Legal Consideration of Crypto-Financing

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Security Tokens

Analyzing Investment Contract Legal Tests

The Howey Test

Does the token purchaser:

1. invest
2. in a common enterprise and
3. have an expectation of profits
4. based primarily on the efforts of third parties/the promoter?

The Risk Capital Test

Does the token purchaser have:

1. actual or practical control
2. over the managerial decisions of the promoter/third-party?

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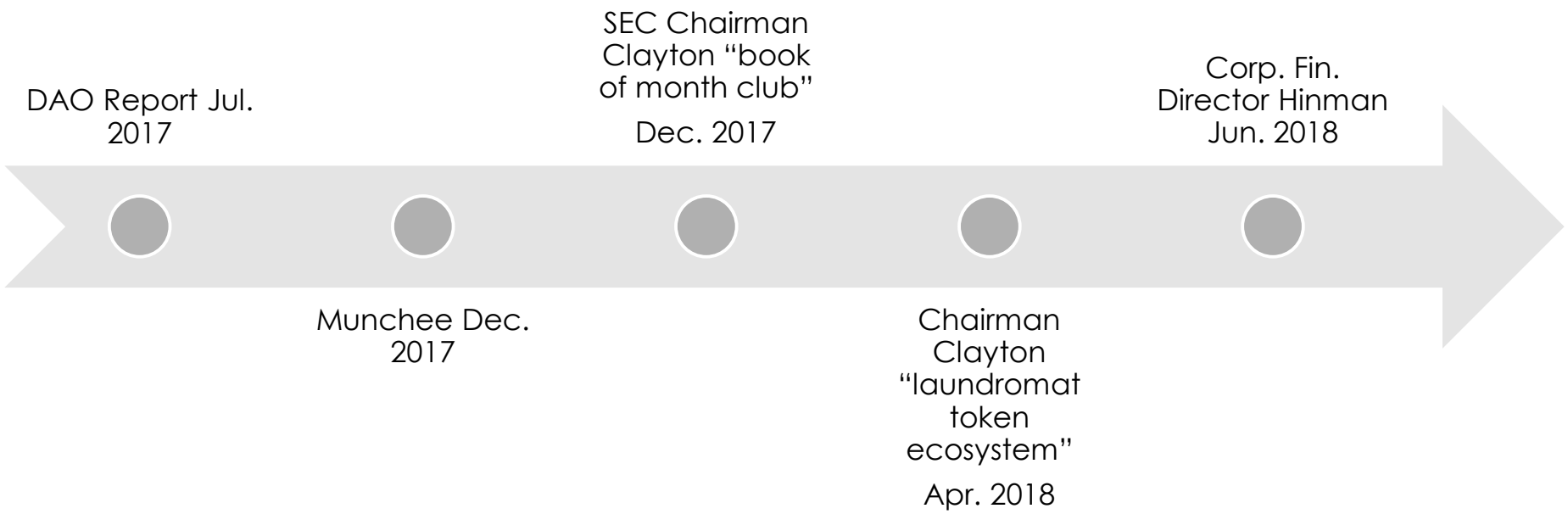
Guidance from the SEC



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"Sufficiently Decentralized"

According to the Director of the SEC's Division of Corporate Finance, William Hinman:

"Where purchasers no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts."

Based on SEC Director of Corporate Finance William Hinman's June 14, 2018 comments.

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Examples of "sufficiently decentralized networks"

The current structure of Bitcoin and Ethereum are deemed sufficiently decentralized such that current offers and sales of BTC & ETH are not securities transactions.

"There may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required."

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Security

Creation, Sponsorship & Promotion	• Was sponsorship or promotion led by an identifiable party, whose actions could affect an increase in value?
Promoter's Role	• Does the promoter have an identifiable stake or interest in the ecosystem? Does this interest motivate the promoter's actions? And do purchasers believe a return on their investment is viable based on these actions?
Usage of Funds	• Has a promoter raised funds beyond what's needed to establish the ecosystem? and has indicated its intent to continue using such funds and describe how funds will continue to add value to the ecosystem?
Marketing & Sales	• Is digital asset marketed and sold as an "investment" to the general public instead of to potential ecosystem participants?
Securities Act	• Does the application of the Securities Act make sense? Are purchasers expecting profits that are derived from the efforts of others?
Governance	• Promoter exercises meaningful influence over the ecosystem.

Based on SEC Director of Corporate Finance William Hinman's June 14, 2018 comments.

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Non-Security

Token Creation	• Token's built-in utility is driven by needs of ecosystem participants.
Token Value	• Value of token is driven by independent actors; promoter is not influencing value in secondary markets.
Motivation for Purchase	• Primary motivation for purchase of ecosystem's token is for personal consumption, not investment.
Token Distribution	• Are there built-in incentives compelling token holders to utilize tokens on ecosystem rather than hold for potential increase in value?
Sophisticated Participants	• Is asset marketed & distributed to general public or potential users?
Governance	• Diverse user base has meaningful influence over the ecosystem.

Based on SEC Director of Corporate Finance William Hinman's June 14, 2018 comments.

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What is a cooperative?

"Co-operatives are people-centered enterprises **owned and ran by and for their members** to realize their common dreams. Profits generated are either reinvested in the enterprise or returned to the members."

https://ica.coop/en/what-co-operative-0

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Principles of Cooperative

- Voluntary and open membership
- Democratic member control
- Member economic participation
- Autonomy and independence
- Education, training, information
- Cooperation among Cooperatives
- Development of token interpolation/interoperability technology

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Why the Cooperative Model Works

- While the Cooperative membership is separate from the token, the Cooperative is the actualization of the project, which is realized by the participation of its members.
- Without the Cooperative, there is no one planting or harvesting the *Howey* citrus groves or otherwise bringing value to the land/project.
- The Cooperative resolves some issues related to solicitation—those purchasing the token are primarily the people intending to build the membership and business model.
- There is no claim to or expectation of net profits because a member's expectation of benefits is related to the member's own level of work.
- The entity structure is designed to incentivize token holders to *use* and *deploy* the token rather than engage in price speculation.

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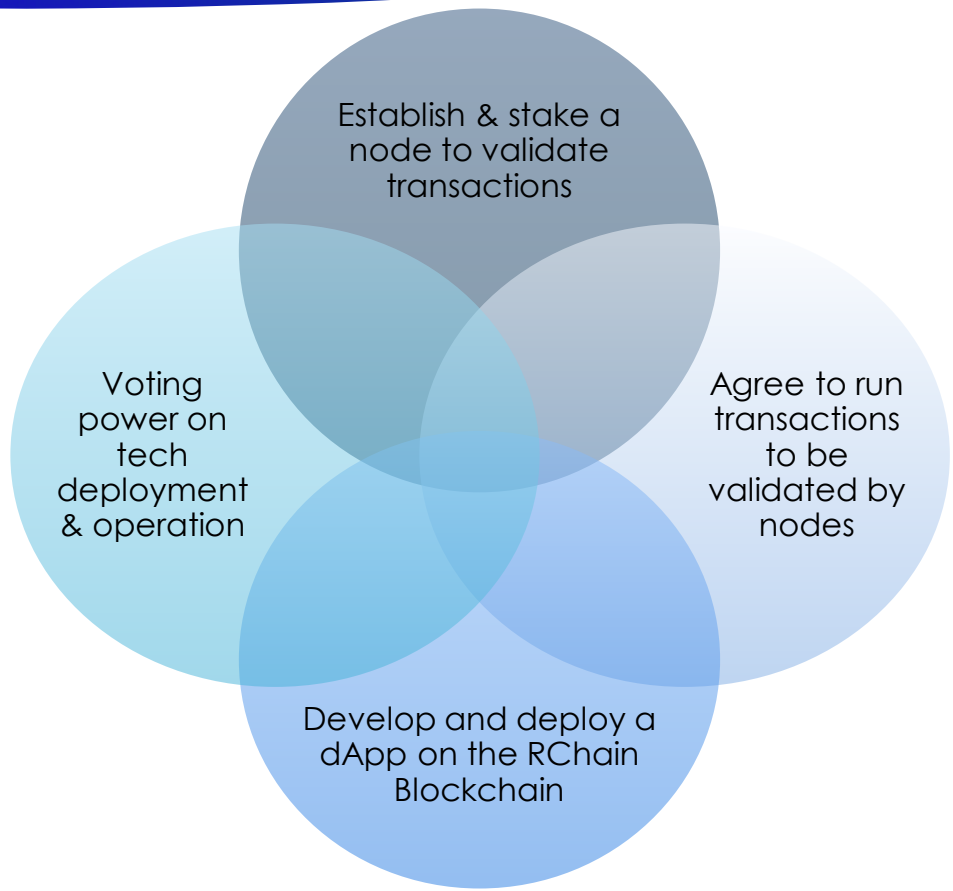
Coop Governance & Member Rights

- Members are able to exercise actual & practical control over the managerial decisions of the Cooperative
- Members can organize into committees to influence token protocol & governance of the Cooperative
- Right to vote on operation and technology related matters such as deciding which dApps to feature at blockchain launch



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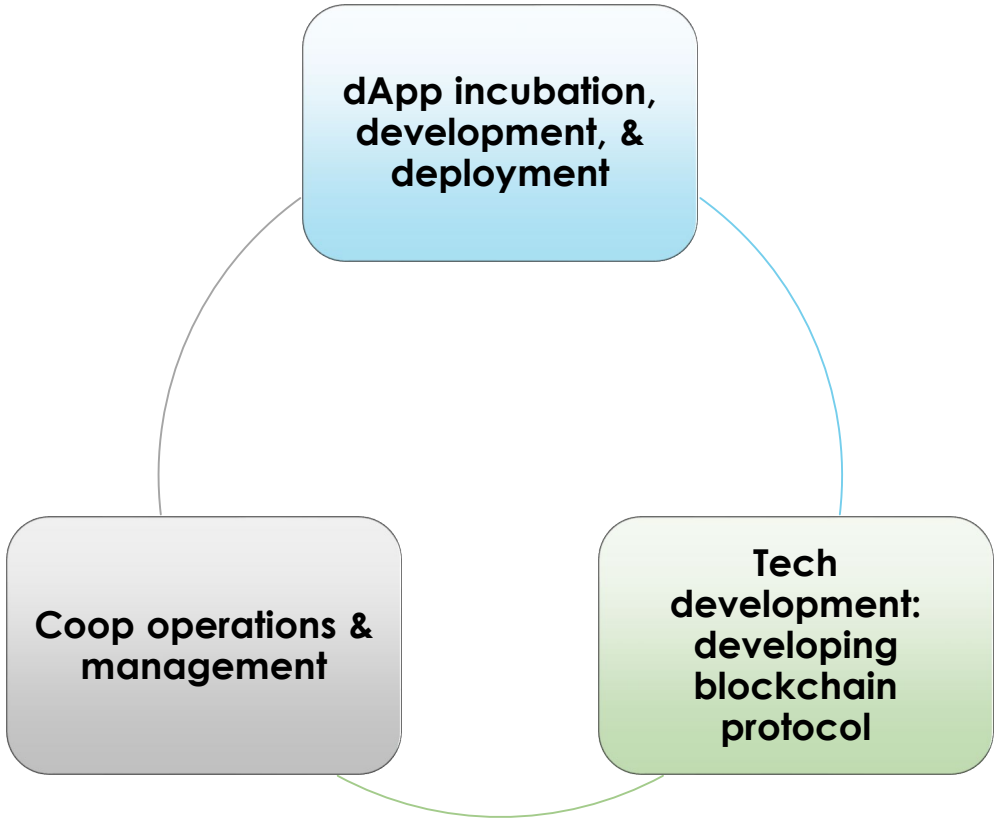
Financial relationships between Coop and member groups in Coop



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Key Takeaways

- Essential built-in rights provided by token (DAO Report)
- Packaging and distribution of token (Munchee/Hinman)
- Participants' reasonable expectations. Consumptive value v. return on investment? (Howey/ DAO Report/ Munchee/ Hinman)
- Actual and practical control over governance ecosystem (DAO Report/ Chairman Clayton statements)
- Targeted purchasers (Munchee)

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Any Questions?

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THANK YOU!

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