

Securities Regulation Daily Wrap Up, INVESTMENT ADVISORS—Division of Examinations issues guidance on digital asset securities, (Mar 1, 2021)

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Citing risks associated with digital asset securities and distributed ledger technology, the Risk Alert outlines areas of focus for upcoming examinations of firms' compliance programs.

The SEC's Division of Examinations, in its first major Risk Alert since being [elevated](#) to division status from the Office of Compliance Inspections and Examinations in December, has [published](#) guidance for investment advisers, broker-dealers, exchanges, and transfer agents regarding digital asset securities and distributed ledger technology. The [Risk Alert](#) is intended to assist firms in developing and enhancing their compliance practices surrounding digital assets and to outline areas of focus in upcoming examinations.

Investment advisers. The Risk Alert outlines specific areas of focus for investment advisers that manage digital asset securities and other digital assets and derivative products for their clients, including those managed indirectly through pooled vehicles such as private funds. These areas include portfolio management, books and records, custody issues, disclosure, and pricing.

Regarding portfolio management, the examinations staff will review firms' classification of digital assets and whether they should be classified as securities; due diligence on digital assets (such as understanding devices, software, and the asset's liquidity and volatility); and the evaluation and mitigation of risks, including security breaches, fraud, market manipulation, and anti-money laundering (AML) regulation compliance.

The staff's books and records focus will include whether trading activity has been recorded in accordance with recordkeeping requirements. The Alert notes that digital asset trading platforms vary in reliability and consistency and urges investment advisers to keep this in mind when designing their recordkeeping practices.

The Alert outlines a number of custody-related issues firms should be aware of when it comes to the custody of digital assets, including: (1) occurrences of unauthorized transactions such as theft; (2) controls around the safekeeping of digital assets, including employing access to private keys; (3) business continuity plans; (4) the reliability of the software used to interact with digital asset networks; (5) storage of digital assets on trading platforms and with third-party custodians; and (6) security procedures related to software and hardware wallets.

The staff will review disclosures made by investment advisers in all types of media, including solicitations, marketing materials, brochures and supplements, and fund documents. This review will include whether firms have disclosed the unique risks associated with the digital nature of these assets. The Alert draws specific attention to risks involving the complexities of these kinds of products and the technology underlying these assets. The Alert highlights valuation challenges for digital assets, which are particularly risky due to market fragmentation, illiquidity, volatility, and the potential for manipulation.

Finally, the Alert cautions that the staff will be reviewing compliance issues related to registration, including how a firm calculates assets under management and how it characterizes the digital assets in the pooled vehicles it manages. Investment advisers should understand how the private funds they manage are exempt from registration as investment companies, the Alert states.

Broker-dealers. The Division also identified risks related to digital assets for broker-dealers based on its recent examinations. Future examinations of broker-dealers will focus on regulatory compliance issues regarding safekeeping of funds, registration requirements, and AML regulations. The Alert advises that 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.

The Alert notes that the pseudonymous aspects of distributed ledger technology can present unique challenges to the implementation of a robust AML program. Broker-dealer AML programs have not consistently addressed or implemented routine searches to check against the Treasury Department's Specially Designated Nationals list, and many of the programs that have done so have not updated those searches, according to the Alert. In addition, the staff has observed inadequate AML procedures, controls, and documents regarding digital asset securities.

The underwriting and private placement activity relating to digital asset securities can raise unique disclosure and due diligence obligations for broker-dealers, the Alert advises. Future examinations will include reviews of the due diligence performed by broker-dealers and their disclosures to customers about the offering of digital asset securities. The Alert also notes that since broker-dealers may operate in multiple capacities, such as trading platforms or proprietary traders of digital assets securities, future examinations will involve reviews of the existence and the disclosures of conflicts of interests and related compliance policies. FINRA-member broker-dealers should also be mindful of their registered representatives' outside business activities involving digital assets.

National securities exchanges and transfer agents. The Alert observes that advances in distributed ledger technology have introduced innovative methods for facilitating electronic trading in digital asset securities and reminds interested parties that a platform that operates as an "exchange" must either register as a national securities exchange or operate under an exemption. The staff will be reviewing these platforms that facilitate trading in digital asset securities to determine whether they meet the definition of an exchange or if they qualify for an exemption. One exemption is for qualifying alternative trading systems (ATSs). An ATS that trades digital asset securities will be scrutinized for compliance with Regulation ATS, including whether it has accurately and timely disclosed information on the relevant forms and if it has adequate safeguards and procedures to protect confidential subscriber trading information.

The staff also will examine compliance with SEC rules by registered transfer agents. According to the Alert, distributed ledger technology is increasingly used by securities issuers to perform shareholder administrative functions such as the recording of share ownership, subjecting them to rules for transfer agents. Future examinations will include a review of whether registered transfer agents that service digital asset securities are in compliance with the SEC's rules, according to the Alert.

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