

Top Things For Advisors To Consider Before Advising Clients On Bitcoin

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Between Bitcoin's recent rise in demand, increasing price, and the growing need to serve a more diverse client base, it feels as if advisors cannot avoid the conversations around Bitcoin anymore. What was brought into the fringes of popular conversations with the runup in price in 2017 appears to have been cemented in conversation now in 2021. This leaves advisors scrambling to figure out how to handle Bitcoin and these new client conversations. Even if you decide you want to be a trusted advisor and the solution provider for your clients, it is not that simple today. Compliance, ADV language, insurance, and other regulatory factors could impact your ability to properly deliver the advice and solutions you want to put in front of clients.

To help advisors get started, we decided to put together a few guidelines on operational, compliance and regulatory items you need to have in order before you dive into advising clients on Bitcoin. Breaking this into two sections, let's first start by examining the overarching processes you need to have in place before giving advice on Bitcoin. Second, we can't forget about our ADVs. If you decide to start providing investment management services and advice around Bitcoin, you will most likely need to update your ADV to address the changes in your investment approach and business.

Processes You Need In Place:

1. **Ensure Proper E&O Insurance & Approval:** First things first, before you start providing advice or investment management on a new asset or strategy make sure your insurance will cover you. This can be as simple as calling your current carrier and checking to see if your existing policy would cover your new desired activities around Bitcoin. If not, inquire to what rider or additional coverage you might need to cover advice on Bitcoin or discretionary cryptocurrency management. Additionally, if you are with a larger company or B/D, make sure you have approval to advise on or provide investment management around Bitcoin.
2. **Identify Investment And Other Risks:** We will cover this in more detail later in the ADV section, but it is important to understand the investment risks associated with any investment strategy or asset - including Bitcoin. You should be ready to both disclose and educate clients on risks associated with the investment strategy. This also includes considering risks that could be present but may not be disclosed on the ADV or elsewhere. For instance, the risks associated with storing Bitcoin online with a wallet versus cold storage on a harddrive or other device would be helpful for a client to know. Additionally, there are issues around estate planning and access that could present risks to investing in Bitcoin or other digital assets.

3. **Due Diligence on a Qualified Custodian:** Make sure you have a qualified custodian if you are going to help clients invest in Bitcoin. Qualified custodians that can (or will) legally safekeep Bitcoin assets are pretty limited today. There are a handful available, but make sure you perform appropriate due diligence beforehand to get comfortable with them and perhaps get compliance or legal sign off before using them. You will need to update your ADV with applicable custodian information, so be prepared. Today, advisors are often using Gemini and Fidelity Digital Assets for custodial purposes, but you still need to do your own homework before selecting a proper custodial set up for your clients' digital assets.
4. **Determine Payments and Advisory Fees:** Determine how you want to charge on these assets and how you want to collect payment. Some of the custodians out there can help with collecting payment from the underlying investment. In other cases, the advisor might choose to take payment from another cash account. Document your payment process and your fees around Bitcoin advice, and be sure they are properly disclosed in your ADV and described in your advisory agreement with clients. You don't have to recreate the wheel with respect to advisory fees, but if you aren't managing or actively trading a particular investment like Bitcoin you may consider a lower comparative fee based on the value and assistance you provide. In other cases, it could be simpler to do a financial planning flat fee that includes advice around Bitcoin planning.
5. **Get Educated:** If you are going to be a fiduciary advisor and advise clients on Bitcoin, you need to understand Bitcoin, cryptocurrencies, and the underlying issues and benefits associated with the investment. This is true for anything you do as an advisor, but don't jump right in before properly educating yourself on the topic. Start by checking out [our website](#), [Interaxis](#), and [a16Z](#) for educational resources to get started. ^[6]
6. **Create Internal Process Documentation:** This is crucial and encompasses a lot of what we have already discussed. But make sure you know how you will trade, invest, manage, or move Bitcoin for clients. Other things to answer are: How will money flow? How will custodians be moving money and trades? How will wallets and client money be protected? Are there protections for the client on who has access to the wallets and their bank accounts? Did you create authentication safeguards for clients? How will you model, track, report, and bill on assets? Make sure you have well thought out processes that are documented to ensure the client is safe in the process. Also, be sure to incorporate corresponding changes to your Compliance Policies & Procedures as applicable.
7. **Identify Tax Issues:** Bitcoin can create significant tax reporting and tax issues for clients. Many clients have not properly reported trades and gains on Bitcoin in the past. The IRS is becoming more aware and vigilant in this area so make sure your clients are properly reporting any gains or losses and paying the correct amount of taxes. This might mean that you need to look for a CPA or tax planner that is qualified to help with complex crypto currency tax planning. But, it is also an area where you can have significant impact with your clients. However, if these tax issues are left unchecked it could impact other tax planning strategies you are using as an advisor.

FORM ADV OVERVIEW

If you will be adding digital assets to your investment universe or otherwise providing advisory services related to digital assets, odds are that various sections of your Form ADV will need to be updated as a result. Though the entirety of your Form ADV should be reviewed for potential updates, a brief outline of

the items most likely to be affected is included below. SEC-registered advisers should also account for corresponding changes that may need to be made to their Relationship Summary (Form CRS).

FORM ADV PART 1

- Item 5(C)(1): To the extent the digital assets on which you advise are not included as part of your “Regulatory Assets Under Management” or “RAUM” in Item 5(D) or 5(F), the clients to which you provided digital asset advice during your prior fiscal year should be counted here. To the extent the digital assets on which you advise are included as part of your RAUM, they should be accounted for in Item 5(D) and 5(F).
- Item 8: This Item should be reviewed and updated as necessary based on whether you invest in digital assets yourself and also recommend such digital assets to clients (see Item 8(A)(2)) or have discretionary authority over digital asset transactions in client accounts (see Item 8(C)).
- Item 9: When advising or managing digital assets, you will need to be mindful of inadvertently accepting custody of such digital assets. If custody is triggered, it would need to be reported in Item 9 (among other additional compliance burdens). For state-registered advisers, Part 1B Item 2I should also be reviewed for potential custody-related updates.
- Schedule D, Section 5.K.(1): Just like any other asset type, the relative percentage of digital assets across your aggregate RAUM should be included here in the “(xii) - Other” category.
- Schedule D, Section 5.K.(3): To the extent you utilize a different custodian to safekeep your clients’ digital assets held in separately managed accounts (and assuming such digital assets are included in your RAUM), the name of such custodian and the aggregate amount of your clients’ digital assets that are held with such custodian should be reported here.

FORM ADV PART 2

- Item 4: Among other requirements, this item is to include a description of the advisory services you offer (with further detail added for any advisory services in which you purport to specialize). Consider describing your digital asset advisory services, and be prepared to go into greater detail if you hold yourself out as specializing in digital assets.
- Item 5: The advisory fee schedule and fee billing methodology applied to digital assets should be included here. This is especially important if you charge on digital assets differently than traditional assets - which could create conflicts of interest that should also be disclosed.
- Item 8: Among other requirements, this item includes the following instruction: “If you recommend primarily a particular type of security, explain the material risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail.” Compared to traditional assets, digital assets would almost certainly be considered to present “significant or unusual risks,” which would in turn warrant a discussion of such risks here. Such risks go beyond pure investment risk (such as volatility and performance), and could be expanded to include a description of the unique risks associated with account establishment/maintenance, trading, custody, and transferability.
- Item 11: If you or any related persons invest in the same digital assets that you recommend to clients, a discussion of the associated conflicts of interest should be included here to the extent not already captured by pre-existing conflicts disclosure.

- Item 12: To the extent you engage in different brokerage practices as it relates to digital assets (e.g., with respect to the broker-dealers used to execute digital asset transactions, soft dollars, directed brokerage, order aggregation, etc.), such differences should be accounted for in this item.
- Item 15: As described above in reference to Form ADV Part 1, Item 9, you will want to be mindful of the potential custody implications of advising on or managing digital assets. To the extent that any novel custody-related issues arise as a result of implementing digital assets into client portfolios, consider whether additional disclosure is warranted here.
- Item 16: To the extent you will assume discretionary authority for the first time through the management of digital assets, such discretionary authority should be described here.

Concluding Thoughts:

Bitcoin is here to stay. For advisors wanting to help clients with Bitcoin, there is a lot of thoughtful work you need to do. Make sure you get educated, communicate with clients, develop internal processes related to Bitcoin, and “document document document.” Lastly, don’t forget to update your ADV and be prepared to explain what you are doing, and why behind it - - - with a client’s best interests first, to any auditor that might come in. Clients need the help, but you need to make sure your business is prepared before you start advising clients on Bitcoin.

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