



COMMENTARY ON FSCA DRAFT DECLARATION OF CRYPTO ASSETS AS A
FINANCIAL PRODUCT UNDER THE FAIS ACT
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INTRODUCTION

The Financial Sector Conduct Authority (“**FSCA**”) published a draft declaration on the 20th of November 2020¹ (“**the declaration**”) in terms of which crypto assets were declared to be financial products as defined in paragraph (h) of the definition of financial product contained in the Financial Advisory and Intermediary Services Act No 37 of 2002 (“**the FAIS Act**” or “**FAIS**”). Paragraph (h) includes the following:

“any other product similar in nature to any financial product referred to in paragraphs (a) to (g), inclusive declared by the registrar after consultation with the Advisory Committee, by notice in the Gazette to be a financial product for the purposes of this Act.”

The declaration defines a crypto asset as:

¹ accessible at <https://www.fsca.co.za/Regulatory%20Frameworks/Pages/FAIS.aspx>

“any digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes, but excluding digital representations of fiat currencies or securities that already fall within the definition of financial product.”

The various manifestations of financial products covered by the FAIS Act include securities, shares, debentures and securitised debt, money market instruments and foreign currency denominated investment instruments. Thus far South African regulatory authorities have adopted a functional approach focusing on the economic activity carried out that allows for crypto assets to perform certain functions similar to those of currencies, securities and commodities². From this perspective many crypto assets may be appropriately characterised as financial products under FAIS as crypto assets may serve as security for a debt³, securities⁴ or a share in (or claim against) a company⁵. By virtue of being declared financial products; the FSCA is of the view that any advice furnished, or intermediary services⁶ rendered by a person on behalf of a client or product supplier⁷ relative to a crypto asset declared to be a financial product is subject to the FAIS Act. According to the statement in support of the draft declaration of crypto assets as a financial product under the FAIS Act⁸ (“**the supporting statement**”), a person who advises on crypto assets or renders

² Page 9 paragraph 2.1.2 of the CAR WG Position Paper

³ On platforms such as Maker which allow for users to generate Dai (a decentralized security “collateral” backed cryptoasset) against asset deposits

⁴ Securities are defined in the Securities Services Act No 36 of 2004 and include: shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980); notes; derivative instruments; bonds; and, debentures;

⁵ Such as the interests or rights acquired by a user pursuant to an Initial Coin Offering

⁶ Subject to subsection 3(b) under the definition of intermediary services and constituting any act other than the furnishing of advice.

⁷ An amendment (substitution) of the definition of intermediary services has been proposed by section 290 of the Financial Sector Regulation Act No. 9 of 2017 with effect from a date to be determined by the Minister in then Government Gazette in terms of which ‘intermediary service’ means, subject to subsection (3)(b), any act other than the furnishing of advice, performed by a person.

⁸ accessible at <https://www.fsc.co.za/Regulatory%20Frameworks/Pages/FAIS.aspx> and published on 20 November 2020 as an explanatory note to the declaration.

intermediary services involving crypto assets will be required to be authorised as a financial services provider (“**FSP**”) and adhere to the requirements of the FAIS Act⁹.

The FAIS Act imposes the following obligations upon authorised FSP’s¹⁰:

- A duty to obtain information from the client relating to their needs and objectives, financial situation, risk profile, financial product knowledge and experience¹¹;
- A duty to conduct an analysis of the client based on their needs and objectives, financial situation, risk profile, financial product knowledge and experience¹²;
- A duty to identify the financial product or products that will suit the client’s risk profile and financial needs¹³;
- A duty to maintain a record of advice furnished to the client that must reflect and include a brief summary of the information and material on which the advice was based (inclusive of the personal information of the client) and the financial product recommended coupled with an explanation detailing why the product selected is likely to satisfy the client’s identified needs and objectives¹⁴.

These are onerous duties which should not be unnecessarily imposed upon industry participants. Essentially, the FSP Code of Conduct requires FSP’s dealing in crypto assets to maintain a complete record of the profile of each client which will include their personal information, needs and objectives, financial position, risk profile and experience in dealing with crypto assets that qualify as financial products.

9 Id ; paragraph 3.6. Recommendations 9 and 10 of the CAR WG Position paper specify the services relating to the buying and selling of crypto assets

10 In terms of the general code of conduct for authorised financial services providers and their representatives as published under Board Notice 80 in Government Gazette 25299 of 8 August 2003 (as amended) (“the FAIS Code of Conduct”) read with section 15 (1) (b) of the FAIS Act

11 Section 8 (1) (a) of the FAIS Code of Conduct

12 Id ; section 8 (1) (b)

13 ID ; section 8 (1) (c)

14 Id ; section 9 (1) (a) and (c)

ISSUE

The FSCA's declaration gives rise to the following question.

- To what extent, if any does the declaration require the authorisation of crypto asset exchanges, platforms and those dealing in crypto assets declared to be financial products (collectively referred to as "**Crypto Asset Service Providers**" or "**CASP's**") as financial service providers subject to and regulated by the FAIS Act?

FAIS AND THE DECLARATION APPLIED TO CASP's

Notably the declaration's express provision is for crypto assets to be classified as financial products, without any declaration or reference being made to FSP's, the provision of financial services or any duty of a person dealing in crypto assets (in any way) requiring authorisation under the FAIS Act to do so. The definition of a FSP and the associated financial services provided do not contain an express reference to financial products¹⁵. Financial products are referred to in the definition of advice¹⁶ and serve as the object in relation to which recommendations, guidance or a proposal of a financial nature may be furnished. The scope of what constitutes financial advice as contemplated in the FAIS Act is

15 Under the FAIS Act financial services are defined as - "financial service" means any service contemplated in paragraph (a), (b) or (c) of the definition of "financial services provider", including any category of such services.

The corresponding definition for "financial service provider" is - "financial services provider" means any person, other than a representative, who as a regular feature of the business of such person -

- (a) furnishes advice; or
- (b) furnishes advice and renders any intermediary service; or
- (c) renders an intermediary service;

16 Under the FAIS Act "advice" means, subject to subsection (3)(a), any recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients -

- (a) in respect of the purchase of any financial product; or
- (b) in respect of the investment in any financial product; or
- (c) on the conclusion of any other transaction, including a loan or cession, aimed at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product; or
- (d) on the variation of any term or condition applying to a financial product, on the replacement of any such product, or on the termination of any purchase of or investment in any such product, and irrespective of whether or not such advice -
 - (i) is furnished in the course of or incidental to financial planning in connection with the affairs of the client; or
 - (ii) results in any such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected;

circumscribed by section 1 (3) (a) of the definitions included in the FAIS Act¹⁷ and excludes factual advice given pertaining to the procedure to follow in concluding transactions, the description of a financial product, answers to routine administrative questions, objective information given about a product or a report about a product given without any recommendations. Any CASP that operates an exchange, a trading platform, offers a digital wallet, custodial or payment services and does not recommend, guide or make propositions to the client of a financial nature in relation to any crypto assets dealt with on its platform would not be furnishing advice as contemplated in the FAIS Act. So, although a CASP may deal in financial products (crypto assets) as defined in section (h) of the definition of financial products – their dealings do not automatically constitute the furnishing of advice in relation to those financial products. Simply put, there are many ways in which a CASP may advise a user on its platform regarding crypto assets, not all of this advice will fall within the scope of the FAIS regime.

The performance of an intermediary service requires an act other than the furnishing of advice, performed by a person for or on behalf of a client or product supplier¹⁸ (or any act other than the furnishing of advice, performed by a person)¹⁹. It is worthwhile to recite the definitions of “product supplier” and “client” contained in the FAIS Act (although the proposed amendment does not contain the phrase product supplier – this phrase exists in the present definition of intermediary services).

17 (1) 3 (a) advice does not include -

- (i) factual advice given merely -
 - (aa) on the procedure for entering into a transaction in respect of any financial product;
 - (bb) in relation to the description of a financial product;
 - (cc) in answer to routine administrative queries;
 - (dd) in the form of objective information about a particular financial product; or
 - (ee) by the display or distribution of promotional material;
- (ii) an analysis or report on a financial product without any express or implied recommendation, guidance or proposal that any particular transaction in respect of the product is appropriate to the particular investment objectives, financial situation or particular needs of a client;

18 This is how the section is currently framed

19 The proposed amendment – it is not clear what the intention of the amendment is as the act performed is still performed relative to a client; presumably on her/his behalf or at her/his behest

A product supplier is defined as:

“... any person who issues a financial product”

Client is defined as:

“...a specific person or group of persons, excluding the general public, who is or may become the subject to whom a financial service is rendered intentionally, or is the successor in title of such person or the beneficiary of such service”

Intermediary services as foreshadowed in the FAIS Act are performed by a person for or on behalf of a client or product supplier. The term was succinctly captured in *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund*²⁰ as contemplating a person who stands with a client (or clients) on the one side, and a supplier of financial products on the other side, acting as the ‘go-between’ to effect the relevant transactions. The CASP would therefore have to intentionally render; presumably in terms of an express mandate, financial services as defined in the FAIS Act to the client in terms of which she/he intermediates between the client and the product supplier in order for it to be said that the intermediary is performing intermediary services. In the case of decentralized ledger, and similar technology the product supplier would be the issuer of the financial product, on whose behalf the CASP may also intermediate. For purposes of illustration Bitcoin may be used as an example. New bitcoin are issued through a mining process which has been employed as a temporary measure to issue bitcoin²¹; no one owns the Bitcoin network, and it operates with the co – operation of its users on a consensus basis²². For a CASP to act as an intermediary in a transaction involving bitcoin (the financial product) that CASP would be required to have intentionally rendered financial services to the user (for the user to qualify as a “client” within the FAIS regime and the definition of intermediary services) whilst

20 *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund* (455/12) [2013] ZASCA 59 (16 May 2013) at paragraph 13; accessible at www.saflii.org.za

21 <https://bitcoin.org/en/faq#mining> under the heading Mining and accessed on 25 January 2021

22 *Id* ; under the heading Who controls the bitcoin network

simultaneously acting as a “go between” between the client on the one hand, and bitcoin miners and consensus mechanisms on the other. It is doubtful that CASP’s engage their users on these terms. Binance, the leading crypto currency exchange²³ expressly excludes the provision of financial services in its terms of use which users agree to by accessing, downloading, using or agreeing to accept any services provided by Binance²⁴. Would the FAIS regulatory regime override an arbitration clause in an agreement between a CASP and its user or grant the FSCA rights to intercede? would the principle of *pacta sunt servanda* (that agreements must be honoured) be discarded? Is a CASP which is not domiciled in South Africa required to undermine the terms of an agreement entered into between it and a South African resident in favour of South Africa’s regulatory regime, where its country of domicile is silent on the issue or takes a different attitude to the regulation of crypto assets? Binance’s terms of use refer to its trades being executed automatically based on the parameters of a client’s order instructions and in accordance with posted trade execution procedures²⁵ - these appear to be technical features relating to the implementation of a user’s instructions and not the furnishing of legal advice. Even if or when the proposed amendment to the definition of intermediary services is gazetted (that only refers to an act performed by a person, other than financial advice and does not mention a product supplier); for the term intermediary to retain its ordinary meaning a third actor separate from a client

23 As ranked by CoinMarketCap based on traffic, liquidity, trading volumes, and confidence in the legitimacy of trading volumes reported. See <https://coinmarketcap.com/rankings/exchanges/> accessed on 25 January 2021

24 See Binance terms of use accessed at <https://www.binance.com/ng/terms> on 25 January 2021, specifically the first paragraph and paragraph VII which contains the exclusion in the following terms: - Binance is n information provided to you by Binance is intended as, or shall be considered or construed as, investment advice, financial advice, trading advice, or any other sort of advice. Unless otherwise specified in these Terms, all trades are executed automatically, based on the parameters of your order instructions and in accordance with posted trade execution procedures, and you are solely responsible for determining whether any investment, investment strategy or related transaction is appropriate for you according to your personal investment objectives, financial circumstances and risk tolerance, and you shall be solely responsible for any loss or liability therefrom. You should consult legal or tax professionals regarding your specific situation. Binance does not recommend that any Digital Asset should be bought, earned, sold, or held by you. Before making the decision to buy, sell or hold any Digital Asset, you should conduct your own due diligence and consult your financial advisors prior to making any investment decision. Binance will not be held responsible for the decisions you make to buy, sell, or hold Digital Asset based on the information provided by Binance.

25 Id ; at paragraph VII

and the FSP would have to be part of the relationship intermediated by the FSP, failing which the FSP will not be capable of acting as an intermediary. This would be the case for instance where a user created an Ethereum account, managed it through a wallet accessed on Ethereum platforms and into which she/he received ether. In this scenario Ethereum could be said to be the supplier of the financial product (ether) and perhaps a provider of custodial services or a wallet if the user receives their ether into MyEtherWallet²⁶. The user would only qualify as being a client if Ethereum deliberately intended to render financial services involving ether to the user, but as there are only two parties involved there would not be an intermediary. In a case where the custodial services are provided by a third party – the same principle applies in respect of the client requirement. The user may only be a client to the CASP custodial service or wallet provider if that CASP intends to render financial services as defined under FAIS legislation relative to the ether (financial product) held in its wallet.

Bitcoin and Ethereum are just two of dozens and dozens of crypto assets whose functions and applications vary whilst Binance is one of numerous exchanges upon which trades and other transactions are concluded; however, the point remains the same and will most likely hold true when applied to many other CASP's – the FAIS Act is not particularly well suited for the purposes of regulating crypto assets and the platforms upon which they are dealt with most likely because the legislator did not have crypto assets and blockchain technology in mind when drafting the Act. This is evidenced by the fact that no provision is made in the FAIS Act to acknowledge or address in any meaningful way the primary distinguishing feature of distributed ledger technology and the applications that run on it which are sought to be regulated (decentralized financial products); namely, the immutability of the shared public record which serves as proof of concluded transactions, nor is there a differentiation (in treatment) made between traditional financial and intermediary services and those sought

²⁶ An open source client – side interface that facilitates the client's interactions with the Ethereum blockchain and allows the user to, amongst others, generate wallets and engage with smart contracts ; see www.myetherwallet.com

to be included by the declaration when in fact there is a real difference between the two. Whereas the FSCA would find it easier to compel compliance with the declaration from a registered FSP or a person that already operates within the regulatory regime of FAIS under threat of sanction for failure to comply, such as a suspension or withdrawal of a person's authority to act as a FSP or representative²⁷. The FSCA does not have a similarly effective mechanism to enforce compliance against CASP's who operate on a blockchain that employs and is dependent upon decentralized mechanisms and code to bring about outcomes.

In its supporting statement the FSCA has asserted that the effect of its declaration is that persons furnishing advice or rendering intermediary services in relation to crypto assets must be authorised under the FAIS Act as financial service providers and that such persons must comply with the relevant FAIS requirement including the General Code of Conduct and FAIS fit and proper requirements²⁸. The express intention behind the declaration is in part to *"immediately capture intermediaries that advise on or sell crypto assets to consumers"*²⁹.

The FSCA's declaration read with the supporting statement are problematic for the following reasons:

1. The terms "financial services" and "financial services provider" have corresponding meanings under the FAIS Act, neither of which include an express or unqualified reference to financial products. Financial products are sub – referenced in the definitions of these terms by the use of the term "advice" which is qualified and excludes advice furnished in terms of section 1 (3) (a) of the definitions, and expressly includes any recommendation, guidance or proposal of a financial nature

27 See sections 9 (c) (f) and (g) of the FAIS Act

28 See paragraph 3.6 of the supporting statement

29 See paragraph 3.7 of the supporting statement

furnished, by any means or medium, to any client or group of clients in relation to a financial product. Before financial services are capable of being rendered to a user of a CASP's services or platforms by that CASP – any advice given by the CASP must not be excluded by section 1 (3) (a) and must be expressly included in the form of a recommendation, guidance or a proposal to a client (a specific person or group of persons, excluding the general public, who is or may become the subject to whom a financial service is rendered intentionally)³⁰. In these circumstances, the general proposition posited by the FSCA³¹ that the effect of declaring crypto assets as a financial product under the FAIS Act is that any person furnishing advice in relation to crypto assets must be authorised under the FAIS Act as a financial services provider is untenable.

2. Financial products are also sub - referenced in the definitions of “financial services provider” and “ financial services” by the express inclusion of persons who as a regular feature of their business render intermediary services within the definition of financial services provider. Financial products are explicitly referenced within the definition of intermediary services, specifically as regards a client in respect of acts other than the furnishing of advice performed for or on behalf of a client or a product supplier. Preconditions for the performance of intermediary services by a FSP are (1) a positive act (2) not constituting the furnishing of advice (3) performed by a person on behalf of a client or product supplier as defined in the FAIS Act (4) which may result in the client concluding or offering to conclude a transaction involving a financial product (5) with a product supplier³². Unless all of these preconditions are present it cannot be said that a person is rendering intermediary services as defined

³⁰ See the definition of client contained in the FAIS Act

³¹ At paragraph 3.6 of their statement

³² See the definition of intermediary service read with the definitions of financial services, financial services provider, client, advice, financial product and product supplier in the FAIS Act

in the FAIS Act. As an example if a CASP does not hold a mandate on behalf of the user or the product supplier and simply avails an open source platform that allows for the user to independently interact with the product suppliers financial products (crypto assets) this would not constitute the provision of intermediary services as the user is neither a client as defined in the FAIS Act nor has the CASP performed a positive act that has directly resulted in the conclusion of a transaction with the product supplier³³. The blanket proposition advanced by the FSCA that the effect of declaring crypto assets as a financial product under the FAIS Act is that any person rendering intermediary services in relation to crypto assets must be authorised under the FAIS Act as a financial services provider cannot be maintained in these circumstances. CASP's may furnish advice to users that is excluded under section 1 (3) (a) of the definitions to the FAIS Act or they may intermediate between a user and a product supplier in circumstances where the user does not qualify to be a client as defined in the FAIS Act or one or other precondition is not met. In either circumstance the CASP would be operating outside the regulatory ambit of FAIS;

3. The authority of a person to act or to offer to act as a financial services provider is derived from sections 7 (1) (a) and (b) which require a FSP to be licensed in accordance with section 8 of the FAIS Act, and a representative to be appointed in accordance with section 13. The empowering provision and statutory authority that permit FSP's and representatives to act as such under the FAIS regime are occasioned by the provisions of section 7 of the FAIS Act pursuant to an application brought in terms of section 8. It is therefore not competent for the FSCA's declaration of crypto assets to be financial products in terms of section (h) of the definition of financial product to cause, trigger or have the effect of requiring a person who

³³ See note 20 above relating to the Tristar Investments (Pty) Ltd case, specifically at paragraph where the following is stated "Sub-clause (a) of the definition of an intermediary service, properly construed, contemplates acts that directly result in the consequences referred to. To construe it as including any act that indirectly has that result would lead to absurdities"

renders advice or performs intermediary services to be authorised under section 7 (1) as a FSP.

CONCLUSION

Apart from the issues mentioned at paragraphs 1 to 3 above, there is a wider conversation which may be worthwhile having regarding the approach adopted by the FSCA and other regulatory bodies in attempting to regulate crypto assets, associated platforms and CASP's. In this case the ostensible target of regulation is the crypto asset (financial product) *per* the declaration made by the FSCA in terms of paragraph (h) of the definition of financial product. However, by peering behind the declaration the stated intention communicated by the FSCA in its supporting statement is "*to immediately capture intermediaries that advise on or sell crypto assets to consumers*" and to effect a blanket obligation imposed upon CASP's rendering intermediary services or advising on crypto assets obliging them to obtain authority under the FAIS regime to conduct the business of a financial services provider and to require CASP's to comply with the FAIS Code of Conduct and fit and proper requirements. These are not concepts that can automatically be uplifted from the FAIS regime and applied to distributed ledger technology (the crypto assets and transactions recorded in the ledger), the specific application or use case of the technology (decentralized finance/currency/payments) and the operator of the technology in any one of its applications (the CASP). Whilst the CASP may be a legally recognised person susceptible to regulatory measures such as compliance notices or capable of being dealt with in tangible terms, the crypto asset is subject to the rules of the blockchain to which it is native and its associated code – it exists in abstract terms and does not need to abide by the same rules which a CASP that is a legal person is obliged to abide by. For these and similar other reasons it may not necessarily be appropriate for the FSCA to use the same tool (FAIS) to simultaneously regulate traditional financial service providers CASP's; it may be useful for the FSCA to consider integrating the same or similar technology into their regulatory mechanisms that will optimise the enforcement of regulatory measures taken.

