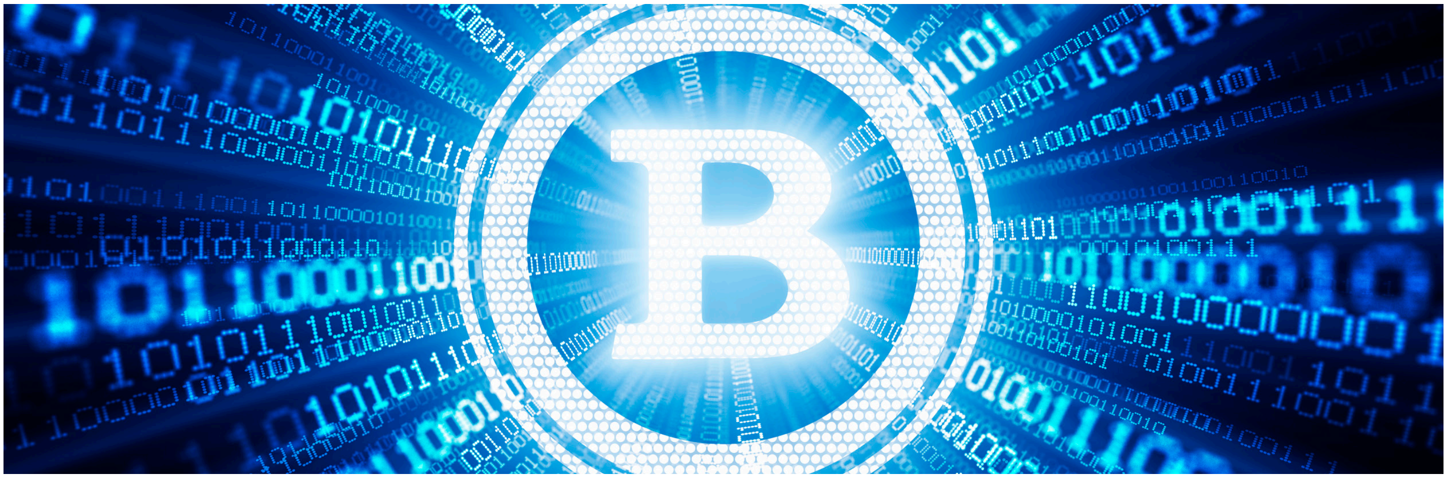

Issues to be Considered in Launching an Offering Involving Digital Instruments Based upon the Use of BlockChain

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When considering an offering of digital instruments that involves the use of blockchain technology, whether in the form of tokens, coins or otherwise, there are a number of issues that need to be considered. Much has been written and said recently about Initial Coin Offerings ("ICOs") and tokens, particularly by the U.S. Securities and Exchange Commission ("SEC")[1]-- and with good reason. According to some estimates, there was over $4 billion in ICO funding in 2017 alone.

In a statement issued in December 2017, SEC Chairman Jay Clayton provided some information and insight into the SEC's thoughts and positions regarding ICOs and related securities law compliance concerns, suggesting that, before moving too quickly with such an endeavor, a company ask itself the following questions:

- Is the product that is the subject or result of the ICO legal? Is it subject to regulation, including rules designed to protect investors? Does the product comply with those rules?
- Is the offering legal? Do those who are proposing to offer the product have licenses to do so?
- Are the trading markets fair? Can prices on those markets be manipulated? Can an investor sell when he or she wants to?
- Are there substantial risks of theft or loss, including from hacking?

The answers to these and other important questions often require an in-depth analysis, and may differ depending on many factors.

One of the most important questions to address in the consideration of such an offering is whether the digital instrument involved is a security or utility within the meaning of applicable federal and state law. In our view, such a classification is not so simple. Any analysis necessarily requires a more inclusive review of the relevant facts and circumstances. In most instances, such an instrument will have characteristics that constitute a hybrid of both a security and a utility.

[1] See https://www.sec.gov/ICO

Digital Instruments as a "Security"

The test for what constitutes a "security" was set forth by the U.S. Supreme Court in the seminal case of SEC v. W.J. Howey Co. (1946). The "Howey Test" is used to determine whether certain transactions qualify as "investment contracts," a catch-all term included in the Securities Act of 1933, as amended (the "Securities Act"). Under the Howey Test, a transaction is an investment contract if:

1. It is an investment of money;
2. There is an expectation of profits from the investment;
3. The investment of money is in a common enterprise; and
4. Any profit comes from the efforts of a promoter or third party.

In most scenarios involving the creation and sale of digital instruments, it is likely (and we believe most prudent) to take the position that, while the instruments may, arguably, have utility features, it will almost certainly be deemed to be a security within the meaning of both federal and state securities laws. Accordingly, and assuming the digital instrument is a security, it is important to ensure that any proposed offering either be registered with the SEC or that it falls under an exemption from the registration requirements under the rules and regulations set forth under the Securities Act, and any applicable state "blue sky" laws. To be clear, ICOs and token offerings are not, *per se*, illegal. They just require careful consideration under, and compliance with, applicable securities laws.

Some general questions that should be asked regarding a digital instrument, such as a token, include (but are not limited to) the following:

- The who, what, where when, how and why of the token?
- Is the token an equity, debt, derivative or convertible instrument, or is it something else?
- Is the token backed by any assets?
- What other rights, if any, does a token holder have?
- What utility features does the token have?
- What currency features, if any, does the token have?

Mistakes and Missteps:

Recent SEC actions against some of the unregistered ICOs undertaken in the past are generally based upon a few issues:

- An issuer was engaged in the commission of an alleged fraud based upon false and misleading statements (misrepresentations) made to investors;

- An issuer's determination and position that their tokens were (or would become) "utilities" (and were not securities) was most likely flawed and led to alleged violations of federal securities laws; and

- An issuer's engagement in general solicitation offerings via white papers available to investors on the internet, which resulted in their either accepting investments from, or making offers to, U.S. based non-accredited investors and U.S. based accredited investors that were not properly certified as required by Rule 506(c) of Regulation D under the Securities Act.[2]

Clearly the SEC has taken this explosion in the ICO market seriously. And while it has been reported that a number of subpoenas have been issued to companies and law firms that have launched and represented ICOs based on insubstantial white papers with little or no investor protective disclosure, it would be an unfair and overly broad assessment to deem all ICOs illegal simply because they are unregistered. What we believe is needed is some sensibility and adherence to long standing securities law principles and practices.

Offering Methods - Registration or Qualification

A basic tenet of the Securities Act is that all securities that are offered or sold must be either registered or exempt from registration. The failure to satisfy this requirement will result in a violation of Section 5 of the Securities Act. A violation the Securities Act is a strict liability offense, thus it does not involve *scienter* (*i.e.* intent).

Registration

Registration under the Securities Act pursuant to a traditional path, on a Form S-1 Registration Statement – involving either a sale of securities directly by the issuer or by way of the resale of securities by existing holders of the securities – is one method that can be pursued.

Qualification

Another option available to issuers is "qualification" under Regulation A ("Regulation A+" or "Reg. A"), adopted under the Jumpstart Our Business Act ("JOBS Act"), on a Form 1-A Offering Circular. Similar to a traditional Form S-1 Registration, qualification may involve either a sale of securities directly by the issuer or by way of resale of securities by existing holders. Opting to engage in this regulatory path is determined largely by the investor requirements of the issuer.

Some important considerations regarding which to path to take include the following:

- any form of security (equity, debt, or otherwise) may be registered for offer and sale pursuant to a Form S-1 Registration Statement, whereas only equity (or a derivative thereof) or debt (or debt convertible into equity) securities may be qualified for offer and sale pursuant to a Form 1-A under Regulation A+; and

- there is no dollar limitation on the amount of securities that may be offered for sale on a Form S-1 Registration Statement, whereas, the currently permitted maximum Regulation A+ offering is $50,000,000 in any 12 month period.

[2] Rule 506(c) of Regulation D provides an exemption for the use of general solicitation in offerings to accredited investors that was expanded by the JOBS Act of 2012 (the "JOBS Act").

Further, one of the many advantages of using a Reg. A Offering (as opposed to a traditional private placement, discussed below) is that issuers are permitted to engage in general solicitation, which aligns well with ICOs.

To the best of our knowledge as of March 28, 2018, there have not been any registered ICOs on a Form S-1 Registration Statement or qualified Reg. A's on a Form 1-A Offering Circular completed.

Exemptions from Registration

Notwithstanding registration as an option, not all securities offerings require registration or qualification if they can qualify for an applicable exemption under the Securities Act. This requires a careful review of the circumstances as well as a consideration of the relevant regulatory and securities law issues. In this regard, some proposed ICOs may be completed under applicable exemptions such as Rule 506(b) or 506(c) of Regulation D, Regulation S and/or Regulation Crowdfunding, provided they are handled properly. This involves the preparation of complete offering documents and a memorandum that includes not only a "White Paper" which describes the business plan and reason for use of the digital instrument, but also risk factors and other disclosures, such as the background and experience of management.

General Requirements for 506(c) and Regulation S Offerings

With respect to exempt offerings under Rule 506(c) of Regulation D (also created under the JOBS Act) and/or Regulation S, the following particular conditions need to be met:

Rule 506(c) (as opposed to a traditional Regulation D private placement under Rule 506(b)) permits issuers to broadly solicit and generally advertise an offering, provided that:

• all purchasers in the offering are accredited investors
• the issuer takes reasonable steps to verify purchasers' accredited investor status; and
• certain other conditions in Regulation D are satisfied.

It is important to note that purchasers in a Rule 506(c) offering receive "restricted securities" (i.e. securities that are not freely tradeable). Similar to a traditional Rule 506(b) Regulation D offering, an issuer is required to file a notice with the SEC on Form D within 15 days after the first sale of securities in the offering. Importantly, the Securities Act provides federal preemption of state blue sky law registration to the extent that the states are only permitted to require "notice" filings and collect fees.

Rule 506(c) offerings are also subject to the SEC's "bad actor" disqualification provisions and require certification of an accredited investor's status (*e.g.*, the issuer must request a copy of an accredited investor's tax return or bank statements in order to verify accredited investor status, or the investor must submit a letter from his or her attorney or accountant certifying the accredited status of their client).

For investors outside the United States, the SEC provides another applicable exemption for issuers, known as Regulation S. Regulation S permits offers and sales of securities to non-U.S. investors outside of the U.S., so long as the offer or sale is made in an offshore transaction and the issuer does not engage in "directed selling efforts" to U.S. Persons.

In addition to securities law considerations, the characteristics of some digital instruments may cause other federal and state laws to apply, including, but not limited to anti-money laundering laws, federal tax laws, consumer protection laws, money transmission laws and/or controlled substance laws, just to name a few.

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This article is for general information purposes and is not a complete description of all issues surrounding these matters, but is rather aimed at providing a general basis of knowledge for understanding securities law concerns in this area. It is not intended to be and should not be taken as legal advice.