

# Division of Examinations Issues Risk Alert on Digital Asset Securities

## WRITTEN BY

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On February 26, the SEC Division of Examinations (Division) (formerly the Office of Compliance Inspections and Examinations) issued a Risk Alert (Alert) relating to the offer, sale, and trading of digital assets that are securities (Digital Asset Securities). The Alert describes observations of Division staff made during examinations of investment advisers, broker-dealers, national securities exchanges, and transfer agents regarding Digital Asset Securities. Since Digital Asset Securities continue to grow in popularity, the Alert also provides transparency about future focus areas of Division examinations.

Indeed, the Division included financial technology (fintech) and innovation, including digital assets, in its 2021 examination priorities, as announced on March 4.<sup>[1]</sup> FINRA, too, is focused on digital assets. In the “2021 Report on FINRA’s Examination and Risk Monitoring Program,” FINRA outlines findings from examinations and provides considerations for member firms relating to outside business activities, communications, risk disclosure, and internal controls as they pertain to digital assets.<sup>[2]</sup> Given the SEC’s attention to digital assets, FINRA, other regulators, and industry participants engaged in the digital asset space should be aware of, and prepared to respond to, inquiries that they may receive relating to digital assets.

With respect to **investment advisers**, the Alert states that examinations will focus on the following areas:

- **Portfolio management.** A review of an investment adviser’s policies, procedures, and practices, relating to:
  - Classification of digital assets, including whether digital assets are classified as securities;
  - Due diligence on digital assets (e.g., ensuring that the investment adviser understands the digital assets in which it transacts, wallets, devices or software used to interact with the relevant digital asset networks or applications, and the relevant liquidity and volatility of digital assets);
  - Evaluation and mitigation of risks related to trading venues and trade execution and settlement facilities;
  - Management of risks and complexities associated with “forked” (i.e., a change in protocol in the underlying blockchain) and “airdropped” (i.e., digital assets provided for free or in exchange for nominal tasks to generate wider interest) digital assets; and
  - Fulfillment of an investment advisers fiduciary duty regarding investment advice across all client types.
- **Books and records.** An examination of an investment adviser’s books and records, including whether accurate books and records are kept for, among other things, trading activity in digital assets. The Alert notes that digital asset trading platforms vary in reliability and consistency for order execution, settlement methods, and post-trade recordation and notification, which an adviser should consider when designing its recordkeeping practices.

- **Custody.** An examination of an investment adviser's custody practices, including whether the investment adviser is subject to and if so, whether the investment adviser complies with the Custody Rule (Rule 206(4)-2 promulgated under the Advisers Act). Regardless of whether digital assets are stored, the staff will review:
  - Occurrences of unauthorized transactions;
  - Controls around safekeeping of digital assets (e.g., employee access to private keys and trading platform accounts);
  - Business continuity plans, including private keys; and
  - Reliability and security of software and platform providers used to interact with digital asset networks.

Custody of digital assets remains an area of scrutiny for the staff. At the same time, clear guidance on what custodial practices are sufficient to comply with the Custody Rule is lacking. Registrants should expect questions of the sort outlined in prior staff statements.<sup>[3]</sup> For example, what role do internal control reports, such as System and Organization Controls (SOC) 1 and SOC 2 reports (Type 1 and 2), play in an adviser's evaluation of potential digital asset custodians, and what role should they play? And do state-chartered trust companies that offer services as custodians of digital assets possess characteristics similar to those financial institutions the SEC identified as qualified custodians? If yes, to what extent?

- **Disclosures.** Examinations will include a review of disclosures to investors regarding the risks associated with digital assets. The review will consider all types of disclosures and statements made by investment advisers and their agents, including solicitations, marketing materials, regulatory brochures and supplements, and fund documents. In particular, the staff will assess disclosures on specific risks, including the complexities of the products and technology underlying such assets, technical, legal, market, and operational risks, price volatility, illiquidity, valuation, related-party transactions, and conflicts of interest.
- **Pricing client portfolios.** Examinations will include a review of 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.
- **Registration issues.** Examinations will include a review of compliance matters related to investment adviser registration, including calculation of regulatory assets under management and classification of digital assets as securities. For private funds managed by investment advisers, the staff will examine whether a private fund must register as an investment company under the Investment Company Act of 1940, as amended, and if it is not registered, whether a private fund qualifies for certain exemptions from registration.

With respect to **broker-dealers**, the Alert states that examinations will focus on:

- **Safekeeping of funds and operations.** The staff will examine broker-dealers to understand operational activities, including operations unique to the safety and custody of Digital Asset Securities.
- **Registration requirements.** Examinations will include broker-dealers' and any affiliated entities' compliance with broker-dealer registration requirements.
- **Anti-money laundering.** The Alert notes that certain aspects of distributed ledger technology present unique challenges to the robust implementation of an anti-money laundering (AML) program. For example, the Alert notes that broker-dealers transacting in digital securities may not consistently conduct routine searches against the Specially Designated Nationals list maintained by the Office of Foreign Assets Control (OFAC) of the U.S. Department of Treasury. The Alert also notes that many broker-dealers transacting in digital assets have inadequate AML procedures, controls, and documentation regarding Digital Asset Securities.

- **Offerings.** Examinations will include a review of the due diligence performed by broker-dealers, as well as the disclosures made by broker-dealers to customers related to the offering of Digital Asset Securities, where broker-dealers participate in underwriting and private placement activity for Digital Asset Securities.
- **Disclosure of conflicts of interest.** Examinations will include a review of the existence and disclosures of conflicts of interest and the compliance policies and procedures to address them. For example, conflicts of interest may exist where broker-dealers operate in multiple capacities, including as trading platforms or proprietary traders of Digital Asset Securities on their own and other platforms.
- **Outside business activities.** The Alert notes that the staff observed instances of registered representatives of broker-dealers offering services related to digital assets apart from their broker-dealer employer. The Alert notes that FINRA-member broker-dealers must evaluate the activities of their registered persons to determine whether such activity is an outside business activity or outside securities activity and therefore should be subjected to the approval, supervision, and recordation of the broker-dealer.

With respect to **national securities exchanges**, the Alert states that examinations will focus on registration of exchanges and compliance with Regulation ATS.

With respect to **transfer agents**, the Alert states that examinations will focus on compliance with transfer agent rules promulgated by the SEC to facilitate prompt and accurate clearance and settlement of securities transactions.

Together, the Alert and the inclusion of digital assets in the 2021 Exam Priorities represents another step forward in the maturation of the digital asset economy. Digital assets present unique compliance and operational risks that financial industry participants need to address to uphold their contractual and legal obligations and to safeguard client assets. As digital assets continue to gain mainstream adoption, it is critical, from a legal and business standpoint, that industry participants have robust compliance programs tailored to their businesses in digital assets.

Troutman Pepper brings extensive experience counseling investment advisers, broker-dealers, and other financial industry participants on all aspects of investment management, including digital assets. For questions, contact any of the authors of this client alert.

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[1] According to the Division's press release announcing its examination priorities, examinations of market participants engaged with digital assets will continue to assess the following: whether investments are in the best interests of investors; portfolio management and trading practices; safety of client funds and assets; pricing and valuation; effectiveness of compliance programs and controls; and supervision of representatives' outside business activities. See, <https://www.sec.gov/news/press-release/2021-39>.

[2] See <https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/communications-with-public>.

[3] 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>.

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