CLARITY AT LAST?
AN ANALYSIS OF THE SEC STATEMENT ON DIGITAL ASSETS

The use of blockchain and other distributed ledger technology has been a catalyst for innovation in ways that the financial markets did not see coming and probably the most commonly known innovation which leverages on blockchain technology is cryptocurrency. Since its inception, cryptocurrency, as a digital asset, has gained significant traction with a global market valuation of about US$267 billion,[1] and across Africa, participation in this market is fast rising. Monthly cryptocurrency transfers to and from Africa of under US$10,000 (typically made by individuals and small businesses) jumped more than 55% in a year to reach US$316 million in June 2020.[2] It is estimated that a large portion of this activity comes from Nigeria.[3]

All the evidence clearly indicates that cryptocurrency and other digital assets are here to stay, and as we see DeFi[4] growing in popularity, the expectation is that this asset class should be a viable alternative finance instrument. Concerns about the inherent risks associated with digital assets, however, remain a hinderance to real growth and most importantly, to institutional participation. Cryptocurrencies and other digital assets have been largely unregulated in many jurisdictions, including Nigeria – with the CBN warning in 2018 that such digital assets were not legal tender, but recently we have seen a marked shift in this approach. A couple of weeks ago the EU proposed a full regulatory

[1] <https://markets.businessinsider.com/currencies/news/bitcoin-price-crypto-market-grows-billions-breaks-threshold-value-total-2020-5-1029182471#> accessed 27 September 2020
[2] https://www.reuters.com/article/us-crypto-currencies-africa-insight/how-bitcoin-met-the-real-world-in-africa-idUSKBN25Z0Q8\accessed 28 September 2020
[3] There was also significant activity in South Africa and Kenya
[4] Decentralised Finance which further leverages on blockchain technology to develop complex financial use cases.

framework for cryptocurrencies and in the U.S., two new Bills are under consideration by lawmakers - the Digital Commodity Exchange Act, and the Securities Clarity Act.

Against this background, the Securities and Exchange Commission ("**SEC**") on 14 September 2020 issued a Statement on Digital Assets and their Classification and Treatment (the "**SEC Statement**"). Essentially, the effect of the Statement is that digital asset investments will now be subject to regulation by the SEC as securities unless proven otherwise.

THE SEC STATEMENT ON DIGITAL ASSETS

The SEC Statement was issued pursuant to the powers of the SEC to make rules and regulate the offering of securities in Nigeria under section 13 of the Investment and Securities Act, 2007 ("**ISA**").

In issuing the SEC statement, the regulator indicated the need to protect investors, promote ethical practices and maintain the integrity and transparency of the market as some of the drivers behind the SEC Statement.

The SEC Position

The approach of the SEC is that unless otherwise proven, digital assets will be treated as securities.

Securities are defined under the ISA as:

"*(a) debentures, stocks or bonds issued or proposed to be issued by a government; (b) debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate; (c) any right or option in respect of any such debentures, stocks, shares, bonds or notes; or (d) commodities futures, contracts, options and other derivatives*".[5]

This definition includes securities which may be transferred by means of any electronic mode approved by the SEC and which may be deposited, kept or stored with any licensed depository or custodian company as provided under the ISA.[6]

By virtue of the SEC Statement, the burden of proving that certain digital assets are not, in fact, securities, and therefore not subject to SEC regulation, is now on the issuer or sponsor, as the case may be.

In order to establish that the digital assets are not securities, the issuer or the sponsor is required to make an initial assessment filing with the SEC to prove that the digital assets in question do not constitute securities and therefore should not be registered ("**Assessment Filing**"). As part of the Assessment Filing, the issuer or sponsor is required to provide sufficient information regarding the contractual design of the said asset.

In the event that the issuer or sponsor is unable to prove to the SEC that the digital assets are not securities or, where the SEC makes a definitive finding that the digital assets are indeed securities, the issuer or sponsor will be required to formally register the digital assets (the "**Registration Filing**").

The SEC Statement also further provides that crypto-offerings such as Digital Assets Token Offering (DATOs), Initial Coin Offerings (ICOs), Security Token ICOs and other forms of blockchain-based offers of digital assets in Nigeria or offered from outside Nigeria but targeted at Nigerian investors, will now be regulated by the SEC.

Based on the foregoing, digital asset offerings that launched prior to the implementation of the SEC Statement will now have three (3) months to either make an Assessment Filing or a Registration filing (as applicable) with the SEC.

5 Section 315 of the ISA 2007

6 Section 315 of the ISA 2007

Who will be regulated?

The SEC Statement provides that any person, (individual or corporate) whose activities are blockchain-related and involves the offering of digital asset services, will be required to be registered with the SEC and comply with the regulatory guidelines of the SEC.

The implication of the above statement is that digital assets which fall within the scope of the SEC Statement will now be subject to the applicable SEC rules and regulations on securities. Some of the digital assets' services which fall under that scope include the reception, transmission and execution of orders on behalf of other persons, dealers on own account, portfolio management, investment advice, custodian or nominee services.

By any account, this is a wide net and it now seems possible that a range of digital assets will be caught under the SEC Statement to the extent that they qualify as securities. It is worth noting though, that the SEC Statement suggests that foreign issuers or sponsors from countries with International Organization of Securities Commissions (IOSCO) membership may be eligible for some form of regulatory forbearance.

Classification of Digital Assets

The SEC Statement defines crypto assets to mean "*a digital representation of value that can be digitally traded and functions as (a) a medium of exchange; and/or (b) a unit of account; and/or (c) a store of value, but does not have legal tender status in any jurisdiction*". Although this is a generally recognized definition, it is very broad, and appears aimed at capturing as many digital assets as possible for potential regulation.

The SEC Statement also provides that a "*crypto asset is – neither issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the crypto asset; and distinguished from fiat currency and e-money*". The foregoing draws a clear distinction between fiat money i.e. legal tender and virtual currencies.

The crucial part of the SEC Statement though, is that it sets out four broad categories of digital assets and how they will be treated under the new regime.

(i) ***Crypto assets*** - non fiat virtual currency will now be treated as commodities if traded on a recognised investment exchange.

(ii) ***Utility tokens or non-security tokens*** - will also be treated as commodities. However, spot trading and utility tokens will notably be exempt from the SEC's purview unless traded under a recognised investment exchange.

(iii) Security tokens - by virtue of the definition of securities under the ISA, that have the characteristics of securities thereby yielding interest, dividends, equities or anything similar, will also be treated as falling under the regulatory purview of the SEC.

(iv) Derivatives and collective investment funds of crypto assets, security tokens and utility tokens – will also be treated as falling under the purview of the SEC.

In each instance therefore, the qualifying digital assets will now clearly be subject to the (traditional) rules of the SEC on securities.

OLD RULES, NEW GAME?

A reoccurring challenge with the regulation of innovation is the application of existing laws developed for traditional and non-technology driven systems to new inventions.

Given the nature of digital assets, there are already a number of challenges from a regulatory perspective (not least being the blockchain technology by which they are created and offered and the pseudonymity which it can provide), which suggest that it

may be impractical to subject crypto issuers or sponsors and digital assets to exactly the same rules as the traditional securities market. This challenge is by no means peculiar to the Nigerian market though, and regulators the world over are dealing with the same considerations.

Taking the U.S. as an example, historically, regulators in the U.S. referred to the decision of the US Supreme Court in SEC v. W.J. Howey Co.[7] (the 'Howey test') to determine whether an instrument qualified as an investment contract and thereby required registration under US securities law.

The traditional Howey test requirements for qualification as registrable securities are; whether (a) there is an investment of money, (b) there is an expectation of profits, (c) the investment of money is in a common enterprise and finally, (d) any profit comes from the efforts of a promoter or third party. The U.S. regulator has declared that where digital assets meet these requirements, they will be subject to U.S. securities regulation and this is certainly significant.

The concern with this approach, however, is that the Howey test was developed for the more traditional securities market and while most digital asset offerings meet those requirements, the crypto world now sees the route to avoid being characterized as securities and is rising to the challenge. Therefore, as digital assets which get around securities regulation are being developed, new regulation must also be introduced to protect investors and maintain the integrity of the markets.

With this in mind, we anticipate that eventually the SEC will look to develop a regulatory framework which conceptually includes digital assets from inception. And this framework would be best developed with other market regulators such as the Central Bank of Nigeria ("CBN"), given the CBN's previous pronouncements on digital assets.

HARMONISING THE REGULATORY APPROACH

By virtue of a circular issued by the CBN dated 12 January 2017, banks and other financial institutions are expressly prohibited from trading or investing in cryptocurrency. This stern approach was followed with a press release in February 2018 pursuant to which the CBN warned the general public that virtual currencies are unlicensed, unregulated and do not constitute legal tender in Nigeria.

On the basis that the SEC Statement now brings virtual currency and digital assets generally, within an identified regulatory framework, the question is whether this will suffice from the perspective of the CBN. The CBN position on the recognition and regulation of digital assets will be decisive to institutional participation at any level, but its natural inclination may be to characterise digital assets along the lines of currencies rather than securities which could conflict with the SEC classification. This is not the only consideration for the CBN though, which would also take into account the licensing and regulation of digital asset exchanges and the layering of investor protections, amongst other factors. The approach of the different regulators to each of these factors could, however, lead to unnecessary regulatory overlap.

Between the potential for regulatory uncertainty arising from such overlap and the CBN's position as a financial sector regulator, it is critical that the SEC, CBN and other relevant regulators work together towards developing a harmonised regulatory framework that turns digital assets into regulated financial instruments, engenders investor confidence and possibly, paves the way for institutional participation to stimulate real growth.

[7] 328 U.S. 293 (1946)

Conclusion

There is no question that regulating digital assets has become a significant priority and will remain so for the foreseeable future, and so the SEC Statement is a welcome step in the right direction as it finally brings some much-needed clarity. If, however, we consider the rapid innovation that is possible with digital assets and DeFi generally, then in the long run it may not be enough to premise the regulation of digital assets solely on characterisation as traditional securities.

To the extent that the market for digital assets continues to grow at this pace, the Nigerian regulators will need to take an authoritative stance on the wider regulatory framework. Eventually, a harmonised approach which develops comprehensive regulation to build on the SEC Statement and provide robust categories (and sub-categories) of digital assets, rules on DATOs, ICOs and COs, regulation of exchanges, digital asset custody and possible capital requirements will need to be put in place following a concerted effort by the key regulators. In the immediate future though, we expect that the SEC may issue guidelines to aid market practice following the SEC Statement.

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