

Dear Client

For this Q2 quarterly newsletter we want to cover a few of the more important updates and news coming from the SEC as it likely relates to Switzerland.

Then, I want to take a deep dive into how we see the SEC viewing digital assets, cryptocurrency and cryptoassets. because this is becoming increasingly a focus area for the SEC, not just in regulation, but it is starting to impact every area of the investment management business. Given that world regulation, like it or not, tends to look toward the US, we feel it important to spend some time looking at it.

1. A few general updates

1.1 Gary Gensler publishes his first agenda as SEC chairman

The new head of the SEC, Gary Gensler, is now up and running and the SEC has published its focus agenda for 2021/2022. There are 49 items on his [“To Do List”](#), many targeting investment advisers. Some of the most important for RIAs are:

- Rules Related to Investment Companies and Investment Advisers to address matters relating to Environmental, Social and Governance Factors (ESG)
- Cybersecurity Risk Governance
- Amendments to Form PF
- Amendments to the Custody Rules for Investment Advisers
- Climate Change Disclosure

Essentially the above are mostly around improving disclosure. No surprises there, in keeping with the general philosophy of “disclose everything, but absolutely everything”.

1.2 \$2 billion budget for the SEC

The SEC has just submitted its budget plan to Congress and for the first time, total budget authority for the fiscal year 2022 (August – September for the SEC) would exceed \$2 billion. The SEC is looking to justify to Congress what it believes it needs to fulfil its tasks. For 2021 the SECs budget will likely be around \$1.9 billion. In 2020 it was around \$1.8 billion.

Generally, the SEC actually returns money to the federal government as fines, fees and other charges usually cover the annual budget. The proposed budget, starting in October 2021, is looking to add 20 people to the Division of Enforcement (up to 1,372 people) plus 16 for the Division of Examinations (up to 1,124 people). In numbers, the SEC wants increases in funding to \$638 Million for Enforcement (\$621 Million in 2021) \$456M for Examinations (\$440 Million in 2021).

The full report, while long on less-than-exciting numbers and statistics, holds some real insights into SEC direction in 2021/2022 and is available for the brave of heart here.

1.3 Latest on the lifting on the new registrations moratorium

With all parties moving at the blistering pace of your average glacier, on Monday, 31st May, we were informed from the usual sources that the [Swiss Federal Data Protection and Information Commissioner](#) (FDPIC) sent a 16 page

position statement to the SEC. The SEC is now ruminating upon its next move. A discussion between representatives from the SEC and FDPIC is planned „soon“, however no timing and importantly, no date has yet been mentioned. At least, not that we are aware of.

1.4 Form CRS revisited

To say that Form CRS has been somewhat contentious is an understatement, so no surprises that one year in, it is already being looked at with revisions being suggested.

The Institute for the Fiduciary Standard, a Fiduciary group has added its voice to the discussion arguing for a revision of Form CRS. Fiduciary Standard is asking the Commission to revise the form to make it “simple and understandable” so readers more clearly understand the differences between RIAs and Broker Dealers. According to the statement released, “The SEC should make fixing disclosure to retail investors in Form CRS and Reg BI a priority. The current disclosures obscure and mislead retail investors”. To make things easier, they even released a template they think the SEC should adopt.

We have not heard the last of this. By the SECs own admission, Form CRS has not been quite the success hoped for and revisions are on the way.

1.5 Tip for your Form CRS

The thing is, for pretty much everybody reading this, here in Switzerland, Form CRS is (mostly) hardly relevant to the clients served. It is aimed at (smaller) retail clients. Many (most) of your clients may not even bother to read your carefully, lovingly prepared Form CRS. However, you can assume one party is taking a real interest in every word: The SEC Division of Examinations.

One US based compliance consultant put it this way, “Examiners doing routine examinations are looking at Form CRS very, very closely,” and went on to say that “The Division wants to see evidence of the form going to prospects,”. Meaning, Form CRS has to be given out even to prospects who have not yet signed investment management agreement and it should be documented.

Therefore make sure that you have a clear tracking procedure for the disclosure documents which are handed out to prospects and clients.

1.6 Duty to maintain records of video sessions

According to the recent [Smarsh 2020 Risk & Compliance Survey Report](#), financial firms have largely failed to implement policies and procedures around video sessions and commonly used collaboration and conferencing technologies.

Neither the SEC nor FINRA will be giving firms a free pass on meeting their obligations in this regard.

The issue is that regulatory focus on video and online communications has been given a massive kick because of the massively increased use of online channels due to Covid. Communication and collaboration tools like Zoom and Microsoft Teams have evolved at lightning speed over the last 15 months with so many people working in home-office-exile. This has created much increased complexity for electronic communications record keeping.

The SEC and the Division of Examinations has made it clear that in a changed environment involving a huge increase in the use of Zoom, Teams and other collaboration software that organizations having adopted these tools to better cope still have to make sure that their policies and procedures are adapted accordingly and adhered to.

1.7 Vaccinations and returning to work

This is not directly SEC related, but we just thought worth mentioning. We think this is going to become a more sensitive issue going forward. Can an employer mandate vaccines? Or should it? Well, No, not (yet) in Switzerland. We may well end up with a majority of people who decide to just get their shot to get on with life as usual - and a minority who simply refuse for whatever reason. For some people there may be legitimate health (medical condition) or other reasons for not vaccinating.

People are entitled to a workplace in which they feel safe, mixing vaccinated with non-vaccinated individuals will likely give rise to concerns. An employer can, presumably, exclude an individual from the workplace, but must be able to provide that individual with accommodation for that, i.e., infrastructure and the ability to work from home. There are going to be risk factor assessment, privacy issues, and so on.

2. Special Focus: Digital Asset Securities

The SEC Division of Examinations (formerly OCIE) is continuing its focus on digital assets and intensifying scrutiny. After a “we really have no idea here” start, the Division has, to no-ones surprise, made this an increasingly “hot topic”. Switzerland has been developing its own laws, notably on 25 September 2020, the Swiss Parliament adopted the „Federal Act on the Adaptation of Federal Law to Developments in the Technology of Distributed Electronic Registers.“ Given all the interest and attention we feel it appropriate to devote some space to the subject and how the SEC sees things.

To start with, we will quote a paragraph from the SEC in its entirety, which we think helps show just how important the SEC is now viewing this.

“Further driving a need for additional resources is the growth and volatility of crypto assets. This asset class, though fluctuating a lot, has grown significantly in scale and valuations over the last five years. Five years ago, the market capitalization for all crypto assets was about \$9 billion. In the last few months, the asset class has remained volatile, hitting highs in the mid-\$2 trillion range and lows in

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the mid-\$1 trillion range. Additionally, new technology developments in capital markets put additional demands on SEC resources—not only in examinations and enforcement matters, but also in new rulemaking and policy areas”

Essentially, they are saying; *It’s gone from 9 billion to 2 trillion in five years. Volatility is off the charts. Volatility (or standard deviation) = Risk. We need to be paying a whole lot more attention to this. New rules to come (soon).*

2.1 Digital Asset Securities

The term, as used by the SEC, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to “virtual currencies”, “coins” and “tokens”. That may or may not meet the definition of “security” under the federal securities law. Things still seem a little fuzzy here.

2.2 When are Digital Assets considered a security?

[Section 2\(a\)\(1\) of the Securities Act of 1933](#) defines a security as:

“any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

The SEC has issued the [“Framework for ‘Investment Contract’ Analysis of Digital Assets”](#) on April 3, 2019. The framework provides some guidance for market participants on whether a digital asset should be considered a security and subject to U.S. securities laws.

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However, as it currently exists, the framework is only useful for entities considering an Initial Coin Offering (ICO) or investors participating in the offer, sale, or distribution of a digital asset. Expect, therefore, more rulemaking.

The key question is: when does a digital asset become an investment contract? The SEC's framework draws on the "[Howey test](#)". (SEC v. W.J. Howey Co. A landmark case used to determine whether an instrument qualifies as an „investment contract“ for the purposes of the Securities Act.) The test, when applied to digital assets, provides four main requirements for potential ICO issuers and token holders

1. monetary investment
2. in a common enterprise
3. reasonable expectation of profits
4. derived from the efforts of others.

The framework focuses in large part on the fourth requirement.

The SEC seems to take a stand that truly decentralized digital assets like Bitcoin are not investment contracts subject to U.S. securities laws. In applying the fourth consideration of Howey, the purchaser of a digital asset relies on the efforts of others when there are “essential tasks or responsibilities performed and expected to be performed by” a promoter, sponsor, or related third party of the digital asset, “rather than an unaffiliated, dispersed community of network users,” as exists in the case of Bitcoin.

The SEC points out that while the Howey test serves as a powerful test for current and prospective market participants, “no one factor is necessarily dispositive as to whether or not an investment contract exists.” Instead, multiple factors and considerations should apply.

2.2.1 Implications for Investment Advisers

Investment advisers must consider developing and enhancing policies, procedures and practices if investing client assets in digital asset securities or other digital assets.

In Switzerland, more relevantly, we believe Digital Assets should be considered part of Personal Account Dealings (PAD). We believe the Division of

Examinations will take the view that disclosure might prevent the misuse of material non- public information when employee's trade in digital assets, making disclosure mandatory on the PAD.

Obviously, the Division is taking the view that Digital Asset Securities present unique risks to investors and firms should consider the features of distributed ledger technology when designing their regulatory compliance program. To address the risks and adapt P&Ps as distributed ledger technologies advance and mature, advisors involved with Digital Asset Securities need to update and enhance their compliance practices. Here we will likely have the added complication of reconciling this with local law – as it continues to develop.

As more market participants engage in digital asset related activities, the SEC is providing increased guidance on focus areas for the Division's future examinations. Given Canton Zugs growing stature (and sheer number of ICOs) as a world leading cryptocurrency, Distributed Ledger Technology and Blockchain center, the "Crypto Valley" as it is starting to be called, we can be virtually certain this will be a focus of any potential examination of RIAs in Switzerland. For those interested, the [Crypto Valley](#) Association offers some insights (Yes, Aviole is a member and a member of the [Regulatory Working Group](#)).

2.3 Areas of focus for Investment Advisers

Based on recent observations, examinations are likely to focus on regulatory compliance associated with, among other things:

2.3.1 Portfolio management

With a focus in particular on:

- Classification of digital assets
- Due diligence on digital assets
- Evaluation and mitigation of risks
- Management of risks and complexities associated with digital assets
- Fulfillment of fiduciary duty with respect to investment advice
- Disclosure

2.3.2 Books and records

Ensure the keeping of accurate books and records in compliance with Rule 204-2. Digital asset trading platforms vary widely in reliability and consistency with regard to order execution, settlement methods, and post-trade recording and notification.

2.3.3 Custody

Review the risks and practices related to the custody of digital assets and examine for compliance with the custody rule:

- Occurrences of unauthorized transactions, including theft of digital assets
- Controls around safekeeping of digital assets
e.g., employee access to private keys and trading platform accounts
- Business Continuity Plans where key personnel have exclusive access to private keys
- How the adviser evaluates harm due to the loss of private keys
- Reliability of software used to interact with relevant digital asset networks
- Storage of digital assets on trading platform accounts and with third party custodians
- Security procedures related to software and hardware wallets

2.3.4 Disclosures

Review disclosures to investors in a variety of media (e.g., solicitations, marketing materials, regulatory brochures and supplements, and fund documents) regarding the unique risks associated with digital assets. Including explanation of increased risks that are a result of the digital nature of these assets.

2.3.5 Pricing and Valuation

We think this is going to be a hot topic. Advisers use a variety of valuation methods to determine the value of digital assets managed on behalf of clients. Advisers may have valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation.

Examinations will almost certainly include a review of, among other things; valuation methodologies utilized, including those used to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets.

Disclosures related to valuation methodologies will also be reviewed as well advisory fee calculations and the impact valuation practices have on these fees.

2.4 Conclusion

The SEC and Division of Examinations is “encouraging” advisors to reflect upon their own practices, policies and procedures, as applicable, and to promote improvements in their supervisory, oversight, and compliance programs. This means, “if you are engaging in advisory business involving digital assets, think about it and take appropriate steps”.

We expect digital assets, Distributed Ledger Technology, Blockchain and their various derivatives to be affecting everyone at some point.

As and when this becomes an issue, please don't hesitate to get in touch.

Impressum

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