

SEC's Division of Examinations Publishes Risk Alert and Compliance Guidance for Digital Asset Securities Activities

March 3, 2021

In a [Risk Alert](#) (Alert) published on February 26, 2021, the U.S. Securities and Exchange Commission (SEC) Division of Examinations (Division) highlighted risks that it identified in recent examinations concerning the offer, sale, and trading of digital assets that are securities, and digital ledger technology.¹ The Risk Alert signals that the staff has stepped up and refined its focus on digital asset securities activities among broker-dealers, investment advisers, transfer agents and other market participants.

The Division based the Alert on its findings in examinations of market participants engaged in activities with respect to digital asset securities and digital assets more broadly.² The Alert is intended to provide transparency into the Division's areas of focus and guidance to firms for developing, implementing and enhancing their compliance programs. In particular, the Division notes that Digital Asset Securities and their underlying technologies have "many distinct features" and present "unique risks" to investors that SEC-regulated firms must consider. Specifically, the Alert provides relevant information to investment advisers, broker-dealers, trading platforms, and digital asset securities issuers and their transfer agents.

Our take. While the Alert raises several risks and related compliance issues, it falls short of providing practical guidance on how to address those risks or how to achieve compliance. In previous guidance, the SEC staff said it believes that certain Digital Asset Securities may present some significant compliance challenges.³ In view of the staff's concerns, regulated market participants engaged in digital asset activities should pay particular attention to their obligations under the federal securities laws, and document how they comply with those laws, or run the risk of regulatory scrutiny.

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

² The Alert defines the term "digital asset" to mean any asset that is issued or transferred through distributed ledger or blockchain technology, such as virtual currencies, coins, and tokens – which may or may not meet the definition of a "security" under the federal securities laws. Digital assets that meet the definition of a security are referred to as "Digital Asset Securities."

³ See *Digital Asset Securities: Joint SEC and FINRA Statement Aimed at Broker-Dealer Custody*, Sidley Update (Jul. 11, 2019), <https://www.sidley.com/en/insights/newsupdates/2019/07/digital-asset-securities>.

Investment Advisers. Although the Division of Investment Management has previously raised issues for registered funds that propose to invest in digital assets, the Alert provides for the first time the SEC’s view on an adequate digital asset compliance program, including for advisers that manage private funds and managed accounts. The Alert identifies the following risks for investment advisers to consider in developing or maintaining a Digital Asset Securities compliance program:

- *Portfolio Management.* Advisers should have procedures to determine whether digital assets are securities.⁴ Advisers should also perform and document due diligence on the technological and operational aspects of the digital assets, as well as due diligence related to digital asset trading venues and execution and settlement risks and take any required risk mitigation steps. An adviser also must address any risks and complexities posed by “forked” and “airdropped” digital assets,⁵ and more broadly, ensure that it is fulfilling its fiduciary duty to clients.
- *Books and records.* The Division observes that digital asset trading platforms vary in reliability with respect to order execution, settlement methods, and post-trade recordation and notification. An adviser should perform diligence on the trading venues it uses and take such factors into consideration to comply with its recordkeeping requirements.⁶
- *Custody of digital assets.* Ensuring that registered investment advisers comply with the custody rule continues to be an examination priority.⁷ The Division emphasized that it will focus on specific risks posed by custody of digital assets and stressed that advisers should ensure the proper safekeeping of digital assets (not just Digital Asset Securities) by addressing the safekeeping of digital assets in business continuity plans and security controls and procedures for both software and hardware wallets maintained by the adviser, as well as digital assets stored on trading platform accounts and with third-party custodians.⁸
- *Disclosure.* Advisers should make sure that relevant investor documents adequately disclose the unique risks of digital assets, such as technical and operational risks posed by their digital nature, as well as legal and market risks and risks related to price volatility, illiquidity, valuation methodology, related-party transactions, and conflicts of interest.
- *Valuation.* Advisers should implement, document, and disclose applicable valuation methodologies related to valuing digital asset holdings in light of the challenges for valuing certain digital assets. Advisers should also raise this area of focus with fund auditors.
- *Registration issues.* Given the nature of digital assets, advisers should pay particular attention to registration requirements that may be impacted depending on how the adviser characterizes the regulatory status of digital assets (e.g., securities, commodity interests)

⁴ See SEC FinHub’s *Digital Asset Framework: A Guide for Issuers and Secondary Trading Markets*, Sidley Update (Apr. 26, 2019), <https://www.sidley.com/en/insights/newsupdates/2019/04/sec-finhub-digital-asset-framework>.

⁵ For purposes of the Alert, the Division defines a “fork” as a backward-incompatible protocol change to a distributed ledger that creates additional versions of the distributed ledger, creating new digital assets, and an “airdrop” 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.

⁶ See Advisers Act Rule 204-2 (Books and Records Rule).

⁷ See Advisers Act Rule 206(4)-2 (Custody Rule).

⁸ Investment advisers that are dually registered with the SEC as broker-dealers may not be able to custody Digital Asset Securities for customers. See the discussion below.

in the pooled vehicles it manages and how the adviser calculates its regulatory assets under management.⁹

Broker-Dealers. The Alert also identifies several areas of continued focus relevant to broker-dealers:

- *Safekeeping of assets and operations.* As with investment advisers, broker-dealers should have policies and controls that address the unique considerations posed by Digital Asset Securities.¹⁰ Broker-dealers that custody fully-paid securities (or excess margin securities) for customers are subject to the possession or control requirements of SEC Rule 15c3-3. However, the SEC's current position is that broker-dealers are not permitted to custody Digital Asset Securities for customers, whether directly or through a good "control" location (such as a U.S.-regulated bank) if the ownership of such securities is reflected solely on a blockchain/distributed ledger, unless the broker-dealer qualifies as a limited purpose broker-dealer that would self-custody under the SEC Custody Statement.
- *Registration requirements.* Broker-dealers should review activities of their affiliates and consider whether the affiliate engages in activities that require registration as a broker-dealer.¹¹
- *Digital Asset Security offerings.* Broker-dealers involved in the underwriting or private placement of Digital Asset Securities should perform and document required due diligence on offered Digital Asset Securities, and adequately disclose the particular risks of such securities to customers.¹²
- *Conflicts of interest.* Broker-dealers that operate in multiple capacities, such as operating a digital asset trading platform or engaging in proprietary trading on their own or other trading platforms, should ensure that any conflicts of interest are adequately disclosed and maintain and comply with policies and procedures reasonably designed to address such conflicts.

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

¹⁰ See *Digital Asset Securities Custody: U.S. SEC Issues Broker-Dealers Enforcement Relief and Requests Industry Comment*, Sidley Update (Dec. 28, 2020), <https://www.sidley.com/en/insights/newsupdates/2020/12/digital-asset-securities-custody-us-sec-issues-broker-dealers-enforcement> (the "SEC Custody Statement"). See also Exchange Act Rules 15c3-1, 15c3-3, 17a-3, and 17a-4.

¹¹ A person who engages in the business of effecting transactions in securities for the account of others is generally viewed as "broker" pursuant to Section 3(a)(4) of the Exchange Act and subject to registration as such pursuant to Section 15(a)(1) of the Exchange Act. The SEC has historically taken the position that, subject to certain limited exceptions, a person who receives a success- or transaction-based form of compensation relating to the consummation of a securities transaction is required to register with the SEC as a broker (and become a member of the Financial Industry Regulatory Authority (FINRA)).

¹² See, e.g., FINRA Regulatory Notice 10-22 relating to due diligence requirements for Regulation D private offerings. FINRA Regulatory Notice 10-22 (April 2010), <https://www.finra.org/sites/default/files/NoticeDocument/p121304.pdf>. Broker-dealers that facilitate distributions/offerings of Digital Asset Securities could be subject to filings/regulation by the FINRA Corporate Financing Department as well as other distribution requirements. See FINRA rule series 5000 rules.

- *Outside business activities.* Broker-dealers should have procedures in place to evaluate whether registered persons engage in services related to digital assets requiring supervision by the broker-dealer of outside business activities.¹³
- *AML compliance.* Broker-dealers should take into account certain pseudonymous aspects of distributed ledger technology when implementing a robust anti-money-laundering (AML) program, consistent with Financial Crimes Enforcement Network guidance and the most current Specially Designated Nationals list maintained by the Office of Foreign Assets Control at the U.S. Department of the Treasury.

National Securities Exchanges. The Alert notes that distributed ledger technology has introduced “innovative methods” for facilitating trading in Digital Asset Securities, possibly a reference to “decentralized exchanges” and similar programs. Such platforms may meet the definition of an “exchange” under the federal securities laws and need to register as national securities exchanges or operate pursuant to an exemption under Section 3(a)(1) of the Exchange Act and Rule 3b-16(a).¹⁴ Trading platforms that operate as alternative trading systems (ATSs) in accordance with Regulation ATS are exempt from registration as a national securities exchange.

Transfer Agents. The Alert notes that certain issuers of securities may use distributed ledger technology to perform various shareholder administrative functions, including recordation of ownership. Such functions enabled by distributed ledger may cause an entity to meet the definition of a transfer agent.¹⁵ Issuers of Digital Asset Securities should note that certain technology providers may meet the definition of a transfer agent and that registered transfer agents servicing Digital Asset Securities must comply with applicable rules.¹⁶

Conclusion

This Alert provides a window into the SEC staff’s perspective on risks related to trading and custody of Digital Asset Securities. Market participants are well advised to review and evaluate their policies and procedures to ensure that they address and manage the risks cited in the

¹³ See FINRA Rule 3270; see also FINRA Rule 3280. With respect to FINRA Rule 3280 (FINRA’s “private securities transaction” rule), if an associated person (natural person) engages in a securities transaction (primary or secondary offering) outside the scope of such person’s association with the person’s FINRA member/firm (so-called “selling away”), and such person receives “selling compensation” for those activities (which is broadly defined by FINRA and includes expense reimbursements), then the associated FINRA member would be subject to supervising the person’s selling away activities “as if the transaction were executed on behalf of the member.” The member would also need to maintain certain associated books and records relating to the selling away activities. This could be difficult if the FINRA member is not authorized by FINRA to engage in the proposed selling away activities directly. Moreover, selling away activities triggering such supervision may require the associated member to notify FINRA pursuant to FINRA Regulatory Notice 20-23 that it is engaging in activities involving Digital Asset Securities, if it has not done so already. Also, associated persons of a FINRA member that has a limited registration as a Capital Acquisition Broker (CAB) are not allowed to engage in selling away activities. See FINRA CAB Rule 328.

¹⁴ See *First SEC Enforcement Action Against Decentralized Digital Asset Exchange Echoes Recent Public Statements*, Sidley Update (Nov. 13, 2018), <https://www.sidley.com/en/insights/newsupdates/2018/11/first-sec-enforcement-action-against-decentralized-digital-asset>.

¹⁵ Section 3(a)(25) of the Exchange Act defines “transfer agent.”

¹⁶ Section 17A(c) of the Exchange Act requires transfer agents to register with the Commission. See Exchange Act Rules 17Ad-1 to 17Ad-7.

Alert. This Alert is just one of several published SEC alerts and bulletins regarding the application of securities laws to digital assets. Digital asset trading platforms and blockchain companies should diligently consider the application of federal securities laws when supporting Digital Asset Securities.

CONTACTS

Jay G. Baris , Partner	+1 212 839 8600, jbaris@sidley.com
David M. Katz , Partner	+1 212 839 7386, dkatz@sidley.com
Laurin Blumenthal Kleiman , Partner	+1 212 839 5525, kleiman@sidley.com
Lilya Tessler , Partner	+1 214 969 3510, ltessler@sidley.com
Daniel Engoren , Associate	+1 212 839 5893, dengoren@sidley.com
Sasha P. Hondagneu-Messner , Associate	+1 212 839 5403, shondagneumessner@sidley.com

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