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To: Michael Horowitz, General Partner
Chaintech Digital GP Inc.

From: Murphy & McGonigle, P.C.

Subject: Whether Loopring Tokens are Securities within the Meaning of the Securities Act of 1933

Date: 2017.Oct.10

You have asked us to analyze whether tokens, referred to as LRC, that the Loopring Foundation ("Loopring") issued in an initial coin offering ("ICO")[1] are securities under the Securities Act of 1933 (the "Securities Act"). As discussed below, although the matter is not free from doubt, we think the better argument is that LRC is not a security under the test that the Supreme Court set out in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946) and guidance from the Division of Enforcement of the U.S. Securities and Exchange Commission (the "SEC").

Background

[1] The Financial Industry Regulatory Authority, Inc. describes an ICO as follows:

> An ICO involves the creation of a new virtual coin or token by a company looking to raise money. In general, the company announces a specified amount of funds that it wants to raise, and the fundraising continues until that amount is reached. ICOs are conducted online, and purchasers use fiat currency, like the U.S. dollar, or virtual currencies, like bitcoin and ether, to pay for the new tokens.

Initial Coin Offerings: Know Before You Invest, FINRA Investor Alerts (Aug. 31, 2017) *available at* http://www.finra.org/investors/alerts/initial-coin-offerings-know-before-you-invest.

Loopring states that it is an "open, multilateral token exchange protocol"[2] and decentralized automated execution system.[3] It allows system users (members) to trade different types of crypto-tokens across exchanges on the Ethereum blockchain.

Loopring describes LRC as a "cryptographic token that provides membership access and is used to pay trading fees"[4] that is based on the ERC20 Ethereum Token Standard.[5] Members with higher LRC balances will have "access to preferential liquidity treatment and discounted trading."[6] We understand from you that LRC does not confer any ownership rights in Loopring to LRC holders, and LRC holders are not entitled to share in any potential profits of Loopring.

Loopring's website indicates that Loopring sold LRC to investors in a public auction. Investors purchased LRC using [ETH?]. Documentation on the website indicates that the total supply of LRC is nearly 1.4 billion tokens.[7] You have represented that Loopring does not plan to create additional LRC or sell additional LRC to the public. Loopring expects that LRC may trade on the secondary market.[8]

Discussion

We believe that LRC can reasonably be classified as a so-called "utility token." A utility token represents services or units of services that can be purchased.[9] The sale of utility tokens is described as "a way to fund projects of shared infrastructure that couldn't be funded before."[10]

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[2] Whitepaper, Loopring Decentralized Token Exchange Protocol v 1.3 (Sept. 26, 2017) *available at* https://loopring.org/en/index.html ("Loopring Whitepaper").

[3] https://loopring.org/en/index.html.

[4] https://loopring.org/en/faq.html.

[5] Loopring Whitepaper at 11.

[6] *Id*.

[7] http://docs.loopring.org/token/#circulating-supply.

[8] *Id*.

[9] https://medium.com/startup-grind/understanding-the-difference-between-coins-utility-tokens-and-tokenized-securities-a6522655fb91.

[10] *Id*. A recently-released whitepaper categorizes tokens as follows: "Tokens leverage computation and cryptography to represent consumptive goods (known as 'utility tokens') or replacements for traditional investments (known as 'securities tokens')." The SAFT Project: Toward a Compliant Token Sale Framework (Oct. 2, 2017) *available at* http://saftproject.com/static/SAFT-Project-Whitepaper.pdf (the "Token Whitepaper"). The Token Whitepaper discusses the uncertainty around the status of token sales under the U.S. securities laws and proposes, among other things, that a company interested in token sales instead raise capital by selling securities to accredited investors with token sales to follow once the issuer has created a functioning service or product.

The threshold question is whether LRC, as a utility token, is a security within the meaning of the federal securities laws. Section 2(a)(1) of the Securities Act of 1933[11] (the "Securities Act") defines a "security" as follows:

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) or any put, call, straddle, option or privilege entered into on a national securities exchange relating to a foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 5 of the Securities Act prohibits the unregistered offer or sale of securities in interstate commerce, absent an exemption from registration.[12] Violations of Section 5 do not require scienter. *SEC v. Universal Major Indus. Corp*., 546 F.2d 1044 (2d Cir. 1976). Thus, an offering of tokens to the public would violate Section 5 of the Securities Act if such tokens are securities but the offering of such securities is not registered under the Securities Act or exempt from registration.

Case law interpreting what is considered a "security" has focused on the term "investment contract," a catch-all term inserted by Congress into the definition intended to "encompass the range of novel and unusual instruments whose economic realities invite application of the securities laws." *See Robinson v. Glynn*, 349 F.3d 166, 172-73 (4th Cir. 2003). The Supreme Court in *Howey* defined an investment contract as "an investment of money in a common enterprise with profits to come solely from the efforts of others." An instrument must meet each of the elements set out in *Howey* to be considered a security.

The staff of the SEC's Division of Enforcement (the "Staff") recently issued the *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (the "Report") in which it analyzed under *Howey* whether tokens ("DAO Tokens") that an organization called The DAO issued in an ICO were securities for purposes of the Securities Act and the Securities Exchange Act of 1934.[13] The Staff described The DAO as follows:

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[11] 15 U.S.C. § 77b(a)(1).

[12] 15 U.S.C. § 77e.

[13] Securities Exchange Act Release No. 81207 (July 25, 2017) *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

> The DAO was created … with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.[14]

The Staff concluded that DAO Tokens were securities under the *Howey* test. In reaching that conclusion, the Staff determined that (1) the purchase of DAO Tokens with Ether ("ETH") was an "investment of money" because the term "money" is broader than cash;[15] (2) investors in DAO Tokens had a reasonable expectation of profits because DAO Token holders were entitled to share in any profits that the projects funded with their investments generated;[16] (3) and DAO Token holders profits were to be derived from the managerial efforts of others, namely the founders and other key personnel associated with The DAO; DAO Token holders' limited voting rights in The DAO did not give them any meaningful managerial power in The DAO.[17]

In our view, although we think the purchase of LRC involved an investment of money and investors will rely on the managerial efforts of Loopring personnel with respect to Loopring, we do not believe that LRC investors have an expectation of profits.

1. Investors in LRC Invested Money

Investors' purchases of LRC likely would be viewed as an investment of money for purposes of the *Howey* test. As noted in the Report, in determining whether an investment contract exists, the investment of "money" need not take the form of cash. In decisions following *Howey*, courts expanded the scope of investment of money to include, more broadly, the investment of consideration. For instance, the Ninth Circuit in *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976), found that an investor simply guaranteeing loans met the first test outlined in *Howey*. *See also, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc*., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of Howey's reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract"). Investors in LRC used ETH to make their investments, and LRC were received in exchange for ETH. If faced with the question, we believe the Staff would take the position that the purchase of LRC in the auction was an investment of money. *See SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual

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[14] Report at 1.

[15] *Id*. at 11.

[16] *Id*. at 12.

[17] *Id*. at 12-15.

currency, meets the first prong of Howey); *Uselton*, 940 F.2d at 574 ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value'.") (citations omitted).

2. No Reasonable Expectation of Profits

The Howey test also requires that a transaction be induced by the investor's expectation of receiving a profit; whether or not the investor receives a profit is irrelevant. The Supreme Court has defined "profits" to mean "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds." "[P]rofits" also include "dividends, other periodic payments, or the increased value of the investment." *SEC v. Edwards*, 540 U.S. 389, 394 (2004). Courts have held that there is no expectation of profit if an investor is motivated to consume the thing purchased. Moreover, the profit motive must be the predominate motive. If a person invests money with an expectation of profit, but the predominate motive is to consume the thing purchased, the expectation of profit prong of the *Howey* test has not been met. *United Hous. Found. v. Forman*, 421 U.S. 837, 858 (1975).

In our view, investors who purchased LRC have no reasonable expectation of earning profits through Loopring by purchasing LRC. The Report noted that The DAO was "a for-profit entity whose objective was to fund 12 projects in exchange for a return on investment." The ETH was pooled and available to The DAO to fund projects. The projects (or "contracts") were to be proposed by specified persons. If the proposed contracts were whitelisted by a designated group called Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, the Staff concluded that a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

By contrast, we understand that LRC holders do not have any input into if and how Loopring is deployed by exchanges. Moreover, LRC holders do not share in any profits that Loopring might earn from exchanges that deploy its protocol. Rather, LRC holders are entitled to benefits for trading on exchanges utilizing Loopring. The holders get certain execution priority, lower liquidity costs, higher service levels and can pay trading fees with LRC. The reasonable investors in LRC would be motivated not by the prospect of profits, but by a more favorable trading environment for cryptocurrencies.

The availability of secondary-market trading for LRC arguably could be viewed as a profit motive. An investor might be motivated to purchase LRC if he or she believed that the tokens could be sold in the future at an increased value if Loopring became successful.

We do not believe that the existence of a secondary market for LRC indicates a profit motive in purchasing LRC, however. We understand that LRC do not represent an equity or similar interest in Loopring. If Loopring grows and becomes more profitable, LRC holders will not

share in that increased value; thus, there is no reason to believe that the profitability of Loopring should impact the price of LRC on the secondary market. Rather, the secondary market allows LRC holders to sell all or some of the benefits to which they are entitled with respect to Loopring. If, for example, an LRC holder determined that he no longer needed the higher benefit and service levels commensurate with his LRC holdings, he could liquidate some portion of this holdings, retain a lower level of Loopring benefits, and recoup a portion of his LRC investment through the market. The value of LRC benefits might vary based on a number of factors, such as benefits available to, and costs to, non-LRC holders in using Loopring. It does not appear, however, that such market fluctuation would be tied to the profitability of Loopring. Stated somewhat differently, although an LRC holder is not precluded from profiting on the sale of LRC, his or her primary motive is consumption of the trading services and other benefits that LRC provides.

3. LRC Holders Would Not Earn Profits Derived Solely from the Efforts of Loopring's Founds and Managers

The Howey test requires that the profits must "come solely from the efforts of others." In determining whether an investor is deriving profits form the efforts of others, the central issue is "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." *SEC v. Glenn W. Turner Enters*., *Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The Staff concluded in the Report that the DAO's investors relied on the managerial and entrepreneurial efforts of specified persons other than the investors "to manage The DAO and put forth project proposals that could generate profits for The DAO's investors." The Staff provided extensive documentation of founders' and managers' efforts to make The DAO successful and profitable.

Although we believe that efforts of Loopring's founders and managers will be essential to the failure or success of the enterprise, we do not believe that LRC holders have a reasonable expectation of earning a profit from such efforts, as discussed above. If investors have no reasonable expectation of profit, then efforts on the part of an enterprise's personnel necessarily are not aimed at creating profits for such investors.

Moreover, there is a colorable argument that any profit an LRC holder earns via Loopring derives from the holder's efforts, not from those of the founders/managers of Loopring. If the primary benefit of holding LRC is to gain access to preferential trading through exchanges that have implemented Loopring, LRC holders may be traders and thus earning profits through their trading activities, not the activities of Loopring. That is, LRC holders are relying on Loopring to build out the Loopring infrastructure so that the holder can derive profits through the holders' trading efforts.

Conclusion

For the reasons set out in this memorandum, we believe that LRC should not be viewed as a security for purposes of the Securities Act. We note that the securities regulatory regime governing ICOs is developing and neither the SEC nor its staff has provided guidance on whether tokens similar to LRC are securities, so we cannot provide assurances that the SEC or its staff would agree with our conclusion.[18] Nevertheless, we note that the SEC staff has taken the position that whether a token is a securities is a facts and circumstances determination, and we believe that LRC, as described above, should not be viewed as a security under application of the *Howey* test and other relevant case law and guidance.

Please note that this memorandum is being delivered to the Chaintech Digital GP Inc. ("Chaintech") in its capacity as a representative of Loopring, and should not be distributed to third parties without our prior consent. This memorandum is furnished solely for the benefit of Chaintech and Loopring with respect to the status of LRC under the U.S. securities laws and may not, without our prior consent, be relied upon by any other person.

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[18] The Token Whitepaper, cited in footnote 9 above, assumes that the primary motivation to invest in tokens is to turn a profit and that, therefore, the issuance of tokens before an issuer has a functioning product or service involves the issuance of securities. The authors conclude that assuming that the profit motive predominates, profits are necessarily derived from the managerial efforts of the issuer if the issuer is in the process of creating its product or service. Token Whitepaper at 8.