

The Crypto-Craze and Blockchain Blues:

Initial Coin Offerings in the Wake of Aggressive SEC Enforcement Actions & Impediments to Patent Registration Involving Blockchain



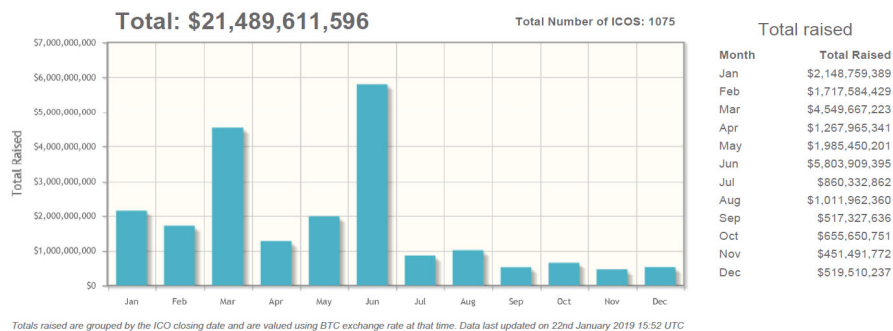
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1. The Crypto Boom

- \$21.5 billion in 1075 initial coin offerings (“ICOs”) in 2018 alone!

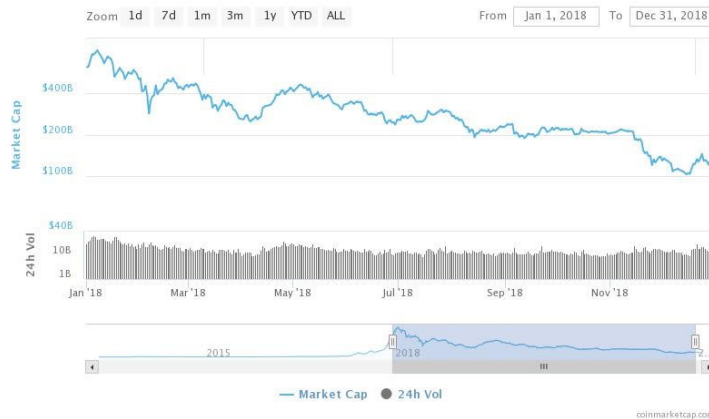
Cryptocurrency ICO Stats 2018

Year:



- Total market cap over \$100 billion and daily trading volume of crypto currencies in excess of \$10 billion.

Total Market Capitalization



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2. BITCOIN: Where it All Started

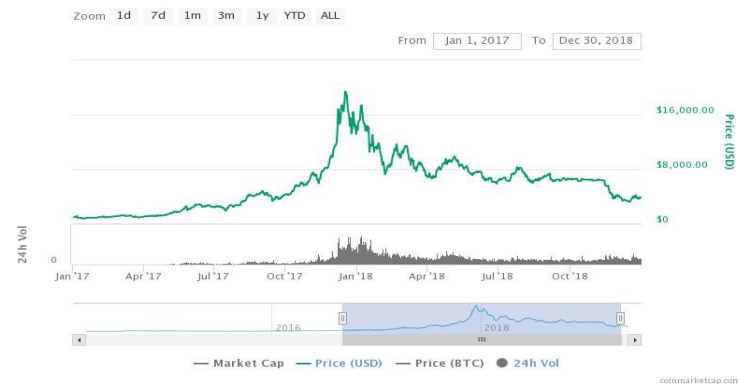


193

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- Shatoshi Nakamoto developed bitcoin in 2009 as a secure, decentralized, peer-to-peer payment system. From \$1,000 per coin in early 2017 to \$19,000 in December 2017, back down to about \$3,600 in early 2019 and now at about \$9,000!

Bitcoin Charts



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- In mid-2017, the SEC arose from its slumber and has since become increasingly assertive in applying the U.S. securities laws to ICOs and crypto exchanges.

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Blockchain Technology

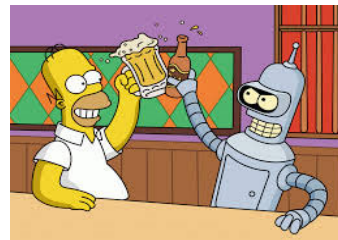
- A distributed ledger that keeps track of transactions and is duplicated across a number of computers (or nodes) to create a network. A transaction must be validated by consensus in order to be recorded on the ledger (typically in an energy intensive computational process known as “mining”). Fun fact: mining consumed as much as 7.7 GW in late 2018, .5% of the entire world’s energy consumption.
- There is intrinsic trust in the system – including avoiding the double spend problem – because all transactions on the blockchain are verified and cannot be altered, hence avoiding the need for intermediaries such as banks.
- In the case of bitcoin, value derives from a 21 million coin limit and the expensive computational work required to mine coins.

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3. Crypto Gone Wild

- Over 2,500 cryptocurrencies.
- Types of cryptocurrencies:
 - **Bitcoin**
 - **Altcoins**: variations of bitcoin and used to transfer value. Can be tied to a limited coin supply, backed by assets (“Asset-backed Coins”) or linked to a “fiat” currency like the dollar (“Stable Coins”)
 - **Tokens**: tradeable but have functions other than transfer of value, such as facilitating smart contracts
- Fidelity and E*Trade recently announced that they will offer cryptocurrency trading.
- Facebook just announced the development of a cryptocurrency based payment system.



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4. Ethereum and Smart Contracts

- **Ethereum:** a programmable blockchain platform that allows developers to create decentralized applications (dApps) including smart contracts. Ether is Ethereum's native cryptocurrency and is used to access and facilitate transactions on the Ethereum blockchain.
- **Smart contracts:** a digital tool that automatically executes transactions and records them on the blockchain when certain conditions are met. Contracts execute automatically, without human intervention. Examples of use cases:
 - Insurance (insured loss → payment)
 - Credit default swaps (creditor's default → payment of funds)
 - Transportation rental (payment → unlocking of bike)
- Many ICO tokens are built as ERC-20 smartcontracts on the Ethereum network.

5. Initial Coin Offerings

- White paper → marketing → sell tokens to the public.
- Tokens are no more than a promise to build some online service for which the coin will be the accepted currency.
- According to one study 80% of ICOs are scams. Warning signs include:
 - A very professional website
 - A shallow and jargon-filled white paper
 - Promoted by rappers and other celebrities, surrounded by lots of international fashion models (Floyd Mayweather and DJ Khaled)
- Tokens don't confer equity in the company typically, but rather are expected to (i) appreciate in value if the company's project succeeds and (ii) become tradeable on a cryptocurrency exchange.



6. Enter the SEC



- The DAO report (July 2017)
 - Tokens issued by The DAO in its \$150 million ICO were securities under the “Howey Test” (an investment contract is an investment of money in a common enterprise with a reasonable expectation of profits from the entrepreneurial or managerial efforts of others). The tokens were offered and sold to U.S. investors through The DAO’s website. The DAO’s tokens expressly offered investors a share of profits in the Ethereum projects funded by The DAO.
 - The SEC thundered that anyone raising capital with an ICO in the U.S. must either comply with the registration requirements of the Securities Act of 1933 or face enforcement action.

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- “Utility tokens” stripped of all equity security features were tried by the industry, but the SEC’s Chairman Clayton poured cold water on the idea in December 2017.
- The DAO Report also made it clear that anyone operating a securities exchange without registration, such as cryptocurrency exchanges, would be held accountable.
 - The QuadrigaCX \$190 mm debacle.



- As a result, ICO promoters fled the U.S., starting in late 2017, and most have adopted stringent procedures to exclude U.S. investors.

201

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- Airfox and Paragon



- In November 2018, the SEC ratcheted things up further with enforcement actions against Airfox (Carrier EQ Inc.) and Paragon Coin Inc. for failing to register the tokens sold to thousands of investors in their 2017 ICOs. Although the tokens lacked equity or voting rights in the companies, the SEC easily found them to be securities under the Howey Test.
- The SEC then proceeded to pull its punches, fining each company a paltry \$250,000, requiring them to register as public companies by filing a Form 10 under the Exchange Act of 1934 and permitting them to conduct an unregistered claims recovery process in lieu of a costly registered rescission offer.

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- EtherDelta, an online trading platform for Ethereum-based tokens, was also targeted by the SEC in November 2018 for failure to register as a securities exchange under the 1934 Act.
 - The new SEC Framework
- The April 3, 2019 “Framework for ‘Investment Contract’ Analysis of Digital Assets” and accompanying *Turnkey Jet* no-action letter offer guidance to ICO issuers as to whether a token is a security under *Howey*. The focus is on the third prong of *Howey*, “a reasonable expectation of profits from the efforts of others.”

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- **Bad Facts:**

- The sponsor is developing, operating, promoting, making a market for the new asset/network;
- The sponsor has an ongoing managerial role (issuing additional tokens, deploying funds raised);
- There's an expectation of capital gain from the token;
- The token can be traded on a secondary market;
- There are so many tokens that investment, rather than network utility, seems to be the intent; and
- The token/network are not functional yet.

204

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- Note that the Framework introduces the concept of tokens losing their status as a security by, for example, the completion of the development of the functionality of the token, such as acquiring goods and services on the network.
- The gloves are off: the Kik Interactive \$100 million ICO
 - A Canadian messaging app company sold "Kin" tokens to the public in 2017 without registration under the U.S. securities laws. The SEC filed a lawsuit against Kik on June 4, 2019.
 - Marketed as an investment opportunity: "make a ton of money."
 - Profits to result from Kik's build-out of an ecosystem and trading on an exchange.
 - Kik kept three trillion Kin tokens to profit alongside investors.
 - SEC alleges a classic *Howey* test security was offered and sold without registration under the Securities Act.



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7. Facebook's Stablecoin, Libra: The New Internet of Money



- The whitepaper was published June 18, 2019.
- Mission: “a simple global currency and financial infrastructure that empowers billions of people” that will “deliver on the promise of ‘the internet of money’.”
- Key elements:
 - A currency built on a new blockchain (Calibra digital wallet, WhatsApp, Facebook Messenger).
 - Backed by a reserve of assets that give it intrinsic value (bank deposits and short-term government securities, i.e., fiat currency).
 - Administered by an independent, non-profit Libra Association, that will evolve the ecosystem.
- A currency or commodity, not a security.

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8. So Where Do We Go From Here?

- ICOs and cryptocurrency exchanges are subject to U.S. securities laws.
- If you're an ICO promoter, either make tracks to Ibiza, register your ICO or exchange with the SEC or find an exemption. *Pro tip:* tokens should be presently usable in an ecosystem, and not be marketed as an investment opportunity.
- Regulation ATS for exchanges.
- ICO exemptions:
 - Regulation D (private placements under Rule 506(b) and (c)).
 - A word on “general solicitation” and the recent CoinAlpha Advisors SEC enforcement action.

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- Regulation A and A+ (limited public offerings (up to \$50 million) for U.S. or Canadian issuers)
- Regulation S (offshore offerings)
- But *beware* the 1934 Act registration problem if the ICO issuer:
 - Has more than \$10 million in assets; *and*
 - Tokens are held of record by ≥ 2000 persons or ≥ 500 non-accredited investors
- But wait, there's more! Other regulatory regimes:
 - SEC: Investment Company Act and Investment Advisers Act
 - U.S. Treasury Department: Bank Secrecy Act and money services business registration
 - CFTC commodities regulation
 - State regulation (e.g., the New York State BitLicense)
 - International

208

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Impediments to Patent Registration Involving “Blockchain” Technologies

- Alice Corp. v. CLS Bank International, 573 U.S. 208, 134 S. Ct. 2347 (2014): Patents were held to be invalid because the claims were drawn to an abstract idea, and implementing those claims on a computer was not enough to transform that idea into patentable subject matter.
- “Fundamentally, blockchain technology refers to data systems [and data processes...]”.
- Examples of U.S. Blockchain Patents.

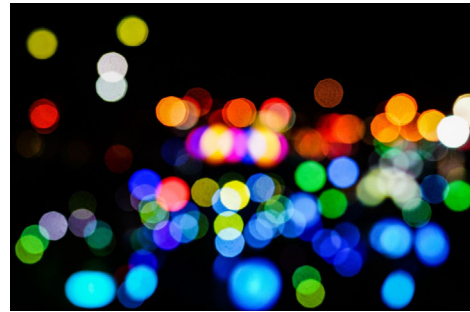


209

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Assessment of “Impediments”

- Decision in *Alice* affirms stringent thresholds for patent eligibility.
- Petitioners need to demonstrate how the application of blockchain technology within a claim is significantly more than an abstract idea simply applied on a computing device.
- Generic computer implementation of code does not transform an abstract idea into a patent eligible invention.
- Inherent nature of blockchain technology may hinder successful patent petitions.

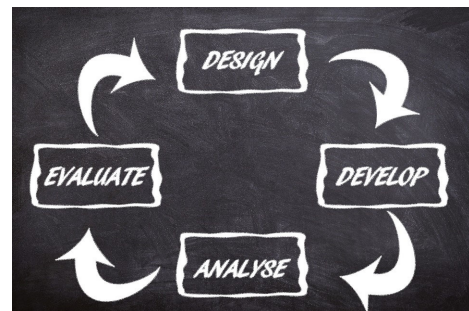


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210

“Blockchain” Benefits for Intellectual Property Portfolio Development and Management

- Problems: Transferability of digital products and content; Unauthorized transfers limitations; Limited and inefficient digital IP protection tools; an aging Digital Millennium Copyright Act; Competing national legal frameworks.
- Blockchain ledgers creates time-stamped records.



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Benefits and Solutions with “Blockchain”

- Registration
- Security
- Smart Contracts
- Counterfeiting and Unauthorized Use
- Public or Private Registration

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Regulatory Trends for Intellectual Property Registration and Management



213

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The United States – National and State Approaches

- National
 - U.S. Chamber of Commerce
 - Blockchain Intellectual Property Council
 - Token Alliance
 - Smart Contracts Alliance
 - Blockchain Alliance
- Selected State Approaches
 - Arizona (HB 2417)
 - Nevada (SB 398)
 - Vermont (SB 269)
 - Illinois (HB 5594)
 - Wyoming (SF 125)



214

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The European Union

- European Union Blockchain Observatory and Forum
 - Blockchain Policy and Framework Conditions Working Group
 - Shall investigate market practices and “define the policy, legal, and regulatory conditions needed to promote the regulatory and legal predictability necessary for larger-scale deployment of blockchain applications”
 - Use Cases and Transition Scenarios Working Group
 - Shall investigate market practices within the public sector
 - European Union Intellectual Property Office
 - Anti-Counterfeiting Blockchain Forum
 - Shall deliver anti-counterfeiting infrastructure for the European Union



215

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General Regulatory Concerns:

- Money Laundering
- Tax Evasion and Compliance
- Anti-Terrorist Financing
- Network Security, Cybersecurity, and Management Standards
- Fraud and Theft



216

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217

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