Startup LAWnchpad Conference

From Silicon Valley to Silicon Alley
Hot Topics at the Intersection of Law and Entrepreneurship

September 14, 2018
Skadden Conference Center (Second Floor)
9 – 9:30 a.m. | registration & breakfast
9:30 a.m. – 4 p.m. | program

CLE Course Materials
Panel One: The Evolving Landscape of Tech Transactions—Legal Issues from Startup to Exit

**Suggested Readings**

- [Davis Polk - Intellectual Property and Tech Transactions Update](View in document)
- [Davis Polk - Impact of the European General Data Protection Regulation on U.S. M&A](View in document)
- [Davis Polk - Supreme Court Upholds Constitutionality of Inter Partes Review and Holds That Petitioners Are Entitled to a Written Decision Addressing All Challenged Claims](View in document)
- [Davis Polk - The Federal Circuit Resurrects Oracle’s Multibillion Dollar Copyright Claim against Google, Narrowing The Fair Use Doctrine for Software](View in document)
- [Goodwin - The GDPR and Startups](View in document)
- [Goodwin - Key Terms Every Entrepreneur Must Know Before Meeting With Investors](View in document)
- [Goodwin - Key Terms Every Entrepreneur Can’t Afford To Ignore](View in document)

Panel Two: Navigating Securities Law Issues in Initial Coin Offerings and Equity Crowdfunding

**Suggested Readings**

- [Updated Investor Bulletin: Crowdfunding for Investors](View in document)
- [Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO](View in document)
- [Chairman’s Testimony on Virtual Currencies: The Roles of the SEC and CFTC](View in document)
- [Digital Asset Transactions: When Howey Met Gary (Plastic)](View in document)
- [Token DPA - Token offerings for all](View in document)
- [Understanding the SAFE with Max Rich, Internal Counsel at Republic](View in document)

Panel Three: Doing Well While Doing Good—Access to Capital for Social Entrepreneurs


Panel Four: Missed Opportunities—The Untapped Talent of Underrepresented Entrepreneurs
• OZ Legislation Resources [Carolyn Kim Allwin] [View in document]
• The ‘State’ of New York MWBE Programs: An Inflection Point? [View in document]
• Democratizing Entrepreneurship: Online Documents, Tools, and Startup Know-How [View in document]
Notable Developments

- First Circuit Finds that Trademark Licensee Loses Rights under Trademark License when Debtor-Licensor Rejects Trademark License
- S.D.N.Y. Rules Embedded Tweets May Constitute Copyright Infringement
- SEC Approves Issuance of Cybersecurity Interpretative Guidance
- PTAB Rules Filing Patent Infringement Suit in Federal Court Waives Sovereign Immunity
- Federal Circuit Rules En Banc That PTAB Time-Bar Rulings Are Appealable
- Cybersecurity Regulation Recommendation from US-China Business Council
- 2017 FTC Privacy and Data Security Update
- European General Data Protection Regulation Goes Into Effect on May 25, 2018

First Circuit Finds that Trademark Licensee Loses Rights under Trademark License when Debtor-Licensor Rejects Trademark License

On January 12, 2018, in In re Tempnology, LLC, 879 F.3d 389 (1st Cir. 2018), the First Circuit held that the rejection by a debtor-licensor of a trademark license agreement terminates the licensee’s rights to use the licensed trademarks. The First Circuit’s decision rejected the rationale in Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012) and sided with the Fourth Circuit’s decision in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), expanding the circuit split on the issue.

Mission Products Holdings, Inc. (“Mission”) originally filed suit on November 12, 2015 following Tempnology, LLC’s (“Tempnology”) voluntary Chapter 11 case and motion to reject certain contracts pursuant to Section 365(a) of the Bankruptcy Code, including an agreement granting Mission a limited, nonexclusive license to use Tempnology’s trademark and logo for the purpose of performing its obligations under such agreement. Mission alleged that Section 365(n) of the Bankruptcy Code allowed it to retain its trademark licenses under the agreement. Following the Fourth Circuit’s decision in Lubrizol Enterprises, the New Hampshire Bankruptcy Court ruled that, because trademarks are not included in the definition of “intellectual property” in Section 101(35A) of the Bankruptcy Code, Section 365(n) does not apply to trademark rights and Tempnology’s rejection of the agreement terminated Mission’s rights to use the licensed trademarks.

Section 365(n) of the Bankruptcy Code permits a non-debtor licensee to elect to retain its rights to “intellectual property” licensed under a rejected license as such rights existed prior to the bankruptcy filing. However, the definition of “intellectual property” in Section 101(35A) of the Bankruptcy Code omits trademarks while explicitly including other forms of intellectual property, such as trade secrets, patents and copyrights. According to the Senate Committee Report on the bill for Section 365(n), Congress excluded trademarks from the definition of “intellectual property” in the Bankruptcy Code due to a concern...
that debtor-licensors would be required to conduct quality control of the products or services sold by the licensee.

On appeal, the Bankruptcy Appellate Panel for the First Circuit concurred with the Bankruptcy Court's decision with respect to the scope of Section 365(n), but overturned the Bankruptcy Court's ruling with respect to the effect of the rejection of the license agreement on Mission’s ability to use the licensed trademarks. The Bankruptcy Appellate Panel concluded that such rights do not necessarily end upon the debtor-licensor’s rejection of the underlying license. In making its determination, the Bankruptcy Appellate Panel adopted the Seventh Circuit's reasoning in *Sunbeam Products* that the post-rejection rights of a non-debtor licensee are governed by the terms of the agreement and applicable non-bankruptcy law, and held that Mission may continue using the licensed trademarks post-rejection.

However, on appeal from the Bankruptcy Appellate Panel, a panel of the First Circuit unanimously held that Section 365(n) does not apply to trademark licenses, and a majority of the panel held that a licensee’s right to use licensed trademarks terminates once the underlying license is rejected. In its decision, the First Circuit reasoned that following *Sunbeam* would limit a debtor’s options for shedding cumbersome obligations stemming from trademark agreements and undermine its ability to start anew. The majority noted that “effective licensing of a trademark requires the trademark owner [. . .] to monitor and exercise control over the quality of the goods sold to the public under the cover of the trademark.” Not doing so would result in naked licensing, which could endanger the validity of the trademarks. The First Circuit took issue with the Seventh Circuit’s approach as it would permit Mission to retain use of Tempnology's trademarks in a way that would force Tempnology to choose between certain obligations arising from continued performance of the license or the risk of permanently losing such trademarks, a choice that “would depart from the manner in which section 365(a) otherwise operates.”

As a result of *In re Tempnology, LLC*, there is now a more prominent split among federal courts of appeals with respect to a licensee’s ability to use a licensed trademark following the rejection of the trademark license by a debtor-licensor.

The First Circuit’s opinion is available [here](#).

**S.D.N.Y. Rules Embedded Tweets May Constitute Copyright Infringement**

On February 15, 2018, in *Goldman v. Breitbart News Network, LLC*, No. 17-CV-3144 (KBF), 2018 WL 911340 (S.D.N.Y. Feb. 15, 2018), the United States District Court for the Southern District of New York denied a motion for partial summary judgment brought by several defendant websites, finding instead that the defendants may have engaged in direct copyright infringement by embedding tweets featuring a copyrighted photograph of New England Patriots quarterback Tom Brady in articles posted on their respective websites. This decision, should it survive appeal, has the potential to upend established case law relating to in-line linking and could create significant risks for website operators.

The plaintiff, photographer Justin Goldman, took a photograph of Brady and shared it on the social media platform Snapchat. The photograph quickly became popular on the Internet and multiple Twitter users tweeted the photo. The defendants embedded these tweets in news articles posted on their respective websites, causing the photograph of Brady to be displayed on those websites. Embedding an image, the court correctly explained, does not actually store the image on a website, but rather adds a portion of HTML code which “directs the browser to the third-party server to retrieve the image.” Nonetheless, plaintiff Goldman argued that embedding the photograph violated § 106(5) of the Copyright Act as an unauthorized display of his copyrighted work.

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The defendants argued that the “Server Test” (as delineated in *Perfect 10, Inc. v. Amazon.com, Inc.*, 508 F.3d 1146 (9th Cir. 2007)), which focuses on whether the subject image is located on the defendant’s server or a third-party server, should determine whether or not the defendant can be held liable for direct infringement of the exclusive display right. In *Perfect 10*, the Ninth Circuit found Google could be liable for direct infringement of the exclusive display right only if the thumbnail images appearing in users’ search results displayed underlying images stored on Google’s servers; to the extent that the underlying images were stored on third-party servers, and displayed by Google’s thumbnails only through “in-line linking,” Google would not be directly liable for infringement of the exclusive display right. The defendants in *Goldman* asserted that they should not have direct liability under the Server Test because they merely directed viewers to the third-party host of the photograph via in-line linking, rather than hosting the Brady photograph on their respective servers.

In a departure from the leading precedent, the court rejected the defendants’ use of the Server Test, finding that neither the location nor possession of an image is determinative as to whether one displays the image under the Copyright Act. Rather, the court found that “defendants’ websites actively took steps to ‘display’ the image” by pasting the line of code within their articles, which caused the photograph to be transmitted and then displayed. The court distinguished between *Perfect 10*, in which the defendant was a search engine whose users performed a “volitional act” to view certain websites, and this case, in which the websites themselves took actions to embed the photograph in their articles. The court did not rule on the applicability of any defenses to the copyright infringement claims, including potential defenses based on fair use or the Digital Millennium Copyright Act.

The district court’s opinion can be found [here](#).

**SEC Approves Issuance of Cybersecurity Interpretative Guidance**

On February 21, 2018, the Securities and Exchange Commission (“SEC”) issued an interpretive guidance to public companies regarding the disclosure of cybersecurity risks and incidents (“Cybersecurity Interpretative Guidance”). While the Cybersecurity Interpretative Guidance does not provide additional rules, it provides the SEC’s latest views on cybersecurity disclosure and supplements the Division of Corporate Finance’s disclosure guidance on cybersecurity provided in October 2011. For example, the SEC states that it “recognize[s] that a company may require time to discern the implication of a cybersecurity incident;” however, “an ongoing internal or external investigation—which often can be lengthy—would not on its own provide a basis for avoiding disclosures of a material cybersecurity incident.” The SEC states that it “expects companies to disclose cybersecurity risks and incidents that are material to investors, including the concomitant financial, legal, or reputational consequences.” In addition, the SEC suggested the inclusion of (i) financial statement disclosures that incorporate information about the range and magnitude of financial impacts of a cybersecurity incident and (ii) disclosures regarding a company’s cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues. The SEC also emphasized the importance of (i) cybersecurity risk management policies and procedures and (ii) refraining from making selective disclosures of material nonpublic information about cybersecurity risks or incidents.

The Cybersecurity Interpretative Guidance is available [here](#).

**PTAB Rules Filing Patent Infringement Suit in Federal Court Waives Sovereign Immunity**

On December 21, 2017, an expanded Patent Trial and Appeal Board (“PTAB”) panel ruled that a state cannot invoke sovereign immunity under the Eleventh Amendment of the U.S. Constitution in order to avoid *inter partes* review (“IPR”) proceedings after having filed a patent infringement case in federal court. Under the Eleventh Amendment, states cannot be sued in federal court without their consent, and the PTAB had affirmed in January 2017 that state sovereign immunity also extends to IPR proceedings.
The University of Minnesota initially filed suit in November 2014 in a Minnesota federal court against AT&T, Sprint, T-Mobile, and Cellco Partnership for infringement of certain of its patents relating to wireless communication technology. On March 30, 2017, Ericsson Inc., which supplies equipment to the defendants, filed IPR petitions with respect to five University of Minnesota patents, arguing that its sovereign immunity had been waived. The University of Minnesota argued that waiver of sovereign immunity only applies to proceedings in the same forum, and that the PTAB and district court are distinct forums.

The seven-member PTAB panel agreed with Ericsson Inc., ruling that the University of Minnesota "waived its Eleventh Amendment immunity by filing an action in federal court alleging infringement of the patent being challenged." The PTAB relied on Regents of Univ. of New Mexico v. Knight, 321 F.3d 1111 (Fed. Cir. 2003), in which a state was found to have waived its sovereign immunity as to compulsory counterclaims, as persuasive authority for its rationale: “Similarly, a party served with a patent infringement complaint in federal court must request an inter partes review of the asserted patent within one year of service of that complaint or be forever barred from doing so. See 35 U.S.C. § 315(b). Thus, it is reasonable to view a State that files a patent infringement action as having consented to an inter partes review of the asserted patent.”

The PTAB further cited fairness to support its holding, reasoning that "[i]t would be unfair and inconsistent to allow a state to avail itself of the federal government's authority by filing a patent infringement action in federal court, but then selectively invoke its sovereign immunity to ensure that a defendant is barred from requesting an inter partes review of the asserted patent from a different branch of that same federal government.” One PTAB judge, who concurred in the opinion, argued (counter to the PTAB’s January 2017 ruling) that a state university’s act of invoking U.S. Patent and Trademark Office procedures in order to secure patent rights should itself render it unable to invoke sovereign immunity as a defense against IPR petitions.

While this expanded panel’s decision is not binding on other PTAB panels, it was authored by the PTAB’s chief judge and signed by its deputy chief judge and two vice chief judges. The decision’s implications for patentees seeking refuge in the shield of sovereign immunity—including via the assignment of patents to Native American tribes as recently seen in Mylan Pharmaceuticals Inc. v. Saint Regis Mohawk Tribe, IPR2016-01132 (PTAB Feb. 23, 2018)—remains to be seen.

The PTAB panel’s opinion is available here.

Federal Circuit Rules En Banc That PTAB Time-Bar Rulings Are Appealable

On January 8, 2018, the United States Court of Appeals for the Federal Circuit held in Wi-Fi One, LLC v. Broadcom Corp., 878 F.3d 1364, 1368 (Fed. Cir. 2018), in a 9 to 4 en banc decision, that PTAB decisions ruling on the timeliness of IPR petitions are appealable. The case began in 2010 when Telefonaktiebolaget LM Ericsson (“LM Ericsson”) filed a patent infringement complaint in a Texas district court against multiple defendants.2 A jury found that the defendants infringed the asserted claims and the Federal Circuit subsequently affirmed the decision. In 2013, Broadcom Corp. (“Broadcom”), which was not a party to the prior litigation, filed an IPR petition with respect to the previously litigated patents, which LM Ericsson then transferred to Wi-Fi One LLC (“Wi-Fi”). Wi-Fi argued before the PTAB that it lacked authority to institute an IPR because Broadcom was in privity with the defendants in the previous litigation and was therefore time-barred, but the PTAB held that Wi-Fi failed to demonstrate such privity.

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and that Broadcom’s IPR petition could be granted. Wi-Fi appealed and a Federal Circuit panel held that PTAB time-bar rulings in connection with IPR proceedings are nonappealable.

Wi-Fi petitioned for rehearing and, in its en banc decision, the Federal Circuit decided that PTAB decisions on IPR timeliness are reviewable, holding that the time-bar is not a minor technicality and that there is a strong presumption in favor of judicial review of agency decisions. The Federal Circuit explained that it could find “no clear and convincing indication in the specific statutory language in the [Leahy-Smith America Invents Act (“AIA”)], the specific legislative history of the AIA, or the statutory scheme as a whole that demonstrates Congress’s intent to bar judicial review of [35 U.S.C.] § 315(b) time-bar determinations.”

The Federal Circuit further noted that the Supreme Court’s opinion in Cuozzo Speed Technologies, LLC v. Lee, 136 S.Ct. 2131 (2016) “strongly points toward unreviewability being limited to the [Director of the U.S. Patent and Trademark Office’s] determinations closely related to the preliminary patentability determination or the exercise of discretion not to institute.” However, the Federal Circuit specifically noted that it issued no opinion on whether other issues relating to IPR are appealable.

The Federal Circuit’s opinion is available here.

Cybersecurity Regulation Recommendation from US-China Business Council

The US-China Business Council (“USCBC”) released a report on February 5, 2018 (“USCBC Report”), pursuant to which USCBC outlined three challenges posed by China’s Cybersecurity Law that came into effect in June of 2017: (i) disruptions caused by China’s policies on data flows and localization; (ii) burdens due to China’s overly restrictive licensing regime; and (iii) the burdens from requirements to use unique “secure and controllable” technologies. The USCBC Report’s recommendations include: (i) narrowing/clarifying the scope of the current policies (for example, narrowing “the definition of national security and ‘state secrets’ to ensure that companies do not unintentionally violate regulations regarding the storage and transfer of such information”); (ii) allowing “implied consent” to be a sufficient standard for outbound data transfer; (iii) allowing greater transparency regarding the licensing approval process; and (iv) providing nondiscriminatory technology requirements and conformance with global standards. The hope for the USCBC Report is to invite discussions with the Chinese government regarding the drafting of new rules and standards such that they are more aligned with global practices.

The USCBC Report is available here.

2017 FTC Privacy and Data Security Update

On January 18, 2018, the Federal Trade Commission (“FTC”) released its annual report summarizing its privacy and data security work in 2017 (“2017 Annual Report”). The FTC is an independent agency in charge of protecting consumers and promoting competition across industries. Section 5 of the Federal Trade Commission Act empowers the FTC to prevent deceptive trade practices in the market. The FTC also has authority to enforce several sector specific laws. The FTC has brought over 130 spam and spyware cases, over 50 general privacy lawsuits, and over 60 cases against companies that have engaged in unfair or deceptive practices that failed to adequately protect consumer’s personal data. Notable cases from 2017 include:

(i) the FTC alleging that Lenovo preinstalled a software program that allowed the program to access, without any notice, consumers’ sensitive personal information transmitted over the Internet; and

(ii) Uber Technologies, Inc. settling with the FTC regarding a claim that Uber Technologies, Inc. failed to satisfy its claims that it closely monitored employee access to consumer and driver data.

In addition, the FTC has brought over 100 cases against companies for violating the Fair Credit Reporting Act, which sets out requirements for companies that use data to determine, among other things, credit worthiness or suitability for employment, and 30 cases for violation of the Gramm-Leach Bliley Act.
GLBA), which requires financial institutions to send consumers initial and annual privacy notices and allow them to opt out of sharing their information with unaffiliated third parties. In 2017, the FTC brought a case against TaxSlayer alleging that it violated the GLBA’s Safeguards Rule, which requires financial institutions to implement safeguards to protect customer information and the Privacy Rule and Regulation P, which requires financial institutions to deliver privacy notices to customers. Internationally, the FTC is involved with (i) the EU-U.S. Privacy Shield, which provides legal mechanisms for companies to transfer personal consumer data from the European Union to the United States, (ii) the Swiss-U.S. Privacy Shield Framework, which is modeled after the EU-U.S. Privacy Shield and applies to companies transferring personal consumer data from Switzerland to the United States, and (iii) the Asia-Pacific Economic Cooperation Cross-Border Privacy Rules, which is a voluntary, enforceable code of conduct for transferring personal consumer data among the United States and other Asia-Pacific Cooperation members.

The 2017 Annual Report is available here.

European General Data Protection Regulation Goes Into Effect on May 25, 2018

On May 25, 2018, the European General Data Protection Regulation will go into effect. Davis Polk has recently published a memorandum summarizing the impact of the European General Data Protection Regulation on U.S. mergers and acquisitions. A copy of the memorandum is available here.
If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Impact of the European General Data Protection Regulation on U.S. M&A

March 26, 2018

The winds of change will shortly sweep across the data privacy landscape in the European Union (“E.U.”) and the gale will be felt worldwide. The European General Data Protection Regulation (“GDPR”) will come into force on May 25, 2018.1 Currently, some U.S. M&A practitioners prioritize U.S. law, absent a target with a strong business nexus with the E.U., but the GDPR’s extraterritorial scope, together with increased fines for non-compliance (up to the greater of 20,000,000 Euros or four percent of annual global revenue), will force its consideration into U.S. M&A activity.

We discuss below the transactional considerations for investors, purchasers and sellers of U.S. companies arising from the GDPR.

Executive Summary

- The extended jurisdiction of the GDPR will encompass companies, regardless of domicile, that process the personal data related to the offering of goods or services to data subjects in the E.U.
- The risk of substantial fines based on global revenue will increase the importance of conducting thorough due diligence on a target’s compliance with data protection laws.
- Transaction structuring and risk allocation mechanisms should expressly contemplate data protection to ensure compliance, and allocate the risk of non-compliance, with the GDPR.
- Monitor GDPR enforcement action and interpretative guidance as implementation clarifies best practices.

Diligence Considerations: GDPR Scope, Compliance and Penalties

Purchasers and investors should first consider whether the target’s data processing is subject to the GDPR. Under the GDPR, processing of personal data is defined broadly to include nearly any act that is performed on personal data, including collection, organization, storage, use, and even the destruction of personal data.2 The GDPR covers processing of personal data that (i) occurs in the context of the activities of an establishment in the E.U.,3 (ii) is related to the offering of goods or services, regardless of whether payment is required, to individuals in the E.U.,4 or (iii) is related to the monitoring of individuals’

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2 Id. Art. 4(2).

3 Id. Art. 3(1). “Establishment” as used in the GDPR will be found when there is effective and real exercise of activity through stable arrangements. Id. Recital 22. The legal form of those arrangements, whether as a branch or a corporate entity, is not determinative. Id.

4 Id. Art. 3(2)(a).
behavior in the E.U. The “offering of goods or services” may be broadly construed and depends on “factors such as the use of a language or a currency generally used in one or more member states with the possibility of ordering goods and services in that other language, or the mentioning of customers or users who are in the [European] Union.” As a result, the GDPR may apply to U.S. companies that do not have substantial E.U. activities and have not previously focused on E.U. data privacy laws.

- **Practice Tip:** Do not rely on the target’s explanation that they do not have material E.U. operations. Go beyond diligence questions and investigate the company’s online presence, including whether visitors to the target’s website from the E.U. are provided with local language or shipping options.

- **Practice Tip:** If the target appears to be subject to the GDPR, consider whether the purchaser will have access to personal data as part of diligence or in the data room. If so, the purchaser could be subject to the GDPR as well and NDAs may need to be tailored accordingly. Unless necessary, some purchasers may prefer to affirmatively exclude any personal data from the data room or diligence process to avoid being subject to the GDPR.

- **Practice Tip:** For sellers, anticipate purchaser GDPR questions and consider practicing diligence responses with outside counsel to prepare for calls. Given the uncertainties regarding interpretation and enforcement, perfect confidence in GDPR compliance is unlikely to be expected, but being able to conversantly discuss the topics will give purchasers comfort that the issue is being thoughtfully considered.

To the extent that a company may be subject to the GDPR, a purchaser may need to re-evaluate and re-orient the target’s data processing activities after the transaction. Such review may look into the process by which the company obtains “freely given, specific, informed and unambiguous” consent from individuals, the company’s use of the data and whether it is consistent with the GDPR’s data processing principles, and the support of data subjects’ rights (including the right to access, rectification, erasure—the “right to be forgotten”—and portability). Under the GDPR, companies must maintain records of their processing activities, including the purposes of the processing, a description of the categories of data subjects and personal data, the categories of recipients, duration of processing, third country transfers and general descriptions of the applicable technical and organizational security measures.

- **Practice Tip:** The target’s records of processing activities will often be a good starting point to approach the key questions, including: (i) Whose personal data is being processed? (ii) What kind of personal data is being processed? (iii) For what purpose? (iv) For how long? (v) Is data transferred to other parties? (vi) Is data transferred out of the E.U.? and (vii) What security measures are in place?

Careful diligence should be conducted on the target’s contracts with third parties that are processing data on its behalf, as amendments may be necessary to conform to the GDPR’s requirements that such contracts contain specific provisions relating to the processing of personal data. Under the GDPR,

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5 Id. Art. 3(2)(b).
6 Id. Recital 23.
7 Id. Arts. 4(11) and 7.
8 Id. Art. 5.
9 Id. Arts. 12 and 15-20.
10 Id. Art. 30(1)-(2).
11 Id. Art. 28(3).
transfer of personal data outside the E.U. may typically only be made to countries where the European Commission has determined that the country has an adequate level of protection for personal data. Absent such an adequacy determination (and the U.S. has not been deemed adequate), transfers may only be made on the basis of (i) implementation of appropriate safeguards or (ii) enumerated derogations. Diligence should be conducted with a focus on the existence of such transfers of data outside the E.U. (which, in the case of a U.S. target, may be likely absent local servers) and the applicable justifications for such transfers.

In addition to heightened obligations regarding the processing of personal data, the GDPR also imposes an affirmative requirement for companies to implement appropriate technical and organizational measures to ensure a level of data security appropriate to the risks presented by the nature, scope, context and purposes of the company’s data processing and to ensure such measures are taken by a company’s third party processors as well.

The GDPR also institutes the strictest data breach notification obligations of any generally applicable cybersecurity law. Companies must notify their “competent supervisory authority” “without undue delay and, where feasible, not later than 72 hours” after becoming aware of a data breach. For particularly egregious breaches, a company may also be required to notify the affected individuals. Whether notification is required or not, the company is required to maintain a breach register and document all breaches—the related facts, effects and remedial action taken—subject to verification by the supervisory authority. During diligence, requesting a copy of the target’s breach documentation may be prudent. If the target does not maintain a record of breaches then it may be operating in violation of applicable law and further diligence may be required to identify whether the target has suffered data breaches that may present future regulatory or litigation risk. Breach-related documentation may also be scrutinized for insight into the target’s data breach remediation procedures and approach to risk management and compliance.

Depending on the extent of the company’s utilization of personal data, compliance with these operational, contractual, governance and notification obligations may prove costly, time-consuming and require C-suite attention.

- **Practice Tip:** GDPR compliance will not be satisfied—or properly diligenced—by a check-the-box approach. Request a copy of the company’s latest data map. The company will need to be able to provide it to a regulator on short notice and if they do not have one ready it may be a sign of an overall lax approach towards compliance.

- **Practice Tip:** U.S. companies may benefit from building direct relationships, typically through their data protection officer, with appropriate data protection authorities in the E.U. to facilitate a smoother notification process as a single data breach may trigger notification obligations in the U.S. as well as the E.U.

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12 Id. Art. 45(1).
13 Id. Art. 46.
14 Id. Art. 49.
15 Id. Art. 32(1).
16 Id. Art. 33(1).
17 Id. Art. 34(1).
18 Id. Art. 33(5).
Practice Tip: For Sellers, pre-empt onerous document requests by proactively providing high-level summaries of the target’s personal data practices.

Non-compliance with the GDPR presents a serious risk. Relevant data authorities are empowered under the GDPR with broad investigatory and corrective powers. These include the power to compel companies to provide whatever information may be required to evaluate compliance with the GDPR and conduct data protection audits, including obtaining access to a company’s premises. The corrective powers include injunctive relief (including modifying a company’s data processing processes, forcing a company to provide notice of a data breach to a data subject or imposing a temporary or permanent ban on data processing) and the ability to impose administrative fines. Administrative fines under the GDPR are not merely compensatory for loss suffered by a data subject, but are rather structured to be “effective, proportionate and dissuasive.” The GDPR provides limits to the administrative fines of up to the greater of 20,000,000 Euros or four percent of global annual revenue for violations of core substantive requirements (including with respect to the GDPR’s principles for processing, conditions for consent, data subject’s rights, and transfers of data). For more procedural violations, there is a lower threshold of the greater of 10,000,000 Euros or two percent of global annual turnover.

Determination of the applicable fine involves a broad, multi-factored evaluation of the nature, gravity and duration of the breach, the intentional or negligent character of the breach, any attempts at mitigating harm and how the relevant data authority became aware of the breach (e.g., whether the company itself notified the data authority). The data authorities in the E.U. will be able to enforce directly against assets in the E.U., but there are contemplated discussions between the European Commission, the FTC and Department of Commerce regarding further cooperation on enforcement.

With the nearing implementation of the GDPR, business and legal communities are anxiously awaiting the first few enforcement actions to judge how and at what level these administrative fines will be levied.

Practice Tip: Investigate the company’s history of cooperation with data privacy regulators in the E.U., and its past handling of data breaches. A history of regulator cooperation may help mitigate future fines.

Practice Tip: Carefully probe the company’s personal data retention practices with an eye towards confirming that the company only retains personal data as necessary.

Valuation Considerations

Should the GDPR apply, consider (i) how consistent the valuation model is with the scope of the company’s ability to use its personal data, (ii) the potential costs to bring the business into compliance

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19 Id. Art. 58.
20 Id. Art. 58(1).
21 Id. Art. 58(2).
22 Id. Art. 83(1).
23 Id. Art. 83(5).
24 Id. Art. 83(4).
25 Id. Art. 83(2).
with the GDPR from an operational, contractual and governance perspective, and (iii) reputational and financial risks associated with GDPR non-compliance.

One of the GDPR’s core principles is the purpose limitation, which binds companies to the specified, explicit and legitimate purposes communicated to the data subject when their personal data is collected. Further processing beyond the original communicated purposes is allowed only to the extent that such processing is not incompatible with the original purpose. If the purchaser’s valuation model relies on different or expanded use of the target’s database of personal data, a purchaser may need to communicate a new privacy statement to each data subject and, in certain instances, obtain affirmative consent in order to be compliant. The cost and time associated with this exercise may impact the purchaser’s business plan as the GDPR may require affirmative consents that may not be satisfied by, for example, simply updating a privacy policy on a website.

- **Practice Tip:** Push financial modelers on their models and assumptions and communicate personal data-related assumptions to legal and business teams to focus on during diligence.

- **Practice Tip:** For Sellers, update privacy policies or obtain appropriate consent before the transaction to ensure that the company’s database of personal data may be transferred in connection with a merger or similar transaction.

The implementation of certain operational, governance and contractual measures prescribed by the GDPR, including those described above, may impose additional financial costs. For instance, in a scenario where the acquisition expands the data processing activities of the target to constitute large scale, regular and systematic monitoring of data subjects, the appointment of a data protection officer may be required. The company may also need to implement extensive documentation processes and conduct data protection impact assessments. This would be in addition to amending its existing contractual arrangements with third parties (which beyond the diversion of resources may require additional consideration) and the implementation of appropriate data protection measures. The total costs of such measures could be significant.

- **Practice Tip:** The diligence gap analysis should include a review of technical cybersecurity and physical security operations as well as an appreciation of the headcount of the company’s data privacy compliance function. IT upgrades can be a significant expense and, if the compliance function is understaffed, additional resources may be required.

Non-compliance with the GDPR risks severe financial and reputational harm. As discussed above, administrative fines for non-compliance can be punitive and the indirect costs of dealing with a data breach can also be significant, involving third-party costs of investigation and remediation (and may involve notifications and credit monitoring, where applicable). Reputational harm associated with a data breach can be even more problematic for companies that rely heavily on consumer trust.

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27 Id. Art. 5(1)(b).
28 Id.
29 Id.
30 Id. Art. 37(1).
31 Id. Art. 30(1).
32 Id. Art 35.
33 Id. Art. 28(3).
34 Id. Art. 32(1).
- **Practice Tip**: Nearly every company faces actual or attempted data security breaches with regularity. The more important question is whether the target company is aware of these attempts and taking measures to ensure its data is as secure as reasonably possible. Do not limit diligence to the target’s legal staff; also speak with the Chief Information Officer regarding penetration testing, patch and logging procedures, and the target’s information security and breach response plans.

- **Practice Tip**: For Sellers, if the company has a history of data breaches, carefully summarize the scope of the breaches, the company’s responses and any material impacts on the business.

### Purchase Agreement Considerations

Prudent purchasers and investors will factor GDPR compliance into their purchase agreement structuring and risk allocation mechanisms. If the transaction is structured as an asset purchase, particular care will be needed to determine whether the transfer of the target’s databases itself may violate the GDPR (e.g., by exceeding the scope of the applicable consent or by transferring data outside of the E.U. to a jurisdiction that has not been deemed adequate by the European Commission).\(^3\) Covenants may be appropriate to ensure continued compliance (or development of a compliance program) or notification of any new breaches between signing and closing the transaction. Risk allocation provisions should also be thoughtfully negotiated to ensure appropriate excluded liability, representation and indemnity coverage. Representations regarding compliance with law are insufficient to fully address data privacy risks and should be expanded to cover data-privacy related contract provisions, industry standards and practices, and existence and handling of data breaches. Representations to consider also include: (i) operation in accordance with the company’s written privacy policy, (ii) provision of all applicable privacy and cybersecurity policies, (iii) absence of written notices regarding related investigations, (iv) existence of commercially reasonable information security program, (v) absence of restrictions with respect to target’s successors’ rights to use, sell, license, distribute, and disclose personal data, and (vi) absence of data security breaches, loss of data, and unauthorized disclosures of personal sensitive information.

- **Practice Tip**: In an asset deal, consider making GDPR non-compliance an excluded liability. Include not only pre-closing operations, but also a reasonable period of time post-closing so that the purchaser has a covered window to bring the business into compliance.

- **Practice Tip**: Depending on the duration between signing and closing, consider adding a covenant for the target to bring itself into compliance with the GDPR before closing. Purchasers that are operating companies with their own robust privacy programs may instead prefer to simply onboard the target as part of post-closing integration.

- **Practice Tip**: To the extent possible as part of the larger deal dynamic, indemnities backing the related representations should be uncapped or subject to limitations of liability sufficiently high to cover the GDPR’s global revenue-based fines.

- **Practice Tip**: If a purchaser is planning to rely on representation and warranty insurance, ensure that data privacy is not on the list of exclusions and carefully discuss with outside counsel the extent to which data privacy diligence should be conducted (as known liabilities are typically excluded from the scope of coverage, regardless of whether they are ultimately disclosed as part of the transaction agreement). Also keep in mind that representation and

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\(^3\) As transfers of data to jurisdictions that have not been deemed adequate by the European Commission are prohibited unless those transfers are made subject to other specified appropriate safeguards or derogations. *Id.* Arts. 45(1), 46 and 49.
warranty insurance, which is often capped at 10% of purchase price, may be insufficient to cover fines under the GDPR.

**Post-Transaction Considerations**

The post-closing process of transferring and integrating data can last for up to several years, especially if the acquisition involves a business carve-out with related transitional services arrangements. During this period, either the seller or the purchaser may be required to continue data processing for the other. In these cases, the GDPR will require the incorporation of specific contractual provisions between the parties in the applicable transitional services agreement.

After the transaction, the purchaser may want to consolidate the target’s data at the purchaser’s existing data centers. If such transfers involve the movement of data outside the E.U., specific measures must be complied with if the recipient country has not been deemed adequate with respect to the protection of personal data by the European Commission.\(^{36}\) The U.S. has not been deemed adequate and so transfers may only be made subject to appropriate safeguards\(^{37}\) or enumerated derogations.\(^{38}\) The current most viable option for broadly permitting transfers to the U.S. may be the E.U.-U.S. Privacy Shield Framework that received an adequacy decision from the European Commission.\(^{39}\) Under this framework, companies may self-certify compliance with certain requirements and submit such certification to the U.S. Department of Commerce to benefit from the adequacy decision. However, the continued viability of this framework is uncertain given significant concerns regarding the U.S. government’s national security personal data practices. As an alternative solution, affiliates may consider implementing binding corporate rules to implement appropriate safeguards for intra-group data transfers.\(^{40}\) Consideration should also be given as to how the affected data subjects would be informed of (and have an opportunity to object to) the movement of their personal data outside the E.U.

**Conclusion**

The GDPR becomes effective on May 25, 2018, and prudent purchasers and sellers are already working with their counsel to better understand a company’s evolving data privacy risk profile under the GDPR and how best to allocate such risks in the transactional setting. The implications of the GDPR may impact all phases of a deal and should be taken into consideration from diligence through structuring to post-closing integration activities. We will monitor and provide further updates as the GDPR becomes effective and enforcement actions begin.

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\(^{36}\) Id. Art. 45(1).

\(^{37}\) Id. Art. 46.

\(^{38}\) Id. Art. 49.


\(^{40}\) Id. Art. 47.
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Supreme Court Upholds Constitutionality of *Inter Partes* Review and Holds That Petitioners Are Entitled to a Written Decision Addressing All Challenged Claims

April 25, 2018

On April 24, the United States Supreme Court issued two opinions about the United States Patent and Trademark Office’s ("USPTO") *inter partes* review procedure. First, it upheld the constitutionality of *inter partes* review, holding that a jury trial before an Article III court is not required to reconsider the grant of a patent. Second, it held that when conducting an *inter partes* review, the USPTO must issue a written decision addressing all challenged claims, rather than a narrower set of claims on which the USPTO might have instituted review. Both decisions collectively ensure that defendants in patent litigation and parties interested in challenging blocking patents retain a comparatively efficient way to challenge patent validity. Please read on for more details on each decision.

**Background**

The Leahy-Smith America Invents Act of 2011 created a new process called "*inter partes* review" ("IPR"). In an IPR, a petitioner can challenge previously issued patent claims before the USPTO. 35 U.S.C. § 311(a). These challenges can request cancellation of "1 or more claims of a patent" on the grounds that the claim fails the novelty or nonobviousness standards for patentability. § 311(b). Before instituting IPR, the USPTO Director must determine "that there is a reasonable likelihood that the petitioner would prevail with respect to at least 1 of the claims challenged." § 314(a). Once an IPR is instituted, the Patent Trial and Appeal Board ("PTAB"), an adjudicatory body within the USPTO, examines the patent’s validity. See §§ 6, 316(c). The PTAB must "issue a final written decision with respect to the patentability of any patent claim challenged by the petitioner." § 318(a). Parties dissatisfied with the PTAB decision may seek judicial review in the United States Court of Appeals for the Federal Circuit. § 319.

**Oil States**

In *Oil States Energy Services, LLC v. Greene's Energy Group, LLC*, Oil States obtained a patent related to hydraulic fracturing and sued Greene’s Energy for infringement. See No. 16-712, slip op. at 4 (U.S. Apr. 24, 2018). Greene’s Energy petitioned the PTAB to institute IPR, arguing that two of the patent’s claims were anticipated by prior art. See id. at 4-5. The PTAB instituted IPR and concluded that the claims were unpatentable. See id. at 5. Oil States appealed, arguing that the IPR procedure was unconstitutional because only a jury empaneled by an Article III court may revoke a patent. See id.

The Supreme Court rejected Oil States’ constitutional challenges, noting that under the public-rights doctrine, the Constitution does not require an Article III court to adjudicate public rights. See id. at 5-6. It held that because granting a patent is a "matter involving public rights," the reconsideration of that grant also involves public rights. Id. at 7. In doing so, the Court recognized that the PTAB considers the same statutory requirements as when the patent is granted as well as the same interests of keeping patents limited to their legitimate scope. See id. at 8-9. And because Congress could properly assign review of revocation of patent rights to a non-Article III tribunal, a jury trial was not required by the Seventh Amendment. See id. at 17. The Court emphasized, however, that its holding was limited to IPR’s constitutionality. See id. at 16. It expressly stated that it was not addressing IPR’s "retroactive application"
or whether the IPR procedure satisfies due process, and that it was not “suggesting that patents are not property for purposes of the Due Process Clause or the Takings Clause.” *Id.* at 17.

**SAS Institute**

In *SAS Institute Inc. v. Iancu*, SAS brought an IPR challenge of a software patent. See No. 16-969, slip op. at 3 (U.S. Apr. 24, 2018). In its petition, it alleged that all sixteen of the patent’s claims were unpatentable. See *id.* Acting on behalf of the USPTO Director, the PTAB instituted a partial IPR, where only some of the claims addressed in the petition were examined. See *id.* at 3-4. The PTAB ultimately issued a final written decision only as to those claims on which IPR had been instituted. See *id.* at 4. SAS sought review, arguing that 35 U.S.C. § 318(a) required the PTAB to decide the patentability of every challenged claim. See *id.* at 4.

The Court’s majority agreed, holding that under the plain text of § 318(a), parties are entitled to a written decision addressing “any patent claim challenged by the petitioner” in the initial petition. *Id.* at 4. It rejected the argument that the USPTO Director had the power to institute partial IPRs, noting that if Congress had wanted to adopt this approach, it could have done so in the statute. See *id.* at 5-8. It also rejected the policy argument that partial institution is efficient, noting that such arguments are best addressed to Congress. See *id.* at 10. Finally, because the statute was unambiguous, it rejected the argument that the USPTO Director is entitled to *Chevron* deference. See *id.* at 11-12.

Justice Ginsburg’s dissent, joined by three other Justices, stated that the PTAB may overcome the Court’s holding by denying an IPR petition and simultaneously noting that some claims in the petition would warrant reexamination. The majority responded that it was not considering whether this strategy would be consistent with the statute, and noted that even if it were permissible, the USPTO Director may not use “unlawful means” to achieve his policy aims. *Id.* at 11 n.*.” It remains to be seen whether this approach will be adopted by the PTAB.

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The Federal Circuit Resurrects Oracle’s Multibillion Dollar Copyright Claim against Google, Narrowing The Fair Use Doctrine for Software

March 29, 2018

On March 27, the United States Court of Appeals for the Federal Circuit reversed the district court’s finding that Google’s use of Java APIs in its Android operating system was fair use, resurrecting Oracle’s multibillion dollar copyright claim. In what will be a landmark ruling if upheld, a three-judge panel of the court sharply limited the jury’s role in deciding fair use cases and materially narrowed the fair use doctrine in the software context.

Background

In 2010, Oracle sued Google for copyright infringement, claiming that Google copied several elements of Oracle’s Java APIs and incorporated them into its Android operating system. In May 2012, a jury found that Google had used Oracle’s copyright-protected software without permission, but was unable to reach a unanimous verdict on the issue of fair use. In post-trial motions, the district court avoided the fair use issue, finding that the APIs were not copyright eligible. It entered final judgment in Google’s favor and Oracle appealed. In May 2014, a panel of the Federal Circuit reversed, finding the APIs copyrightable and remanding for further consideration of the fair use issue. Oracle Am., Inc. v. Google Inc., 750 F.3d 1339 (Fed. Cir. 2014).

In May 2016, the district court held a second jury trial to resolve the fair use issue. This time, the jury found that Google’s use of Oracle’s code was a fair use. The district court again entered final judgment in Google’s favor, and Oracle again appealed. On March 27, 2018, the same three-judge panel reversed the district court for a second time and remanded for a trial on damages. Oracle Am., Inc. v. Google Inc., Case No. 1017-1118 (Fed. Cir. March 27, 2018) (“Oracle II”).

Fair Use and the Jury

In Oracle II, the court began its analysis with a detailed discussion of the standard of review and the subsidiary question of what, if any, aspects of the fair use inquiry are factual in nature and thus for a jury to decide. Applying Ninth Circuit law, the court concluded that fair use is a mixed question of law and fact such that the jury’s role “is limited to determining disputed ‘historical facts,’ not the inferences or conclusions to be drawn from those facts.” Oracle II Slip Op. at 24. In the fair use context, such facts include the “‘origin, history, content, and defendant’s use’ of the copyrighted work.” Id. at 21–22. The court recognized, however, that these historical facts are rarely disputed in fair use cases. Id. at 22. In such cases, fair use can be decided by the court alone. Id. at 24.

The court emphasized that, because the ultimate question of whether the use is fair is a question of law for the court, it is reviewed de novo. Id. at 21. Indeed, the court made clear that “[a]ll jury findings relating to fair use other than its implied findings of historical fact must . . . be viewed as advisory only.” Id. at 26. In this way, the court established a standard similar to that applied to obviousness in the patent context. Id. at 25 fn. 4. And, because the fair use inquiry generally turns on the inferences drawn from the historical facts rather than the historical facts themselves, the court proceeded to conduct a largely de novo review of the jury’s fair use finding.
Google’s Unfair Use

In analyzing whether Google’s copying of Oracle’s Java API constituted fair use, the court walked through the four traditional fair use factors: (1) the purpose and character of the use; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used; and (4) the effect upon the potential market. Of particular interest, the court found that even though Google’s Android software was distributed for free under an open source license, the court found that the nature of the use was overwhelmingly commercial, reasoning that it supported Google’s overall ad-revenue and that repeated distribution, even for free, could be commercial when it is distributed without paying the copyright holder’s customary price. Id. at 30. And, while the functional nature of the APIs weighed in favor of a finding of fair use, the court held that “allowing this one factor to dictate a conclusion of fair use” would negate copyright in software and thus the factor has “less significance to the overall analysis.” Id. at 44. Ultimately, the court found that Android’s release prevented Oracle from participating in the smartphone market and that “[t]his superseding use is inherently unfair.” Id. at 54.

The court concluded by noting that it had not held that a fair use defense could never be sustained in an action involving the copying of computer code. Id. However, by emphasizing the commercial purpose of software distribution even in an open source environment, and de-emphasizing the functional nature of the copyrighted work, the court appears to have materially narrowed the applicability of the fair use doctrine to software.

Google now has the opportunity to request further review by the Federal Circuit en banc, and ultimately by the Supreme Court. We will follow up with additional information should there be any further significant developments.

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There has been lots of buzz about the EU General Data Protection Regulation (GDPR), which entered into full forced on May 25, 2018. As an entrepreneur, you've seen GDPR significantly reshape the global data protection landscape for businesses that process EU personal data, adding new data breach reporting obligations and imposing extensive record keeping and vendor management rules.

In this issue of the Flash, we highlight Goodwin’s panel discussion featuring top privacy and cybersecurity experts – including Bruno Gencarelli, Head of International Data Flows and Protection for the European Commission, and Stephen McCartney, EU Director of Privacy for Pearson plc, along with members of Goodwin’s global Privacy + Cybersecurity team.

Also in this week’s Flash:

• You Should Spend 70 Percent of Your Time Doing Hard Things, Says This 5-Time Entrepreneur (Inc.)
• What To Be An Entrepreneur? You Need These Skills (Entrepreneur)
• AI in Startups (Forbes)
• The 3 Words That Define a Business Owner's Success (Entrepreneur)

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Founders Workbench
Founders Flash: Key Terms Every Entrepreneur Must Know Before Meeting With Investors

Posted By Founders Workbench | 08.07.2018

Between venture capitalists, angel investors and equity crowdfunding, more and more channels of funding are becoming available for your startup. To enter into these meetings with confidence, entrepreneurs must be prepared and armed with basic startup terminology.

In this issue of the Flash, we are defining five key terms every entrepreneur should be familiar with before meeting with investors. For more key terms, please check out our Deal Dictionary which is designed to help entrepreneurs understand the jargon that comes up in discussions with investors and legal counsel.

#1 Bylaws
This is a constitutional document for the company (but subordinate to the certificate of incorporation) and generally sets out the procedural rules that govern the company. Bylaws typically regulate the rules and procedures of director elections, board and stockholder meetings, officer appointments and their roles and responsibilities, and similar matters.

#2 Change of Control
This generally occurs when a company is acquired by or merged into another entity, or when a majority of the voting power of the company changes hands.

#3 Full Ratchet
This is a form of a price-based Anti-dilution Provision that is most aggressive (in favor of the investors) in balancing against the dilution caused by the issuance of stock at a price lower than existing preferred stock. It adjusts the conversion ratio of the existing preferred stock (that was sold for more than the stock being sold now) so that such stock retains the same percentage on an as-converted basis as it did before the issuance.

#4 No Shop Provision
A provision in term sheets that prohibits the company that is being invested in from shopping the deal around to other investors. Also referred to as an "exclusivity" provision. Depending on deal dynamics and who has leverage, the No Shop typically ranges from 30-45 days, and occasionally, a No Shop is not included in the term sheet.
#5 Warrant Coverage Amount
In some financing deals involving convertible Promissory Notes, investors will ask for warrants exercisable for shares of a series of the company's preferred stock (or if none exist, then shares of the next series of preferred stock to be issued by the company or common stock). The number of shares the warrant is exercisable for will usually be expressed as a percentage of the amount of the investment (i.e. the principal amount of a Promissory Note) divided by the exercise price (the purchase price) of the underlying stock.

Also in this week's Flash:

• 10 European startups making big waves in the travel industry (EU-Startups)
• 4 Fundamentals to Successfully Jump-Start Your Startup (Entrepreneur)
• What Are Some Good Resources For Women Entrepreneurs? (Forbes)
• Top 10 Startup Accelerators Based On Successful Exits (Forbes)

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Founders Workbench
As an new entrepreneur, learning business and industry terms is vital to improving your startup intellect. Every founder should have a basic understanding of startup terminology in order to fully comprehend how to launch and fund a successful business.

In this issue of the Flash, we are defining five key terms every entrepreneur should know. For more key terms, please check out our Deal Dictionary which is designed to help entrepreneurs understand the jargon that comes up in discussions with investors and legal counsel.

#1 Double Trigger Vesting Acceleration
This is a type of accelerated Vesting that causes all or a portion of the shares to be deemed Vested upon the occurrence of a combination of two events, which are typically (1) a Change of Control and (2) an involuntary termination (customarily defined as termination without cause or a resignation caused by events/circumstances that essentially forced the person to resign) within some period after that Change of Control. Full acceleration pursuant to this version of vesting acceleration is generally acceptable to investors.

#2 Key Person Insurance
Life insurance on one or more "key person(s)" to a company's future success (usually a founder, current CEO or lead technical employee). This is sometimes required by investors as a condition to an investment in the Company. The proceeds of the life insurance are typically payable to the company.

#3 Piggy-Back Registration Rights
This is a right typically given to investors alongside Demand Registration and S-3 Registration Rights. Piggy-Back Registration Rights entitle investors to have their shares included with any shares the company itself wants to sell and register for public sale (hence, the investors can sell their shares to the public by "piggy-backing" on top of the company's public offering).

#4 Post-Money Valuation
The valuation of the Company after the investors have made their investment. Typically, this is just the Pre-Money Valuation plus the total amount of investment in the round.

#5 Qualified Financing (Next Equity Financing)
This is a term that is in Promissory Notes that are convertible into equity. It is often the trigger for the
automatic conversion of the outstanding amount in the Promissory Note into equity, and this term will typically specify a minimum round size. For example, if a Qualified Financing is defined as one resulting in $1,000,000 of new cash proceeds to the company, if the company raises a new equity round of $2,000,000, the Promissory Notes would automatically convert, but not if the size of the raise in the new round was less than $1,000,000.

Also in this week’s Flash:

• Europe’s Start-Up Hotspots Revealed (Forbes)
• 6 Ways To Ask For Help As An Entrepreneur (Forbes)
• 9 Ways Successful Group Networking Empowers Women Entrepreneurs (Entrepreneur)
• The Senior Planet Course That Launches Entrepreneurs Over 60 (Forbes)

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Founders Workbench
UPDATED INVESTOR BULLETIN:
CROWDFUNDING FOR INVESTORS

05/10/2017

The SEC’s Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate investors about a new investing opportunity in the form of securities-based crowdfunding.

Crowdfunding generally refers to a financing method in which money is raised through soliciting relatively small individual investments or contributions from a large number of people. Over the last few years, crowdfunding websites in the United States have proven a popular way by which to solicit charitable donations and to raise funds for artistic endeavors like films and music recordings.

Under rules adopted by the SEC in 2015, the general public now has the opportunity to participate in the early capital raising activities of start-up and early-stage companies and businesses by way of crowdfunding. Companies can use securities-based crowdfunding to offer and sell securities to the investing public.

Can I make a crowdfunding investment?

Anyone can invest in a securities-based crowdfunding offering. Because of the risks involved with this type of investing, however, you are limited in how much you can invest during any 12-month period in these transactions. The limitation on how much you can invest depends on your net worth and annual income.

If either your annual income or your net worth is less than $107,000, then during any 12-month period, you can invest up to the greater of either $2,200 or 5% of the lesser of your annual income or net worth.

If both your annual income and your net worth are equal to or more than $107,000, then during any 12-month period, you can invest up to 10% of annual income or net worth, whichever is lesser, but not to exceed $107,000.

The following table provides a few examples:

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Net Worth</th>
<th>Calculation</th>
<th>12-month Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000</td>
<td>$105,000</td>
<td>greater of $2,200 or 5% of $30,000 ($1,500)</td>
<td>$2,200</td>
</tr>
<tr>
<td>$150,000</td>
<td>$80,000</td>
<td>greater of $2,200 or 5% of $80,000 ($4,000)</td>
<td>$4,000</td>
</tr>
<tr>
<td>$150,000</td>
<td>$107,000</td>
<td>10% of $107,000 ($10,000)</td>
<td>$10,700</td>
</tr>
<tr>
<td>$200,000</td>
<td>$900,000</td>
<td>10% of $200,000 ($20,000)</td>
<td>$20,000</td>
</tr>
<tr>
<td>$1.2</td>
<td>$2 million</td>
<td>10% of $1.2 million ($120,000), subject to</td>
<td>$107,000</td>
</tr>
</tbody>
</table>
**Joint calculation.** You can calculate your annual income or net worth by jointly including your spouse’s income or assets. It is not necessary that property be held jointly. However, if you do calculate your income or assets jointly with your spouse, each of your crowdfunding investments together cannot exceed the limit that would apply to an individual investor at that annual income or net worth level.

**How do I calculate my net worth?**

Calculating net worth involves adding up all your assets and subtracting all your liabilities. The resulting sum is your net worth.

**For purposes of crowdfunding, the value of your primary residence is not included in your net worth calculation.** In addition, any mortgage or other loan on your home does not count as a liability up to the fair market value of your home. If the loan is for more than the fair market value of your home (i.e., if your mortgage is underwater), then the loan amount that is over the fair market value counts as a liability under the net worth test.

Further, any increase in the loan amount in the 60 days prior to your purchase of the securities (even if the loan amount doesn’t exceed the value of the residence) will count as a liability as well. The reason for this is to prevent net worth from being artificially inflated through converting home equity into cash or other assets.

While your individual circumstances will vary, the following table sets forth examples of calculations under the net worth test in order to determine crowdfunding investment limits:

<table>
<thead>
<tr>
<th></th>
<th>Jane Doe</th>
<th>John Smith</th>
<th>James Lee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary residence</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>not included except for related liabilities below:</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home value</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Mortgage</td>
<td>200,000</td>
<td>200,000</td>
<td>330,000</td>
</tr>
<tr>
<td>Home equity line:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>more than 60 days old</td>
<td>–</td>
<td>20,000</td>
<td>–</td>
</tr>
<tr>
<td>less than 60 days old</td>
<td>–</td>
<td>10,000</td>
<td>–</td>
</tr>
<tr>
<td><strong>Included assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank accounts</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>401(k)/IRA accounts</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Other investments</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Car</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Total included assets</td>
<td>$190,000</td>
<td>$190,000</td>
<td>$190,000</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
</tr>
<tr>
<td>Included liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Student and car loans</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Portion of mortgage underwater</td>
<td>–</td>
<td>–</td>
<td>30,000</td>
</tr>
<tr>
<td>Home equity line (less than 60 days old)</td>
<td>–</td>
<td>10,000</td>
<td>–</td>
</tr>
<tr>
<td>Total included liabilities</td>
<td>$120,000</td>
<td>$130,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Net worth</td>
<td>$70,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

How do I make a crowdfunding investment?

You can only invest in a crowdfunding offering through the online platform, such as a website or a mobile app, of a broker-dealer or a funding portal. Companies may not offer crowdfunding investments to you directly—they must use a broker-dealer or funding portal.

The broker-dealer or funding portal—a crowdfunding intermediary—must be registered with the SEC and be a member of the Financial Industry Regulatory Authority (FINRA). You can obtain information about a broker by visiting FINRA’s BrokerCheck (https://brokercheck.finra.org) or calling FINRA’s toll-free BrokerCheck hotline at (800) 289-9999. You can obtain information about a funding portal by visiting the SEC’s EDGAR (http://www.sec.gov/edgar/searchedgar/companysearch.html) website.

Keep in mind that you will have to open an account with the crowdfunding intermediary—the broker-dealer or funding portal—in order to make an investment and all written communications relating to your crowdfunding investment will be electronic.

What should I keep in mind?

Crowdfunding offers investors an opportunity to participate in an early-stage venture. However, you should be aware that early-stage investments may involve very high risks and you should research thoroughly any offering before making an investment decision. You should read and fully understand the information about the company and the risks that are disclosed to you before making any investment.

The following are some risks to consider before making a crowdfunding investment:

- **Speculative.** Investments in startups and early-stage ventures are speculative and these enterprises often fail. Unlike an investment in a mature business where there is a track record of revenue and income, the success of a startup or early-stage venture often relies on the development of a new product or service that may or may not find a market. You should be able to afford and be prepared to lose your entire investment.

- **Liquidity.** You will be limited in your ability to resell your investment for the first year and may need to hold your investment for an indefinite period of time. Unlike investing in companies listed
on a stock exchange where you can quickly and easily trade securities on a market, you may have to locate an interested buyer when you do seek to resell your crowdfunding investment.

- **Cancellation restrictions.** Once you make an investment commitment for a crowdfunding offering, you will be committed to make that investment (unless you cancel your commitment within a specified period of time). As detailed in the box below for Changing your mind, the ability to cancel your commitment is limited.

- **Valuation and capitalization.** Your crowdfunding investment may purchase an equity stake in a startup. *Unlike listed companies that are valued publicly through market-driven stock prices, the valuation of private companies, especially startups, is difficult and you may risk overpaying for the equity stake you receive.* In addition, there may be additional classes of equity with rights that are superior to the class of equity being sold through crowdfunding.

- **Limited disclosure.** The company must disclose information about the company, its business plan, the offering, and its anticipated use of proceeds, among other things. An early-stage company may be able to provide only limited information about its business plan and operations because it does not have fully developed operations or a long history to provide more disclosure. The company is also only obligated to file information annually regarding its business, including financial statements. A publicly listed company, in contrast, is required to file annual and quarterly reports and promptly disclose certain events—continuing disclosure that you can use to evaluate the status of your investment. *In contrast, you may have only limited continuing disclosure about your crowdfunding investment.*

- **Investment in personnel.** *An early-stage investment is also an investment in the entrepreneur or management of the company.* Being able to execute on the business plan is often an important factor in whether the business is viable and successful. You should also be aware that a portion of your investment may fund the compensation of the company’s employees, including its management. You should carefully review any disclosure regarding the company’s use of proceeds.

- **Possibility of fraud.** In light of the relative ease with which early-stage companies can raise funds through crowdfunding, it may be the case that certain opportunities turn out to be money-losing fraudulent schemes. *As with other investments, there is no guarantee that crowdfunding investments will be immune from fraud.*

- **Lack of professional guidance.** Many successful companies partially attribute their early success to the guidance of professional early-stage investors (e.g., angel investors and venture capital firms). These investors often negotiate for seats on the company's board of directors and play an important role through their resources, contacts and experience in assisting early-stage companies in executing on their business plans. An early-stage company primarily financed through crowdfunding may not have the benefit of such professional investors.

**How do I get informed?**

Broker-dealers and funding portals that operate crowdfunding platforms are required to offer educational materials to help investors understand this type of investing. These materials further detail the risks involved when making a crowdfunding investment. *You should take advantage of this resource to educate yourself and understand the risks of making crowdfunding investments. Remember, this is your money that you are putting at risk, and you should only invest after careful consideration of the risks.*

**Review and acknowledgement.** Before you can make a crowdfunding investment, the broker-dealer or funding portal operating the crowdfunding platform you are using must ensure that you review educational materials about this type of investing. In addition, you will have to positively affirm that you understand that you can lose all of your investment and that you can bear such a loss. You will also have to demonstrate that you understand the risks of crowdfunded investing.
As mentioned, the companies that you invest in are required to disclose a limited amount of information to you. This information includes general information about the company, its officers and directors, a description of the business, the planned use for the money raised from the offering, often called the use of proceeds, the target offering amount, the deadline for the offering, related-party transactions, risks specific to the company or its business, and financial information about the company. **You should use this information to determine whether a particular investment is appropriate for you.**

**Tiered financial disclosure.** The minimum level of financial disclosure required by the company depends on the amount of money being raised or raised by the company in the prior 12 months:

- **$107,000 or less** – financial statements and specific line items from income tax returns, both of which are certified by the principal executive officer of the company.
- **$107,000.01 to $535,000** – financial statements reviewed by an independent public accountant and the accountant's review report.
- **$535,001 to $1.07 million** – if first time crowdfunding, then financial statements reviewed by an independent public accountant and the accountant’s review report, otherwise financial statements audited by an independent public accountant and the accountant's audit report.

An audit provides a level of scrutiny by the accountant that is higher than a review.

The sharing of views by members of the crowd is considered by some to be an integral part of crowdfunding. Broker-dealers and funding portals, through their crowdfunding platforms, are required to have communication channels transparent to the public—for example, on an online forum—relating to each particular investment opportunity. In these channels, the crowd of investors can weigh in on the pros and cons of an opportunity and be able to ask the company questions. All persons representing the company must identify themselves. It may be worthwhile to monitor these communication channels before and after you make your commitment to invest.

**Changing your mind.** You have up to 48 hours prior to the end of the offer period to change your mind and cancel your investment commitment for any reason. **Once the offering period is within 48 hours of ending, you will not be able to cancel for any reason even if you make your commitment during this period.** However, if the company makes a material change to the offering terms or other information disclosed to you, you will be given five business days to reconfirm your investment commitment.

**What’s different about being a crowdfunding investor?**

Being a crowdfunding investor is different than being a shareholder in a publicly listed company. For one thing, you cannot sell your shares at any time as you would be able to do if you held shares in a publicly listed company. In fact, **you are restricted from reselling your shares for the first year,** unless the shares are transferred:

- to the company that issued the securities;
- to an [accredited investor](http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors);
- to a family member;
- in connection with your death or divorce or other similar circumstance;
- to a trust controlled by you or a trust created for the benefit of a family member;
as part of an offering registered with the SEC.

**Family member.** For purposes of the above, a family member is defined as a child, stepchild, grandchild, parent, stepparent, grandparent, spouse or spousal equivalent, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships.

Another difference from being a shareholder of a publicly listed company is the amount of information you'll receive about your investment. Publicly listed companies generally are required to disclose information about their performances at least on a quarterly and annual basis and on a regular basis about material events that affect the company. **In contrast, crowdfunding companies are only required to disclose annually their results of operations and financial statements.**

**Additional Information**

To learn more about crowdfunding, see the adopted [rules](http://www.sec.gov/rules/final/2015/33-9974.pdf).

To learn about SAFEs, a type of security, being used in crowdfunding, see our [Investor Bulletin](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-be-cautious-safes-crowdfunding).

For a list of funding portals registered with FINRA to act as crowdfunding intermediaries, visit [here](https://www.finra.org/about/funding-portals-we-regulate).

For a list of broker-dealer firms registered with FINRA, visit [here](https://www.finra.org/about/firms-we-regulate).


For FINRA's [BrokerCheck](http://brokercheck.finra.org/), visit [brokercheck.finra.org](http://brokercheck.finra.org/).

For information on how to search for company documents in the SEC's EDGAR database, see [Using EDGAR - Researching Public Companies](http://investor.gov/researching-managing-investments/researching-investments/using-edgar-researching-public-companies).


For more information about accredited investors, see our [Investor Bulletin](http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors).

For additional investor educational information, see the SEC's website for individual investors, [Investor.gov](http://www.investor.gov).

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 81207 / July 25, 2017

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:
The DAO

I. Introduction and Summary

The United States Securities and Exchange Commission’s (“Commission”) Division of
Enforcement (“Division”) has investigated whether The DAO, an unincorporated organization;
Slock.it UG (“Slock.it”), a German corporation; Slock.it’s co-founders; and intermediaries may
have violated the federal securities laws. The Commission has determined not to pursue an
enforcement action in this matter based on the conduct and activities known to the Commission
at this time.

As described more fully below, The DAO is one example of a Decentralized
Autonomous Organization, which is a term used to describe a “virtual” organization embodied in
computer code and executed on a distributed ledger or blockchain. The DAO was created by
Slock.it and Slock.it’s co-founders, with the objective of operating as a for-profit entity that
would create and hold a corpus of assets through the sale of DAO Tokens to investors, which
assets would then be used to fund “projects.” The holders of DAO Tokens stood to share in the
anticipated earnings from these projects as a return on their investment in DAO Tokens. In
addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling
DAO Tokens on a number of web-based platforms (“Platforms”) that supported secondary
trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding
projects, an attacker used a flaw in The DAO’s code to steal approximately one-third of The
DAO’s assets. Slock.it’s co-founders and others responded by creating a work-around whereby
DAO Token holders could opt to have their investment returned to them, as described in more
detail below.

The investigation raised questions regarding the application of the U.S. federal securities
laws to the offer and sale of DAO Tokens, including the threshold question whether DAO
Tokens are securities. Based on the investigation, and under the facts presented, the Commission
has determined that DAO Tokens are securities under the Securities Act of 1933 (“Securities
appropriate and in the public interest to issue this report of investigation (“Report”) pursuant to

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1 This Report does not analyze the question whether The DAO was an “investment company,” as defined under
Section 3(a) of the Investment Company Act of 1940 (“Investment Company Act”), in part, because The DAO never
commenced its business operations funding projects. Those who would use virtual organizations should consider
their obligations under the Investment Company Act.
Section 21(a) of the Exchange Act\textsuperscript{2} to advise those who would use a Decentralized Autonomous Organization ("DAO Entity"), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, "smart contracts,"\textsuperscript{3} or computer code, does not remove conduct from the purview of the U.S. federal securities laws.\textsuperscript{4} This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

II. Facts

A. Background

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether ("ETH"), a

\textsuperscript{2} Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." This Report does not constitute an adjudication of any fact or issue addressed herein, nor does it make any findings of violations by any individual or entity. The facts discussed in Section II, infra, are matters of public record or based on documentary records. We are publishing this Report on the Commission’s website to ensure that all market participants have concurrent and equal access to the information contained herein.

\textsuperscript{3} Computer scientist Nick Szabo described a "smart contract" as:

a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.


\textsuperscript{4} See \textit{SEC v. C.M. Joiner Leasing Corp.}, 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as 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 contracts,' or as 'any interest or instrument commonly known as a 'security.'"); see also \textit{Reves v. Ernst & 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 by whatever name they are called.").
virtual currency\(^5\) used on the Ethereum Blockchain.\(^6\) As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars ("USD") at approximately $150 million.

The concept of a DAO Entity is memorialized in a document (the "White Paper"), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a "Blockchain and IoT ([internet-of-things]) solution company," incorporated in Germany and co-founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch's brother), and Stephan Tual ("Tual").\(^7\) The White Paper purports to describe "the first implementation of a [DAO Entity] code to automate organizational governance and decision making."\(^8\) The White Paper posits that a DAO Entity "can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law." The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations.\(^9\) As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are "formalized, automated and enforced using software."\(^10\)

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5 The Financial Action Task Force defines "virtual currency" as:

a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfills the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. "real currency," "real money," or "national currency"), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.


6 Ethereum, developed by the Ethereum Foundation, a Swiss nonprofit organization, is a decentralized platform that runs smart contracts on a blockchain known as the Ethereum Blockchain.

7 Christoph Jentzsch released the final draft of the White Paper on or around March 23, 2016. He introduced his concept of a DAO Entity as early as November 2015 at an Ethereum Developer Conference in London, as a medium to raise funds for Slock.it, a German start-up he co-founded in September 2015. Slock.it purports to create technology that embeds smart contracts that run on the Ethereum Blockchain into real-world devices and, as a result, for example, permits anyone to rent, sell or share physical objects in a decentralized way. See SLOCK.IT, https://slock.it/.


9 Id.

10 Id. The White Paper contained the following statement:

A word of caution, at the outset: the legal status of [DAO Entities] remains the subject of active and vigorous debate and discussion. Not everyone shares the same definition. Some have said that [DAO Entities] are autonomous code and can operate independently of legal systems; others
B. The DAO

“The DAO” is the “first generation” implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a “crowdfunding contract” to raise “funds to grow a company in the crypto space.”\(^\text{11}\) In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a “for-profit DAO [Entity],” where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to “rewards.”\(^\text{12}\) Christoph Jentzsch likened this to “buying shares in a company and getting … dividends.”\(^\text{13}\) The DAO was to be “decentralized” in that it would allow for voting by investors holding DAO Tokens.\(^\text{14}\) All funds raised were to be held at an Ethereum Blockchain “address” associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO’s anticipated earnings from the projects it funded.\(^\text{15}\) The DAO was intended to be “autonomous” in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.\(^\text{16}\)


\(^{13}\) Id.

\(^{14}\) Id. supra note 8.

\(^{15}\) Id. In theory, there was no limitation on the type of project that could be proposed. For example, proposed “projects” could include, among other things, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.

\(^{16}\) Id.
On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions. This code was to govern how The DAO was to operate.

To promote The DAO, Slock.it’s co-founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO’s intended purpose: “To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code.” The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity’s structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO’s source code had been reviewed by “one of the world’s leading security audit companies” and “no stone was left unturned during those five whole days of security analysis.”

Slock.it’s co-founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO’s status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it’s co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered “The DAO Slack” channel, an online messaging platform in which over 5,000 invited “team members” could discuss and exchange ideas about The DAO in real time.

1. **DAO Tokens**

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects

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17 According to the White Paper, a DAO Entity is “activated by deployment on the Ethereum Blockchain. Once deployed, a [DAO Entity’s] code requires ‘ether’ [ETH] to engage in transactions on Ethereum. Ether is the digital fuel that powers the Ethereum Network.” The only way to update or alter The DAO’s code is to submit a new proposal for voting and achieve a majority consensus on that proposal. See Jentzsch, supra note 8. According to Slock.it’s website, Slock.it gave The DAO code to the Ethereum community, noting that:

The DAO framework is a side project of Slock.it’s and a gift to the Ethereum community. It consisted of a definitive whitepaper, smart contract code audited by one of the best security companies in the world and soon, a complete frontend interface. All free and open source for anyone to re-use, it is our way to say ‘thank you’ to the community.


18 The DAO Website was available at https://daohub.org.

19 Stephen Tual, Deja Vu DAO Smart Contracts Audit Results, SLOCK.IT BLOG (Apr. 5, 2016), https://blog.slock.it/deja-vu-dao-smart-contracts-audit-results-d26be088e32e.
that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock.it’s co-founders touted that DAO Token holders would receive “rewards,” which the White Paper defined as, “any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded.” DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the “Offering Period”), The DAO offered and sold DAO Tokens. Investments in The DAO were made “pseudonymously” (i.e., an individual’s or entity’s pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO’s Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.20

In addition to secondary market trading on the Platforms, after the Offering Period, DAO Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity “split.”21

2. Participants in The DAO

According to the White Paper, in order for a project to be considered for funding with “a DAO [Entity]’s [ETH],” a “Contractor” first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the

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20 The Platforms are registered with FinCEN as “Money Services Businesses” and provide systems whereby customers may exchange virtual currencies for other virtual currencies or fiat currencies.

21 According to the White Paper, the primary purpose of a split is to protect minority shareholders and prevent what is commonly referred to as a “51% Attack,” whereby an attacker holding 51% of a DAO Entity’s Tokens could create a proposal to send all of the DAO Entity’s funds to himself or herself.
Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.  

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders. DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. Specifically, as noted in a May 27, 2016 blog post by a group of computer security researchers, The DAO’s structure included a “strong positive bias to vote YES on proposals and to suppress NO votes as a side effect of the way in which it restricts users’ range of options following the casting of a vote.”  

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO’s “Curators.” At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it. According to the White Paper, the Curators of a DAO Entity had “considerable power.” The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for “failsafe protection” and for protecting The DAO from “malicious [sic] actors.” Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2)  

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22 It was stated on The DAO Website and elsewhere that Slock.it anticipated that it would be the first to submit a proposal for funding. In fact, a draft of Slock.it’s proposal for funding for an “Ethereum Computer and Universal Sharing Network” was publicly-available online during the Offering Period.  

23 DAO Token holders could vote on proposals, either by direct interaction with the Ethereum Blockchain or by using an application that interfaces with the Ethereum Blockchain. It was generally acknowledged that DAO Token holders needed some technical knowledge in order to submit a vote, and The DAO Website included a link to a step-by-step tutorial describing how to vote on proposals.  

24 By voting on a proposal, DAO Token holders would “tie up” their tokens until the end of the voting cycle. See Jentzsch, supra note 8 at 8 (“The tokens used to vote will be blocked, meaning they can not [sic] be transferred until the proposal is closed.”). If, however, a DAO Token holder abstained from voting, the DAO Token holder could avoid these restrictions; any DAO Tokens not submitted for a vote could be withdrawn or transferred at any time. As a result, DAO Token holders were incentivized either to vote yes or to abstain from voting. See Dino Mark et al., A Call for a Temporary Moratorium on The DAO, HACKING, DISTRIBUTED (May 27, 2016, 1:35 PM), http://hackingdistributed.com/2016/05/27/dao-call-for-moratorium/.  

25 At the time of The DAO’s launch, The DAO Website identified eleven “high profile” individuals as holders of The DAO’s Curator “Multisig” (or “private key”). These individuals all appear to live outside of the United States. Many of them were associated with the Ethereum Foundation, and The DAO Website touted the qualifications and trustworthiness of these individuals.
confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the “whitelist,” which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had “complete control over the whitelist … the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhitelisted … [and] clear ability to control the order and frequency of proposals,” noting that “curators have tremendous power.”26 Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics.27 Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.


During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform’s system, which would then match with orders from other customers residing on the system. Each Platform’s system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers’ orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.


27 Andrew Quentson, Are the DAO Curators Masters or Janitors?, THE COIN TELEGRAPH (June 12, 2016), https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors.
4. Security Concerns, The “Attack” on The DAO, and The Hard Fork

In late May 2016, just prior to the expiration of the Offering Period, concerns about the safety and security of The DAO’s funds began to surface due to vulnerabilities in The DAO’s code. On May 26, 2016, in response to these concerns, Slock.it submitted a “DAO Security Proposal” that called for the development of certain updates to The DAO’s code and the appointment of a security expert.\(^\text{28}\) Further, on June 3, 2016, Christoph Jentzsch, on behalf of Slock.it, proposed a moratorium on all proposals until alterations to The DAO’s code to fix vulnerabilities in The DAO’s code had been implemented.\(^\text{29}\)

On June 17, 2016, an unknown individual or group (the “Attacker”) began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO’s Ethereum Blockchain address to an Ethereum Blockchain address controlled by the Attacker (the “Attack”).\(^\text{30}\) Although the diverted ETH was then held in an address controlled by the Attacker, the Attacker was prevented by The DAO’s code from moving the ETH from that address for 27 days.\(^\text{31}\)

In order to secure the diverted ETH and return it to DAO Token holders, Slock.it’s co-founders and others endorsed a “Hard Fork” to the Ethereum Blockchain. The “Hard Fork,” called for a change in the Ethereum protocol on a going forward basis that would restore the DAO Token holders’ investments as if the Attack had not occurred. On July 20, 2016, after a majority of the Ethereum network adopted the necessary software updates, the new, forked Ethereum Blockchain became active.\(^\text{32}\) The Hard Fork had the effect of transferring all of the funds raised (including those held by the Attacker) from The DAO to a recovery address, where DAO Token holders could exchange their DAO Tokens for ETH.\(^\text{33}\) All DAO Token holders

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\(^\text{28}\) See Stephan Tual, Proposal #1-DAO Security, Redux, SLOCK.ITAL BLOG (May 26, 2016), https://blog.slock.it/both-our-proposals-are-now-out-voting-starts-saturday-morning-ba322d6d3ea. The unnamed security expert would “act as the first point of contact for security disclosures, and continually monitor, pre-empt and avert any potential attack vectors The DAO may face, including social, technical and economic attacks.” Id. Slock.it initially proposed a much broader security proposal that included the formation of a “DAO Security” group, the establishment of a “Bug Bounty Program,” and routine external audits of The DAO’s code. However, the cost of the proposal (125,000 ETH), which would be paid from The DAO’s funds, was immediately criticized as too high and Slock.it decided instead to submit the revised proposal described above. See Stephan Tual, DAO Security, a Proposal to guarantee the integrity of The DAO, SLOCK.IT BLOG (May 25, 2016), https://blog.slock.it/dao-security-a-proposal-to-guarantee-the-integrity-of-the-dao-3473899ace9d.


\(^\text{30}\) See Stephan Tual, DAO Security Advisory: live updates, SLOCK.ITAL BLOG (June 17, 2016), https://blog.slock.it/dao-security-advisory-live-updates-2a0a42a2d07b.

\(^\text{31}\) Id.

\(^\text{32}\) A minority group, however, elected not to adopt the new Ethereum Blockchain created by the Hard Fork because to do so would run counter to the concept that a blockchain is immutable. Instead they continued to use the former version of the blockchain, which is now known as “Ethereum Classic.”

who adopted the Hard Fork could exchange their DAO Tokens for ETH, and avoid any loss of the ETH they had invested.\textsuperscript{34}

III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as “Initial Coin Offerings” or “Token Sales.” Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, 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. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the “full and fair disclosure” afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed “information about the issuer’s financial condition, the identity and background of management, and the price and amount of securities to be offered . . . .” \textit{SEC v. Cavanagh}, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), \textit{aff’d}, 155 F.3d 129 (2d Cir. 1998). “The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act’s comprehensive scheme for protecting public investors.” \textit{SEC v. Aaron}, 605 F.2d 612, 618 (2d Cir. 1979) (citing \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119, 124 (1953)), \textit{vacated on other grounds}, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. \textit{SEC v. Universal Major Indus. Corp.}, 546 F.2d 1044, 1047 (2d Cir. 1976).

\textsuperscript{34} \textit{Id.}
B. DAO Tokens Are Securities

1. *Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology*

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes “an investment contract.” See 15 U.S.C. §§ 77b-77c. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); see also *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) (The “touchstone” of an investment contract “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”). This definition 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.” *Howey*, 328 U.S. at 299 (emphasis added). The test “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security.” *Id.* In analyzing whether something is a security, “form should be disregarded for substance,” *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), “and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.” *United Housing Found.*, 421 U.S. at 849.

2. *Investors in The DAO Invested Money*

In determining whether an investment contract exists, the investment of “money” need not take the form of cash. See, e.g., *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) (“[I]n spite of Howey’s reference to an ‘investment of money,’ it is well established that cash is not the only form of contribution or investment that will create an investment contract.”).

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*. See *SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*); *Uselton*, 940 F.2d at 574 (“[T]he ‘investment’ may take the form of ‘goods and services,’ or some other ‘exchange of value.’”) (citations omitted).

3. *With a Reasonable Expectation of Profits*

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO’s Ethereum Blockchain address in exchange for DAO Tokens. “[P]rofits” include “dividends, other periodic payments, or the increased value of the investment.” *Edwards*, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund
projects in exchange for a return on investment.\textsuperscript{35} The ETH was pooled and available to The DAO to fund projects. The projects (or “contracts”) would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. \textit{Derived from the Managerial Efforts of Others}

a. The Efforts of Slock.it, Slock.it’s Co-Founders, and The DAO’s Curators Were Essential to the Enterprise

Investors’ profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO’s Curators. The central issue is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” \textit{SEC v. Glenn W. Turner Enters., Inc.}, 474 F.2d 476, 482 (9th Cir. 1973). The DAO’s investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO’s Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO’s investors.

Investors’ expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO’s Curators, to provide significant managerial efforts after The DAO’s launch. The expertise of The DAO’s creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a

\textsuperscript{35} That the “projects” could encompass services and the creation of goods for use by DAO Token holders does not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others.
vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO’s protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders’ votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.\footnote{DAO Token holders could put forth a proposal to split from The DAO, which would result in the creation of a new DAO Entity with a new Curator. Other DAO Token holders would be allowed to join the new DAO Entity as long as they voted yes to the original “split” proposal. Unlike all other contract proposals, a proposal to split did not require a deposit or a quorum, and it required a seven-day debating period instead of the minimum two-week debating period required for other proposals.}

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO’s code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

b. DAO Token Holders’ Voting Rights Were Limited

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators.\footnote{Because, as described above, DAO Token holders were incentivized either to vote yes or to abstain from voting, the results of DAO Token holder voting would not necessarily reflect the actual view of a majority of DAO Token holders.} Even if an investor’s efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter’s significant managerial efforts or control over the enterprise. See, e.g., Glenn W. Turner, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter’s managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); Long v. Shultz, 881 F.2d 129, 137 (5th Cir. 1989) (“An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not
pay off.”). See also generally SEC v. Merchant Capital, LLC, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders’ ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators. And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. Indeed, based on the particular facts concerning The DAO and the few draft proposals discussed in online forums, there are indications that contract proposals would not necessarily provide enough information for investors to make an informed voting decision, affording them less meaningful control. For example, the sample contract proposal attached to the White Paper included little information concerning the terms of the contract. Also, the Slock.it co-founders put forth a draft of their own contract proposal and, in response to questions and requests to negotiate the terms of the proposal (posted to a DAO forum), a Slock.it founder explained that the proposal was intentionally vague and that it was, in essence, a take it or leave it proposition not subject to negotiation or feedback. See, e.g., SEC v. Shields, 744 F.3d 633, 643-45 (10th Cir. 2014) (in assessing whether agreements were investment contracts, court looked to whether “the investors actually had the type of control reserved under the agreements to obtain access to information necessary to protect, manage, and control their investments at the time they purchased their interests.”).

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market—an arrangement that bears little resemblance to that of a genuine general partnership. Cf. Williamson v. Tucker, 645 F.2d 404, 422-24 (5th Cir. 1981) (“[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many [limited] partners that a partnership vote would be more like a corporate vote, each partner’s role having been diluted to the level of a single shareholder in a corporation.”). Slock.it did create and maintain online forums on which

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39 The Fifth Circuit in Williamson stated that:
investors could submit posts regarding contract proposals, which were not limited to use by DAO Token holders (anyone was permitted to post). However, DAO Token holders were pseudonymous, as were their posts to the forums. Those facts, combined with the sheer number of DAO Token holders, potentially made the forums of limited use if investors hoped to consolidate their votes into blocs powerful enough to assert actual control. This was later demonstrated through the fact that DAO Token holders were unable to effectively address the Attack without the assistance of Slock.it and others. The DAO Token holders’ pseudonymity and dispersion diluted their control over The DAO. See Merchant Capital, 483 F.3d at 758 (finding geographic dispersion of investors weighing against investor control).

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. Steinhardt Group, Inc. v. Citicorp., 126 F.3d 144, 152 (3d Cir. 1997) (“It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action … a security may be found to exist … . [The] emphasis must be placed on economic reality.”) (citing SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 n. 14 (5th Cir. 1974)).

By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO’s Curators, as described above. Their efforts, not those of DAO Token holders, were the “undeniably significant” ones, essential to the overall success and profitability of any investment into The DAO. See Glenn W. Turner, 474 F.2d at 482.

C. Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies

The definition of “issuer” is broadly defined to include “every person who issues or proposes to issue any security” and “person” includes “any unincorporated organization.” 15 U.S.C. § 77b(a)(4). The term “issuer” is flexibly construed in the Section 5 context “as issuers devise new ways to issue their securities and the definition of a security itself expands.” Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 909 (5th Cir. 1977); accord SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980) (“When a person [or entity] organizes or sponsors the organization of

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Williamson, 645 F.2d at 424 & n.15 (court also noting that, “this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.”).
limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer ... ").

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was “crucial” to the DAO Token holders’ investment decision. See Murphy, 626 F.2d at 643 (“Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.”) (citation omitted). The DAO was “responsible for the success or failure of the enterprise,” and accordingly was the entity about which the investors needed information material to their investment decision. Id. at 643-44.

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately $150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. See, e.g., Murphy, 626 F.2d at 650-51 (“[T]hose who ha[ve] a necessary role in the transaction are held liable as participants.”) (citing SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 81 (2d Cir. 1970); SEC v. Culpepper, 270 F.2d 241, 247 (2d Cir. 1959); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 28 (10th Cir. 1972); Pennaluna & Co. v. SEC, 410 F.2d 861, 864 n.1, 868 (9th Cir. 1969)); SEC v. Softpoint, Inc., 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) (“The prohibitions of Section 5 ... sweep[] broadly to encompass ‘any person’ who participates in the offer or sale of an unregistered, non-exempt security.”); SEC v. Chinese Consol. Benevolent Ass’n., 120 F.2d 738, 740-41 (2d Cir. 1941) (defendant violated Section 5(a) “because it engaged in selling unregistered securities” issued by a third party “when it solicited offers to buy the securities ‘for value’”).

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. See 15 U.S.C. §78e. Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ... .” 15 U.S.C. § 78c(a)(1).

Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange under Section 3(a)(1). Under Exchange Act Rule 3b-16(a), an
organization, association, or group of persons shall be considered to constitute, maintain, or provide “a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange,” if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.\textsuperscript{40}

A system that meets the criteria of Rule 3b-16(a), and is not excluded under Rule 3b-16(b), must register as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act\textsuperscript{41} or operate pursuant to an appropriate exemption. One frequently used exemption is for alternative trading systems (“ATS”).\textsuperscript{42} Rule 3a1-1(a)(2) exempts from the definition of “exchange” under Section 3(a)(1) an ATS that complies with Regulation ATS,\textsuperscript{43} which includes, among other things, the requirement to register as a broker-dealer and file a Form ATS with the Commission to provide notice of the ATS’s operations. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

IV. Conclusion and References for Additional Guidance

Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the

\textsuperscript{40} See 17 C.F.R. § 240.3b-16(a). The Commission adopted Rule 3b-16(b) to exclude explicitly certain systems that the Commission believed did not meet the exchange definition. These systems include systems that merely route orders to other execution facilities and systems that allow persons to enter orders for execution against the bids and offers of a single dealer system. See Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) (“Regulation ATS”), 70852.


\textsuperscript{42} Rule 300(a) of Regulation ATS promulgated under the Exchange Act provides that an ATS is:

- any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers’ trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading.

Regulation ATS, supra note 40, Rule 300(a).

\textsuperscript{43} See 17 C.F.R. § 240.3a1-1(a)(2). Rule 3a1-1 also provides two other exemptions from the definition of “exchange” for any ATS operated by a national securities association, and any ATS not required to comply with Regulation ATS pursuant to Rule 301(a) of Regulation ATS. See 17 C.F.R. §§ 240.3a1-1(a)(1) and (3).
economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless 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 whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

To learn more about registration requirements under the Securities Act, please visit the Commission’s website here. To learn more about the Commission’s registration requirements for investment companies, please visit the Commission’s website here. To learn more about the Commission’s registration requirements for national securities exchanges, please visit the Commission’s website here. To learn more about alternative trading systems, please see the Regulation ATS adopting release here.

For additional guidance, please see the following Commission enforcement actions involving virtual currencies:


- **In re Erik T. Voorhees**, Rel. No. 33-9592 (June 3, 2014)

- **In re BTC Trading, Corp. and Ethan Burnside**, Rel. No. 33-9685 (Dec. 8, 2014)


- **In re Bitcoin Investment Trust and SecondMarket, Inc.**, Rel. No. 34-78282 (July 11, 2016)

- **In re Sunshine Capital, Inc.**, File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

- **Bitcoin and Other Virtual Currency-Related Investments** (May 7, 2014)

- **Ponzi Schemes Using Virtual Currencies** (July 2013)

By the Commission.
Testimony

Chairman’s Testimony on Virtual Currencies: The Roles of the SEC and CFTC

Chairman Jay Clayton

Washington D.C.

Feb. 6, 2018

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

Chairman Crapo, Ranking Member Brown and distinguished senators of the Committee, thank you for the opportunity to testify before you today.[1] I am pleased that the Committee is holding this hearing to bring greater focus to the important issues that cryptocurrencies, initial coin offerings (ICOs) and related products and activities present for American investors and our market.

I am also pleased to join my counterpart, Commodity Futures Trading Commission (CFTC) Chairman Christopher Giancarlo, for our second time testifying together before Congress. Since I joined the Commission in May, Chairman Giancarlo and I have built a strong relationship. Cryptocurrencies, ICOs and related subjects are the latest in a host of market issues on which we and our staffs have been closely collaborating to strengthen our capital markets for investors and market participants.[2]

The mission of the SEC is to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. We do so through our enforcement of the federal securities laws and our oversight of the securities markets and their participants including (1) approximately $75 trillion in securities trading annually on U.S. equity markets; (2) the disclosures of approximately 4,100 exchange-listed public companies with an approximate aggregate market capitalization of $31 trillion; and (3) the activities of over 26,000 registered entities and self-regulatory organizations, including investment advisers, broker-dealers, transfer agents, securities exchanges, clearing agencies, mutual funds, exchange-traded funds (ETFs), the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB), among others.

For those who seek to raise capital to fund an enterprise, as many in the ICO space have sought to do, a primary entry into the SEC’s jurisdiction is the offer and sale of securities, as set forth in the Securities Act of 1933.[3] As I will explain in greater detail below, determining what falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change for over 80 years.

The cryptocurrency and ICO markets, while new, have grown rapidly, gained greater prominence in the public conscience and attracted significant capital from retail investors. We have seen historical instances where such a rush into certain investments has benefitted our economy and those investors who backed the right ventures. But when our laws are not followed, the risks to all investors are high and numerous — including risks caused by or related to poor, incorrect or non-existent disclosure, volatility, manipulation, fraud and theft.
To be clear, I am very optimistic that developments in financial technology will help facilitate capital formation, providing promising investment opportunities for institutional and Main Street investors alike. From a financial regulatory perspective, these developments may enable us to better monitor transactions, holdings and obligations (including credit exposures) and other activities and characteristics of our markets, thereby facilitating our regulatory mission, including, importantly, investor protection.

At the same time, regardless of the promise of this technology, those who invest their hard-earned money in opportunities that fall within the scope of the federal securities laws deserve the full protections afforded under those laws. This ever-present need comes into focus when enthusiasm for obtaining a profitable piece of a new technology "before it’s too late" is strong and broad. Fraudsters and other bad actors prey on this enthusiasm.

The SEC and the CFTC, as federal market regulators, are charged with establishing a regulatory environment for investors and market participants that fosters innovation, market integrity and ultimately confidence. To that end, a number of steps the SEC has taken relating to cryptocurrencies, ICOs and related assets are discussed below.

**Message for Main Street Investors**

Before discussing regulation in more detail, I would like to reiterate my message to Main Street investors from a statement I issued in December.[4] Cryptocurrencies, ICOs and related products and technologies have captured the popular imagination – and billions of hard-earned dollars – of American investors from all walks of life. In dealing with these issues, my key consideration – as it is for all issues that come before the Commission – is to serve the long term interests of our Main Street investors. My efforts – and the tireless efforts of the SEC staff – have been driven by various factors, but most significantly by the concern that too many Main Street investors do not understand all the material facts and risks involved. Unfortunately, it is clear that some have taken advantage of this lack of understanding and have sought to prey on investors’ excitement about the quick rise in cryptocurrency and ICO prices.[5]

There should be no misunderstanding about the law. When investors are offered and sold securities – which to date ICOs have largely been – they are entitled to the benefits of state and federal securities laws and sellers and other market participants must follow these laws.

Yes, we do ask our investors to use common sense, and we recognize that many investment decisions will prove to be incorrect in hindsight. However, we do not ask investors to use their common sense in a vacuum, but rather, with the benefit of information and other requirements where judgments can reasonably be made.

This is a core principle of our federal securities laws and is embodied in the SEC’s registration requirements. Investors should understand that to date no ICOs have been registered with the SEC, and the SEC also has not approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies. If any person today says otherwise, investors should be especially wary.

Investors who are considering investing in these products should also recognize that these markets span national borders and that significant trading may occur on systems and platforms outside the U.S. Investors’ funds may quickly travel overseas without their knowledge. As a result, risks can be amplified, including the risk that U.S. market regulators, such as the SEC and state securities regulators, may not be able to effectively pursue bad actors or recover funds.

Further, there are significant security risks that can arise by transacting in these markets, including the loss of investment and personal information due to hacks of online trading platforms and individual digital asset "wallets." A recent study estimated that more than 10% of proceeds generated by ICOs – or almost $400 million – has been lost to such attacks.[6] And less than two weeks ago, a Japanese cryptocurrency market lost over $500 million in an apparent hack of its systems.[7]

In order to arm investors with additional information, the SEC staff has issued investor alerts, bulletins and statements on ICOs and cryptocurrency-related investments, including with respect to the marketing of certain offerings and investments by celebrities and others.[8] If investors choose to invest in these products, they should
ask questions and demand clear answers. I would strongly urge investors – especially retail investors – to review the sample questions and investor alerts issued by the SEC’s Office of Investor Education and Advocacy.\[9\]

These warnings are not an effort to undermine the fostering of innovation through our capital markets – America was built on the ingenuity, vision and spirit of entrepreneurs who tackled old and new problems in new, innovative ways. Rather, they are meant to educate Main Street investors that many promoters of ICOs and cryptocurrencies are not complying with our securities laws and, as a result, the risks are significant.

With my remaining testimony, I would like to provide the Committee an overview of the Commission’s ongoing work on cryptocurrencies and ICOs.

**Cryptocurrencies and Related Products and Trading**

Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions. Many are promoted as providing the same functions as long-established currencies such as the U.S. dollar but without the backing of a government or other body. While cryptocurrencies currently being marketed vary in different respects, proponents of cryptocurrencies often tout their novelty and other potential beneficial features, including the ability to make transfers without an intermediary and without geographic limitation and lower transaction costs compared to other forms of payment. Critics of cryptocurrencies note that the purported benefits highlighted by proponents are unproven and other touted benefits, such as the personal anonymity of the purchasers and sellers and the absence of government regulation or oversight, could also facilitate illicit trading and financial transactions, as well as fraud.

The recent proliferation and subsequent popularity of cryptocurrency markets creates a question for market regulators as to whether our historic approach to the regulation of sovereign currency transactions is appropriate for these new markets. These markets may look like our regulated securities markets, with quoted prices and other information. Many trading platforms are even referred to as “exchanges.” I am concerned that this appearance is deceiving. In reality, investors transacting on these trading platforms do not receive many of the market protections that they would when transacting through broker-dealers on registered exchanges or alternative trading systems (ATSs), such as best execution, prohibitions on front running, short sale restrictions, and custody and capital requirements. I am concerned that Main Street investors do not appreciate these differences and the resulting substantially heightened risk profile.

It appears that many of the U.S.-based cryptocurrency trading platforms have elected to be regulated as money-transmission services. Traditionally, from an oversight perspective, these predominantly state-regulated payment services have not been subject to direct oversight by the SEC or the CFTC. Traditionally, from a function perspective, these money transfer services have not quoted prices or offered other services akin to securities, commodities and currency exchanges. In short, the currently applicable regulatory framework for cryptocurrency trading was not designed with trading of the type we are witnessing in mind. As Chairman Giancarlo and I stated recently, we are open to exploring with Congress, as well as with our federal and state colleagues, whether increased federal regulation of cryptocurrency trading platforms is necessary or appropriate. We also are supportive of regulatory and policy efforts to bring clarity and fairness to this space.

The SEC regulates securities transactions and certain individuals and firms who participate in our securities markets. The SEC does not have direct oversight of transactions in currencies or commodities, including currency trading platforms.

While there are cryptocurrencies that, at least as currently designed, promoted and used, do not appear to be securities, simply calling something a "currency" or a currency-based product does not mean that it is not a security. To this point I would note that many products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that rely on the efforts of others, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic. As discussed in more detail below, if a cryptocurrency, or a product with its value tied to one or more cryptocurrencies, is a security, its
promoters cannot make offers or sales unless they comply with the registration and other requirements under our federal securities laws.[10]

In this regard, the SEC is monitoring the cryptocurrency-related activities of the market participants it regulates, including brokers, dealers, investment advisers and trading platforms. Brokers, dealers and other market participants that allow for payments in cryptocurrencies, allow customers to purchase cryptocurrencies (including on margin) or otherwise use cryptocurrencies to facilitate securities transactions should exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations.[11] As I have stated previously, these market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other.

Finally, financial products that are linked to underlying digital assets, including cryptocurrencies, may be structured as securities products subject to the federal securities laws even if the underlying cryptocurrencies are not themselves securities. Market participants have requested Commission approval for new products and services of this type that are focused on retail investors, including cryptocurrency-linked ETFs. While we appreciate the importance of continuing innovation in our retail fund space, there are a number of issues that need to be examined and resolved before we permit ETFs and other retail investor-oriented funds to invest in cryptocurrencies in a manner consistent with their obligations under the federal securities laws. These include issues around liquidity, valuation and custody of the funds’ holdings, as well as creation, redemption and arbitrage in the ETF space.

Last month, after working with several sponsors who ultimately decided to withdraw their registration statements, the Director of our Division of Investment Management issued a letter to provide an overview of certain substantive issues and related questions associated with registration requirements and to encourage others who may be considering a fund registered pursuant to the Investment Company Act of 1940 to engage in a robust discussion with the staff concerning the above-mentioned issues.[12] Until such time as those questions have been sufficiently addressed, I am concerned about whether it is appropriate for fund sponsors that invest substantially in cryptocurrencies and related products to register. We will continue engaging in a dialogue with all interested parties to seek a path forward consistent with the SEC’s tripartite mission.

**ICOs and Related Trading**

Coinciding with the substantial growth in cryptocurrencies, companies and individuals increasingly have been using so-called ICOs to raise capital for businesses and projects. Typically, these offerings involve the opportunity for individual investors to exchange currency, such as U.S. dollars or cryptocurrencies, in return for a digital asset labeled as a coin or token. The size of the ICO market has grown exponentially in the last year, and it is estimated that almost $4 billion was raised through ICOs in 2017. Note that this number may underestimate the size of the ICO market (and the potential for loss) as many ICOs "trade up" after they are issued.

These offerings can take different forms, and the rights and interests a coin is purported to provide the holder can vary widely. A key question all ICO market participants – promoters, sellers, lawyers, officers and directors and accountants, as well as investors – should ask: "Is the coin or token a security?" As securities law practitioners know well, the answer depends on the facts. But by and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. As noted above, the foundation of our federal securities laws is to provide investors with the procedural protections and information they need to make informed judgments about what they are investing in and the relevant risks involved. In addition, our federal securities laws provide a wide array of remedies, including criminal and civil actions brought by the DOJ and the SEC, as well as private rights of action.

The Commission previously urged market professionals, including securities lawyers, accountants and consultants, to read closely an investigative report it released. On July 25, 2017, the Commission issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934[13] regarding an ICO of DAO Tokens.[14] In the Report, the Commission considered the particular facts and circumstances presented by the
offer and sale of DAO Tokens and concluded that DAO Tokens were securities based on longstanding legal principles, and therefore that offers and sales of the DAO Tokens were subject to the federal securities laws. The Report also explained that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption from registration applies, and that platforms that provide for trading in such securities must register with the SEC as national securities exchanges or operate pursuant to an exemption from such registration.

The Commission’s message to issuers and market professionals in this space was clear: those who would use distributed ledger technology to raise capital or engage in securities transactions must take appropriate steps to ensure compliance with the federal securities laws. The Report and subsequent statements also explain that the use of such technology does not mean that an offering is necessarily problematic under those laws. The registration process itself, or exemptions from registration, are available for offerings employing these novel methods.

The statement I issued in December that was directed to Main Street investors and market professionals provided additional insight into how practitioners should view ICOs in the context of our federal securities laws. Certain market professionals have attempted to highlight the utility or voucher-like characteristics of their proposed ICOs in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions that the federal securities laws do not apply to a particular ICO appear to elevate form over substance. The rise of these form-based arguments is a disturbing trend that deprives investors of mandatory protections that clearly are required as a result of the structure of the transaction. Merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security.[15] Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens, i.e., the ability to sell them on an exchange at a profit. In short, prospective purchasers are being sold on the potential for tokens to increase in value — with the ability to lock in those increases by reselling the tokens on a secondary market — or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities. I have urged these professionals to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.[16]

I also have cautioned market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. Engaging in the business of selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of "scalping," "pump and dump" and other manipulations and frauds. Similarly, my colleagues and I have cautioned those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

I do want to recognize that recently social media platforms have restricted the ability of users to promote ICOs and cryptocurrencies on their platforms. I appreciate the responsible step.

Enforcement

A number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. The ability of bad actors to commit age-old frauds with new technologies coupled with the significant amount of capital — particularly from retail investors — that has poured into cryptocurrencies and ICOs in recent months and the offshore footprint of many of these activities have only heightened these concerns.
In September 2017, the Division of Enforcement established a new Cyber Unit focused on misconduct involving distributed ledger technology and ICOs, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain nonpublic information and threats to trading platforms.[17] The Cyber Unit works closely with our cross-divisional Distributed Ledger Technology Working Group, which was created in November 2013. We believe this approach has enabled us to leverage our enforcement resources effectively and coordinate well within the Commission, as well as with other federal and state regulators.

To date, we have brought a number of enforcement actions concerning ICOs for alleged violations of the federal securities laws. In September 2017, we brought charges against an individual for defrauding investors in a pair of ICOs purportedly backed by investments in real estate and diamonds.[18] According to the SEC’s complaint, investors provided approximately $300,000 in funding and were told they could expect sizeable returns despite neither company having real operations. In December 2017, we obtained an emergency asset freeze to halt an alleged ICO fraud that purportedly raised up to $15 million from thousands of individual investors beginning in August 2017.[19] According to the complaint, the scam was operated by a recidivist securities law violator and promised investors a more than 1,300 percent profit in under 29 days. As another example, after being contacted by the SEC last December, a company halted its ICO to raise capital for a blockchain-based food review service, and then settled proceedings in which we determined that the ICO was an unregistered offering and sale of securities in violation of the federal securities laws.[20] Before tokens were delivered to investors, the company refunded investor proceeds after the SEC intervened.

And most recently, we halted an allegedly fraudulent ICO that targeted retail investors promoting what it portrayed as the world’s first decentralized bank.[21] We were able to freeze some of the allegedly ill-gotten cryptocurrency assets and obtained a receiver to try to marshal these assets back to harmed investors.

I also have been increasingly concerned with recent instances of public companies, with no meaningful track record in pursuing distributed ledger or blockchain technology, changing their business models and names to reflect a focus on distributed ledger technology without adequate disclosure to investors about their business model changes and the risks involved. A number of these instances raise serious investor protection concerns about the adequacy of disclosure especially where an offer and sale of securities is involved. The SEC is looking closely at the disclosures of public companies that shift their business models to capitalize on the perceived promise of distributed ledger technology and whether the disclosures comply with the federal securities laws, particularly in the context of a securities offering.

With the support of my fellow Commissioners, I have asked the SEC’s Division of Enforcement to continue to police these markets vigorously and recommend enforcement actions against those who conduct ICOs or engage in other actions relating to cryptocurrencies in violation of the federal securities laws. In doing so, the SEC and CFTC are collaborating on our approaches to policing these markets for fraud and abuse.[22] We also will continue to work closely with our federal and state counterparts, including the Department of Treasury, Department of Justice and state attorneys general and securities regulators.

Conclusion

Through the years, technological innovations have improved our markets, including through increased competition, lower barriers to entry and decreased costs for market participants. Distributed ledger and other emerging technologies have the potential to further influence and improve the capital markets and the financial services industry. Businesses, especially smaller businesses without efficient access to traditional capital markets, can be aided by financial technology in raising capital to establish and finance their operations, thereby allowing them to be more competitive both domestically and globally. And these technological innovations can provide investors with new opportunities to offer support and capital to novel concepts and ideas.

History, both in the United States and abroad, has proven time and again that these opportunities flourish best when pursued in harmony with our federal securities laws. These laws reflect our tripartite mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Being faithful to each part of our mission not in isolation, but collectively, has served us well. Said simply, we should embrace the pursuit of
technological advancement, as well as new and innovative techniques for capital raising, but not at the expense of the principles underpinning our well-founded and proven approach to protecting investors and markets.

Thank you for the opportunity to testify before you today and for your support of the Commission and its workforce. I stand ready to work with Congress on these issues and look forward to answering your questions.

APPENDIX

Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators Are Looking at Cryptocurrency (Jan. 25, 2018)
Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018)
Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piwowar on “NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution” by NASAA (Jan. 4, 2018)
Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017)
Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others (Nov. 1, 2017)
Investor Alert: Celebrity Endorsements (Nov. 1, 2017)
Press Release: SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017)
Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014)
Investor Alert: Ponzi Schemes Using Virtual Currencies (July 23, 2013)

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission, or any Commissioner.


[3] Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes, among other items, “an investment contract.” See 15 U.S.C. §§ 77b-77c. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or

[4] In December, I issued a statement that provided my general views on the cryptocurrency and ICO markets. The statement was directed principally at two groups: 1) Main Street investors and 2) market professionals — including, for example, broker-dealers, investment advisers, exchanges, lawyers and accountants — whose actions impact Main Street investors. See Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[5] In one instance, the SEC brought an enforcement action against a purported bitcoin mining company that claimed to have a product “so easy to use that it is ‘Grandma approved.’” In this case, in less than six months, the company allegedly raised more than $19 million from more than 10,000 investors. The SEC charged that company with operating a Ponzi scheme. See Press Release 2015-271, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), available at https://www.sec.gov/news/pressrelease/2015-271.html; SEC Obtains Final Judgment Against Founder of Bitcoin Mining Companies Used to Defraud Investors (Oct. 4, 2017), available at https://www.sec.gov/litigation/litreleases/2017/lr23960.htm.


[10] It is possible to conduct an offer and sales of securities, including an ICO, without triggering the SEC’s registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an ICO that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements.

[11] I am particularly concerned about market participants who extend to customers credit in U.S. dollars – a relatively stable asset – to enable the purchase of cryptocurrencies, which, in recent experience, have proven to be a more volatile asset.


[13] Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to “publish information concerning any such violations.” The Report does not constitute an adjudication of any fact or issue addressed therein, nor does it make any findings of violations by any individual or entity.

[15] See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (“[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as 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 contracts,’ or as ‘any interest or instrument commonly known as a ‘security’.”); see also Reves v. Ernst & 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 by whatever name they are called.”).


Digital Asset Transactions: When Howey Met Gary (Plastic)

San Francisco, CA

June 14, 2018

Remarks at the Yahoo Finance All Markets Summit: Crypto

Thank you Andy. I am pleased to be here today.[1] This event provides a great opportunity to address a topic that is the subject of considerable debate in the press and in the crypto-community – whether a digital asset offered as a security can, over time, become something other than a security.[2]

To start, we should frame the question differently and focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold. To that end, a better line of inquiry is: “Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?” In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely “no.” In these cases, calling the transaction an initial coin offering, or “ICO,” or a sale of a “token,” will not take it out of the purview of the U.S. securities laws.

But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified “yes.” I would like to share my thinking with you today about the circumstances under which that could occur.

Before I turn to the securities law analysis, let me share what I believe may be most exciting about distributed ledger technology – that is, the potential to share information, transfer value, and record transactions in a decentralized digital environment. Potential applications include supply chain management, intellectual property rights licensing, stock ownership transfers and countless others. There is real value in creating applications that can be accessed and executed electronically with a public, immutable record and without the need for a trusted third party to verify transactions. Some people believe that this technology will transform e-commerce as we know it. There is excitement and a great deal of speculative interest around this new technology. Unfortunately, there also are cases of fraud. In many regards, it is still “early days.”

But I am not here to discuss the promise of technology – there are many in attendance and speaking here today that can do a much better job of that. I would like to focus on the application of the federal securities laws to digital asset transactions – that is how tokens and coins are being issued, distributed and sold. While perhaps a bit dryer
than the promise of the blockchain, this topic is critical to the broader acceptance and use of these novel instruments.

I will begin by describing what I often see. Promoters,[3] in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing. But, in many cases, the economic substance is the same as a conventional securities offering. Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.

When we see that kind of economic transaction, it is easy to apply the Supreme Court’s "investment contract" test first announced in SEC v. Howey.[4] That test requires an investment of money in a common enterprise with an expectation of profit derived from the efforts of others. And it is important to reflect on the facts of Howey. A hotel operator sold interests in a citrus grove to its guests and claimed it was selling real estate, not securities. While the transaction was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges. The purchasers could have arranged to service the grove themselves but, in fact, most were passive, relying on the efforts of Howey-in-the-Hills Service, Inc. for a return. In articulating the test for an investment contract, the Supreme Court stressed: “Form [is] disregarded for substance and the emphasis [is] placed upon economic reality.”[5] So the purported real estate purchase was found to be an investment contract – an investment in orange groves was in these circumstances an investment in a security.

Just as in the Howey case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit. And, as in Howey – where interests in the groves were sold to hotel guests, not farmers – tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.

In the ICOs I have seen, overwhelmingly, promoters tout their ability to create an innovative application of blockchain technology. Like in Howey, the investors are passive. Marketing efforts are rarely narrowly targeted to token users. And typically at the outset, the business model and very viability of the application is still uncertain. The purchaser usually has no choice but to rely on the efforts of the promoter to build the network and make the enterprise a success. At that stage, the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.

As an aside, you might ask, given that these token sales often look like securities offerings, why are the promoters choosing to package the investment as a coin or token offering? This is an especially good question if the network on which the token or coin will function is not yet operational. I think there can be a number of reasons. For a while, some believed such labeling might, by itself, remove the transaction from the securities laws. I think people now realize labeling an investment opportunity as a coin or token does not achieve that result. Second, this labeling might have been used to bring some marketing “sizzle” to the enterprise. That might still work to some extent, but the track record of ICOs is still being sorted out and some of that sizzle may now be more of a potential warning flare for investors.

Some may be attracted to a blockchain-mediated crowdfunding process. Digital assets can represent an efficient way to reach a global audience where initial purchasers have a stake in the success of the network and become part of a network where their participation adds value beyond their investment contributions. The digital assets are then exchanged – for some, to help find the market price for the new application; for others, to speculate on the venture. As I will discuss, whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security requires a careful and fact-sensitive legal analysis.

I believe some industry participants are beginning to realize that, in some circumstances, it might be easier to start a blockchain-based enterprise in a more conventional way. In other words, conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and the digital assets offer. This
allows the tokens or coins to be structured and offered in a way where it is evident that purchasers are not making an investment in the development of the enterprise.

Returning to the ICOs I am seeing, strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security, just as the orange groves in Howey were not. Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers. When someone buys a housing unit to live in, it is probably not a security.[6] But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others. For example, if the housing unit is offered with a management contract or other services, it can be a security.[7] Similarly, when a CD, exempt from being treated as a security under Section 3 of the Securities Act, is sold as a part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, the Gary Plastic case teaches us that the instrument can be part of an investment contract that is a security.[8]

The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense. The impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials. These are important safeguards, and they are appropriate for most ICOs. The disclosures required under the federal securities laws nicely complement the Howey investment contract element about the efforts of others. As an investor, the success of the enterprise – and the ability to realize a profit on the investment – turns on the efforts of the third party. So learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision. Without a regulatory framework that promotes disclosure of what the third party alone knows of these topics and the risks associated with the venture, investors will be uninformed and are at risk.

But this also points the way to when a digital asset transaction may no longer represent a security offering. If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise’s success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.[9] And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value. Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins.

I would like to emphasize that the analysis of whether something is a security is not static and does not strictly inhere to the instrument.[10] Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security. If a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment
contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter’s efforts.

Let me emphasize an earlier point: simply labeling a digital asset a “utility token” does not turn the asset into something that is not a security.\textsuperscript{[11]} I recognize that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security.\textsuperscript{[12]} But, the economic substance of the transaction always determines the legal analysis, not the labels.\textsuperscript{[13]} The oranges in Howey had utility. Or in my favorite example, the Commission warned in the late 1960s about investment contracts sold in the form of whisky warehouse receipts.\textsuperscript{[14]} Promoters sold the receipts to U.S. investors to finance the aging and blending processes of Scotch whisky. The whisky was real – and, for some, had exquisite utility. But Howey was not selling oranges and the warehouse receipts promoters were not selling whisky for consumption. They were selling investments, and the purchasers were expecting a return from the promoters’ efforts.

Promoters and other market participants need to understand whether transactions in a particular digital asset involve the sale of a security. We are happy to help promoters and their counsel work through these issues. We stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use.\textsuperscript{[15]} In addition, we recognize that there are numerous implications under the federal securities laws of a particular asset being considered a security. For example, our Divisions of Trading and Markets and Investment Management are focused on such issues as broker-dealer, exchange and fund registration, as well as matters of market manipulation, custody and valuation. We understand that market participants are working to make their services compliant with the existing regulatory framework, and we are happy to continue our engagement in this process.

What are some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security? Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances, and this list is illustrative, not exhaustive:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?

2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?

3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?

4. Are purchasers “investing,” that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?

5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?

6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

While these factors are important in analyzing the role of any third party, there are contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security. Again, we would look to the economic substance of the transaction, but promoters and their counsels should consider these, and other, possible features. This list is not intended to be exhaustive and by no means do I believe each and every one of
these factors needs to be present to establish a case that a token is not being offered as a security. This list is meant to prompt thinking by promoters and their counsel, and start the dialogue with the staff – it is not meant to be a list of all necessary factors in a legal analysis.

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users’ needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser’s expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

These are exciting legal times and I am pleased to be part of a process that can help promoters of this new technology and their counsel navigate and comply with the federal securities laws.

[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author’s views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.


[3] I am using the term “promoters” in a broad, generic sense. The important factor in the legal analysis is that there is a person or coordinated group (including “any unincorporated organization” see 5 U.S.C. § 77n(a)(4)) that is working actively to develop or guide the development of the infrastructure of the network. This person or group could be founders, sponsors, developers or “promoters” in the traditional sense. The presence of promoters in this context is important to distinguish from the circumstance where multiple, independent actors work on the network but no individual actor’s or coordinated group of actors’ efforts are essential efforts that affect the failure or success of the enterprise.

[4] SEC v. W.J. Howey Co., 328 U.S. 293 (1946). Depending on the features of any given instrument and the surrounding facts, it may also need to be evaluated as a possible security under the general definition of security – see footnote 2 – and the case law interpreting it.

[5] Id. at 298.


[9] Secondary trading in digital assets by regulated entities may otherwise implicate the federal securities laws, as well as the Commodity Exchange Act. In addition, as SEC Chairman Jay Clayton has stated, regulated financial entities that allow for payment in cryptocurrencies, allow customers to purchase cryptocurrencies on margin or otherwise use cryptocurrencies to facilitate securities transactions should exercise caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations. Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017). In addition, other laws and regulations, such as IRS regulations and state money servicing laws, may be implicated.

[10] The Supreme Court’s investment contract test “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.” Howey, 328 U.S. at 299.


[15] For example, some have raised questions about the offering structure commonly referred to as a Simple Agreement for Future Tokens, or “SAFT.” Because the legal analysis must follow the economic realities of the particular facts of an offering, it may not be fruitful to debate a hypothetical structure in the abstract and nothing in these remarks is meant to opine on the legality or appropriateness of a SAFT. From the discussion in this speech, however, it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction. I expect that some, perhaps many, may not. I encourage anyone that has questions on a particular SAFT structure to consult with knowledgeable securities counsel or the staff.
Token DPA - Token offerings for all

August 28, 2018
5.9 min read

Introducing
The Token DPA™
A token presale instrument for blockchain companies to fund their growth with investments from everyone – created by Republic Crypto

Republic, the startup that lets anyone invest in exciting private companies and token projects, has developed a securities instrument specifically for blockchain and crypto token presales. We’re calling it the Token DPA.

By the end of 2017, ICOs (Initial Coin Offerings) had raised approximately $3.8 billion from over 200 projects. The majority of these sales were exclusive to international and U.S. accredited investors, which means the majority of people who wanted to participate in the ICOs couldn’t do so because they didn’t meet the high income and net worth threshold (approximately 3% of the U.S. population meets these requirements). This substantially reduced the amount and types of people that could legally participate in the public crypto-assets offerings pursuant to Rule 506(c) — also known as Reg D or an advertised private placement.

The majority of these offerings were conducted without documents, some relying on smart contracts, and many others used the SAFT (Simple Agreement for Future Tokens) instrument. This means, generally, investors would have little recourse if their monies were not used to develop protocols and those tokens were never minted and distributed.

While we won’t speak to the legality of many of these sales, we do believe that everyone should have the opportunity to invest in exciting equity and blockchain projects. We knew that if retail investors, who are generally unaccredited, were to have access to this exciting emerging market, we needed to develop a new security instrument for crowdfund blockchain projects.

So, we created the Token DPA, which not only has built in protections for investors in the event that tokens are not distributed but also gives founders the opportunity to raise funds to develop their protocols from their actual users and supporters.

The Token DPA (Debt Payable by Assets) is a debt instrument that blockchain projects on Republic can use to raise capital responsibly. (They can also use them in their own Reg D and Reg S offerings.) Created by the Republic Crypto team specifically for token presales, the Token DPA is designed to align the interests of founders with their investors.

The Token DPA has four main features: (i) a fixed maturity date, where investors are due cash or tokens with interest; (ii) a timeline that investors can reference to track a company’s protocol development progress and request money back if necessary; (iii) optional escrow provisions that can further secure funds; and (iv) greater priority in the event of a project’s bankruptcy or liquidation.

Currently, the SAFT is the instrument widely used by blockchain companies to pre-sell tokens. Republic believes that this instrument is not optimal for less sophisticated retail investors, especially when the SAFT includes no maturity date or a provision to claim company assets if a project fails. The use of the derivative SAFTE (Simple Agreement for Future Tokens & Equity), which provides the prospect of future equity, may not provide...
return on their investment can be left unfulfilled, possibly forever. In contrast, the Token DPA provides a method for investors to either receive part or all of their principal back, earn a cash return or receive the desired tokens when certain events occur.

With all investments there are risks. If a company issuing a Token DPA spends all of their capital before investors’ right to request a return of capital occurs, investors could force the company into insolvency when they make the request. However, as debt holders, Token DPA participants should have the first rights to assets, assuming none of the assets of the project were secured by another lender.

Since the Token DPA is a loan contract between the investor and the blockchain startup, investors have the right to receive interest on their loan or have their loan paid back in the future with the token or cash. With the value of principal of the loan rising due to interest and a promised discount on tokens, investors who hold a Token DPA can receive an advantaged rate on tokens after a period of time, a token distribution offering occurs and the company uses the money responsibility. The ability to have their loan paid back in tokens is contingent on a trigger event, meaning they will not receive tokens unless a token distribution event occurs. This means if the tokens are developed and the company can complianly give them to investors, they will receive them, or investors will receive cash equal to the amount of interest that has accrued for lending their money to the project’s growth.

The Token DPA allows companies that issue it to provide check-points when investors can request to be paid back in cash. It should be noted that payments can only be made if the company has retained assets sufficient to service the debt or has made a profit.

Generally, the Token DPA relies on issuing companies to manage the money they raise responsibly, to ensure monies are left if investors request a full or partial refund under the terms of the Token DPA. Investors should be aware that if a high number of investors request a refund, it could lead to the company’s insolvency as the company may not have sufficient funds to pay all of the refund requests.

The Token DPA provides flexibility for issuers and investors in the form of an optional escrow provision. If a company elects to use an escrow account, the Token DPA can require that a percentage of the monies raised will be held in escrow, ensuring a hard cap on investors’ loss for a set term of the DPA. (Investors should note that this protection is contingent on the company issuing the Token DPA following its terms and that placing funds raised in escrow will reduce the Company’s amount of liquid capital, which can negatively affect the company’s day-to-day operations.

The Digital Reserve, which is developing blockchain technology to eliminate predatory loans, is already using the Token DPA for a private presale. After evaluating the SAFT and other investment instruments, CEO and Founder Jomari Peterson said he decided to use the Token DPA because it makes it easier to stay in regulatory compliance. He also noted that the Token DPA helps investors better understand what they might get out of their investment.

Though initially designed for use on Republic, we encourage adoption of the Token DPA across other crowdfunding platforms. Since our primary objective is to create investment opportunities for all people — no matter their income or net worth — we hope the Token DPA will catch on as a widely-used instrument for blockchain and crypto projects.

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**Max R. Rich**

About the Author:

Max received his JD from Boston University where he graduated with honors from the Transactional Law program. He currently serves as Internal Counsel for Republic, a leading equity crowdfunding marketplace. In addition, he works as a Regulatory Advisor to CoinList, a multi-service platform for creating asset-backed tokens that can be easily bought and sold, and is passionate about alternative investing markets.
Meet The Man Bringing Silicon Valley to the Midwest
Annechambers — Yes- Marvin is bringing Silicon Valley to the Midwest. His crowdfund platform, #Wunderfund, is amazing. We have been thrilled to work with #Marvin Abnica on our...

Founder Profile: Solving The Day Stay With Yannis Moati of HotelsByDay
KINGSCROWD — Thanks for the question Bobby. It is more of the latter. The company is focused on optimizing utilization. Though turnover can be slow occupancy at many hotels is far...

The Kickass Founder Disrupting Healthcare with VR
Chris Lustrino — Thanks Stephen, most appreciated. Please let me know if I can answer any other questions you may have!

Know Before You Sign: Notes on Different Investment Vehicles Used by Equity Crowdfunding Platforms
Chuck Pettit — Thank you Rob for the great overview! One thing on the comment you made about Republic’s SAFE. We offer 4 standard SAFE options for issuers to choose from for their...

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Regulation Crowdfunding platforms allow you to invest in startups using a variety of securities instruments. These can include stock, preferred stock, debt, revenue participation rights, SAFEs, Token DPAs and SAFEs. Each investment instrument has a unique set of pros and cons and may or may not be appropriate for a particular offering. Which instrument is most appropriate largely rests on the circumstances.

On Republic, the majority of companies make use of the Crowd Safe, a customizable version of the Y Combinator SAFE - designed specifically for securities crowdfunding offerings. Republic created the Crowd Safe instrument because existing instruments can be problematic when used by companies without a formal valuation, or where a priced round is impractical. These companies hope to one day become unicorns; achieving a major exit is the ultimate goal for a majority of the founders. These driven individuals are looking for a way to raise funds and engage their users, but don’t want to burden their operations.

The Crowd Safe is designed to be a win-win for both companies and investors, aligning the investor and company interests, however, as a gatekeeper, Republic monitors companies use of the Crowd Safe to protect investors from possible abuses.

The benefits of raising with the Crowd Safe

For companies to feel comfortable offering the right to equity to the crowd prior to an IPO, they need to have controls in place. Using the Crowd Safe gives the company the power to choose if and when its crowdfunding investors become shareholders or owners of record. The Crowd Safe is also extendable – unless the company goes public, has a change of control or is acquired a conversion is not forced, so companies can take in additional capital without incurring a messy cap table or giving investors rights that cannot yet be fully realized. Because companies raising with the Crowd Safe don’t have to deal with the burden of cap table management, they can pour more of their operational resources into developing their businesses, which can increase their odds of success and ultimately lead to upside returns for investors.

Another benefit of the Crowd Safe is the ability to ensure a fixed conversion price. If there is a conversion, this fixed conversion price ensures that investors have the same economic outcome, regardless of whether the Crowd Safe is converted to common stock or shadow shares. If a conversion occurs before an exit, due to the company wanting to add the investors to their cap-table, Investors receive unique shadow shares with limi
August 01, 2018

ACTIONABLE STARTUP INVESTMENT RESEARCH

As the crowdfunding ecosystem has matured, and with a unicorn event, generally, the issuing company does not have to provide tax paperwork to the investor until that event, further reducing operational burdens.

When issuing common stock, companies can be left with hundreds of unaccredited investors on their cap table, each with a relatively small capital commitment, which can be problematic for several reasons:

For starters, company operations can become more complex with more shareholders who are entitled to certain information and voting rights. But with the Crowd Safe, information and rights are not provided by default to shareholders, until conversion. However, the Crowd Safe can also be used to incentivize large investments—clauses can grant investors who commit over a certain high threshold additional rights, meaning those investors (if accredited) won’t want to make a separate investment through a Reg D exemption, possibly muddying the cap-table further.

Another problem is that any company with 500 unaccredited shareholders and $10 million in assets falls under the SEC’s public reporting requirement, unless they meet certain requirements—the Crowd Safe makes meeting those requirements easier as it can leave investors in the Reg CF security longer, allowing a company that is (i) current in its reporting requirements and (ii) using a registered transfer agent to have up to $25 million in assets without needing to become a public reporting company.

So-called “problem investors” have limited impact when invested through a Crowd Safe, as their terms and rights are diminished, compared to common stockholders.

Having hundreds of unaccredited investors can also lead to a messy cap table, which can deter future institutional investment. Additionally, assigning valuations at an early stage, which is generally necessary when companies issue common stock, can be burdensome. The process is often costly and time-consuming, and this can hurt investors’ potential upside. Many in the industry are skeptical of placing a valuation on an early-stage company because the time and cost incurred in assigning one can sometimes amount to a mere educated guess.

Convertible notes often present many problems for both investors and companies and are difficult to manage for hundreds of investors. Convertible notes require lots of paperwork, have maturity dates, and accrue taxable interest. These issues are one reason raising with SAFEs has grown in popularity in recent years.

The Crowd Safe is admittedly an instrument meant for investors who are looking for a unicorn—a substantial return only comes about if there is a large exit. If the company never experiences that exit, the investment has limited value. But common stockholders are placed in the same position given equity holders’ gains are also tied to the success of a company, and minority stockholders have almost no ability to influence the course of an early-stage private company.

Each investment opportunity is unique and using an appropriate instrument does not necessarily guarantee the viability of the investment. Republic thoroughly vets each company we host to ensure they meet our standards—this includes evaluating whether the Crowd Safe is an appropriate instrument to raise with.

In the end, companies can be more likely to embrace securities crowdfunding when raising with the Crowd Safe given the multiple benefits. This further democratizes crowdfunding as a whole, giving companies greater access to capital and investors greater investment opportunities.

See how the Crowd Safe works upon a liquidation event: https://crowdsafe.info/
To download Crowd Safe templates: https://republic.co/crowdsafe

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About the Author:

Max received his JD from Boston University where he graduated with honors from the Transactional Law program. He currently serves as Internal Counsel for Republic, a leading equity crowdfunding marketplace. In addition, he works as an Regulatory Advisor to CoinList, a multi-service platform for creating asset-backed tokens that can be easily bought and sold, and is passionate about alternative investing markets.
Abstract

Social entrepreneurship and law are increasingly interconnected. This article enumerates ten ways in which law students and attorneys can play a meaningful and often unique role in social entrepreneurship. The roles and examples described span the public and private sectors. However, these ten typologies — (1) The Student, (2) The Social Entrepreneur, (3) The Social Enterprise Staffer, (4) The Outside Counsel, (5) The In-House Counsel, (6) The Government Official, (7) The Scholar, (8) The Writer, (9) The Board Member, and (10) The Fundraiser — are by no means exhaustive. As the article discusses, anybody with a legal background can become involved in social entrepreneurship in multiple ways.
IRC

§1400Z-1
§1400Z-2

Legislative Intent

Joint Explanatory Statement - see page 398

IRS

IRS Rev Proc 2018-16 [governor of each state and Chief Executive Officer of United States territories and the District of Columbia needed to nominate communities as Qualified Opportunity Zones and submit the nomination to the Secretary of the Treasury by April 20, 2018]

Rev Proc 2018-48 - OZ Census Tract Zones

FAQs

White Papers:

Guiding Principles for Opportunity Zones (Bruce Katz and Jeremy Nowak, Commissioned for the Governance Project*)

A Primer on the New Federal Qualified Opportunity Zone Provisions (Butler Snow)

Qualified Opportunity Zones and Tax Credit Incentives under the Tax Cuts and Jobs Act (Greenberg Taurig)

Opportunity Zones - A Golden Opportunity (Lorman and K&L Gates)

Georgetown - Beeck (Lisa Hall)

2 Pagers

Economic Innovation Group - Tax Benefits of Investing in an Opportunity Zone

OZ News Alerts - Novogradac & Co (Accountants)

Webinars

EY Webinar

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This Briefing Paper examines Minority and Women-owned Business Enterprises (“MWBE”) law in New York as well as addressing prospective changes to the law and its impact on subsequent public sector procurement.

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  - The 'State' of New York MWBE Programs: An Inflection Point?

- **Section 1:**
  - MWBE Programs in NYS and NYC

- **Section 2:**
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- **Section 3:**
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- **Section 5:**
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THE ‘STATE’ OF NEW YORK MWBE PROGRAMS

AN INFLECTION POINT?

When used in the context of business, the term ‘inflection point’ means a time of significant change. MWBE programs have become an integral component of the procurement regimes of New York State (NYS) and New York City (NYC). Through initiatives of Governor Mario M. Cuomo and Mayor Bill de Blasio, each of NYS and NYC has made increasing MWBE contracting opportunities a top priority. Still, important stakeholders focused on utilization rates and anecdotal evidence of continued struggles by MWBE firms, continue to call for greater diversity and inclusion in governmental contracting. These stakeholders are putting a great deal of pressure on NYS and NYC to make New York MWBE programs the strongest in the nation.

Disparity studies are currently being conducted that are likely to have a significant impact on both the NYS and NYC MWBE programs on a range of matters including the MWBE related laws, utilization goals and program operations. Given the confluence of executive commitment, legislative focus and MWBE community advocacy, New York MWBE programs are poised for significant positive changes that address structural issues that have perpetuated discriminatory conduct and hurt the ability of MWBEs to participate in government contracting. Five years into the Cuomo Administration and three years into the de Blasio Administration, the foundation has been set for MWBE programs to build on previous gains and to reach greater utilization rates. At a recent MWBE conference where he discussed NYS possibly raising its 30% goal to 35% or even 40%, Alphonso David, Counsel to Governor Andrew Cuomo, announced plans to increase the utilization rate in New York contracting.

NYS and NYC MWBE Performance

In 2015, New York State (NYS) and its agencies reported MWBE contract expenditures of 9% or 23% statewide utilization. Under Mayor de Blasio Administration’s economic plan, New York City reported $1.6 billion in MWBE spending.

Based on a limited set of NYC contracts that was used for the MWBE Indicator reported 7%

NYC MWBE contracting in order to remediate historic underutilization. NYC has set a goal of achieving 30% of MWBE firms. NYC has indicated its goal of achieving a 10% MWBE participation in government contracting.

More Must be Done and Faster

Despite the strong commitment, Mayor de Blasio has recently called on minority groups and women in urgent need of help "to do more and do faster." The NYC Comptroller, Scott Stringer, recently issued a report. He noted that NYS and NYC have a "poor grades for its MWBE program" in 2010 and 2015. (as discussed below). After the Trump Administration put pressure on both NYS and NYC, several New York City and NYC legislators have also been vocal in calling for increased MWBE participation in government contracting.

NYS and NYC Disparity Studies

Both NYS and NYC are presently conducting disparity studies to determine current MWBE utilization. The results of the studies could cause substantial changes to these programs. The most recent study was conducted in 2010 by NERA Economic Consulting for the New York State Department of Economic Development. The report, New York State Disparity Study: New York and Woman-Owned Business Enterprises (NY and Woman-Owned Business Enterprises) ("NY and Woman-Owned Business Enterprises had the lowest disparity scores, substantially more likely to be denied contracts on denial, substantially more likely to be denied contracts on diversity, and substantially more likely to be denied contracts on diversity."

The recommendations and its contributors were the basis for new MWBE programs in 2012, including changes to NYS procurement laws.
In July 2016, NYC changed its procurement rules to allow MWBE firms to get a 10% preference in the scoring of their bids under the “best value” procurement model. NYC had previously relied on the “lowest bid” model and the de Blasio Administration had been arguing that it needed a change in the NYC Charter to have the same ability as NYS to use the “best value” procurement model. The de Blasio Administration held that the “lowest bid” procurement model limited its choices in implementing MWBE goals. With the rule change, the constraint was removed, which should result in greater MWBE utilization in NYC government contracting.

Is the Table Set for Transformative MWBE Growth?

Given the strong support for MWBE programs expressed by Governor Cuomo and Mayor de Blasio and other state-wide elected leaders and agency heads, it is to be expected that MWBE programs are likely to get stronger over time and attain or exceed current MWBE goals.

With the results of the pending disparity studies and current as well as future legislative proposals, it is anticipated that over the next several legislative sessions significant attention will be devoted to crafting comprehensive MWBE legislation that incorporates the findings of the disparity studies and that address issues that arise in the operations of the programs.

Given the convergence of these circumstances, 2016 may be a turning point for MWBE programs as MWBE firms become stronger and participate to a greater extent in New York government procurements.
AN AGGRESSIVE COMMITMENT TO 30% MWBE UTILIZATION

NEW YORK STATE'S MWBE PROGRAM IN NYS AND NYC

NYS has made MWBE participation a top priority in its procurement and economic development strategy. In his 2014 State of the State address, Governor Andrew M. Cuomo announced the benchmark to increase the participation of MWBE firms from the prior year's goal of 20% to 30% for all projects, including those funded by federal agencies. This has been achieved through a variety of initiatives, including the Bond Act, the MWBE utilization goal, and the creation of the MWBE Certification Program.

Recognizing the importance of access to capital for MWBE firms, NYS has also established several programs, such as the Bonds to Success Loan Assistance Program, which offers access to capital to small businesses, and the MWBE Utilization Program, which provides assistance to MWBE firms in securing contracts. These programs are designed to help increase MWBE participation in the state's procurement efforts and to ensure that MWBE firms have access to the resources they need to succeed.

With such strong support, NYS has reported a utilization rate of 22.3% in fiscal year 2014, with total dollar expenditures of over $7.8 billion. One of the contributors to the NYS performance, DASNY (The Dormitory Authority of the State of New York), the state's largest issuer of municipal bonds, reported a 54% MWBE utilization rate for broker-dealer services in 2015. The state's MWBE program is expected to grow in the coming years, with the governor's commitment to increasing MWBE participation from 20% to 30% by 2016.

The New York State MWBE program is not only achieving its goals, but it is also serving as a model for other states and jurisdictions across the country. As a result, NYS is recognized as a leader in the field of MWBE procurement, and its success is due in large part to the support and dedication of its leaders and stakeholders.

Challenges to Advancing New York's MWBE Programs

Despite the successes of MWBE firms and advocacy groups and the efforts of government officials to improve the MWBE utilization rate, there are still significant challenges that need to be addressed. One of the biggest challenges is the lack of awareness and understanding of MWBE programs among contractors and procurement professionals. This lack of awareness leads to missed opportunities for MWBE firms to participate in public contracts and to access the resources needed to grow their businesses.

To address these challenges, New York State has taken several steps, including the creation of a MWBE Utilization Center, which provides training and support to contractors and procurement professionals. The center also offers assistance in understanding the requirements and regulations associated with MWBE programs, helping to ensure that MWBE firms have the information they need to participate in public contracts.

Another challenge is the lack of access to capital for MWBE firms. While NYS has established several programs to provide access to capital, many MWBE firms still face significant barriers in securing funding. This is due in part to the high cost of capital and the lack of awareness of the resources available to MWBE firms.

To address this challenge, NYS has established the MWBE Certification Program, which provides access to capital for MWBE firms through a variety of financing options, including bond financing, private placements, and loans. The program also provides technical assistance and support to MWBE firms, helping them to navigate the complexities of accessing capital.

The success of NYS's MWBE programs is a testament to the commitment of its leaders and stakeholders. Through their efforts, the state has achieved significant progress in increasing MWBE participation in public contracts, and it is poised to continue making strides in the future.
NEW YORK CITY’S MWBE PROGRAM
OneNYC Plan - Commitment to $16 Billion Dollars in Contract Awards by 2025

In April of 2015, the de Blasio Administration announced its OneNYC plan with a ten-year goal of reaching $16 Billion of expenditures with MWBE and Emerging Business Entities (“EBE”). An EBE is a businesses certified as being socially and economically disadvantaged by NYC. The plan includes an initiative, Directive No. 2, which requires all NYC governmental entities, including the Housing and Economic Development Agency, to report and “to be held accountable for helping to meet the OneNYC commitment.” In NYC in FY 2015, OneNYC announced contract awards of roughly $1.6 billion with MWBE firms. According to a report of the Mayor’s Office of Contract Services, in FY 2015, NYC MWBE expenditures reflected 7% of the applicable contract universe.¹¹

NYC’s MWBE goals are set forth in Subchapter 6-129 of the NYC Administrative Code (the “NYC Code”), which was amended by Local Law 1 in 2013. The “Citywide Goals” are set forth below. The Citywide Goals are organized by contract type, i.e., Construction Services, Standard Services, Professional Services, Goods below $100,000, etc. Citywide Goals are further delineated by the background of the owner of the applicable business: Black Americans (average goal of 11%); Hispanic Americans (average goal of 6.25%); Asian Americans (average goal of 4.75%); Women (average goal of 17.5%); and Emerging Businesses (average goal of 6%). Notably, Local Law 1 of 2013 advanced utilization goals range from no stated goal for Asians in Professional Services to 25% for Women related to goods contracts under $100,000.

New York City – A Challenged Performance Record

On the NYC level, the criticism has been more vocal from both governmental and community participants. While NYC reported 7% MWBE utilization in FY 2015, because of the wide gap between utilization levels and MWBE demographic percentages, MWBE advocates have pushed for more effective action by NYC. According to recent US Census Data for NYC, over two and a half years after taking office, the de Blasio Administration faces a MWBE community that is deeply concerned about its efforts to achieve meaningful MWBE participation in NYC procurement.¹²

Report Card Results. The Office of the Comptroller of the City of New York, Scott M. Stringer, issued two annual reports on NYC’s MWBE utilization in FY 2014 and FY 2015, which were highly critical of NYC’s MWBE efforts. The Comptroller issued overall grades of D for 2014 and D+ for 2015. The Comptroller’s reports identified transparency issues and procurement failures that were not in line with NYC MWBE laws or its stated policy, including Agency lapses relating to tracking subcontractor utilization. The Comptroller’s reports “prepared in an effort to increase competition in procurement and to increase transparency and boost agency performance around MWBE spending…” stated that the over 700,000 MWBE firms in NYC receive “a disappointingly small share of City procurement contracts.” The reports calculated actual MWBE procurement expenditures of 2.7% in FY 2013, 3.9% in FY 2014 and 5.3% in FY 2015, with the increase in FY 2015 being largely attributable to the inclusion of Mayoral entities previously excluded from prior year calculations.¹³

Until the recent change to its procurement rules, the de Blasio Administration had contended that NYS law, as set forth in the NYC Charter, presented a legal barrier to greater success in achieving NYC’s MWBE goals. In spring of 2015, the de Blasio administration indicated that it was seeking legislative changes in the NYC Charter to give NYC greater contracting flexibility to facilitate higher MWBE utilization. The administration’s “OneNYC Minority and Women-owned Enterprise Bulletin” described that

“One of the most significant limits on diversifying the City’s vendor base are state procurement laws that preclude the City from taking contractor’s MWBE status into account

In July 2016, the Mayor’s Office of Contract Services caused a change in NYC’s procurement rules without the need of a change in the state’s procurement rules were amended to ensure the “best value” procurement method. This change allows for firms to get a 10% preference in prequalification of the NYC MWBE law.¹⁶

Summary of NYS and NYC Contracting Opportunities

In summary, both NYS and NYC have been putting attention on their respective MWBE efforts. Private business communities have been stagnating and frustrated at the state of affairs, and stakeholders to see progress in the MWBE efforts may be merging at a ripe time to consider how and why NYC to become stronger in meaningful and regulatory barriers to meaningful change exist. Despite the Constitutional limits that make it legal and that curtail its ability to make an impact, programs that meet community demands can provide immediate progress.

*One of the most significant limits on diversifying the City’s vendor base are state procurement laws that preclude the City from taking contractor’s MWBE status into account

In July 2016, the Mayor’s Office of Contract Services caused a change in NYC’s procurement methods without the need of a change in the state’s procurement rules. The “best value” procurement method is now used to ensure that firms get a 10% preference in prequalification of the NYC MWBE law.
2. The Constitutional
   Framework

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key drivers to the
court and across the
country for justification
in procurement.
The Constitutionality of MWBE Law

Because of their use of race and gender classifications, MWBE programs are subject to Constitutional analysis under the equal protection clauses of the Fifth and Fourteenth Amendments. Under current jurisprudence, the Supreme Court reviews race-based programs using the most rigorous judicial standard, strict scrutiny, which requires a compelling governmental interest to justify any law or program involving a suspect classification such as race, religion or, in some contexts, gender.

Under strict scrutiny, even when a compelling governmental interest is established, the affirmative action program must be narrowly tailored to achieve the governmental interest of remedying identified discrimination so as to both lessen the “harm” caused to those affected by the affirmative action program, i.e., majority group members and to ensure that beneficiaries of affirmative action programs are victims of discrimination who have been socially disadvantaged.

Racial Classifications by State Entities. In its 1989 decision, City of Richmond v. J.A. Croson Co., the United States Supreme Court found that the City of Richmond’s minority set-aside program, created to increase opportunities for minority businesses, but created in the absence of a record of specific prior discrimination, violated the Fourteenth Amendment of the Constitution.

Writing for the majority in Croson, Justice O’Connor said “the city failed to demonstrate a compelling interest in apportioning public contracting opportunities on the basis of race.” The Croson Court applied the strict scrutiny test to determine the Constitutionality of the City of Richmond’s program. Under strict scrutiny, courts are instructed to take a highly skeptical view of any law or program that involves a racial classification. The set-aside law at issue in Croson was passed to increase opportunities in the City of Richmond for “minorities,” who reflected a majority of the population. The law was not supported by a finding of specific discrimination. The Court held that general past discrimination could not support an affirmative action program that set racial quotas like the City of Richmond program.

Under the Croson decision, any State or local law or regulation, whether related to procurement or employment or otherwise, that includes racial classifications violates the Fourteenth Amendment unless it is adopted as a remedy to address prior, identified discrimination. If a compelling governmental interest is found, strict scrutiny further requires that the law or program be narrowly tailored and that the remedy should use race neutral means as much as possible.

Croson followed the decision in Bakke v. Regents of the State of California (“Bakke”). In Bakke, the challenged program created a set number of medical school admission seats reserved for minority students at the University of California at Davis. The program was created to remedy general, historical discrimination, to facilitate a more diverse student body and to increase the likelihood that minority communities, which were traditionally underserved by medical professionals, would be better served with more minority doctors. The program in Bakke was created without a prior finding of racial discrimination to justify the race-based set aside.

In its decision in Bakke, a majority of the Supreme Court interpreted the Fourteenth Amendment to grant each citizen the right of protection against harms created by racial classifications, including individual members of the majority class who the Supreme Court found had Fourteenth Amendment protections against reverse discrimination. Dissenting members of the Supreme Court argued that the discrimination was benign and that the program was clearly remedial. They argued that it was perverse to require minorities to prove discrimination in a country where racial discrimination was lawful for most of its history.

Racial Classifications by the Federal Government. In Adarand Constructors, Inc. v. Peña, a Federal case involving a race-based set-aside program created by Congress, the Supreme Court reversed a Court of Appeals decision, which rejected a claim of reverse discrimination made by the plaintiff, Adarand Constructors, Inc., and found that the Federal set aside program violated the 5th Amendment. The Department of Transportation Program gave Federal contractors a financial incentive to work with subcontractors that were certified as being “socially and economically disadvantaged individuals,” which was not a factor. The plaintiff argued that the right to equal protection under the Constitution of its use of race as a factor in determining certification.

The Court of Appeals had decided the claim, which it analyzed using the intermediate standard. Prior to Adarand, affirmative action programs were analyzed using intermediate and strict scrutiny. The Court of Appeals had relied on the Met都是非常有趣的笑话。Met也代表了一个“幽默”组织。这个组织成立于1990年代初期，主要是为了在互联网上分享搞笑的内容。这个幽默组织是一个非常活跃的社区，他们的成员经常发布各种各样的笑话和幽默段子，吸引了许多人关注。
Bakke, Croson and Adarand, represent a unification of a theory of deep skepticism of any program including racial classifications, even benign racial classifications. Fulfillove and Metro Broadcasting represent an acceptance of benign discrimination as a reasonable counter to the centuries of malevolent discrimination that long plagued the United States.

Several Supreme Court Justices have bemoaned the Supreme Court's adoption of strict scrutiny for all affirmative action cases. The standard has been derided as being 'strict in theory, fatal in fact.' No critic has more eloquently attacked the approach than Justice Thurgood Marshall. In his dissenting opinion in Bakke, Justice Marshall wrote immortal words that sum up the disconnect between those who believe that benign racial preferences are appropriate given the history of racial discrimination in the United States and those who believe that reverse discrimination is a harm worthy of protection over benign racial classifications.

Justice Marshall found the majority's decision to be incongruent and entirely dismissive of the long history of discrimination in America. Recounting the 350-year history of Black Americans in the United States, as slaves for 230 of those years and then as a powerless caste (a Jim Crow class) facing a hostile majority, Justice Marshall wrote

"it is more than a little ironic that, after several hundred years of class-based discrimination against Negroes, the Court is unwilling to hold that a class-based remedy for that discrimination is permissible. In declining to so hold, today's judgment ignores the fact that for several hundred years, Negroes have been discriminated against not as individuals, but rather solely because of the color of their skins. It is unnecessary in 20th-century America to have individual Negroes demonstrate that they have been victims of racial discrimination; the racism of our society has been so pervasive that none, regardless of wealth or position, has managed to escape its impact. The experience of Negroes in America has been different in kind, not just in degree, from that of other ethnic groups. It is not merely the history of slavery alone, but also that a whole people were marked as inferior by the law. And that mark has endured. The dream of America as the great melting pot has [p.401] not been realized for the Negro; because of his skin color, he never even made it into

objectives of the MBE provision must be considered against the background of ongoing efforts directed toward delivery of the century old promise of equality and economic opportunity." 32

Where courts have historically interpreted laws to empower legislative bodies and to streamline processes, the current state of affirmative action laws go against both judicial objectives. Contrary to the approach advocated in Justice Marshall's dissent and in Chief Justice Burger's opinion in Fulfillove, strict scrutiny requires specific findings of discrimination to support every affirmative action program that uses race as a component.

Despite the overwhelming evidence amassed by Congress and easily found in the historical record, despite the overwhelming volume of data reflecting disparities in wealth, health, education, business ownership and access to credit faced by groups that have been the victims of historic discrimination, current Supreme Court preceident would have each individual government contracting entity that has power to develop a procurement program pursue a separate, time consuming and expensive disparity study if it wants to ensure that groups held out from contracting opportunities are brought into such opportunities through race-based affirmative action programs.

Given the wide differences still found in disparity studies such as the 2010 Nera Economic Consulting study, it is clear that the approach taken by the Supreme Court has had a disastrous impact on the process of bringing discriminated against groups into government contract opportunities and has done more to maintain the status quo. The impact has been to prolong the recovery of impacted communities.

Following the Croson decision, litigation was commenced against the NYS MWBE program using the holding of Croson to challenge the program, 33 which had only been enacted two years before in 1988. The NYS MWBE program was suspended in order to allow NYS to gather facts that would support the program's Constitutionally. During the period of the suspension, MWBEs lost opportunities. In fact, it could be argued that the impact of Croson and Adarand has been to preserve the status quo of historical discrimination based on disingenuous arguments of the inviolate nature of the due process clauses of the Fifth Amendment and the Fourteenth Amendment, and the affirmative action jurisprudence corrected through Supreme Court decisions. Until then, before a MWBE program classification,Strict Scrutiny required proof which for MWBE programs is typically a disparity study. From that point, reverse discrimination, a program may be considered tailored to remedy the discrimination.

How Can MWBE Programs Succeed?

To summarize the legal standard, Federal programs that have race or gender based on the equal protection clauses of the Constitution and the Fourteenth Amendment, unless it is a compelling governmental interest to reverse discrimination, through a narrowly tailored approach. Any such laws or programs are reviewed under the test known as Strict Scrutiny and are structured to avoid or overcome the tend to have the following attributes:

1. They are supported by evidence whether based on specific actions or proof of practical disparity study to preclude them or women.

2. They have a limited duration and current conditions not historically Programs that require utilization updated periodically.

3. They are not overbroad and to address identified racial or gender based discrimination. Recent Court decisions suggest that they may also provide relief to MWBE firms that were not

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3. The New York State MWBE Program: A Summarized Overview and Perspective

New York State law provides a framework for the development of minority- and women-owned businesses (MWBE) in various sectors of the economy. The program aims to promote minority and women’s participation in the state’s procurement opportunities, thereby fostering economic growth and development.

The program is governed by the New York State Economic Development Corporation (NYSED), which is responsible for establishing policies, guidelines, and procedures for the administration of the MWBE program. The program includes several key components, including the procurement process, certification, and compliance.

Under the program, businesses that meet the criteria for certification as minority- or women-owned firms are eligible to participate in state procurement opportunities. The certification process is administered by the NYSED and involves a thorough review of the business’s financial statements, management, and ownership structure.

Once certified, businesses can participate in state procurement opportunities, which include contracts for goods and services. The program includes various strategies to increase the participation of minority- and women-owned businesses, such as set-aside programs, mentorship programs, and technical assistance.

The program also includes a compliance component, which involves monitoring and evaluating the performance of certified firms to ensure compliance with the program’s requirements. Non-compliance can result in the revocation of certification and the exclusion from future procurement opportunities.

In conclusion, the New York State MWBE Program is an essential tool for promoting economic development and diversity in the state procurement sector. The program aims to increase the participation of minority- and women-owned businesses, thereby fostering economic growth and development.
The New York State MWBE Program

The NYS MWBE program consists of NYS laws and regulations, the formal and informal orders of the NYS Governor and the guidance and directions of the NYS Chief Diversity Officer, NYS's Division of Minority and Women-owned Business Development (the "Division"), the Director of the Division, the Statewide MWBE Advocate and the Agency heads and Agency MWBE officers.

The program is founded on Article 15-A of the Executive Law of the State of New York ("Article 15-A"), which was enacted in 1988 and which has been subsequently amended including major revisions in 2010. Article 15-A is supported by regulations set forth in Chapter XIV of Title 5 of the Official Compilation of Codes, Rules and Regulations of the State of New York.

In addition to Article 15-A and its accompanying regulations, components of the NYS MWBE program are set forth in the Economic Development Law, the Public Authorities Law and the State Finance Law. Other NYS MWBE programs related to the NYS pension plans and its deferred compensation plan and insurance funds are set forth in the New York Retirement and Social Security Law, the Education Law, the Workers' Compensation Law and the State Finance Law. The descriptions below are high-level summaries of the various provisions of the laws.

**Article 15-A of the Executive Law**

The Executive Law of NYS sets forth laws applicable to its agencies and authorities that are subject to the control of the NYS Governor. Sections 310 through 318 of Article 15-A of the Executive Law codify the MWBE program. Section 310 of Article 15-A sets forth certain definitions applicable to Article 15-A, including "Minority-owned business enterprise," "Women-owned business enterprise," which set certain eligibility requirements for MWBE firms, including that the entity is not less than 51% owned and controlled by minorities for MBEs or women for WBEs. The definitions set the minority groups that fall within the term "minority-group" as Black, Hispanic, Native American and Asian. The Section also identifies the NYS agencies or authorities, which are subject to Article 15-A among other definitions.

The procedures of state authorities in complying with Article 15-A. Section 3-11-a of Article 15-A creates a "statewide advocate" position, which is a position appointed by the Commissioner of ESD to act as a liaison for MWBEs to assist with obtaining technical assistance, investigate complaints concerning MWBE certification delays and State entity violations of the MWBE program, among other duties. It appears that this position is vacant and if it has been filled, the Division's website does not identify the statewide advocate. It is not clear how the tasks of this role differ from the Chief Diversity Officer position, which is currently held by Rose Rodriguez.

Section 312 requires that NYS contracts and solicitations include language regarding the contractor's agreement to refrain from discrimination and to undertake affirmative action efforts with respect to its performance of the NYS contract.

Section 312-a of Article 15-A requires that the Director commission a report, a new disparity study, to be delivered to the Governor upon its completion. As discussed above, the disparity study results will serve as a foundation for the MWBE program. The disparity study is likely to result in changes to the utilization goals as set forth in Section 313 and will result in other changes to operational aspects of the MWBE program.

Section 313 of Article 15-A sets forth NYS's MWBE goals for agencies and contractors. Such statutory goals are separate from the Governor's aspirational goal of 30% MWBE expenditures and are based on the disparity study results of 2010. The section charges NYS agencies with developing procurement procedures in accordance with the findings of the 2010 Disparity Study to achieve the following procurement goals:

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>MBE Goal</th>
<th>WBE Goal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction Industry Services</td>
<td>14.34%</td>
<td>8.41%</td>
</tr>
<tr>
<td>Construction Industry for Professional Services</td>
<td>13.29%</td>
<td>11.32%</td>
</tr>
<tr>
<td>Non Construction Services</td>
<td>19.06%</td>
<td>17.44%</td>
</tr>
<tr>
<td>Commodities Industry</td>
<td>16.11%</td>
<td>10.93%</td>
</tr>
<tr>
<td>Overall Agency Procurement</td>
<td>16.53%</td>
<td>12.39%</td>
</tr>
</tbody>
</table>

Section 313 is a key provision of the program, as it empowers the Director for further action against a contractor who fails to comply with the MWBE requirements. If after a review of utilization plans and efforts, it appears that the contractor is failing to comply with the MWBE requirements, Section 313 also makes legal it for entities subject to the goals of Article 15-A (such as construction or demolition requirements) to take action when the costs of such efforts exceed $100,000.

With respect to compliance and complaint, it is clear that the State agencies and contractors are tasked with ensuring that the goals are met. The State agencies and contractors may have either with other contractors or with the State agencies.

While Section 313 seems to put the burden on the State agency and contractor to ensure compliance, it is not clear whether the dispute resolution will be handled by the State agencies or contractors. It is clear that Section 313 allows for Fraud Reporting, which can be filed by the public on an on the record submission or an anonymous report.

It appears that dispute resolution and reporting responsibilities exist at every level of the MWBE program. In an environment where it is difficult to meet MWBE goals, this seems sensible. The program creates a structure where there is a dissenting voice, which can help prevent potential fraud, and more independent mechanism exists.

The NYS Comptroller's Office performs its own work at every level as do MWBE firms themselves. It is not clear whether the dispute resolution has been better served structurally by the Chief Diversity Officer or, as is the case with the designee, the MWBE Advocate for each State agency. The Advocate is charged to work with the NYS Attorney General and the New York State Comptroller.

Section 313 is a key provision of the program, as it empowers the Director for further action against a contractor who fails to comply with the MWBE requirements. If after a review of utilization plans and efforts, it appears that the contractor is failing to comply with the MWBE requirements, Section 313 also makes it clear that entities subject to the goals of Article 15-A (such as construction or demolition requirements) to take action when the costs of such efforts exceed $100,000.
- 51% owned and controlled by one or more Minorities or Women;
- where such ownership is demonstrated to be real, substantial and continuing;
- minorities or women control the day to day business and general management of the business;
- the firm is authorized to do business in NYS;
- the firm agrees to be subject to physical inspection to verify 51% ownership, its independence from other businesses, etc.;
- no 51% owner has an adjusted personal net worth in excess of $3.5 Million; and
- the entity must be a small business under NYS law.

Importantly, Section 314 of Article 15-A allows the Director to confer a "provisional MWBE certification" to applicants from a designated industry if it is found that industry specific factors coupled with the Personal Net Worth or Small Business eligibility criteria, have led to the significant exclusion of businesses owned by firms that would qualify as MWBE firms, but for those tests. Any such determinations are to be made public on the Division’s website. This provisional MWBE certification power has been raised by the Director as the tool to address any concerns about the Personal Net Worth test. Section 314 allows the Director to approve an industry exemption that addresses unique industry challenges presented by MWBE eligibility criteria.

Section 315 of Article 15-A sets forth the responsibilities of the contracting agencies, including requirements to implement the NYS MWBE program into the agencies contracting processes and to report on performance MWBE program performance. Section 315 charges the Division with including the reports of State agencies in its annual report on MWBE program compliance. Section 315 also requires any State agency that substantially failed to meet the goals in its utilization plan to submit a remedial plan to address steps that it will take to meet its goals in the future. Section 315 empowers the Director to make a determination of whether a State agency has failed to make good faith effort to implement its remedial plan and, if so, to provide a written, public notice of such findings.

Under the provision, the State agency is subject to take remedial actions outlined by the Director. Upon a finding

Section 316 of Article 15-A relates to enforcement. Section 316 gives the Director the power to work with State agencies and contractors to resolve any disputes and, if such efforts are unsuccessful, to turn the matter over to the Division’s hearing officers. Upon the conclusion of any administrative hearing, the hearing officer shall make a binding decision that is provided to the parties by the Director. The decision of the hearing officer is subject to appeal under Article 78 of the NYS Civil Practice Rules.

Under Section 316, the penalties for fraud or intentional misrepresentation by a contractor include being made ineligible to submit a bid to a contracting agency for a period of one year, provided, however, that repeat offenders may be ineligible for a period of up to five years. Section 316 describes the Division's obligation to include a list of ineligible contractors on its website. The enforcement and publication of ineligible contractor provisions of Article 15-A may be subject to attention for transparency reasons. The Division’s website does not appear to have a list of ineligible contractors as required by Section 316.

Sections 317 and 318 of Article 15-A relate to the operation of Article 15-A with other New York law and with Constitutional requirements. Section 317 states that Article 15-A supersedes other NYS laws dealing with equal employment opportunities with certain exceptions. Section 318 of Article 15-A states if a court finds that any provision of Article 15-A is invalid, the other provisions of Article 15-A shall survive and not be affected by such invalidity.

Sections 136-B, 139-G, 147 and 163 of the State Finance Law

Under the State Finance Law, the MWBE program is addressed through Sections 136-B, 139-G and Section 147. Section 136-B requires state agencies that are involved in selling bonds to consider including NYS certified MWBE firms as underwriters in the transaction. Section 139-G of the State Finance Law obligates every "state agency" with expenditures in excess of two million dollars on service or construction contracts to undertake and submit bi-annual studies to determine whether the agency's procurement practices preclude small businesses or MWBE firms and whether any changes in NYS procurement policies are needed because of such impact, including breaking

heads are directed to report to the Secretary on the list of small businesses that were identified as described above. Under the law, each state agency that is subject to Section 139-g is required to maintain a service directory comprised of small and M/WBE firms and to at least annually notify all entities notifying them of the contact information available through the agency. Section 147 of the State Finance Law describes how to "develop a mentor-protégé program" including relationships between approved mentor-protégé programs and M/WBE firms to enhance the long-term success of small and M/WBE firms.

Sole Source - Discretionary Public Authority Law

Section 163(6) of the State Finance Law, also known as the Public Authorities Law, permits a public authority to procure goods or services through a sole source procurement.

Section 2879(3)(b)(i) of the Public Authorities Law specifies that a public authority of NYS to adopt rules to include special M/WBE and small business participation and "provisions relating to the implementation of the special M/WBE and small business participation rules to the use of a two thousand dollar threshold for which [M/WBE firms] may be required to participate in a sole source procurement process."

In addition, Section 2879(3)(c) requires that the public authority rule include "an identification of the entity for which [M/WBE firms] may be required to participate in a sole source procurement process."
Comptroller as “owned and controlled” by minority group members or women, as applicable. The law added related definitions for “MWBE Asset Managers” and “MWBE Financial Institutions.” The definitions allow for certification of broker dealers and financial and professional service firms that are “at least 51% owned and controlled” by minority group members or women and firms that are “substantially owned” by minority group members or women, if such entities are actually controlled by minority group members or women. The sponsors of the Emerging Manager Law and concerned constituents, questioned whether the Division’s certification regime would be appropriate for businesses involved in financial or professional services, especially given the Personal Net Worth test enacted in the amended Article 15-A. As a result, a new certification standard was developed with the intent of creating a more flexible process for financial institutions and professional service firms through the Office of the State Comptroller. The new certification regime was not followed.

The law called for the Fiduciary Entities to engage in outreach efforts regarding the Strategy, including advertising the existence of the Strategy. It further calls on the Fiduciary Entities to work together to create a uniform database of MWBE firms for asset management, brokerage and other financial and professional services, to hold public conferences on various aspects of the Strategy and to provide annual reports to the Governor, Legislature and Chief Diversity Officer regarding activity with MWBE firms as compared to business with all firms in areas identified by the bill. These reports are to be published on a website of each such Fiduciary Entity.

By formalizing and coordinating the programs of the Fiduciary Entities, who collectively control over $2.5 Billion of assets, the bill attempted to clarify for MWBE firms who provide financial and professional services that there are unprecedented opportunities to compete for business in NYS. The law codified many programs already conducted by some Fiduciary Entities (and many other public pension plans around the United States) for many years.

As the amendments in the Strategy were largely discretionary, the Fiduciary Entities have largely continued to conduct business in the manner that they had prior to the 2010. Aside from NYSTRS, which complies with the annual reporting, the other Fiduciary Entities have not consistently reported activity as set forth in the law.

NYS Credit Access Programs

NYS has taken steps to alleviate working capital needs through a loan program and through a surety-bonding program. NYS has created a “Bridge to Success Program,” a $20 million loan program administered through regional lenders that offer short-term bridge loans of between $75,000 and $200,000 to MWBE firms that do business with NYS. NYS provides loan loss reserves for the banks to support the loans and the lenders perform their own underwriting and loan origination as appropriate.

NYS has also implemented a Surety Bond Assistance Program, which provides “technical and financial assistance to help contractors secure surety bonding. Contractors may be eligible to receive a guarantee of up to 30% to secure a surety bond line, bid bond or performance and payment bond on state and city projects. To be eligible for the program, a business must be a small business or MWBE with two years of operations, minimum average gross revenues of $400,000 in the prior two years and have maximum gross revenue of $5 million, among other eligibility criteria.”

Whether through the various laws of Article 15-A or related provisions in the State Finance Law, the Public Authorities or other laws, NYS has a rich set of law and programs that reflect significant effort to bring MWBE firms into NYS procurements.
The New York City MWBE Program

NYC’s MWBE Program is founded on laws and rules set forth in the NYC Charter, NYC’s Administrative Code (the “NYC Code”) and the Rules of the City of New York (the “NYC Rules”). In addition, Mayor de Blasio’s OneNYC initiative sets forth certain executive goals for increasing MWBE participation in NYC. In some instances, the laws, regulations and codes are duplicative.

The New York City Charter

Section 1304 of Chapter 56 of the NYC Charter creates the division of economic and financial opportunity (the “NYC Division”) and describes its purpose of “enhancing the ability of MBE and [emerging business enterprises (“EBE”)] firms to compete for NYC contracts, to enhance NYC agency awareness of these entities and to ensure their meaningful participation in NYC procurement.” 34 Section 1304 sets general parameters for the NYC MWBE program that are further developed in the NYC Code and NYC Rules.

Section 1304(e)(6)(b) of the NYC Charter sets forth certain definitions, including the definitions of “minority owned business enterprise” and “women-owned business enterprise”, which include standard criteria, but do not include a personal net worth test.35

Section 1304(d) and (e) of the NYC Charter charges the Commissioner of the Department of Small Business Services (“SBS”) with monitoring NYC’s MWBE program including “the implementation of all financial, technical, managerial, and bonding assistance programs operated by city agencies to enhance participation by minority and women owned businesses and emerging businesses in city procurement.” Among other powers, the Commissioner is empowered to:

“direct and assist agencies in their efforts to increase participation by minority and women owned business enterprises and emerging business enterprises as contractors and subcontractors in city procurement; to periodically review the compliance of city agencies with the provisions of applicable local law; to annually report to the mayor and the council, as required by such local law, on the activities of the division and efforts by agencies to comply with the provisions of such local laws and to establish, and operate, an annual MWBE procurement plan.”

The purposes of establishing the eligibility of such businesses for participation in the programs and processes established pursuant to local law to ensure their meaningful participation in city procurement.”

Clause (f) of Section 1304 also sets rules requiring that each head of a NYC agency

“(a) establish and implement reasonable measures and procedures to secure, and to monitor and report on, the meaningful participation of city certified business enterprises in the agency’s (1) procurement of goods, services and construction and (2) financial, technical and managerial assistance programs for such business enterprises.”

NYC Agency heads are also responsible for monitoring contract compliance, ensuring that appropriate outreach is conducted and reporting on agency performance, among other responsibilities.

New York City Code

While Section 1304 of the NYC Charter set the broad outlines of the NYC MWBE program, the NYC Code sets forth the more specific details of the program. In 2013, Local Law No. 133, a Local Law to amend the New York charter and the administrative code of the city of New York, in relation to opportunities for minority and women owned businesses and emerging business enterprises in city procurement, made several upgrades to NYC’s MWBE Program. Local Law No. 1 amended Title 6, Chapter 1, Subchapter 6-129 of the NYC Code.

The amendment established “Citywide Goals” for MWBE firms and EBE firms.40 The 2013 changes also removed a $1 million cap on contracts subject to the non-binding goals and permitting agencies to meet participation goals through both prime contracting and subcontracting, which had the effect of causing the NYC MWBE program to apply to a broader set of contracts with aggregate values in total dollars that are significantly higher than before the change.41

Subchapter 6-129(b) of the NYC Code sets forth NYC’s policy on MWBE participation as follows:

“Clause (2)(a) of Section 6-129(d) requires the Chief Procurement Officer of NYC to prepare and submit to the city council annual procurement plans for goods, services, and construction contracts.”

The Citywide Goals are as follows:

<table>
<thead>
<tr>
<th>Citywide Goal by Contract Type</th>
<th>Black</th>
<th>Hispanic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction Service</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>Professional Service</td>
<td>12%</td>
<td>8%</td>
</tr>
<tr>
<td>Standard Service</td>
<td>12%</td>
<td>8%</td>
</tr>
<tr>
<td>Goods Contract</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt;$10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;$100,000</td>
<td>12%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Clause (2)(c) of Section 6-129(d) requires the Chief Procurement Officer of NYC to prepare and submit to the city council annual procurement plans for goods, services, and construction contracts.”
Section 6-129(o) relates to violations of the NYC procurement laws. It requires the Chief Procurement Officer to investigate any alleged violation by a procurement officer, and to report any findings to the Office of the New York City Comptroller. The Office of the Comptroller may then take any action it deems appropriate, including the suspension or debarment of a procurement officer.

Section 6-130 also requires that any contract or agreement entered into by the NYC government that exceeds $50,000 in value be competitively bid or negotiated. The NYC government must also publish a Notice of Intent to contract in the New York City Register and allow a period for public comment on the proposed contract.

Section 6-131 relates to the NYC Procurement Office. It requires the Office to establish a system for the procurement of goods and services, including the development of procurement policies and procedures, and the establishment of a system for the monitoring and evaluation of procurement activities.

Section 6-132 relates to the NYC Procurement Office and the Office of the Comptroller. It requires the two offices to work together to ensure that procurement activities are conducted in accordance with the law.
5. Recommendations and Guidance

This final section provides guidance on implementing more robust MWBE programs.
Recommendations

1. **New York State Recommendations**

   a. **Use NYS Influence to Curb Stronger Coordination among MWBE Firms**

   - MWBE firms are a number of administrative burdens in New York that affect the cost of doing business. The process of certification of MWBEs in certain categories is also a significant amount of effort and leaves some uncertainty about the future of their benefits.

   b. **Confront the Risks of Losing Certification**

   - MWBE firms must ensure that they are aware of the risks associated with losing certification. This includes understanding the processes and requirements for maintaining certification.

   c. **Review Existing Contractors’ Programs and Need for Change**

   - MWBE firms should review their existing programs and consider making changes to improve competitiveness. This includes reviewing the costs and benefits of different programs and determining the best approach for their business.

   d. **Conduct a Cost-Benefit Analysis**

   - MWBE firms should conduct a cost-benefit analysis to determine the financial impact of different programs and determine the most cost-effective approach for their business.

2. **Enhance MWBE Support Programs**

   a. **Bridge to Success Program**

   - Expand programs such as the State University System’s Surety Bond Assistance Program, which provides information on the performance of the program, including how it is being used.

   b. **Programs**

   - Highlight successful cases and examples of joint venture arrangements that provide long-term benefits to both parties.

   c. **Make Sure**

   - Source opportunities and strategies for joint ventures that may benefit both parties.

   d. **Dispute Resolution**

   - Ensure that the dispute resolution process is transparent and accessible to both parties.

   e. **Prime/Associate/Subprogram**

   - MWBE firms should work with the Prime/Associate/Subprogram to ensure that all parties are aligned and clear on expectations.

   f. **Prime/Associate/Subprogram**

   - Ensure that the Prime/Associate/Subprogram is well-coordinated and aligned with other programs to avoid duplication.

3. **Under Croson to Ensure that NYS should include local ownership and report expenditures on local MWBE contracting opportunities.**

   a. **Understand the Importance of Local Ownership**

   - Local ownership is crucial for the success of local MWBE programs. It ensures that the benefits of the programs are distributed locally and that the programs have a direct impact on the local economy.

   b. **Report Expenditures on Local MWBE**

   - Reporting expenditures on local MWBE contracting opportunities will help to ensure that the programs are transparent and accountable to the public.

   c. **Enhance Local MWBE Contracting Opportunities**

   - Enhancing local MWBE contracting opportunities will help to ensure that the programs are effective and sustainable.

   d. **Support Local MWBE****

   - Supporting local MWBE firms will help to ensure that the programs are successful and that the benefits of the programs are distributed locally.

4. **Understand the Importance of Local Ownership**

   a. **Understand the Importance of Local Ownership**

   - Local ownership is crucial for the success of local MWBE programs. It ensures that the benefits of the programs are distributed locally and that the programs have a direct impact on the local economy.

   b. **Report Expenditures on Local MWBE**

   - Reporting expenditures on local MWBE contracting opportunities will help to ensure that the programs are transparent and accountable to the public.

   c. **Enhance Local MWBE Contracting Opportunities**

   - Enhancing local MWBE contracting opportunities will help to ensure that the programs are effective and sustainable.

   d. **Support Local MWBE****

   - Supporting local MWBE firms will help to ensure that the programs are successful and that the benefits of the programs are distributed locally.
Therefore, it is perverse to deem her success to be disqualifying as it relates to the benefits of the MWBE program. Logic suggests that whatever personal net worth she has achieved it remains depressed compared to achievements that might have been attained in a non-discriminatory environment. The leveling of the playing field aspect of the program would still be important to her firm's success at least until the firm no longer qualifies as a small business.

While all minority groups have faced some level of discrimination, it is entirely unfair to the victims of the harshest doses of discrimination in the US to lump all minority groups in the same category. Narrow tailoring should focus on historically challenged groups and businesses that meet the NYS small business test. That test is not established through third-party certification and does not have a cap on the personal net worth of the owners, but does put a cap on the size of the business, which cannot have more than 100 employees.

Given the well documented history of racial discrimination in the United States and the well understood racial disparities in measures like wealth, health, employment and education, it is simply a breach of the promise of equal protection under the 14th Amendment when the “tail of reverse discrimination” wags the ‘dog of actual and continuing discrimination in the United States’, which is the impact of Croson. If NYS wants MWBE businesses in New York to actually grow and thrive, it is well positioned to be a leader in a coalition of MWBE advocates to support Federal changes that put MWBE programs on a firmer footing through coherent, consistent national policies. Efforts could be established that seek to:

a. Use the Commerce Clause to argue that the “50 State Approach to MWBE programs” fails to achieve the goals of the 13th and 14th Amendments. The 50 State approach harms interstate commerce because MWBE businesses tend to be certified on a regional basis and thus tend to pursue opportunities only in regions where they are certified;

b. Establish National Findings on Racial/Gender Discrimination and Policy on MWBEs in order to Eliminate the Need for Local Disparity Studies;

c. Advocate for a rational approach to utilization that is based on a formula rather than the number of projects.

Actions such as these would do much to address the inefficiencies of the 50 State approach and would give MWBE’s a greater market to pursue opportunities. This should have the impact of increasing the likelihood of MWBE firms taking reasonable risks in forming businesses in various industries that are largely underserved.

NEW YORK CITY RECOMMENDATIONS

1. Engage with New York State agencies and authorities to achieve stronger coordinated approach regarding MWBE Programs

NYC’s MWBE program leaders should embrace the strongest, most successful aspects of the NYS MWBE program and seek to replicate them on the NYC level. NYC should also embrace efforts to coordinate with NYS and other governmental players to achieve the efficiencies discussed above.

2. Adopt Improvements to NYC MWBE Law

NYC should pursue modifications of the NYC MWBE law to (i) create a Chief Diversity Officer to oversee and implement NYC MWBE Program, which works with NYC Agencies and that report directly to Mayor and the City Council Speaker. This professional should have the ability to coordinate NYC agencies to achieve the goals it espouses, and (ii) make other changes to the NYC MWBE law to make it consistent with NYS MWBE law operation and to eradicate provisions that penalize success such as the provisions on graduation. The NYC law threatens decertification through a “Graduate MWBE status” for MWBE firms that have worked on contracts with total city funding of expenditures in excess of $50 million in a three-year period. The wording of the provision is vague. Does it mean that MWBE’s that earn much less than $50 million but are on large contracts could be deemed “Graduate MBE” firms? Many of the NYC MWBE law provisions are duplicative or confusing. A close examination needs to be taken of the NYC laws to correct deficiencies and to address provisions that were not well conceived.

3. Embrace NYC’s Ten Year Plan, but also report on utilization percentages

As a matter of transparency, NYC should report on both dollar value of MWBE contracting as well as expenditures as a metric for utilization. This will drive efforts to increase utilization in this critical area.

An Inflection Point for Creating Sustainable Change

2016 represents an important moment in the governance of the state and city of New York. At the NYS and NYC levels, the opportunities to eradicate MWBE and other forms of disparity studies are clear. The New York State program can be improved, Governor Cuomo has sought to make the NYS program even more successful. The NYC program, after a rocky start, should be a model for how such programs can be managed. The need to conduct disparity studies is clear and the leadership of many of theexclude the MBE program and the NYC legislative bodies should start debating the future of this program.

For MWBE businesses, this all bodes well. As various forces come together in a unifying posture that the objectives of greater diversity are possible, the prospects for addressing historical harms can be seized, not by the government alone, but collaboratively by the procurement community.
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Democratizing Entrepreneurship:
Online Documents, Tools, and Startup Know-How

Jeff Thomas, Praveen Kosuri, and Bernice Grant

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I. Introduction

New ventures are inherently cash strapped. The entrepreneurs who start them are typically doers—problem-solvers who will find a way within given constraints. For most entrepreneurs, the legal formalities of a new venture are low priority at best and unnecessary bureaucracy at worst. No startup wants to expend scarce resources on what it perceives to be legal formality. Whether a venture is a limited liability company, C-corporation, or S-corporation, it will not exist if it has no product, sales, customers, or strategy to compete in the marketplace. This is a truth across all new ventures whether community-based, socially conscious, or high-tech and high growth. Online tools have recently emerged that address this issue by making it easier for entrepreneurs to comply with formalities. These tools also democratize access to legal documents and startup know-how for all types of entrepreneurs.

Leading venture capital (VC) law firms and startup accelerators are sharing their playbooks for forming and financing new ventures. Their websites provide free access1 to battle-tested legal documents and wizards that even generate documents based on a company’s particular facts and circumstances. Although these open source legal resources are made available by competing law firms, the materials are strikingly similar. This is because best practices have evolved in servicing the typical clients of these law firms: VC seeking companies. While only a small percentage of entrepreneurs are likely to raise VC, best practices built-in to these open source legal resources, and the reasons for using them, are far more universal. Leveraging this know-how could significantly impact a much broader range of entrepreneurs, including community-based businesses, worker cooperatives, social ventures, and even sole proprietors. Maybe most significantly, open source startup documents allow ventures outside major metropolitan areas newfound access to the same documents used in entrepreneurial epicenters such as Silicon Valley, New York, and Boston. Further, the open source movement is impacting organizations that assist all types of entrepreneurs. These organizations include law firms, legal clinics, small business development centers, accelerators, accounting and tax professionals, university entrepreneurship centers, and crowdfunding portals—all of which now have access to the same documents that were once exclusive to elite Silicon Valley law firms. The democratization of startup documents has the potential to transform entrepreneurial ecosystems and the global economy.

Parts II and III of this Article will recount the origins and evolution of open source legal documents for startup companies. Part IV will examine how the impact and utility of these documents extends far beyond the narrow slice of VC-backed businesses that were their initial intended audience. And finally, Part V describes how advisors and service providers

1. Most of the open source legal resources referred to herein are free. We have also noted some that are low cost.
that are not themselves entrepreneurs or lawyers may leverage open source legal documents to better execute their own missions.

II. Open Source Legal Resources: Lessons from Venture Capital Seeking Companies

Less than one percent of new businesses will likely raise venture capital.\(^2\) However, there are at least four reasons why the entire spectrum of entrepreneurs, and the organizations supporting them, should examine open source legal resources aimed at VC seeking companies.\(^3\) First, these resources bridge the gap between expensive legal services and customary non-lawyer, do-it-yourself options available to entrepreneurs by providing foundational documents that entrepreneurs and even attorneys can use to reduce startup costs.\(^4\) If companies on the verge of raising millions of dollars are turning to open source legal resources to formalize their businesses and reduce costs, it is likely that entrepreneurs with fewer resources would benefit even more from the same offerings. Second, many of the open source legal resources address transactions commonly faced by all types of entrepreneurs, such as forming an entity,\(^5\) creating

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2. **Ewing Marion Kauffman Foundation, Entrepreneurship Policy Digest—How Entrepreneurs Access Capital and Get Funded** (June 2, 2015), http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/how-entrepreneurs-access-capital-and-get-funded (stating that the “main sources of equity financing are angel investors and venture capitalists, which finance less than 3 percent and 1 percent of new firms, respectively”).

3. A summary of examples of such resources is included as Exhibit A to this Article. This summary was presented by the authors at the 2017 Transactional Clinical Conference. An electronic version of the summary is available at https://teachvlg.com/files.wordpress.com/2017/05/revised-resources-1-pager2.pdf (last visited June 29, 2017).

4. See, e.g., **Model Legal Documents, National Venture Capital Association**, http://nvca.org/resources/model-legal-documents/ (last visited June 29, 2017) (“By providing an industry-adopted set of model documents that can be used as a starting point in venture capital financings, it is our hope that the time and cost of financings will be greatly reduced and that all principals will be freed from the time consuming process of reviewing hundreds of pages of unfamiliar documents and instead will be able to focus on the high level issues and trade-offs of the deal at hand.”); **About the Series Seed Documents, SeriesSeed.com**, http://www.seriesseed.com/posts/2010/02/about-the-series-seed-documents.html (Feb. 24, 2010) (“The Series Seed Documents should reduce both the time and cost of a financing transaction. It should go without saying, but time and money are the two things most vital to a young company.”).

ating governance structures, and raising startup capital.\textsuperscript{6} Third, leading law firms are sharing their resources and thereby giving credibility to both specific open source legal resources and the overall movement. In fact, five of the United States’ most active VC law firms in 2016 have put company formation documents online for anyone to use.\textsuperscript{7} By way of further example, the nation’s most active seed investors,\textsuperscript{8} VC law firms,\textsuperscript{9} and people affiliated with these parties\textsuperscript{10} are sharing seed financing materials with the public. Seed financing is a fancy term for startup formation/ (last visited June 29, 2017); WilmerHale LAUNCH, Document Generator, Wilmer Cutler Pickering Hale and Dorr LLP, https://launch.wilmerhale.com/build/document-generator/ (last visited June 29, 2017).


9. See PITCHBOOK VC LAW FIRMS LIST, supra note 7.

10. See, e.g., SERIESSEED.COM (Feb. 24, 2010), http://www.seriesseed.com/posts/ (presumably written by Ted Wang, Special Counsel at Fenwick & West LLP: “these are not Fenwick & West or my own form documents. Although I undertook the laboring oar (with the assistance of Khang Tran) and many of my colleagues at Fenwick & West have assisted me in the original drafts, these documents are intended to be an open source project and not particular to any lawyer or law firm. Similarly, this is not an Andreessen Horowitz undertaking. Although I am pleased to have the firm’s support in launching this effort, the Series Seed Documents will require broad adoption in order to become an effective standard. The following investors have agreed to use the Series Seed Documents in certain of the [sic] their deals: Baseline, Charles River Ventures, SV Angel (Ron Conway), First Round Capital, Harrison Metal Capital, Mike Maples, Polaris Venture Partners, SoftTech VC and True Ventures.”) (Fenwick & West LLP is also one of the firms listed in the PITCHBOOK VC LAW FIRMS LIST, supra note 7).
capital, which every business needs. In addition to being battle-tested, these open source legal documents have a better chance of being supported by others and even creating standards. In fact, the similarities found when comparing these resources against each other suggest that standards and best practices have already emerged. This provides a fourth reason to consider these resources—many firms unable to raise venture capital are now able to take advantage of strategies that they previously did not have the ability to pursue. For example, the resources make it easier for these firms to grant employees equity that is subject to vesting or to create two classes of stock. Neither of these options is typically used in community-based businesses but could be if incorporated into standard formation documents that are used widely and available broadly. They may even influence how lower growth, less complex businesses incentivize employees and owners. These strategies were previously too complex and costly for most entrepreneurs to employ. However, the combination of open source legal documents and new tools and practices make it feasible for additional entrepreneurs to benefit from these strategies. The end result is that there is a leveling of the playing field for all entrepreneurial ventures, whether located in Silicon Valley, inner-city Chicago, or Clinton, Iowa.

III. Evolution of Open Source Tools and Practices

Form banks have long existed in law firms across the country. Lawyers rarely create a document starting with a blank piece of paper, or these days a blank screen. Lawyers are more efficient when customizing a docu-

11. While seed investors may include angel investors, or funds associated with accelerator programs, they may also include an entrepreneur's friends and family members.
13. See, e.g., Portions of a Restricted Stock Purchase Agreement, generated by Cooley GO's Incorporation Package, attached as Appendix B to this Article.
14. It is well settled that companies seeking venture capital will leverage a structure that includes two classes of stock. One class, the less expensive common stock, is reserved for a company's founders and other employees. The other class, the more expensive convertible preferred stock, is issued to the venture capitalists. By holding convertible preferred stock, venture capitalists have rights and preferences generally not given to holders of common stock. In addition to providing investors with unique economic and control rights, issuing them convertible preferred stock may help to justify the lower fair market value for common stock and the associated minimal tax on employee incentive compensation. See, e.g., Constance E. Bagley & Craig E. Dauchy, The Entrepreneur's Guide to Law and Strategy 95–97 (5th ed. 2017); Ronald J. Gilson & David M. Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harv. L. Rev. 874, 879 (2003) (convertible preferred stock is "practically the exclusive means of external financing for U.S. venture capital-backed companies"); Michael A. Woronoff & Jonathan A. Rosen, Practitioner Note, Effective vs. Nominal Valuations in Venture Capital Investing, 2 N.Y.U. J.L. & Bus. 199, 206 (2005).
ment from an existing template than creating a new document from scratch every time. Clients benefit from this efficiency as well in the form of lower costs and quicker turnaround times. However, an unintended consequence to this practice is the notion that lawyers use the same form over and over again and just change the names. That notion has created the belief in many consumers that if they simply had the forms, they could change the names and do the work themselves. Some assert businesses like LegalZoom.com, Inc. and Incorporate.com have seized upon this belief by offering generic forms that consumers can fill in to complete before executing—no lawyer needed. The appeal is obvious—save money by not hiring a lawyer. The implication is that lawyers are not essential. The result, however, may be documents that do not comply with jurisdictional requirements or local laws, documents that do not address the factual reality of a particular business, and documents that were generated without any input from the consumer. Often, consumers that have utilized these types of self-help documents seek out legal counsel at some future point because they have discovered that their documents are a mess. Lawyers are often retained to clean up these messes.

Considering this context, the remainder of this Part III summarizes the evolution of tools and practices associated with open source legal resources. Resources aimed at VC seeking companies are used as examples; however, as discussed in Parts IV and V, many of these tools and practices can be utilized by the entire spectrum of entrepreneurs as well as the organizations that support them. We selected these as our examples for two reasons. First, there is a strong ecosystem of VC seeking companies and it has a solid history of providing open source legal resources. Second, these examples highlight the fact that established, sophisticated international law firms utilize these tools and practices, making it difficult for anyone to argue that only uniformed solo practitioners or small niche firms are engaging in these actions.

15. LegalZoom.com, Inc., https://www.legalzoom.com (last visited June 29, 2017) (noting the LegalZoom.com, Inc. disclaimer reads, “Disclaimer: Communications between you and LegalZoom are protected by our Privacy Policy but not by the attorney-client privilege or as work product. LegalZoom provides access to independent attorneys and self-help services at your specific direction. We are not a law firm or a substitute for an attorney or law firm. We cannot provide any kind of advice, explanation, opinion, or recommendation about possible legal rights, remedies, defenses, options, selection of forms or strategies. Your access to the website is subject to our Terms of Use.”).

16. Incorporate.com, https://www.incorporate.com (last visited June 29, 2017) (noting small print at the bottom of Incorporate.com’s website that “incorporate.com is a service company and does not offer legal or financial advice”).

17. See, e.g., John F. Coyle & Joseph M. Green, Startup Lawyer 2.0, 95 N.C. L. Rev. 1403, 1412 (2017) (“In 2003, the National Venture Capital Association (‘NVCA’) published a set of ‘model’ documents for venture finance transactions.”).
A. Shared Documents and Collections

After cleaning up enough messes caused by using the low-cost, non-lawyer forms, some lawyer presumably thought to post her own form documents that were at least vetted by her and other members of her firm and thus likely to be of higher quality than those documents that were then available in the marketplace. The lawyer-posted forms may have addressed company formation, business governance, or seed financing and were available on her law firm’s website for visitors to access. These lawyer-posted forms were not advertised or marketed, but were available to enterprising entrepreneurs who may have been considering hiring that lawyer in the first place. The firm’s intent was not for the entrepreneurs to use the forms themselves, but to see what well-crafted forms looked like in order to influence the entrepreneurs to call the lawyer to help draft and execute their own documents. Eventually, resources like Orrick’s Startup Form Library emerged and went further by providing comprehensive sets of starting point documents that can be downloaded and completed by anyone with an Internet connection. In addition to providing more documents, these collections create value by ensuring that various documents work well together. For example, if an entire set of incorporation documents is provided and maintained by one source, that set’s organizational resolutions, bylaws, and restricted stock purchase agreements are more likely to accurately reference each other and to otherwise be internally consistent.

B. Wizards and Generators

Wizards and generators, such as Cooley GO’s Incorporation Package, went beyond sharing collections of starting point documents. When using wizards and generators, people enter specific data into simple online forms designed to solicit only the necessary information. An online program or “wizard” then “generates” (i.e., completes) the applicable documents by populating appropriate fields within each document with the user-provided data. The documents created by the wizards and generators are immediately made available online in a compressed (ZIP) folder that can easily be saved by the user. The wizards and generators add value by allowing users to focus on providing small amounts of data be-

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18. See Orrick, Herrington & Sutcliffe LLP, supra note 5.
19. Problems are more likely to arise if documents from multiple sources are used instead of documents from one set. For example, a right of first refusal may be found in bylaws prepared by one author but restricted stock purchase agreements drafted by another. If a company used each such document, and thus granted the same right using two different documents, issues would arise if the terms of the right of first refusal varied by document.
fore addressing the much lengthier documentation. As an example, it took the authors approximately ten minutes to enter data into the online forms associated with Cooley GO's Incorporation Package. Of course, Cooley GO's Incorporation Package is only one such generator. The authors reference it frequently throughout this Article to demonstrate various aspects of open source documents. However, resources provided by other law firms, including firms referenced in Appendix A, are also available. The wizard then took less than one additional minute to generate twenty-four entity formation-related documents. The Cooley GO offering (and others like it) is a substantial step forward to the consuming entrepreneur. If they were already inclined to form their company without formal legal assistance, the Cooley GO Incorporation Package saves the entrepreneur the time of figuring out what documents she needs. Further, the information that an entrepreneur must gather in advance of making any decisions is centralized and summarized in one location.

C. Incorporating Terms and Conditions by Reference

Interestingly, some of the documents generated by wizards also shift lengthy legalese from an otherwise long agreement into a separate "terms and conditions" exhibit, which is attached to a much shorter agreement that incorporates the terms and conditions by reference. The result is a simple and short document that contains only the key business terms and signature blocks with the lengthier text (i.e., legalese) attached as an exhibit. Portions of a Restricted Stock Purchase Agreement, generated by Cooley GO's Incorporation Package, are included in Appendix B of this Article in order to provide an example of this approach. In this particular case, the terms and conditions approach turned a nine-page agreement into a one-page agreement with a signature page and a seven-page exhibit containing the terms and conditions.

D. Comprehensive Platforms

Another development is the use of comprehensive platforms, such as those offered by Shoobx, Inc., eShares, Inc., and Gust. These subscription-based platforms leverage technology to help companies with various legal and related needs, which may include forming entities, onboarding employees, granting equity, administering stock incentive plans, managing equity ownership, storing records and documents, performing bookkeeping and payroll functions, obtaining electronic signatures, obtaining board and stockholder approvals, communicating with counsel, raising capital, and conduct-

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21. While some appreciate this feature, others are concerned that value is actually lost (not gained) when it is easier for users of legal documents to more easily avoid reading the legal provisions.

ing due diligence. While the pricing for these comprehensive platforms varies depending on a company's particular needs and size (e.g., number of employees, number of investors, and storage space needs), at least one of the platforms offers a free version to small companies. Once again, top VC law firms are already using these resources, but the potential benefits apply to a much broader spectrum of entrepreneurs.

Combining the terms and conditions approach with comprehensive platforms creates interesting possibilities. In such a world, managers of platforms, attorneys, and others could analyze which documents have a significant terms and conditions component. Those documents could then be broken up so that the terms and conditions could apply to an entire group using the platform. This group of users could range from people within a single company to all of the users of a platform. Members of the group could use much shorter forms to capture user-specific information and incorporate the lengthier terms and conditions by reference. For example, the terms and conditions of a restricted stock purchase agreement could apply to founders and employees of a single company (or, if desired, all companies using a platform). Thus, when founders and other employees acquire their company’s common stock, a simple form could capture specific information for each individual (e.g., the individual’s name and address, purchase date, number of shares being acquired, purchase price, and vesting commencement date). The individual would also agree that the applicable terms and conditions apply. Examples of other items with heavy terms and conditions components include stock option plans,

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23. Id.

24. See SHOOBX, INC., https://www.shoobx.com/pricing/ (last visited June 29, 2017) (offering free service to small businesses with up to five workers, up to 10 stockholders, one class of common stock, and up to 100MB of storage space).


26. In the spirit of the open source movement, perhaps parties who do not even use a platform could incorporate the terms and conditions of various documents by reference if, for example, the terms and conditions were made available on an open website.

27. Ancillary documents would also be created. Platform users should still understand the consequences of using the resources. However, as more users adopt the same terms and conditions, offering reusable high-quality educational materials becomes more feasible. Furthermore, platforms and their users will need to con-
employment agreements and policies, and seed financing documents. However, due to the complex nature of issuing equity, users should be advised to seek legal counsel to ensure compliance with securities, tax, and other laws. They may also desire to engage counsel and other professionals who are able to use the same platform. This results in simplification for entrepreneurs, more productive basic services, and tied-in professionals who are ready to get more involved when complexities arise.

E. Ethical and Professional Responsibility Issues

Open source legal resources, tools, and practices present at least six ethical and professional responsibility issues. First, are providers of wizards, generators, or platforms practicing law when they create legal documents for users who share specific facts and circumstances? Unfortunately, there is uncertainty as to what constitutes the practice of law. Because of this uncertainty, some attorneys do not adopt tools and technologies that could provide underserved clients with more affordable solutions. Other members of the legal profession use the tools and technologies but take additional precautions. With respect to wizards and generators, the attorney-providers' terms of use attempt to make clear that the providers are not practicing law, even though they are law firms (unlike LegalZoom.com, Inc. and Incorporate.com). With respect to comprehensive platforms, some law

erider that some aspects of such agreements, such as state securities laws and the requirement for spousal consents, tend to vary significantly by state law.

28. However, platforms and their users will need to consider that some documents, such as Confidential Information, Invention Assignment, and Non-Compete Agreements, tend to vary significantly by state law.

29. See, e.g., Jacqueline Nolan-Haley, Lawyers, Non-Lawyers and Mediation: Rethinking the Professional Monopoly from a Problem Solving Perspective, 7 Harv. Negoc. L. Rev. 235, 262 (2002) ("Efforts to define the 'unauthorized practice of law,' or conversely the 'practice of law,' are characterized, at best, by longstanding ambiguity. The ethical rules governing lawyers' behavior do not define unauthorized practice and instead leave it to the states for individual determination. There is little uniformity in the definition of unauthorized practice or law practice.

. . . Despite the uncertainties of what constitutes the practice of law, vagueness challenges to UPL statutes have been routinely rejected.").

30. See, e.g., Mary Juetten, Part V: Examining LegalTech Adoption, Law Tech Today (Jan. 19, 2016), http://www.lawtechnologytoday.org/2016/01/part-5-mary-mary-juetten/ (quoting an attorney who worked at two law tech startups: “It’s not necessarily the technology that lawyers have trouble with adopting; it’s how and when they’re permitted to deliver their services. So, for us, we see a major barrier being regulatory ambiguity. . . . As technology develops that can help provide more affordable and accessible support for families, we should see regulations get clarified and evolved so they don’t do more harm than good.").

31. See, e.g., COLEY LLP, Cooley GO Does Terms of Use, accessed by clicking “Click here” at https://www.cooleygo.com/documents/ incorporation-package/ (“You acknowledge and agree that the making available of these documents (the “Cooley
firms have embedded the tool within their business models by having clients use the platforms as a part of their attorney-client relationship.\textsuperscript{32}

Second, are the users of these resources protected by attorney-client privilege? The answer to this question should mirror the answer to the first question, i.e., if the attorney-client relationship exists, the attorney-client privilege applies. Once again, out of uncertainty or as a precaution, attorney-providers' terms of use attempt to make clear that neither an attorney-client nor other confidential relationship exists.\textsuperscript{33}

Third, does providing these resources constitute attorney advertising? Here, the law firms providing the resources assume that their actions could amount to attorney advertising and simply make the required disclosure of such.\textsuperscript{34}

Fourth, security issues should be considered, particularly with respect to the comprehensive platforms since confidential documents may be stored on servers for long periods of time and outsiders may be allowed access to certain items but not others. While uses of technology often involve security risks, that risk would presumably be managed by experts engaged by platform operators. Although this results in attorneys and law firms having less control, important security tasks would be taken care of by professionals with the proper expertise. However, several attorneys are still concerned about ethics-related issues, including the protection of confidential information and preservation of the attorney-client privilege.\textsuperscript{35} Considering various ethics opinions that address cloud computing, issues to con-

\textsuperscript{32} See supra note 25.

\textsuperscript{33} It may also be possible that, even if the attorney-client relationship does not actually exist, a prospective client using the resources expects confidentiality and thus possibly makes the attorney-client privilege applicable.

\textsuperscript{34} See supra note 31.

\textsuperscript{35} See, e.g., Robert Ambrogi, This Week In Legal Tech: Lawyers Still Fear The Cloud, ABOVE THE LAW (Nov. 7, 2016), http://abovethelaw.com/2016/11/this-week-in-legal-tech-lawyers-still-fear-the-cloud/?rf=1 (discussing concerns regarding attorneys' use of cloud computing: "[a]s for concerns about security and confidentiality, lawyers are right to worry about them. After all, lawyers are bound by rules of professional conduct to safeguard confidential client information and to protect client property, including client files, from loss. However, ethics panels in at least 20 states have considered lawyers' use of cloud computing and have been unanimous in ruling that lawyers may ethically use the cloud—provided they take reasonable steps to minimize risk to confidential information and client files.").
sider may include the reputation of the company providing the platform, whether attorneys can access data on the platform without restriction, whether attorneys can retrieve data from the platform after service is terminated, whether the platform uses advanced passwords and two-step verifications, the policies governing how the platform’s employees and third-parties may access data, whether data is encrypted while in transit and when stored on the servers, data backup procedures, and security protections in place at data centers used by the platform. While companies often share this information openly on their websites, attorneys should contact platform companies directly when they are unable to confirm this information.

Fifth, many attorneys may resist using tools and practices that make it easier for clients (and even non-clients) to avoid dealing with complex legal issues when completing transactions (e.g., by moving legalese from documents to terms and conditions, which are then attached to the resulting—and much shorter—documents). The merit of this concern depends on several factors, including (1) whether users would be more likely to read and understand the legalese if it were included in the document itself, and (2) whether the terms and conditions are standards that users of documents will be aware of, even if they fail to read the legalese each time they engage in the applicable transaction. An example of the applicable risk comes from considering the bylaws that the Cooley GO Incorporation Package generates. The bylaws are the constitution of a corporation. They provide the rules by which the business will be governed. In a corporation, bylaws often articulate the rights of owners and, as a result, give rise to remedies if those rules are not followed. When the authors used the Cooley GO Incorporation Package, the generated bylaws were twenty-four pages long. They are comprehensive and thorough. If a startup’s founders used Cooley GO to form their company and failed to read or understand the bylaws, the startup and its founders may be open to a stockholder lawsuit.

Finally, while ethical issues may challenge the use of these resources, it is also argued that both (1) the legal community has failed to satisfy its ethical obligation to ensure access to justice for the low and middle-income populations and (2) solutions like open source legal resources can improve that access. Thus, ethical considerations cut both ways and could support the use of these resources since they make legal services more affordable and more available to a wider segment of the entrepreneurial population.

While many ethical and professional responsibility issues have been raised, it is worth remembering that examples provided in this Article involve several respected international law firms. Even if “everybody’s
doing it” is not always a good defense, this Article presents evidence that a significant number of prominent members of the legal community are not only supporting open source legal resources—they are already providing them to the public on their websites.

IV. Impacting a Broader Spectrum of Entrepreneurs

Open source legal resources like the Cooley GO Incorporation Package and Orrick Startup Forms Library were designed for high growth emerging companies that have the potential to attract outside investor capital. For many law firms, startup formation work is unprofitable. A financing transaction, however, is more likely to generate significant fees. But very few startups will attract outside investment. Yet, some best practices contained in the tools and forms provided by open source legal resources apply to all entrepreneurs across the spectrum. First, these resources bridge the gap between expensive legal services and do-it-yourself options by providing foundational documents that entrepreneurs and attorneys can use to reduce transaction costs. Second, when entrepreneurs utilize comprehensive platforms, the quality of the legal and related services they receive may actually increase, even though transaction costs decrease. For example, by providing ways for entrepreneurs to manage and store information and more effectively communicate with others (e.g., legal counsel, other professionals, investors, co-managers, and employees), platforms encourage better transactions, compliance, and record keeping. Third, if the same quality documents are available online for all ventures, whether VC seeking or community-based, at least one structural impediment is removed. Entrepreneurs in different markets with different demographics, in theory, have the same legal construct and foundation from which to build their enterprises.

A. Additional High Growth Profit Driven Ventures

While VC-backed companies make up a small percentage of all entrepreneurial ventures, many additional high growth profit driven ventures should be able to take advantage of open source legal resources already available to VC seeking companies. This is because they share similar formation and financing goals. For example, many of these additional firms will also benefit from issuing equity to members of their teams and making that equity subject to vesting. In fact, since these additional firms are not raising VC, they should be even more dependent on using their equity to recruit, compensate, and retain talented employees. Moreover, although companies not seeking VC would appear to save money by forming entities in their home states (instead of Delaware, as many VC seeking companies do),39 they may actually save money by forming their busi-

39. Forming the entity in one’s home state (instead of forming it in Delaware and then qualifying to do business in the home state) will eliminate the require-
nesses as Delaware corporations. This is because the costs savings from using existing resources designed for Delaware corporations may outweigh the extra costs of having to qualify their Delaware entities in their home states and pay ongoing fees in both Delaware and their home states. For example, assume an entrepreneur can either pay a Chicago attorney: (1) $2,000 to organize an Illinois corporation and provide the applicable startup documents or (2) $500 to qualify a Delaware corporation, formed using an incorporation package, to transact business in Illinois. Assume further that the annual incremental cost of paying the Delaware franchise tax, annual report fee, and registered agent fee equals $500.40 The initial $1,500 of savings appears to last only three years. However, additional resources designed for Delaware corporations, such as financing-related documents, may also reduce ongoing legal costs. Moreover, the business should consider reasons why VC seeking companies prefer Delaware, such as making it easier to raise funds from investors located in several states. These considerations apply to these additional high growth ventures as well. By way of further example, and because they will issue equity to their team members, these additional firms will benefit from leveraging and preserving two classes of stock. Granting equity to employees, making that equity subject to vesting and leveraging two classes of equity are strategies that are more commonly used by companies raising venture capital. However, the democratization of legal documents and online tools has created a new market of additional ventures that are now ready to tap this startup know-how. This new market is huge and its emergence should come as no surprise, since "if only the skilled and the rich have access to a product or service, then you can reasonably assume the existence of a market creating opportunity."41

40. Filing fees with the Illinois Secretary of State should be a "wash" since they must be paid in either scenario, i.e., these fees must be paid regardless of whether the company is formed as (1) an Illinois corporation or (2) a Delaware corporation that then qualifies to transact business in Illinois.

41. Clayton M. Christensen & Derek van Bever, The Capitalist's Dilemma, Harvard Bus. Rev. at 5 (June 2014), https://hbr.org/2014/06/the-capitalists-dilemma ("Market-creating innovations have two critical ingredients. One is an enabling technology that drives down costs as volume grows. The other is a new business model allowing the innovator to reach people who have not been customers (often because they couldn't afford the original product). Think of it like this: An efficiency innovation pointed in the right direction—toward turning nonconsumption into consumption—becomes a market-creating innovation. Ford's Model T, for example, brought automobile ownership within reach for most Americans because of both its simple design and the revolutionary assembly line that brought scale to the enterprise. In the same way, Texas Instruments and Hewlett-Packard used solid-
B. Social Ventures

Social ventures are enterprises that champion people (often workers) and the environment as well as profit. They will also benefit from utilizing open source legal resources and the tools and practices discussed above. Like VC seeking companies, entrepreneurial social ventures commonly have formation and seed financing goals. However, the specific documents needed may differ significantly from the templates available for VC seeking companies. For example, social ventures are likely to consider additional entity types, such as not-for-profit corporations, L3Cs, benefit corporations, and worker cooperatives. Moreover, social ventures are likely to form entities in their home states (instead of Delaware, as many VC seeking companies prefer to do). Thus, social ventures require resources that support multiple entity types from numerous jurisdictions. While this diversity brings flexibility and other benefits, it makes it more difficult to develop standards and provide scalable open source materials. Further, financing materials used by VC seeking companies would be inappropriate for many social ventures, including those prohibited from issuing ownership interests that provide economic returns (e.g., if the social venture is a 501(c)(3)). Despite these challenges, social ventures still benefit from open source document collections, wizards and generators, and comprehensive platforms aimed at their unique needs. In fact, resources have been available to the public for several years via the IRS.gov website. These resources include information about tax-exempt organizations, forms and instructions, and an interactive wizard-like form that provides definitions, examples, explanations, links to resources, and prerequisite questions for users. Non-government organizations also provide resources aimed at social ventures.

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state technology to bring low-cost calculators to millions of students and engineers worldwide.”)


45. See, e.g., SLS Mills Legal Clinic, Stanford Univ., Nonprofit Corporations: Forms and Sample Documents, https://nonprofitdocuments.law.stanford.edu (last visited Sept. 1, 2017); B Lab, How to Become a Benefit Corporation, http://benefitcorp.net/businesses/how-become-benefit-corporation (last visited June 29, 2017); Public Counsel, Publications (Community Development), http://www.publiccounsel.org/publications#Community Development (last visited June 29,
C. Community-Based Ventures and Small Businesses

Community-based ventures are those that typically do not employ a high growth strategy or attract professional investors. These are corner stores, restaurants, barber shops, beauty salons, dry cleaners, and daycare centers that populate the landscape of most communities in America. When starting a community-based venture, the legal needs are no less significant than those of a high growth, VC-backed business. There are formation issues, regulatory and licensing requirements, liability concerns, and governance needs. Because the capital behind these ventures is typically that of the entrepreneur and her friends and family, the stakes are arguably higher than for the VC-backed firm. If the business fails, the entrepreneur risks everything.

The same is true of the “small business.” Some argue that small business is not entrepreneurial in the same manner as the high growth VC seeking venture and that communities serious about economic development should focus on supporting high growth ventures. Listening to these positions, one might attempt to encourage small business owners to transform their companies into high growth ventures. That is, some small businesses may actually be quite scalable. For example, a current coffee shop might become the next Starbucks or an existing corner store might become the next Whole Foods Market. If such efforts worked, and applying the logic expressed in Part IV.A, the resources available for VC seeking companies would fit more entrepreneurs. However, even if such conversion efforts were desirable and wildly successful, small businesses would still continue to make up a significant part of the economy—and they would benefit from having access to more resources aimed at their particular needs. Like social ventures, these entrepreneurs need formation-related resources that support multiple entity types from numerous jurisdictions. They would also benefit from resources that could support employment and other contracting needs and platforms designed to help with bookkeeping, payroll, and other tax matters. There is an opportunity to offer more open source legal resources aimed at these entrepreneurs. Part V.B discusses some initiatives currently underway.


46. See, e.g., Rui Baptista & Ana Naia, Entrepreneurs Education: A Selective Examination of the Literature, 11:5 FOUNDATIONS AND TRENDS IN ENTREPRENEURSHIP 337, 342 (2015) (“while economists may regard all kinds of self-employment as entrepreneurship, organizational theorists are more likely to focus on the creation of growth-orientated ventures”).

47. See, e.g., Daniel J. Isenberg, How to Start an Entrepreneurial Revolution, HARVARD BUS. REV. at 6 (June 2010) (arguing that community development programs “should try to focus first on ambitious, growth-orientated entrepreneurs who address larger potential markets”).
V. Impacting Organizations that Assist Entrepreneurs

Entrepreneurs are not the only population set that can benefit from open source legal resources. Law firms, law school clinics, small business development centers, business accelerators, accounting and tax advisors, university entrepreneurship centers, and crowdfunding portals can also gain from the development and proliferation of free online legal tools.

A. Law Firms

Silicon Valley based law firms represent a tiny slice of legal service providers to entrepreneurs. Most entrepreneurs cannot afford the market rates of large law firms that must cover the high fixed cost of large overhead. If a startup is going to consult an attorney, it is more likely to be a small firm or solo practitioner. Often firms of this size do not have the same quality of form banks or collections of standardized documents that larger firms do. The technology they employ is also typically less sophisticated than that of large firms. For these smaller firms and solo practitioners, having access to the form banks of larger firms that regularly do more sophisticated and higher volumes of work, levels the playing field a bit. The non-VC law firms can essentially offer the same product as the VC law firms by utilizing their online tools and resources. The non-VC lawyers can also modify the templates to fit the transactions of their clients.

Since there is a void in the current offerings of open source legal resources aimed at community-based ventures and mainstream small businesses, regional and other smaller firms might develop their own tools to service the entrepreneurs from their own communities. Perhaps local bar associations could play a role, much like the National Venture Capital Association did for VC-backed companies when it commissioned attorneys from several firms to develop and maintain its model legal documents. These firms also have an opportunity to collaborate with legal clinics already taking steps to address this gap.

B. Legal Clinics

For the VC law firms, business formation work is usually unprofitable yet necessary to get the client to the next stage. For lawyers representing community-based ventures and other small businesses, it is also difficult to bill clients for the time necessary to properly form a company. Often the work is done at a flat rate. Though entity choice and selection can be a complex issue for some ventures, it is pretty straightforward for most entrepreneurs. Open source documents provide lawyers, both VC law firms

48. For example, online services such as UpCounsel provide entrepreneurs with attorneys (most of whom formerly practiced at large law firms) on demand for project-based services. See UpCounsel, Inc., https://www.upcounsel.com/ (last visited June 29, 2017).
49. See National Venture Capital Association, supra note 4.
and others, with a tool that allows them to be more efficient and cost-effective for their startup clients. That allows the lawyers and clients the ability to spend more time on higher value-add services.

The same holds true for law school clinics. There are over 150 transactional clinics spread across America's 200 law schools. Nearly all of them provide pro bono legal assistance to entrepreneurs and organizations. But because they are typically curricular offerings within law schools, they are limited in the number of clients they can service at any given time. Existing open source legal resources provide transactional clinics with the ability to service more clients with formation issues, much more efficiently.

Many transactional clinics service community-based enterprises and other mainstream small businesses rather than high growth, VC seeking companies. Thus, the vast majority of businesses created in the United States resemble the types of businesses represented by transactional clinics. These businesses typically have fewer resources and less access to advisors than high growth ventures. Until very recently, there was almost a complete void in the open resource marketplace. Specifically, there was very little explanation or guidance for the material that was made publicly available for download. There were a lot of forms but little educational guidance. As such, an entrepreneur was on their own to figure out whether a document was relevant to him, how to manipulate it, and whether to execute it. Open source offerings began to alter that with the inclusion of tutorials, brief articles, and frequently asked questions; however, the educational content void is still large.

Some law school clinics have attempted to fill that void with offerings targeting community-based enterprises and small businesses. Two such initiatives are the University of Pennsylvania Law School's Entrepreneurship Legal Clinic's (ELC) StartUp Kit and the Legal Technology Laboratory's Startup Advisor Toolkit.

With Penn ELC's StartUp Kit, the user is presented with numerous modules, each addressing common obstacles entrepreneurs face in getting their business off the ground. The modules include founder's agreements, entity choice, seed financing, financing generally, convertible notes, employment law, intellectual property, and independent contractors. Each


51. That efficiency may come at the expense of pedagogy and learning, however. The balance between legal training of law students and client service is an important consideration for law school clinics but beyond the scope of this Article.

52. These initiatives were addressed at the Transactional Clinical Conference held at the University of Pennsylvania Law School on June 2, 2017.
module includes some combination of a primer on the topic, checklists to assist in self-navigation, and annotated sample documents. The StartUp Kit also contains interactive web tutorials to facilitate entrepreneurs’ deeper understanding of these and related topics. In creating the StartUp Kit, the ELC recognized the reality that entrepreneurs are going to continue creating businesses on their own without consulting lawyers. However, in order to help them avoid common mistakes, the StartUp Kit offers user-friendly materials written specifically for non-lawyers and designed to educate as well as service entrepreneurs.53

Another online resource targeting mainstream small businesses is the Legal Technology Laboratory’s Startup Advisor Toolkit, which will have two parts: (1) the Founders’ Terms Sheet Generator Tool and (2) the LLC Formation suite of tools.54 The Founders’ Terms Sheet Generator Tool, which was designed for startups in their initial formation stage, addresses the rights and obligations between/among co-founders who are not seeking (and may never seek) VC or other professional investors.55 The LLC Formation suite of tools will include checklists, templates, transmittal letters, and documents to complete the state-specific formation requirements of LLCs and it will initially be an online tool for law school entrepreneurship clinics serving a broad range of jurisdictions.56 In contrast to Cooley GO’s Incorporation Package, the LLC Formation suite of tools is being designed to help entrepreneurs create limited liability companies. The thought behind this is that most small businesses are better off as LLCs rather than corporations, especially if they do not seek to raise venture capital. LLCs are more flexible, less formal, and easier to administer in most circumstances. They still provide limited liability to owners while allowing flexible management structures.

Because both of these toolkits are aimed at community-based enterprises and are suitable for LLCs, they have the ability to bridge the gap between community-based enterprises and legal resources designed for VC seeking companies. In so doing, these toolkits help democratize access

53. The Penn ELC StartUp Kit can be found at https://www.law.upenn.edu/clinic/entrepreneurship/startupkit/ (last visited Sept. 9, 2017).
54. See Portfolio: Automated Document Creation, LEGAL TECHNOLOGY LABORATORY, http://www.thegaltechlab.com/portfolio/automated-document-creation/ (last visited June 29, 2017) (The Founders’ Terms Sheet Generator Tool project is being led by Tony Lupino, the Rubey M. Hulen Professor of Law and Director of Entrepreneurship Programs at the University of Missouri-Kansas City; Jeff Ward, Associate Clinical Professor of Law and Director of the Start-Up Ventures Clinic at Duke University Law School; and Larry Farmer, Director of the MediaNotes Project and J. Reuben Clark Law School Faculty at Brigham Young University. The LLC Formation suite of tools is also being developed by Jeff Ward and Larry Farmer.).
55. Id.
56. Id.
to legal documents and startup know-how for these underserved entrepreneurs who form the backbone of small businesses across the country.

C. Small Business Development Centers and Accelerators

Non-legal service providers, such as small business development centers and business accelerators, are also poised to benefit from open source legal resources. Small business development centers are a nationwide network of nonprofit organizations affiliated and supported by the Small Business Administration; they provide business consulting and business planning advice to entrepreneurs.57 Business accelerators are mostly for profit ventures that provide education, mentorship, and sometimes financing to early stage ventures. Unlike SBDCs, which often offer à la carte services for all types of entrepreneurs to sample and participate in, accelerators are usually selective in the businesses they work with and often require participation in a fixed duration educational program followed by formal mentoring. Some take equity in the companies they assist as payment.58 As organizations designed to help businesses create business plans and start their ventures, the desire to assist in creating the legal foundation for the entrepreneurs' businesses is natural. Before the development of open source legal resources, these organizations may have been practicing law without a license if they helped business founders create an entity or draft bylaws or draft a financing agreement. Now, because the documents are being provided online by law firms, business development centers and accelerators can point out the existence of these resources and perhaps assist businesses as they complete a wizard or document generator. In fact, some accelerators are even providing their own resources.59

D. Accounting and Tax Professionals

In addition to legal aspects of entrepreneurship, open source materials are impacting accounting and tax aspects of entrepreneurship as well. Accounting and tax professionals, as well as entrepreneurs themselves, stand to benefit from these open source resources. Accounting and tax issues are critical to the success of startups. If startups do not track their expenses, monitor their burn rate, invoice and collect payments from customers, keep accurate books and records, comply with applicable employment and business tax laws, and properly process payroll, they will be unable to flourish, or perhaps even survive. Furthermore, many cash-strapped

59. See Y COMBINATOR, supra note 6.
startups choose to compensate their workforce with equity rather than cash, presenting a host of accounting and tax issues.

Accounting issues, just like legal issues, are often misunderstood and not prioritized by entrepreneurs, who are primarily focused on building their businesses.\footnote{Startup Savant, Bookkeeping 101: Everything You Need to Know (May 7, 2017), https://startupsavant.com/understanding-bookkeeping/ (noting that “TD Bank surveyed over 500 small-biz owners to find out what they liked least about running their businesses, and bookkeeping won, hands-down”).} Furthermore, certified public accountants often prefer to work with more established companies that can provide lucrative auditing, financial reporting, compliance, and tax work that many entrepreneurs may not need or be able to afford. As such, entrepreneurs face hurdles in the accounting realm that mirror those in the legal realm.

Fortunately, there are various accounting platforms for entrepreneurs, many of which are conveniently integrated into open source legal resources. These enable entrepreneurs, and the accountants who advise them, to properly handle accounting and tax needs with minimal time and effort. These resources can be particularly helpful for community-based entrepreneurs because they often cannot afford extensive help from accountants and other advisors. Rather than saving boxes of receipts and simply presenting them to an accountant once per year, entrepreneurs with limited financial resources and accounting know-how can now get real-time information about the financial operations of their business. This is critical information that can enable entrepreneurs to correct course if, for example, they discover they are running out of cash because an aged accounts receivable report alerts them to large outstanding invoices. Moreover, entrepreneurs can access accountants through these resources, either on demand or by providing their accountant with direct electronic access to the platform. Although these resources are quite user-friendly and have online tutorials, many small business owners find it helpful to grant an accountant access to their accounting platform so they can ensure that transactions are properly classified under Generally Accepted Accounting Principles and that any accounting errors are corrected.\footnote{Telephone interview with Khadyja Taylor, CPA, Owner of KTD Accounting Advisory (June 22, 2017).}

For many years, there have been online tools to help small businesses manage their bookkeeping and taxes. For example, many small businesses use QuickBooks\footnote{QuickBooks, https://quickbooks.intuit.com/?xcid=seq_intuit_qb_click_hd (last visited June 29, 2017).} and TurboTax\footnote{TurboTax, https://turbotax.intuit.com/ (last visited June 29, 2017).} for their bookkeeping and taxes, respectively. Accountants who represent small business clients are very familiar with these tools because they are widely used.\footnote{Taylor, supra note 61.} In recent years,
some of these tools have migrated from download-only programs to easily accessible cloud-based and app-based programs that are constantly updated. Although some accounting tools are subscription-based, many are available for free; this may be particularly helpful for community-based or low- to moderate-income entrepreneurs. For example, there are various free, open source accounting software programs, such as TurboCASH,\textsuperscript{65} which is “known as the world’s leading open source accounting software for small businesses.”\textsuperscript{66} Another very popular free accounting software is Wave,\textsuperscript{67} which has been heavily featured in well-known publications and is designed for small businesses with nine employees or less.\textsuperscript{68}

In addition, new platforms that integrate legal, accounting, and/or tax tools have arisen in recent years, including the comprehensive platforms referenced in Part III.D of this Article: Shoobx, eShares, and Gust Launch. For example, Gust Launch has several bookkeeping and accounting packages for entrepreneurs.\textsuperscript{69}

Furthermore, many transactions that are facilitated by such comprehensive platforms have important accounting and tax implications for businesses and their employees. For example, the above-referenced platforms help companies issue equity to employees, which presents issues under several sections of the Internal Revenue Code, including Sections 409A (regarding deferred compensation), 83(b) (regarding the recognition of income), and 422 (regarding incentive stock options). Some of these provisions can result in substantial penalties—such as a 20% penalty in the case of Section 409A—if non-compliance occurs.\textsuperscript{70}


\textsuperscript{68} Id.

\textsuperscript{69} These include: (1) a pre-revenue package for $99/month that provides basic bookkeeping for very early-stage companies, which includes monthly financial statements, bookkeeping by Simplexity and accounting software by Xero, as well as (2) a revenue and billing package for $199/month, and (3) CFO services at customized prices. Gust, Gust Launch FAQ: What Is Provided in Each Financials Package? (June 1, 2017), http://faqs.launch.gust.com/article/301-what-is-included-in-each-financials-package.

\textsuperscript{70} Tahir J. Naim, Section 409A Valuations and Stock Option Grants for Start-up Technology and Life Science Companies, Fenwick & West LLP, http://www.fenwick.com/FenwickDocuments/409_Valuations_Stock_Options.pdf (last visited June 29, 2017) (“Employees, officers, directors and consultants who receive stock options with exercise prices that cannot be shown to be at or above the
The platforms referenced above have wizards that ask a series of questions to promote compliance with these sections of the Code. For example, companies issuing stock options need to ensure that the strike price is at least equal to fair market value on the grant date for compliance with Section 409A of the Code. The platforms provide 409A valuations to assist entrepreneurs with determining the fair market value of their company's equity. 71

It is important to note that because these are complex sections of the Code, users are advised to consult with an accountant or tax lawyer for further guidance. However, having tools at their disposal can be very valuable for entrepreneurs—especially those with limited resources—as well as the accountants who advise them. Ultimately, these various accounting resources, just like the legal resources described in this Article, can help level the playing field between community-based entrepreneurs and VC-backed entrepreneurs.

E. University Entrepreneurship Centers

Open source materials are also impacting university entrepreneurship centers and their initiatives, including campus pitch competitions. For example, in addition to sharing educational resources about non-law topics, the University of Chicago's New Venture Challenge (NVC) provides a Simple Agreement for Future Equity (SAFE) and frequently asked questions about SAFEs on its resources webpage. 72 The NVC can also recruit judges, mentors, and advisors who support the use of these resources and are willing to use them to invest in NVC participants, which, in turn, become local businesses that create new products and services and generate employment opportunities. Thus, the NVC utilizes open source legal resources to both provide educational value (e.g., by demonstrating

reasonably determined FMV on the date of grant face immediate tax on vesting at a combined federal and state tax rate as high as 85% or more."


how seed financings can be structured and documented) and further economic development (e.g., by empowering the NVC's network of professional volunteers to make seed investments with low transaction costs). In addition to giving practicality and prestige to its program, the NVC's use of open source legal resources encourages additional positive spillover effects. For example, friends and family members of NVC participants can also use these resources to make seed investments. Moreover, people who become familiar with the resources may use them to make investments in other ventures (e.g., other local businesses not even participating in the NVC). Similar to how VC-law firms are likely to have high growth clients with access to more resources than many small businesses, the NVC is likely to have participants with high growth ambitions and access to more resources than students at typical universities. That said, universities everywhere have students with lofty dreams; the open source legal resources should be needed more (not less) by students with less resources, and the resources are equally accessible to such students. Further, the NVC's use of open source legal resources signals to other programs that use of open source legal resources is an acceptable practice.

F. Crowdfunding Portals

The Jumpstart Our Business Startups (JOBS) Act recently created a "crowdfunding exemption" that allows companies to raise up to $1 million every twelve months by selling stock (or other unregistered securities) to accredited or non-accredited investors as long as the sales are made through a registered intermediary (often an SEC registered funding portal). Prior to the JOBS Act, it was more difficult for companies to raise much needed capital from non-accredited investors. One SEC study estimated that, in 2013, 10.1% of the households in the United States were


74. However, as discussed above, resources could also be provided for additional types of entrepreneurs (e.g., social ventures and smaller community-based businesses).


76. After the passage of the JOBS Act, the SEC adjusted the $1 million amount for inflation and increased the limit to $1.07 million. See 80 Fed. Reg. 71,537 (Nov. 16, 2015), as amended at 82 Fed. Reg. 17,552 (Apr. 12, 2017).


 accredited investor households.\textsuperscript{79} While angel investors and VCs will usually be accredited, many entrepreneurs are unable to raise capital from them. Thus, the crowdfunding exemption is important because it creates a new source of capital (i.e., funds from non-accredited investors, which make up approximately 90\% of the nation's households) for historically underrepresented entrepreneurs (i.e., entrepreneurs who are unlikely to raise money from angel investors or VCs or qualify for a bank loan).

While the JOBS Act was signed into law in 2012, the SEC’s final crowdfunding rules did not permit the first equity crowdfunding transaction in the United States until May 16, 2016.\textsuperscript{80} Even though equity crowdfunding is still in its infancy, the funding portals are already embracing open source legal resources. For example, funding portals are sharing resources that entrepreneurs can use to raise capital through their platforms.\textsuperscript{81} As the founder of one SEC registered funding portal notes, these resources reduce costs for issuers raising money through their platforms and add value beyond the equity crowdfunding:

Issuers are using templated offering documents on many platforms . . . along with other tools to help them assess their valuation, complete all SEC filings, required background checks and all investor flows during the investment process. The issuer may incur modest third party expenses—like an accountant’s independent review, but these tend to pale in comparison to the $5-25k that a lawyer might charge just to create traditional offering documents. We discovered this point after being approached by a few accelerators that sought access to our platform solely for the legal offering documents for their current cohorts and alumni.\textsuperscript{82}

Equity crowdfunding also illustrates a risk associated with open source legal resources: entrepreneurs and others may use documents that are inappropriate for their transaction. For example, arguments have been made that the SAFEs being shared by funding portals are, in fact, not suitable for

(\textquotedblleft Securities laws . . . are a formidable barrier to investment crowdfunding in the United States.	extquotedblright).


\textsuperscript{80} See, e.g., Joseph M. Green & John F. Coyle, \textit{Crowdfunding and the Not-so-Safe SAFE}, 102 VA. L. REV. ONLINE 168 (2016) (\textquote{On May 16, 2016, more than four years following the enactment of the Jumpstart Our Business Startups Act . . . the much-anticipated era of retail crowdfunding officially began in the United States.}).


equity crowdfunding. Despite this risk, and given the small size of the investments in equity crowdfunding, open source legal resources are critical to reduce transaction costs to the point where the transactions are economically viable. Stated differently, even small transaction costs become economically prohibitive if the transactions themselves are quite small. Thus, open source legal resources must be leveraged to bring the transaction costs close to zero. Considering the above discussion, there may be opportunities to build entity formation resources and comprehensive platforms into funding portals. Imagine if all companies on a funding portal used essentially the same formation and financing documents, had the same stock option plan, and used the same bookkeeping and payroll tools. These resources not only reduce transaction costs associated with companies raising funds directly from crowdfunding investors, they decrease other transaction costs (e.g., costs associated with forming entities, issuing equity to employees, and secondary trades of their securities) and possibly enhance the companies’ operations (e.g., by improving compliance, record keeping, and communications).

VI. Conclusion

The open source movement has begun. Legal documents, wizards, and other resources are already available online for a broad spectrum of entrepreneurs—including underserved entrepreneurs who may stand to benefit from them the most. While these resources raise ethical and professional responsibility issues, they cannot be easily dismissed as something that only involves attorneys practicing on the fringe. Highly respected international law firms are not only supporting the open source movement, they are leading the charge by providing and maintaining high quality resources on their websites. Perhaps these firms are promoting themselves; however, they understand the importance of entrepreneurship and they see an opportunity to contribute to the ecosystem. They have the opportunity to share battle-tested resources and to make legal services more affordable and accessible to entrepreneurs who have been historically underrepresented. They also have the opportunity to help create a new market—a market where the attorney-client relationship is redefined and best prac-

83. See, e.g., Green & Coyle, supra note 80, at 170 (the SAFE “is not the right tool for channelling retail investment capital to crowdfunding companies”); Investor Bulletin: Be Cautious of SAFEs in Crowdfunding, U.S. SECURITIES AND EXCHANGE COMMISSION (May 9, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

84. While this appears to reduce options for entrepreneurs, it may reduce costs to the point where entrepreneurs actually have access to things, such as sophisticated entity structures and seed capital, they previously did not. It is also reminiscent of Henry Ford’s attributed quote that customers, who previously could not afford cars, could get a Model T in “(a)ny color . . . so long as it is black.” Patrick Vlaskovits, Henry Ford, Innovation, and That “Faster Horse” Quote, HARVARD BUS. REV. (Aug. 29, 2011), https://hbr.org/2011/08/henry-ford-never-said-the-fas
tices are themselves open sourced. While some entrepreneurs may attempt, or even need, to utilize these resources without seeking legal counsel, many will use the resources to build more productive attorney-client relationships. Other organizations that assist entrepreneurs are also shaping their business models to capture and share the value created by these resources. Legal clinics, small business development centers, accelerators, accounting and tax firms, university entrepreneurship centers, and crowdfunding portals are all taking part in the open source movement. In short, open source legal resources are disrupting many business models and astute entrepreneurs and organizations are already capitalizing on the value they add.

While this Article focused on the impact open source legal resources have on entrepreneurs and the organizations that support them, the open source movement will spark broader implications in the legal community. Other transactions could also benefit from a pool of high quality resources that are open to clients, attorneys and others. Whether entering into a lease, submitting a trademark or copyright application, creating a will, preparing a prenuptial agreement, or (if things do not work out) filing for a divorce, open source legal resources will make legal work more productive and thus more affordable and accessible. It is time to bridge the gap between traditional legal services that few can afford and customary do-it-yourself options. The open source movement is building that bridge.
# APPENDIX A

## Examples of Existing Open Source Resources

<table>
<thead>
<tr>
<th>FORMATIONS</th>
<th>FINANCINGS</th>
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<tbody>
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<td><strong>Delaware Corporation</strong></td>
<td><strong>Convertible Debt</strong></td>
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<td>Incorporation Questionnaire</td>
<td>Term Sheet</td>
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<tr>
<td>Certificate of Incorporation</td>
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<tr>
<td>Bylaws</td>
<td>KISS: Debt Version</td>
</tr>
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<td>Action by Written Consent of Incorporator</td>
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<tr>
<td>Initial Organizational Board Resolutions</td>
<td><strong>Convertible (Non-Debt) Securities</strong></td>
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<td>Founder Stock Purchase Agreement</td>
<td>SAFE: Primer</td>
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<tr>
<td>Common Stock Certificate</td>
<td>SAFE: Cap, no Discount</td>
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<tr>
<td>Indemnification Agreement/Provisions</td>
<td>SAFE: Discount, no Cap</td>
</tr>
<tr>
<td>Stock Plan</td>
<td>SAFE: Cap and Discount</td>
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<tr>
<td>Board Approval of Stock Plan</td>
<td>SAFE: MFN, no Cap, no Discount</td>
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<tr>
<td>Stockholder Approval of Stock Plan</td>
<td>Convertible Security Financing Term Sheet</td>
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<tr>
<td>Option Agreement (Grant)</td>
<td>Convertible Security Purchase Agreement</td>
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<tr>
<td>Restricted Stock Purchase Agreement “RSP” (Grant)</td>
<td>Convertible Security</td>
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<tr>
<td>Board Approval of Option/RSP Grant</td>
<td>KISS: Equity Version</td>
</tr>
<tr>
<td><strong>Delaware LLC (Single &amp; Multiple Member)</strong></td>
<td><strong>Loans</strong></td>
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<td>Certificate of Formation</td>
<td>Promissory Note</td>
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<td>LLC Agreement</td>
<td>Revenue Loan Agreement</td>
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<tr>
<td>Subscription Letter</td>
<td><strong>Series Seed Convertible Preferred Stock</strong></td>
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<tr>
<td>Contribution &amp; Assignment Agreement</td>
<td>Term Sheet</td>
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<tr>
<td>Founder’s Restricted Unit Agreement</td>
<td>Restated Certificate of Incorporation</td>
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<tr>
<td></td>
<td>Stock Investment/Purchase Agreement</td>
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<td></td>
<td>Investors’ Rights Agreement</td>
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<tr>
<td><strong>OTHER RESOURCES</strong></td>
<td><strong>Series A Convertible Preferred Stock</strong></td>
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<td>Employee Offer Letter /Employment Agreement</td>
<td>Term Sheet</td>
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<tr>
<td>Consulting Agreement</td>
<td>Stock Purchase Agreement</td>
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<td>Advisor Agreement</td>
<td>Amended and Restated Certificate Of Incorporation</td>
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<td>Confidential Info &amp; Invention Assignment Agreement</td>
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<td>Right of First Refusal and Co-Sale Agreement</td>
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<td>Website Terms &amp; Conditions and Privacy Policy</td>
<td>Management Rights Letter</td>
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<td>Equity Management Platform</td>
<td>Indemnification Agreement</td>
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<td>SOURCE</td>
<td>LINKS</td>
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<td>2 Orrick, Herrington &amp; Sutcliffe LLP’s Startup Forms Library</td>
<td><a href="https://www.orrick.com/Total-Access/Tool-Kit/Start-Up-Forms">https://www.orrick.com/Total-Access/Tool-Kit/Start-Up-Forms</a></td>
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<td><a href="http://www.foundersworkbench.com">http://www.foundersworkbench.com</a></td>
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<tr>
<td>4 Perkins Coie LLP’s Startup Percolator*</td>
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<td>6 Reed Smith LLP’s RStart*</td>
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<td>8 500Startups’ KISS (“Keep It Simple Security”)</td>
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<td>9 Y Combinator’s Startup Documents</td>
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</tr>
<tr>
<td>II WeFunder’s Loan &amp; Promissory Notes</td>
<td><a href="https://wefunder.com/faq/securities#loan">https://wefunder.com/faq/securities#loan</a></td>
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<tr>
<td>12 Ted Wang’s Series Seed Financing Documents</td>
<td><a href="http://www.seriesseed.com">http://www.seriesseed.com</a></td>
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<tr>
<td>13 Gust’s Series Seed Documents</td>
<td><a href="http://gust.com/series-seed/">http://gust.com/series-seed/</a></td>
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<td>14 NVCA’s Model Legal Documents</td>
<td><a href="http://nvca.org/resources/model-legal-documents/">http://nvca.org/resources/model-legal-documents/</a></td>
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<tr>
<td>15 Shoobx, Inc.</td>
<td><a href="https://www.shoobx.com">https://www.shoobx.com</a></td>
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</tbody>
</table>

* Resources include a generator or wizard-like tool.

DISCLAIMER. This summary has been prepared for informational purposes only. We do not assume responsibility for the accuracy, adequacy or timeliness of any information contained in it (or found through it). The fact that we have provided links to organizations does not mean that we endorse them or have any relationship with them. This information should not be considered legal (or any other professional) advice. Do not rely on this information for any purpose without seeking advice from an attorney and other qualified professionals licensed in their jurisdiction.
APPENDIX B

RESTRICTED STOCK PURCHASE AGREEMENT

This Restricted Stock Purchase Agreement (the “Agreement”) is made as of ________________ by and between Startup Inc., a Delaware corporation (the “Company”) and Ben Franklin ("Purchaser"). Certain capitalized terms used below are defined in the terms and conditions set forth in Exhibit A attached to this Agreement, which are incorporated by reference.

Total shares of Stock purchased: 4,000,000 shares of Common Stock (the “Stock”)
Purchase Price per share: $0.0001
Total Purchase Price: $400.00
Form of Payment: Cash: $400.00

Vesting Schedule:

4,000,000 shares of the Stock (the “Restricted Stock”) are subject to the Repurchase Option as of the date of this Agreement. On the date 12 months from ________________, 20__ (the “Vesting Anniversary Date”), 12/48th of the Restricted Stock shall vest and be released from the Repurchase Option; thereafter, 1/48th of the Restricted Stock shall vest and be released from the Repurchase Option on a monthly basis measured from the Vesting Anniversary Date, until all the Restricted Stock is released from the Repurchase Option (provided in each case that Purchaser remains a Service Provider as of the date of such release).

[Remainder of page intentionally left blank]
Additional Terms/Acknowledgements: The undersigned Purchaser acknowledges receipt of, and understands and agrees to, this Restricted Stock Purchase Agreement, including the terms and conditions set forth in Exhibit A attached to this Agreement, which are incorporated by reference.

COMPANY:

**Startup Inc.**

By: ________________________________

Name: Rocky Balboa
Title: Chief Executive Officer

Address: 123 Main Street
Suite 1302
Philadelphia, Pennsylvania 94500

PURCHASER:

**Ben Franklin**

______________________________ (Signature)

Address: 789 Main Street
Philadelphia, Pennsylvania 94500
EXHIBIT A

TERMS AND CONDITIONS INCORPORATED INTO
RESTRICTED STOCK PURCHASE AGREEMENT

1. PURCHASE AND SALE OF STOCK. Purchaser agrees to purchase from the Company, and the Company agrees to sell to Purchaser, the number of shares of Stock for the consideration set forth in the cover page to this Agreement. The closing of the transactions contemplated by this Agreement, including payment for and delivery of the Stock, shall occur at the offices of the Company immediately following the execution of this Agreement, or at such other time and place as the parties may mutually agree.

2. INVESTMENT REPRESENTATIONS. In connection with the purchase of the Stock, Purchaser represents to the Company the following:

(a) Purchaser is aware of the Company’s business affairs and financial condition and has acquired sufficient information about the Company to reach an informed and knowledgeable decision to acquire the Stock. Purchaser is purchasing the Stock for investment for Purchaser’s own account only and not with a view to, or for resale in connection with, any “distribution” thereof within the meaning of the Securities Act of 1933, as amended (the “Act”).

(b) Purchaser understands that the Stock has not been registered under the Act by reason of a specific exemption therefrom, which exemption depends upon, among other things, the bona fide nature of Purchaser’s investment intent as expressed in this Agreement.

(c) Purchaser further acknowledges and understands that the Stock must be held indefinitely unless the Stock is subsequently registered under the Act or an exemption from such registration is available. Purchaser further acknowledges and understands that the Company is under no obligation to register the Stock. Purchaser understands that the certificate evidencing the Stock will be imprinted with a legend that prohibits the transfer of the Stock unless the Stock is registered or such registration is not required in the opinion of counsel for the Company.

(d) Purchaser is familiar with the provisions of Rule 144 under the Act as in effect from time to time, that, in substance, permits limited public resale of “restricted securities” acquired, directly or indirectly, from the issuer of such securities (or from an affiliate of such issuer), in a non-public offering subject to the satisfaction of certain conditions.
The Wealth Gap and the Racial Disparities in the Startup Ecosystem

St. Louis University Law Journal, Vol. 68, No. 2, 2018
Boston College Law School Legal Studies Research Paper No. 486

43 Pages
Posted: 17 Aug 2018

Boston College - Law School

Date Written: August 16, 2018

Abstract

Although much attention has been given to structural inequality as it manifests in the criminal justice context, little has been said about economic inequality as it relates to the startup ecosystem. This Article details how the historic creation of the wealth gap affects entrepreneurship, highlighting how the wealth gap adversely impacts entrepreneurs of color. Entrepreneurship is a compelling solution to wealth inequality, but wealth inequality can be an impediment to success in entrepreneurship. This Article explains how the United States' history of bolstering wealth creation for some, while inhibiting wealth creation for people of color, matters for understanding the startup ecosystem today. This Article describes how access to traditional and innovative sources of capital raising perpetuates the racial wealth gap, and this Article makes concrete proposals for addressing these shortcomings.

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