

# Legal Update

## SEC Examinations Division Issues Risk Alert Regarding Digital Assets

On February 26, 2021, the Division of Examinations (“Division”) of the US Securities and Exchange Commission (“SEC”) published a [risk alert](#) regarding its continued focus on digital assets (“Risk Alert”). The term “digital asset,” as used in the Risk Alert, refers 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.”<sup>1</sup>

In the Division’s view, activities related to the offer, sale and trading of digital assets that are securities (“Digital Asset Securities”) present unique risks to investors. Further, it believes that distributed ledger technology has distinct features that firms should consider when designing their regulatory compliance program.

The Risk Alert outlines the Division staff’s observations made during examinations of investment advisers, broker-dealers and transfer agents regarding Digital Asset Securities and is intended to provide transparency about areas of focus for the Division’s future examinations.

This Legal Update summarizes the Division staff’s observations regarding, and areas of focus in examinations of, investment advisers in connection with their management of Digital Asset Securities, as well as other digital assets and derivative products, for advisory clients.

### Summary of Observations and Focus Areas

The Division staff outlined six areas of focus for investment advisers, as summarized below:

**Portfolio management.** The Division warned that their 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 advisory clients, including whether they are classified as “securities.”<sup>2</sup>

**Practice Pointer:** The classification of a digital asset as a security, or not, could impact the manner in which the adviser treats the asset for Advisers Act compliance and other purposes. However, the Risk Alert makes clear that the Division will be focusing on digital assets generally.

- **Due diligence** on digital assets (e.g., to evidence whether the adviser understands the digital asset, wallets or any other devices or software used to interact with the relevant digital asset network or application, and the relevant liquidity and volatility of the digital asset).<sup>3</sup>

*Practice Pointer:* This focus relates to the SEC’s expectations outlined in the fiduciary interpretation.<sup>4</sup>

- **Evaluation and mitigation** of risks related to trading venues and trade execution or settlement facilities.

*Practice Pointer:* The Division provides the following as examples: security breaches, fraud, insolvency, market manipulation, the quality of market surveillance, KYC/AML procedures and compliance with applicable rules and regulations.

- **Management of risks and complexities** associated with “forked” and “airdropped” digital assets (e.g., allocations thereof across client accounts, conflicts of interest or other issues that may result from the fork or airdrop event).
- **Meeting fiduciary obligations** with respect to investment advice for all client types.<sup>5</sup>

*Practice Pointer:* Advisers that jump headfirst into the digital asset arena should be wary of doing so before legal, compliance and related obligations are fully evaluated and related risks are addressed or otherwise mitigated.

**Books and records.** The Division warned that its examinations will include a review of whether advisers are making and keeping accurate books and records, and whether they are complying with Advisers Act Rule 204-2.

*Practice Pointer:* The Division raised a concern about books and records because digital asset trading platforms can vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification.

**Custody.** The Risk Alert indicated that the Division’s investment adviser examinations will review the risks and practices related to the custody of digital assets by investment advisers, and examine for compliance with the custody rule, Rule 206(4)-2 under the Advisers Act.<sup>6</sup> In addition, regardless of how digital assets are stored, Division staff will review:

- Occurrences of unauthorized transactions, including theft of digital assets;
- Controls around safekeeping of digital assets (e.g., employee access to private keys and trading platform accounts);
- 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.

**Disclosures.** Examinations will include a review of disclosures to investors in a variety of media (e.g., solicitations, marketing materials, regulatory brochures and supplements, and fund documents) regarding the unique risks associated with digital assets, including any risks that are heightened as a result of the digital nature of such assets. Division staff will also review disclosures related to methodologies that advisers use to value digital assets.

**Practice Pointer:** Division 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.

**Valuation.** Division staff observed that investment advisers are applying various valuation methods to determine the value of digital assets managed on behalf of their advisory clients. Staff also observed that advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation.

Accordingly, the Division said that its examinations will include a review of valuation methodologies, including those used to determine principal markets, fair value, valuation after significant events and recognition of forked and airdropped digital assets.<sup>7</sup>

**Practice Pointer:** A continuing examination focus, the staff will also review advisory fee calculations and the impact that the adviser's valuation practices and methodologies have on these fees.

**Registration issues.** Examinations will include a review of compliance matters related to appropriate registration under the Advisers Act. This includes, among other things, understanding how the investment adviser calculates its regulatory assets under management for purposes of Form ADV<sup>8</sup>, and characterizes the digital assets in the pooled vehicles it manages<sup>9</sup> and the status of clients in Form ADV and other required filings (e.g., Form PF). For private funds managed by investment advisers, this also includes understanding how the funds determine applicable exceptions from the investment company definitions under the Investment Company Act or exemptions from registration and regulation as investment companies under that act.<sup>10</sup>

**Practice Pointer:** The above examination focus highlights particularly challenging or complex areas of digital asset management, including the status of issuers as "investment companies" as that term is defined under the Investment Company Act and any related exceptions from that definition. An issuer's status as an "investment company" under the Investment Company Act is inherently dependent on whether and to what extent the issuer invests, expects to invest or holds itself out as investing, in digital assets that are "securities."<sup>11</sup>

## Conclusion

In the Risk Alert, the Division specifically encouraged investment advisers to reflect upon their own practices, policies and procedures, as applicable, and to promote improvements in their supervisory, oversight and compliance programs.

We agree. Examination risk alerts serve as "fair warning" to investment advisers. This Risk Alert, in particular, also serves as "fair warning" to digital asset managers that may be taking the view that they do not meet the definition of "investment adviser" under the Advisers Act or that the investment vehicles that they manage do not meet the definition of "investment company" under the Investment Company Act. Such conclusions should only be reached after careful examination and analysis.

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## Endnotes

- <sup>1</sup> Interestingly, the Risk Alert noted that a particular digital asset may or may not meet the definition of “security” under the federal securities laws.
- <sup>2</sup> The Risk Alert cited to Section 2(a)(1) of the Securities Act of 1933 (“Securities Act”) and Section 3(a)(10) of the Securities Exchange Act of 1934, Section 2(a)(36) of the Investment Company Act of 1940 (“Investment Company Act”), and Section 202(a)(18) of the Investment Advisers Act of 1940 (“Advisers Act”). It also referenced Staff publication, Framework for “Investment Contract” Analysis of Digital Assets (Apr. 3, 2019), available at <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Exchange Act Rel. No. 81207) (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.
- <sup>3</sup> See SEC Interpretation Regarding Standard of Conduct for Investment Advisers, IA Rel. No. 5248 (June 5, 2019) [“Fiduciary Interpretation”].
- <sup>4</sup> Id.
- <sup>5</sup> Id.
- <sup>6</sup> The Division cited to Staff Letter: Engaging on Non-DVP Custodial Practices and Digital Assets (Mar.12, 2019), available at <https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets>; and Staff Statement on WY Division of Banking’s “NAL on Custody of Digital Assets and Qualified Custodian Status” (Nov. 9, 2020), available at <https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets>.
- <sup>7</sup> The Risk Alert cited to Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>.
- <sup>8</sup> As a general matter, “regulatory assets under management” for purposes of Form ADV includes the value of each securities portfolio for which the adviser provides continuous and regular supervisory or management services. An account is a securities portfolio if at least 50 percent of the total value of the account consists of “securities.” See footnote 2 above.
- <sup>9</sup> The characterization of such assets and, in turn, the characterization of the adviser’s pooled investment vehicle clients impacts the availability of adviser registration exemptions. The latter is dependent on an analysis of the status of each of the adviser’s pooled investment vehicle clients as an “investment company” as defined under the Investment Company Act and the availability of or dependence on various exceptions from that definition.
- <sup>10</sup> A private fund or other pooled investment vehicle that meets the definition of an “investment company” in Investment Company Act Section 3(a) must register with the SEC as an investment company, unless it satisfies an exclusion or exemption from that definition. See, e.g., Crypto Asset Management, LP and Timothy Enneking, Securities Act Rel. No. 10544 (Sept. 11, 2018) (settled order), available at <https://www.sec.gov/litigation/admin/2018/33-10544.pdf> [domestic pooled investment vehicle formed for the purpose of investing in digital assets (“fund”); fund engaged in the business of investing, holding and trading certain digital assets that were “investment securities” (as defined in Investment Company Act Section 3(a)(2)) having a value exceeding 40 percent of the value of the fund’s total assets (exclusive of government securities and cash items) and thus met the definition of “investment company” under Investment Company Act Section 3(a)(1)(C); fund did not register with the SEC as an investment company, meet any statutory exemptions or exclusions from the definition of an investment company or seek an exemptive or similar order from the SEC].
- <sup>11</sup> See footnote 2, above. See also statements, press releases and other information regarding the SEC’s focus on initial coin offerings and digital assets at <https://www.sec.gov/ICO> and <https://www.sec.gov/spotlight-initial-coin-offerings-and-digital-assets>.

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