

The Division of Examinations' Focus on Digital Asset Securities February 2021

On February 26, 2021, the SEC's the Division of Examinations (the "Division") issued a Risk Alert outlining observations made by Division staff during examinations of investment advisers, broker-dealers, and transfer agents regarding Digital Asset Securities that may assist firms in developing and enhancing their compliance practices. The Risk Alert defined "Digital Asset Securities" as assets that are securities and issued and/or transferred using distributed ledger or blockchain technology, including but not limited to, "virtual currencies," "coins," and "tokens," noting that digital assets may or may not need the definition of "security" under the federal securities laws.¹

The SEC noted that examinations of advisers and private fund managers utilizing Digital Asset Securities, as well as other digital assets and derivative products, will focus on the following policies, procedures, and practices, which advisers should likewise consider:

- **Portfolio Management**
 - Classification of digital assets managed on behalf of their clients, including whether they are classified as securities;
 - Due diligence on digital assets (e.g., that 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);
 - Evaluation and mitigation of risks related to trading venues and trade execution or settlement facilities (e.g., with respect to 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)²; and
 - Fulfillment of their fiduciary duty with respect to investment advice – across all client types.
- **Books & Records** – Digital asset trading platforms vary in reliability and consistency regarding order execution, settlement methods, and post-trade recordation and notification, which an adviser should consider when designing its recordkeeping practices.
- **Custody** – Digital assets must be compliant with the custody rule (Rule 206(4)-2 under the Investment Advisers Act of 1940)
 - Occurrences of unauthorized transactions, including theft of digital assets;

¹ See SEC 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>.

² According to the Risk Alert, "forked" refers to backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets", and "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."

- 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 – Disclosures to investors regarding the unique risks associated with digital assets, including any risks that are heightened as a result of the digital nature of such assets. 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/Pricing – Examiners will review 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. disclosures related to valuation methodologies, and advisory fee calculations and the impact valuation practices have on these fees.
 - Registration Issues – Compliance matters related to appropriate registration. Understanding how the investment adviser calculates its regulatory assets under management and characterizes the digital assets in the pooled vehicles it manages and the status of clients. For private funds managed by investment advisers, this also includes understanding how the funds determine applicable exemptions from registration as investment companies.

The Risk Alert further noted observations and focus areas related to transactions and activities in Digital Asset Securities by broker-dealers, national securities exchanges and transfer agents and encouraged market participants to reflect upon their own practices, policies and procedures, as applicable, and to promote improvements in their supervisory, oversight, and compliance programs.

There remains ambiguity as to which digital assets constitute securities, whether the SEC, the Commodity Futures Trading Commission (“CFTC”), or both will regulate digital assets and cryptocurrencies, and how such regulation will be accomplished. Nevertheless, as digital assets continue to grow in popularity and utility, investment advisers and private fund managers must consider whether and how their compliance policies and procedures should reflect such digital assets. For many advisers, the primary implications are ensuring that their Code of Ethics appropriately addresses employee trading activities in digital assets. While the risk alert does not specifically address Code of Ethics issues, advisers should consider clarifying whether personal trading, reporting and pre-approval policies apply to all digital assets or solely Digital Asset Securities as well as providing guidance on what constitutes a Digital Assets Security.

For those advisers and private fund managers who invest in digital assets directly or indirectly, this Risk Alert provides useful guidance on areas that should be addressed in compliance policies, procedures and disclosures. CORE-CCO can assist in implementing such guidance.