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VIA EMAIL

Mr. Alexander Gryaznov
Izetex Pte. Ltd.

January 16, 2018

RE: Securities Analysis of IZX Token Sale

Mr. Gryaznov,

This Memorandum sets forth our firm's legal opinion as to whether the sale of the IZX Tokens ("IZX") would likely be considered a securities offering pursuant to existing United States and Singapore regulatory frameworks. This Memorandum discusses the relevant legal principles for determining what constitutes a security, and why our firm concludes, based on those principles, that the IZX Tokens are not securities given the attributes that our firm has been provided. Our analysis is based on our discussions with you, the materials you provided to our firm, information from https://izx.co, and the law as it exists as of the date of this Memorandum.

Before proceeding, we must clarify that there are two digital tokens involved in the IZX platform: the "IZX Drive Token" and the "IZX Token". This legal opinion shall only address the latter, since this token is the Ethereum-based token that is the subject of the Initial Token Sale. It is not necessary to address the former in any extensive detail because it is an "internal" token that functions only within the confines of the IZX platform. It is not generated and sold within the Initial Token Sale event. In any case, since the two tokens are linked together, it is only necessary to analyze the IZX Drive Token to the extent that it has an effect on the nature of the IZX Token as either a utility or security token.

I. Analysis under United States Federal Securities Law

This section sets forth our firm's legal opinion as to whether the sale of IZX Tokens would likely constitute a securities offering for purposes of Section 2(a)(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act").

In order to analyze the IZX Tokens under federal securities laws, we begin with the definition of "security" contained in Section 2(a)(1) of the Securities Act: "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement … investment contract … 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."

The foundational Supreme Court case for determining whether an instrument meets the definition of security is *SEC v. W.J. Howey*, 328 U.S. 293 (1946). The Supreme Court has reaffirmed the *Howey* analysis more recently in *SEC v. Edwards*, 540 U.S. 398 (2004). *Howey* focuses specifically on the term "investment contract" within the definition of security, noting that it has been used to classify those instruments that are of a "more variable character" that may not fit neatly into other categories and that may be considered a form of "contract, transaction, or scheme whereby an investor lays out money in a way intended to secure income or profit from its employment."[1]

Not every contract or agreement is an "investment contract," rather, the Supreme Court has developed a four-prong test to determine whether an agreement constitutes an investment contract and therefore a security. The Court articulated the test as follows: A contract constitutes an investment contract that meets the definition of security if there is (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) solely from the efforts of others (e.g., a promoter or third party), "regardless of whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets used by the enterprise."[2] In order to be considered a security, all four prongs must be satisfied.

Most recently, the SEC Division of Enforcement's investigative report involving DAO tokens revealed that tokens that function like investment contracts under *Howey* will be treated as securities.[3] The DAO Report applied the *Howey* test to digital tokens offered and sold by a virtual organization known as "The DAO," and concluded that the tokens were in fact securities. The DAO was created by German corporation Slock.it UG and Slock.it's co- founders with the objective of operating for profit. The DAO would raise assets by selling digital tokens (the "DAO tokens") to investors, and then using the assets to fund projects intended to generate profits. Investors contributed original versions of Ethereum tokens, now known as Ethereum classic ("ETC"), and received DAO tokens, which granted the DAO token holder certain voting and ownership rights. According to the SEC, promotional materials for The DAO stated that The DAO would earn profits by using the contributed assets to fund projects that would provide DAO token holders a return on investment. The projects would be proposed by the holders of the DAO tokens, vetted by "curators" (initially identified by Slock.it), and voted upon by the holders of the DAO tokens. The SEC emphasized that the various promotional materials disseminated by Slock.it's co-founders touted that DAO token holders would receive "rewards," which the promotional materials and White Paper defined as, "any [ETC] received by a DAO generated from projects the DAO funded." DAO token holders would then vote to either use the rewards to fund new projects or to distribute the ETC to DAO token holders. In addition, DAO token holders could monetize their investments in DAO tokens by re-selling DAO tokens on a number of web-based platforms that supported secondary trading in the DAO tokens.

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[1] *W. J. Howey*, 328 U.S. at 298-99.
[2] *Id.*
[3] SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf (the "DAO Report").

The DAO Report is a clear warning signal to the industry and market participants that the federal securities laws "apply to those who offer and sell securities in the U.S., regardless of whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless of whether they are distributed in certificated form or through distributed ledger technologies."[4] The SEC did not take the position that virtual currencies, or interests in such currencies, are themselves securities.

The *Howey* test has not yet been directly applied by the courts to any digital currency or blockchain token. To determine whether IZX Tokens are securities, we examine each of the *Howey* factors in light of the SEC's analysis of the DAO tokens.

a. Investment of Money

Under Howey and subsequent case law, an investment of money may include not only the provision of capital, assets, and cash, but also goods, services, or a promissory note.[5] In short, to constitute a security, there must be a contribution of value. Investors in the DAO tokens used ETC to make their investments. The SEC found that an investment of ETC is the type of contribution of value that can create an investment contract under the Howey test.[6]

According to izx.io, the IZX Initial Token Sale accepts payment in ETH, BTC, and possibly other cryptocurrencies. However, given the broad interpretation of a money investment, and the SEC's finding that investment of digital currency constitutes an investment of money, our firm concludes that the IZX Token sale would constitute an investment of money where contribute a cryptocurrency such as ETH or BTC in exchange for IZX.

b. Common Enterprise

To be a security, the investment of money must be "in a common enterprise." Different courts use different tests to analyze whether a common enterprise exists. The two dominant approaches are horizontal and vertical.

Under the horizontal approach, a common enterprise is deemed to exist where multiple buyers pool funds into an investment and the profits of each investor correlate with those of the other buyers such that the fortunes of all investors rise and fall together.[7] Whether funds are pooled appears to be the key inquiry, thus, in cases where there is no sharing of profits or pooling of funds, a common enterprise may not be deemed to exist.[8]

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[4] *Id.* at 18.
[5] See, e.g., Int'l Bhd. Of Teamsters v. Daniel, 439 U.S. 551, 560 (1979); Hector v. Wiens, 533 F.2d 429, 432-33 (9th Cir. 1976); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975).
[6] *DAO Report*, *supra* note 3, at 11.
[7] *See, e.g., Curran v. Merrill Lynch*, 622 F.2d 216 (6th Cir. 1980).
[8] *See, e.g., Hirk v. Agri-Research Council, Inc.,* 561 F.2d 96, 101; *Wals v. Fox Hills Dev. Corp.*, 24 F.3d

Conversely, the vertical approach looks at whether the profits of the buyer are tied to the promoter such that the fortunes of buyers and sellers rise and fall together.[9] More precisely, vertical commonality exists where the financial success of the seller's enterprise itself rises and falls with the value of the tokens. This is the case where the seller is attempting to make a profit from an ongoing business that uses the token. However, where a seller is not seeking to make a profit, but instead plans to spend the money raised from the token sale on development (and then liquidate the entity), courts will be less likely to find vertical commonality. Under such a model, the seller intentionally becomes insolvent over a period of time, but the value of the utility token simultaneously increases.

The DAO Report did not specifically analyze the common enterprise prong. However, the SEC did assert that "investors who purchased DAO tokens were investing in a common enterprise,"[10] presumably based on the fact that The DAO raised ETC from multiple investors who had a common interest in the success of The DAO. Here, like most token sales, the sale of the IZX Tokens would likely be considered investment in a common enterprise under the horizontal approach since the tokens are fungible, and, thus, the values rise and fall together. As for the vertical approach, the whitepaper does not make clear how the funds raised from the token sale shall be used. Therefore, we do not have sufficient to arrive at a conclusion as to whether the common enterprise criterion is met under the vertical approach.

c. *Expectation of Profits*

The third prong of the *Howey* test looks to whether buyers who purchased an instrument reasonably expected to earn profits from the enterprise. For tokens, this can refer to any type of return or income earned as a result of being a token holder. However, subsequent case law interpreting *Howey* has clarified that the expectation of profit from the mere existence of a secondary market is insufficient to satisfy this prong.[11]

The SEC found that the promotional materials publicized by The DAO creators informed investors that The DAO was a for-profit entity whose objective was to finance projects in exchange for a return on investment. The DAO was intended to make profits, via investments in contractor projects proposed by the token holders, to share with its token holders, once the projects had been approved by The DAO curators and voted upon by the token holders. Since the functional value of a DAO token was to provide token holders with the prospect of profits, the SEC reasoned that The DAO's investors would have been motivated by a reasonable

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1016 (7th Cir. 1994).

[9] See e.g., SEC v. Eurobond Exchange Ltd., 13 F.3d 1334 (9th Cir. 1994); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).
[10] DAO Report, supra note 3, at 11.
[11] Note, the existence of a secondary market may be sufficient to satisfy this prong if the seller itself creates the secondary market by, for example, guaranteeing repurchase.

expectation of profits.[12] The SEC statements in the DAO Report make it clear that the "expectation of profits" is not necessarily limited to distributions of cash or appreciation of equity interests, and it can include the types of rewards that The DAO promised to provide such as participation in contractor projects.

The expectation of profit need not be the only motivating factor for purchasers, but it must predominate to constitute a security. Since IZX Tokens serve the purpose of being used to issue IZX Drive Tokens, which are then sold to advertisers, it is reasonable to conclude that the predominant factor motivating potential investors in purchasing IZX Tokens is the expectation of profit from selling IZX Drive Tokens to advertisers. Therefore, based on this consideration, we conclude that the third criterion regarding expectation of profits is satisfied.

d. Solely from the Efforts of Others

The fourth prong of the *Howey* test examines whether or not the profits of an instrument are derived from the managerial efforts of others. Typically, courts have been flexible with the word "solely," such that, in addition to the literal meaning, it need only be predominately from the efforts of others.[13]

The SEC determined that because the efforts of the DAO organizers and curators were required for the success of The DAO enterprise, and because the DAO token holders' voting rights were limited, The DAO's investors were reliant on the managerial efforts of others. Specifically, without the efforts of The DAO organizers and curators, The DAO would not have been able to succeed for several reasons. First, through their conduct and marketing, the organizers of The DAO led investors to believe that they could be relied on to provide significant managerial efforts and the Ethereum blockchain expertise required to make The DAO a success. Second, the contractor project approval program placed substantial discretion in the hands of The DAO organizers and curators, and the limited nature of the DAO token holders' voting rights meant that they were substantially reliant on the efforts of The DAO organizers and curators. Third, when The DAO was attacked by hackers, the organizers intervened and took crucial steps to resolve the situation, demonstrating the organizers' active oversight of The DAO.

In this case, we would conclude that although purchasers of IZX Tokens may have a reasonable expectation of profit, such expectation does not predominantly result from the managerial efforts of others. Token holders are not passive investors, but they must actively review buy orders placed by advertisers for IZX Drive Tokens and must exercise judgment in deciding whether to accept such buy orders and to issue IZX Drive Tokens to advertisers accordingly. Token holders must then wait for IZX Tokens to be "burnt" by players in mobile games used by the advertisers in order for them to sell IZX Drive Tokens again. Therefore, since the expectation of

[12] DAO Report, supra note 3, at 11-12.
[13] See e.g., SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482-83 (9th Cir. 1973); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

profit from purchasing IZX Tokens does not predominantly depend on the management efforts of others, the IZX Token is not likely to be considered a security under U.S. federal law.

II. Analysis Under the Laws of Singapore

This section sets forth our firm's legal opinion as to whether the IZX Tokens would likely constitute a security for purposes of the Securities and Futures Act.

Following the SEC's DAO Report, Singapore's financial regulatory body and central bank, the Monetary Authority of Singapore ("MAS"), clarified its own position and treatment of token offerings.[14] The statement indicated that the offer or issue of digital tokens in Singapore will be regulated by MAS if the digital tokens constitute products regulated under the Securities and Futures Act (Cap. 289) ("SFA"). Specifically, where digital tokens fall within the definition of securities in the SFA, issuers of such tokens are required to issue and register a prospectus with MAS before the offering of such tokens, unless otherwise exempted. The MAS further clarified their interpretation of the applicability of the SFA to digital token offerings in a set of guidelines issued on November 14, 2017.[15] Digital tokens may be securities subject to the SFA where they represent ownership or a security interest over an issuer's assets or property and may therefore be considered an offer of shares or units in a collective investment scheme.[16] Secondly, digital tokens may also be considered a security if they constitute a debenture. A digital token would be considered a debenture if it represents debt owed by the issuer of the token to the token holder. Thirdly, a digital token could be a security if it represents a unit in a collective investment scheme ("CIS")[17], which is a right or interest in a CIS, or an option to acquire a right or interest in a CIS.

a. Share

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[14] Monetary Authority of Singapore, MAS Clarifies Regulatory Position on the Offer of Digital Tokens in Singapore, Media Release (Aug. 1, 2017), available at http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on- the-offer-of-digital-tokens-in-Singapore.aspx.

[15] Monetary Authority of Singapore, A Guide to Digital Token Offerings, Media Release (Nov. 14, 2017), available at http://www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/Regulations%20Guidance%20and%20Licensing/Guidelines/A%20Guide%20to%20Digital%20Token%20Offerings%20%2014%20Nov%202017.pdf

[16] *Id*.

[17] According to Section 2(1) of the SFA, a "collective investment scheme" is "an arrangement in respect of any property bearing all of the following characteristics:

- Participants have no day-to-day control over management of the property;
- Property is managed as a whole by or on behalf of a manager;
- Participants' contributions and profits or income of the arrangement from which payments are to be made to the participants are pooled; and
- Purpose or effect (or purported purpose or effect) of the arrangement is to enable participants to participate in or receive profits, income or other payments or returns arising from acquisition, holding, management or disposal of, the exercise of, the redemption of, or the expiry of any right, interest, title or benefit in the property or any part of the property."

Based on the nature of the IZX Token, there are no grounds to argue that it constitutes a "share" under the SFA. The IZX Token does not offer any ownership rights over the assets of Izetex Pte. Ltd.

b. Debenture

Based on the nature of the IZX token, there is no basis for concluding that it constitutes a "debenture" under the SFA. The IZX Token does not represent a loan issued by the purchaser to Izetex Pte. Ltd.

c. CIS Unit

In order to analyze whether the IZX Token would be considered a unit in a CIS under Singaporean law, one must consider a set of criteria somewhat similar to the *Howey* test under the U.S. approach. According to Singaporean law, a CIS exists in an arrangement where participants have no day-to-day control over the management of the property (which is the subject of the CIS), the property is managed as a whole by or on behalf of a manager, participants' contributions and profits or income from the arrangement are pooled together, and lastly, the purpose of the arrangement is to enable participants to receive profits.

As has already explained under the U.S. analysis, any profits earned by token holders depends on their own efforts in reviewing and accepting buy orders placed by advertisers. Furthermore, the other participants to the IZX platform, such as the advertisers and game developers are each actively involved in creating the advertising campaigns and mobile games respectively. Therefore, any profits earned from using the IZX platform does not depend on the efforts of any single manager.

III. ***<u>Conclusion</u>***

While no jurisdiction has implemented a clear and comprehensive regulatory framework specific to token sales, regulators globally are increasingly watching the space. With a growing number of jurisdictions issuing compliance guidance in recent months, the general trend is a move toward increased regulation. The above analysis highlights and assesses the legal implications of the IZX Token under United States and Singapore law.

In Singapore, the IZX would likely not represent a unit in a collective investment scheme, since any profits generated by the token holders depend on their own active efforts, rather than that of a manager. Therefore, the IZX Token would most likely not be deemed a security subject to the SFA and regulation by the MAS.

In the United States, the implication of the DAO Report is that depending on the facts and circumstances of an individual token sale, the virtual coins or tokens that are offered or sold may be securities, and that if they are securities, the offer and sale of these virtual coins or tokens are subject to the federal securities laws. To avoid being an investment contract and

thus a security, the IZX Token sale need only avoid one of the *Howey* criteria. In this case, we have concluded that the IZX token does not fall within the criterion of depending on the management efforts of others. Therefore, it should not be deemed a security subject to regulation under U.S. law.

Our firm has conducted a thorough analysis under both U.S. and Singaporean law in order to determine whether or not your token may qualify as a utility token. However, considering the regulatory warnings given by multiple international jurisdictions regarding the potential for tokens to be viewed as securities offerings, our firm finds it necessary to advise you that even if we had concluded that your token was a utility token, a legal opinion issued by a law firm would not exempt it from registration requirements in the United States or any other jurisdiction. Many international jurisdictions have indicated that token sales may qualify as sales of investment contracts, or qualify as crowdfunding sales under pre-existing regulations, and may be regulated as such.

Given the guidance recently received from these regulatory authorities, our firm believes that a growing number of jurisdictions will be closely scrutinizing token sales. Developing an argument for why the IZX Token sale qualifies as a utility token sale does not guarantee that the SEC or a regulatory authority in another jurisdiction will not determine the tokens to be securities subject to registration. Should IZX Tokens be determined securities by the SEC, or another regulatory authority, the IZX Foundation (or whoever is the issuer of the IZX Tokens) could be subject to civil or criminal penalties if the tokens are not properly registered.

If you have any questions, please do not hesitate to contact me via email at jason@silklegal.com or via phone at +66(0)21072007 Ext. 310.

Yours faithfully,

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