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SEC Continues its Focus on Digital Asset Securities

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On February 26, 2021, the Securities and Exchange Commission (“**SEC**”) issued a risk alert (“**Risk Alert**”)¹ relating to the offer, sale, and trading of digital assets that are securities (“**Digital Asset Securities**”), which include certain virtual currencies, coins, and tokens.² Digital Asset Securities and distributed ledger technology present many unique and distinctive features that investment advisers and broker-dealers should be mindful of when designing regulatory compliance programs. Where Digital Asset Securities are concerned, investment advisers and broker-dealers should note the following key areas the SEC’s Division of Examinations (“**Division**”) will focus on in future examinations and adjust and update their compliance programs as necessary. While the Risk Alert details a variety of key focus areas, this article focuses only on the impact to investment advisers and broker-dealers.

Investment Advisers

Investment advisers should note that the following six areas will be of particular focus in relation to Digital Asset Securities or other digital assets and derivative products in future examinations:

- **Portfolio management:** Policies, procedures, and practices, particularly as related to classification (including whether the digital assets are classified as “securities”); due diligence; risk evaluation and mitigation associated with trading venues, trade execution, and settlement facilities; risk management related to “forked” and “airdropped” digital assets;³ and the fulfillment of fiduciary duties, all of which an investment adviser should expect, will be reviewed.
- **Books and records:** Books, records, and recordkeeping practices will be examined for accuracy and compliance with Rule 204-2 under the Investment Advisers Act of 1940, as amended (“**Advisers Act**”). It is noted that any potential variability and inconsistency of digital asset trading platforms should be accounted for in recordkeeping practices.

¹ SEC Risk Alert, “The Division of Examinations’ Continued Focus on Digital Asset Securities” (February 26, 2021), <https://www.sec.gov/files/digital-assets-risk-alert.pdf>.

² The Risk Alert utilizes the term “digital asset” to refer to an asset that is “issued and/or transferred using distributed ledger or blockchain technology (“**distributed ledger technology**”).” The SEC notes that certain “digital assets” may or may not meet the definition of “security” under the federal securities laws and current SEC guidance.

³ The Risk Alert defines (i) “forked” as “backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets” and (ii) “airdropped” as “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.”

- **Custody:** Risks and practices related to the custody of digital assets will be examined, and where applicable, for compliance with the SEC's custody rule⁴. Note that regardless of the methods used to store digital assets, unauthorized transactions (including any theft of digital assets), safekeeping controls, storage, business continuity plans where personnel are granted exclusive access to private keys and methods used to evaluate harm if such keys are lost, as well as the reliability and security procedures related to software and hardware wallets, will be reviewed.
- **Disclosures:** Disclosures to investors describing the unique risks, complexities, underlying technology, technical, legal, market, and operational risks, price volatility, illiquidity, valuation methodology, related-party transactions, and conflicts of interest as related to digital assets will be examined.
- **Pricing client profiles:** Valuation methodologies and related disclosures, advisory fee calculations, and the impact valuation practices have on advisory fees as related to digital assets will all be examined.
- **Registration issues:** Compliance matters related to appropriate registration, calculation methods associated with regulatory assets under management, characterization of digital assets in pooled vehicles, and any elected exemption from investment company registration will be reviewed.

Broker-Dealers

Broker-dealers engaged in the business of effecting transactions in Digital Asset Securities should note that the following six areas will be of particular focus in future examinations in relation to Digital Asset Securities:

- **Safekeeping of funds and operations:** Operational activities, including those unique to the safekeeping and custody of Digital Asset Securities, will be examined.
- **Registration requirements:** Broker-dealers' and any affiliated entities' compliance with SEC and FINRA registration requirements will be reviewed (i.e., whether the appropriate entity effecting transactions in Digital Asset Securities is registered as a broker-dealer).
- **Anti-Money Laundering ("AML"):** Compliance with AML obligations, procedures, controls, and documentation regarding Digital Asset Securities will be reviewed.
- **Offerings:** Performance of due diligence and disclosures made to customers as related to the offering of Digital Asset Securities will be examined.
- **Disclosure of conflicts of interest:** The existence and disclosures of conflicts of interest, and the requisite compliance policies and procedures enforced to address them as related to Digital Asset Securities will be examined.
- **Outside business activities:** Compliance processes of broker-dealers in connection with any outside business activities or outside securities activities of its registered representatives related to any digital assets will be reviewed.

⁴ Rule 206(4)-2 under the Advisers Act.



Conclusion

The Risk Alert illuminates the importance the Division places on robust policies and procedures relating to the safeguarding of Digital Asset Securities and other digital assets and derivative products. We encourage all investment advisers and broker-dealers to consider these focus areas carefully and to contact any one of the following Haynes and Boone attorneys for more information:

[Kellie Bobo](#), [Madelyn Calabrese](#), [Ricardo Davidovich](#), [Daren Domina](#), [Evan Hall](#), [Vicki Odette](#), [Shelley Rosensweig](#), or [Taylor Wilson](#)