Session 403 | Securities, Smart Contracts, & Blockchain: Promises vs. Reality

Smart contracts. Security token offerings (STO’s). Cutting edge uses of blockchain technology raise a host of complex issues across a number of legal, financial, regulatory, and business disciplines. Starting beyond the basics of blockchain, this panel will provide insightful discussions of these complicated legal issues. Are smart contracts really smart? Are they really contracts? More specifically, smart contracts raise intriguing issues of contract interpretation, applicable law, dispute resolution, and enforcement. With regard to STO’s, are these tokens going to fully replace ICO’s? Are the regulatory burdens going to be acceptable to potential investors? More specifically, STO’s require understanding relevant international securities regulations, the various exemptions, and the differences between ICO’s. Later portions of the panel would address the potential future for blockchain from these advanced technical and business perspectives, including IP, commercial law, and international law.

Blockchain continues its rise as a disruptive technology, and these newest applications of the technology will be of wide interest to NAPABA members of various backgrounds and practices. The panel will address these issues through presentations based on their expertise and experience in these industries. Through interactive discussions with the attendees, the panel will present insights on what lawyers need to know about these advanced issues in blockchain.

Moderator:
Peter H. Kang, Sidley Austin LLP

Speakers:
Tung Chan, DAV Foundation
Jason Gottlieb, Morrison Cohen LLP
Jor Law, Lexcuity PC
Amy Wan, Sagewise
Securities, Smart Contracts, & Blockchain: Promises vs. Reality

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## PANELISTS

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NAPABA – BLOCKCHAIN PANEL
BLOCKCHAIN – INTRODUCTION
Blockchain solves the issue of order, validity, and authority.
WHEN DOES BLOCKCHAIN MAKE SENSE?

davidgerard 3 hours ago | unvote [-]

> It may have failed at adoption, but the problem ... has been solved.

I am unconvinced that a solution nobody uses counts as a solution to a problem anyone has.
SMART CONTRACTS – INTRODUCTION

Since lawyers think in analogy you should also become familiar with its cousin metaphor. Smart Ks aren’t trying to create legal binding, they are doing by other means important functions formerly done by trad contracts (e.g. controlling assets and incentivizing performance).

To be clear, at this point I quite regret adopting the term “smart contracts”. I should have called them something more boring and technical, perhaps something like “persistent scripts”.

I like "stored procedures"

But I for one don’t regret the terminology, it has been a great learning opportunity for everyone 😊
SMART CONTRACTS
DEVELOPMENTS & UPDATES

• Enterprise smart contracts v. decentralized smart contracts
  – Enterprise smart contracts are just execution/performance mechanisms embedded into the contract
• Makes sense when there is lack of trust or communication amongst various parties
  – The barrier here will be industry-wide cooperation
• We’re still in the early days
Evolution

• Initial Coin Offerings (ICO)
• ICOs with AML/KYC
• Security Token Offerings (STO)
• Initial Exchange Offerings (IEO)
• OTC, ATS, Lending
Tokenization

Tokenization of anything

- Securities laws implicated, and if not…then
- CFTC (commodities), FinCen (money transmission)
- Lots of regulation

STOs

- Same, same, but different
- Crowdfunding
- JOBS Act
Promises vs Reality

• Decentralization
• Globalization
• Trustless
• Lower costs
• Liquidity
• Capital source
• “Smart” contracts

But…properly utilized, very useful and innovative.

Almost all blockchain projects with smart contracts are start-ups.

A little history....

- **Ethereum launch of Genesis block was in July of 2015** – considered the launch of smart contracts on the blockchain into the mainstream and the beginning of the mad rush to issue tokens.

- Initially, almost all token launches ("ICO" or "initial coin offerings") starting from 2015 were for ERC-20 tokens, meaning Ethereum compatible and built on top of Ethereum protocol.

- **Ether value as proxy for market impact and public interest:**
  - Ether in July 2015 @ $0.30, market capitalization about $18 million.
  - Ether by January 2018 @ $1,200, market capitalization over $80 billion.
  - Ether by August 2019 @ $190, market capitalization about $20 billion.
START UP CONSIDERATIONS: The Set Up

1. Where to incorporate?

- **Switzerland**: Ethereum was incorporated in Zug, Switzerland, as a stiftung in 2015. It single-handedly put Zug on the map as “Crypto Valley.”

- **Why Zug?** to “follow Vitalik,” to “appear credible,” to “be where the action is,” and more recently, to “be where regulators understand crypto.”

- These are not good reasons to incorporate in Switzerland.

- Zug is incredibly expensive. Regulators are inconsistent and backlogged after issuing 2018 guidance on ”utility tokens” v “payment tokens” v “securities.” The legal community is still working with a lot of uncertainty.

- **Other trending jurisdictions**: Malta, Gibraltar and Singapore. Each has their challenges. Lack of resources, bureaucratic, far, expensive.

- **Recommendation**: Drill your clients to find out why they want to be in a certain jurisdiction and help them find the practical choice. Remind your clients that if they sell or solicit securities to, or engage in money transmittal with, US citizens, they are subject to US regulators regardless of where they incorporate.
START UP CONSIDERATIONS:  
The Set Up


- The DAO (May 2016) “decentralized autonomous organization” – a venture fund run by Ethereum smart contracts. The project founders believed that since everyone votes and decides what to invest in and the smart contracts execute per voting, there is no central control and no one is responsible because it’s totally decentralized. The mantra “code is law” is supposed to result in no human being responsible when code executes.

- Raised 12.7 million Eth in May 2016 (@ $150 million). In June 2016, a hacker caused a “loss” of 3.6 million Eth (@$70 million). Crisis, hard fork.

- SEC issued an investigative report on July 25, 2017, where the SEC concluded that the investments were securities and the backend management of the project was centralized enough to implicate liability.

- Two years later, on March 12, 2019, SEC Chairman Clayton made a statement suggesting that a security can evolve to no longer be a security if the central elements of managerial and entrepreneurial efforts have gone away. Basically, something like Ethereum can become so decentralized, it might not be a security anymore even if it once was.
START UP CONSIDERATIONS: The Set Up

2. **What corporate structure?** The third-rail question of decentralization cont.

- Swiss regulators similarly suggest projects can become decentralized to the point of changing the nature and liability of a project.

- But how? When? At what point? Could investments in the DAO have one day become not a security? Did Ethereum become not a security? The answer is: who knows? No one knows for sure.

- What about the back-end administrators who incorporate updates into codes, hold multi-sigs, EIP 999 –participate in coin votes, are core developers, those who decide to implement hard forks that change protocol? At what point do they no longer manage? No one knows.

- **Recommendation:** Start with a traditional governance structure. This will provide certainty at least at first. Maybe the project will be truly decentralized later on and your clients won’t be liable anymore, but don’t count on it.
BLOCKCHAIN: THE U.S. REGULATORY ENVIRONMENT

• Blockchain versus cryptocurrency
  – Blockchain technologies welcome
  – Cryptocurrency … not so fast.
  – The concerns: money laundering, fraud, market regulation

• What is cryptocurrency? Securities, utility tokens, commodities, currencies …

• The goals of the enforcers

• The three tiers of cryptocurrency misbehavior
  – Outright frauds, with no legitimate project
  – A legitimate project, but sold with allegedly fraudulent means
  – A legitimate project, sold honestly, but an unregistered sale of securities
BLOCKCHAIN: THE U.S. REGULATORY ENVIRONMENT

• Securities laws and regulations
  – Securities Act of 1933; Exchange Act of 1934
  – Investment Advisers Act of 1940; Investment Company Act of 1940

• Commodity futures laws and regulations
  – CFTC has jurisdiction over futures trading
  – And also over fraud in spot markets

• Criminal law
  – Fraud, money transmission

• The States: Operation Cryptosweep (state securities laws)

• Private litigation
  – Fraud, unregistered securities offerings
BLOCKCHAIN: INTERNATIONAL APPROACHES

• Different countries; different approaches
  – Some take a very harsh approach
  – Some are more welcoming

• The issues when a technology is not locale-dependent

• The extraterritorial reach of U.S. regulators
  – Morrison v. National Australia Bank
  – Dodd-Frank Section 939P

• America as 800-pound gorilla: the necessity of “bubbles”
Blockchain and Patents: Numbers

• 303 issued US Patents with “blockchain” in the Title, Abstract, or Claims (vs. 94)
• 1,698 published US Patent Applications (vs. 705)
• 1,559 published PCT applications (vs. 602)

• as of 8/30/2019 per FPO
Blockchain Patent Applications

Source: IPlytics GmbH (iam media June 12, 2019)
Blockchain & Patent Owners

Source: IPlytics GmbH (iam media June 12, 2019)
Blockchain: Geographic Scope of Patents

Source: Swiss Federal Institute of Intellectual Property (Nov. 2018)
Blockchain: Geographic Scope of Patentees

Source: Questel (2019)
Blockchain and Patent Law

• *Alice* and patentability under 35 U.S.C. § 101
• Divided infringement
• Damages calculation
Blockchain and IP Evolution

Hype Cycle for Emerging Technologies, 2018

Blockchain

Source: Gartner (Aug. 2018)
Questions and Comments from the Audience
CONCLUSION

Takeaways & Final Thoughts
THANK YOU
On behalf of the Speakers and the organizers of the 2019 NAPABA Convention, thank you for your participation.
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