



Trading and Investing in Bitcoin, Ether, Cryptocurrencies and Initial Coin Offerings

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OVERVIEW OF PRESENTATION

- Crypto-confusion:
 - Is it a security?
 - A commodity?
- Is it Investible from a Fund Operations and Trading Standpoint?
- Managing Compliance Unknowns: ‘Private Keys’, Custody and Verification



INITIAL COIN OFFERING LANDSCAPE

- ICO “boom” heard ‘round the world – a fast way to raise big money
- Gap between what happened from 2016-2017 and the current legal landscape <https://www.tokendata.io/>

	Tezos	Completed	\$230,498,884.00	Jul 2017				
	EOS	Active	\$200,000,000.00	Jun 2018				
	Filecoin	Completed	\$200,000,000.00	Sep 2017				
	MobileGo	Completed	\$53,069,235.00	May 2017	\$0.758	\$0.519	0.68x	
	Centra	Completed	\$49,696,100.00	Sep 2017	\$0.731	\$1.135	1.55x	
	Kyber Network	Completed	\$49,304,000.00	Sep 2017	\$0.357	\$1.713	4.79x	
	Enigma Catalyst	Completed	\$45,000,000.00	Sep 2017				
	Monetha	Completed	\$36,388,800.00	Aug 2017	\$0.181	\$0.129	0.71x	
	Basic Attention Token	Completed	\$36,000,000.00	May 2017	\$0.036	\$0.214	5.96x	
	SONM	Completed	\$35,000,000.00	Jun 2017	\$0.106	\$0.155	1.47x	

DISTRIBUTED LEDGER/BLOCKCHAIN

- What is Distributed Ledger / Blockchain?
 - “A distributed ledger is a database that is **consensually shared and synchronized** across network spread across multiple sites, institutions or geographies. It allows transactions to have public ‘witnesses,’ thereby making a cyberattack more difficult. The participant at each node of the network can access the recordings shared across that network and can own an identical copy of it. Further, any changes or additions made to the ledger are reflected and copied to all participants in a matter of seconds or minutes. Underlying the distributed ledger technology is the blockchain, which is the technology that underlies bitcoin.” See Investopedia Definition of “Distributed Ledger”.
- Core principles of trust, verifiability, immutability and transparency.
- Distributed ledger as a technology will have multiple uses for multiple industries.
- Cryptocurrencies are just one aspect of the uses for blockchain.

DISTRIBUTED LEDGER/BLOCKCHAIN

- Bitcoin is a single purpose blockchain; it's purpose is limited to creation of Bitcoins.
- Ethereum is a distributed ledger separate and apart from Bitcoin. Currency of denomination for Ethereum is Ether.
- Ethereum is an application blockchain; it provides for the ability to create “smart contracts” on a distributed ledger. These smart contracts enable the issuance of separate digital tokens in exchange for a contribution of Ether or other cryptocurrencies or fiat currency to the sponsor.
- Ethereum has spawned a proliferation of over 350 cryptocurrencies that are based on smart contracts.
- These cryptocurrencies are the digital tokens that are typically offered in ICOs.

INITIAL COIN OFFERINGS

- Digital tokens should be distinguished from primary cryptocurrencies.
 - Often issued pursuant to creation of a smart contract formed on Ethereum distributed ledger. Other ledgers, like Tezos, also provide this flexibility.
 - Many different purposes for tokens and can implicate various regulatory frameworks.
 - Often trade off-market. Not all cryptocurrency exchanges accept them.
- Digital tokens often have the following features alone or in combination:
 - Equity like features (e.g., voting rights and rights to distributions).
 - Debt like features (e.g., right to receive fixed additional tokens or revenue from mining or other activities).
 - Consumptive use tokens (e.g., prepayment of right to use services on the platform).

CRYPTOCURRENCY - BITCOIN

Increase in Bitcoin from 10/06/2016 – 10/06/2017

\$4,604.00

BITCOIN PRICE

+\$3,985.40

SINCE LAST YEAR (USD)

+644.26%

SINCE LAST YEAR (%)



Source: Coinbase. Please note that there are multiple cryptocurrency exchanges that have multiple values for a cryptocurrency at any given time.

CRYPTOCURRENCY - ETHER

Increase in Ether from 10/06/2016 – 10/06/2017

\$308.98

ETHEREUM PRICE

+\$296.66

SINCE LAST YEAR (USD)

+2407.95%

SINCE LAST YEAR (%)



Source: Coinbase. Please note that there are multiple cryptocurrency exchanges that have multiple values for a cryptocurrency at any given time.

GROWING REGULATORY CONCERN

- Regulators globally have expressed concern about the potential for fraud, money laundering, tax evasion and cybersecurity risks.
- In addition to fraud concerns, securities law implications of certain digital-token offerings are also of particular concern.
- Regulators from the following countries have signaled concerns with ICOs:
 - Singapore
 - Canada
 - Peoples Republic of China
 - Republic of Korea
 - Russian Federation
 - Hong Kong
 - United Kingdom
 - Malaysia
 - Thailand
 - Dubai

FRAUD RISKS

The SEC Filed Fraud Charges Against 2 'Initial Coin Offerings'

<http://fortune.com/2017/10/01/sec-ico-fraud-charges/>

October 1, 2017

In a move that should be welcomed by anyone serious about innovation in financial technology, the Securities and Exchange Commission announced Friday that it would prosecute the creator of two stock-like “ICOs,” or Initial Coin Offerings, which it alleges were sold on the basis of fraudulent claims.

The two ICOs in question were marketed as “REcoin” and “DRC,” and both were run by Maksim Zaslavskiy. REcoin was advertised as “The First Ever Cryptocurrency Backed by Real Estate,” while DRC, or Diamond Reserve Club, claimed to be backed by investments in diamonds. They were touted as full-fledged companies with staff, lawyers, and relationships with retailers. But according to the SEC, neither scheme had “any real operations.” They made no investments on behalf of token buyers, and misrepresented their total level of investment.

Nearly as bad, the SEC says the digital tokens they claimed to be selling “don’t really exist,” meaning REcoin and DRC – much like the notorious global scam OneCoin – weren’t running on blockchains at all, and therefore weren’t even really ICOs.

FRAUD RISKS

- What to look for - -
 - Is there a real underlying business?
 - Does the business have assets, expertise, staff?
 - Who is behind the operations?
 - Marketing over-promising?
 - Too good to be true?

ARE TOKENS SECURITIES?

- Whether a digital token is a security depends on the facts and circumstances of the particular case
- If a token is a security it can be offered and sold only in compliance with United States securities law
 - Under the Securities Act, is the offering properly registered or exempt from registration? If exempt, are the investors accredited investors and did they receive adequate disclosure?
 - Under the Exchange Act, is the offering conducted through a platform compliant with Regulation Crowdfunding? Are any intermediaries, such as token exchanges or brokers, registered as broker-dealers?
 - Depending on the structure of a token offering, investment advisory considerations may be applicable, including the SEC custody rule. Similarly, investment company act issues may come into play.

ARE TOKENS SECURITIES?

- Recently, the U.S. Securities and Exchange Commission issued its report concluding that the tokens issued by the DAO constituted securities.
- The DAO - acronym for “decentralized autonomous organization,” i.e., a virtual organization embodied in computer code and executed on a distributed ledger or blockchain.
- Investors contributed Ether in exchange for DAO Tokens.
- DAO Tokens had limited voting and ownership rights.
- The DAO intended to earn profits by funding projects that would provide DAO Token holders a return on investment.
- No limit on number of DAO Tokens offered or on the number or accreditation status of purchasers
- Capital raise equivalent to US\$150 million.

ARE TOKENS SECURITIES?

- SEC applied the US Supreme Court's *Howey* test to determine whether DAO Tokens constituted an “investment contract” (and thus a security) under Section 2(a)(1) of the U.S. Securities Act of 1933 and Section 3(a)(1) of the U.S. Securities Exchange Act of 1934.
- Pursuant to the *Howey* test a transaction is an “investment contract” if all of these features exist:
 - (1) an investment of money
 - (2) in a common enterprise
 - (3) with a reasonable expectation of profits
 - (4) to be derived from the entrepreneurial or managerial efforts of others.

SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)

ARE TOKENS SECURITIES?

- Utility tokens – i.e., those with a consumptive use -- might not be securities because of their consumptive or redemptive qualities.

“[W]hen a purchaser is motivated by a desire to use or consume the item purchased – ‘to occupy the land or to develop it themselves,’ as the *Howey* Court put it, - the securities laws do not apply. . . .” *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

- Securities regulatory characterization may depend on the nature of the smart contract, features of the token, accounting treatment, the use of proceeds and the extent and nature of presale or build-out activities.

- The SEC will look closely at facts and circumstances and whether a token represents consumptive value or an investment contract. An important consideration may be whether the consumptive use is immediately available.

ARE TOKENS SECURITIES?

- ICO sponsors and intermediaries need to keep in mind that *Howey* might not be the only test that could be applied.
- The application of a particular test may depend in part on whether the token has debt or equity features as discussed in a prior section
 - *Risk Capital Test.* *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811 (1961).
 - *Family Resemblance Test.* *Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1990).
 - (1) “the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]”; (2) “the ‘plan of distribution’ of the instrument,” including an assessment of whether “there is common trading” of the instrument “for speculation or investment”; (3) “the reasonable expectations of the investing public”; and (4) “whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the investment, thereby rendering application of the Securities Acts unnecessary.”
- Also remember – in addition to securities law considerations digital tokens may raise commodity law issues depending on the facts.

GENERAL

If tokens are securities they may be offered in the United States or to US investors only in compliance with the registration requirements of the Securities Act or pursuant to an exclusion or exemption from those requirements

OPTION ONE – OFFSHORE SALES ONLY

SAMPLE: Representation and Warranties of Contributor

By making a contribution (i.e. transferring ETH to the Smart Contract System) for the purchase of Tokens, you hereby represent and warrant that:

you are not a citizen of or resident or domiciled in the United States of America or making a contribution for the purchase of Tokens from a location in the United States of America, nor are you an entity (including but not limited to any company or partnership) incorporated, established or registered in or under the laws of the United States of America, nor are you making a contribution for the purchase of Tokens for or on behalf of any such person or entity;

Query: How effective are these restrictions?

OPTION 2 – PRIVATE PLACEMENT/REG D

- Private placement (or non-public offering) is a funding round of securities which are sold not through a public offering, but rather through a private offering, mostly to a small number of chosen investors. PIPE (Private Investment in Public Equity) deals are one type of private placement.
- Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(a)(2) of the Securities Act. Companies relying on the Rule 506 exemption can raise an unlimited amount of money from accredited investors.
- A Private Placement Memorandum ("PPM"), also known as a private offering document and confidential offering memorandum, is a securities disclosure document used in a private offering of securities by a company or investment fund.

OPTION 2 – PRIVATE PLACEMENT/REG D

Reg D on the Rise? Investor-Grade ICO Products Are Coming – and Soon

<https://www.coindesk.com/reg-d-on-the-rise-investor-grade-ico-products-are-coming-and-soon/>

Innovators in the initial coin offering (ICO) sector appear to be stepping up efforts to target an increasingly interested institutional market.

While professional investors and money managers have historically struggled to gain exposure to the Wild West of token sales and ICOs, work is now underway to create new offerings geared toward not only this audience, but the evolving regulations that both buyers and sellers must abide by.

In short, a strategy pioneered with the launch of the first token designed specifically as a security, VC firm Blockchain Capital's pioneering BCAP token, is showing signs of further adoption.

Using the same investment bank, California-based Argon Group, Protos Cryptocurrency Asset Management announced a plan last week to launch an ICO via a Regulation D placement that would see it collecting funds for a cryptocurrency hedge fund.

OPTION 3 – REGULATION A OFFERING

Regulation A unregistered offerings to retail investors subject to conditions that may make it unsuitable for large offerings but may be useful for small ones

- Amended in 2015 pursuant to the JOBS Act to be more practically useful
- Annual volume limitation (\$50 million or \$20 million with sublimits for sales by selling security-holders) depending on whether the issuer is a tier 1 issuer or a tier 2 issuer as defined in Regulation A.
- As with a registered offering, Regulation A requires that the issuer provide specified disclosures to investors and file an offering statement with the SEC, and it provides the SEC with power to issue stop orders.
- Tier 2 issuers are also subject to additional disclosure and ongoing reporting requirements, including enhanced blue sky requirements

SEC CREATES CYBER UNIT ON SEPTEMBER 25, 2017 TO “TARGET CYBER-RELATED MISCONDUCT” SUCH AS ...

- Hacking to obtain material nonpublic information
- Intrusions into retail brokerage accounts
- Market manipulation schemes involving false information spread through electronic and social media
- Misconduct perpetrated using the dark web

AND

- Violations involving distributed ledger technology and initial coin offerings