Substance Over Form

WINSTON & STRAWN LLP

SEC v. REcoin Group Foundation, LLC, DRC World Inc. a/k/a Diamond Reserve Club, and Maksim Zaslavskiy, Memorandum and Order dated September 11, 2018 (United States District Court for the Eastern District of New York, Case No. 1:17-cr-00647-RJD-RER) at pp. 6, 15:

> "The label Zaslavskiy chooses to attach to the alleged scheme does not control our analysis. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004) ('Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called.') (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)... simply labeling an investment opportunity as a 'virtual currency' or 'cryptocurrency' does not transform an investment contract – a security – into a currency... in searching for the meaning and scope of the word 'security'...form should be disregarded for substance and the emphasis should be on the economic reality."

Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto, William Hinman, Director, ***Securities and Exchange Commission Division of Corporation Finance*** (June 14, 2018) at pp. 2, 4:

> "[Y]ou might ask, given that these token sales often look like securities offerings, why are the promoters choosing to package the investment as a coin or token offering? This is an especially good question if the network on which the token or coin will function is not yet operational. I think there can be a number of reasons. For a while, some believed such labeling might, by itself, remove the transaction from the securities laws. I think people now realize labeling an investment opportunity as a coin or token does not achieve that result...

> "Let me emphasize an earlier point: simply labeling a digital asset a 'utility token' does not turn the asset into something that is not a security...I recognize that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security...But, the economic substance of the transaction always determines the legal analysis, not the labels."

Testimony on Virtual Currencies: The Roles of the SEC and the CFTC, Jay Clayton, Chairman of the Securities and Exchange Commission (delivered at hearing, entitled "Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission," before the Senate Committee on Banking, Housing, and Urban Affairs, Washington, D.C., February 6, 2018) at pp. 7-8:

> "Certain market professionals have attempted to highlight the utility or voucher-like characteristics of their proposed ICOs in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions that the federal securities laws do not apply to a particular ICO appear to elevate form over substance. The rise of these form-based arguments is a disturbing trend that deprives investors of mandatory protections that clearly are required as a result of the structure of the transaction. Merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security... Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens, *i.e.*, the ability to sell them on an exchange at a profit. In short, prospective purchasers are being sold on

the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering."

In the Matter of Carriereq, Inc., d/b/a Airfox, Securities Act Release No. 10575 (November 16, 2018) at p. 6; ***In the Matter of Paragon Coin, Inc.***, Securities Act Release No. 10574 (November 16, 2018) at p. 8; ***In the Matter of Munchee, Inc.***, Securities Act Release No. 10445 (December 11, 2017) at p. 8; Dao Report at p. 11:

"In analyzing whether something is a security, 'form should be disregarded for substance,' *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), 'and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.' United Housing Found., 421 U.S. at 849."

Statement on Cryptocurrencies and Initial Coin Offerings, SEC Chairman Jay Clayton (December 11, 2017) at p. 2:

"A change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed…Said another way, replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance.

"I urge market professionals, including securities lawyers, accountants and consultants, to read closely the investigative report we released earlier this year [the Dao Report] and review our subsequent enforcement actions…In the [Dao Report], the Commission applied longstanding securities law principles to demonstrate that a particular token constituted an investment contract and therefore was a security under our federal securities laws. Specifically, we concluded that the token offering represented an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Following the issuance of the [Dao Report], certain market professionals have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions appear to elevate form over substance. Merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."

Testimony on "Oversight of the U.S. Securities and Exchange Commission" before the Committee on Financial Services – U.S. House of Representatives (June 21, 2018), Securities and Exchange Commission Chairman Jay Clayton:

"Determining what falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change for over 80 years. If you are attempting to fund a project - whether it be opening a new manufacturing plant or creating an application on a distributed network - by inviting others to invest in the enterprise based on the expectation that they will profit from other people's efforts, the same laws and standards apply: register the securities offering or use an exemption from registration. Issuing a 'token' rather than a share certificate does not change that approach. Concluding otherwise would ignore the fundamental tenets of over 80 years of securities regulation and put other businesses seeking to raise capital at a competitive disadvantage."

Statement on Digital Asset Securities Issuance and Trading, SEC Divisions of Corporation Finance, Investment Management and Trading and Markets (November 16, 2018) at p. 4, fn. 4:

> "On July 27, 2017, the Commission issued a report, which concluded that particular digital assets were securities and explained that issuers of digital asset securities must register offers and sales of such securities unless a valid exemption applies. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) ('DAO Report')... On Dec. 11, 2017, the Commission issued a settled order against an issuer named Munchee, Inc., making clear that a token may be a security even if it has some purported utility. *Munchee, Inc.*, Securities Act Rel. No. 10445 (Dec. 11, 2017) (settled order) ('Munchee Order'). Together, the DAO Report and the Munchee Order emphasize that digital assets offered and sold as investment contracts (regardless of the terminology or technology used in the transaction) are securities."

Framework for "Investment Contract" Analysis of Digital Assets, Strategic Hub for Innovation and Financial Technology (FinHub) of the Securities and Exchange Commission (April 3, 2019) at pp. 1, 3 (note 12) and 9:

> "The focus of the Howey analysis is not only on the form and terms of the instrument itself (in this case, the digital asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales)... in searching for the meaning and scope of the word 'security' in the [Acts], form should be disregarded for substance and the emphasis should be on economic reality... When assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction."