



Legal Opinion: PengCoin

In this opinion letter, purchasers of the PengCoin (“PENG”) tokens will be divided generally into categories of “donors” and “investors”. “Donors” include organizations and individuals who elect to use PENG to make donations to charities that accept this token in lieu of using fiat currency. “Investors” are parties whom purchase PENG in order to hold and/or sell the tokens with the expectation of future profits in the form of capital gains or other income with respect to PENG. To be sure, investors will likewise be permitted to send PENG as donations to charities and have access to all other PENG functionality. An understanding of the PengCoin business model will be presumed with respect to the recipient of this opinion letter.

Section 2(a)(1) of the Securities Act of 1933 defines “securities” 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 ... investment contract ... or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

The seminal Supreme Court case for determining whether an instrument meets the definition of security is *SEC v. Howey*, 328 U.S. 293 (1946). The Supreme Court has reaffirmed the *Howey* analysis as recently as 2004. *Howey* focuses specifically on the term “investment contract” within the definition of a security, noting that it has been used to classify those instruments that are of a “more variable character” that may be considered a form of “contract, transaction, or scheme whereby an investor lays out money in a way intended to secure income or profit from its employment.” Not every contract or agreement is an “investment contract” and the Supreme Court developed a four-part test to determine whether an agreement constitutes an investment contract and therefore a security.

The Court articulated the test as follows: A contract constitutes an investment contract that meets the definition of “security” if there is (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) solely from the (entrepreneurial or managerial) efforts of others (e.g., a promoter or third party), “regardless of whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets used by the enterprise.” In order to be considered a security, all four factors must be met.

1. Under *Howey*, and case law following it, an investment of money may include not only the provision of capital, assets and cash, but also goods, services or a promissory note. Given the broad definition of a money investment and the fact that PENG has been distributed through a token offering by the issuer to purchasers with a price set per token, the first factor will very likely be **satisfied** and requires no further discussion.
2. Different circuits use various tests to analyze whether a common enterprise exists. Three approaches predominate: (i) horizontal; (ii) narrow vertical and (iii) broad vertical.
 - a. Under the horizontal approach, a common enterprise is deemed to exist where buyers or investors pool funds into an investment and the profits of each token buyer correlate with those of the other investors. Whether funds are pooled appears to be the key

question, and thus in cases where there is no proportional sharing of profits or pooling of funds, a common enterprise may be deemed not to exist.

- i. Under the horizontal approach, PENG is unlikely to be deemed a security at this stage of development due to the fact that the PengCoin platform is substantially operational and able to process donation transactions. There is no pooling of funds at this stage as much of investor funds have already been expended on project development and generally the profits or losses for those initial investors have already been realized. Therefore at this stage of project development, PENG is substantially a utility coin akin to a currency which is used and consumed to transfer value across the PengCoin network with a relatively stable value across various exchanges.
 - b. The narrow vertical approach looks to whether the profits or fortunes of an investor are tied to a promoter so that they rise and fall together. It is similar to the next approach and will be analyzed with it.
 - c. The broad vertical approach considers whether the success of the investor depends on the promoter's expertise. If there is such reliance, then a common enterprise may be deemed to exist.
 - i. At this stage, given the decentralized nature of the PENG ecosystem, whereby PENG investors will depend equally upon the efforts of the donors of PENG and the functionality of the automated PENG platform itself, rather than the issuer's expertise (even though the issuer may control or influence technical permissions or changes to the overall system protocol), PENG is likely to fail this test. There does not appear to be any voting or management rights inherent in the functionality of PENG, such rights would militate toward less reliance on the issuer and therefore lower likelihood of being deemed a security. Thus, depending on the level of control exerted by the issuer, **the less of a reliance on the issuer's expertise, then the less chance that this element would be met.**
 - d. Given the diverging approaches, the law on the "common enterprise" element is somewhat unclear and not easily susceptible to analysis but more to the whims of a given court. Putting things in more practical terms: in one sense, it would appear that the PENG platform is a common enterprise because investors previously purchased PENG during the token offering with expectation of profits. However, because the platform is operational and able to process donations, PENG's main function is to fuel the platform and process donations, thereby using and consuming the PENG in the process. Finally, any reliance on the issuer is currently minimal since the PENG system is public, decentralized, minimally managed, and generally automated. In conclusion, although not definitive in this regard, at this point, because the construction of the PENG ecosystem is substantially complete with minimal reliance on the issuer; this militates toward there not being a "common enterprise" present under any of the tests.
3. Under the "expectation of profits" element, "profit" refers to the type of return or income an investor seeks on their investment (rather than the profits that the system or issuer might earn).

Thus, for purposes of PENG, this could refer to any type of return or income earned as a result of being a PENG investor or holder, which would be narrowed to the extent it is derived passively, i.e., from the efforts of others. Since courts consider this factor through the lens of the “efforts of others” factor, this prong is analyzed along with the fourth factor below. In other words, just because there is a return on investment or profit, does not mean that the investment contract is a security. It is the essentially *passive nature of the return*, as determined by the “efforts of others” analysis that results in an “investment contract” and therefore a “security” as opposed to a simple contract instrument. This factor is **probably met** in the case of PENG since at this point the PengCoin is purchased by at least some investors with an expectation of capital gains, or income from proof of stake based mining activity, regardless of the activity related to making donations.

4. “Solely from the (entrepreneurial or managerial) efforts of others”: typically, courts have been flexible with the word “solely,” such that, in addition to the literal meaning, it also may include (undeniably) significant or essential managerial or other efforts necessary to the success of the investment. The SEC takes a liberal, and possibly unreasonable, interpretation of this factor.
 - a. The expectation of profits resulting from the purchase of PENG would primarily relate to whether an investor receives rights and/or investment interests. While non-security token holders may receive money, digit currency, dividends, capital gains, or other forms of financial incentives by virtue of merely owning the token, any such incentives should ideally be derived *through their own efforts*, rather than through a passive investment.
 - b. Generally, most of the transactions on the PengCoin blockchain will occur among donors and recipients of donations; while transfers of PENG may also occur over the counter, as rewards to miners, or through exchanges, mainly for the purpose of utilizing the PENG platform to fuel the decentralized charity-centered ecosystem. Therefore, PENG would mostly be held and used by active participants, similar in nature to franchisees or licensees, although certainly some parties would purchase PENG for the purpose of obtaining capital gains. The latter use of PENG would likely be deemed to be passive, though the former would not likely be deemed to be a passive activity and would probably fail this test. It should be noted that the over 17 billion total tokens to be issued overall are of such a significant amount that this factor would likely tend to substantially reduce the amount of investors who will hold this token with the sole intent to profit, and not to utilize it on the platform; however, such passive profit motive will likely still be a possibility.
 - c. Again, the capital gains aspect of PENG, wherein the investors would expect an increase in the value of PENG from the purchase price of the token, would not be dispositive towards either security or non-security status of PENG because the capital gains would occur not only because of the donors’ actions/efforts but also because of the operations of the PengCoin platform itself, in addition to the minimal efforts of the issuer/promoter to maintain the platform. This factor shifts the scale toward PENG failing this test.
 - d. The manner in which the sale of PENG occurs, particularly the promotion and marketing, may also affect the “expectation of profits” analysis. For example, if the language used

to promote PENG includes words like “investment,” “returns” or “profits,” the purchasers of PENG may be more likely to expect profits from the efforts of others than if PENG is promoted on the basis of the usefulness of the rights and services attaching to it through the PengCoin ecosystem.

- e. Courts have also analyzed the existence of voting rights through this Howey factor. Whether voting rights are determinative of a security will be based on the facts at hand. Greater voting rights militate toward the instrument *less* likely to be deemed a security. In this case it does not appear that PENG will provide any managerial control over the platform or the enterprise to any PENG holder, though this aspect may change in the future at the discretion of the development team.
5. In conclusion, based on the above analysis of the unique nature of PENG, the security/non-security scale currently tends to lean towards the PENG **not** being a security due to generally failing the second and fourth test factors. The following will provide a summary of the above factors used in the analysis.
- a. PENG is sold for value therefore satisfying the first element of the “security” analysis.
 - b. Currently, the platform is substantially operational and decentralized, reducing the dependence of future PENG purchasers on the issuer. This factor leans towards PENG not being a security.
 - c. There does appear to be pooling of funds at this time creating a “common enterprise” because the platform has been substantially completed and prior investment funds have already been pooled and utilized in the development of the platform. Gains and losses have generally already been realized by early investors.
 - d. PENG will pay mining rewards to parties who purchase masternodes and actively contribute to the maintenance, security and stability of the PengCoin network, and process transactions; this would be a dividend-like passive payment to miners, as minimal effort is necessary to stake PENG on the blockchain. This factor would tend to shift the scale toward PENG being a security.
 - e. The PENG platform has specific functionality which may not be accessed by anyone other than PENG holders; this factor pushes the scale toward the PENG not being a security.
 - f. Overall, the majority of transactions on the platform, and its overall purpose, will be to use it to transfer value in the form of donations, which is an active behavior, such as a license, that tends to shift the scale to PENG not being a security.
 - g. PENG does not provide any managerial control over the platform. This factor tends to push PENG into the ‘security’ category since it increases the passive nature of the investment and reliance on the issuer/promoter.
 - h. Any usage of marketing terms that appear to promise PENG price appreciation, ROI, profits, or similar forward-looking statements will push PENG toward “security” status.

CONCLUSION:

1. At this stage of development, PENG is likely not to be deemed a “security” under U.S. federal securities laws.
2. Trading of PENG may be subject to regulation under laws applicable to trading of commodities or currencies.

BRUCE BELENKY, ESQ

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Disclaimer:

The above analysis is based on information obtained from a representative of PengCoin, the company’s whitepaper, publicly available information, and the law as it exists as of the date hereof. No US state or non-US law was considered herein; only U.S. federal securities laws. No opinion is expressed with regard to any other body of law or legal construct, including without limitation the franchise laws of any US state. No court has addressed the question of whether any blockchain-based tokens are “securities” under U.S. federal law; as such, the SEC or a court of competent jurisdiction may reach an alternative conclusion to that stated in this opinion letter. No warranties or guarantees of any kind as to the future treatment of the PengCoin platform or PENG tokens or similar tokens are being made herein.