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CRYPTOCURRENCY AND BLOCKCHAIN DEVELOPMENTS

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The Blockchain

- Instead of one centralized ledger maintained by a trusted intermediary, every participant or node in the network maintains a complete copy of the ledger so that every transaction can be verified, and it is impossible to falsify, lose, or delete the ledger.
- In order to transact in the network, a member broadcasts a message: “X transferred 1 token to Y, signed X.” Every member of the network receives a copy of the message, but the transaction is encrypted and must be decrypted or verified before the ledger, called the blockchain, is updated.
- Cryptocurrency “miners” use their personal resources—time, electricity, and computing power—to decrypt these messages, verify the transaction, and record it in the distributed software ledger, or “blockchain.” In return, the miners earn virtual tokens, such as “bitcoins.” Once verified, every participant in the network updates the ledger with the new block in the chain.

Cryptocurrency vs. Blockchain Technology

- Blockchain technology has applications beyond cryptocurrencies
 - Large banks are increasingly conducting tests of decentralized asset technology and implementing blockchain in business processes. Banks continue to invest in a variety of projects and start-ups that are developing blockchain-based solutions.
 - Asset registration
 - Payment – Make bank-to-bank and international money transfers faster
 - Fraud reduction
 - Credit data
 - Identity services
 - Transferring money is currently time-consuming and often requires financial intermediaries, each of which takes a service charge and is subject to greater regulation and higher costs due to the prevalence of fraud. Blockchain reduces the number of middlemen while increasing security, which could reduce industry-wide transaction and processing costs by billions. But this reduction in back-office red tape comes at the cost of eroding traditional roles within the financial industry.
 - Concept of “smart contracts” also has many applications beyond cryptocurrencies. Derivatives markets which essentially involve the trading of contracts may lend itself to a decentralized technology.
 - Auto-executable computer code

The Imperative to Regulate Cryptocurrencies

- Criminal Uses
 - Money Laundering
 - Ransomware
 - Terror Financing
- Tax Evasion
- Investment Fraud
 - Ponzi Schemes
 - ICOs (unregistered offerings of securities)
- Market Manipulation
- Theft/Hacks

How US Regulators View Cryptocurrency and Its Uses

- A Commodity (CFTC)
 - Cryptocurrencies are commodities subject to CFTC antifraud and antimanipulation regulation. Derivative and futures contracts are subject to registration.
- A medium of exchange that operates sort of like a currency (FINCEN and state banking regulators)
 - Money Transfer Laws, new state licensing of dealers in cryptocurrencies
- An Investment Contract (SEC and states)
- Property (IRS)

Initial Coin Offerings

- Initial Coin Offerings (“ICOs”)
 - Initially aspired to be new co-operative financing model (crowdfunding, peer-to-peer lending)
 - Disruptive challenge to traditional sources of capital raising (VC firms, angel investors, banks)
 - Named after the IPO, but very different; unlike IPO, an ICO is not the sale of equity in corporate entity, so does not share in the financial returns or governance rights of the corporation
 - ICOs involve the sale of a “token” that enables its holder to use and/or govern a network that the promoters plan to build with the funds raised through the ICO
 - Tokens are typically issued in exchange for a fiat currency (\$ or €), or cryptocurrencies that have an established market (bitcoin or ether)
 - Seen by owners as an innovative, low-cost method to raise capital, without giving up economic ownership or legal control of corporate entity
 - Tokens traded on hundreds of start-up markets, in diverse jurisdictions, under little to no regulation

ICO Rise and Fall

- Explosive ICO growth from mid-2017 to mid-2018
 - Following Bitcoin, the creation of the Ethereum blockchain established a simple set of steps to create tokens. The market grew slowly until it exploded globally in 2017.
 - 2016: 29 ICOs raised \$90.3 million*
 - 2017: 875 ICOs raised \$6.2 billion* - Broad interest and excitement in 2017
 - 2018: 1,257 ICOs raised \$7.9 billion* - Continued hype in strong first six months led to record year
 - But in the latter half of 2018, declining crypto prices, increased regulatory scrutiny and alarming amounts of fraudulent activity led to precipitous declines, and a virtual halt of ICOs by the end of the year
- 2019 Outlook
 - Jan/Feb. 2019: 9 ICOs raised just \$51.1 million*
 - Increasing return to need for traditional financing sources, such as VC firms
 - More SEC-compliant ICOs, but far fewer ICOs overall

*(source: icodata.io)

ICO Document Informality vs. Smart Contracts

- ICO Document Informality
 - When explosion took place in early 2017, no SEC guidance specific to ICOs existed
 - Founders create the supply of digital tokens to be issued to themselves and to new investors
 - ICO market took a much less formal approach using a “White Paper”, a public document describing plans for the development of a network, the token offering and other disclosures of their choosing
 - Some saw a clever way to circumvent the securities laws, while others, with no idea about securities law requirements, saw ICOs as novel forms of technology to address social governance concerns
- ICO Smart Contracts
 - Tokens are digital and exist on the Internet, embodied in software code known as smart contracts
 - The token should be providing investor protections through computer code, not legalistic means
 - Key ICO protections in code should be: (1) constraint on supply of tokens, (2) lock-up/vesting of founders’ tokens, and (3) non-modifiable token rights (per immutable nature of blockchain)
 - Consider future offerings where reading code is critical to understanding transactional relationships

Securities Registration Issues Presented by Cryptocurrencies

- Currencies vs. Utility Tokens vs. Securities Tokens – Is There a Difference?
 - Crypto Currencies – Intended to be used as a means of exchange across various platforms and applications
 - Utility Tokens – Intended to be used on a specific platform or application
 - Security Tokens – Tokens that offer profit incentives or potential appreciation based on development of the platform
- Bitcoin, Ethereum, and other digital currencies
 - Security or Commodity (or both)?
 - Who Controls/Who Is the Issuer?
 - SEC Disintermediation Test
 - *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018).
 - Mining Operations and Other cryptocurrency-related investments

Currencies vs. Utility Tokens vs. Securities Tokens – Is There a Difference?

- Types of Tokens
 - “Utility tokens” provide the holder with access to the blockchain platform, products, and/or services
 - “Security tokens” provide the holder with equity or debt-like rights to an entity
 - In re Munchie – Even if no profit sharing opportunities, can be a security if a development stage platform and proceeds from ICO used to develop the platform
 - On the other hand, if platform is operational at the time of the ICO, and the development was financed through traditional means, it would be view as an utility token
 - Seed/risk capital vs product purchase
 - Assets Purchased to Use or Consume Are Not Securities
 - Whiskey Warehouse Receipts
 - Condominiums
 - Golf Club Memberships
 - SAFT/Warrant Concept – Tokens released upon launch of platform; SAFTs restricted to accredited investors
 - Attempted to solve securities law issues with pre-functional token sales, but raised other concerns
- Tokenized Securities
 - Overstock.com

SEC Enforcement Actions

- The Howey Test
 1. Investment of Money
 2. in a common enterprise
 3. with the expectation of profits
 4. from the efforts of others.
- The DAO Enforcement Action
 - Purported to be a Disintermediated Fund
 - Profits Principally from Efforts of Others
 - “Perfunctory” Participation Not Enough
- The Munchee Enforcement Action
 - Enterprise Risk/Vertical Commonality
- In re AirFox, Administrative Proceeding File No. 3-18898, Release No. 10575 (November 16, 2018).
- Securities and Exchange Commission v. Blockvest LLC, et al., Civil Action No. 18-CV-2287-GPB(MSB) (S.D. Cal.)

Options Available to Token Issuers

- Conclude Not a Security
- Seek SEC Guidance FinHub Portal: 131 inquiries two months after launch
- Concede Possible Security Status
 - Private Placement
 - Accredited Investors
 - Holding Periods
 - Offshore Placement
 - Flow Back Issues
 - Local Regulatory Issues
 - Regulation A+
 - Register
 - Monster Products, Inc., 300,000,000 Monster Money Tokens (“MMNY Tokens”)
 - <https://www.sec.gov/Archives/edgar/data/1675583/000149315218007872/forms-1.htm>
 - Bed bugged
 - Effect on Eligibility to Trade on Unregistered Exchanges
 - Broker-Dealer, Investment Adviser and Investment Company Registration Issues.

Private Fund Considerations

- A number of fund managers have established private investment funds to offer investors the opportunity to gain exposure to cryptocurrency without having to invest directly in the digital assets.
 - Regulatory Scrutiny
 - Structural Considerations
 - Valuation
 - Liquidity
 - Custody
 - Compliance Issues

Fund Risk Disclosure

The offering memorandum for a fund that trades cryptocurrency or invests in firms using Blockchain technology should include relevant risk disclosures related to:

- Legal and regulatory risk
- Market risk
- Potential manipulation of markets
- Custody risk
- Cybersecurity and hacking risks
- Trading risk
- Volatility
- SEC Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings
 - January 18, 2018 <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>
- Must comply with exemptions from registration under Securities Act and Investment Company Act (if assets are securities)

Registered Funds

- SEC Moratorium on Registered Products
 - [UNITED STATES BITCOIN AND TREASURY INVESTMENT TRUST:Sponsored by Wilshire Phoenix Funds, LLC](https://www.sec.gov/Archives/edgar/data/1750145/000091957419000279/d8050549a_s-1.htm)https://www.sec.gov/Archives/edgar/data/1750145/000091957419000279/d8050549a_s-1.htm
 - Bitwise ETF Trust, <https://www.sec.gov/Archives/edgar/data/1746379/000149315218010390/forms-1.htm>
 - Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (Nov. 16, 2018)
<https://www.sec.gov/news/public-statement/digital-asset-securites-issuance-and-trading>

Q&A

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James W. McKenzie, Jr., serves as the primary outside counselor in most of his client relationships. Jim advises public and privately-held companies on securities offerings of debt and equity, disclosure and corporate governance matters, fiduciary duties, NYSE and NASDAQ compliance, mergers and acquisitions, and cross-border transactions. He works with clients in the healthcare services, life sciences, technology, social media, manufacturing, financial services, and real estate industries.

As a former public company general counsel, Jim provides ongoing advice to the general counsels, management and directors of NYSE-listed and NASDAQ-listed clients.

Jim is a member of the Firm's Audit Committee and has served on the Firm's Advisory Board and in leadership positions in the capital markets and corporate & business transactions practice.

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David A. Sirignano focuses on international and domestic corporate finance, mergers and acquisitions (M&A), and US Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) regulation. David represents foreign and domestic public companies, broker-dealers, underwriting syndicates, investment managers, and private funds with respect to issues arising under US federal securities laws, including SEC and FINRA registration and reporting obligations, disclosure issues, and insider trading and trading practice regulation.

Before joining Morgan Lewis, David was associate director for international corporate finance in the Division of Corporation Finance at the SEC. In that position, he developed SEC policy on cross-border offerings, acquisitions, and listings, which included offshore Internet offerings, international disclosure and accounting standards, and international corporate governance guidelines. David also advised the SEC and its Division of Enforcement on financial fraud cases and cross-border offering abuses.

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