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CRYPTO ASSET CUSTODY BY INVESTMENT ADVISERS AFTER THE SEC'S PROPOSED SAFEGUARDING RULE

Abstract: The Custody Rule under the Advisers' Act requires registered investment advisers to custody client funds and securities with a clearly defined set of "qualified custodians." Few such qualified custodians exist for crypto assets, and crypto assets have several characteristics that distinguish them from traditional securities — these unique characteristics often pose distinct challenges for traditional custodians. We briefly examine the evolution of, and the principles underlying the Custody Rule under the Advisers Act, and the SEC's proposed new Safeguarding Rule to suggest that instead of requiring investment advisers to custody crypto assets with qualified custodians, investment advisers should be permitted to self-custody crypto assets, provided their custody fulfills certain specified criteria.

By Scott Walker and Neel Maitra *

THE CRYPTO-CUSTODY PROBLEM AND THE SAFEGUARDING RULE

Custody continues to be the single greatest question facing crypto market participants. Although it is too early to definitively declare what caused the recent and remarkable fall of FTX, it appears likely that weaknesses in custodial arrangements may have played a part.[1] Nor is FTX an isolated instance. A recent Chainalysis report found that through July 2022, $1.9 billion worth of crypto assets[2] were stolen in hacks of services, compared to just under $1.2 billion at the same point in 2021.[3]

[1] *FTX Violated Its Own Terms of Service and Misused User Funds, Lawyers Say*, (Nov. 10, 2022), *available at* https://www.coindesk.com/policy/2022/11/10/ftx-violated-its-own-terms-of-service-and-misused-user-funds-lawyers-say/.

[2] For purposes of this essay, the term "crypto asset" is used in the identical sense the SEC refers to a "digital asset," i.e., it refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

[3] Eric Jardine (Chainalysis), *Mid-Year Crypto Crime Update: Illicit Activity Falls With Rest of Market, With Some Notable Exceptions* (Aug. 16, 2022) *available at* https://blog.chainalysis.com/reports/crypto-crime-midyear-update-2022/.

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The urgent need for secure custodial solutions for crypto assets is brought home on almost a daily basis to market intermediaries such as banks, asset managers, and broker-dealers. These intermediaries face two different demands from many of their customers. The first is a demand for investment access to crypto assets. The second is a demand to ensure that customer or client crypto assets are held securely. In making these two demands, crypto asset investors are not unlike traditional investors. But crypto assets pose distinct custodial challenges that traditional securities and traditional assets do not. For example, unlike most traditional securities, a holder's control over a crypto asset is not proof of the absence of any other person's control over that same crypto asset. More than one entity may have access to the private keys related to a set of crypto assets, and consequently, more than one person may be able to effectuate a transfer or disposition of those crypto assets regardless of the contractual rights authorizing such conduct. Yet another challenge is that there is still considerable uncertainty about which crypto asset transactions are securities transactions, and consequently, about whether rules that apply to the custody of securities should apply to these transactions. A third challenge has been the absence of any regulatory consensus, or even regulatory guidance, on what constitutes secure custody for crypto assets. As a result, crypto market intermediaries have thus far had relatively few custodial options that come with the assurance of being regulatorily-compliant.

A fourth challenge is that, unlike traditional debt or equity securities, which can earn income (such as dividends or interest) "passively," i.e., without their holder having to transfer the assets or take any further action after acquiring them, crypto asset holders may have to temporarily deploy these assets out of custody to unlock certain income streams or governance rights associated with the assets. For example, certain crypto assets can earn income from staking.[5] Others may be moved out of custody for use in yield farming and in lending programs. Unrelated to income, but of equal importance, is the right to exercise one's vote in connection with a crypto asset. Similar to the right to vote traditional securities on corporate actions, crypto assets often grant the holder the right to vote on protocol development. While not always the case with staking or voting, in many instances, control of the assets may shift from the custodian to an unaffiliated third-party program to deploy the asset and effectuate the vote or staking. Holders of such crypto assets are therefore faced with the hard choice of either leaving the assets in custody at all times and foregoing all associated income or governance participation, or trying to use the asset by moving the assets out of custody and potentially risking their loss.[6]

The problem is particularly acute for investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). Investment advisers are simultaneously subject to both a fiduciary duty to optimize client portfolios and make informed governance decisions for their investments, as well as to a rule under the Advisers Act that specifically requires registered investment advisers ("RIAs") to custody client funds and securities with certain "qualified custodians" (the "Custody Rule"). To unpack this problem more

[5] In the context of traditional securities, the analogy might be drawn to securities lending or repurchase programs, or dividend distributions. However, this may be somewhat misleading. Receipt of dividends does not require an affirmative action undertaken by the record holder. Arguably, securities lending is an ancillary service that asset managers holding traditional

footnote continued from previous column…

securities may opt to provide. By contrast, staking, for example, is a core feature of many crypto assets and is the central mechanism by which transfers of such assets are validated and the underlying protocol is secured. Further, while securities lending primarily provides an income stream for an asset manager, features such as staking or yield farming provide income streams primarily to the holder of the crypto asset, although they may also provide revenue to the manager of the crypto asset (depending on the terms of the contract between the manager and the holder).

[6] Institutions that offer custody services are increasingly able to offer additional services in which movement of the asset out of their safeguarding is unnecessary (i.e., 'delegated' staking or governance). However, it is an intensive process to onboard such features, and service providers are challenged by resource constraints to meet demand.

clearly, we should first acknowledge that even complying with the Custody Rule, on its own, is currently very difficult for most RIAs who hold certain crypto assets on behalf of clients. However, even RIAs who seek to devise a solution for crypto assets that complies with the Custody Rule may find such solutions effectively unworkable in light of their fiduciary duty to use client crypto assets productively. This dilemma underscores the need for a new approach to RIAs' custody of their clients' crypto assets.

This new approach is evident in the Securities and Exchange Commission's recent proposal to amend the Custody Rule.[7] The newly proposed rule (hereafter, the "Safeguarding Rule")[8] seeks to expand the Custody Rule in several respects. For example, the Safeguarding Rule:

- Significantly expands the assets RIAs must maintain with qualified custodians.
- Expands the custody definition to cover assets over which the RIA has discretionary authority.
- Provides a new definition of when an RIA has "possession or control" of an asset.
- Specifies several assurances or contractual representations that an RIA must receive from a custodian.
- Expands the types of assets which an RIA need not maintain with a qualified custodian.

In this essay, we begin with a brief description of the Custody Rule and the principles and objectives that underlie the Custody Rule. We then outline the problem we identify above in more detail and discuss some of the problems that RIAs face in trying to apply the Custody Rule to crypto assets.[9] We look at some of the best practices within the industry around the custody of crypto assets, and we identify how these practices are consistent with the principles and objectives of the Custody Rule. We then look at the changes proposed by the Safeguarding Rule, and note that the treatment of crypto assets that can be staked or that have a yield function continues to be unsatisfactory (indeed, unaddressed altogether). We suggest that the most effective way forward, at least at this time, is to look to the principles that underpin custody for RIAs, and use those principles to outline the circumstances under which RIAs should be permitted to custody a crypto asset, for the asset's continued productive use.

FROM THE CUSTODY RULE TO THE PROPOSED SAFEGUARDING RULE — A BRIEF SUMMARY

The Custody Rule

The Custody Rule, Rule 206(4)-2 under the Advisers Act, requires RIAs to put in place certain controls or safeguards to protect client "funds and securities." The principal controls the Custody Rule contemplates are:

- The use of a qualified custodian — RIAs that have custody of client funds or securities must maintain such assets with a "qualified custodian."[10] The Custody Rule defines a "qualified custodian" to mean banks, broker-dealers, futures commission merchants ("FCMs"), and certain types of foreign custodians.[11]
- Client notification — RIAs must promptly notify their clients in writing as to the identity of the qualified custodian who holds their assets.[12]
- Periodic account statements — RIAs must reasonably believe that the qualified custodian sends an account statement at least quarterly to each client for which the custodian holds funds or securities.[13]
- Unscheduled annual verification — RIAs that have custody of client assets must undergo a "surprise" annual verification by an independent public accountant.[14]

[7] *Safeguarding Advisory Client Assets*, Release No. IA-6240 (Feb. 15, 2023).

[8] The SEC proposes to renumber the Safeguarding Rule as the new Rule 223-1 so as to rely on "the more expansive and explicit language" in Section 223 of the Advisers Act, which was added to the statute by the Dodd-Frank Act and which describes the adviser's duty to safeguard client assets over which the adviser has custody.

[9] We have previously identified the same problem and suggested some measures to address it in a brief piece for Coindesk.com. Neel Maitra & Scott Walker, *A Call to the SEC: Treat Crypto-Assets as if Clients Matter*, (Sept. 21, 2022) *available at* https://www.coindesk.com/layer2/2022/09/21/a-call-to-the-sec-treat-crypto-assets-as-if-clients-matter/.

[10] Rule 206(4)-2(a)(1).

[11] Rule 206(4)-2(d)(6).

[12] Rule 206(4)-2(a)(2).

[13] Rule 206(4)-2(a)(3).

[14] Rule 206(4)-2(a)(4).

Notably, the Custody Rule does not invariably require that client funds and securities be maintained by a Qualified Custodian. The Rule recognizes that there are circumstances in which client assets may be maintained by the RIA or by a "related person," which the Rule defines as any person directly or indirectly controlling or controlled by the RIA, and any person that is under common control with the RIA.[15]

There are two fairly common situations[16] where the RIA typically self-custodies client assets. One is where the RIA is "dual-hatted," i.e., is also a registered broker-dealer, or has a broker-dealer affiliate.[17] In these situations, the RIA or its affiliate is effectively a qualified custodian within the terms of the Custody Rule and so can exercise custody of client securities. Another situation where self-custody is common is where the RIA is an adviser to a pooled investment vehicle, such as a hedge fund or a private equity fund, and holds certain types of privately offered securities.[18] A RIA to a pooled investment vehicle that self-custodies privately issued securities must either:

- subject itself to an audit by an independent public accountant and distribute its audited financial statements to each investor in the pool within 120 days of the pooled vehicle's fiscal year end[19] or
- undergo an annual unscheduled examination by an independent public accountant.[20]

The Safeguarding Rule

The proposed Safeguarding Rule has several elements in common with the current Custody Rule, but it also expands the requirements of the Custody Rule in important ways. As with the Custody Rule, the Safeguarding Rule would require:

- RIAs to maintain client assets with qualified custodians;[21]
- qualified custodians to send statements, at least quarterly to clients; and
- RIAs to be subject, at least annually, to a "surprise" examination by an independent public accountant.

However, the Safeguarding Rule also proposes to change the Custody Rule in several respects. Perhaps most significantly, the Safeguarding Rule would extend to all assets held by an RIA for its clients.[22] This proposed coverage of all client assets would broaden the Custody Rule, which currently covers only client "funds and securities." The proposing release for the Safeguarding Rule (the "Proposing Release") expressly states that the proposed Rule would extend, among other things, to crypto assets that are not securities.[23]

This proposed change purports to address the questions of which crypto assets are securities and therefore which crypto assets are required to be maintained with a qualified custodian. The Safeguarding Rule removes this question by simply requiring all assets, including all crypto assets, to be maintained with a qualified custodian.[24] As we note below, this proposed sweeping change may raise its own set of concerns and challenges.

The Safeguarding Rule also proposes to exempt more assets from the qualified custodian requirement. As with the Custody Rule, RIAs are not required to maintain privately offered securities with qualified custodians, but the Safeguarding Rule goes further and states that "physical assets" also do not have to be maintained with qualified custodians.[25] At the same time, the

[15] Rule 206(4)-2(d)(6).

[16] While these are two situations in which RIAs commonly self-custody client assets, there are a variety of other custodial situations in which RIAs may not be covered by the Custody Rule — such where an RIA is an adviser to a registered investment company. These cases are largely irrelevant to, and beyond the scope of, this essay.

[17] Rule 206(4)-2(a)(6).

[18] Rule 206(4)-2(b)(4). "Privately offered securities" are (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (2) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

[19] Rule 206(4)-2(b)(4)(i).

[20] Rule 206(4)-2(b)(4)(ii).

[21] The Safeguarding Rule proposes to retain the same four categories of qualified custodians — i.e., banks, broker-dealers, FCMs, and foreign financial institutions, but it proposes to add significantly more additional requirements for banks and foreign financial institutions to be considered qualified custodians. Proposed Rule 223-1(d)(10).

[22] Proposed Rule 223-1(d)(1) defines "assets" to mean "funds, securities, or other positions held in the client's account."

[23] Proposing Release at 28.

[24] Proposed Rule 223-1(a).

[25] Proposed Rule 223-1(b)(2).

Safeguarding Rule makes it significantly more difficult for an RIA to self-custody these assets. The Rule proposes that an RIA need not maintain privately offered securities or physical assets with qualified custodians, but only if the following conditions are met:

- the RIA determines, in writing, that the asset cannot be custodied by a qualified custodian;[26]
- the RIA reasonably safeguards the asset from loss and from the RIA's insolvency;
- an independent public accountant verifies any purchase, sale, or other transfer of beneficial ownership of the asset, and notifies the SEC of any discrepancies;
- the RIA notifies the independent public accountant of any purchase, sale, or other transfer of beneficial ownership of the asset, within one business day; and
- the existence and ownership of the asset is verified during the annual surprise examination, or as part of a financial statement audit.[27]

The Proposing Release specifically notes that crypto assets issued on public, permissionless blockchains would not constitute privately offered securities and RIAs must maintain such crypto assets with a qualified custodian.[28] The Proposing Release states that "[t]he market for crypto asset custodial services continues to develop" and notes that there are several qualified custodians who service crypto assets.[29]

One further significant change proposed by the Safeguarding Rule that is motivated, in part, by the emergence of crypto assets is a new definition of when a qualified custodian has "possession or control" of an asset. The Rule proposes to define "possession or control," as holding assets such that the qualified custodian:

- is required to participate in any change in beneficial ownership of those assets,
- the qualified custodian's participation would effect the transaction involved in the change in beneficial ownership, and
- the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

The Safeguarding Rule notes that crypto assets are typically not subject to the same operational controls as traditional securities, making it difficult for custodians to demonstrate possession or control of crypto assets.[30] The Safeguarding Rule notes that the updated definition of possession or control will allow custodians to demonstrate possession or control by generating and maintaining private keys for advisory client wallets in a manner that will not allow RIAs to effect a change of beneficial ownership without the custodian's involvement.

The Safeguarding Rule would also require an RIA to obtain the following reasonable assurances in writing from the qualified custodian, and at all times to reasonably believe that the qualified custodian will:

- exercise due care and safeguard client assets;
- indemnify the client and insure client assets against risk of loss;[31]
- not have any sub-custodial, depository, or other arrangements to excuse the qualified custodian's obligations to the client;
- segregate the client assets from its proprietary assets; and

[26] The Proposing Release notes that it is likely that a qualified custodian can hold certain physical assets, such as gold bullion, and it would therefore be difficult for an RIA to make the determination required to self-custody. Proposing Release at 139.

[27] Proposed Rule 223-1(b)(2)(i) - (v).

[28] Proposing Release at 135.

[29] Proposing Release at 265. "Our understanding is that one OCC-regulated national bank, four OCC-regulated trusts, approximately 20 state-chartered trust companies, and other state-chartered, limited purpose banking entities, and at least one FCM currently offer custodial services for crypto assets."

[30] As the Staff notes, an advisory client and a qualified custodian might simultaneously hold copies of the advisory client's private key material to access the associated wallet with the client's crypto assets, and thus both have authority to change beneficial ownership of those assets. Proposing Release at 66.

[31] In the context of crypto assets, obtaining suitable insurance may be a significant challenge for custodians, and the resulting costs may be pushed on to RIAs and their clients, resulting in higher transaction costs for crypto assets generally.

- not subject client assets to any unauthorized liens in favor of the qualified custodian, its related persons or creditors.

The costs imposed by these assurances proposed by the Safeguarding Rule are, we believe, significant, and requirements such as indemnities for the custody of certain crypto markets may be well in advance of the still-nascent crypto insurance market.[32] These requirements are, therefore, likely to be significant changes that may tax the ability of custodians to comply — and by extension, make compliance more difficult for many RIAs. However, significant though these changes are, the Safeguarding Rule also displays continuity with the objectives and principles of the Custody Rule — and it is that continuity that we briefly examine next.

THE OBJECTIVES OF THE CUSTODY RULE AND THE SAFEGUARDING RULE

The Custody Rule originally arose in 1962, in a world which predated not only crypto, but even securities held in book-entry form. As originally adopted, the Custody Rule was intended to safeguard RIA client assets against "any unlawful activities or financial reverses, including insolvency, of the adviser."[33] The Rule originally required client assets to be segregated and held in a place where they would "be reasonably free from risk of destruction or other loss."[34] Advisers were required to disclose the manner and the location in which client assets were held in monthly client statements,[35] and the adviser was required to arrange for an independent public accountant to examine the securities at least once annually, and without prior announcement of such examination to the adviser.[36]

Even in this rudimentary original form, however, the Rule enshrined three principles which continue to be foundational to the Rule as it exists today, as well as to the Safeguarding Rule, as proposed. We summarize these as:

- Security — i.e., the assets must be custodied in a secure manner and location;
- Disclosure — i.e., clients must be informed of the manner and location in which their assets are custodied, and must receive periodic statements for their custodied assets; and
- Independent verification — i.e., an independent and duly qualified third party must verify the assets held periodically, and without prior notice to the adviser.

These principles have survived subsequent amendments to the Custody Rule, notably in 2003 (when the qualified custodian requirement was added to the Rule)[37] and in 2009 (which added certain new safeguards in the wake of the Madoff scandal).[38] These three principles undergirding the Custody Rule are, we believe, important in understanding the Rule's objectives — and in understanding how the Rule should be extended into new territory. The SEC appears to adopt a similar approach, noting the continuity between the Custody Rule and the Safeguarding Rule, and that "the proposal maintains the core purpose of protecting client assets from loss, misuse, theft, or misappropriation by, and the insolvency or financial reverses of, the adviser and maintains the Commission's ability to pursue advisers for failing to properly safeguard client assets under the Act's antifraud provisions."[39] The Safeguarding Rule maintains all three of the principle elements of the Custody Rule — secure custody, disclosure to clients, and independent verification — while attempting to modernize the Custody Rule and expand it to cover new types of assets and new types of custodial practices.

In order to more fully understand how the Safeguarding Rule should apply to a wholly new type of asset, with its own distinctive features, it may be helpful to first describe some of the problems RIAs holding crypto assets currently face in seeking to comply with

[32] John Hintze, *4 Hurdles Facing the Cryptocurrency Insurance Market*, (Feb. 24, 2021), *at* https://riskandinsurance.com/4-hurdles-facing-the-cryptocurrency-insurance-market/. The Staff notes that it has "observed that the contractual limitations on custodial liability vary widely in the marketplace, in some instances reducing a qualified custodian's liability to such an extent as to not provide an appropriate level of investor protection." (Proposing Release at 286) However, there is no detailed discussion of the reasons for such variance, or whether adequate insurance arrangements exist across the range of assets.

[33] *Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940*, Adv. Act Rel. No. 123 (1962).

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Custody of Funds or Securities of Clients by Investment Advisers*, Adv. Act Rel. No. 2176 (2003).

[38] *Custody of Funds or Securities of Clients by Investment Advisers*, Adv. Act Rel. No. 2968 (2009).

[39] Proposing Release at 19.

the Custody Rule, and how the Safeguarding Rule addresses some, but not all of them.

CRYPTO ADVISERS' COMPLIANCE WITH THE CUSTODY RULE AND THE SAFEGUARDING RULE'S PROPOSED REFORMS

It is established law that RIAs must familiarize themselves with the requirements of the Custody Rule and that a failure to do so is no defense.[40] However, even the most well-informed, well-advised, compliance-minded RIA may struggle to bring its crypto asset advisory business into compliance with the Custody Rule. The compliance hurdles are many. They range from determining the nature of the crypto assets custodied for the purposes of the federal securities laws, to finding a suitable qualified custodian, to establishing possession or control; to determining whether custody of the crypto assets can be maintained without depriving asset holders of valuable economic and governance rights. These problems are considered further below.

Categorizing Crypto Assets

Most fundamentally, RIAs have routinely faced the question of which crypto assets are securities,[41] and should therefore be subject to the Custody Rule. Even if some crypto assets are not securities, then the RIA must determine whether the non-security crypto assets are "funds" under the Rule.[42] Only then can an RIA be sure whether the Custody Rule extends to the crypto assets in its client's portfolio. Compliance-minded RIAs have dealt with the ambiguity of the characterization of the crypto assets in two ways — while some have made good faith attempts to determine whether the crypto assets that they hold are securities or funds, other advisers have made the prudential decision to treat their crypto assets as securities for the purpose of the Rule, in the absence of any specific regulatory or judicial decision to the contrary.

The Safeguarding Rule, as we have discussed earlier, proposes to solve this question by simply subjecting all client assets to the Rule's custodial requirements. While clarity through a rulemaking is welcome, this Proposed Rule may raise some questions as to the SEC's jurisdiction over RIA activities involving assets that are non-securities, as well as likely draw criticism for overreach into areas of digital property (e.g., non-fungible tokens ("NFTs")) that create a new set of custody challenges. The Rule also seemingly proposes to treat crypto assets alike, although crypto assets span a range of features and functions — some of which (such as the use of a private blockchain) may bear directly on the manner of custody of the asset.

Although it would require RIAs to custody all assets with a qualified custodian regardless of security status, the Safeguarding Rule then proposes a narrow exception to allow RIAs to self-custody privately offered securities and physical assets. The effect of this narrow exception is to undo the Rule's clear requirement of a qualified custodian for all assets, regardless of security status. Now, by proposing an exception which allows self-custody only for privately offered securities and physical assets, the Rule would effectively force RIAs to spend valuable resources determining whether a crypto asset constitutes a privately offered security and is therefore eligible to be self-custodied. The security status determination, which the Rule proposes to dispense with for crypto assets generally, is brought back through this proposed exception.

It is unclear why the exception for self-custody was not framed to permit RIAs to self-custody any asset (and not just privately offered securities and physical assets), for which no qualified custodian could reasonably be found. The Rule also unhelpfully states that crypto assets issued on public, permissionless blockchains would not constitute privately offered securities, and RIAs would be required to maintain such crypto assets with a qualified custodian. This observation is overbroad — whether a security is privately offered has to do with the manner in which the security is offered, and who it is offered to, rather than with the character of the underlying blockchain.

Identifying a Qualified Custodian for Crypto Assets

Under the Custody Rule, once an RIA has decided that its crypto assets are covered by the Custody Rule, it must then begin the hard task of achieving compliance.

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[40] *Ascension Asset Mgmt., LLC*, Initial Decision Rel. No. 1400 (2020).

[41] SEC staff have spoken to this issue, for example through the FinHub staff's *Framework for Investment Contract Analysis of Digital Assets* (Apr. 3, 2019). The SEC has also brought a series of successful enforcement actions against a number of crypto asset issuers, most recently against the issuers of LBRY (*SEC v. LBRY, Inc.*, (D.N.H., Nov. 7, 2022)). Nevertheless, a number of industry participants have consistently complained that there is insufficient guidance regarding the security status of crypto assets.

[42] Notably, the Safeguarding Rule takes the novel position never before articulated by the Commission or its staff that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule." Proposing Release at 18.

RIAs must seek out qualified custodians who are willing to custody their crypto assets — and this is no easy task. Of the four categories of qualified custodians specified in the Rule (i.e., banks, broker-dealers, FCMs, and foreign custodians),[43] very few are qualified to custody crypto assets, and even these few serve a relatively small number of crypto assets.[44] This scarcity of qualified custodians for crypto assets has been a feature of the U.S. market for crypto assets for some years now[45] and despite the Commission's optimism,[46] progress has been slow.

The SEC has provided no guidance on how traditional broker-dealers can take custody of crypto assets.[47] We note, however, that while the SEC has provided little guidance on crypto-custody generally, staff in the SEC's Office of the Chief Accountant have provided guidance through Staff Accounting Bulletin No. 121 regarding the accounting treatment of crypto assets held in custody for clients. SAB No. 121 was issued in April 2022 and provides the SEC staff's view that it would be appropriate for a platform that has an obligation to safeguard crypto assets held for platform users to record a liability and corresponding asset on its balance sheet at the fair value of the crypto assets.[48] Due to increasing balance sheet risk and institutional capital concerns, the outcome of this guidance may be to disincentivize new entrants to offer crypto-custody services.

Turning, once again, to broker-dealers, the SEC staff has described certain services a traditional broker-dealer can provide with respect to crypto asset securities (such as trade-matching), without taking custody or exercising control over crypto asset securities.[49] The only broker-dealers who are expressly permitted to custody crypto asset securities are "special purpose broker-dealers" — a category created by the SEC in December 2020.[50] Special purpose broker-dealers are permitted to self-custody crypto asset securities,[51] but they cannot deal in traditional (i.e., non-crypto) securities[52] and they cannot take custody of crypto assets that are not securities.[53] These restrictions upon the special-purpose broker's business are unworkable to many crypto intermediaries,

[43] Rule 206(4)-2(d)(6).

[44] We should clarify here that crypto custodial services exist on a spectrum. Some custodians, such as for example, some crypto asset exchanges, provide a "full" custodial service, from insurance arrangements, security measures, and the ability to redress complaints and customers. In other cases, asset holders may seek to store assets in so-called "unhosted wallets" — essentially, arrangements where the asset holder is self-custodying crypto assets through a hardware wallet, or a mobile application.

[45] Proposing Release at 265. "Our understanding is that one OCC-regulated national bank, four OCC-regulated trusts, approximately 20 state-chartered trust companies, and other state-chartered, limited purpose banking entities, and at least one FCM currently offer custodial services for crypto assets."

[46] *Id*. "The market for crypto asset custodial services continues to develop."

[47] The Proposing Release notes that "not all registered broker-dealers and registered FCMs meet the definition of qualified custodian under the custody rule or the proposed safeguarding rule. Notably, only those broker-dealers or FCMs holding client assets in customer accounts meet this definition. This would include the broker-dealers subject to the customer protection rule (Exchange Act Rule 15c3-3) and FCMs holding futures customers funds subject to 17 CFR 1.20." Proposing Release at 43, n. 89.

[48] SEC Staff Accounting Bulleting 121, April 11, 2022. Note also that while a recent decision of the U.S. Bankruptcy Court for the Southern District of New York found that certain crypto-related assets deposited by customers of a crypto lending program into so-called "Earn Accounts" belonged to the bankruptcy estate of the lender, the Earn Accounts were treated as being distinct from other accounts (including custodial accounts) held with the lender. *In re Celsius Network LLC*, Case No. 22-10964 (MG), 2023 WL 34106 at *4 (Bankr. S.D.N.Y., Jan. 4, 2023).

[49] SEC Division of Trading and Markets and FINRA Office of General Counsel, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, (July 8, 2019) noting that "Generally speaking, non-custodial activities involving digital asset securities do not raise the same level of concern among the Staffs, provided that the relevant securities laws, SRO rules, and other legal and regulatory requirements are followed."

[50] *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Rel. No. 34-90788 (2020).

[51] *Id*. at 7.

[52] *Id*. at 7. "One step that a broker-dealer could take to shield traditional securities customers, counterparties, and market participants from the risks and consequences of digital asset security fraud, theft, or loss would be to limit its business exclusively to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for digital asset."

[53] *Id*. at 7. "In addition, by limiting its activities exclusively to digital asset securities, the broker-dealer would shield its customers from the risks that could arise if the firm engaged in activities involving non-security digital assets, which are not expressly governed by the Customer Protection Rule."

and perhaps for that reason, even two years after the SEC's creation of the special purpose broker-dealer category, there are no special purpose brokers as yet in existence. In other words, there are currently no broker-dealers who can currently act as qualified custodians for crypto assets, within the meaning of the Advisers Act.

The outlook for bank custodians of crypto is somewhat better. Unlike the SEC, the Office of the Comptroller of Currency ("OCC") has affirmatively stated that banks may take custody of crypto assets.[54] The OCC granted national trust bank charters to several entities that are seeking to custody crypto assets.[55] There are also a far larger number of crypto asset custodians organized in the form of trusts under the laws of the various states, such as trusts chartered under New York, South Dakota, or Wyoming law. The staff of the SEC's Division of Investment Management and of the SEC's Strategic Hub for Financial Innovation had sought submissions on whether such trusts could be considered to be qualified custodians under the Advisers Act,[56] but neither the SEC nor its staff have as yet taken any definitive position on whether a state-chartered trust is a bank for the purposes of the Advisers Act.[57]

The Safeguarding Rule does not expressly discuss the question of whether a state -chartered trust is a bank and therefore a qualified custodian, but it appears to implicitly acknowledge that state-chartered trusts can custody crypto if they meet the conditions required for qualified custodians. This may be a positive development as state-chartered trusts have typically pioneered custody for a range of crypto assets.

There are two other categories of other potential qualified custodians under the Advisers Act — viz., FCMs, and foreign custodians. FCMs are qualified custodians under the Advisers Act "only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon."[58] Most crypto assets do not qualify as securities futures or as securities incidental to commodity derivative transactions, and so FCMs cannot serve as qualified custodians with respect to the vast majority of crypto assets.

While foreign custodians for crypto assets do exist, the lack of regulatory guidance on the circumstances under which such custodians may be used, makes RIAs reluctant to seek out foreign custodians for their crypto assets.[59] The SEC notes that recent events in crypto markets have also highlighted the need for enhanced safeguards of client assets held outside the U.S.[60] Accordingly, the Safeguarding Rule significantly strengthens the requirements for foreign financial institutions to be qualified custodians, requiring these entities to:

- be regulated as a banking institution, trust company, or other financial institution that customarily holds financial assets, by a foreign government, a foreign government agency,or a foreign financial regulator;
- be required to comply with anti-money laundering provisions similar to those under the Bank Secrecy Act;

[54] *Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers*, OCC Interpretive Letter 1170 (July 22, 2020).

[55] *OCC Conditional Approval of Application by Anchorage Trust Company, Sioux Falls, South Dakota to Convert to a National Trust Bank* (Jan. 13, 2021); *OCC Conditional Approval of Application to Charter Paxos National Trust* (Apr. 23, 2021); *OCC Conditional Approval of Application by Protego Trust Company, Seattle, Washington, to Convert to a National Trust Bank* (Feb. 4, 2021).

[56] Division of Investment Management Staff in Consultation with FinHub Staff, *Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"* (Nov. 9, 2020).

[57] It should be noted however that the standard for whether a state-chartered trust is a qualified custodian under the Advisers Act is an objective test borne in the regulations and does not rely upon an affirmative SEC determination. *See* 202(a)(2) of the Advisers Act, which includes, among other things, that a trust company, "whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this subchapter" is a bank and therefore a qualified custodian under the Custody Rule.

[58] Rule 206(4)-2(d)(6)(iii).

[59] The Custody Rule requires only that such foreign financial institutions keep the advisory clients' assets in client accounts segregated from its proprietary assets, but does not specify any further requirements for foreign financial institutions to be qualified custodians. Rule 206(4)-2(d)(6)(iv).

[60] Proposing Release at 47.

- hold customer financial assets in an account designed to protect such assets from the foreign financial institution's creditors in the event of the institution's insolvency;

- have the financial strength required to provide due care for client assets;

- be required by law to implement practices, procedures, and internal controls to ensure the exercise of due care for the safekeeping of client assets; and

- not be operated to evade the provisions of the Safeguarding Rule.[61]

Put simply, under the Custody Rule, an RIA will find it difficult to be completely sure which entities constitute a qualified custodian under the Advisers Act. While the Safeguarding Rule's proposals acknowledge that state-chartered trusts may be qualified custodians for crypto assets and create a path for more foreign financial institutions to achieve qualified custodian status, we do not as yet know whether the Safeguarding Rule will be adopted as proposed, and whether the Rule will have the effect of growing the number of qualified custodians available for crypto assets.

Transitory Custody and Crypto Asset Operations

Under the Custody Rule, even if an RIA did find the rare entity which would likely be a qualified custodian, this leaves other significant custodial problems unanswered. Prominent among these is the often transitory nature of custody for many types of crypto assets, which may require temporarily moving crypto assets out of a custodian's control in order to earn income using those assets.

For example, many crypto assets are capable of being "staked" or require "staking," i.e., committing the crypto assets in order to validate transactions on their underlying protocol.[62] Stakers temporarily deposit tokens, and an algorithmic lottery of sorts determines which stakers get to perform some action, e.g., verify transactions, and win rewards for doing so.[63] In the staking process, the holder of the assets may be temporarily deprived of their use until the staking process is completed. For certain protocols, if misconduct occurs at the time of transaction validation, the staker may lose a portion of his/her stake (this is often called "slashing").

Other crypto market opportunities may operate on similar bases — such as "yield farming," in which users' crypto assets are "locked-up" in protocols in order to earn a yield.[64] By contrast to traditional staking, in yield farming the crypto assets are being used in the protocol for purposes other than securing the provenance of transactions. Notably, both these strategies may involve temporarily removing a crypto asset from a custodian's control in order to earn income.[65]

RIAs must consider whether the crypto assets they hold could be used for governance decisions or produce such income streams from activities such as staking or yield farming, their obligation to execute the investment strategy agreed upon in a client investment policy statement or investment management agreement, and all attendant risks. Under federal law, an investment adviser is a fiduciary,[66] and as part of that fiduciary duty, an adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own.[67] The SEC notes that an investment adviser must consider "an investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit — to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client."[68] Faced with this duty of care which forms part of its fiduciary

[61] Proposed Rule 223(d)(10)(iv).

[62] This is often done to participate in the security of the underlying protocol, and in so doing, accrue more fungible tokens.

[63] Loïc Lesavre, Priam Varin, Dylan Yaga, NISTIR 8301, *Token Design and Management Overview* at 16 (2021).

[64] Brady Dale, What is Yield Farming? The Rocket Fuel of DeFi, Explained, (Mar. 9, 2022) *at* https://www.coindesk.com/learn/what-is-yield-farming-the-rocket-fuel-of-defi-explained/. The removal from custodial control is usually for a very short period of time, unless there is a longer contractual lock-up period.

[65] Importantly, a temporary loss of control by the custodian does not always coincide with movement of the crypto asset out of the wallet. Instead, it may simply mean that the crypto asset cannot be used while the staking is underway.

[66] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers,* Adv. Act Rel. No. 5248 (2018) at 17.

[67] *Id*. at 8.

[68] *Id*. at 17.

duty, RIAs that invest in crypto assets may not be able to cite the difficulties of custody as sufficient reason to absolutely deny their investors participation in governance and/or access to strategies such as staking or yield farming, particularly when a client's specific circumstances indicate that these strategies may be in its best interest.[69]

The Safeguarding Rule does not appear to have considered the question of staking, of crypto assets with yield features, or voting, or other governance rights. Instead, it appears to take the view that RIAs cannot treat crypto assets issued on public, permissionless blockchains as privately offered securities.[70] This view pre-empts any attempt by RIAs to self-custody many crypto assets (such as, for example, crypto assets issued on the Ethereum blockchain), and leaves RIAs with the same dilemma between securing yields for customers and risking the loss of assets. Nor can RIAs simply solve the question by delegating staking duties to their qualified custodians — the significant indemnities and other safeguards against the risk of loss of assets that the Rule proposes to require from qualified custodians will make many (and perhaps most) qualified custodians very reluctant to assume the power to stake or gather yields on behalf of clients.

We began by identifying four distinctive challenges posed by crypto assets, namely:

- ambiguities regarding which crypto assets are securities;
- the lack of regulatory clarity regarding custodial standards;
- the near impossibility of demonstrating possession and control over a crypto-asset; and
- the difficulty of custodying assets with staking, yield, voting, or other participative features.

The Safeguarding Rule attempts to address some of these challenges. By proposing to require a qualified custodian for all client assets, it attempts to relieve RIAs of the need to determine which crypto assets are securities or funds. The Rule acknowledges the difficulty of proving possession and control, and instead proposes contractual and other proxies for such control. However, the Safeguarding Rule leaves entirely unaddressed the considerable difficulties associated with custodying assets with staking, yield, voting, or other participative features — assets which are today proliferating across the developing Web3 universe.

Fortunately, the absence of established custodial solutions has not completely frustrated efforts by RIAs to arrange custody for their clients' assets. Compliance-minded RIAs have sought ways to invest in, and deploy crypto assets for their clients, while maintaining robust custodial practices. We now turn to what some of these custodial practices look like, and how they may provide some basis for future regulations.

CRYPTO CUSTODIAL PRACTICES TODAY AND THE PATH FORWARD

In custodial terms, we might have traveled back to 1962. In that year, when the SEC first formulated and adopted the Custody Rule, it did so based on a collection of best practices that had coalesced among securities custodians.[71] Today, in the absence of clear regulatory guidance around the custody of crypto assets, many custodial practices have become so common as to be viewed as standard, or perhaps even required. For example, most entities that custody crypto assets will use some or all of the following protective measures:

- operational controls for multi-step transfer instructions, and multi-person or multi-system approval mechanisms (e.g., the requirement that two or more unaffiliated persons authorize any transfer of crypto assets);
- relatedly, strong authentication requirements to access private key materials (whether complete or shards), that require authorization from multiple other key holders, or multi-party computation (a method for joint computation of a crypto asset transaction while each component input is maintained private from one another);
- the use of hardware security modules, which are tamper-resistant devices aimed at securing cryptographic keys;

[69] Contractual language in the investment management agreement between client and adviser may be enough to absolve the investment adviser of the duty to perform governance or staking functions. However, that is untested in court.

[70] Proposing Release at 65.

[71] Robert E. Plaze (Proskauer), *Regulation of Custodial Practices Under the Investment Advisers Act of 1940 Rule 206(4)-2* (June 2022) at 1.

- "air-gapping," i.e., ensuring that the device that holds private key material is isolated from any connected network;[72]

- insurance arrangements against breaches of the custodian's cybersecurity (insurance arrangements for specific crypto assets are evolving but are still nascent);

- System and Organization Controls ("SOC") reports around the custodian's security, availability, processing integrity, and privacy controls, as well as annual audits of the crypto assets under custody; and

- transparency to investors (through instant access through an API or website) regarding crypto assets held by the custodial entity.

Notably, most of these protective measures can still be grouped around the three basic principles that the Custody Rule put in place, and that the Safeguarding Rule continues — namely security, disclosure, and independent verification. Measures such as multi-signature mechanisms, multi-party computation, hardware security modules, and air-gapping all seek to satisfy the requirement that assets be custodied in a secure manner and location.[73] Audit arrangements seek to satisfy the independent verification requirement, while insurance arrangements not only reinforce the security of the assets custodied, but also provide a measure of independent verification through the insurer's role in verifying and assessing custodial mechanisms. Finally, providing clients with instant or real-time access[74] to information about the assets custodied enhances the levels of disclosure typically provided by advisers.

Perhaps most importantly for this discussion, in the absence of qualified custodian options, these protective custodial mechanisms can be deployed by any entity that has the economic means, the technological capacity, and the sophisticated clients to do so. The entity-agnostic nature of these mechanisms prompts us to ask whether any purpose is served by requiring the use of a qualified custodian for crypto assets. There seems to be no reason why an RIA that uses these or other equivalent protective mechanisms should not be permitted to custody its clients' crypto assets. An RIA using an effective combination of internal controls and software solutions (including solutions and controls provided by third parties on a contractual basis) would, in our view, provide as efficient and secure a custodial solution as a qualified custodian under the Advisers Act.

We would therefore urge the SEC to consider allowing RIAs to self-custody crypto assets. We put forward four reasons why the SEC should not only permit, but perhaps even encourage self-custody of crypto assets by RIAs.

First, self-custody frees RIAs from having to find qualified custodians at a time when very few crypto asset custodians clearly meet the Advisers Act's definition of a qualified custodian. While the Safeguarding Rule attempts to advance the discussion on custody, the Rule is at least many months away from adoption, and it is unclear whether qualified custodians will emerge with the ability and the willingness to serve the full range of crypto assets that are currently traded.

Second, self-custody avoids an RIA having to repeatedly approach the custodian to temporarily lock and unlock crypto assets that the RIA plans to stake or otherwise deploy. Self-custody makes the RIAs' use of crypto assets for staking feasible on a day-to-day basis.

Third, self-custody avoids the concentration of crypto assets in the hands of a few custodians, so that the failure of any one custodian or a cybersecurity breach at any one custodian is less likely to result in systemic consequences for the crypto asset ecosystem as a whole.

Fourth, self-custody may be necessary given the very wide breadth of assets that constitute crypto assets. Some of these assets may be on private blockchains, some on public blockchains, some may be so-called "cryptocurrencies" (i.e., intended as a medium of exchange), others may be so-called governance tokens, and still others may be NFTs. If self-custody is ruled out as an option for some crypto assets (or some sub-set thereof), the RIA is implicitly barred from investing on behalf of clients in those crypto assets, irrespective of their suitability for the RIA's clients.

Self-custody is not an alien concept under the Advisers' Act. However, the Act typically permits self-custody only when it is accompanied by robust

[72] For a discussion of cryptographic key management methods, *see* Nassim Eddequiouaq and Riyaz Faizullabhoy, Wallet Security: The 'Non-custodial' Fallacy (Oct. 14, 2022) *at* https://a16zcrypto.com/wallet-security-non-custodial-fallacy/.

[73] Arguably, in the case of crypto assets, security of manner and security of location may often overlap, so that a custodial location is often only as secure as the manner in which it is secured.

[74] Note that such access does not amount to giving clients the right to transact with the assets held in custody.

independent verification and periodic disclosure of the custodied assets. Developing on this principle, we too would suggest that an RIA that self-custodies its clients' crypto assets should be required to arrange for a surprise annual audit by an independent public accountant, an annual audit of the cybersecurity and resilience of its systems, and ongoing disclosures to all clients of assets self-custodied by the RIA on their behalf. While we would welcome rulemaking by the SEC towards a self-custody solution for crypto assets, we think the SEC staff could instead simply clarify the terms and conditions for RIA self-custody of crypto assets as part of its final adoption of the Safeguarding Rule. Below, we consider what some of these terms and conditions underpinning a robust RIA self-custody regime might look like.

THE CONDITIONS FOR INVESTMENT ADVISERS' SELF-CUSTODY OF CRYPTO ASSETS

While we clearly favor self-custody as a solution for RIAs who custody crypto assets, we believe that there are certain principles that should govern such self-custody, consistent with the three objectives of the Custody Rule and the Safeguarding Rule, viz., security, disclosure, and independent verification. Most fundamentally, as a threshold requirement, and consistent with the Safeguarding Rule, we would require RIAs to first assess whether they are capable of self-custodying crypto assets, and to determine that no qualified custodian is capable of providing the full scope of services discussed above to the particular crypto asset.[75]

In another recently proposed rule, the SEC proposes to require RIAs to exercise diligence in outsourcing any functions that are necessary or material to their advisory functions.[76] The SEC proposes that this assessment would not extend to the outsourcing of custodial functions because, in the SEC's view, custody is not necessary for the investment advisory function.[77] Although the proposed rule does not discuss crypto assets, one could strongly argue, as we have done earlier in this essay, that arranging for custody and negotiating the terms of that custody, form a critical aspect of providing investment advice with respect to crypto assets. Adapting the terms of the SEC's proposed rule on outsourcing by RIAs,[78] we would ask that the SEC require RIAs that propose to self-custody crypto assets to first determine:

- the nature and scope of the crypto assets that the RIA proposes to self-custody;
- how the RIA will mitigate and manage the potential risks to clients from such self-custody;
- whether the RIA has the competence, capacity, and resources necessary to self-custody effectively;
- whether the RIA has any subcontracting arrangements material to its self-custody (such as with technology providers), and how the RIA will mitigate and manage potential risks from such arrangements; and
- whether the RIA has in place a process for orderly termination of self-custody, if required.

Once an RIA has determined that it is, in fact, capable of self-custodying crypto assets, we would propose that its self-custody be governed by a series of technologically-neutral conditions.[79] In particular, we would suggest that only an RIA that meets the following conditions should be permitted to self-custody crypto assets:

- regardless of the character of the crypto asset, the RIA should be able to demonstrate, to the satisfaction of the SEC examination staff, the existence and the RIA's possession and control over the crypto asset (consistent with the definition of "possession and control" under the Safeguarding Rule);
- the RIA should have in place arrangements for an annual surprise audit of its custodial and broader cybersecurity systems;
- the RIA should have in place arrangements for an annual surprise audit of its custodial holdings;

[75] Proposed Rule 223-1(b)(2).

[76] *Outsourcing by Investment Advisers*, Adv. Act Rel No. 6176 (2022).

[77] *Id*. at 21. Appearing to acknowledge that this view is debatable, the SEC has expressly sought comment on whether custody should be covered by the proposed rule as being a part of the advisory function. *Id*. at 37.

[78] *Id*. at 40-41.

[79] A similar technology-neutral approach to custody has been adopted by the SEC in its Statement on *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Rel. No. 34-90788 (2020).

- the RIA should provide its clients with real-time access to its custodial holdings, and should provide its clients with statements of their custodial holdings, on at least a quarterly basis; and

- the RIA should have in place written policies and procedures to ensure:

  — periodic checks against vendors and subcontractors and

  — periodic security and resiliency checks against all hardware and software used.

We suggest the SEC adopt these or similar measures. We put forward these measures not as novel insights or suggestions but precisely because of their resemblance to many existing measures under the Custody Rule and the proposed Safeguarding Rule. Crypto assets are new, but the principles underlying the custody of client assets by investment advisers are established and well-tested. We would hope that measures such as these would provide RIAs with the flexibility to optimize their use of crypto assets, while simultaneously providing for secure and transparent custody. The custody of crypto assets is, we believe, far too important to be left to traditional custodians alone. ■

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