

CLIENT ALERT

## SEC Division of Examinations Continues to Focus on Digital-Asset Securities

APRIL 15, 2021

The U.S. Securities and Exchange Commission (SEC) Division of Examinations (Division<sup>[1]</sup>) recently released a Risk Alert<sup>[2]</sup> highlighting its continued focus on digital assets<sup>[3]</sup> that are securities (Digital Asset Securities). The Division emphasized that the offer, sale, and trading of Digital Asset Securities present unique risks to investors and encouraged firms to consider the distinct features of distributed-ledger technology when designing their regulatory-compliance programs. The Risk Alert provides observations made by Division staff during recent examinations of industry participants that may assist firms in developing their compliance practices and policies. The Risk Alert also provides transparency about areas of focus for the Division's future examinations.

For investment advisers managing Digital Asset Securities and other digital assets and derivative products, the Division identified six distinct areas of risk related to regulatory compliance, which will also be areas of focus for future examinations of advisers managing Digital Asset Securities:

- **Portfolio Management.** Areas of interest for the Division upon examining an adviser's policies, procedures, and practices include *whether digital assets managed on behalf of clients are classified as securities*,<sup>[4]</sup> whether the investment adviser conducted appropriate due diligence on the digital assets, whether the investment adviser evaluated and mitigated the risks related to trading venues, the adviser's management of risks and complexities associated with "forked" and "airdropped" digital assets, and whether the adviser fulfilled its fiduciary duty with respect to investment advice.
- **Books and Records.** The Division will review whether advisers are making and keeping accurate books and records, particularly because digital-asset trading platforms vary in the reliability and consistency of their own record-keeping practices.
- **Custody.** Examinations will focus on the custody of digital assets, including compliance with the Custody Rule<sup>[5]</sup> where applicable. Staff will focus on issues including unauthorized transactions and safekeeping of digital assets.
- **Disclosures.** Division staff will review disclosures to investors regarding the unique risks associated with digital assets, including issues related to the technical, legal, market, and operational risks (including custody and price volatility).
- **Pricing Client Portfolios.** The Division will review, among other things, the valuation methodologies used and disclosures related to valuation methodologies, advisory-fee calculations, and the impact that the firm's valuation

practices have on the fees charged.

- Registration Issues. Examinations will include a review of compliance matters related to SEC registration, including calculation of regulatory assets under management, how funds determine applicable exemptions from registration as investment companies, and related issues.

For broker-dealers, the Division identified six different areas of regulatory compliance risk:

- Safekeeping of Funds and Operations. Examinations will focus on operational activities, including operations surrounding the safety and custody of Digital Asset Securities.
- Registration Requirements. Division staff will examine broker-dealers and affiliated entities' compliance with registration requirements, such as broker-dealer registration requirements that may be triggered when affiliates engage in the business of effecting transactions in Digital Asset Securities for the accounts of others.
- Anti-Money Laundering (AML). The Division notes that distributed-ledger technology presents certain unique challenges to the robust implementation of an AML program, including performing customer due diligence. Examinations will thus focus on broker-dealer compliance with AML obligations.
- Offerings. Examinations will include a review of due diligence performed by firms and disclosures made to customers in connection with underwriting and private-placement activity related to Digital Asset Securities.
- Disclosure of Conflicts of Interest. Conflicts of interest may arise when broker-dealers operate in multiple capacities, such as by acting as trading platforms or proprietary traders of Digital Asset Securities on their own or other platforms. Division staff will examine broker-dealers to ensure that such conflicts are appropriately disclosed.
- Outside Business Activities. Registered representatives of registered broker-dealers may offer services related to digital assets apart from their employer, which may constitute outside business activities or an outside securities activity subject to the approval, supervision, and recordation of the broker-dealer. Division staff will examine broker-dealer compliance processes related to such activities.

The Division also noted that platforms that facilitate trading in Digital Asset Securities should review whether they must register as a national securities exchange or potentially rely on the exemption from national-securities-exchange registration as an alternative trading system ("ATS"), in which case the Division will examine the entity for compliance with Regulation ATS. The Division will also examine registered transfer agents for compliance with applicable SEC rules.

Finally, the Division acknowledged that financial innovation continues rapidly and encouraged market participants to contact the SEC's Strategic Hub for Innovation Technology ("FinHub") via the SEC's FinHub webpage<sup>[6]</sup> with questions regarding Digital Asset Securities.

Firms that seek to engage in digital asset-related activities should review the Risk Alert and consider whether any amendments may be necessary to their compliance programs according to the guidance provided by the Division.

For further information, please contact the authors or your Winston relationship attorney.

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<sup>[1]</sup> The SEC's Office of Compliance Inspections and Examinations was renamed the Division of Examinations in December 2020. See "SEC Statement on the Renaming of the Office of Compliance Inspections and Examinations to the Division of Examinations" (Dec. 17, 2020), [available here](#).

<sup>[2]</sup> Secs. and Exch. Comm'n Div. of Examinations Risk Alert, "The Division of Examinations' Continued Focus on Digital Asset Securities" (Feb. 26, 2021), [available here](#).

<sup>[3]</sup> The Risk Alert uses the term "digital asset" to refer to "an asset that is issued and/or transferred using distributed ledger or blockchain technology ('distributed ledger technology'), including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'" The Risk Alert further notes that "[a] particular digital asset may or may not meet the definition of 'security' under the federal securities laws."

<sup>[4]</sup> As of the date of this briefing, the SEC has informally concluded that Bitcoin is not a security. While past statements by SEC officials have also alluded to Ethereum not being a security, more-recent statements have cast some doubt on that assessment. The SEC is continuing to explore options designed to balance the need for investor protection and market innovation. Most recently, Commissioner Hester Peirce released an updated version of her Token Safe Harbor proposal, which calls for a three-year grace period from registration under the Securities Act of 1933 for digital assets, so long as developers satisfy certain regulatory requirements such as providing detailed disclosures to purchasers. The proposal is available [here](#).

<sup>[5]</sup> Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended.

<sup>[6]</sup> The SEC's FinHub webpage is available at [here](#).

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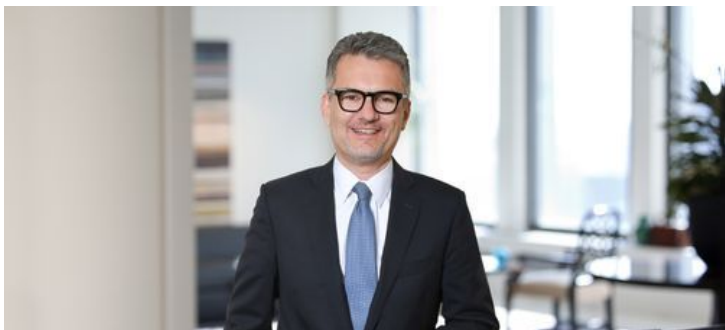
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