



## Special Alert

March 15, 2021

# Division of Examinations, Feb. 26, 2021: Continued Focus On Digital Asset Securities



The SEC Division of Examinations issued a Risk Alert on Feb. 26, 2021, providing the Division's observations made during examinations of investment advisers, broker-dealers and transfer agents regarding digital asset securities. For purposes of the Division, digital asset securities are those digital assets that are securities. In addition, the Division provided the following definition for the term "digital assets": "An asset that is issued and/or transferred using the distributed ledger or blockchain technology, including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.' A particular digital asset may or may not meet the definition of security under the federal securities laws."

**This DCS Alert focuses upon the Division's observations relating to investment advisers.**

Pursuant to its examination process, the Division identified risks relating to investment advisers managing digital asset securities, as well as other digital assets and derivative products for their clients either directly or indirectly through pooled vehicles.

Following are the risk areas identified by the Division.

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## Portfolio Management

The Risk Alert highlights the following areas related to portfolio management for consideration by advisers in reviewing policies, procedures and practices:

- The classification of digital assets and whether they are classified as securities;
- Due diligence – evidence that the adviser understands the digital asset, wallets, or any other devices or software used to interact with the digital asset network or application, and the liquidity and volatility of the digital asset;
- Evaluation and mitigation of risks relating to trading venues and trade execution or settlement facilities – including such things as –
  - Security breaches;
  - Fraud;
  - Insolvency;
  - Market manipulation;
  - The quality of market surveillance;
  - KYC/AML procedures;
  - Compliance with applicable rules and regulations;
- Fulfillment of their fiduciary duty with respect to investment advice, e.g. advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client; and
- Management of the risks and complexities associated with “forked” and “airdropped” digital assets, including such things as allocations across client accounts, conflicts of interest, or other issues that may result from the fork or airdrop event.

For purposes of the Risk Alert, the Division of Examinations defines “forked” as backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets. In addition, for these purposes “airdropped” refers to the distribution of digital assets to numerous addresses, usually at no monetary cost to the recipient or in exchange for certain promotional or other services.

## Books and Records

The Division of Examinations will review whether advisers are making and keeping accurate books and records, including recording trading activity as required by recordkeeping requirements. The Risk Alert highlights that digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification, of which advisers should be aware when designing recordkeeping practices.

## Custody

Related to the Custody Rule, the Division of Examinations 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 advisers evaluate 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 reviews of disclosures to investors regarding the unique risks associated with digital assets. Among other things, the Division of Examinations will assess disclosures regarding such risks as:

- 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 transactions; and
- Conflicts of interest.

## 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 valuation methodologies utilized, including those used to determine principal markets, fair value, valuation after significant events, and recognition of forked or airdropped digital assets.

## Registration Issues

Examination issues relating to registration will include such things as how advisers:

- Calculate regulatory assets under management;
- Characterize digital assets in the pooled vehicles managed by advisers; and
- The status of clients.

For private funds managed by advisers, examinations will also include a review of how the funds determine applicable exemptions from registration as investment companies.

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