

Article written by Ayanda Motlou, Candidate Attorney, checked and released by Dave Loxton, Senior partner at Schindlers Attorneys

What are crypto assets?

Various terms have been used to refer to the phenomenon that is crypto; these include assets such as cryptocurrency, digital currency, cyber cash, virtual currency, e-money, amongst others. The general basis of crypto is moving away from concentrated, towards distributed means of production and consumption of goods and services, through shifts in technology (Distributed Ledger Technology). When implemented with decentralized control, each cryptocurrency works through distributed ledger technology, typically a blockchain, that serves as a public financial transaction database. The definitions used to describe crypto assets usually centre around their electronic nature, their potential role as something that can be used as currency, and them being viewed as a representation of value. In some countries, they are accounted as a monetary unit, while other countries have renounced them as financial instruments such as security. Notably, central banks have been unwilling to refer to crypto assets as currency, as they are not considered to be a kind of legal tender/money, or fiat currency (paper currencies such as the euro and the U.S. dollar). The characteristics of a currency are durability, portability, divisibility, uniformity, limited supply, and acceptability. Certain commentators also include elasticity as an essential component.

In South Africa, crypto is not yet regulated: the Intergovernmental Fintech Working Group, a collection of financial sector regulators working towards the regulation of crypto assets, have opted to take the functional route, by concentrating more on the economic activities being performed, as opposed to the more universal, overarching classification. It is recognized that crypto assets may perform certain functions similar to those of 'traditional' currencies, securities or financial products and commodities.

The following definition has been adopted:

A crypto asset is a digital representation of value that is not issued by a central bank but is traded, transferred and stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility, and applies cryptography techniques in the underlying technology¹.

Collective investment schemes

A collective investment scheme is defined as follows in terms of the Collective Investment Scheme Act ("CIS"):

Collective investment scheme means a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which-

- (a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and
- (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed.

In South Africa, such schemes are commonly referred to as mutual funds.

In terms of the CIS, marketing or soliciting investments in a foreign collective investment scheme is prohibited, except where the collective investment scheme has in itself been officially sanctioned in accordance with the requirements of the CIS. Enforcement of this prohibition is strict and severe, in so far as merely introducing an unapproved foreign collective investment scheme into the South African economic landscape is strictly prohibited. An infringement of the prohibition constitutes a criminal offence.

The definition of a collective investment scheme includes an open-ended investment company, and instances where the general public is invited to make an investment in a portfolio where participatory interests are held by the investors, and the profits are shared pro rata depending on their investment in the gambles and gains of the scheme.

Whether or not the CIS is applicable to crypto assets is entirely dependent on whether the definition of a collective investment scheme under the CIS is met. Therefore, in certain instances, crypto asset may trigger the application of the CIS.

The fundamental considerations when deciding whether or not crypto assets are a regulated instrument under the CIS are whether:

- The particular use of the crypto assets includes pooling funds from investors for investment in

crypto assets;

- Investors retain participatory interests, and;
- Investors share in the gambles and gains on the investment, proportioned according to their participation.

Recommendations by the Crypto Position Paper (a position paper published by the Treasury, on the current South African policy position on crypto) suggest that the pooling of crypto assets should be treated as an Alternative Investment Fund, making it a licensable action under the Conduct of Financial Institutions Bill. In terms of the Crypto Position Paper, collective investment schemes should not be permitted to include crypto assets in their portfolios. Certain crypto assets, e.g. stablecoins, can potentially be classified as derivative instruments, which are governed by the Financial Marketing Authority, and the Financial Sector Conduct Authority² ("FSCA").

Contravention of CIS

Persons found guilty of offences criminalised by the CIS will be liable to a fine not exceeding R10 000 000 (Ten Million Rands), or up to 10 years' imprisonment, or both.

In 2019, the FSCA announced that it had imposed a fine of R 350 000.00 on One Asset Management Pty Ltd, an asset management company, because it had been found to be in breach of the CIS. It was found that the asset manager sought investments in funds which were not approved. Information regarding these funds was published on the company website using newsletters sent to clients, and in presentations to clients. According to the FSCA, the abovementioned publications constituted soliciting, despite the fact that no actual investments had been made by South African investors.

The asset manager appeared before the Financial Service Tribunal for reconsideration of the decision by the FSCA. The only matter in dispute before the Tribunal was whether the publication of the information on the website constituted soliciting. In terms of the CIS, "solicit" is "any act to promote investment by members of the public in a collective investment scheme;". The manager argued that the word "solicit" meant an intentional request to the public to invest, and that he was under the impression that the company's publications were merely publications including marketing material, with no intention to solicit. This, he argued, was evidenced by the disclaimers included on the company website, and, further, that no investments in the funds in question could

be done directly through the website.

The Tribunal did not agree with this view and found that even though investments in the fund could not be made directly through the website, persons were invited to consider the investment. Further, the Tribunal added that the CIS prohibits the act of promotion, and the fact that the promotion did not result in any investments is immaterial. According to the Tribunal, if published information promotes or sparks interest in making investments in the product, it qualifies as soliciting. The Tribunal also took into account the fact that the business of the company entails the administration of funds, and accordingly, publishing the investment funds in its portfolio included the marketing of those funds.

Conclusion

Crypto assets are part of a plethora of digital currency exchanges that are rapidly growing into the mainstream of forms of exchange, and as such, the regulation of crypto is the next critical step in the South African financial landscape. Whether or not the use of crypto assets is governed by the CIS depends on the facts of each case. Should they trigger application of the CIS, the consequences could be dire if a breach occurs. As such, persons dealing in crypto ought to educate themselves on same, to not find themselves on the wrong side of the law.

Value

Exercising caution when dealing in crypto is imperative, as the consequences of non-compliance with legislation such as the Collective Investment Schemes Act may be dire.

[1] Position Paper on Crypto Assets

http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf

[2] *FinTech in South Africa: Overview*