

MEMORANDUM ('Memo')

From:

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Date: 6 June, 2019

To: Adrenaline.AI (ADAI Token)

Re: The evaluation of a Token as described below in Section A to determine if the Token may be considered as a security under laws of the USA.

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A. BACKGROUND

Adrenaline.AI, a company registered under the laws of Costa Rica ('Adrenaline.AI'), plans to introduce and distribute a cryptographic token ('ADAI' or 'Token') which can be used by persons to purchase CPU processing power. The issuer considers that the Token is an asset which represents CPU processing power which is linked to the Tokens when they are purchased. This CPU processing power can then be allocated back to Adrenaline.AI through a process of staking wherein the Tokens are rented out to Adrenaline.AI and the Token holder can derive a rent for the use of his processing power. Adrenaline.AI in turn uses the computing power for running an algorithmic trading bot which runs their trading platform ('ADB') and is already in existence and functional.

Adrenaline.AI as the issuers of the Token have informed us that the Token would not be offered to persons who are US citizens or resident in the USA.

B. QUERY:

The release of 'Tokens or Coins' has come under strict scrutiny as many of them are considered as 'Initial Coin Offerings (ICO's)'. ICO sector has come under cloud in some countries owing to the release of the Investor Bulletin by the SEC on 25 July, 2017 under which they have sought to inform the investors that certain ICO's may have characteristics which may be similar to securities and hence they may be regulated as securities by the SEC.

In the present scenario, an opinion has been sought on whether ADAI possesses characteristics similar to securities considering its features and mode of distribution.

C. ISSUES DEALT WITH IN THE MEMORANDUM:

In the present Memorandum ('Memo') we deal with the following issues:

- Understand whether the ADAI which are being sold would be classified as 'securities' under the laws of USA
- The status for ADAI under the Howey Test

● Evaluation of ADAI under the Risk Capital Test and Reves Test

Limitations, Assumptions and Disclaimer

The evaluation in this Memo does not cover in any manner the following issues:

- (a) The legal validity of the business model followed by Adrenaline.AI, the developer, backers, its Platform(s) or promoters
- (b) The financial status of any of the companies or parties related to ADAI
- (c) The status of the Tokens under the legal framework of any country except under the specific situations and for the countries mentioned explicitly.
- (d) The functionality or the legal status of the Platform where the Token will be used including the ADB Platform.
- (e) The need for any permission from competent authorities for operation of the ADB Platform or any other business linked to the ADAI Token
- (f) The characteristics or the qualities of other Tokens which may be released by the developers or which may be used on the ADB Platform.
- (g) Information about ADAI used for this Memo is limited to the information provided by Adreanaline.AI to us

In connection with rendering this opinion, we have investigated such matters and examined such documents as we have deemed necessary. In examining any documents and emails submitted to us by Adrenaline.AI, we have assumed the genuineness of signatures (both manual and conformed), the authenticity of documents submitted as originals, the conformity with originals of all documents furnished as copies, and the correctness of the facts set forth in such documents. Nothing came to our attention during the course of the investigation that led us to conclude that any such documents were not genuine or authentic and that the facts set forth therein were not true. Any opinion expressed herein relates only to the Token- ADAI. Please note that the information here is based on our assessment of the existing legislations and the information provided to us by Adreanaline.AI and should not be used for any decisions. It should not be considered as investment or financial advice under any situation. We will not be responsible for any losses arising out of the use of this information

for any investments or any other business decisions. Our maximum liability under all circumstances and in all jurisdictions is limited to the fee paid for this information only and no additional liability is accepted for any situation arising directly or indirectly from the use of this information.

This opinion is expressed solely on the facts and assumptions set forth herein and is specifically limited to the investigation and examinations stated and such other investigation as we deemed necessary. After such investigation, we know of no facts which lead me to conclude that any opinion set forth below is not correct. This opinion is limited to laws in effect on the date hereof and to the facts as they currently exist and of which we currently have knowledge. We assume no obligation to revise, supplement or otherwise update this opinion. This opinion is limited strictly to the matters expressly set forth herein, and no opinion is intended, nor may one be implied or inferred beyond the matters expressly so stated.

Conditions which Adrenaline.AI undertakes to fulfil:

The assessment made under this Memo is subject to the fulfilment of the following conditions:

1. The Computing Power which can be allocated through the Tokens can also be rented out by the token holders to other parties except the Token issuers as and when they deem fit
2. The rent which can be received from the Tokens is fixed and pre-determined and no promise of guaranteed increase of the rent is provided
3. The demand for computing power which can be rented out through the Tokens is independently determined based on demand and supply and the issuer of the Token or Adreanaline.AI does not guarantee directly or indirectly to the purchaser of the Token that the Tokens will be taken for rent for any specific time period or for a specific price at any time in the future after they have been purchased.
4. The Tokens are not linked as a source of computing power for the ADB platform only and can be used as a source of computing power for other purposes.
5. No guarantee of a minimum or fixed amount of rent or guarantee of use of the Token by the issuer for computing power through the Tokens should be made to the purchaser or holder of the Token.

6. No guarantee of buyback of the Token at any price and at any time should be made to the purchaser or holder of the Token.
7. No commitment should be made to receive any profits or benefits of any kind whether directly or indirectly through purchase and holding the Token.
8. The processing power through the ADAI is readily available for rental to other customers except the issuer and the Token is functional at the time of their issuance.

D. UNDERSTANDING THE SEC REGULATIONS AND IDENTIFYING IF ADAI WOULD BE REGULATED AS A SECURITY

I. United States of America

The recent Investor Bulletin by the SEC opened the possibilities that Tokens and 'Coins' could possibly be regulated as 'Securities'. The SEC in its Bulletin dated 25 July, 2017¹ states that *"in certain cases, the tokens or coins will be securities and may not be lawfully sold without registration with the SEC or pursuant to an exemption from registration."* The determination whether a particular 'Token' or a 'Coin' is a security is done through an evaluation of the features and the rights which are associated with the Token.

The determination of whether a particular financial instrument is a security can be normally done through an evaluation of the 'Token' through

- (a) the definition of 'Security' in the Securities Act, 1933 and the Securities Exchange Act, 1934
- (b) the Howey Test
- (c) the Risk Capital Test in certain states
- (d) the Reves test

We make the evaluation under these **four parameters** for ADAI in the sections below.

a) The definition of 'Security' prescribed under legislations

The Securities Act, 1933 and the Securities Exchange Act, 1934 are the two primary regulations governing the definition of a 'security'.

¹ The Investor Bulletin can be accessed at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings

The Securities Act, 1933 under Section 2(1) (a) defines a 'security' as *“any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”*

Section 3(a) (10) of Securities Exchange Act, 1934 defines a security as:

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

On a bare reading of the definitions we find that ADAI *prima facie* does fall into the definition of a 'security' according to the documents reviewed, but the assessment is dependent on ADAI also complying with the tests designed by the Courts.

As mentioned above, ADAI may also be subject to certain tests which have been designed by the higher courts. This makes it essential to review the three major tests provided by the courts.

b) The Howey Test

For a better evaluation of the Token as a security, we will have to move to the four step 'Howey Test' which was framed in the famous case- *SEC v. Howey Co.*, 328 U.S. 293 (1946). In the 'Howey test', a particular instrument called "an investment contract" had to be evaluated, if it could be considered as a 'security.' The SEC has further released additional guidance through a document called the *Framework for "Investment Contract" Analysis of Digital Assets*² ('Framework') which covers the application of the Howey Test to digital assets in detail.

The Howey test laid down that: *"... an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.... Such a definition...permits the fulfilment 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.... It 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."* Broadly, it stated that *"The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."*

The definition and observations put forward in the case were designed into a four part test which has the following elements:

- (a) An investment of '**money**': The term used here is money, but in later cases, it has been expanded to include any money equivalents and it can be expected that in the future it will also cover virtual currencies as can be seen from the interpretation provided in the FinCEN guidance.³

² The document can be downloaded from <https://www.sec.gov/files/dlt-framework.pdf>

³ A copy of the Guidance is available for download at <https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering>

- (b) In a **common enterprise**: A common enterprise has been divided into 'vertical commonality' and 'horizontal commonality.' "Horizontal commonality" is a process where money or assets from different investors are brought together in a common pool and profits and risks are shared in some proportion.

"Vertical commonality" on the other hand *places emphasis on the relationship of the parties and whether one is relying on the efforts of the other. If a commonality of enterprise is found, regardless of the form it has taken, this factor in the test will be satisfied.* Vertical commonality can further be broken down into "broad vertical commonality" whereby the promoter's profits are not tied to the investor's profits and "narrow vertical commonality" whereby the promoter only profits if the investor profits.

In any case, any form of commonality found may be considered sufficient to satisfy the test.

- (c) An expectation of **'profit'**: Profits can be provided in any form of- interest, dividends, rental income, tax benefits, cash return, capital appreciation to name a few. Even Ponzi schemes can be securities if they provide profits and also fulfil other tests.
- (d) **Efforts of promoters**: The investors do not have to put in any individual effort to gain benefits and the promoters work to create profits for them. The investors gain the benefits merely by being a part of the contract.

For a Token, an evaluation of the characteristics of the Token can provide a broad idea of whether it fulfils the essentials of the Howey Test as stated above. The SEC considers that the first two prongs of the test ('investment of money' and 'common enterprise') are generally fulfilled in most cases and they may also be fulfilled in case of ADAI.⁴ However, it is considered unlikely that the second element will be fulfilled since the ADAI token holder works in a completely different business of renting out processing power than the issuer Adrenaline.AI which works in the business of algorithmic trading. Therefore a service provider-customer relationship is prima facie more likely. The main factors therefore are the last two elements- 'expectation of profits' derived from 'efforts of others'.

In case of the element of expectation of others (the promoter or third parties, referred to as an 'Active Participant' or 'AP'), there are two key issues which has been considered for evaluation by the SEC:

⁴ Framework, p. 2.

- *Does the purchaser reasonably expect to rely on the efforts of an AP?*
- *Are those efforts “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,” as opposed to efforts that are more ministerial in nature?*

The SEC considers that greater the role of the Active Participant, there is a greater possibility that the Token will fulfill the test. In the present case, it is seen that the ADB platform has already come into existence and is functional as an algorithmic trading platform. It has no direct relation with the Token except as a potential customer. The processing power through the ADAI has also been stated to be readily available at the time of their issuance.

Regarding the issue of expectation of profits, the SEC has discussed elements such as the functionality of the asset and the correlation between the price of the asset and the price of the asset. In these cases, it has been informed to us that the ADAI will be functional from the time of their release and they have a definite utility as a medium for rental of processing power to the ADB Platform or other potential customers who wish to rent out the processing power available through staking the Tokens. The tokens have been marketed on the basis of their functionality as a source of processing power and not on the potential increase in value, a key consideration according to the TurnKey Jet Response ('TJR').⁵

Other relevant considerations which have considered are the functionality and operational status of the network, the stable price of the asset, ability for the use of the asset as a virtual currency and the use of the network by the purchasers. The functionality of the platform has been considered as a key component to evaluate a Token in the TJR. The ADAI is already scheduled for use by purchasers on a functional network and hence it is likely to fulfill these considerations. There is no additional value which is attributed to the Token which could make it attractive for potential buyers and hence buyers are expected to buy it only when they seek to obtain ADAI as an asset which can be rented out according to their preferences to a customer who is willing to obtain the processing power provided through the Tokens.

It may also be considered that the sale of processing power through ADAI and rental of the processing power by the issuers Adrenaline.AI is a form of a sale and rent back transaction. While

⁵ A copy of the response can be viewed at <https://www.sec.gov/divisions/corpfm/cf-noaction/2019/turnkey-jet-040219-2a1.htm>

sale and rent back transactions can indeed possess certain elements of a transaction in securities as can be seen from the discussion in *Huberman v. Denny's Restaurants, Inc.*, 337 F. Supp. 1249 (N.D. Cal. 1972) , it is not likely to be fulfilled in the present case.

This can be based on a reevaluation of the perceived sale and rent back transaction in the present case under the *Howey* Test. While it can be stated that there has been an investment of money to purchase the Tokens and their associated processing power, the other three elements of the *Howey* Test cannot be fulfilled. It can be seen that no specific rents are guaranteed to the Token holder as in a pure sale and rent back transaction and the value of rent for the processing power of the Token holder will be determined on a case to case basis even when it is rented by the issuer Adrenaline.AI themselves. Also, there is no guarantee that any such rents will be paid for a specific time period. As such no expectation of profits could be made. There is also prima facie no common enterprise since the Token issuer is in the business of operating an algorithmic trading platform while the Token holder is only in the business of renting out processing power to potential customers including the issuer. The third element of profits solely from the efforts of others also does not arise since the Token holder is not dependent only on the efforts of the issuer to generate revenues for the Token holder and he can rent out the processing power to other potential customers as required. The Token holder is the sole decision maker regarding the use of the Tokens to generate revenue.

Based on the evaluation of the elements of the *Howey* Test, the ADAI may not be considered as a security under the test.

c) *The Risk Capital Test in certain states*

The Supreme Court of California in the case of *Silver Hills Country Club v. Sobieski*, 55 Cal.2d 811, designed a test called the 'Risk Capital Test' which was later accepted by a number of states across USA. In the given case, a club in California sold memberships for the purpose of construction of the club. According to the offer, the people who purchased memberships would not secure any direct profits but would secure a right to use the facilities. The court looked into the sale of memberships and determined that:

'We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not

lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.'

So although, the memberships might not have come under the coverage of definition securities under the 1933 and 1934, they were covered by the new interpretation of the court based on local state laws and the duty of the courts to protect public from schemes which attract risk capital.

The court through its decision formulated a four part test which is an evaluation of the following parameters:

- The raising of funds for business ventures
- The availability of the offer for general public
- If the investors have any power to determine the success of the venture
- If the money invested is at risk because of inadequate security.

The risk capital test varies from the Howey test mainly on the parameter that it does not require the element of profit and the benefit from the investment does not need to be a material benefit.

In the present situation, the Risk Capital Test is unlikely to be fulfilled because the purchasers of the ADAI receive an asset is functional and can be rented out immediately as a source of processing power. It thus utility and value immediately on purchase. The purchasers of the ADAI also have minimum possibility to influence the success of the ADB Platform which is expected to be one of its customers since it is already functional and in use. The value of the ADAI is linked to its limited utility as a source of processing power and no additional benefits are available from the Token. The money which has been paid by the purchasers in the present case is not directly at risk since the purchasers receive an asset (processing power) with its independent value.

d) *The Reves Test*

The US Supreme Court in the case of *Reves v. Ernst & Young*, 494 U.S. 56 (1990) adopted the *Family Resemblance Test* developed by the Second Circuit Court in *Exchange National Bank v.*

Touche, Ross & Co., 544 F.2d 1126 (2d Cir. 1976) to determine if a 'note' is a security. The court laid down a four point test which we use to evaluate the ADAI Tokens below:

- i. **Motivation of the buyer and seller:** The motive behind the buyer and the seller behind the transaction are evaluated. If the seller is selling the Tokens for generally raising funds for business and the buyer is buying the Token as an investment, then it may have characteristics similar to a security. In the present case, it has been clearly stated that the seller of the Tokens already has a separate functional business where they run an algorithmic trading platform. The buyer of the Token on the other hand has a motivation to purchase the Token as an asset which provides processing power which can be used and rented out by the buyer as he deems fit.
- ii. **Plan of distribution:** The plan of distribution of the Token as communicated by the issuer indicates that the ADAI are being sold as a product for a particular fixed price and the product has a definite use.
- iii. **Reasonable expectations of the public:** The expectation of the public that the Token would be considered as a security is expected to be minimal considering that it is being sold as a product which has a particular use, i.e. for obtaining processing power which can be used or rented out to potential customers.
- iv. **Presence of alternative regulatory regime:** The cryptocurrencies and Tokens may also be considered as Commodities as stated by the CFTC in their Primer on virtual currencies.⁶ It is however clarified that they may also be regulated as securities. In this situation, it can be seen that a potential alternative regulatory scheme may exist for certain Tokens which can only be considered as Commodities and not as Tokens. In the present instance, the Token may be expected to be covered under alternative regulatory mechanisms since it may function as a digital asset.

Considering this situation, it may be considered that the ADAI Token does not fulfil the *Reves Test* to be considered as security.

⁶ A copy of the document is available for download at http://www.cftc.gov/idc/groups/public/documents/file/labcftc_primercryptocurrencies100417.pdf

E. EVALUATION OF CHAIRMAN JAY CLAYTON'S PUBLIC STATEMENT OF DECEMBER 11, 2017

The crux of the statement by Chairman Jay Clayton can be divided into two main issues:

- (a) Evaluation of the use of ICO's and Token sales for sale of securities
- (b) Use of cryptocurrency for transactions and trading in cryptocurrencies

On the first issue, the general assertion that *"cryptocurrencies are not securities and that the offer and sale of cryptocurrencies are beyond the SEC's jurisdiction"*, has found mention in the SEC Chairman Jay Clayton's Public Statement of December 11, 2017.⁷ Although, no opinion has been expressed on the validity of the assertion, but he has clarified that *"Whether that assertion proves correct with respect to any digital asset that is labelled as a cryptocurrency will depend on the characteristics and use of that particular asset."*

In this regard, Chairman Clayton referred to the Dow investigation report and why DAO Tokens were considered as securities, it was stated that: *"we concluded that the token offering represented 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."*

The explanation to this statement as to what are the characteristics of a 'security' was provided in the same public statement where he clarified that *"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."*

Now, when we put the above observations into play in case of ADAI Tokens based on the communication by the issuer and seller of the Token, the Token is not likely to be considered as a security since it does not provide a reasonable expectation of profits based on the efforts of others. The Token has no value beyond its limited utility and hence is not expected to be attractive as an investment medium.

⁷ A copy of the public statement by SEC Chairman Jay Clayton on December 11, 2017 is available for download at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>

Regarding the second issue, it is pertinent to clarify here, that Chairman Clayton had stated: *“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.”*

The issuers when selling the Tokens are expected to comply with international Know your Customer (KYC) and Anti- Money Laundering (AML) best practices. It is expected that adequate measures will be taken to comply with the legal requirements for sale of cryptocurrencies and regulating their transfer.