



CARPENTER & ASSOCIATES

MEMORANDUM

TO:

FROM: Carpenter & Associates

DATE: November 19, 2019

RE: U.S. Securities and Commodities Laws in re the CARR token

INTRODUCTION

Carpenter & Associates has been asked to provide an opinion as to whether the Carnomaly CARR token (CARR) is likely to be deemed a security under U.S federal securities laws, and thus subject to commodity regulations. No opinion is expressed with regard to any other body of law or legal construct. It is widely recognized that neither an opinion letter nor any particular legal opinion expressed therein is intended to be – or is – a guarantee of a particular outcome.¹ Please be advised that the Security Exchange Commission (“SEC”), a U.S. court of competent jurisdiction, or a cryptocurrency exchange, may reach an alternative conclusion to that stated in this letter.

The analysis in this opinion is based on the information provided to our firm by Carnomaly, Carnomaly’s whitepaper, and related documents until this opinion’s date. If these documents are revised in the future, the relevant analysis may change. While our firm conducts reasonable due diligence to establish the veracity of the factual information provided to us, we do not conduct an audit of computer code to confirm that a particular software or algorithm functions as intended or as described. Further, the provision of this opinion is not to be taken as implying that we owe any duty of care to anyone other than our client. Nothing in this opinion is intended to create an attorney-client relationship with any purchaser of CARR. Purchasers of CARR should seek independent legal counsel regarding the implications of their purchase.

¹ *Smith v. Lewis*, 13 Cal. 3d 349, 358, 118 Cal. Rptr. 621, 627 (1975). See RESTATEMENT § 52, comment b; ABA Principles § I.D.

The Carnomaly Network

Carnomaly was created by a team with a combined experience of over 27 years in the automotive industry, and is designed to bridge the gap between cryptocurrency and the automotive industry. Carnomaly is a network built to revolutionize the online digital automotive market by becoming the first ever worldwide automotive rebate program. Members of Carnomaly will be able to utilize the CARR token for rebate redemption. With the Carnomaly platform, users will be able to do everything from buying, selling, shipping, and locating a vehicle service and registration history all in one central location. Carnomaly will have two separate portals. First, the consumer portal which will include both buying and selling options. Consumers will be able to shop for vehicles without giving their contact information to dealers; they will also be able to see the current market for their desired vehicle. Second, the dealer portal which will charge a smaller fee and will have more features than current third party vehicle listing platforms. Dealers will also be able to utilize Carnomaly to buy and sell inventory dealer to dealer.

The CARR Token

Carnomaly will use the Ethereum network and its ERC-20 smart contract to host the CARR token. ERC-20 tokens are tokens designed and used solely on the Ethereum platform. They follow a list of standards so that they can be shared, exchanged for other tokens, or transferred to a crypto-wallet. In order to use CARR, one must become a member at www.Carnomaly.io. After the member is registered he must go to the market place where CARR tokens are for sale, he then may purchase tokens. Once CARR tokens are purchased the member can transfer the tokens to the Carnomaly.IO site to begin the rebate redemption process and earn rebates on automotive purchases.

THE CARR IS NOT LIKELY TO BE DEEMED A SECURITY AS DEFINED BY U.S. LAW

After thorough research and investigation it is of our opinion that the CARR token does not meet the qualifications of a security as required by federal U.S. law. The analysis for our opinion is as follows:

A digital asset is an asset that is issued and transferred using distributed ledger or blockchain technology, including coins and tokens.² Engaging in the offer, sale or distribution of a digital asset is referred to as an Initial Coin Offering. Determining whether a digital asset should be deemed a security recently became considerably easier. On April 3, 2019, the SEC issued "Framework for 'Investment Contract' Analysis of Digital Assets." ("the Framework").³ The Framework essentially provides guidance for market participants to gauge whether a digital asset has the characteristics of a type of security called an "investment contract," and is thus subject to U.S. securities laws. Federal securities laws

² SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (April 3, 2019), available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn10

³ *Id.*

requires that offers and sales of securities to be registered under its provisions or to qualify for an exemption from registration.⁴ Therefore, persons or entities engaged in the marketing, sale, resale, distribution, or offer of any digital assets need to evaluate the relevant transaction to ascertain whether federal securities laws apply.⁵

The U.S. Supreme Court decided in *Howey* that an investment contract exists where there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.⁶ From this decision came the “*Howey* test.” The *Howey* test is applicable to any scheme, transaction, or contract, regardless of whether it has the characteristics of typical securities.⁷ The *Howey* test can be broken down into three separate elements. Those elements are: (1) that there is an investment of money, (2) in a common enterprise (3) with the expectation of profits solely from the efforts of others.⁸ If and only if all elements are satisfied, then a contract, scheme, or transaction passes the *Howey* test and constitutes a security and is subject to use U.S. securities laws. If any one of the elements is not met, the arrangement fails the *Howey* test and the subject of the test is not a security.

Further, the *Howey* test aids in the answering of two key questions: is the digital asset or token valuable primarily as an investment or is it utility in nature? And is there an issuer backing up that value or is the value the result of a network of unaffiliated participants in an industry and market? These questions help distinguish digital assets or tokens that may provide positive returns for holders as a result of the efforts of others, versus assets that increase in value as a reflection of the positive qualities of the network and a natural demand for the coins or tokens that operate within that network. With regard to coins or tokens that function as a utility on a network, these coins or tokens streamline commerce and provide a decentralized and democratized mechanism for equitable prices and efficient transactions between individuals.

I. INVESTMENT OF MONEY

The first element of the *Howey* test is usually satisfied in an offer and sale of a digital asset because the digital asset is typically purchased or acquired in exchange for value. However, the lack of consideration for digital assets does not mean that the investment of money element is not satisfied. The Commission provided in *The DAO Report* “[i]n determining whether an investment contract exists, the investment of ‘money’ need not take the form of cash” and “in spite of *Howey*’s reference to an ‘investment of money,’ it is well

⁴ *Id.*

⁵ *Id.*

⁶ *SEC v. Howey Co.*, 328 U.S. 293 (1946).

⁷ *Id.* at 299

⁸ *Id.*

established that cash is not the only form of contribution or investment that will create an investment contract."⁹

The "investment of money" element is likely to be satisfied as CARR tokens will be able to be obtained in exchange of money. Purchasers of CARR will use the Carnomaly digital portal to buy CARR to use for rebate redemption. This qualifies as an offer and sale of a digital asset, and thus the first element of the *Howey* test is satisfied.

II. COMMON ENTERPRISE

For the second element of "common enterprise" to be satisfied, federal courts requires that there either be horizontal commonality, narrow vertical commonality, or broad vertical commonality.

Horizontal Commonality

The horizontal approach focuses on the relationship among investors in an economic venture. Integral to this approach is the pooling of investors' money in a common venture. 'Pooling' requires that investors funds be combined and as a result of which the individual investors share all the risks and benefits of the business enterprise.¹⁰

Under the Carnomaly network, there is no pooling of investors' funds in a common venture. Further, individual investors will not share all the risks and benefits of the Carnomaly business. Therefore, there is no horizontal commonality.

Narrow Vertical Commonality

The narrow vertical approach finds a common enterprise if there is a correlation between the fortunes of an investor and a promoter. A narrow vertical common enterprise is a venture in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment.¹¹ It is not necessary that the funds of investors are pooled; what must be shown is that the fortunes of the investors are linked with those of the promoters, thereby establishing the requisite element of vertical commonality. Thus, a common enterprise exists if a direct correlation has been established between success or failure of the promoter's efforts and success or failure of the investment.

Under the Carnomaly network, investors' profits are not linked with the profits of the promoter. The success or failure of investors does not correlate with that of the promoter's. Therefore, narrow vertical commonality does not exist.

⁹ *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017) ("*The DAO Report*")

¹⁰ *Sec. & Exch. Comm'n v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284 (11th Cir. 2002).

¹¹ *Sec. & Exch. Comm'n v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1339 (9th Cir. 1994).

Broad Vertical Commonality

The broad vertical approach finds a common enterprise if the success of an investor depends on a promoter's expertise. Broad vertical commonality only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns.¹² Courts focus on the expertise of the promoter in the industry of the alleged security. If the investor relies on the promoter's expertise, then the transaction or scheme represents a common enterprise and satisfies the second prong of the *Howey* test.

Under the Carnomaly network, the success of the CARR token depends on the expertise of the creators and promoters of the CARR. As discussed above, the creators of Carnomaly have substantial experience in the automotive industry and Carnomaly was created based on their expertise in the field. Therefore, broad vertical commonality exists and the second element of the *Howey* test is satisfied.

III. EXPECTATION OF PROFITS SOLELY FROM THE EFFORTS OF OTHER

The third element of the *Howey* test must be dissected into two parts. First, does the purchaser have an expectation of profits, and second if the purchaser does have an expectation of profits does said expectation arise solely from the efforts of others.

A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market.¹³ There is no expectation of profit where a purchaser is motivated primarily by the desire to use or consume the item purchased.¹⁴ Even purchasing an asset for consumption and profit is not enough, to satisfy the first part of this element, the purchaser's expectation of profit must predominate the expectation of using the item purchased.¹⁵

Purchasers of the CARR token will be motivated primarily by the desire to utilize their tokens in the Carnomaly rebate program rather than by an expectation of future profits. The CARR is not designed for purchasers to receive a profit. It is designed so that purchasers of the CARR can participate in the Carnomaly rebate redemption program and receive rebates on transactions. The first part of the third element of the *Howey* test is not satisfied as there is no purchaser expectation of profits. The third element of the *Howey* test is not fulfilled, therefore the CARR token should not qualify as a security under federal law and registration of the CARR with the SEC should not be required.

¹² *Sec. & Exch. Comm'n v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284 (11th Cir. 2002).

¹³ *United Hous. Found. v. Forman*, 421 U.S. 837, 854-55 (1975).

¹⁴ *Id.* at 858

¹⁵ *Id.*

THE CARR WILL LIKELY BE DEEMED A UTILITY TOKEN

If a digital asset or token does not qualify as a security according to the *Howey* test, then it classifies as a utility token.¹⁶ Utility tokens simply provide users with access to a product and/or service. They help in building an internal economy within a system. Investors can buy these tokens and use them as a means of payment on the platform developed by the issuing company.¹⁷ Essentially, utility tokens are digital assets designed for spending within a specific blockchain ecosystem.¹⁸

For the reasons illustrated above, the CARR does not qualify as a security, and is therefore a utility token. The CARR is designed to be used in the Carnomaly ecosystem. Purchasers of CARR tokens may utilize the token to earn rebates on automotive purchases on the Carnomaly rebate platform.

CONCLUSION

Under U.S. federal law, for a digital asset to be considered a security said digital asset must satisfy the three elements of the *Howey* test. The elements of the *Howey* test are: (1) that there is an investment of money, (2) in a common enterprise (3) with the expectation of profits solely from the efforts of others. We conclude that the CARR token likely satisfies the first two elements of the *Howey* test; however, it does not satisfy the third element. If one element of the *Howey* test is not met, a security does not exist. Based on our review of *Howey* and SEC guidance, we are of the opinion that the CARR will not likely be deemed a security. The CARR token is utility in nature and should not be subject to regulation by the SEC.

Sincerely,



Joshua Carpenter
Attorney at Law



Ashley Smith
Law Clerk

¹⁶ Unibright.io, *Coin vs. Token vs. Security—Regulated?*, MEDIUM (Dec. 13, 2017), <https://medium.com/@UnibrightIO/coin-vs-token-vs-security-regulated-9e3eb4af6b68> [https://perma.cc/9PR7-LDKM]

¹⁷ *Id.*

¹⁸ *Id.*