

CLIENT ALERT

# SEC Staff Issues Risk Alert on Continued Focus on Digital Asset Securities in Examinations

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The staff of the Securities and Exchange Commission’s Division of Examinations (the “Division”) published a risk alert on February 26, 2021,<sup>1</sup> offering guidance on the digital-asset related activities that the Division will focus on during examinations of investment advisers, broker-dealers, exchanges and transfer agents. Notably, the guidance applicable to investment advisers and broker-dealers, in certain instances, applies to both digital assets that are securities (“Digital Asset Securities”) as well as other digital assets issued and/or transferred using distributed ledger or blockchain technology – including, but not limited to, virtual currencies, coins and tokens – that may or may not be securities under the federal securities laws (“digital assets”).

The Division’s continued focus on this area is further demonstrated by the inclusion of digital assets and FinTech as priorities in the Division’s 2021 Examination Priorities, which were published on March 3, 2021.<sup>2</sup> The Examination Priorities release notes that examinations of market participants engaged in digital asset activities will continue to assess: (i) whether investments are in the best interests of investors; (ii) portfolio management and trading practices; (iii) safety of client funds and assets; (iv) pricing and valuation; (v) effectiveness of compliance programs and controls; and (iv) supervision of representatives’ outside business activities.

In this client alert, we outline the key areas of focus highlighted by the Division in the February 26th risk alert.

<sup>1</sup> The Division of Examinations’ Continued Focus on Digital Asset Securities, Division of Examinations Risk Alert (February 26, 2021), *available* [here](#).

<sup>2</sup> SEC Division of Examinations Announces 2021 Examination Priorities, Division of Examinations Press Release (March 3, 2021), *available* [here](#).

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### **Investment Advisers**

The Division explained in the risk alert that its examinations of investment advisers will focus on portfolio management, books and records, custody, disclosure, valuation and registration issues.

**Portfolio management:** The Division will review the policies, procedures and practices of investment advisers investing client assets in Digital Asset Securities and other digital assets. In particular, the Division will review the due diligence performed by an adviser on digital assets and classification of the digital assets, including whether they are classified as securities, treatment of the digital assets upon a fork or airdrop<sup>3</sup> and evaluation and mitigation of the risks related to trading venues, trade execution and settlement facilities for digital assets.

The Division will also review whether investment advisers are fulfilling their fiduciary duties when investing in or providing advice regarding digital assets (e.g., providing investment advice that is in the best interest of the client). The Division noted that investment advisers must sufficiently understand the technology used to trade digital assets as well as liquidity and volatility issues particular to digital assets.

**Books and records:** The Division noted that “digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification.” Examinations will therefore review whether investment advisers’ records of trading activity adhere to the recordkeeping requirements under the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>4</sup>

**Custody:** The Division will review investment advisers’ practices regarding custody of digital assets and examine for compliance with the custody rule, where applicable.<sup>5</sup> The Division’s review will focus on the overall efficacy of an investment adviser’s procedures and practices. Division staff will review for occurrences of unauthorized transactions, safeguards around access to digital assets, including employee access to private keys, business continuity plans for private keys and evaluation of harm for loss of private keys. The Division will also review the reliability of software, third party custodians and security procedures related to software and hardware wallets.

**Disclosures:** Examinations will include a review of disclosures made to investors to determine whether the unique and heightened risks of digital assets have been sufficiently disclosed. This review will assess whether representations contain sufficient information about risks that are particular to or amplified by digital assets. The

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<sup>3</sup> A fork refers to an instance when a blockchain separates into different paths, which could result in a previously singular digital asset trading simultaneously at two different prices. An airdrop is the issuance of shares of new digital assets via a blockchain to holders of an existing asset.

<sup>4</sup> See Rule 204-2 under the Advisers Act.

<sup>5</sup> Rule 206(4)-2 under the Advisers Act.

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Division identified as examples of such risks: financial and legal complexity, potential custody and cybersecurity issues, price volatility, illiquidity, valuation methodology, related-party transactions and conflicts of interest.

Pricing client portfolios: The Division will review investment advisers' valuation methods for determining the value of digital assets within a client's portfolio. The Division will examine valuation methodologies to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets. The Division will also examine disclosures regarding valuation methodology and the impact valuation practices have on fees.

Registration: The Division will examine whether investment advisers providing advice with respect to digital assets are appropriately registered under the Advisers Act. In that regard, the Division noted that it will review whether investment advisers are properly calculating their regulatory assets under management in relation to digital asset portfolios. The risk alert further notes that the Division will seek to identify whether private funds managed by investment advisers are required to register as investment companies under the Investment Company Act of 1940 as a result of the digital assets held by such funds, or are eligible to rely on an exemption from registration.<sup>6</sup>

### **Broker-Dealers**

The Division explained that examinations of broker-dealers will focus on safekeeping of funds, registration requirements, anti-money laundering ("AML"), private offerings, and disclosure of conflicts of interest as they pertain to Digital Asset Securities. The Division also noted that examinations of broker-dealers will review outside business activities related to digital assets.

Safeguarding funds and operations: The Division's examination will review whether broker-dealers properly custody and safeguard Digital Asset Securities.

Registration requirements: The Division will examine whether any affiliates of broker-dealers that engage in effecting transactions in Digital Asset Securities comply with applicable broker-dealer registration requirements.

AML: The Division will review whether broker-dealers adhere to applicable AML and know your customer rules for Digital Asset Securities and whether procedures are sufficiently robust and account for the pseudonymous nature of distributed ledger technology.

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<sup>6</sup> A private fund or other pooled investment vehicle that meets the definition of an "investment company" must register with the SEC as an investment company, unless it satisfies an exclusion or exemption from that definition. See Section 3 of the Investment Company Act of 1940.

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Offerings: The Division will review whether and to what extent broker-dealers involved in Digital Asset Security underwriting and private placements provide disclosures and perform due diligence with respect to such Digital Asset Securities.

Disclosure of conflicts of interest: The Division will review conflicts of interest that arise when broker-dealers operate as trading platforms or proprietary traders of Digital Asset Securities on their own or other platforms, whether such conflicts have been disclosed, and whether compliance policies and procedures are designed to address such conflicts.

Outside business activities: The Division noted that certain representatives of broker-dealers offer services related to digital assets apart from their employer. In that regard, the Division noted that it will review FINRA-member broker-dealer compliance processes in connection with the evaluation, approval, and monitoring of outside business activities.

### **Exchanges**

The Division will examine platforms that facilitate trading in Digital Asset Securities to determine whether they meet the definition of an “exchange”<sup>7</sup> and therefore must register as a national securities exchange under the Exchange Act. With respect to alternative trading systems (“ATS”) that offer trading in Digital Asset Securities, the Division noted that it will review whether such an ATS 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**

The Division notes that the use of distributed ledger technology by issuers of securities for various shareholder administration functions, including recordation of ownership, may constitute transfer agent activity and that transfer agents are required to register with the SEC. Relatedly, in its examinations, the Division will review whether registered transfer agents servicing Digital Asset Securities are operating in compliance with the promulgated rules for registered transfer agents.

### **Conclusion**

The risk alert offers valuable insight into the specific issues that the Division is reviewing with respect to Digital Asset Securities and digital assets. SEC registrants who engage in activities relating to these instruments should continue to remain vigilant and consider whether enhancements to their compliance programs are warranted based on the guidance

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<sup>7</sup> See Section 3(a)(1) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 3b-16(a) thereunder.

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in the risk alert. Notably, the risk alert acknowledges that the digital asset market is evolving rapidly and encourages market participants to engage with the SEC through the agency's FinHub for questions that arise.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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