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Digital Assets and Investment Advisers Act Compliance

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As anyone paying attention to the business press knows, the soaring popularity (and volatility) of investments in cryptocurrencies, initial coin and token offerings (ICOs) and similar assets (collectively, digital assets) has caught the eye of U.S. regulators, including the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). As a result, one of the most important current regulatory issues for the investment management, financial services and related industries is whether digital assets are deemed "securities" under the U.S. federal securities laws. The answer to this question, which is playing out in real time as regulators and industry participants gain experience with digital assets, not only will have a large impact on U.S. and international capital markets, but will also require adjustments to compliance programs by investment advisers registered under the Investment Advisers Act of 1940 (Advisers Act) to the extent they provide advice related to digital assets or have employees who invest in such assets.[1]

The SEC has stated that ICOs and similar offerings may be considered offerings of securities under certain circumstances and therefore subject to the registration, anti-fraud and other provisions of the U.S. federal securities laws.[2] Furthermore, in a recent speech, William Hinman, the SEC's Director of the Division of Corporation Finance, stated that while many digital assets have the attributes of securities, in his view Bitcoin and Ethereum, two popular cryptocurrencies, should not be considered securities (and therefore should not be subject to such regulation).[3] Mr. Hinman noted that the SEC's analysis of digital assets will turn on the economic substance of the transaction and whether the value of a digital asset is dependent on the actions of a third party, and that the economic substance of a transaction can change over time.

In This Issue

The SEC has made clear that the examination and potential regulation of digital assets is a top priority for the agency.[4] In light of this focus, it is crucial for registered advisers to understand the implications of providing advice relating to digital assets on their compliance obligations, especially if those assets are deemed securities. The following highlights some of those compliance considerations under the Advisers Act. While some of these considerations hinge on whether the digital asset is a security, others do not. Because it is expected that there will be some ambiguity for the near future regarding whether many digital assets are securities, advisers working with such assets may find it prudent to treat all digital assets as securities subject to the requirements of the Advisers Act unless there is specific SEC guidance to the contrary.

Compliance Considerations that Depend on Whether a Digital Asset is a Security

Section 202(a)(11): Definition of "Investment Adviser"

As an initial matter, Section 202(a)(11) of the Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of *securities* or as to the advisability of investing in, purchasing, or selling *securities*, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning *securities* (*emphasis added)*…." Therefore, a person who provides advice solely with respect to digital assets that are not deemed securities will not have any registration or other obligations under the Advisers Act. Conversely, a manager who advises with respect to at least some digital assets that are deemed securities will be subject to SEC registration and regulation under the Advisers Act.

Rule 204(A)-1: Code of Ethics Reporting

Rule 204(A)-1 under the Advisers Act mandates that registered advisers adopt a code of ethics, which requires certain employees (access persons) to report their personal securities holdings and trading activities to the adviser. Since reportable assets are limited to "securities," any digital assets that qualify as such are covered. Access persons typically comply with this requirement by having copies of their personal brokerage statements and trade confirmations automatically submitted to the adviser. However, because digital assets generally are not traded on public exchanges or through registered broker-dealers, such information will have to be manually submitted, and registered advisers will need to update their codes of ethics to account for this complexity.

Section 206(3): Principal Transactions and Agency Cross Transactions

Under Section 206(3) of the Advisers Act, it is unlawful for any investment adviser (whether registered or unregistered), acting (i) as principal for its own account, to sell any *security* to or purchase any *security* from a client, or (ii) as broker for a person other than such client, knowingly to effect any sale or purchase of any *security* for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which it is acting and obtaining the consent of the client to such transaction (*emphasis added*).[5] To the extent a digital asset is considered a security, an adviser would be prohibited from engaging in these transactions without the requisite disclosure and advance consent. Note, however, that in light of the fiduciary nature of the investment advisory relationship, even such transactions that do not involve securities generally require the adviser to ensure that the client is treated fairly and is apprised of all relevant conflicts of interest.

Compliance Considerations that Apply Regardless of Whether a Digital Asset is a Security

Rule 206(4)-2: The Custody Rule

Rule 206(4)-2 under the Advisers Act, commonly known as the Custody Rule, provides that registered investment advisers with access to client funds or securities must maintain those assets in accounts with a "qualified custodian."[6] Because the rule applies to "funds and securities," it arguably covers all digital assets, regardless of whether they are considered securities. We understand that advisers for digital assets have found complying with the Custody Rule difficult given the nature of those assets and the small number of qualified custodians currently willing to provide custodial services in this area.

To date, the SEC has not provided guidance on how advisers holding digital assets should comply with the Custody Rule. However, on July 2, 2018, Coinbase, one of the largest cryptocurrency exchanges, launched Coinbase Custody in partnership with an SEC-registered broker-dealer to hold Bitcoin, Ethereum, Litecoin and Bitcoin Cash. This platform qualifies as a "qualified custodian" under the Custody Rule and solves a significant problem for registered advisers looking to invest in those cryptocurrencies.

Section 204 and Rule 204-2: The Books and Records Rule

Under Section 204 of the Advisers Act and Rule 204-2 thereunder, registered advisers are required to maintain extensive books and records relating to their investment advisory business. Records regarding transactions in digital assets are included in this requirement regardless of whether the digital asset is a security. However, given that the documentation for these transactions has not yet become standardized, registered advisers dealing with digital assets should take extra care to ensure they are complying with all aspects of these provisions.

Rule 206(4)–7: The Compliance Rule

Rule 206(4)-7 under the Advisers Act, commonly known as the Compliance Rule, requires registered advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. The Compliance Rule also requires that registered advisers conduct at least annual reviews of their compliance policies and procedures. Therefore, registered advisers will need to review their compliance policies and procedures to ensure that they appropriately cover digital assets to the extent necessary. For example, there may be unique issues regarding digital assets with respect to valuation or trading on material non-public information that should be addressed.

Thinking Outside the Box: Private Fund Managers and Corporate Conversions

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In response to recent changes in U.S. federal income tax law under the Tax Cuts and Jobs Act (TCJA), private fund managers are mulling over the question of whether or not to incorporate or otherwise adjust the structures of the entities that receive management fees (each a management company) from the private equity funds managed by such managers. Certain large, publicly traded alternative asset managers have already converted from publicly traded partnerships to corporate status. However, their considerations for making the switch will not necessarily apply with the same weight where other private equity sponsors are concerned. The following is a discussion of certain factors that may sway more typical domestic privately held private equity businesses either to maintain pass-through tax treatment or to convert their management companies to corporate status.

I. Corporate v. Pass-Through Income Tax Rates

The TCJA lowered the base federal income tax rates for both corporate and pass-through entities. The corporate tax rate was reduced from a staggered structure with a top marginal rate of 35% to a flat 21% rate, and the pass-through top marginal tax rate was reduced from 39.6% to 37%.[7] The taxation regime for a U.S.-based investor in a corporation is a two-level one, imposing tax both on income of the underlying U.S. corporation, and dividends therefrom,[8] such that the effective post-TCJA top tax rate on corporate income is 39.8% once such income is distributed.

In certain circumstances, corporate status could confer a tax benefit by deferring the shareholder level tax.[9] Still, notwithstanding a company's corporate structure, obtaining a net benefit from such tax deferral depends on the characteristics of the relevant business. Additionally, as described directly below, in order to ascertain the benefits of the corporate structure as applicable to a particular management company, it is necessary to evaluate the risk of the applicability of certain anti-deferral tax regimes (i.e. the accumulated earnings tax (AET) and the personal holding company tax (PHCT)).

II. Tax Deferral, the AET, and the PHCT

Tax deferral at the shareholder level is a potential benefit where a corporation chooses to retain its earnings and profits rather than distributing them. Specifically, a corporation may reinvest such earnings and profits into its operations, and a U.S. investor is not generally liable to pay tax in respect of its investment in such corporation until an actual distribution of dividends occurs or such investor divests of its stock. However, the AET and PHCT anti-deferral provisions of the Code were enacted to disincentive shareholders' use of this potential benefit.

The AET is a 20% tax on a corporation's "accumulated taxable income," and applies to corporations that accumulate earnings beyond the reasonable needs of their business operations.[10] Similarly, the PHCT is a 20% tax on a "closely held" corporation's "undistributed personal holding company income." If either of these taxes applies, the tax assessed at the corporate level on the designated "accumulated taxable income" or "undistributed personal holding company income" rises to 36.8%.[11] By the time that a dividend is actually paid to a U.S. shareholder, the income earned by the corporation could be subject to a combined federal corporate and shareholder tax rate of 51.8%.[12]

To avoid application of the AET, an incorporated management company should ensure that its retained earnings are no more than the greater of $250,000 and the "reasonable needs of the business."[13] Additionally, if a management company would otherwise be subject to the PHCT rules, such management company could avoid the PHCT by distributing the income that would otherwise be subject to such tax. Based on the foregoing, the decision to change a management company's tax classification requires serious consideration of such company's reasonable business needs and modeling of the anticipated future income stream and the expected after-tax return on reinvestment of corporate earnings and profits.

III. Other Considerations

If the question of choosing a corporate or pass-through form to earn management fees persists past the inquiries into the AET and PHCT, the following factors, if applicable, may significantly impact a decision to potentially incorporate. Once incorporated, the management company will no longer pass through losses to its owners and migrating out of corporate status and back to a pass-through structure (e.g., in the event that corporate and individual rates converge again or the AET and PHCT rules are expanded) could incur significant tax cost. In view of the foregoing, it is telling that the large, publicly traded alternative asset managers that already have converted to corporate status rationalize their transition in terms of simplifying structure, broadening their potential public investor base, improving liquidity and trading volume and providing a more attractive currency for strategic acquisitions, and not in terms of lower corporate rates.[14] These potential benefits are generally inapplicable to most private fund sponsors. As such, private fund managers considering a management company incorporation should weigh the potential benefits and costs carefully.

Recent Notable Enforcement Actions Involving Private Fund Managers

The past several months have seen the SEC sanction private fund managers for a variety of Advisers Act violations, as described below.

Failure to Disclose Conflicts of Interest – Group Purchasing Organizations

The SEC settled an enforcement action with a private fund manager for alleged violations of the Advisers Act arising from the manager's failure to disclose conflicts of interest.[15] The alleged conflict related to an arrangement between the manager and a group purchasing organization (the GPO), an entity that aggregated spending on certain items in order to provide group-purchasing discounts to portfolio companies of the manager, and whereby the manager received fees in connection with such services.

During the relevant period, the manager advised two private equity funds (the Funds). The Funds' organizational documents established an Investment Review Committee (the Committee) comprised of Fund limited partners not affiliated with the manager to "approve in advance any transactions that give rise to potential conflicts of interest" between the manager and the Funds.

Certain Fund portfolio companies used the services of the GPO. An employee of the manager (the Manager Employee) provided advice to the portfolio companies regarding purchasing activities as well as certain services for the benefit of the GPO. In addition, an affiliate of the GPO (the GPO Affiliate) had an agreement with one portfolio company (Portfolio Company A) whereby the GPO Affiliate directly provided services to that portfolio company (the Portfolio Company Agreement).

The GPO Affiliate, Portfolio Company A and the Manager Employee entered discussions regarding a renewal of the Portfolio Company Agreement. In connection therewith, the manager and the GPO began negotiating an agreement whereby the GPO would pay the manager 25% of the net revenue the GPO received from vendors based on the purchasing activity of Fund portfolio companies done through the GPO (the Manager Agreement). The Manager Agreement provided that the payments were to be made in consideration for the Manager Employee's services to the GPO. The SEC noted that a GPO Affiliate employee emailed the Manager Employee to suggest that the Manager Agreement would be approved by the GPO when Portfolio Company A executed the renewal of the Portfolio Company Agreement. Both agreements were signed, and from September 2012 through December 2016, the manager received $623,035 pursuant to the Manager Agreement.

The SEC alleged that because of the Manager Agreement, the manager had an incentive to recommend the GPO's services to the Funds' portfolio companies since the manager would receive a share of revenue generated for the GPO by the portfolio companies' purchasing activity. In addition, the manager had an incentive to encourage Portfolio Company A to renew the Portfolio Company Agreement because the email mentioned above suggested the GPO would not enter into the Manager Agreement until such renewal occurred. As these conflicts had not been disclosed to Fund investors at the time of their investment (which pre-dated these arrangements), the SEC stated that in accordance with its fiduciary obligation to the Funds the manager should have sought approval from the Committee for the conflicts of interest arising from the Manager Agreement.

The SEC alleged that the manager violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. As part of the settlement, the manager paid disgorgement of $623,035, prejudgment interest of $65,784.78 and a civil penalty of $90,000.

Failure to Disclose Conflicts of Interest – Payments Related to Investments

The SEC settled an enforcement action with a private fund manager for alleged violations of the Advisers Act arising from the manager's failure to disclose conflicts of interest relating to payments it received for investing client assets with affiliated fund managers (the Affiliates).[16] The manager had an agreement with the Affiliates pursuant to which the Affiliates made payments to the manager based on the total amount of client assets placed or maintained in funds advised by the Affiliates. This arrangement was not disclosed to the manager's clients, and was in contravention of its investment management agreements with two clients (the IMAs).

Upon notification from the Affiliates that they intended to pay the manager approximately $648,000 pursuant to the agreement, the manager instructed the Affiliates to make the payment to the manager's parent company. The manager did not notify its clients of this payment or otherwise rebate fees to the clients, in contravention of the IMAs.

The SEC alleged that the manager violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which included a failure to adopt and implement reasonably designed policies and procedures related to preventing conflicts of interest. The SEC also alleged that the manager violated the recordkeeping provisions of Section 204(a) of the Advisers Act and Rule 204-2 thereunder for failing to keep accurate records of the payment due from the Affiliates. As part of the settlement, the manager rebated to its clients the amounts due under the IMAs plus interest and paid a civil penalty of $500,000.

Failure to Disclose Accelerated Fees

The SEC settled an enforcement action with a private fund manager for alleged violations of the Advisers Act arising from the manager's failure to disclose that it could receive accelerated fees from its portfolio companies upon the occurrence of certain events.[17] The manager typically entered into agreements with its funds' portfolio companies pursuant to which it received periodic fees in exchange for performing consulting and advisory services. Upon the initial public offering or sale of the portfolio companies, certain of these agreements terminated automatically, and the manager received an accelerated, lump sum payment of the fees that would have been payable for providing services for the remaining term of the agreement. Between 2013 and 2015, the manager received accelerated fees upon the early termination of portfolio company agreements in five cases.

The manager disclosed in the funds' governing and offering documents that it (i) may enter into consulting agreements with portfolio companies and receive fees therefrom and (ii) would offset a percentage of these fees against the funds' management fees. Additionally, as to one of its funds, the manager entered into side letters that made clear that it could collect accelerated fees upon the sale or IPO of portfolio companies. However, not all fund investors received notice of this provision. The manager also disclosed, in semi-annual financial reports provided to all limited partners, the amount of periodic and accelerated fees and the portions of these fees offset against the funds' management fees, and amended its Form ADV to include disclosure on accelerated fees. However, the SEC alleged that the manager did not adequately disclose to the funds, their advisory committees, or all the funds' limited partners, prior to their commitment of capital, that the manager could receive accelerated fees upon the early termination of portfolio company agreements.

The SEC stated that because the manager's receipt of accelerated fees from portfolio companies posed at least a potential conflict of interest between the manager and the funds, the manager could not effectively consent to this practice on behalf of the funds. Because of the conflict and its failure to disclose the same prior to limited partners' commitment of capital, the manager breached its fiduciary duty to the funds in violation of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. In addition, the manager violated Section 206(4) and Rule 206(4)-7 thereunder by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act arising from its undisclosed receipt of accelerated fees from portfolio companies. In connection with the settlement of this proceeding, the manager agreed to pay $5,006,016 in disgorgement and prejudgment interest and a civil penalty of $1,500,000.

Failure to Offset Fees

The SEC settled an enforcement action with a private fund manager for alleged violations of the Advisers Act arising from the manager's failure to offset consulting fees against the management fees paid by certain venture capital funds it advised, in violation of the funds' governing documents.[18] Pursuant to the limited partnership agreements and offering documents of its funds, the manager, which is not a registered investment adviser but rather files reports with the SEC as an exempt reporting adviser (ERA), could receive transaction fees from the funds' portfolio companies for certain services that it provided, including consulting fees. The manager was required to offset a specified percentage of transaction fees it received against the management fees paid by the funds. The SEC alleged that between July 2012 and September 2013, the manager received $1,208,253 in consulting fees from two portfolio companies, of which the manager was required to offset $759,870. However, the manager failed to offset these fees, resulting in the funds and their limited partners overpaying $759,870 in management fees in violation of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

Since the manager is an ERA (and the SEC typically does not engage in routine examinations of such entities), it is unclear how this issue first came to the attention of the SEC staff. However, upon being contacted by the SEC's Division of Enforcement, the manager voluntarily (i) reimbursed limited partners of the affected funds the amount of the overpaid management fees plus interest, (ii) named a new chief compliance officer who implemented new controls to verify the accuracy of management fees that the manager charged and the calculation of offsets for consulting fees and (iii) retained a compliance consulting firm that, among other things, will conduct quarterly testing of existing policies and procedures for expense allocations and ensuring compliance with disclosure obligations. The manager also paid a civil penalty of $200,000.

Repeated Failures to File Form PF

The SEC settled enforcement actions with 13 private fund managers for alleged violations of the Advisers Act arising from the managers' repeated failure to File Form PF.[19] Rule 204(b)-1 under the Advisers Act requires a registered investment adviser to file reports on Form PF if the investment adviser acts as manager to one or more private funds and as of the end of its most recently completed fiscal year, managed private fund assets of at least $150 million. The managers involved in the settlements all failed to file Form PF as required over multiple years. In connection with the settlements, each manager agreed to make the required filings and pay a $75,000 civil penalty.

Violation of Political Contributions Rule

The SEC settled enforcement actions with three private fund managers for alleged violations of Rule 206(4)-5 under the Advisers Act (the "political contributions" or "pay-to-play" rule).[20] The rule, among other things, prohibits managers from receiving compensation for investment advisory services to a government client (or to an investment vehicle in which a government entity invests) for two years after the manager or certain of its employees (covered associates) makes a campaign contribution to elected officials or candidates who can influence the selection of the manager. The rule does not require a showing of actual intent to influence the official or candidate or that an investment was made with the manager as a result of the contribution.

In all three actions, covered associates of the managers made political contributions to government officials with influence over the selection of investment advisers for public entities and pension plans, and within two years of such contributions the managers received compensation from the entities and plans for providing advisory services in violation of Rule 206(4)-5. Many of the investments by the public entities and pension plans pre-dated the contributions at issue, and in some cases the covered associates requested that the contributions be returned. In connection with the settlements, the managers paid civil penalties of $100,000, $120,000 and $500,000, respectively.

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ENDNOTES

[1] Although beyond the scope of this article, to the extent the CFTC deems certain digital assets "commodity interests," advisers dealing with these assets could face additional CFTC-related compliance burdens.
[2] See here.
[3] *Remarks at the Yahoo Finance All Markets Summit: Crypto; Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018). In discussing how to judge whether a digital asset is or is not a security, Mr. Hinman stated that "[i]f the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures [required under the securities laws] becomes difficult, and less meaningful."
[4] Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: *Regulators are Looking at Cryptocurrency* (Jan. 25, 2018).
[5] Rule 206(3)-2 under the Advisers Act provides limited relief from the advance consent requirement with respect to an agency cross transaction, which is defined as a transaction in which a person acts as an investment adviser in relation to a transaction in which such investment adviser, or any person controlling, controlled by, or under common control with such investment adviser, acts as broker for both such advisory client and for another person on the other side of the transaction.
[6] A qualified custodian is generally a bank or savings association, a registered broker-dealer, a registered futures commission merchant or a foreign financial institution that customarily holds financial assets for its customers.
[7] Certain individuals with ownership interests in pass-through entities may also qualify for a 20% "pass-through deduction" for certain "qualified business income," depending on income, filing status, and other criteria. Such deduction becomes unavailable with respect to income derived from "specified services" when such income exceeds a certain threshold amount. Because investment management fits the description of such services, with the consequence that management fee income is likely ineligible for such deduction, this article does not discuss such deduction. In addition, income from a pass-through business may be subject to incremental taxes such as the self-employment tax or net investment income tax. Such incremental taxes are not factored into the pass-through rates described above.
[8] Generally, the tax rate on qualified dividends to individual U.S. shareholders is 20%. For purposes of the following discussion, we assume that the rate applicable to dividends is the combination of the qualified dividends rate and the net investment income tax of 3.8%, resulting in a combined rate of 23.8%.
[9] It should also be noted that corporate taxpayers are able to deduct state and local taxes, whereas such deductions for individual taxpayers have been severely limited by the TCJA. Taxpayers that are considering incorporating a pass-through business should factor a corporation's ability to deduct state and local taxes into their analysis.
[10] While the AET is not self-assessed and may be imposed only on audit (unlike the PHCT, which is self-assessed), it is important for taxpayers to anticipate the extent of their AET exposure. This analysis is inherently imprecise, as it depends on the subjective inquiry into what constitutes the reasonable needs of the relevant business, in the eyes of the IRS. In contrast, the "undistributed personal holding company income" analysis of the PHCT is objective and quite clear.
[11] 21% corporate tax rate + (79% x 20% AET or PHCT tax rate).
[12] If the management company is subject to the PHCT, the AET framework is inapplicable.
[13] A management company's reasonable needs (such as development of its management services or contracting with service providers) will likely depend on the sums required to develop its own management service offerings. Ideally, the facts and circumstances in support of the decision to retain management company earnings for reasonable business needs should be contemporaneously documented.
[14] See Exhibit 99.1 to Form 8-K filed by Ares with the SEC on February 15, 2018.
[15] The settlement order can be found here.
[16] The settlement order can be found here.
[17] The settlement order can be found here.
[18] The settlement order can be found here.
[19] The SEC's press release and links to the settlement orders can be found here.
[20] The settlement orders can be found here, here and here.