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September 15, 2017

Family Offices and the Madness of Crowdsales

Recently, I have had an opportunity to review many "tokens" that can be transferred over the Ethereum blockchain and used for various "smart contracts." Depending on their facts and circumstances, certain kinds of tokens being sold in so-called "initial coin offerings" were the subject of a recent SEC [Section 21\(a\) report](#). I have also seen correspondence from family offices seeking to participate in these token offerings, in some cases before the developer has fully worked out the token. This raises a concern that a family office may wound itself trying to get in on the "cutting edge" of this new way to disseminate technology.

## The 21(a) Report

The SEC issued its report in response to the increasing use of:

distributed ledger technology to offer and sell instruments such as [a particular kind of tokens] to raise capital. These offers and sales have been referred to, among other things, as "Initial Coin Offerings" or "Token Sales."

The report stressed:

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.

Thus, unless the tokens are properly constructed and their sale is properly conducted, selling tokens that are freely transferable on a distributed ledger may violate federal and state securities laws.

## Fiduciary Concerns

Issuance of the 21(a) report has led purchasers to focus on whether a token would be a "security" as defined by the SEC. For a family office or other investment adviser, unless the client intends to use the token to obtain a product or service, the first question must be whether a token, if bought for investment purposes, would be a sound investment. Until we can gauge the effects of the SEC's report, "caveat emptor" are the watchwords and heightened diligence is called for. Most tokens are described in so-called "white papers." The focus of the white paper tends to be describing what the newly invented technology does and how it can remove inefficiencies in human interactions and change the world for the better. These white papers should be scrutinized to determine whether developers have set forth a viable business plan, including demonstrating a focus on demand and/or a detailed marketing plan. In the current market, a fiduciary must make sure to find and review the information necessary to exercise reasonable care in recommending investments in a token. Indeed, many developers want to sell their tokens only to potential users, so their terms and conditions insist that you not buy the token for investment.

## Legal Concerns

An investor may accept the risk of an asset's value falling to zero, but few wish to take on additional liability. In this regard, it is worth noting that the risk of a token being a "security" is not limited to the developer of the token. The SEC's report warns that:

those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5.

This means that a family office that buys a token subsequently found to be a security may not be able to resell it. That SEC's pronouncement is just one of a number of considerations that are in play when reselling instruments that may be deemed to be unregistered securities. **Conclusions** Recommending a new token should require the same analysis as recommending an investment in the token's developer. Among other things, a family office or adviser must understand the blockchain community, the ever-evolving token market and the token's prospects for achieving its use case. If an adviser would not think of recommending a start-up venture based solely on the limited information available in a white paper, then he should probably not recommend the newly offered token. Moreover, if you would have an attorney advise you as to the terms of any venture, then you should have an attorney with experience in the token market review any token as well.

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