

# Legal Update

## SEC Division of Examinations Risk Alert: New SEC Leadership Continues Focus on Examinations Related to Digital Asset Securities

On February 26, 2021, the US Securities and Exchange Commission's ("SEC") Division of Examinations published a [risk alert](#) in connection with the offer, sale, and trading of digital assets that are securities.<sup>1</sup> The risk alert provides observations made by Division of Examinations staff during examinations of broker-dealers, investment advisers, exchanges, and transfer agents. The risk alert also highlights areas of focus for the Division of Examinations' future examinations.

The Division of Examinations notes that activities relating to digital asset securities "present unique risks to investors."<sup>2</sup> Market participants should reflect upon their own practices, policies and procedures in light of the considerations highlighted by the risk alert to develop and enhance their compliance programs.

### Key Takeaways

- ***New leadership continues focus on exams.*** The SEC, including the Division of Examinations, appear poised to continue to focus on enforcement and examination of issues related to dealings in digital assets or the use of distributed ledger technology by capital markets participants and the securities markets themselves.
- ***"That which we call a rose by any other name would smell as sweet."*** Some things from the times of Shakespeare's *Romeo and Juliet* remain true to this day. The risk alert is a signal to market participants that just because an asset is purported to be a "digital asset," it does not mean it is not a security. The SEC maintains jurisdiction over digital asset securities and over SEC registrants, so firms should be aware of the uncertain status of many of these instruments and consider how their activities (or the activities of their affiliates) may implicate SEC registration requirements and otherwise be subject to SEC rules and regulations.

- **What makes you unique?** The SEC views activities in digital assets as involving unique risks, which require unique policies and procedures, due diligence and investor disclosures to address and mitigate those risks. Firms should be aware of the key differences among digital assets with which they engage and ensure that they understand the key risks that may be idiosyncratic to such assets and their underlying technologies. These unique factors should be considered when developing and enhancing firm policies, procedures, and compliance programs. We are working to develop a separate chapter in the Written Supervisory Procedures dedicated to digital assets, for example.

## Considerations Highlighted by the Risk Alert

### BROKER-DEALERS

The risk alert highlights a number of considerations for broker-dealers operating a digital assets business that the Division of Examinations has noted will be a focus in examinations going forward:

- **Safekeeping of Funds and Operations:** Division of Examinations staff will examine broker-dealers to understand operational activities, including operations that are unique to the safety and custody of digital asset securities.
- **Registration Requirements:** Examinations will include broker-dealers' and any affiliated entities' compliance with registration requirements, particularly where an affiliate may assist in effecting transactions in digital asset securities.
- **Anti-Money Laundering ("AML"):** The pseudonymous nature of distributed ledger technology presents unique challenges to firm AML programs. Division of Examinations staff observed inadequate AML procedures, controls, and documentation regarding digital asset securities and will continue to examine for compliance with AML obligations.
- **Offerings:** Underwriting and private placements of digital asset securities may implicate "unique disclosure and due diligence obligations." Examinations will include a review of the due diligence performed by broker-dealers, and the disclosures made by broker-dealers to customers related to the offering of digital asset securities.
- **Disclosure of Conflicts of Interest:** Division of Examinations staff observed circumstances where firms operate in multiple capacities, including as trading platforms or proprietary traders of Digital Asset Securities on their own and other platforms. Future examinations will include a review of the existence and disclosures of conflicts of interest and the compliance policies and procedures to address them.
- **Outside Business Activities ("OBAs"):** Division of Examinations staff observed instances of registered representatives of broker-dealers offering services related to digital assets apart from their employer. FINRA Rule 3270 requires that FINRA-member firms evaluate OBAs to determine whether they should be subjected to the approval, supervision, and

recording of the broker-dealer. Division of Examinations staff will continue to review these activities and their treatment under FINRA-member firm compliance programs.

## INVESTMENT ADVISERS

Examinations of investment advisers managing digital asset securities, as well as other digital assets and derivative products, have identified several key risks for future examination based on Division of Examinations staff's observations. The Division of Examinations has noted that future examinations will focus on the following:

- **Custody:** Examinations will review the risks and practices related to custody of digital assets and examine for compliance with the custody rule (Rule 206(4)-2) under the Investment Advisers Act of 1940, where applicable. Regardless of how digital assets are stored, Division of Examinations staff will review:
  - Occurrences of unauthorized transactions, including theft of digital assets;
  - Controls around safekeeping of digital assets;
  - Business continuity plans where key personnel have exclusive access to private keys;
  - How the adviser evaluates harm due to the loss of private keys;
  - Reliability of software used to interact with relevant digital asset networks;
  - Storage of digital assets on trading platform accounts and with third party custodians; and
  - Security procedures related to software and hardware wallets.
- **Books and Records:** Digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recording and notification, which an adviser should consider when designing its recordkeeping practices.
- **Disclosures:** Examinations will include a review of investor disclosure relating to the risks associated with digital assets. Division of Examinations staff will assess disclosures regarding specific risks, including the complexities of the products and technology underlying such assets, technical, legal, market, and operational risks (including custody and cybersecurity), price volatility, illiquidity, valuation methodology, related-party transactions, and conflicts of interest.
- **Portfolio Management:** A review of policies, procedures, and practices of investment advisers investing client assets in digital asset securities and other digital assets will focus in particular on the following areas:
  - Classification of digital assets managed on behalf of their clients, including whether they are classified as securities;
  - Due diligence on digital assets;

- Evaluation and mitigation of risks related to trading venues and trade execution or settlement facilities;
  - Management of risks and complexities associated with “forked” and “airdropped” digital assets; and
  - Fulfillment of their fiduciary duty with respect to investment advice – across all client types.
- **Pricing Client Portfolios:** Investment advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation. Examinations will include a review of, among other things, the valuation methodologies utilized, including those used to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets, as well as disclosures relating to valuation methodologies, and advisory fee calculations and the impact valuation practices have on these fees.
  - **Registration Issues:** Examinations will include a review of compliance matters related to appropriate registration, including calculation of regulatory assets under management, characterization of digital assets, status of clients, and understanding applicable exemptions from registration for investment companies.

## NATIONAL SECURITIES EXCHANGES

Distributed ledger technology has created new, innovative methods for facilitating electronic trading in digital asset securities. Firms that operate digital asset trading platforms need to consider whether those assets may be securities such that the firm meets the definition of “exchange” in Section 3(a)(1) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 3b-16(a) thereunder and must therefore register as a national securities exchange or operate pursuant to an exemption. Division of Examinations staff will examine platforms that facilitate trading in digital asset securities and review whether they meet the definition of an exchange.

The Division of Examinations will also review the conduct of firms that act as an alternative trading system (“ATS”). Examinations will include a review of whether an ATS that trades digital asset securities is operating in compliance with Regulation ATS, including, among other things, whether the ATS has accurately and timely disclosed information on Form ATS and Form ATS-R, and has adequate safeguards and procedures to protect confidential subscriber trading information.

## TRANSFER AGENTS

Although distributed ledger technology may impact the way firms perform various shareholder administrative functions on behalf of issuers, including recordation of ownership, it does not obviate the need to comply with existing registration requirements for transfer agents or conduct requirements for transfer agent activities.<sup>3</sup> Examinations will include a review of whether registered transfer agents servicing digital asset securities are operating in compliance with rules for transfer agents promulgated by the SEC.

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For more information about topics raised in this Legal Update, please contact any of the lawyers listed below.

**Marlon Q. Paz**

+1 202 263 3044 | Washington DC

+1 212 506 2307 | New York

[mpaz@mayerbrown.com](mailto:mpaz@mayerbrown.com)

**Kyle Swan**

+1 202 263 3072

[kswan@mayerbrown.com](mailto:kswan@mayerbrown.com)

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## Endnotes

<sup>1</sup> The term “digital asset,” as used by the Division of Examinations, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called “virtual currencies,” “coins,” and “tokens.”

<sup>3</sup> SEC, Division of Examinations, Announcement, *The Division of Examinations’ Continued Focus on Digital Asset Securities* (Feb. 26, 2021). <https://www.sec.gov/ocie/announcement/risk-alert-digital-assets>.

<sup>4</sup> Section 17A(c) of the Exchange Act requires transfer agents to register with the SEC. See Exchange Act Rules 17Ad-1 to 17Ad-7.



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