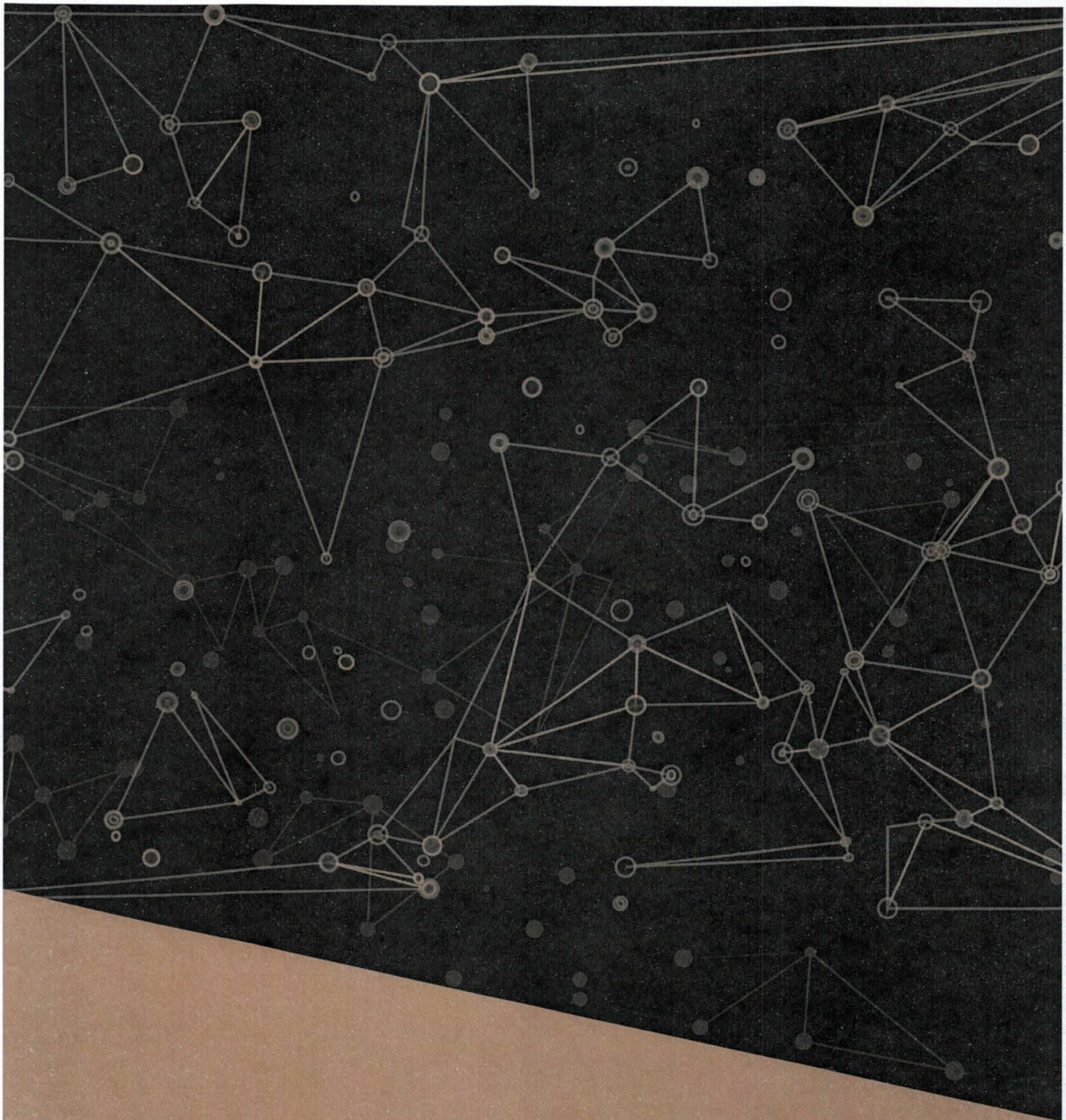

Legal Opinion: The Project Ukit

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ICO LAW

LEGAL OPINION
PROJECT: UKIT ICO

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I. Introduction, Background and Nature of Blockchain Tokens

ICO represents a new way of crowd funding that allows promoters to accumulate a certain amount of funds for developing and enhancing blockchain start-up projects. In such a manner, in consideration of funds received from purchasers, the latter obtains tokens that may be exploited in numerous ways depending on peculiarities of ICO projects.

There are many types of blockchain tokens, each with their own characteristics. For example, one kind of blockchain tokens may be used in a blockchain protocol to fuel functioning of an application designed on it. Another kind of tokens may be utilized as a virtual (digital) currency that is served as a certain medium of exchange both within a certain blockchain platform and beyond that.

An inherent feature of any token is to be tradable on a "secondary market" of tokens on a cryptocurrency exchange market. That is to say, a token is free for sale and after being issued is subject to market speculations according to the rules of demand and supply.

However, there is a number of complicated legal issues concerning tokens since some of them may fall into a definition of a security instrument and therefore be subject to the US federal or state securities laws. As a consequence, it means that the sale of such tokens may be illegal for US residents.

In many jurisdictions, there may also be issues under anti-money laundering laws and general consumer protection laws, as well as specific laws depending on what a token actually does.

Based on our analysis of the current case law, regulations issued by the competent government institutions in different parts of the world, including such agencies as SEC (Security and Exchange Commission) or CFTC (Commodity Futures Trading Commission), MAS (Monetary Authority of Singapore), ECB (European Central Bank) and various facts and materials derived from a plethora of ICOs conducted in different parts of the world, we conclude that an appropriately designed token may not entail risks of being recognized as an investment instrument.

Nevertheless, it has to be clearly understood that we can not provide a thorough review aimed at the compliance with the regulatory regime of each jurisdiction. Hence, in this legal opinion we will focus on the United States security law.

This memorandum is devoted to the examination of a token issued by uKit on its risks of being considered an investment instrument (hereinafter - "**uKit Token**" or "**Token**").

In Section I, we introduce you to the general concept of an ICO and blockchain token. Section II describes a security law framework for blockchain tokens in light of SEC Report. In the third Section,we analyze whether a uKit Token meets the Howey Test and then in Section III we sum up whether uKit Tokens fall into a definition of security instruments or not.

II Security Law Framework for Blockchain Tokens in Light of SEC Report

In re SEC v C.M. Joiner Leasing Corp., 320 U.S..344, 351 (1943) were established that

"The reach of the Securities Act does not stop with the obvious and commonplace. Novel, uncommon, or regular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contract", or any interest or instrument commonly known as security."

The same was held in Reves v. Ernst and Young, 494 U.S. 56, 61 (1990)

"Congress purpose in enacting the securities laws was to regulate investments, in whatever form they are made and whatever name they are called."

The U.S. Securities and Exchange Commission adheres to this position and declares that any new forms of investments via smart contracts or blockchain technology fall under the purview of US federal securities laws and on July 25, 2017 issued a Section 21(a) investigative report, Release No. 81207 ("**the Report**") on investigation of DAO case.

Among others, the Report distinguishes ICOs where tokens represent securities as described above. Hence, in this analysis we shall investigate and provide our legal opinion as to whether uKit ICO is a type of crowd funding that does not trigger or trigger prospectus requirements and any of security laws provisions of the United States.

III. Security Law Analysis For Ukit Tokens

*A.For purposes of this analysis we have researched the White Paper (**WP**) of the uit ICO project and adopted the following terms.*

uKit platform is a software, designed to provide users with a tool that helps to build websites and webpages according to the needs of their customers (hereinafter - "**uKit Platform**" or "**Platform**").

As it is stated in WP and video published on the website of uKit ICO, the Platform consists of three main components 1) database on various interests of internet users 2) the system of personification of landing pages and websites for the internet users 3) and artificial intelligence analysis of data.

It also can be inferred out of WP that there are three main roles in ecosystem of uKit Platform: its users (purchasers of uKit Token), visitors of landing pages, created by the Platform and developers with founders of the Platform.

uKit Platform evangelizes the principle of dynamic landing pages where internet visitors land on web pages designed based on their behavior on the internet:

"When a user visits the needed URL address, the system will automatically identify which segment this user belongs to and generate a list of recommendations to rebuild your landing page based on the details of their previous behavior."

uKit Platform uses internally gained data on behavior of internet users or purchases it from the outer resources such as so-called data management platforms. Besides, data storage of uKit Platform is constantly updated and refilled by its users. The founders underline that

"the database is updated both through purchasing information from data management platforms (DMPs) where the details of different players of the advertising industry (websites, apps, advertising agencies, etc.) are forwarded, and thorough data contributions from other project members."

Besides, the uKit Platform allows a simultaneous display of different versions of web pages for different segments of internet users. Another functional feature is an A/B testing called to reveal the most relevant design for particular segment of internet users.

"The tool lets you check different design versions on one audience. Either two pages (page A and page B) or more design versions (A/B/n) that differ in one or several elements are shown to one segment in equal proportion. By providing the statistically significant amount of views, this makes it possible to determine the most matching page variation."

It is declared in WP that uKit Platform has three out of four components of the Platform "*at different stages of completion*". The first component is complete

"A website building platform. It's a commercially viable product that has been on the market for over 2 years. It is a modern version of a website builder targeted towards user-friendliness."

Another tool is uLanding.io. It is under prototype and "*You can try a closed beta version by using the invite code*". The third component uKit.AI is a prototype too and "a *beta release is planned in the second quarter of 2018.*" The stage of development of the fourth component is not mentioned in WP.

The concept of a uKit Token has also been articulated in WP. A uKit Token is a digital unit to acquire access to uKit Platform. Basically, in exchange of a token its holder receives certain digital services that allow tailoring the tokenholder's website under the needs of the website's visitors.

"UKT tokens will be used to pay for your landing pages in the system. This means a user will need to spend a certain amount of tokens to convert their landing page into a new dynamic one."

As it is evidenced from WP, uKit Token holders play an active role in Platform development since they may be involved in "*sharing the data on how their landing pages were used by the visitors.*" And in this respect, they may receive additional tokens "*from the reserve fund.*"

Furthermore, the Platform developers claim that the participation of token holders in updating the data storage will increase effectiveness of the system.

"The greater the amounts of data the system processes and the greater the contribution made by a user, the bigger the absolute value ensured by this percentage. This way, the UKT token value will go up for its holder as the system grows if a token is being actively used."

At the same time, it is noted that funds received as a result of ICO funding "*will be used for further platform development.*"

Last but not least, uKit Token holders may participate in developing the Platform voting for particular features to be implemented in the Platform.

"UKT token holders are eligible to vote (1 token equals 1 vote) to decide what features should be implemented to the builders of the company. In this way, thanks to blockchain decisions about functional development of the product are made and executed transparently for all users of uKit services."

A thorough investigation of the White Paper has not revealed that uit founders offer any distribution of assets or dividends derived from the use of the Platform or any other form of return of investments. However, even though it is not clearly stated in the text, we admit that uKit Tokens may be sold on a cryptocurrency exchange market in the future.

B. Howey Test and Its Adoption by the Federal Courts

In accordance with Section 2(a)(1) of the Securities Act security:

"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."

Exchange and Securities Acts tend to control the emission of investment instruments and to testify particular interests attached. However, the Security Law evangelizes the priority substance over the form. Therefore, if the Security and Exchange Commission reveals any type of cooperation promising any future profits merely out of signing particular contract, it may investigate the case and declare this contract a security instrument. Under such circumstances, promoters of such an instrument shall disclose particular information and submit it to SEC.

The Supreme Court case for determining whether an instrument meets the definition of a security is SEC v. Howey, 328 U.S. 293 (1946). In that case, the promoter offered to purchase certain services (cultivation of land) for the fixed price and cost of services. It is important to note that the promoter further was delegated to distribute the net profits derived from the sale of the flourishing land among the holders of tracts of lands at the harvesting period. There were only 42 investors interested in purchasing the land.

Analyzing the fact pattern, the Court expands over "*investment contract*" within the definition of a security, noting that it has been used to classify those instruments that are of a "*more variable character*" that may be considered a form of "a *contract, transaction, or scheme whereby an investor lays out money in a way intended to secure income or profit from its employment.*" 11 Howey, 328 U.S. at 298; Golden v. Garafolo, 678 F.2d 1139, 1144 (2d. Cir. 1982).

More specifically, the court comes to the conclusion that the contract between the promoter and investor constitutes an investment contract. The court explains the definition of a security transaction as follows: "*a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.*"

Moreover, the court said that this definition is "*crystallized*" in the state courts cases that were far beyond adoption of the federal act. The Supreme Court continues that the term "*had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed on economic reality.*"

The Court stated that its definition of investment contracts "*embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.*"

Eventually, the court articulates the following four-part tests to face an investment contract: (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).

Upon the first prong "*investment of money*", there is no basis for disagreement. The only issue that may arise here is whether cryptocurrency may constitute a viable consideration interest in lieu of the obtained interests attached to the token. This issue is addressed by the Supreme Court itself holding that the first prong requires only "*tangible and definable consideration in return for an interest that had substantially the characteristics of a security.*"

However, the Supreme Court fails to specify the definition of a common enterprise. Federal circuits developed two different concepts to analyze the underlying contractual relationships of the parties. The first doctrine is a "*horizontal commonality*" and the second is a "*vertical commonality*". A horizontal commonality is found when a) investors' contributions are pooled and b) the fortune of each investor rests on the success of the overall enterprise.

In contrast, a vertical commonality presupposes that a common enterprise may be found where the investors' fortune is dependent on the expertise of the promoter or third parties. In case of a narrow vertical commonality, investors' profits shall be tied to the profits of managers. In a broad vertical commonality, investors success depends on the efficacy of the manager or third parties. As it was mentioned above, the circuits now disagree over the term "a *common enterprise.*"

The third prong is an "*expectation of profit derived from the entrepreneurial or managerial efforts of others.*" Analyzing this prong, courts consider whether potential investors 1) expect to receive profits from their own efforts (use of rights or services obtained from promoters) or 2) from the efforts (managerial expertise) of the ICO founders. Even though in re Howey, the Court used the phrase "solely" from the efforts of others, the lower courts relaxed this prong, adopting concepts "*undeniably significant*" or "*predominantly*".

The federal courts now have divided in its application of "*solely*" standard introduced by the Supreme Court. Some courts are investigating whether there is "de minimis" efforts of investors and whether their efforts are an insubstantial factor for the investor to participate in the contract.

Other courts, have a look whether efforts of offerors of the contract are predominant and more significant in comparison with those of investors in light of the future expectation of profits or that efforts of those other than the investors are "*the undeniably significant ones.*"

Finally, some courts hold that the third prong is satisfied when the expectations of profits derive from the managerial and entrepreneurial efforts of the offerors, "in unspecified measure and unspecified comparative weight as to the relative significance with investors' *efforts and offerors' or third parties' efforts.*"

C. Analysis Under the Howey Test

We provide our analysis of a non-security Blockchain Token below, based on each Howey factor.

(1) Investment of Money

The first prong is clear here since promoters of uKit Tokens offer their tokens for sale in exchange for fiat or any cryptocurrency. Therefore, this factor liens towards a uKit Token being a security.

(2) Common Enterprise

Under a horizontal approach, a common enterprise is not likely to be found. While contributions of uKit Token holders may be pooled together for the development of the Platform as it is described below, it can not be proclaimed that profits of each uKit Token holder rests on the profits of other holders.

Purchasers of uKit Tokens are granted with equal rights that, however, may be exercised differently in accordance with the skills of a token holder. For example, those users of the Platform that constantly supply behavioral data to the ecosystem are provided with additional tokens. And, as a result, they accrue additional profits. Consequentially, those users who passively hold uKit Tokens and do not exploit advantages of the Platform will not generate any revenue for themselves.

Therefore, it can not be concluded that fortune and profit of one token holder of the Platform correlates with the fortune or profit of another. And it can not be concluded that under a horizontal approach, there is any evidence of a common enterprise.

We also do not believe that a common enterprise may be found applying a vertical commonality approach.

As with the horizontal commonality, in narrow and broad vertical approaches, uKit Token holders' fortune in some respect depends on the success of the whole company. For instance, an investor is likely to profit with the raise of a token`s price resulted out of the effective managerial actions of the managers of the Platform or founders of the uKit ICO. And that is true regardless of the type of the reward promised to managers of the Platform, whether it is a fixed price or profit sharing.

Nevertheless, even if the uKit enterprise may not demonstrate successful development of the company in the future and increase in a market value of a uKit Token, its functionality will not be diminished, hence investors will continue enjoy tokens and receive advantages of the Platform.

Therefore and taking into account the above mentioned, we suppose that this prong is more likely to push the scale toward a uKit Token not being deemed a security.

(3) Expectation of Profits

On the one hand, uKit Token holders may benefit from its use by selling them on a cryptocurrency exchange market. However, on the other hand, it can not be ultimately declared that tokens may be purchased exclusively for speculation purposes.

As it was described above, the Platform suggests to its users a plethora of opportunities. uKit Token holders' smart use of the Platform`s generative designs or tools for A/B testing may cause more benefits for them rather than trading on a secondary cryptocurrency market.

According to the White Paper, uKit Token holders have the voting right. However, unlike with the DAO, prospective purchasers are not granted with any right to share potential profits from activities of uKit founders. Hence, no reasonable investor would be enticed to purchase the token merely expecting to receive future dividends out of its trading

Therefore, we believe a uKit Token does not satisfy this prong of the Howey Test.

(4) Solely from the Efforts of Others

As we discussed above, not all courts share an approach of the Supreme Court using the term "*solely*" defining the efforts of others. Some federal courts relaxed this approach exploiting "*de minimis*" efforts of others or the concept of "*undeniably significant" or predominantly*.

If we apply the concept "*only*" from the efforts of others, this prong is more likely not to be satisfied, since uKit Token holders use the token as a license right to unlock the Platform. This right allows users of the Platform not only derive income out of the use of the Platform via a uKit Token but also to participate in the development of the uKit ecosystem voting *"to decide what features should be implemented to the builders of the company."*

At the same time, it is also true that founders of the Platform also work on the software to make it more interesting functionally and as a result more attractive for the users. Since under such circumstance the market value of a token increases and so investors' active assets arise, it is fair to declare that the expected profits derived from the efforts of others as well.

Therefore, if we apply a strict approach of the Supreme Court focusing on efforts of third parties this prong is more likely yet to be satisfied. However, if we apply a relaxed approach either of the Federal Courts this element of the Howey Test may be satisfied.

IV.Summary and Conclusion

As we may see, the Howey Test met only partly. The first prong (investment of money) is for uKit Token to be considered a security. The factor of the common enterprise we consider not to be satisfied. The third factor is not satisfied either. The fourth factor depends on the relevant and specific approach used by the courts and may or may not declare the token to be a security instrument.

Since not all the elements of the Howey Test met, in our view, uKit Token may not be considered a security instrument.

THE ABOVE ANALYSIS IS BASED ON THE INFORMATION OBTAINED FROM A REPRESENTATIVE OF UKIT PLATFORM FOUNDERS, WHITE PAPER OF THE PROJECT AND ITS WEBSITE HTTPS://ICO.UKIT.COM/. THE SEC OR A COURT OF THE COMPETENT JURISDICTION MAY REACH AN ALTERNATIVE CONCLUSION TO THAT STATED IN THIS LEGAL OPINION LETTER. NO WARRANTIES OR GUARANTEES OF ANY KIND AS TO THE FUTURE TREATMENT OF UKIT TOKENS OR SIMILAR TOKENS ARE BEING MADE HEREIN.

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