

December 14, 2022

SEC Staff Publishes Guidance on Disclosure of Crypto-Related Risks

On December 8, 2022, the staff of the Division of Corporation Finance of the Securities and Exchange Commission (the “SEC”) published a sample comment letter highlighting issues related to crypto assets, markets and exposure that registrants should consider when preparing disclosure in connection with their periodic filings and securities offerings. The sample letter includes one general comment and 15 comments relating to Business Description, Management’s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors disclosures illustrative, but not exhaustive of the types of comments that may be made by the staff during its typical selective reviews of registrant’s filings and should be taken into consideration as registrants prepare disclosure documents that may not typically be subject to review, such as automatically effective registration statements and prospectus supplements for shelf takedowns.

Although the comments in the sample letter would be tailored to the specific registrant and transaction, and many of them will be most relevant to companies that do business in the crypto space, including companies that issue, hold, buy or sell crypto assets, every registrant should consider whether they are or may be materially impacted by developments in the crypto asset market, including whether they or their customers are impacted by any downstream effects of bankruptcies or financial distress of crypto market participants or by any devaluation of crypto assets.

The comments highlight disclosure considerations related to counterparty risk, as well as risks related to safeguarding and holding crypto assets, liquidity and financing risks for companies that use crypto assets for funding or lend against such assets and legal and reputational risks.

The Sample Comment Letter

The sample comment letter is broad – including comments that registrants should provide disclosure regarding any significant crypto market developments material to understanding or assessing their business or any material impact on their business from price volatility of crypto assets, and that registrants describe risks to their stock price, risk of loss of customer demand, financing risk, risks of increased losses or impairments, legal risk and risks relating to volatility that are due to disruptions in the crypto asset markets.

In preparing disclosures relating to any material direct or indirect impacts of the crypto asset markets to their businesses, registrants should ensure that such disclosures are tailored to their circumstances and should bear in mind that the sample comment letter does not constitute an exhaustive list of crypto-related matters to be considered.

We have summarized below, by substantive topic, key points from the sample comment letter.

Counterparties and customers

The SEC staff included a number of comments aimed at eliciting disclosure about exposure, however indirect, to the crypto space due to counterparty and related risks. Registrants will need to consider disclosure regarding the following:

Description of Business

- Direct or indirect downstream effects of bankruptcies of crypto market participants to their business or financial condition or that of their customers or counterparties, and whether material assets may be lost.
- Material exposure to customers, counterparties, custodians or other crypto market participants who have undergone bankruptcies, experienced financial distress or material corporate compliance failures.

Liquidity and financing risks related to crypto assets

Companies that rely on borrowed crypto assets (including through deposit-like products), lending against crypto assets or raising funds by selling crypto assets will need to consider disclosure regarding the following:

Management's Discussion and Analysis of Financial Condition and Results of Operations

- Excessive redemptions or withdrawals of crypto assets or suspensions thereof and potential effects on liquidity and financial condition.
- Whether crypto assets issued by them or held by them on behalf of third parties serve as collateral for financing or similar activities to which they or their subsidiaries are party. If so, disclosure on the identity and amount of such assets, whether there are any encumbrances on such collateral and nature of their relationship for loans that are with affiliated parties. Discussion on the impact of crypto market disruption on the value of the collateral.
- To the extent that they have knowledge of crypto assets issued by them serving as collateral for any other person's financing or similar activities, a discussion on the impact of crypto market disruption on the value of the collateral and any financing or liquidity risk this raises for their (i.e., the registrant's) business.

Risk Factors

- Risks arising from the impact of the current crypto asset market disruption on the value of crypto assets they use as collateral or on the value of their crypto assets used as collateral by others.
- Any gaps in risk management processes or policies identified by their management in light of current crypto asset market conditions and any changes to address such gaps.
- Direct or indirect risks due to excessive redemptions or withdrawals of crypto assets or suspensions thereof, including identifying and quantifying concentrations of risk and material exposures.

Safeguarding and holding crypto assets

The sample comment letter also focuses on disclosure relating to holding and safeguarding crypto assets. Companies that engage in those activities will need to consider disclosure regarding the following:

Description of Business

- Steps they take to safeguard their customers' crypto assets, their policies and procedures to prevent self-dealing, conflicts of interest and comingling of assets, including any changes to such processes in light of the crypto asset market disruption.

Risk Factors

- Risks relating to safeguarding their and their affiliates' crypto assets, including any risks if policies and procedures to safeguard such assets and prevent conflicts of interest and comingling of assets are not effective.
- Risks of customers accessing their products and services from jurisdictions where they (i.e., the registrant) have not obtained required licenses and registrations, and steps they take to restrict such access.

Legal and reputational risks

The sample comment letter also addresses legal and reputational risks. Registrants engaged in activities related to crypto assets should consider disclosure regarding the following:

Risk Factors

- Potential reputational harm arising from the disruption of crypto asset markets, including impact of market conditions on the perception of their business by customers, counterparties and regulators.
- Risks of customers accessing their products and services from jurisdictions where they (i.e., the registrant) have not obtained required licenses and registrations, and steps they take to restrict such access.
- Risks from regulatory developments related to crypto assets and crypto markets.
- Risks related to assertion of jurisdiction over crypto assets and crypto asset markets.

Background – SEC’s Increased Focus on Crypto Regulation and Enforcement

The sample letter comes in the wake of significant turmoil relating to the crypto industry and as most registrants prepare for their annual reporting season and underscores the SEC’s push for disclosure and regulation of the crypto market. In addition to a series of high-profile enforcement actions and related litigation and statements by Chair Gensler, Commissioner Peirce and others regarding the applicability of the federal securities laws to certain crypto assets, the SEC has also been focused on disclosure of crypto assets and related risks by registrants. For example, in 2022 the SEC staff has, among other things, issued a Staff Accounting Bulletin (SAB No. 121) on accounting for obligations to safeguard crypto assets and issued comment letters regarding the treatment of non-GAAP financial measures relating to crypto assets, while the SEC has allocated significantly more resources to the Crypto Assets and Cyber Unit in the Division of Enforcement and brought an enforcement action against a major chip manufacturer for inadequately disclosing the impact of cryptomining on its business. Furthermore, the SEC recently added an Office of Crypto Assets to the Division of Corporation Finance’s Disclosure Review Program, a new industry office to solely focus on reviewing disclosure related to the constantly evolving crypto space. The sample comment letter represents a continuation of the SEC’s focus in this area.

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If you would like to follow up regarding any of the matters covered by this Alert, please contact your usual Ropes & Gray attorney.