

Investment Management Alert

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SEC Continues Focus on Digital Asset Securities

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The offer, sale and trading of digital assets has been a focus of the Securities and Exchange Commission (SEC) for the past several years. On February 26, 2021, the Division of Examinations (the “Division”) of the SEC released a comprehensive summary of observations from its examinations of investment advisers, broker-dealers and transfer agents in order to assist firms in developing and enhancing their compliance policies and to provide transparency into the Division’s areas of focus for future examinations¹ relating to digital assets that are securities (“Digital Asset Securities”).²

Based on its observations, the Division’s examinations of investment advisers expects to focus on regulatory compliance associated with the following:

Portfolio Management

Examinations will analyze policies and procedures of investment advisers regarding:

- The classification of digital assets as Digital Asset Securities.
- The extent of due diligence performed on the digital asset, including the digital network, liquidity and volatility.
- The evaluation and mitigation of risks related to trading venues, trade execution and settlement of digital assets, including but not limited to with respect to the potential for security breaches, fraud, insolvency and market manipulation and the quality of market surveillance, anti-money laundering (AML) procedures and compliance with applicable rules and regulations.
- The management of risks and complexities associated with “forked”³ and “airdropped”⁴ digital assets, including considering conflicts of interest and allocation across client accounts.
- Fulfillment of investment adviser fiduciary duties.

Books and Records

Examinations will also evaluate whether advisers are making and keeping accurate books and records, including recording trading activity in accordance with the recordkeeping requirements. The Division noted that advisers should consider order

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execution, settlement methods and post-trade recordation and notification when designing their recordkeeping practices.

Custody

Examinations will assess the risks and practices related to the custody of digital assets by investment advisers and examine for compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the “Custody Rule”). This will include review of:

- Unauthorized transactions, including theft.
- Safekeeping controls, including employee access to private keys and accounts.
- Business continuity plans.
- Adviser evaluation of harm for loss of private keys.
- Reliability of software.
- Storage of digital assets on trading platform accounts and with third-party custodians.
- Security procedures for wallets.

Disclosures

Examinations will also include a review of disclosures to investors regarding the unique risks associated with digital assets. The Division noted the following specific items it will look for in disclosures:

- Any risks that are heightened as a result of the digital nature of the assets.
- Complexities of the product.
- Technical, legal, market and operational risks (including custody and cybersecurity).
- Price volatility.
- Illiquidity.
- Valuation methodology.
- Related-party transactions.
- Conflicts of interest.

Pricing Client Portfolios

Examinations will include analysis of the valuation methodologies utilized to determine the value of digital assets managed on behalf of clients, including those used to determine principal markets, fair value, valuation after significant events and recognition of forked and airdropped digital assets.

Registration Issues

Examinations of advisers will also include an assessment of appropriate registration, including understanding how the investment adviser calculates its regulatory assets under management and characterizes the digital assets in the investment vehicles it manages. In addition, an examination will also take into account how the adviser to a

private fund applies exemptions from registration as an investment company under the Investment Company Act of 1940, as amended.

Key Takeaways

The SEC continues to focus on cryptocurrency and digital assets. Investment advisers can use the Risk Alert as guidance for their internal compliance efforts in preparation for Division examinations.

¹ The Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021) (the "Risk Alert") available at https://www.sec.gov/files/digital-assets-risk-alert.pdf?utm_medium=email&utm_source=govdelivery. This alert addresses the Division's observations relating to investment advisers. The Risk Alert also addresses other regulated persons.

² The term "digital asset," as used herein, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology ("distributed ledger technology"), including, but not limited to, so-called "virtual currencies," "coins" and "tokens." A particular digital asset may or may not meet the definition of "security" under the federal securities laws.

³ For purposes of this statement, "forked" refers to backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets.

⁴ For the purposes of this statement, "airdropped" refers to 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.

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