

The Division of Examinations' Continued Focus on Digital Asset Securities and Implications for Investment Advisers

03.02.21

If you are a securities industry participant seeking to engage in digital asset-related activities, it is time to develop and enhance your compliance practices, says a risk alert by the SEC's Division of Examinations.

Investment advisers must consider developing and enhancing policies, procedures and practices if investing client assets in digital asset securities or other digital assets. According to the risk alert issued on February 26, 2021, examinations for these investment advisers (IAs) will focus on regulatory compliance for, among other things, (1) portfolio management, (2) books and records, (3) custody, (4) disclosures, (5) pricing client portfolios and (6) registration issues. IAs should expect examination staff to focus on these topics (at least initially) and prioritize accordingly. Of course, there are other compliance topics for digital assets which may become focus areas over time, such as insurance. In the meantime, here is a summary of topics from the risk alert for IAs to consider in compliance planning.

Portfolio Management

Be prepared to demonstrate that, in your portfolio management process, you (a) classify digital assets appropriately, (b) perform due diligence to understand the digital asset, wallets, access devices, liquidity and volatility of the digital asset, (c) evaluate and mitigate risks of trading venues, trade execution or settlement facilities in targeted areas, (d) can manage complexities of forks and airdrops (particularly with respect to allocations across client accounts and conflicts of interest) and (e) fulfill your fiduciary duty to provide investment advice in the best interests of the client, including suitability for the client.

Books and Records

Ensure the information you receive from digital asset trading platforms is consistent and reliable, particularly for order execution, settlement methods, and post-trade records. In other words, you may need to design recordkeeping practices to address any information gaps or delays which could lead to inaccurate or incomplete books and records.

Custody

Expect examination staff to look at compliance with the custody rule (or at least the risks sought to be addressed by the rule) for all digital assets. (The risk alert does not limit the custody discussion to "digital asset securities"). Expect examiners to look closely at (a) any unauthorized transactions, (b) controls around safekeeping of digital assets, (c) the business continuity plan addressing access to private keys by key personnel, (d) software reliability for access to digital asset networks, (e) arrangements for storage of digital assets on trading platform accounts and with third party custodians and (f) security procedures for wallets. The review will apply regardless of how digital assets are stored. In other words, do not expect this review to be glossed over simply because you retain a well-known third-party custodian for client digital assets.

Disclosures

Ensure you address the unique risks of digital assets in all disclosures to investors, from marketing materials to the brochure registered investment advisers must deliver to clients. Confirm your disclosures address specific risks identified in the risk alert such as: complexity of the underlying technology; legal; market; custody, cybersecurity and other operational risks; price volatility, illiquidity, valuation methodology, related-party transactions and conflicts of interest.

Pricing of Client Portfolios

Expect examination staff to look closely at the valuation methodology you utilize for the digital assets you manage for clients. To prepare for this, review how you or your service providers determine principal markets, fair value, and the impact of significant events, as well as recognition of forked and airdropped digital assets. Finally, the examination staff will review how these valuation practices impact your disclosures and advisory fee calculations.

Registration

Review whether you and any private funds you manage have appropriate registrations and exemptions in place. According to the risk alert, examination staff will look at your compliance practices for calculating regulatory assets under management, determining whether a private fund is an investment company (and the availability of exemptions or exclusions such as 3(c)(1) and 3(c)(7) under the Investment Company Act), as well as how digital assets are characterized for these purposes.

Other Securities Industry Participants

While we focus in this particular client alert on the risk alert's importance for investment advisers making client investments in digital assets, you should be aware it also addresses broker-dealers, national securities exchanges, and transfer agents.

Next Steps

The Winstead team is available to discuss the impact of this news alert on both disclosure and compliance planning for investment advisers making client investments in digital assets.

A copy of the Risk Alert, issued by the SEC's Division of Examinations on February 26, 2021, is available at <https://www.sec.gov/files/digital-assets-risk-alert.pdf>.

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