Investor Alerts and Bulletins

Exercise Caution with Crypto Asset Securities: Investor Alert

March 23, 2023

TLDR: The SEC's Office of Investor Education and Advocacy continues to urge investors to be cautious if considering an investment involving crypto asset securities. Investments in crypto asset securities can be exceptionally volatile and speculative, and the platforms where investors buy, sell, borrow, or lend these securities may lack important protections for investors. The risk of loss for individual investors who participate in transactions involving crypto assets, including crypto asset securities, remains significant. The only money you should put at risk with any speculative investment is money you can afford to lose entirely. Investors should understand that:

1. ***Those offering crypto asset investments or services may not be complying with applicable law, including federal securities laws.*** Under the federal securities laws, a company may not offer or sell securities unless the offering is registered with the SEC or an exemption to registration is available. Similarly, the law requires parties such as securities broker-dealers, investment advisers, alternative trading systems (ATS), and exchanges to register with the SEC, a state regulator, and/or a self-regulatory organization (SRO), such as FINRA. Moreover, entities and platforms involved in lending or staking crypto assets may be subject to the federal securities laws.

Registration of a securities offering requires the issuer to disclose important information about the company, the offering, and the securities offered to the public. Unregistered offerings in crypto asset securities may not provide key information that investors need to make informed decisions. For example, registration typically requires an issuer to include financial statements audited by an independent public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB). Audited financial statements play an important role in making sure investors are provided the information they need to understand the securities in which they want to invest. Issuers of unregistered crypto asset securities offerings might not provide audited financial statements, depriving investors of this key information.

Proof of Reserves is a term crypto asset entities, including trading platforms and/or entities that issue crypto assets securities, use to describe a voluntary method for offering evidence that in the aggregate an entity has sufficient reserve assets to cover what is held for customers and/or accounts at a given point in time. Crypto asset entities may be offering these types of assessments as a way to satisfy customers that their funds are safe and available upon demand. However, these types of services may not provide any meaningful assurance that these entities hold adequate assets to back their customers' balances. Further, crypto asset entities might use these in lieu of audited financial statements in order to obscure and confuse customers about the safety of their assets. For example, a proof of reserves typically:

- *may only provide a snapshot of what is, for example, held by an entity in certain wallets or accounts, or backing customer assets as of a point-in-time;*
- *may not disclose management's activities during the period between the snapshots (for example, use of customer crypto assets in crypto asset lending or other activities);*
- *does not tell customers the whole story about the entity's liabilities and, for example, whether the customer has to "stand in line" behind other creditors if the entity fails; and*
- *may not offer protection against the entity moving customer assets shortly after a proof of reserves is completed.*

In addition, a proof of reserves is not as rigorous, or as comprehensive, as a financial statement audit and may not provide any level of assurance. For example, audited financial statements typically require audits of a complete set of financial statements performed by a registered public accounting firm in accordance with PCAOB auditing standards. With so-called proof of reserves, there are no specific audit requirements for the engagement or the information reported, allowing an entity full discretion to manage the terms of the engagement. For example:

- *the extent and frequency of assessments performed around customer assets;*
- *the determination of the reserves (for example, which*

wallets and accounts are examined as part of the assessment);

- *the level of assurance provided (for example, reasonable, limited, or no assurance) and the standards applied;*
- *the type of third-party assurance provider engaged (i.e., accountant or non-accountant assurance providers, affiliated or independent); and*
- *whether the results are made public, including the extent and format of the information shared.*

Investors should be aware that this level of management discretion undermines any suggestion that a proof of reserves offers protections similar to a financial statement audit. In sum, investors should exercise extreme caution when relying on proof of reserves to conclude that a crypto asset entity has sufficient reserve assets to meet customer liabilities.

Similarly, registration with the SEC by an entity as a "broker-dealer" and/or "investment adviser" provides important protections for investors. Some of those benefits include rules around custody of assets, fees, conflicts of interest, standards of conduct, and minimal capital requirements for broker-dealers. For example, a broker-dealer must comply with custody requirements such as the customer protection rule, which requires broker-dealers to safeguard customer assets and to keep customer assets separate from the firm's assets – increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. In addition, a broker-dealer making recommendations of securities or investment strategies involving securities (including crypto asset securities) to retail customers is subject to Regulation Best Interest, which requires broker-dealers to make recommendations in the retail customers' best interest, and requires compliance with specific disclosure, care, conflict of interest, and compliance obligations.

Recordkeeping and reporting rules require a broker-dealer to make and keep current ledgers reflecting all assets and liabilities. Moreover, financial responsibility rules require that broker-dealers routinely prepare financial statements. These books, records, and financial reporting requirements assist securities regulators in examining for compliance with the federal securities laws. Crypto asset entities not offering these types of protections put investors at risk.

ATSs, which are marketplaces for securities, must be registered broker-dealers and members of an SRO, such as FINRA. In addition to complying with federal securities laws and its SRO's rules, an ATS must comply with Regulation ATS, which includes filing disclosures with the SEC about the ATS's operations and securities trading and protecting its users' trading information.

SEC-registered investment advisers that hold or have the ability to obtain possession of their clients' funds or securities are required to maintain those assets with a qualified custodian, like a bank or broker-dealer. SEC-registered investment advisers that have "custody" of client funds and securities are also generally required to undergo an annual "surprise examination" in which an independent public accountant verifies the existence of these assets and to make and keep records showing all purchases and sales for each client.

Also, unlike SEC-registered entities, crypto asset securities trading platforms or other intermediaries (such as so-called "crypto exchanges") may offer a combination of services that are typically performed by separate firms that may each be required to be separately registered with the SEC, a state regulator, or a SRO. The commingling of these functions, exchange, broker-dealer and custodial functions, for example, creates conflicts of interest and risks for investors. SEC-registered entities are subject to a number of rules to minimize these risks and conflicts of interests, in some cases by separating the functions into legally separate and unaffiliated entities. Registered broker-dealers, ATSs, and investment advisers are also subject to examination by regulators. None of the major crypto asset entities is registered with the SEC as a broker-dealer, exchange, or investment adviser—so investors may not get the protections afforded by the rules applicable to these entities.

In particular, no crypto asset entity is registered with the SEC as a national securities exchange (like, for example, the New York Stock Exchange or the Nasdaq Stock Market). And no existing national securities exchange currently trades crypto asset securities. As a result, investors in crypto asset securities may not benefit from rules that protect against fraud, manipulation, front-running, wash sales, and other misconduct when intermediaries for those products do not comply with the federal securities laws that apply to registered exchanges.

Investors who hold registered securities with registered broker-dealers also generally benefit from protections offered by the Securities Investor Protection Corporation (SIPC). Similarly, people who place deposits in banks enjoy insurance, up to a defined limit, provided by the Federal Deposit Insurance Corporation (FDIC). The National Credit Union Administration (NCUA) insures deposits in federal credit unions. There are no such protections for accounts that you place with crypto asset entities.

In sum, investors in crypto asset securities should understand they may be deprived of key information and other important protections in connection with their investment.

2. ***Investments in crypto asset securities can be exceptionally risky, and are often volatile.*** Over the last year, the crypto asset space has been exceptionally volatile – and a number of major platforms and crypto assets have become insolvent and/or lost value. Investments in crypto asset securities continue to be subject to significant risk, including:

- volatility and illiquidity in the crypto asset markets;
- the potential for the company holding your crypto assets to fail or go bankrupt;

> Investors who deposit funds or crypto assets with a crypto asset securities entity might cease to have legal ownership of those assets and might not be able to get those assets back when they want to. Over the past year, a number of crypto asset entities have faced severe financial difficulties, sometimes resulting in suspending customers' ability to withdraw their assets. Some crypto asset entities have entered bankruptcy proceedings, and it is unclear how much of their holdings (if any) customers might be able to recover. Investors need to be wary of claims that "you always retain ownership of your crypto assets" and "you can withdraw your assets whenever you like."

- unpredictability, including that the market for a particular crypto asset security may disappear altogether or the crypto asset security may no longer be tradable anywhere;
- sometimes highly concentrated and opaque ownership and control structures;
- enforcement of laws and regulations by federal, state, or foreign governments that may restrict the use and exchange of crypto assets;
- unauthorized lending or transfers of customers' crypto asset securities, or halting of customer withdrawals;
- the inability for an investor to be made whole should fraud, default, or a mistake occur;
- technical glitches, hacking, or malware; and
- lack of investor protections due to crypto asset securities entities not acting in compliance with applicable law.

3. ***Fraudsters continue to exploit the rising popularity of crypto assets to lure retail investors into scams, often leading to devastating losses***. Crypto asset securities-related investments continue to be replete with fraud, including bogus coin offerings, Ponzi and pyramid schemes, and outright theft where the project promoter simply disappears with investors' money.

Some promoters use social media to find and entice new investors with testimonials about returns made on deposits and investments, but what is not mentioned is that the promoter is often paying investor withdrawals out of new investor funds – a Ponzi scheme. Moreover, recovering money from the wrongdoers can be nearly impossible. In part, that can be because of the anonymity or pseudonymity associated with crypto assets. However, the SEC and state regulators continue to bring enforcement actions in this space.

> ***Celebrity endorsements****: It is never a good idea to make an investment decision just because someone famous says a product or service is a good investment. A celebrity endorsement does not mean that an investment is appropriate for all investors, or even that it is legitimate. Often, a celebrity is getting paid to promote the investment opportunity, including those involving crypto assets. Even if a celebrity endorses an investment opportunity, you should consider the potential risks and opportunities to determine whether it is right for you.*

Learn more about investment fraud, including how to spot "red flags" of a scam, in our Investor Bulletin, What You Can Do to Avoid Investment Fraud.

4. ***Having an investing plan, as well as understanding your risk tolerance and time horizon, can be critical to your investing success.***

What are the best saving and investment products for you? The answer depends on when you will need the money, your goals, and whether you will be able to sleep at night if you purchase a risky investment (one where you could lose your entire principal). Before making any investment, consider these tips:

- Create and follow an investment plan. Do not let short-term emotions about investments disrupt your long-term investment objectives. If you are considering short-term investments, think about how much of your overall portfolio you should allocate to these types of investments.
- Pay off credit cards or other high interest debt first. No investment

strategy pays off as well as, or with less risk than, eliminating high interest debt.

- Consider the importance of asset allocation and diversification. Asset allocation involves dividing your investments among different assets, such as stocks, bonds, and cash. The allocation that works best for you changes at different times in your life, depending on how long you have to invest and your ability to tolerate risk.
- Understand risk. All investments have risk. While some regulated institutions may offer retail investors ways to gain exposure to crypto asset securities, even when using a regulated entity, investors should ask questions and make sure they understand the terms of the investment. Never invest if you do not understand the product – including the risks involved.

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Modified: March 23, 2023