

Investment Management

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Digital Tokens: Should SEC Registered Investment Advisers Update Their Code of Ethics?

By **Scott H. Moss, Esq.**, **Benjamin Kozinn, Esq.**, and **Brent A. Morowitz Esq.**

On July 25, 2017, the Securities and Exchange Commission's (the "SEC's") Division of Enforcement (the "Division") issued an investigative report (the "Report") (i) analyzing the offer or sale of digital tokens by DAO, a Decentralized Autonomous Organization ("DAO Tokens") under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") and (ii) determining that the DAO Tokens were securities under the definitions set forth in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act (together, the "Acts"). While the conclusions in the Report were limited to the particular facts and circumstances regarding the DAO Tokens, the Report raises significant questions about whether other digital tokens or assets would qualify as "securities" under the Acts.

SEC registered investment advisers ("Advisers") should understand the implications of the Report as it relates to the potential impact on an Adviser's Code of Ethics and the personal trading policies and obligations therein.

This alert provides a brief overview of the Report and provides a summary of certain items and steps that an Adviser should consider with respect to its Code of Ethics.

Blockchain Technology, Digital Tokens and Initial Coin Offerings

Blockchain, or distributed ledger technology, is the latest innovation to captivate the technology community. As interest in blockchain technology has rapidly grown, so too has the number of developers working on blockchain-related applications. Blockchain technology can be programmed to record, among other things, financial transactions, through shared recordkeeping. Developers of blockchain technology are seeking to expand its applications beyond their current uses and, in order to do so, require capital to build their application

platforms. Rather than seek financing from traditional venture capital sources (which is difficult to obtain and expensive), many of these developers have sought alternative sources of capital. Some developers have sold "digital tokens" during an application's development stage, releasing nothing more than a white paper describing the blockchain application being built. In addition to describing the application, a white paper will often include a description of the digital tokens themselves. The description will generally provide both information related to the utility of a digital token (for example, some digital tokens may provide general access to an application while others may be redeemed for premium content) and information related to their overall supply, manner of release and purchase (which is often articulated with reference to a digital currency, such as Bitcoin or Ether). A developer's initial sale of its platform's digital tokens is commonly referred to as an "initial coin offering."

The Report

On July 25, 2017, the Division issued the Report clarifying that digital tokens, such as the DAO Tokens, could be "securities" and thus subject to United States federal securities laws.¹ As outlined in the Report, purchases of the DAO Tokens (i) represented an investment of money (which was not required to be U.S. dollars, as the DAO Tokens were sold for Ether) (ii) with a reasonable expectation of profits (from the success of the issuer's projects) which (iii) derived from the managerial efforts of others (as DAO's founders and "curators" had necessary input as to which projects were put forth for funding consideration as an initial step). Accordingly, the Division concluded that the DAO Tokens were "investment contracts" (*i.e.*, securities), and required such offering to be registered with the SEC or conducted pursuant to an exemption from registration.

The Report acknowledged that the analysis was only applicable to the DAO Tokens, and all digital token offerings would be

¹ Under the Acts, a "security" includes "an investment contract," which is defined as (1) an investment of money in a common enterprise (2) with a reasonable expectation of profits to be (3) derived from the entrepreneurial or managerial efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The Division used the three-part test, first set forth in *Howey*, to determine whether the DAO Tokens were investment contracts.

subject to a facts and circumstances test as to whether or not a particular token is a security. However, the Report makes it clear that the SEC stresses that the federal securities laws 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.

Considerations for SEC Registered Investment Advisers

Each Adviser is required to establish a Code of Ethics requiring, among other things, its access persons to periodically report their securities transactions and holdings as well as pre-approve transactions in initial public offerings and limited offerings. Many Advisers have established their own enhanced personal trading policies that apply to all employees (and certain other agents) of the Adviser. These enhanced requirements often include, without limitation, pre-approval on a wide variety of personal securities transactions (not just initial public offerings and limited offerings), maintaining restricted lists with respect to trading in securities or other instruments of certain issuers, instituting blackout periods, prohibiting short-term trading, and requiring employees to trade only through certain brokers.

Although the Report is clear that whether or not a digital token is a security depends on the particular facts and circumstances surrounding the digital token, Advisers should consider their treatment of digital tokens generally for purposes of their Code of Ethics. Many issuers of digital tokens have taken the position, and may continue to take the position, that their specific tokens are not securities. However, the SEC may take a position after

the issuance of a digital token that such token was a security. In light of the fluid nature of the legal analysis regarding digital tokens, an Adviser should consider implementing a policy regarding all digital tokens to ensure that its access persons (or all employees and other access persons) are not trading in digital tokens deemed to be securities outside of compliance with the Adviser's Code of Ethics (including pre-approval and reporting requirements contained therein). It is important for Advisers to review their Codes of Ethics with respect to digital tokens, as access persons (or all employees and other access persons) trading digital tokens may create other regulatory issues for Advisers that arise out of particular facts and circumstances unique to the Adviser. Even if an Adviser believes that its current Code of Ethics applies to digital tokens (for example, if the Code of Ethics covers all personal trading whether in securities, commodities or otherwise), the Adviser is to clearly communicate that digital tokens are within the ambit of the Adviser's Code of Ethics.

Advisers should carefully review their Code of Ethics to ensure that they have considered how to treat digital tokens for purposes related thereto and have effectively communicated the application of the Code of Ethics to digital tokens to all covered persons. As each Adviser's organization is unique, an Adviser should not seek a universally accepted approach with respect to digital tokens and should ensure that its policies are tailored to suit the unique aspects of its organization.

The Report is available [here](#). An additional SEC investor bulletin relating to Initial Coin Offerings is available [here](#).

Contacts

Please contact any of the authors of this article, or any other member of Lowenstein Sandler's Investment Management Group for further information on the matters discussed in this alert. Similarly, we are available to assist you in developing best-in-class policies and compliance programs for your firm in accordance with all applicable rules and regulations and industry standards.

Scott H. Moss, Esq.

Partner

T 646.414.6874 | smoss@lowenstein.com

Benjamin Kozinn, Esq.

Partner

T 212.419.5870 | bkozinn@lowenstein.com

Brent A. Morowitz, Esq.

Counsel

T 646.414.6933 | bmorowitz@lowenstein.com

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