Southern District of New York issued the injunction in favor of the SEC with analysis under the Howey test barring the delivery of Grams and finding that the SEC had shown a substantial likelihood of proving that Telegram's sales were part of a larger scheme to unlawfully distribute the Grams to the secondary public market, setting aside representations, warranties, and undertakings of the initial purchasers to take the Grams for the investor's own account and not with a view towards, or for resale in connection with, sale or distribution.

Telegram gave notice of the offering filing on two occasions the Form D Notice of Sales of Securities with the SEC in January 2018 and March 2018, checking the exemption Rule 506(c), describing the type of security as a "Purchase Agreement for Cryptocurrency" with a minimum investment of $1,000,000. The Form D notices stated the offering was made under a claim of federal exemption under Rule 506(c) and/or Regulation S under the Securities Act of 1933. According to court records, representatives of the SEC and the Telegram Entities were in discussions during 2019 regarding the launch of the Gram Network.

Although notices were filed with the SEC purporting to claim a Regulation D exemption, the court stated that no private placement exemption was available given that the purchase agreements were part of a larger scheme to evade the registration requirements of the U.S. federal securities laws by making a public distribution of the Grams. Moreover, in a subsequent clarification-of-order hearing in which Telegram argued that the ruling should not apply to foreign purchasers where substantive foreign law applied to the purchase agreements, the court upheld the injunction on the basis that Telegram's operational scheme, which contemplated that purchasers would be able to sell into a public secondary market, would likely result in U.S. purchasers despite post-preliminary injunction issuer devised plans to safeguard against future sales to U.S. purchasers; given the anonymous nature of subsequent purchasers whose assurance at the time of purchase of non-U.S. connection provided the court insufficient comfort as neither efficacious or enforceable even if the issuer would have adopted such plans before the preliminary injunction hearing and have drafted its original unamended agreements with existing purchasers to have so provided.

The Telegram Court's conclusion that Telegram in "economic reality" conducted a single transaction (aggregating the initial purchase agreement contract, with the subsequent delivery of the Grams later in time, coupled with eventual resales of those Grams) should be carefully evaluated as it may be that under differing facts and circumstances it would seem that another more-favorable-to-issuer result should yield. Perhaps, out of an abundance of caution, a no-action letter should be sought by issuers in similar, but apparently compliant, circumstances as the SEC in Telegram took what under various IRS case reasoning would be a step-transaction or substance over form approach. Under the SEC Staff's FINHub guidance (including Director Hinman's 2018 speech), the evaluation of a digital asset as a security, commodity, or other utility asset should be evaluated over time as should the decentralization and functionality of the network (including the status post-network launch) at the time of delivery and/or resale of the digital assets. Clearly, the SEC and district court decision forewarns that under an "economic realities" approach, the Purchase Agreement representations and warranties must be carefully structured and aligned with the developers marketing materials, the disclosure materials, and the stage of development of the Network.

In June 2020, the SEC announced that it obtained court approval of settlements with the Telegram Entities to resolve charges that Telegram's unregistered offering of digital tokens called "Grams" violated the federal securities laws. The Telegram Entities agreed to return more than $1.2 billion to investors and to pay an $18.5 million civil penalty.

Filling the Gap – Proposed Rule 195: When Is a Token Transaction Not a Securities Transaction?

In an unusual action by an SEC commissioner, on Feb. 6, 2020, Commissioner Peirce delivered an undaunted speech at the International Blockchain Conference in Chicago entitled Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization, accompanied by a preliminary proposal for a three-year nonexclusive safe harbor for network development projects to issue tokens which should not be treated as traditional securities transactions under the Howey test for investment contracts. Describing a "regulatory Catch-22," Commissioner Peirce focused on the void in a U.S. regulatory framework which does not currently, under the Howey test considerations, allow the network developers transfers of their tokens into the hands of other network participants and users of the would-be network enabling the network to move towards and achieve network maturity. The proposed Securities Act Rule 195, authored solo by Commissioner Peirce, one of five SEC commissioners, outlined a framework under which developmental tokens would be afforded a registration exemption for up to three years if the proposed rule were made policy.

Key conditions in the proposed Rule 195 safe harbor include the following:

- The initial development team for the digital asset must intend the network to be fully decentralized or functional within three years and take reasonable efforts to achieve that end.
- The initial development team must disclose information on a freely accessible public website, as well as commit to provide any subsequent material updates, including disclosures of source code, transaction history, the token launch, supply and release process, and timeline for network development.
- Tokens must be sold for the purpose of facilitating access to, participation on or the development of the network.
- The initial development team must undertake good faith and reasonable efforts to create secondary market liquidity.
- A notice must be given to the SEC of distribution of the tokens with a member of the network development team attesting that all the conditions of the safe harbor are satisfied.

The Rule 195 proposal envisions that the initial development team disclosure will in fact be subject to the anti-fraud rules of the Securities Act and that if network maturity were not achieved within the three-year safe harbor registration, under the Securities Act would be required. At the end of the three-year period, digital asset transactions would not be deemed a securities transaction if the network is either a decentralized or functioning network on which the digital asset can be used for the exchange of goods or services. The proposed Securities Act Rule 195 would also create an exemption under the Exchange Act of 1934, allowing token exchanges to facilitate digital asset sales transactions that were conducted pursuant to the rule. These exchanges would be considered exempt from the Exchange Act's definitions of "exchange," "broker," and "dealer" if activities are conducted pursuant to Rule 195.

The draft Rule 195 followed on the heels of the SEC's October 2019 filing of the publicized complaint and motion for a restraining order against the Telegram Entities from continuing their ongoing offering of Grams. Commissioner Peirce's proposed safe harbor solution was timely and seems even more so juxtaposed with the Telegram outcome. Following Telegram, the stark regulatory gap between digital asset development and decentralization is further pronounced with continued significant economic consequences for market participants unable to complete their projects some years in the making.

As of the time of this update, the Rule 195 token safe harbor has not, to date, been included in SEC proposed rulemaking releases. The framework could, alternatively, be the starting point for other draft federal and/or state legislation addressing the current void for network developers in transferring their digital assets and evolving into the decentralized network.

Simple Agreement for Future Tokens or Equity (SAFTE)

The Simple Agreement for Future Tokens or Equity (SAFTE) was proposed in 2016–2017 as a compliant investment contract to facilitate the initial funding of Blockchain-based offerings made to accredited investors. The SAFTE, as generally structured, is a derivative instrument designed to effectuate the future issuance of tokens in order to obtain the financing needed to fund a tech product or system prior to its development or commercial launch, and may represent a promise for future tokens at a fixed price—in effect, a simple promise to issue a certain number of tokens based upon the happening of one or more future events. The SAFTE agreement may be structured so that investors receive these tokens if and when the network launches. The SAFTE (or similar investment structure) could also be used to raise funds for further network or other related development with tokens to issue at a future time based upon the happening of certain events. In each setting, the SAFTE may be a forward contract regulated by the Commodity Futures Trading Commission (CFTC), if no exemption from such regulation exists, and, thus, network developers should seek legal counsel in the careful drafting of these instruments if considered for use. From an investment standpoint, one would need close scrutiny to help determine whether such investment has value, and, if so, what that value is (and its believed present and future bases to make any determination about its place as a small part of an investment portfolio). The SAFTE, analogous in structure to the crowdfunding SAFE (Simple Agreement for Future Equity) should not—ever—be characterized as standard, simple, or safe. The SAFTE framework of preselling tokens has generated skepticism—and among many, cynicism—in the legal community on several grounds including oversimplification of securities laws and material omissions. This framework, if followed, is likely, in most settings, to result in a heightened risk to investors, token price manipulation, and fraudulent trading practices. At the same time, a SAFTE agreement is the security being offered by Blockstack in its Regulation A+ offering, with tokens delivered over time when and if the agreement milestone is met. The milestone, in the case of Blockstack, is an operational network with token functionality as determined by the company in its sole discretion. Among the various considerations frequently not discussed by issuers of SAFTE include such matters as (1) what happens if no agreement milestone is met; (2) what compensation limitations over what time periods are the parameters on senior management payments; and (3) what exit plan, if any, is there.

State Law Developments

The legal landscape governing Blockchain technology is evolving constantly. As of September 2020, state legislation granting legal validity to Blockchain-based distribution (and in some cases, smart contracts) has been passed in multiple state jurisdictions. A compendium of state law is beyond the scope of this writing; however, the state law focus during 2019–2020 is the passage of laws addressing the application of state money transmitter laws to virtual currencies, treatment of digital assets under state securities laws, and the recognition of Blockchain records under corporate laws. Some noteworthy mentions include, without limitation:

- The passage of a state regulatory sandbox for FinTech businesses in Arizona and Utah (and introduction of a similar bill in Florida to create a Financial Technology Sandbox)
- Delaware's corporate laws recognizing Blockchain corporate records
- Bills and resolutions related to Blockchain pending in Illinois (Blockchain Technology Act, which provides for permitted uses of Blockchain technology and limitations on local government to restrict the technology), California (the pending bill authorizes a county, until Jan. 1, 2022, to issue certified copies of marriage records by means of Blockchain technology and would exempt those records from the required physical properties and features in the provisions of current law), and elsewhere as this list is changing monthly

In 2020, Louisiana became the second state following New York to adopt a virtual currency regulation entitled the Virtual Currency Businesses Act, effective August 1, 2020, requiring licensure of virtual currency businesses and establishing requirements to apply for licensure. New York's forward-looking "BitLicense" regulation has been in place since June 2015, when the New York State Department of Financial Services issued its virtual currency regulation under the New York Financial Services Law. Globally, financial regulators are, on a weekly basis, issuing penalties, official permissions, regulations, and missives related to cryptocurrency transactions. Nearly all state jurisdictions have now addressed the growing digital economy in some respect, including at the least legislation establishing task forces and initiatives to study the respective jurisdictions needs for the growing digital economy balanced with consumer protections. Federally, the Office of the Comptroller of Currency, having a specially authorized FinTech charter yet having lost to New York in federal court (appeal pending) in a challenge to the FinTech authorization, has recently announced its willingness to issue a FinTech charter for payments without requiring the institution to be a depository. Clarity, as to whether states (under virtual currency regulations such as New York), the federal government (under potential payment only banking charters) or both, depending on jurisdictions and whether involving a security or commodity, will be the applicable regulatory regime(s) to govern will be some time in coming.

Rocky Mountain Utility Token Law

Wyoming, Colorado, and Montana are the leading state jurisdictions carving out a utility token exemption (in Wyoming and Montana) and a digital asset transactional exemption (in Colorado) from their state securities statutes.

Wyoming Utility Token Act

Advocates for the sweeping Wyoming legislation embracing financial technology over the past year have called the state "the Delaware of digital asset law." In addition to other laws, the "Wyoming Utility Token Act-property amendments," in 2018, established a new asset class under the state's law, defining "open blockchain tokens with specified consumptive characteristics [as] intangible personal property." The utility tokens do not require an exemption from federal securities laws, and the legislation states that:

> The open blockchain tokens governed by this act do not constitute securities because a person who is sold a consumptive open blockchain token cannot receive a cash payment or share of profits from a developer or business, but will instead receive a fixed amount of consumable services, content or property.

Colorado Digital Token Act

The Colorado Digital Token Act (Colorado Act) became effective August 2019, under which legislation Colorado businesses will be permitted to effect transactions involving the sale and transfer between certain persons of digital tokens secured through a decentralized ledger or database, with a focus on the production, distribution, and consumption of goods. Transactions under the Colorado Act will be exempt from the securities registration requirements under the Colorado Securities Act (CSA), and those persons dealing in these digital tokens will be exempt from the securities broker-dealer and salesperson licensing requirements under the CSA.

Montana Bill Titled "Generally Revise Laws Relating to Cryptocurrency"

Montana is the third Rocky Mountain state to pass legislation which became effective July 1, 2019, exempting Blockchain-based tokens from securities laws so long as the tokens have a "primarily consumptive" purpose, defined as having a primary aim to "provide or receive goods, services, or content including access to goods, services, or content." The bill provides that tokens that qualify for the exemption must be available no more than 180 days beyond its date of sale or transfer, and initial buyers of the tokens are not permitted to transfer the token until its consumptive purpose is available.

Key Initial Steps to Prepare and Raise Capital and Launch a Blockchain Technology Venture

To ensure the success of a Blockchain technology business, consider the following actions mission critical prior to the commencement of the STO:

1. Consult with and ensure the availability of a dedicated team of developers with prior experience in Blockchain coding and web development.
2. Prepare a legitimate and comprehensive white paper describing the planned development of the technology business, including a persuasive case for the economic and/or social benefits of (and need for) the to-be-developed network, solution, product, platform, or service and read through and try to understand the Howey test and 2019 Framework as they will be fundamental to step 4. Unless a business plan and issuance can be compliant with both (which is believed by the authors to be infrequent, at best), expect that the money to be raised must be fully compliant with all securities laws and will be expensive to put together and very uncertain of success, at best.
3. Incorporate or organize the business in a state, such as Delaware, with statutory recognition or pending legislation for Blockchain protocols and smart contracts. For example, the recently revised Delaware General Corporation law makes it possible for entities to place shareholder records such as issuances, sales, and redemptions on a computer-based distributed ledger.
4. Consult with a seasoned securities attorney in the planning stages of the capital raise to evaluate the technology which supports the digital asset, and have counsel evaluate the project vis-à-vis the Howey test and the 2019 Framework to determine the factors likely to be controlling.
5. Employ a multidisciplinary approach in building a team of legal advisors with the securities, technology, and tax structuring considered at the outset. In that vein, developers of Blockchain-based networks should be aware of potential regulation under the following additional state and federal laws:

    a) Technology and intellectual property laws

    b) Cybersecurity and privacy laws

    c) FinCen and state money transmitter business laws

    d) Commodities laws

    e) FTC, consumer protection, and business opportunity laws

    f) Tax laws

    g) Banking laws

Other Key 2019–2020 Developments

Inaugural Security Token IPO Declared Effective by the SEC

Gibraltar-based INX Ltd. launched its long-awaited initial public offering of INX security tokens (INX Tokens) on August 20, 2020, over two years after filing its initial draft registration statement on Form F-1 in July 2018, confidentially, with the SEC. The INX registration marks the first registered offering of security tokens declared effective by the SEC. Prior to INX, at least two other issuers noted earlier have successfully qualified security token offerings with the SEC under the Regulation A, Tier 2 offering exemption. The INX Tokens are being offered directly to the public in a self-underwritten offering by officers and directors of the company at an initial public offering price of $0.90 per Token.

The INX offering is being conducted in 14 U.S. states on a minimum-maximum basis with minimum gross proceeds of $7.5 million sold as a condition to the offering proceeding. Until it satisfied (which it did on Sept. 10, 2020) satisfaction of this condition, all subscription payments, in U.S. dollars, were transmitted to an escrow agent. On Sept. 14, 2020, each of U.S. dollars, bitcoin, and ether were accepted for payment of subscriptions using an exchange rate calculation using the two indices described in the prospectus. Secondary trading of the INX Tokens is proposed on an INX securities trading platform to be launched once regulatory approvals are received.

According to the prospectus, INX intends to establish both a digital currency and a securities trading platform through its subsidiaries, becoming a regulated solution for trading Blockchain assets. INX emphasizes it intends to provide regulatory clarity to Blockchain assets by differentiating between security and non-security Blockchain asset classes and providing trading opportunities for each class. INX also has said it seeks to obtain money transmitter licenses or become qualified to operate in most U.S. states within nine months after obtaining the minimum offering amount of this offering in addition to plans to register as a licensed broker-dealer.

The prospectus further states each INX Token (including fractions of INX Tokens) will entitle its holder to share in distributions of the company's cumulative net cash flow from operating activities, as well as entitling a holder to use the token as a form of payment for transaction fees

on its future INX securities trading platform the company's proposed platform for the trading of security tokens, and other discounts. The INX Tokens holders will be additionally entitled to promotional discounts on transaction fees on the to-be-launched INX digital trading platform although those discounts are promotional and not a right associated with ownership of the INX Token.

If INX is successful in both the token capital raise and in launching compliant trading platforms for digital assets and token securities, the INX offering and business model will inevitably lead to migration of offshore native token issuers back to the United States.

Global Regulators Proceed Cautiously Towards a Stablecoin?

Stablecoins this year gained attention as alternative currency projects have been unveiled including the Facebook Libra project and although they should have less risk for consumers, they face regulatory scrutiny given the potential for stablecoin arrangements to scale quickly. Stablecoins are generally digital assets designed to maintain a valuation pegged to one or more traditional currencies to protect against volatility. The value of the traditional currency or other underlying asset typically determines or affects the market value of a stablecoin. A stablecoin may also employ algorithmic means to stabilize the market value of the stablecoin, by adjusting its supply in response to changes in demand. An objective of building a payment instrument on a basket of underlying multinational currencies is to increase global acceptance by limiting fluctuations in the value of the basket of currencies relative to any given currency. Earlier in the year, the global Financial Stability Board (FSB), the international financial standards, and policy making board established at the G20 summit, began to review the risks associated with global stablecoins (GSCs), as distinguished from GSCs from other digital assets and other stablecoins, and released a consultative document proposing 10 high-level recommendations that are addressed to authorities at jurisdictional level to advance consistent and effective regulation and supervision of GSC arrangements. The current risks of GSC arrangements as outlined in the consultative release include:

- Challenges for financial stability
- Consumer and investor protection
- Data privacy and protection
- Financial integrity, including compliance with rules governing anti-money laundering and countering the financing of terrorism and proliferation (AML/CFT)
- Tax evasion
- Fair competition and anti-trust policy
- Market integrity
- Sound and efficient governance
- Cybersecurity and other operational risks
- The safety, efficiency, and integrity of financial market infrastructures (FMIs) (e.g., payment systems) –and–
- Resolution and recovery considerations

The Federal Reserve Board released in June 2020 an economic study assessing the impact of a digital currency backed by a two-currency basket. The paper, titled "Global Demand for Basket-Backed Stablecoins," states, under initial modeling, that fears of a so-called global stablecoin replacing domestic sovereign currencies may be overstated. Whether or not the United States is an early adopter, globally we are on the precipice of a digital native currency with government backing whether it be in the form of a stablecoin or central bank issued digital currency (linked to fiat currency).

National Bank Custody of Crypto

The OCC published an interpretative release on July 22, 2020, which may clear a path forward for banks to custody their customers' cryptocurrency assets. For the first time, the OCC has concluded a national bank may provide cryptocurrency custody services on behalf of customers, including providing permissible banking services to any lawful business they choose, including cryptocurrency businesses, so long as they effectively manage the risks and comply with applicable law. The interpretive release makes clear the term "cryptocurrency" as used in the release encompasses virtual currencies as well as digital assets that are not broadly used as currencies. The release confirms the legal authority for both national banks and federal saving associations (FSAs) to provide safekeeping services for digital activities and, specifically, that national banks may escrow encryption keys used in connection with digital certificates because a key escrow service is a functional equivalent to physical safekeeping. The interpretative release provides that holding the cryptographic access key to a unit of cryptocurrency is an electronic corollary of these traditional safekeeping activities. The OCC's regulations expressly authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform. Because national banks are authorized to perform safekeeping and custody services for physical assets, the interpretive release provides guidance that national banks are likewise permitted to provide the same custody services by electronic means (i.e., custody of cryptocurrency).

Market Outlook

Blockchain technology advanced during 2018–2020 with a view to transforming business processes and is now increasingly differentiated from the development of underlying cryptocurrencies supported by the Blockchain. It is likely that many visionary research and development companies formed around or inspired by distributed ledger technology are currently stifled by the lack of clear guidelines from the multiple regulators that have expressed or exerted authority in this area. Distributed ledger technical impediments such as scalability, cybersecurity, privacy, custody of assets, mining processing time, and integration of systems will continue to be a significant focus for both STO and non-STO tech firms.

The SEC and the U.S. regulatory community will continue to exercise some restraint where warranted and provide relief from enforcement actions and settlements to issuers self-reporting prior violations for failure to register, in the absence of fraud or misrepresentations.

Following *Munchee*, STOs are now regularly conducted as a private placement transaction (requiring compliance with all mandated disclosures) under Regulation D with no interaction with the SEC other than a required Form D filing. The small-cap and middle markets now have the SEC qualifications of two token issuers under Regulation A+ allowing a limited size offering available to the general public to move forward, further detailed below. Additionally, the INX Ltd. registration analyzed below will serve as a catalyst to other entrants willing to allocate significant monetary and temporal resources to innovate the Blockchain capital markets in the United States. If state legislative action is coordinated to follow similar policies and approaches to exemptions and registrations, again, small-cap and middle markets will be more likely to undertake public market capital raises in the U.S.

The **TKY NAL** and **POQ NAL** guidance coupled with the **2019 Framework** will assist issuers in gray areas. Determining when a digital asset, which may have begun its life cycle as an investment contract, has evolved into a non-security utility token or some other form of non-security virtual currency or commodity is but one example. This difficult question of when a network is decentralized and management efforts (or efforts of the AP and in the context of the Howey analysis) are no longer relevant will remain a complex facts-and-circumstances analysis aided, yet not resolved, by the evolving contours of potential regulatory safe-harbors, future no-action letters, and the inevitable case law to follow. Definitive answers in other areas, such as secondary markets, digital asset custody, and the applicability of the spectrum of other SEC, FINRA, and the alphabet ménage of other regulatory bodies' mandates, will require time, money, and patience to sort through.

The recent July 2019 SEC approved Blockstack PBC Reg A+ and YouNow, Inc. securities offerings—at a legal cost approximating $1.5 million on a $28 million raise and $1.4 million on a $50 million raise, respectively—provide useful indirect guidance on how to navigate—and perhaps structure—various aspects of an STO and, in measuring a client's business plan and operations against it, as a form of check in determining whether a given token is a security. For those not yet familiar, Blockstack, attuned to the heightened consumer interest in online privacy and user control of user generated data and in contrast to Google's, Facebook's, and other centralized networks approach, seeks a first-mover-of-scale advantage through an operational decentralized network which provides a decentralized approach to today's market-dominant centrally controlled browsers and social networking, email, word processing, and a host of other applications. It utilizes open source coding permitting developers and consumers to develop—through smart contracts and otherwise—what seems to be one of today's compelling propositions: user-controlled decentralization of needed, useful, and beneficial applications for which the current centralized offerings provide not. Whether Blockstack's network—and business model—will rapidly expand through whatever capital is raised from its A+ offering is unknowable. What is knowable is that Blockstack and YouNow's investment in a costly legal and regulatory process to define, address, and refine its business model and methods in order to withstand SEC scrutiny of the many thorny issues it was required to solve are the same ones likely to be involved with most STOs. The efforts of these pioneers will be of much benefit to every future issuer of an STO.

U.S. lawmakers are at last acknowledging Blockchain as a permanent internet integrated feature. Committees in the House of Representatives are now, at the time of this update, advancing the Blockchain Innovation Act, the Digital Taxonomy Act, and the Advancing Blockchain Act. Congressional sponsors for these bills have stated the new legislation is intended to help ensure use of the benefits of Blockchain technology to help curb fraud and provide other consumer benefits. Congressman Darren Soto of Florida is a co-sponsor of the Digital Taxonomy Act (with Congressman Warren Davidson of North Carolina), advocates for regulatory clarity to Blockchain technology, and used the COVID-19 pandemic medical research to identify candidates for antiviral therapies, including Remdesivir, as an example of how Blockchain, an immutable repository for data sets, enables data to be credible

and protectable. Congressman Soto also propounded cryptocurrencies as an important use case for Blockchain describing how small businesses may make international payments at a lower cost through use of these alternative currencies.

A House of Representatives bill emerged in September 2020, entitled the "American Competitiveness Of A More Productive Emerging Tech Economy Act" (or the American COMPETE Act) calls for a study by the Department of Commerce and the Federal Trade Commission to advance Blockchain technology in the United States to effectively compete in Blockchain technology with China which has advanced its Blockchain-based Service Network (BSN). The BSN describes itself as a cross-cloud, cross-portal, and cross-framework global public infrastructure network used to deploy and operate all types of Blockchain distributed applications (DApps) and is reportedly integrated with public Blockchains including Tezos and Ethereum begging the question of where the epicenter of Blockchain technology will reside—China or other jurisdiction outside of the United States.

The SEC and other regulators have and are deftly trying to continue to optimize along the regulatory spectrum between laissez-faire and definitive GDP-throttling regulatory exhaustiveness. In the decentralized ledger world, developers in the United States continue to press financial regulators to establish a simple, coherent, navigable, and certain legal framework for the issuance, custody, primary and secondary trading marketplace for digital assets, be they securities or not. Digital innovation residing and flourishing in the United States is the objective (acknowledging that it is likewise the objective of most other jurisdictions).

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Rebecca G. DiStefano concentrates her diverse practice in securities regulation, corporate finance, and mergers and acquisitions law and serves on the Greenberg Traurig Blockchain Task Force. Rebecca counsels public and private companies in areas including private placements, registrations, Regulation A+ qualifications, and crowdfunding under the JOBS Act of 2012 and the Securities Act of 1933. Related to these transactions, she advises companies and their boards regarding attendant corporate governance best practices, fiduciary duties, continuing disclosure and reporting requirements of Regulation A+ and the Securities Exchange Act of 1934, as well as helping clients navigate cross-border and blue sky issues, secondary trading issues and the initial and continued listing of corporate securities. Additionally, she structures and organizes for clients non-U.S. regulated investment vehicles including private equity funds, funds of funds, and hybrid funds. Rebecca regularly represents her clients before the U.S. Securities and Exchange Commission and FINRA and is experienced structuring ESOP transactions and counseling ESOP-owned companies and ESOP trustees (both prior to and subsequent to the ESOP purchase).

Rebecca frequently speaks and authors on recent trends in U.S. Capital Markets, post-JOBS Act financial regulation, and related Blockchain & Cryptocurrency developments. Since 2013, she has been devoted to improving lives of children and adults diagnosed with diabetes through JDRF advocacy in Florida and in Washington D.C. and is a member of the JDRF Ride-to-Cure Team. Rebecca has been listed in The *Legal 500 United States*, 2009, and *The Best Lawyers in America*, for Corporate Law, from 2016-2019.

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Bill provides business strategic business legal counsel to small and middle-market companies and their owners. He guides business owners in the decisions and implementations involved with buying, funding (including various securities offerings), growing, and selling companies, as well as the structuring (including tax structuring), pricing, and negotiating of these transactions. Amongst other professional activities, he authored two chapters for Mergers and Acquisitions Handbook for Small and Midsize Companies, edited by West and Jones (New York: Wiley, 1997) and co-authored an IICLE handbook chapter on Illinois/Delaware/Nevada Corporations. He has repeatedly been the lead co-author of and taught Management and Leadership Structures for LLCs and Corporations (Illinois and Delaware) to attorneys for the Illinois Institute of Continuing Legal Education, intermittently teaches the legal portion of the certification program (CM&AA ™) for merger and acquisition advisors to the lower middle-market, and has made numerous presentations concerning, amongst others, investment crowdfunding, closely held businesses, mergers and acquisitions, Illinois and Delaware limited liability companies, Regulation D securities offerings, and fiduciary duties.