Not So Fast: Why Compliance Can't Ignore Digital Assets Even If the Investment Team Does

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Registered investment advisers – even those that do not provide advice about **digital assets** – are increasingly becoming aware of the need to take digital assets into account when drafting and implementing their codes of ethics. This is a direct result of the increasing frequency with which an adviser's **access persons** may want to make personal investments in digital assets. Below, after providing a brief background on the personal transaction reporting requirements of the code of ethics rule, we discuss different types of digital assets, the securities law analysis that is currently applied to digital assets, and the resulting application of the code of ethics rule to digital assets.

For purposes of this article, the term "digital assets" has the meaning given to it by the SEC in its recent complaint against Ripple Labs, Inc. alleging that Ripple's sales of the company's digital asset – XRP – constituted an unregistered offering of a security. In its complaint, the SEC defined a digital asset as "an asset issued and/or transferred using distributed ledger or blockchain technology, including assets sometimes referred to as 'cryptocurrencies,' 'virtual currencies,' digital 'coins,' and digital 'tokens.'" There are many digital assets now in existence. In addition to Ripple, well-known examples of digital assets include Bitcoin and Ether.

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I. Code of Ethics Rule

Rule 204A-1 under the Investment Advisers Act of 1940 (Advisers Act) is aimed at preventing insider trading and market manipulation. Under the rule, an adviser must adopt a code of ethics that, among other things, requires the adviser's access persons to report to the adviser's compliance officer the access persons' holdings of and transactions in "reportable securities." In general, these reporting requirements relate to most "securities," as that term is defined in Section 202(a)(18) of the Advisers Act, although quarterly reporting is not required for transactions in securities such as government securities, money market funds, and open-end mutual funds not managed by the adviser or certain of its affiliates. Thus, to ensure compliance with Rule 204A-1 and the adviser's code of ethics thereunder, an adviser must require its access person to report their personal transactions in, and personal holdings of, digital assets if those digital assets are also securities.

II. Background on Digital Assets

Digital assets are not a homogeneous asset class; rather, they come in many varieties. For example, certain digital assets, such as Bitcoin and Ether, are decentralized virtual currencies that transfer on a peer-to-peer basis and can be used like money to purchase goods or engage in other commercial transactions. They are not subject to any central authority or backed by any government. The SEC has stated that these types of digital assets are so decentralized that they should not be deemed to be securities. Different from Bitcoin and Ether, many "tokens" or "coins" that have been offered in initial coin offerings (ICOs) as a means of raising capital for a business or blockchain project represent another

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iteration of digital assets. A shared characteristic of many truly decentralized virtual currencies and many ICO tokens is that they generate their values intrinsically; their values are what everyone agrees their values to be.

In contrast, another variety of digital assets generates value through reference to an identified pool of collateral (*e.g.,* real estate, fiat currency, precious metals, or other digital assets). One example of an asset-backed digital asset is called a "stablecoin." Stablecoins are a type of digital asset that seeks to maintain price stability with respect to an asset with a stable value, such as U.S. dollars. There are also digital assets that have registered or qualified as securities. These include digital securities issued by INX Ltd (registered on Form S-1), Blockstack PBC (qualified on Form 1-A), and Arca U.S. Treasury Fund (registered on Form N-2).

III. Securities Analysis

To date, when considering if a digital asset is a security, the SEC has applied the investment contract test set forth in *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946). Under the *Howey* test, whether any instrument is an investment contract depends on: (1) whether purchasers of the instrument contributed money (or other valuable goods or services); (2) whether purchasers invested in a common enterprise; (3) whether purchasers reasonably expected to earn profits through that enterprise; and (4) whether the expected profits are to be derived from the efforts of others. The presence of all four of these factors is required in order to conclude that an instrument is an investment contract, and therefore a security. Nonetheless, the potential scope of the analysis under *Howey* is broad, as is the statutory definition of a "security," designed by Congress to embody 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." (328 U.S. 293, 299 (1946))

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As can be seen in the SEC's *Ripple* complaint, most of the *Howey* analyses that, to date, have been applied to digital assets have focused in particular on whether digital asset purchasers rely on the efforts of others with respect to any expectation of profits by those purchasers. Focusing on this *Howey* factor, the SEC has successfully challenged digital asset offerings by issuers Kik (*U.S. Securities and Exchange Commission v. Kik Interactive Inc.,* 19-cv-05244-AKH (S.D.N.Y. Sept. 30, 2020)) and Telegram (*U.S. Securities and Exchange Commission v. Telegram Group Inc., et al.,* 19-cv-09439-PKC (S.D.N.Y Oct. 11, 2019)) as unregistered securities offerings. Also focusing on the "efforts of others" *Howey* factor, the SEC staff has determined that two truly decentralized virtual currencies, Bitcoin and Ether, are not investment contracts and therefore not securities. The SEC and its staff have yet to apply *Howey* or any alternate security analysis to the context of a stablecoin. However, it seems reasonable that stablecoins should not be deemed to be securities, not because of the "efforts of others" factor but rather because, unlike more volatile virtual currencies or the ICO tokens, stablecoins generally seem to fail another of the principal *Howey* tests: that is, that a purchaser must have an expectation of profit.

IV. Application of Code of Ethics Rule to Digital Assets

Regardless of where the SEC comes out on an analysis of stablecoins under the *Howey* test, it is clear that some digital assets qualify as what the SEC Staff has referred to as "**digital asset securities**." It is equally clear that firms and individuals that seek to participate in the marketplace for digital asset securities must comply with relevant securities laws (*see, e.g.,* the SEC's and FINRA's *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, July 8, 2019 (Joint Statement)).

What does this mean for registered investment advisers? In short, even if the investment adviser does not provide any investment advice regarding digital assets, decisions need to be made about whether individual access persons should be able to transact in such assets. If a registered investment adviser does allow its access persons to transact in digital assets for their personal accounts, the adviser should recognize that many digital assets may qualify as "reportable securities" under Rule 204A-1. Accordingly, the advisers' code of ethics must ensure that transactions in digital assets are captured for purposes of both quarterly personal securities transaction reports and annual personal securities holdings reports.

In addition to the difficulty of determining which digital assets qualify as securities, an adviser seeking to ensure compliance with Rule 204A-1 may confront some additional unique challenges. For example, many registered investment advisers use compliance systems that automate the quarterly reporting process by automatically sending the compliance team duplicate copies of quarterly brokerage statements for each of the adviser's access persons. Moreover, to facilitate this reporting,

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many advisers limit the broker-dealers with which their access persons can do business to a discrete list of identified brokerage firms. In many cases, those broker-dealers maintain custody of the funds and securities owned by its customers. As the SEC and FINRA noted in the Joint Statement, however, compliance with the safekeeping requirements of the Customer Protection Rule (Rule 15c3-3) under the Securities Exchange Act creates practical challenges to broker-dealer custody of digital asset securities. In short, Rule 15c3-3 requires broker-dealers to physically hold customers' securities or maintain them in a "good control" location (for example, the Depository Trust Company (DTC) or a clearing bank). Digital assets, however, are not DTC-eligible. As a result, compliance with the Customer Protection Rule makes it difficult for broker-dealers to maintain custody of digital assets owned by their customers.

Rather than being held by broker-dealers, digital assets are generally held in a digital wallet, owned and controlled by the individual investor. And, practically speaking, there is no way for an investment adviser to effectively monitor ownership through digital wallets: notwithstanding the relative transparency of the chain of ownership on a blockchain, the owners of digital wallets are anonymous, represented only by a public key (*i.e.,* a string of letters, numbers, and symbols). Addressing the investment in digital assets by access persons isn't an insurmountable challenge, but it does suggest the need for increased vigilance on the part of compliance professionals to ensure that an investment adviser is complying with its responsibilities under Rule 204A-1.

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