

# SEC Reporting & Compliance Alert

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## SEC Staff Issues Digital Asset Accounting Guidance

On March 31, 2022, the Division of Corporation Finance and the Office of the Chief Accountant (Staff) of the U.S. Securities and Exchange Commission (SEC) published Staff Accounting Bulletin No. 121 (SAB 121), which provides guidance concerning accounting and disclosure obligations for companies that provide a platform for users to transact in digital assets<sup>1</sup> and safeguard those assets on behalf of customers. Specifically, SAB 121 provides that affected companies should record digital assets as liabilities on their balance sheets, accounted at fair value, and disclose the nature and amount of the digital assets held by the company and related risks. SAB 121 states that “[t]he obligations associated with these arrangements involve unique risks and uncertainties not present” in arrangements to safeguard non-digital assets.

As discussed further below, subject to certain transition periods, the guidance in SAB 121 will apply to reporting companies under the Securities Exchange Act of 1934, as amended (Exchange Act), companies that have submitted or filed a registration statement under the Securities Act of 1933, as amended (Securities Act), companies reporting under or that have submitted offering statements under Regulation A and private operating companies whose financial statements are included in filings with the SEC in connection with a business combination involving a shell company, including a special purpose acquisition company (SPAC).

### Digital Asset Accounting

SAB 121 provides guidance for companies that operate platforms that allow users to transact in digital assets and that safeguard users’ digital assets, including maintaining the cryptographic key information required to access digital assets. Citing unique technological, legal and regulatory risks associated with such businesses, and in particular the risk of financial loss, SAB 121 states that as long as a company is responsible for safeguarding the digital assets held for its platform users, the company should present a liability on its balance sheet to reflect its obligation to safeguard such assets. To measure digital assets, SAB 121 states that it would be appropriate to measure liability at initial recognition and each reporting date at the fair value of the digital assets. SAB 121 also acknowledges that it would be appropriate for affected companies to recognize an asset at the same time a company recognizes a liability.

<sup>1</sup> SAB 121 refers to “crypto-assets,” which is defined as “a digital asset that is issued and/or transferred using distributed ledger or blockchain technology using cryptographic techniques.”

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## Disclosure Guidance

In addition, SAB 121 provides guidance on the Staff's expectations for disclosure regarding the safeguarding obligations of a company relating to digital assets held for customers. According to the Staff, in light of the "significant risks and uncertainties" associated with safeguarding digital assets, including the risk of loss associated with holding the cryptographic key information necessary to secure and transact using the digital assets, the notes to the financial statements of an affected company should include "clear disclosure of the nature and amount" of digital assets that the company is responsible for holding for its platform users. In addition, the Staff will expect the financial statements to include separate disclosure for each significant digital asset and the company's vulnerabilities due to concentration in such activities. An affected company also should include disclosures regarding fair value measurements. In providing these disclosures, companies should consider disclosing who (*e.g.*, the company, its agent or another third party) holds the cryptographic key information, maintains the internal recordkeeping of those assets and is obligated to secure the assets and protect them from loss or theft.

Outside of the financial statements, SAB 121 suggests that companies consider disclosures regarding the significant risks and uncertainties associated with holding digital assets under existing SEC rules, such as in the description of business or risk factors or in management's discussion and analysis of financial condition and results of operation. In this regard, SAB 121 provides the following examples of potential disclosure:

- the types of loss or additional obligations that could occur, including customer or user discontinuation or reduction of use of services, litigation, reputational harm and regulatory enforcement actions and additional restrictions;
- analysis of the legal ownership of digital assets held for platform users, including whether the assets would be available to satisfy general creditor claims in the event of a bankruptcy;
- the potential impact that the destruction, loss, theft, compromise or unavailability of cryptographic key information would have to the ongoing business, financial condition, operating results and cash flows of the entity; and

- information about risk-mitigation steps the entity has put in place (*e.g.*, insurance coverage directly related to the digital assets held for platform users).

## Transition Periods

The guidance in SAB 121 will apply to financial statements in reports filed by reporting companies under the Exchange Act and Rule 257(b) of Regulation A covering the first interim or annual period ending after June 15, 2022, with retrospective application as of the beginning of the fiscal year to which the interim or annual period relates.

For all other companies, including companies currently in registration or submitting initial registration statements under the Securities Act or the Exchange Act, companies conducting an offering under Regulation A and private operating companies entering into a business combination transaction with a shell company, including SPACs, the guidance will be effective beginning with their next submission or filing with the SEC. For these companies, the guidance will apply retrospectively as of the beginning of the most recent annual period ending before June 15, 2022, provided the filing includes a subsequent interim period that also reflects application of this guidance. If the filing does not include a subsequent interim period that also reflects application of the guidance, the Staff expects the guidance to be applied retrospectively to the beginning of the two most recent annual periods ending before June 15, 2022.

## Conclusion

SAB 121 represents the latest update in the Staff's evolving view on regulation of and accounting for digital assets. While the guidance appears most likely to affect digital asset exchanges and custodians, it reflects the Staff's continued focus on potential technological, legal and regulatory risks and uncertainties related to such assets and has potential implications for any company holding digital assets on behalf of customers. For example, the guidance may impact the capital or leverage ratio requirements for entities that are subject to capital requirements, whether by regulation or contract.

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