



THE CRYPTO LAWYERS

Joseph Collement, Esq. | Rafael Yakobi, Esq.

1041 Market Street #340 San Diego, California 92101 USA

+1 (805) 280-6944 | Info@TheCryptoLawyers.com | www.TheCryptoLawyers.com

MEMORANDUM

To: The VeriCoin and Verium Development Team
From: The Crypto Lawyers, LLP
Date: June 6, 2018
Re: VeriCoin and Verium Under U.S. Securities Laws

Introduction

Our firm has been asked to render an opinion as to whether VeriCoin (“VRC”) and Verium (“VRM”) (collectively referred to as the “Coins”) are likely to be deemed securities under U.S federal securities laws or subject to possible regulation as a commodity.¹ No opinion is expressed with regard to any other body of law or legal construct. It is widely recognized that neither an opinion letter nor any particular legal opinion expressed in it is intended to be – or is – a guarantee of a particular outcome.² Please be advised that the Security Exchange Commission (“SEC”), a U.S. court of competent jurisdiction, or a cryptocurrency exchange, may reach an alternative conclusion to those stated in this letter.

The analysis in this opinion is based on the information provided to our firm by the Coins’ developers (the “Developers”), the Coins’ whitepapers, and related documents until this opinion’s date. If these documents are revised in the future, the relevant analysis may change. While our firm conducts reasonable due diligence to establish the veracity of the factual information provided to us, we do not conduct an audit of computer code to confirm that a particular software or algorithm functions as intended or as described. Further, nothing in this opinion is intended to create an attorney-client relationship with any purchaser of the Coins. Purchasers should seek independent legal counsel regarding the implications of their purchase.

Launched on May 10th, 2014, VRC is a decentralized, peer-to-peer³ digital currency running on its own blockchain protocol known as proof-of-stake-time (“PoST”). It is decentralized because it is powered by its users and has no central authority. It is peer-to-peer because payment transactions do not require a third-party intermediary such as a bank or credit card company to validate the transaction.

¹ For clarity, the Coins will be referred to as VRC and VRM, and the VeriCoin and Verium networks will be referred to as VeriCoin or Verium, or the “Networks.”

² *Smith v. Lewis*, 13 Cal. 3d 349, 358, 118 Cal. Rptr. 621, 627 (1975). See RESTATEMENT § 52, comment b; ABA Principles § I.D.

³ Peer-to-peer (P2P) computing or networking is a distributed application architecture that partitions tasks or workloads between peers. Peers are equally privileged, equipotent participants in the application. They are said to form a peer-to-peer network of nodes.

Similar to Bitcoin, VRC did not have an initial coin offering (“ICO”) or token sale. VRC coins were initially created with a proof-of-stake (“PoS”) / proof-of-work (“PoW”) hybrid protocol. To stake, VRC holders post collateral in the form of the VRC cryptocurrency, proving to the VeriCoin network they are stakeholders in the network. Once the collateral (i.e. the stake) has been posted in a staking wallet, VRC holders can process transactions in the network, secure the network, and keep network users synchronized in exchange for freshly minted VRC.⁴ On the first anniversary of VeriCoin, May 10th, 2015, VeriCoin implemented a new protocol called PoST. Under the PoST protocol, users who stake their coins for longer periods of time are rewarded with a higher stake reward while simultaneously increasing the overall network security.

In July 2016, VeriCoin’s developers introduced the Verium network, a separate blockchain protocol with a new block-time paradigm called proof-of-work-time⁵ (“PoWT”) that speeds up transaction time as mining power increases. Variable block-times allow Verium to scale automatically while enhancing transaction speeds and network capacity to ensure high levels of network security at any level of mining throughput. Verium’s native currency, VRM, was created to be its own independent store of value asset and to support the VeriCoin blockchain by allowing the Verium network to process VeriCoin blocks through Verium’s auxiliary mining protocols. This process speeds up VeriCoin’s block-time while maintaining lower fees across all VRC transactions.⁶

Together, VeriCoin and Verium represent a binary-chain, which secures and accelerates transactions by leveraging their respective complimentary PoST and PoWT protocol technologies into a dual blockchain ecosystem.

In response to VeriCoin community’s feedback, the Developers conducted a token swap for VRM in exchange for VRC (no other coins were accepted) from July 18, 2016 to August 18, 2016.⁷ The Developers marketed VRM as a “reserve commodity” to supplement the VRC network.⁸ The Developers did not market VRM as an investment opportunity with any profits beyond the opportunity to mine or stake for more VRM coins, as typical of commodity styled cryptocurrencies that strive to be successful stores and transfers of value. The proceeds from the token swap were not used for the initial development and launch of the Verium network. Indeed, at the time of the token swap, the Verium blockchain was already functional.

A total of 564,705 VRM coins were mined by the Developers from Verium’s genesis block for the token swap and exchanged for VRC at a sliding scale ratio.⁹ 50% of the proceeds from the token swap were allocated to the “stake endowment fund and the remaining 50% were reserved to Verium’s continuous development, marketing, and third-party partnerships as voted on by the VeriCoin and Verium community. Since the token swap, 1,0077,908 VRM have been mined starting with Verium’s second block. There is a current circulating supply of 1,642,613 VRM, which are traded on various cryptocurrency exchanges including but not limited to Bittrex, Upbit, Poloniex, Livecoin, Cryptopia, Bleutrade, CryptoBridge, and UpCoin.

⁴ “Staking” means that the coins will be inaccessible and unsellable for a period of time and held in order to guarantee their honest participation in the maintenance of the network.

⁵ Verium users can mine new Verium coin by using computing power to perform complex calculations that process transactions on the Verium network, secure the network, and keep network users synchronized.

⁶ As a blockchain keeps growing, eventually, the file size gets so large that it becomes harder to download, synchronize and manage. This is due to the fact that every node needs to store all transactions ever processed since the blockchain was created to maintain the blockchain’s integrity. New nodes are also required to re-process all data when they download the blockchain for the first time. This creates major scalability issues as the blockchain size increases, especially with the rising number of transactions per second.

⁷ The token swap was marketed as an “ICO.” However, in July 2016, such nomenclature did not carry the connotation that exists today as to whether an ICO is an offering of securities.

⁸ <https://portal.VerCoin.info/verium/> (May 21, 2018).

⁹ 350,000 VRM were sold at a 6 VRM: 1 VRC ratio and the remaining 214,705 VRM were sold at a 10:1 ratio.

The Howey Test Applied to VRC and VRM

It is illegal to offer or sell securities in the U.S. unless the offer and sale are exempt under the federal securities laws or made pursuant to an effective registration statement filed with the Securities and Exchange Commission (the “SEC”). One type of a security under federal law is an “investment contract.”¹⁰ Consistent with the general position of the SEC, we believe that the “investment contract” analysis is the best fit for analyzing most coin sales under the U.S. federal securities laws.¹¹ Since the 1930s, courts have generated significant analysis of what is an “investment contract” and this opinion will apply this analysis to VRC and VRM.

The United States Supreme Court in its 1946 decision in *SEC v. W.J. Howey* provided the seminal definition for the term “investment contract.” An investment contract is a “contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”¹² Many courts in the succeeding seventy-two years have further expounded on each of the constituent parts of this test, now known as the *Howey* test. Courts often break the *Howey* test into three elements to determine whether an asset is a security. Those elements are: (1) that there is an investment of money, (2) in a common enterprise (3) with the expectation of profits solely from the efforts of others.¹³ If and only if all elements are satisfied, then a contract, scheme, or arrangement passes the *Howey* test and constitutes a security. If any one of the elements is not met, the arrangement fails the *Howey* test and subject of the test is not a security.

Our analysis is based on two key questions inherent in the flexible *Howey* test that demarcates a securities classification of a given asset: (1) is the coin or token valuable primarily as an investment or as a useful item? And (2) is there an issuer backing up that value or is the value the result of a network of unaffiliated participants in an industry and market? These questions illustrate the difference between coins or tokens that may provide positive returns for holders as a result of the efforts of others, versus assets that increase in value as a reflection of the positive qualities of the network and a natural demand the coins or tokens that operate within that network.

Further, as Jay Clayton, Chairman of the SEC, recently highlighted in his speech at Princeton University, “[w]hat we find in the regulatory world, the use of a [utility] token evolves over time. The use can evolve toward or away from a security.”¹⁴ This statement is particularly relevant to the analysis of cryptocurrencies because while some may have satisfied some elements of the *Howey* test at the time of their inception (assuming there was a token sale), these outcomes can realistically change over time when comparing incomplete platforms and token sales, versus complete decentralized platforms that can only be joined via the secondary market or individual effort. Given the regulatory uncertainty over the last few years, we find the most relevant time period for assessing whether a token or coin is a security is the current time. While we will analyze the historical development of the coin or token as well, our ultimate conclusions reflect the current status of the asset as it stands at the date of this opinion.

¹⁰ The Securities Act of 1933, as amended, Section 5, 15 U.S.C. § 77e(a), (c); 77d.

¹¹ See SEC Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

¹² *SEC v. Howey Co.*, 328 U.S. 293 (1946).

¹³ *Id.* at 301.

¹⁴ Nikhilesh De and Mahishan Gnanaseharan, *SEC Chief Touts Benefits of Crypto Regulation*, (May 12, 2018) available at <https://www.coindesk.com/sec-chief-not-icos-bad>

1. Investment of Money

“The first component of the *Howey* test focuses on the investment of money. The determining factor is whether an investor ‘chose to give up a *specific consideration* in return for a *separable financial interest with the characteristics of a security*.’”¹⁵ (emphasis added). Therefore, coins that are not sold for consideration do not satisfy the investment of money element. For example, if all coins are distributed for free, then there is no consideration and thus no investment of money. Coins which are sold in a crowdsale, regardless of whether sold for fiat or digital currency (or goods, services, or promissory notes) almost definitely involve an investment of money.

VRC

Here, VRC coins have not been sold (with the exception of the secondary market) at any time and VeriCoin had no initial public offering (“IPO”) or ICO for VRC. To date, the only time where money or assets are exchanged for VRC is in the secondary market. We believe that the existence of the secondary market is irrelevant because a secondary market involves an exchange between coin holders and users who are unconnected with the development of the project and do not represent issuers providing a “separable financial interest with the characteristics of a security.” For example, in a secondary market exchange, there is no contract or agreement between the buyer and seller, there are no obligation besides the exchange of funds at the given rate, and there are no promises for “effort” by either party.

Since the only way to obtain VRC is through PoST, the remaining issue is whether staking (i.e. foregoing the use of VRC coins for a certain period time) and the dedication of marginal amount of computer processing power associated with staking amounts to “specific consideration... in return for a separable financial interest with the characteristics of a security,” and thus, satisfy the first element of the *Howey* test.

Under a broad contract law interpretation of consideration, actions associated with staking and mining would likely be regarded as specific consideration. And it is also likely that coins which result from the process of staking or mining likely fit the definition of a “separable financial interest,” since they are precisely that, a separable financial interest in virtual currency or commodity within decentralized network.

However, VRC do not have “the characteristics of a security” for several reasons. First, VRC serve as the fuel of a decentralized network of computers of which there is no owner or director. Indeed, in the absence of VRC, the VeriCoin blockchain would not function as a medium of exchange or store of value. Moreover, there is no contract (necessary for an investment contract characterization) because a contract requires, *inter alia*, two parties entering into a set of promises in a bargained-for exchange. Instead, when staking, VRC users interact with a distributed network of other users and computer code. This touches on one of the foundational aspects of permissionless blockchain and cryptocurrency technology -- the intentional and conspicuous absence of a trusted third party who can control the outcome of the activity on the network, and thus the value of the native currency of that network.

While some commentators have found that this element is satisfied with respect to Bitcoin (not based on the use of mining or staking, but seemingly because money is exchanged for Bitcoin on the secondary market, which we find unpersuasive), we believe that VRC is not likely to satisfy the “investment of money” element of the *Howey* test.¹⁶

¹⁵ *SEC v. SG Ltd.*, 265 F.3d 42, 46 (1st Cir. 2001) (quoting *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979)).

¹⁶ A securities Law Framework for Block Token, An initiative of Coinbase, Coin Center, Union Square Ventures and Consensys,

VRM:

In accordance with the definitions and analysis above, it is likely that VRM purchasers made an “investment of money” during Verium’s token swap because VRM coins were purchased in exchange for VRC coins. As discussed above, an investment of money can be satisfied by a cryptocurrency like ETH or BTC, and as such VRC. The distributed VRM would also likely constitute a “separable financial interest” since each VRM represents a separable interest in the total supply of VRM.

However, the token swap, which took place nearly two years ago accounted for less than 20% of the total current supply of VRM. Since then, 1,0077,908 VRM were mined via the PoWT protocol. Moreover, any new VRM will also be mined using that same protocol. As explained above, we believe that decentralized peer-to-peer cryptocurrencies like VRM do not have the characteristics of a security. Therefore, while purchases of VRM that took place during the token swap may be considered an investment of money, any VRM mined or purchased today via secondary market would likely not satisfy the investment of money.

2. Common Enterprise

Federal circuit courts have used varying tests to analyze whether a common enterprise exists. Three approaches predominate: (i) horizontal; (ii) narrow vertical and (iii) broad vertical. However, the United States Supreme Court has not explicitly adopted any of the above definitions thus far.

Various commentators have argued that if a sale of coins is made before any code has been deployed on a blockchain, it is more likely to result in a common enterprise where the profits arise from the efforts of others. This is because the buyers are completely dependent on the actions of the developers, and the buyers cannot actually participate in the network until a later time. In contrast, if there is a functioning network, there is less likely, but still it may have some similarities to a common enterprise where the profits arise from the efforts of others. The closer the sale is to launch of the network, the less likely there is to be a common enterprise.¹⁷ Here, as a matter of threshold, VRC coins were not sold. Moreover, VRC were only obtainable once the VeriCoin Blockchain was created. Similarly, although a portion of VRM’s current was sold to the public, VRM were only obtainable when the Verium blockchain network was functional. This weighs strongly in favor of VRC and VRM not being considered a “common enterprise” under the *Howey* test.

Horizontal Common Enterprise

Under the horizontal approach, a common enterprise exists if there is a pooling of assets from multiple investors so that all share in the profits and risks of the enterprise.¹⁸ Whether funds are pooled is the key question, and thus in cases where there is no sharing of profits or pooling of funds, a common enterprise may not be deemed to exist.¹⁹

Here, VRC is most clearly not a horizontal common enterprise because no pooling of assets took place as VeriCoin did not have a token sale or ICO for VRC. Similarly, to Bitcoin, VRC operates on a decentralized network. There is no common entity that generates, sells, or controls VRC. Moreover, a holder of VRC will not receive any

(May17, 2018)<https://www.coinbase.com/legal/securities-law-framework.pdf>

¹⁷ See *supra* note 16.

¹⁸ *SG Ltd.*, 265 F.3d at 49.

¹⁹ See e.g., *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 101 (finding discretionary future trading account was not investment contract because there was no pooling of funds); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016 (7th Cir. 1994) (promoter of condominium timeshare did not pool profits and thus no common enterprise existed).

benefit other than the utility of the coin and the platform unless that holder takes independent action to support, rather than consume, the network. The only users that receive an economic benefit are users that choose to help run the network through the staking process. Currently, holders of VRC who choose to “stake” their coins earn a return of new coins that are brought into existence for this purpose as described above.

With respect to VRM, during the token swap in 2016, a pooling of assets took place because purchasers of VRM commingled their funds together by depositing VRC into a “swap address” in exchange for VRM coins. However, that pooling of assets was not for the purpose of purchasing an interest or a share for future profits within a common enterprise, but rather for interested parties to purchase VRM coins, which can be used on the VRM and VRC network. Indeed, no representations were made to any pro-rata distributions of profits, no actual distribution of profits took place. Moreover, the token swap was a response to the VRC community’s desire for a faster, more secure and further decentralized platform, and VRM tokens were only being offered as a coin for use on the VRC/VRM platform, leaving VRM holders with no expectation of receiving a distribution of profits or losses, pro-rata or otherwise. Therefore, we conclude that the horizontal approach to the common enterprise element of the *Howey* test is not met with respect to either VRC or VRM.

Narrow Vertical Common Enterprise

Under the narrow vertical approach, it is not necessary that the funds of investors are pooled, there must be a direct correlation between success or failure of the investment and success or failure of the promoter(s)’ efforts.²⁰

VRC is not likely to be considered a common enterprise under the narrow vertical approach because VRC has no promoter. What it does have is a voluntary team of software developers who may, but have no obligation to, improve VRC’s source code. Any future non-secondary market coin holders generated their coins via proof-of-stake on a 100% functioning network. Therefore, the fortune of VRC’s coin holders is not interwoven with and dependent upon the effort and success of the promoters’ effort.²¹

With regard to VRM, at the time of the token swap, it is likely that the success of VRM depended upon the success of the Developers who collected funds to market and spread adoption of VRM, and fund its future development. Indeed, had the Developers stopped working on VRM at the time of the token swap, it is likely that the project would have failed entirely. However, given that the Verium network has been fully operational and decentralized for nearly two years, there is currently no reliance from VRM holders and prospective purchasers on the Developers’ efforts, who could abandon the project without impairment to the network. Therefore, at this time, VRM does not represent a common enterprise under the narrow vertical approach.

Broad Vertical Common Enterprise

The broad vertical approach considers whether the success of the coin holders depends on the promoter’s expertise.²² If there is such reliance, then a common enterprise will be deemed to exist.

As noted in the discussion of horizontal commonality, there is currently no common promoter of VRC or VRM because the creation of VRC and VRM is a function of a computer program on a decentralized network that does not require any human interaction. Given that the only possible way to receive an economic benefit is from a holder interacting with a computer program, and since the computer program is not a promoter nor does it have any

²⁰ See *SEC v. Eurobond Exchange Ltd.*, 13 F.3d 1334 (9th Cir. 1994) (imposition of profit limitations on investors through requiring promoter to receive excess return rate tied promoter’s fortunes to investors)

²¹ *Eurobond Exchange Ltd.*, 13 F.3d 1334 at 1339.

²² See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974).

expertise, there is likely no broad vertical common enterprise.

The only parties resembling promoters are the Developers. Their expertise contributed to the inception of the VeriCoin and Verium networks. However, given that both networks are currently complete with regard to any possible acquisition of VRC or VRM, we believe that there is no connection between the expertise of the Developers and the “success” of VRC and VRM. In the absence of any obligation on the part of the Developers to use their expertise to further the value of the coins, it is not reasonable to contend the future value of VRC or VRM is dependent on the expertise of the promoters of each respective network. For this reason, it is not likely that the common enterprise element is satisfied under the broad vertical approach.²³

3. Expectation of Profits Solely From the Efforts of Others

The final element of the *Howey* test requires that a person “is led to expect profits solely from the efforts of the promoters or a third party.”²⁴ This is a two-part element. First, that the purchaser has an expectation of profit, and second that the expectation of profit arises solely or predominantly from the efforts of others.

First, an expectation of profit generally means expected capital appreciation resulting from the development of the initial investment or expected participation in earnings resulting from the use of investor funds.²⁵ There is no expectation of profit where a purchaser is motivated primarily by the desire to use or consume the item purchased.²⁶ Even purchasing an asset for consumption and profit is not enough, to satisfy this prong, the purchaser’s expectation of profit must *predominate* the expectation of using the item purchased.²⁷

Here, there is no expectation of profit in purchasing or holding VRC because the primary purpose and functionality of VRC, as represented in VeriCoin’s whitepaper, is to serve as an affordable and efficient medium of exchange for goods and services and to maintain the integrity of the VeriCoin network. Similarly, there is no expectation of profit in purchasing or holding VRM because its sole intended purpose and functionality is to decrease VRC’s transaction time and fees through the use of an auxiliary mining protocol. The block generation mining/staking process, which is crucial to the VeriCoin and Verium’s blockchain existence, requires use of the native VRC and VRM tokens. Moreover, purchasers or holders of VRC and VRM are not investing in the profits and risks of an entity or enterprise with the hope they will receive a distribution of profit or losses, pro-rate, or other compensation because no such entity or enterprise exist.

To the extent that VRC and VRM holders view their purchase as an investment with potential risks and rewards, their investment is based secondary market factors such as supply and demand based upon the attractiveness of the utility of the network to other users, rather than the sole efforts of a voluntary group of programmers with no legal obligation to continue development. Accordingly, it is not reasonable to conclude that VRC/VRM users’ expectation of profits predominate their expectation of using the Coins for their intended purposes.

²³ Commentators have similarly argued that decentralized peer-to-peer digital currencies like Bitcoin and VRC/VRM are not securities under the broad vertical approach based on the fact there is no common promoter. See *Is Bitcoin a Security?* JEFFREY E. ALBERTS & BERTRAND FRY, B.U. J. SCI. & TECH. L. (April 27, 2018) available at https://www.bu.edu/jostl/files/2016/01/21.1_Alberts_Final_web.pdf

²⁴ *SEC v. Howey Co.*, 328 U.S. 293, 298-99 (1946).

²⁵ *United Hous. Found. v Forman*, 421 U.S. 837, 854-55 (1975).

²⁶ See *Forman*, 421 U.S. at 852-53.

²⁷ See *Forman*, 421 U.S. at 858 (“What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption . . .”).

As demonstrated by several of the SEC enforcement actions with regards to token sales, (and as applicable here to VRC/VRM), the type of activities and behavior that the SEC considers unregistered securities offerings include: tokens backed by real estate where money is pooled for investment²⁸, where tokens represent a share of an interest in a company that invests in diamonds to achieve high returns²⁹, and where promoters represent to investors that the tokens would yield “a 1354 percent profit in less than 29 days.”³⁰ Here, the Developers made no representations that either VRC or VRM would generate returns, that the tokens are “backed by” any tangible items, or that the funds would be used to invest in business ventures.

Second, assuming, *arguendo*, that the expectation of profit predominates the consumptive use, the “solely from the efforts of others” portion of the element asks “whether the efforts made by those other than the investor are the undeniably significant ones, those *essential* managerial efforts which affect the failure or success of the enterprise.”³¹

Several federal courts have held, and we agree, that the mere possibility of an increase in value on a secondary market is not from the “efforts of others.” For example, in *Noa v. Key Futures*, a case involving a forward contract for silver bars, the Ninth Circuit found no expectation of profits from the efforts of others because once the purchase of silver bars was made, the profits to the investor depended primarily upon the fluctuations of the silver market, not the managerial efforts of Key Futures.³² In another case involving a futures contract for sugar, a federal court in New York held the presence of a speculative motive on the part of the purchaser or seller did not, on its own, evidence the existence of an investment contract.³³

Although analogies are often made between Bitcoin (as a placeholder for cryptocurrencies generally) and gold, these tangible precious metals and similar commodities are different from cryptocurrency.³⁴ For example, a development team may continue to improve the network and the secondary market price of the token may appreciate as a result. This characteristic is not shared by precious metals. In the case of a decentralized token, the secondary market price is driven exclusively by supply and demand. Supply and demand can be due to a variety of factors. One of those factors could be the efforts of the development team creating the token’s functionality; but once that functionality is created, any essential efforts have by definition already been applied. It would be difficult to argue that any improvement on an already-functional token is an “essential” managerial effort.

On the other hand, tokens which give, or purport to give, traditional equity, debt or other investor rights almost certainly satisfy the “efforts of others” query. For example, a token which does not have any current function is likely to be bought with an expectation of profit from the efforts of others, because no real use or participation by coin holders is possible. In contrast, a token which has a specific function that is only available to token holders is more likely to be purchased in order to access that function and less likely to be purchased with an expectation of profit that predominates the interest in consumption.

Here, assuming that purchasers of VRC/VRM were motivated by an expectation of profit, they would not be relying on the efforts of others, this is because the only way to earn profit in connection with the purchaser or use of VRC or VRM is through a user’s own active participation in the Coins’ networks via the PoST or PoWT

²⁸ <https://www.sec.gov/news/press-release/2017-185-0> (last visited May 17, 2018)

²⁹ See *supra* note 28.

³⁰ <https://www.sec.gov/news/press-release/2017-219>

³¹ *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973) [*emphasis added*].

³² *Noa v. Key Futures*, 638 F.2d 77, 79 (9th Cir.1980).

³³ *Sinva v. Merrill Lynch*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966).

³⁴ Commodity Futures Trading Commission (CFTC) Chairman J. Christopher Giancarlo recently stated that Bitcoin bears several similarities to gold, although it has elements of many different asset classes.

protocols.

VRC and VRM's clear utility case, and economic mechanisms available to Coins holders as set forth above are in contrast to the scheme implemented in *Munchee*, where the users targeted by *Munchee* in its marketing efforts for the purchase of MUN coins were not the ultimate users of the *Munchee* app wherein MUN coins could be used. *Munchee* also "burned" MUN coins in order to increase their value by decreasing their supply, whereas VRC holders are incentivized to "stake" their coins in order to increase the total supply of VRC, which is likely to lead to decrease in value unless greater demand manifests in the future.³⁵

Lastly, all functionality associated with VRC and VRM are inherent in the VeriCoin and Verium networks and occurs programmatically with the active participation of the coins holders. The necessary technical permissions and the coin holders do not rely on manual actions of any third party outside the network on which the Coins reside. This arguably sets forth the most critical part of the platform's functionality (at least from a technical perspective) such that it may be reasonable to conclude that any future efforts from the Developers are not essential efforts as described above.

Therefore, we conclude that is unlikely that VRC or VRM satisfies either the "expectations of profits" or "solely from the efforts of others" portions of this element of the *Howey* test.

Commodity Analysis

In 2015, and in the context of an enforcement action, the CFTC first asserted that "Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities," citing Section 1a(9) of the Commodity Exchange Act ("CEA") ("commodity" defined to include, among other things, "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in.").³⁶

In January 2018, the CFTC filed an unrelated action in the U.S. District Court for the Southern District of New York against an individual and corporate entity alleging that defendants operated a deceptive and fraudulent virtual currency scheme to induce customers to send money and virtual currencies to defendants in exchange for purported virtual currency trading advice concerning the trading of virtual currencies, including Bitcoin and Litecoin, and for virtual currency purchases and trading on behalf of customers under the individual defendant's direction. Alleging that the customers had lost substantial sums and that others were at risk of likewise suffering such losses, the CFTC sought to enjoin such acts and practices, to compel compliance with the CEA, and to recover civil monetary penalties and remedial ancillary relief, including but not limited to trading bans, restitution, disgorgement, rescission, and pre- and post-judgment interest.³⁷

Following the defendant's motion to dismiss, on March 6, 2018, Judge Weinstein concluded that the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency. That said, the court recognized that Congress has yet to authorize an agency to regulate virtual currency.³⁸

While plenty of regulatory uncertainty remains, these CFTC's actions as described above are not

³⁵ See SEC Release No. 10445, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-And-Desist Order (Dec. 11, 2017), available at <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

³⁶ *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*. CFTC Docket No. 15-29, September 17, 2015.

³⁷ *CFTC v. Coindrop Markets*, E.D.N.Y., Case 1:18-cv-00361, (January 18, 2018.)

³⁸ *CFTC v. Coindrop Markets*, E.D.N.Y., 18-CV-361 at 9. (March 6, 2018.)

incongruent with their previous statements regarding CFTC jurisdiction. In particular, the CFTC stated as follows:

*The CFTC's jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce. – Beyond instances of fraud or manipulation, the CFTC generally does not oversee “spot” or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.*³⁹

Based on this statement, absent the existence of fraud, market manipulation, derivative products, or margin trading, the CFTC's jurisdiction does not relate to the exchange of VRC or VRM in the context of a cryptocurrency exchange.

Conclusion

Whether a coin is a security is based on the facts and circumstances of each coin.⁴⁰ In accordance with our analysis above, we conclude that the “investment of money” element of the *Howey* test is not likely satisfied for VRC because there was no token sale. On the other hand, it is likely VRM satisfies the first element because there was an investment of money (VRC coins) with respect to all coins sold during the token swap in 2016. However, it is reasonable to conclude that there is no investment of money with regard to any VRM coin that has or will be created as a result of mining or staking since the token swap.

With regards to the second element of the *Howey* test, whether a common enterprise exists, applying the conservative horizontal approach, the narrow vertical, and the broad vertical approaches lead to the determination that both VRC and VRM are not currently likely to satisfy the second element of the *Howey* test because of absence of reasonable reliance upon promoters, the decentralized nature of both protocols, and the ability to obtain economic benefits being exclusively achievable via individual action associated with mining (PoWT) and staking (PoST).

Third, we believe it is unlikely that holders of VRC and VRM have an expectation of profit solely based on the efforts of others because of the specific purpose and functionality that VRC and VRM serve, the decentralized nature of the network, the absence of obligations by the Developers, the level of network development, the fact that no implicit or explicit promises were made regarding profits, and that the only holders of VRC and VRM who can expect a profit are those that actively participate in the maintenance of the network.

Based on our review of *Howey*, other relevant case law, SEC guidance, albeit limited, on the subject of cryptocurrencies, and based on information provided and representations made to us by VeriCoin and Verium's development team, **we conclude that both VRC and VRM are not likely to be deemed securities**. Further, given the CFTC's relatively clear position regarding its jurisdiction over cryptocurrency exchanges in the spot markets, we conclude that VRC and VRM trading should not be subject to commodity regulation.

³⁹ A CFTC Primer on Virtual Currencies, LabCFTC, October 17, 2017, (last accessed May 13, 2018), available at (https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercryptocurrencies100417.pdf)

⁴⁰ SEC Release No. 81207 at 10.