Token Securities Framework & Launching a Network

SPEAKER

Brian Brooks, Former Chief Legal Officer, Coinbase
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Brian Background

**COINBASE**
Chief Legal Officer

**FANNIE MAE**
Board of Directors
Previously Executive Vice President, General Counsel, Corporate Secretary

**CALIFORNIA BANKERS ASSOCIATION**
Board of Directors, Executive Committee

**SPRING LABS, FLYHOMES, EARNUP, GRASSHOPPER BANK AND TEXTIQ**
Early stage investor/advisor
Agenda

Regulatory Background: Tradeoffs and Opportunities
Is Being a Security Really That Scary
Crypto Rating Council
Tradeoffs in Your Business Strategy?
Now and Later
The choices you make in the design phase now will have significant consequences for:

Operate
Network

Fundraise
Token

Go Public
Company

Keep in Mind
The choices you make now may not be the choices you’ll make later.
Digital Asset Regulation

**Treasury**
- FinCEN
  - Bank Secrecy Act
  - Anti-Money Laundering
  - Counter-Terrorism Financing

**CFTC**
- Trading of futures, swaps, and other derivatives, including commodity tokens

**SEC**
- Regulation and oversight of securities industry, including exchanges, broker-dealers, investment advisors, mutual funds, and public companies

**International Jurisdictions**
- European Union
- Singapore
- Japan

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Why Do the Securities Laws Care About Your Token?

The securities laws care about what an investor is entitled to know.

Keep in Mind

If the value of your token is contingent upon your success, then it’s a security.

When you are raising money, the vehicle you use may be a security.
Howey Test

- SEC v. W.J. Howey (1946): Citrus grove tracts in Florida
- The Supreme Court defined “investment contract”
  - An investment of money
  - In a common enterprise
  - With an expectation of profit
  - Solely from the efforts of others
- Uncertainty: How does it apply to each case?
Safe Harbor Proposal

Token Safe Harbor Proposal
Office of Commissioner Hester M. Peirce
February 8, 2020


Preliminary Notes:

1. Distributed ledger technology may be used to offer and sell digital assets, such as tokens, to raise capital and for other purposes. The U.S. federal securities laws may apply to such transactions, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale.

The analysis of whether a token is offered or sold as a security is not static and does not strictly adhere to the digital asset. A token may be offered and sold initially as a security because it is wrapped in a transaction involving an investment contract, but that designation may change over time if the token is later offered and sold outside of an investment contract. For example, a token sale may no longer be the sale of an investment contract if purchasers no longer reasonably expect a person or group to carry out the essential managerial or entrepreneurial efforts.

However, in order for a network to mature into a functional or decentralized network that is not dependent upon a single person or group to carry out the essential managerial or entrepreneurial efforts, the tokens must be distributed to and freely tradeable by potential users, programmers, and participants in the network. Additionally, secondary trading of the tokens typically provides essential liquidity for the users of the network and acts in the development of the network. The application of the federal securities laws to these transactions frustrates the network’s ability to achieve maturity and prevents the transformation of the token sold as a security to a non-security token functioning on the network.

Accordingly, the safe harbor is intended to provide Initial Development Teams with a three-year time period within which they can facilitate participation in, and the development of, a functional or decentralized network, exempt from the registration provisions of the federal securities laws so long as the conditions are met. The safe harbor is also designed to protect token purchasers by requiring disclosures tailored to the needs of the purchasers and preserving the application of the anti-fraud provisions of the federal securities laws.

Upon the conclusion of the three-year period, the Initial Development Team must determine whether token transactions involve the offer or sale of a security. Token transactions may not constitute securities transactions if the network has matured to a functioning or decentralized network. The definition of Network Maturity is intended to provide clarity as to when a token transaction should no longer be considered a security transaction.

2. Rule 183 is not an exemption.
Crypto Rating Council

Purpose

Framework

Scoring
## CRC Score Card

<table>
<thead>
<tr>
<th>Digital Asset Review Questions</th>
<th>Answers</th>
<th>Howey Prongs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Investment of Money</td>
</tr>
<tr>
<td>1. Did purchasers contribute fiat or digital currency in exchange for tokens, excluding secondary purchases through a platform which are not from the Project Team? If a Project Team both (i) conducted a substantial pre-mine and (ii) sold pre-mined tokens to fund its operations, indicate “Yes”.</td>
<td>YES</td>
<td>+100</td>
</tr>
<tr>
<td></td>
<td>NO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
<td>0</td>
</tr>
<tr>
<td>2. If the answer to #1 is No, did token holders contribute services or other individual efforts that support the system/network (e.g., proof of work mining) in exchange for tokens?</td>
<td>YES</td>
<td>+50[^4]</td>
</tr>
<tr>
<td></td>
<td>NO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
<td>0</td>
</tr>
<tr>
<td>3. If the answer to #1 and #2 are No, were token holders required to provide email addresses, KYC information, wallet information or other non-monetary consideration that could have value to the Project Team in exchange for tokens?</td>
<td>YES</td>
<td>50[^5]</td>
</tr>
<tr>
<td></td>
<td>NO</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
<td>0</td>
</tr>
</tbody>
</table>

A **score of 1** - few or no characteristics consistent with treatment as a security.

A **score of 5** - asset has many characteristics strongly consistent with treatment as a security.

The following are all possible scores from the framework: 1, 2, 3, 3.5, 3.75, 4, 4.25, 4.5, 4.75, 5.
## CRC Score Card

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3 prongs have scores below 100</td>
</tr>
<tr>
<td>2</td>
<td>2 prongs have scores below 100</td>
</tr>
<tr>
<td>3</td>
<td>1 prong has a score below 100, and no prong is above 150</td>
</tr>
<tr>
<td>3.5</td>
<td>3 prongs are 100 or greater, and one or more prongs is above 150 but below 200</td>
</tr>
<tr>
<td>3.75</td>
<td>3 prongs are 100 or greater, and either (1) the 4th prong is 75 or above; or (2) one of the other 3 prongs is 200 or greater</td>
</tr>
<tr>
<td>4</td>
<td>All 4 prongs are 100 or greater, but no prong is above 150</td>
</tr>
<tr>
<td>4.25</td>
<td>All 4 prongs are 100 or greater, and no more than one prong is above 150</td>
</tr>
<tr>
<td>4.5</td>
<td>All 4 prongs are 100 or greater; two prongs are above 150, or one prong is above 200</td>
</tr>
<tr>
<td>4.75</td>
<td>All 4 prongs are 100 or greater; three prongs are above 200, or one prong is above 250</td>
</tr>
<tr>
<td>5</td>
<td>All 4 prongs are 100 or greater; three prongs are above 250, or one or more prong are above 300</td>
</tr>
</tbody>
</table>
Security or Not a Security?

2 things to consider

**WHAT** are you distributing

- Your token might or might not be a security

**VS**

**HOW** are you distributing

- The manner you distribute may be a securities offering
  - Exempt Offerings: Reg D, Reg A+, Crowdfunding
  - Crypto Offerings: ICO, IEO, STO

**Keep in Mind:** The CRC Score Card is a new tool to help you answer this question.
## Fundraising, Functionality, Some Blend (Oh my!)

### What are you trying to do?

<table>
<thead>
<tr>
<th>Functionality</th>
<th><strong>Score: ~1</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Priority is to sell a service</td>
<td></td>
</tr>
<tr>
<td>• Trading and Liquidity less important</td>
<td></td>
</tr>
<tr>
<td>• Pricing and volume is tied to utility</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Fundraising</strong> (Fully-operational project)</th>
<th><strong>Score: ~2</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Priority for trading and liquidity</td>
<td></td>
</tr>
<tr>
<td>• Already decentralized and open-sourced</td>
<td></td>
</tr>
<tr>
<td>• Asset value and marketing is independent of project team's involvement</td>
<td></td>
</tr>
<tr>
<td>• Asset is necessary for functioning of network</td>
<td></td>
</tr>
<tr>
<td>• Asset does not pay dividends</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Fundraising</strong> (Work in progress)</th>
<th><strong>Score: ~3.5</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Priority for trading and liquidity</td>
<td></td>
</tr>
<tr>
<td>• Not fully decentralized</td>
<td></td>
</tr>
<tr>
<td>• Dev team involvement is material</td>
<td></td>
</tr>
<tr>
<td>• Imperfect marketing</td>
<td></td>
</tr>
<tr>
<td>• No staking, or no requirement to stake</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Seed Users</strong></th>
<th><strong>Score: ~3.75</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Priority is to seed large network of users</td>
<td></td>
</tr>
<tr>
<td>• Assets distributed for free</td>
<td></td>
</tr>
<tr>
<td>• Dependent on dev team</td>
<td></td>
</tr>
<tr>
<td>• Minimal development</td>
<td></td>
</tr>
<tr>
<td>• Avoids marketing faults</td>
<td></td>
</tr>
</tbody>
</table>
Fundraising, Functionality, Some Blend (Oh my!)

What are you trying to do?

- Priority is to sell a service
- Trading and Liquidity less important
- Pricing and volume is tied to utility

Functionality

Score: ~1
Fundraising, Functionality, Some Blend (Oh my!)

What are you trying to do?

Fundraising (Fully-operational project)

- Priority for trading and liquidity
- Already decentralized and open-sourced
- Asset value and marketing is independent of project team’s involvement
- Asset is necessary for functioning of network
- Asset does not pay dividends

Score: ~2
Fundraising, Functionality, Some Blend (Oh my!)

What are you trying to do?

Fundraising (Work In Progress)

- Priority for trading and liquidity
- Not fully decentralized
- Dev team involvement is material
- Imperfect marketing
- No staking, or no requirement to stake

Score: ~3.5
Fundraising, Functionality, Some Blend (Oh my!)

What are you trying to do?

Seed Users

- Priority is to seed large network of users
- Assets distributed for free
- Dependent on dev team
- Minimal development
- Avoids marketing faults

Score: ~3.75
**Fundraising, Functionality, Some Blend (Oh my!)**

What are you trying to do?

### Membership

- Priority is access to users without access to traditional capital markets
- Tokens represent membership interest in non-stock entity
- Limited transferability
- Expectation of dividends derived by in-network worth

**Score: Untested**
Familiar Membership Models

**Member pays one-time $20 lifetime membership fee**
- 10% annual dividend on your purchases
- Vote for Board of Directors
- Access to members-only designs and sales
- Events and classes at members-only discounted prices
- Stores all your receipts with your account for returns and exchanges

**Premiums based on age and coverage**
- No private stockholders; policyholders share stock
- Has paid out dividends to policyholders each year since 1872
- Held #1 spot for premiums written in last four years (more premiums, increased opportunity for dividends)
- Each member is entitled to one vote regardless of coverage

**Equity investment of 5.5 percent of annual income**
- Profits are returned to the farmers, employees, and community through an established formula
- Member-farmers elect the Board of Directors
- Farmers also make up a separate executive committee
- Stable pay price that has been above the commodity price
- Veterinary support and access to feed and forage
Hot Button Topics

- Gambling Tokens
- Privacy Tokens
- FATF Regulations (black and white markets)
- Tax Reporting
Help Is Available!

Come start a conversation with the Coinbase Launch team

Engage with advisors **early in your development process**

**Receive counsel on your project:** what could contribute to a subsequent positive securities law analysis

All crypto projects, not just future Coinbase listings