

Legal Due Diligence for Initial Coin Offering

A. Background

1. I am associated with a highly proficient, high-profile, software engineering entrepreneur and thought-leader, let us call him **Josh**, reckoned by many to be one of the most experienced, and imaginative, technical and regulatory experts in the *blockchain and 'cryptocurrencies'* field. Josh, a US citizen, and a noted forensic computer systems expert, has professionally assisted me, as a Senior CASTELL Associate Consultant, with past expert witness client assignments (eg software copyright infringement cases), and he and I have for several years also been in visionary discussion and collaboration on mutually-created ideas concerning various innovative developments for implementing new forms of digital financial instruments, securities, currencies and economics in the World Digital Market.

2. Josh is in the process of developing and launching various **Initial Coin Offering** ('ICO') ventures and services, and he asserts "nobody knows more about how to do this work in the RIGHT way, in compliance with every single rule and regulation, than I do". In particular, there is a substantial going-concern OTC-listed company, let us call it **X-CAPL, Inc.** ('X-CAPL'), which is poised to do an ICO, designed, led, promoted, launched and actioned-to-market by Josh. I have been raising various legal 'due diligence' concerns over this plan to Josh, culminating in some latest exchanges:

Me: "I stand ready to assist, as ever, in seeing the professional completion of your/our first actual going-concern business implementation, X-CAPL, demonstrating that you/we have indeed unquestionably done it (a) RIGHT; and (b) in compliance with every single rule and regulation. So, please set out, for the client, and me, and the world, shorn of geeky tech-speak, exactly what is your/our defensible, credible definition of:

1) 'RIGHT', bearing in mind that there are no international standards (so, make sure you explain in detail how you/we will do thorough systems and operational testing of the software engineering before going live, in case of any later allegations to the contrary, if for no better reason).

2) 'every single rule and regulation' (bearing in mind the paradox that it is your much-stated position that there are none that apply; and, in re securing independent professional legal advice on this, agree with me that it is vital therefore that this is sought).

Come on, Josh, step up to the plate and let's show the world how to do 'this work' demonstrably carefully, professionally, rigorously, beyond regulatory challenge, commercially successfully, with client satisfaction and accolade, and as a gold standard high benchmark *modus operandi* for all aspiring others".

Josh (to the CEO of X-CAPL): "Stephen has been somewhat grumpy lately in regards to cryptocurrency in general, legitimacy thereof, scams and frauds, etc. In the process he has raised an important point that I want to be clear on as we work this detail properly into the Business Plan Summary.

There may not be a good reason for the creation of a coin whose purpose is solely a future purchase of X-CAPL products. For that function, to the extent it is one of the objectives, please just use your existing on-line store and let customers decide when they're ready to make a purchase, then fill the order.

When we engineer a new cryptocurrency the core purpose is ALWAYS the creation of a new public open source blockchain project and associated community of participants, some of whom are involved because they are your competitors seeking to sell similar products or services to the same customers. Imagine creating Bitcoin in 2009 as an X-CAPL blockchain and cryptocurrency project, but then telling people who want to use it for activities unrelated to the X-CAPL business that they aren't welcome in the community and shouldn't use the coin for their own business purpose. That would be absurd, right?

This is the reason for my 'Managed Blockchain' platform and business model. We will be creating together a brand-new open source community project, and working diligently to ensure that everyone who participates can create value for themselves. Anchoring the economic value of the cryptocurrency to its first use case, the purchase of products from the X-CAPL Smart Contracts, and later the purchase of other inventory and assets we acquire or develop, is a compelling concept. I like it and it will work, **without being any kind of securities offering**, but it's very important to remember that we're co-founding a new open platform here, not just launching an X-CAPL store using a blockchain in place of your online webstore functionality for end-user self-service order entry.

The fact that this is a new open platform we're building, and **putting the X-CAPL name on it, and that X-CAPL is 'asset-backing' its belief in the fundamental value of the cryptocurrency that bears its name**, justifies the X% share of the ICO proceeds and Y% ownership of the initial coin supply which are the standard terms of agreement for my role in this business model.

I wanted to be sure we were clear about that, and answer any questions or clear up any misunderstanding, before I include these details in the Business Plan Summary that we give to your Board.

This brings us back to one of my prior discussion points which didn't get enough of a response (presumably because it's complicated and it's not clear what the response is) -- what are you thinking presently about how pricing of X-CAPL products available from the Smart Contracts which we deploy to Ethereum and to the X-CAPL Blockchain will be determined? Whatever we start with in terms of pricing in each place where a cryptocurrency can be used to buy a Smart Contract Token, how do you envision revising those prices later?

Assume that at LEAST 100% inflation will occur in the available coin supply on the X-CAPL Blockchain in a relatively short amount of time (a few years, at most) and tell me what you expect that will do to the economics and the pricing, especially if, as will probably be the case, X-CAPL receives NO additional revenue from the organic addition of these new coins, doubling the coin supply because of cryptoeconomics and community participation, rather than from additional sales to the public of newly-created coins.

Remember that every purchase of a Smart Contract Token from one of our X-CAPL stores (for fungible units of value, redeemable for the asset class indicated by the Token) results in the X-CAPL Coin coming back into our possession after the ICO, and resales of those coins will require FinCEN licensing in the USA as soon as X-CAPL Coin is listed on crypto exchanges. Adding new X-CAPL Coin supply through a mechanism of 'minting' of new coins is possible, we can build that into the system, but probably we won't want to do it that way, we will instead only mint the number of X-CAPL Coin that the ICO determines we mint, based on the number purchased in the ICO. **When we 'mint' new crypto assets arbitrarily, such as to match one-for-one new inventory added to our product portfolio, we are going to be doing that 'minting' of new crypto asset value in the form of Smart Contracts and Tokens.** We will probably be able to list individual Tokens on crypto exchanges, also, in addition to listing the X-CAPL Coin itself as the native currency of the X-CAPL Blockchain, and when we unilaterally 'mint' new Tokens that represent underlying assets, and liquidate

those Tokens through a crypto exchange, this activity also will require FinCEN licensing as a money transmitter based on current regulations.

Because we don't know the location of the buyers who buy through the crypto exchanges, it is my understanding (possibly incorrect) that we will be required to register as a money transmission business in all fifty states before we do such exchange-based liquidations of crypto assets or 'convertible virtual currency' X-CAPL Coin, such as when we resell the X-CAPL Coin that come back to us through Smart Contract purchases of products post-ICO.

I hope that was all clear and easily understood as-explained. **Definitive answers to these questions of cryptoeconomics are not required right now, it is okay that they evolve over time.** But it's very important to be aware that as an open community blockchain project, X-CAPL will be only 'first among equals' in governance and use of the cryptocurrency it sponsors/issues as the native currency of this new cryptoeconomic community. Even Satoshi Nakamoto (if he were still alive today) would be unable to unilaterally dictate changes to the Bitcoin source code and cryptoeconomics -- **we are truly considering launching something that will have the X-CAPL name attached to it in perpetuity but giving up exclusive control of what it becomes.**

If we need to retain veto power or some kind of kill switch to turn it off in the future if we don't like what happens with it all, something more powerful than retaining the right to stop accepting the X-CAPL Coin as payment through our Smart Contracts for the assets which helped to launch the blockchain project, something more than refusing to continue to participate because we're being ignored or disadvantaged or insulted and disparaged by other members of the open platform and crypto community, then **we need to discuss what that kill switch would look like; because, once the source code is released and the public accepts this new form of cryptocurrency as valuable, in all probability the only thing we would actually have the ability to do would be to file trademark infringement lawsuits and those are only possible in jurisdictions that recognize our registered trademark.** There will very likely be no way to ever stop people around the world from continuing to use the trademark if they believe it gives them cryptoeconomic value because it associates what they're doing in the future with what X-CAPL originally set in motion with its ICO and the launch of its blockchain project.

Looking forward to your thoughts on all this. I do think Stephen is correct that there is no point, and no legitimate purpose, behind a 'closed' platform that is nothing but another online store but that uses X-CAPL Coin instead of credit cards for purchasing X-CAPL products. The thing that has been making Stephen grumpy is not at all what I ever intended this or any of my other cryptocurrency engineering projects to become, which is why in my proposed contract I do **require you to grant a perpetual unlimited non-exclusive license to everyone, everywhere to use the X-CAPL trademark to identify the blockchain project, or any derivative work built or forked from it, as a form of value to be known in the crypto industry as 'X-CAPL'** -- this freedom for the community to choose its own path and do whatever it wishes to do with the open source project and the platform for crypto asset value that we're launching together is a first principle of cryptocurrency engineering. It's necessary to emphasize this rather than presume that this is already clear to you."

3. I drew out one main point from this thorough exposition, addressed to the CEO, X-CAPL:

Me: “Way to go, Josh.
[For ‘grumpy’ please read ‘professional’. ;o]
Josh has put his finger on a crucial point: “we are truly considering launching something that will have the X-CAPL name attached to it in perpetuity but giving up exclusive control of what it becomes”.
Are you happy to do that, with your brand and trademark?”.

B. The Critical Legal, Regulatory, Business, Professional Liability Questions

There are many, but my focus is principally on these three at present:

[1] If the X-CAPL Coin created by this ICO is likely to be deemed by any relevant (US or other) regulatory or law-enforcement authority to be ‘asset-backed’, and for that reason (or, indeed, any other) equivalent to *issuing a security*, would it not be advisable, ‘just to be safe’, to *seek securities regulatory approval for this ICO before it is publicly launched?* Assuming so, what exactly is the relevant and correct ‘securities regulatory approval’ to be sought, with whom, where, etc and how does one go about that, correctly, accurately and timeously? How long would it take to secure reliable regulatory ‘blessing’, and at what cost?

[2] Assuming that the CEO of X-CAPL is *not* wholly comfortable and happy with “launching something that will have the X-CAPL name attached to it in perpetuity but giving up exclusive control of what it becomes”, are there any sensible steps that X-CAPL can take to protect its name, brand and trademark to counter (or at least ameliorate) ‘giving up control of what it becomes’? If so, what, and how, at what cost and how long to put it in place?

[3] Suppose this ICO (and/or the whole cryptocurrency ‘thing’) goes badly wrong at some point, and either the X-CAPL company, or the public at large subscribing for, or using, the X-CAPL Coin in the future, or both, claim they have lost money, been damaged, made destitute etc by taking part in its launch and use, and also claim that Josh, and/or I, made misrepresentations, were careless, negligent, fraudulent etc and thus seek reparation from or, worse, criminal prosecution of, us (jointly or severally, in the US or elsewhere), what can he and I do to avoid, or protect against, that possibility, or its consequences, *at the outset*, i.e. *before* the ICO is launched publicly? Are there any sensible legal and practical protective steps we can take? Maybe extra/special PI insurance...? If so, what, from whom?

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February 07, 2018

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