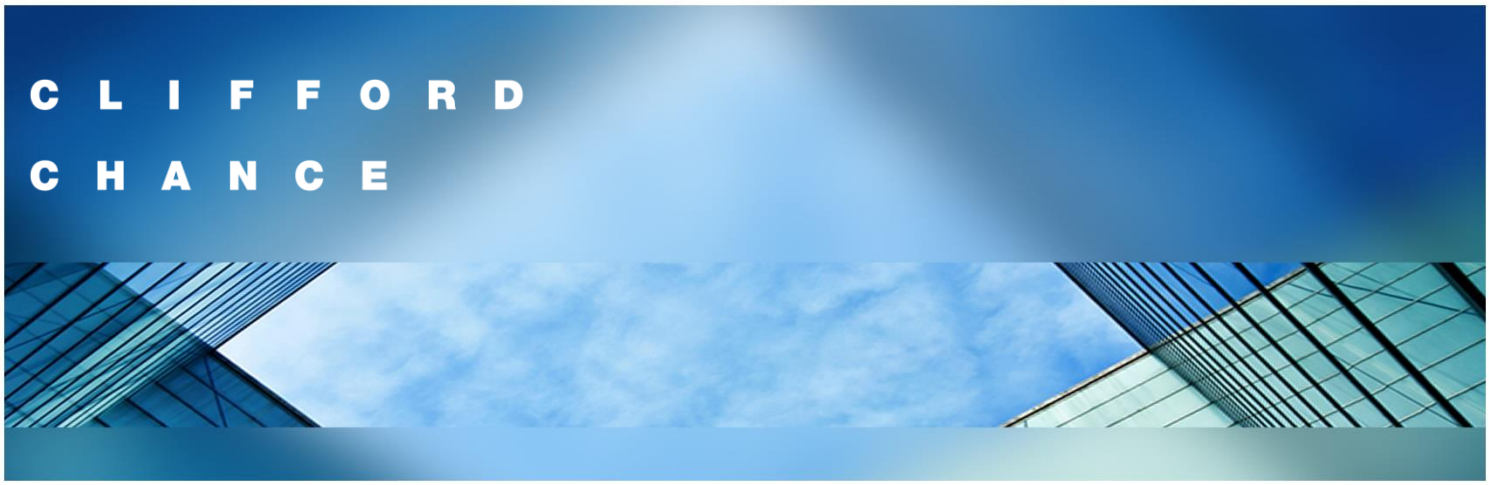

ARE YOUR TOKENS OUTSIDE US SECURITIES LAW JURISDICTION? IMPORTANT EXTRATERRITORIALITY DECISION HANDED DOWN BY US DISTRICT COURT

Token issuers often sell their securities offshore and consider such sales to be exempt from US securities regulation. But this raises the question of location - are the token sales in fact outside the US for securities law purposes? In *In re Tezos Securities Litigation*[1], a class action lawsuit brought by investors alleging that the tokens sold in the Tezos Initial Coin Offering ("**ICO**") were in fact securities, a federal court recently asked and answered the question: "where does an unregistered security [transaction], purchased on the internet, and recorded “on the blockchain,” actually take place?"[2]

In the process, the court formulated a US federal securities law extraterritoriality analysis that – for what we believe is the first time ever – specifically takes the unique characteristics of blockchains into account. The court listed several factors that contributed to its determination that the sale of Tezos tokens had occurred in the United States, including that: US investors bought Tezos tokens; a website that sold the tokens was hosted in the US and run by a person located in the US; marketing efforts targeted US residents; and, most intriguingly, payments made in Ether for the Tezos tokens were validated by a network of Ethereum nodes clustered more densely in the US than in any other country.

We anticipate that going forward, in deciding questions of jurisdiction over cryptocurrencies, ICOs, and other token offerings by issuers based abroad, US courts will, like the *Tezos* court, look to the location of blockchain validation nodes as a factor in determining whether the US securities laws apply. Given the logic of the Tezos court's reasoning, future US courts could also potentially look to the location of blockchain miners as well, although the Tezos court itself did not.

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1 Case 3:17-cv-06779 (N.D.Cal.).

2 Order on Defendant's Motion to Dismiss, *In Re Tezos Securities Litigation*, No. 3:17-cv-06779-RS, Dkt. No. 148 (N.D.Cal. Aug. 8, 2018), at 14 (the "**Tezos Order**"). Tezos disputes the notion that the sale of Tezos tokens was an ICO, but the court used the term "ICO" throughout the Tezos Order to describe the offering.

Extraterritoriality and the Federal Securities Laws

In *Morrison v. National Australian Bank*, the US Supreme Court held that the presumption against extraterritorial applicability of congressional legislation renders the Securities Exchange Act of 1934 (the "**Exchange Act**") applicable to fraudulent or deceptive conduct only in connection with "transactions in securities listed on domestic exchanges and domestic transactions in other securities … [and w]ith regard to securities *not* registered on domestic exchanges, the exclusive focus [is] on *domestic* purchases and sales."[3] The Supreme Court went on to extend its Exchange Act holding to the reach of the Securities Act of 1933 (the "**Securities Act**") as well.[4]

However, other than establishing the general principle, the *Morrison* Court "provide[d] little [detailed] guidance as to what constitutes a domestic purchase or sale", leaving that task to the courts.[5] To determine whether purchases or sales of securities not listed on a domestic stock exchange occur in domestic transactions, the federal Second Circuit has formulated a test (now adopted by the Ninth Circuit as well) that examines whether "[1] irrevocable liability is incurred in the United States, or [2] title passes within the United States."[6] Under this test, irrevocable liability is deemed to have been incurred at the point at which the purchaser is bound "to take and pay for a security", or that the seller is bound "to deliver a security."

In Re Tezos: Facts

The Tezos blockchain project was conceived of by Arthur and Kathleen Breitman. In 2015, the Breitmans incorporated a Delaware corporation called Dynamic Ledger Solutions, Inc. ("**DLS**"), listing their Mountain View, California home address as the corporate headquarters and appointing themselves as officers. DLS owns the source code to the Tezos blockchain as well as the rights to Tezos' trademarks and certain other property.

In May 2017 the Breitmans and DLS established a Swiss non-profit *stiftung* (the "**Tezos Foundation**") to oversee the ICO and have control of the proceeds. Throughout this period, the Breitmans and DLS conducted the lion's share of the marketing to promote the upcoming offering, continued to develop the software, and arranged private pre-sales of Tezos tokens to cryptocurrency-focused investment funds and high net worth individuals.

The Tezos public ICO took place in the first two weeks of July 2017, raising $232 million worth of Bitcoin and Ether. DLS and the Tezos Foundation established an interactive English-language website, www.tezos.com, hosted on a server located in Arizona, to allow investors to participate in the ICO. No measures – such as blocking of US IP addresses – were taken to prevent US persons from participating. Investors who contributed Bitcoin or Ether to the Tezos ICO

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3 *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 267-8 (2010). *See also* Clifford Chance Client Memorandum, *F-Cubed Gets An F Grade From US Supreme Court,* (Jun. 30, 2010), available online at https://www.cliffordchance.com/briefings/2010/06/f-cubed_gets_an_fgradefromussupremecourt0.html.

4 *Morrison*, at 268 ("The same focus on domestic transactions is evident in the Securities Act of 1933 …. That legislation makes it unlawful to sell a security, through a prospectus or otherwise, making use of "any means or instruments of transportation or communication in interstate commerce or of the mails," unless a registration statement is in effect.")

5 *Absolute Activist Value Master Fund Limited v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

6 *Id.*

("**Contributions**") through the US-hosted website – which were styled as "donations" to the non-profit Tezos Foundation – would be recommended by the Tezos Foundation for a future award of Tezos tokens once the tokens were issued following the Tezos blockchain becoming fully operational.

The Contributions were governed by a document titled *Tezos Contribution and XTZ Allocation Terms* (the "**Contribution Terms**"),[7] which contained two different clauses with the objective of ensuring that "contributors agreed to Europe as the legal situs of all ICO-related participation and litigation."[8] Clause 45 of the Contribution Terms stated that the "contribution procedure, the XTZ [Tezos tokens] creation and XTZ allocation is considered to be executed in Alderney", a small English Channel Island, while clause 48 stated that "[t]he applicable law is Swiss law", and "[a]ny dispute arising out of or in connection with the creation of the XTZ and the development and execution of the Tezos Network shall be exclusively and finally settled by the ordinary courts of Zug, Switzerland."[9]

The US plaintiff, a resident of Illinois, contributed Ether in the Tezos ICO and brought a class action lawsuit alleging violations of the registration provisions of the Securities Act, based on the theory that Tezos tokens are securities.

In Re Tezos: Court's Holding

In denying the defendants' motion to dismiss the complaint on, among other grounds, improper extraterritorial application of the Exchange Act, the court rejected the Tezos Foundation's arguments that the transactions occurred outside the United States. The defendants asserted that the Contribution Terms expressly stated that the tokens were created in the Channel Islands and disputes were subject to Swiss law. The court found that irrevocable liability with respect to the payment of Ether was incurred, and titled passed, in the United States, thereby triggering the applicability of the US securities laws. In explaining its reasoning, the court stated:

> [The investor] participated in the transaction from this country [the US]. He did so by using an interactive website that was: (a) hosted on a server in Arizona and; (b) run primarily by [Tezos promoter] Arthur Breitman in California. He presumably learned about the ICO and participated in response to marketing that almost exclusively targeted United States residents. Finally, his contribution of Ethereum to the [Tezos] ICO became irrevocable only after it was validated by a network of global "nodes" clustered more densely in the United States than in any other country. While no single one of these factors is dispositive to the analysis, together they support an inference that alleged securities purchase occurred inside the United States …[10]

The last factor is especially interesting: the court found that for purported securities purchased on a blockchain network, one factor for determining US jurisdiction over the transaction is the *actual* situs of a blockchain's validation nodes at the time the transaction is recorded on the blockchain. Investors

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7 *See* Declaration of Andrew S. Gehring in Support of Motion to Dismiss filed by Tezos Stiftung, Exhibit B (Contribution Terms), *In Re Tezos Securities Litigation,* No. 3:17-cv-06779-RS, Dkt. No. 122 (N.D.Cal. filed May 15, 2018)

8 Tezos Order, at 4.

9 Contribution Terms, at 10.

10 Tezos Order, at 14-15.

purchased Tezos tokens by making Contributions of Ether and Bitcoin to the Tezos Foundation. The plaintiff's transfer of Ether to the Tezos Foundation was recorded on the Ethereum blockchain after a miner hashed the transaction into a block, broadcast the proposed block to the global network of Ethereum validation nodes, each validation node verified the block's validity, and each validation node subsequently added the verified block to their respective individual local copy of the Ethereum blockchain (which, in the aggregate, constituted the reaching of a "consensus" among all Ethereum validation nodes of the block's validity). The fact that more Ethereum network validation nodes are located in the United States than in any other country, according to a website cited in the complaint (www.ethernodes.org/network/1),[11] suggested to the court that irrevocable liability was incurred, or title passed, within the US, because – once recorded on the Ethereum blockchain – the transfer of Ether to the Tezos Foundation could not be revoked by the plaintiff.

While the location of validation nodes is only one factor discussed by the court, it could have far reaching implications for blockchain transactions and future blockchain infrastructure development. First, while this factor in the Tezos case was articulated in the context of transfers of Ether, the native cryptocurrency of the Ethereum network, it could potentially also apply to decentralized application ("**app**") token offerings by foreign issuers which are based on Ethereum (e.g. ERC-20 tokens), since the smart contracts powering decentralized apps rely on the Ethereum blockchain to run. Second, the court's focus on the "clustering" of Ethereum *validation* nodes downplays the location of the *miner* (or mining pool) that first mined and then broadcast the new block containing the plaintiff's purchase transaction to the validation nodes.[12] A different court could presumably give greater weight to the miner's location. Third, while at present the traditional open-source nature of prominent blockchains such as those of Bitcoin or Ethereum has enabled persons from all over the globe, including from the United States, to download the software needed to run validation nodes or engage in mining without restrictions based on nationality or residency, the Tezos Order could have the effect of causing future foreign-based blockchain developers and organizations to think twice about letting US persons download the client software needed to run a validation node or become a miner. If future foreign-based blockchain projects prohibit US persons from participating as nodes in an attempt to avoid triggering the perceived burdens of US regulation, based on the analysis enunciated in the Tezos Order, it could have the effect of hampering US competitiveness in the fast-evolving global blockchain industry.

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11 See Consolidated Class Action Complaint, *In Re Tezos Securities Litigation*, No. 3:17-cv-06779-RS, Dkt. No. 108 (N.D.Cal. filed Apr. 3, 2018), at ¶ 29, page 9.

12 The website cited by plaintiff in the Consolidated Class Action Complaint lists the current number of Ethereum full nodes, which perform the validation function and participate in the consensus process, at 15,179 as of September 27, 2018. *See supra* n.11 and https://www.ethernodes.org/network/1. By contrast, the website www.etherchain.org states that, as of September 26, 2018, there are only 68 distinct Ethereum miners, while in July 2017, during the Tezos ICO, the number of distinct Ethereum miners numbered roughly 30 (presumably counting mining pools as one miner). *See* https://www.etherchain.org/charts/distinctMiners. Not all validation nodes will choose to either join a mining pool or mine Ether on their own; many full nodes merely validate transactions, without also engaging in mining.

Conclusion

The Tezos Order has given parties a new pathway to strategically assess Internet-based blockchain assets, and new factors to analyze when considering the extraterritorial applicability of the US securities laws. Predictably, the analysis includes consideration of the targeted marketing audience, and the location of the persons maintaining the website. Critically, the analysis, starting with the *Tezos* decision, likely will include assessment of the location of the blockchain nodes used to validate and record the transaction as well. Whether future US courts will seek to limit the reach of the Tezos Order's analysis or – alternatively – to build on and extend it to other areas outside the securities context, and whether there will be adverse effects on US fintech innovation and investment, is unknown. Fintech innovators, investors, regulators, and counsel should watch these developments closely as judicial decisions in this area could have far reaching effects.

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