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The Division of Examinations' Continued Focus on Digital Asset Securities*

I. Introduction

In the experience of the Division of Examinations (the "Division"), a number of activities related to the offer, sale, and trading of digital assets[1] that are securities ("Digital Asset Securities") present unique risks to investors. Moreover, distributed ledger technology has many distinct features that the Division encourages firms to consider when designing their regulatory compliance program. To address these risks and adapt as distributed ledger technologies change and mature, many market participants involved with Digital Asset Securities have been updating and enhancing their compliance practices.

This Risk Alert provides 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. In addition, as more securities industry participants seek to engage in digital asset-related activities, this Risk Alert provides transparency about areas of focus for the Division's future examinations.

II. Investment Advisers

The staff has identified risks from recent examinations of 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 (e.g., private funds). Based on these observations, examinations will focus on regulatory compliance associated with, among other things:

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* This statement represents the views of the staff of the Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations). It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

1 The term "digital asset," as used herein, 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." A particular digital asset may or may not meet the definition of "security" under the federal securities laws.

- *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;[2]
    - 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);[3] and
    - Fulfillment of their fiduciary duty with respect to investment advice – across all client types.[4]
- *Books and records*. Examinations will include a review of whether advisers are making and keeping accurate books and records, including recording trading activity in

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[2] *See* Section 2(a)(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act"), 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"). *See also* 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.

[3] Digital assets essentially operate on software running across networks of peers that create and maintain shared ledger accounting for holdings of these assets. For purposes of this statement, "forked" refers to backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets. For the purpose of this statement, "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.

[4] Advisers Act Section 206. *See also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, IA Rel. No. 5248 at 12 (June 5, 2019) 84 FR 33669 (July 12, 2019) at 33672 (explaining that Section 206 imposes "a [fiduciary] duty to provide investment advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client").

accordance with the recordkeeping requirements, if applicable.[5] Digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification, which an adviser should consider when designing its recordkeeping practices.

- *Custody.* 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 Adviser's Act), where applicable.[6] Regardless of how digital assets are stored, the 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.[7] In particular,

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[5] *See* Advisers Act Rule 204-2 ("Books and Records Rule"), which requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the Commission.

[6] Advisers Act Rule 206(4)-2 (the "Custody Rule"). *See also* 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.

[7] Registered investment advisers are required to provide their advisory clients and prospective clients with a written disclosure document (these requirements, and a few exceptions, are set forth in Rule 204-3 under the Advisers Act).

and among other things, the 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.

- *Pricing client portfolios*. Investment advisers apply a variety of valuation methods to determine the value of digital assets managed on behalf of clients. 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.[8] The staff will also review disclosures related to valuation methodologies, and advisory fee calculations and the impact valuation practices have on these fees.

- *Registration issues*. For investment advisers, examinations will include a review of compliance matters related to appropriate registration. This includes, among other things, understanding how the investment adviser calculates its regulatory assets under management,[9] and characterizes the digital assets in the pooled vehicles it manages[10] and the status of clients.[11] For private funds managed by investment advisers, this also includes understanding how the funds determine applicable exemptions from registration as investment companies.[12]

III. Broker-Dealers

The staff has identified risks through regulatory coordination and through observations from recent examinations of broker-dealers. Due to the risks the staff has observed, future examinations of broker-dealers will focus on regulatory compliance associated with, among

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[8] *See, e.g.,* 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.

[9] Advisers Act Section 203A sets forth the requirements for investment adviser registration, including assets under management thresholds.

[10] *See* The definition of "investment company," contained in Section 3(a) of the Investment Company Act.

[11] *See* General Instructions to Form ADV, available at https://www.sec.gov/about/forms/formadv-instructions.pdf and definition of "client" in Item 7 of the Glossary of Terms.

[12] A private fund or other pooled investment vehicle that meets the definition of an "investment company" in Section 3(a) of the Investment Company Act 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.

other things:

- *Safekeeping of funds and operations.* The staff will examine broker-dealers to understand operational activities, including operations that are unique to the safety and custody of Digital Asset Securities.[13]

- *Registration requirements.* Examinations will include broker-dealers' and any affiliated entities' compliance with registration requirements. For example, if an affiliate of a registered broker-dealer engages in the business of effecting transactions in Digital Asset Securities for the accounts of others, that affiliate may be required to register as a broker-dealer.[14]

- *Anti-Money Laundering (AML).* Certain pseudonymous aspects of distributed ledger technology present unique challenges to the robust implementation of an AML program. The staff has observed broker-dealer AML programs that have not consistently addressed or implemented routine searches or, to the extent they implemented routine searches, have not updated those searches to check against the Specially Designated Nationals list maintained by the Office of Foreign Assets Control ("OFAC") at the U.S. Department of the Treasury. The staff also has observed inadequate AML procedures, controls, and documentation regarding Digital Asset Securities. The staff will continue to examine broker-dealer compliance with AML obligations (e.g., filing suspicious activity reports and performing customer due diligence).[15]

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[13] *See* Exchange Act Rules 15c3-1, 15c3-3, 17a-3, and 17a-4. *See also* Commission Statement and Request for Comment, *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, dated December 23, 2020, available at https://www.sec.gov/rules/policy/2020/34-90788.pdf (setting forth time-limited circumstances for broker-dealer custody of digital asset securities and requesting comment); Letter to Ms. Kris Dailey, Financial Industry Regulatory Authority (FINRA), ATS Role in the Settlement of Digital Asset Security Trades, dated September 25, 2020, available at https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf (setting forth the Commission's Division of Trading and Markets staff position describing circumstances under which staff will not recommend enforcement action against a broker-dealer operating an ATS that trades digital asset securities using a specified 3-step process); *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, dated July 8, 2019, available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities (statement of the Commission's Division of Trading and Markets and FINRA Office of General Counsel concerning application of federal securities laws and FINRA rules to the potential intermediation of digital asset securities and transactions).

[14] Securities exchanges and broker-dealers are required to be registered under the Exchange Act Sections 6 and 15(a), respectively. See generally the Division of Trading and Markets Investor Publication: Guide to Broker-Dealer Registration (April 2008), available at https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#II.

[15] *See, e.g.*, Bank Secrecy Act implementing rules at 31 CFR 1023.320 (suspicious activity rule), 31 CFR 1023.210 (AML program rule including customer due diligence requirement), and 31 CFR 1010.320 (beneficial ownership rule). *See also* FINRA 3310 (AML compliance program rule for FINRA member firms); SEC's AML Source Tool for Broker-Dealers, available at

- *Offerings*. Broker-dealers may be involved in underwriting and private placement activity with respect to Digital Asset Securities, which can raise unique disclosure and due diligence obligations.[16] 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.[17]

- *Disclosure of conflicts of interest*. As the staff has observed, broker-dealers may operate in multiple capacities, including as trading platforms or proprietary traders of Digital Asset Securities on their own and other platforms.[18] 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*. The staff has observed instances of registered representatives of broker-dealers offering services related to digital assets apart from their employer. FINRA-member broker-dealers must evaluate the activities of their registered persons to determine whether such activity constitutes outside business activities or an outside securities activity and therefore should be subjected to the approval, supervision, and recordation of the broker-dealer.[19] The staff will continue to review FINRA-member broker-dealer compliance processes in connection with the evaluation, approval, and monitoring of outside business activities.

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https://www.sec.gov/about/offices/ocie/amlsourcetool.htm. In addition, for FINRA member firms, the staff will assess firms' compliance with FINRA Rule 2090 ("Know Your Customer" rule).

[16] Securities Act Section 17(a), Exchange Act Section 10(b), and FINRA Regulatory Notice 10-22 Regulation D Offerings – Obligation of Broker-Dealers to Conduct Reasonable Diligence Investigations in Regulation D Offerings.

[17] To the extent a broker-dealer engages in trading on behalf of clients or in their own accounts, the staff will examine for compliance with relevant rules.

[18] *See also* Exchange Act Section 15(c) and FINRA Rules 2010 and 2020.

[19] FINRA Rule 3270. *See also* FINRA Rule 3280.

IV. National Securities Exchanges

- *Exchange Registration*. Advances in distributed ledger technology have introduced innovative methods for facilitating electronic trading in Digital Asset Securities. A platform that operates as an "exchange" as defined under Section 3(a)(1) of the Exchange Act and Rule 3b-16(a) thereunder must register as a national securities exchange or operate pursuant to an exemption.[20] The staff will examine platforms that facilitate trading in Digital Asset Securities and review whether they meet the definition of an exchange.

- *Compliance with Regulation ATS*. One exemption from national securities exchange registration that is available to an entity that meets the definition of an exchange is the exemption for alternative trading systems ("ATSs").[21] 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.

V. Transfer Agents

- *Compliance with Transfer Agent Rules*. Distributed ledger technology is increasingly being used by issuers of securities to perform, directly or indirectly, various shareholder administrative functions, including recordation of ownership.[22] The Commission has

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[20] Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. Exchange Act Rule 3b-16(a) provides that an entity shall be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by an exchange" if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade. *See, e.g.*, Zachary Coburn, Exchange Act Rel. No. 84553 (Nov. 8, 2018) (settled order), available at https://www.sec.gov/litigation/admin/2018/34-84553.pdf.

[21] Exchange Act Rule 3a1-1(a)(2) exempts from the Exchange Act Section 3(a)(1) definition of "exchange" an organization, association, or group of persons that complies with Regulation ATS. A person or entity that meets the definition of an exchange and complies with Regulation ATS is not required to register as a national securities exchange. An entity that meets the exchange definition that fails to comply with the requirements of Regulation ATS would no longer qualify for the exemption provided under Rule 3a1-1(a)(2), and thus, could be deemed to be operating as an unregistered exchange in violation of Section 5 of the Exchange Act. *See* Exchange Act Release No. 83663 (July 18, 2018) 83 FR 38768 (August 7, 2018) at 38772.

[22] Section 3(a)(25) of the Exchange Act defines "transfer agent."

promulgated rules for registered transfer agents[23] that are intended to facilitate prompt and accurate clearance and settlement of securities transactions. Examinations will include a review of whether registered transfer agents servicing Digital Asset Securities are operating in compliance with such rules.

VI. Conclusion

In sharing the focus areas for the digital asset initiatives, the Division encourages market participants to reflect upon their own practices, policies and procedures, as applicable, and to promote improvements in their supervisory, oversight, and compliance programs. The Division understands that, as financial innovation continues, market participants may have questions as to their regulatory obligations. Should such questions arise regarding Digital Asset Securities, market participants are encouraged to engage with the Commission's staff through the agency's Strategic Hub for Innovation Technology ("FinHub"). To contact Commission staff for assistance, please visit the Commission's FinHub webpage.[24]

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[23] Section 17A(c) of the Exchange Act requires transfer agents to register with the Commission. *See* Exchange Act Rules 17Ad-1 to 17Ad-7.

[24] https://www.sec.gov/finhub.