February 21, 2023

U.S. Securities and Exchange Commission Proposes Amendments to and Redesignation of the Current Custody Rule under the Investment Advisers Act of 1940 – Impacts on the Crypto Asset Market

On February 15, 2023, the U.S. Securities and Exchange Commission (the "**SEC**") announced its proposal (the "**Proposal**") of significant changes to, and a redesignation of, Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), known as the custody rule (the "**Custody Rule**").[1] Under the Proposal, investment advisers[2] registered with the SEC, as well as those required to be registered even if not (collectively, "**Advisers**"), will face dramatically expanded requirements that will impact the Advisers themselves, their clients, and those providing custody or safeguarding services to Advisers. We also anticipate a significant indirect impact on both U.S. and overseas crypto asset marketplace providers that hold customer assets pending trading orders. Also within the Proposal are changes to the recordkeeping rules under the Advisers Act and to Form ADV for the registration of Advisers under the Advisers Act. This memorandum focuses on the impact of the Proposal on the crypto asset market.

If adopted in its current form, the Proposal would dramatically expand the overall scope of client assets subject to the Custody Rule, create practical challenges as to which entities providing safeguarding services are permitted to be used to meet Advisers' obligations under the Custody Rule (referred to as "**Qualified Custodians**"), and mandate new contractual terms between Advisers and entities acting as Qualified Custodians, among other things.

Following recent enforcement actions against a number of Advisers for violations of the Custody Rule, the Proposal appears to be a continuation of the SEC's focus on the potential issues arising from a perceived lax approach to custody generally by Advisers. Meanwhile, by emphasizing the Proposal's coverage of crypto assets, the SEC also appears to be continuing to narrow the ability of financial intermediaries viably to participate in crypto asset related activities.

[1] The redesignated Custody Rule will be found at Rule 223-1 under the Advisers Act.

[2] As defined in the Advisers Act, an "investment adviser" includes any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. The definition excludes entities subject to a separate regulatory regime in certain circumstances, like banks and broker-dealers, as well as certain publishers, rating agencies and others.

The use by Advisers of banks and other entities that are directly or indirectly owned by publicly traded companies as Qualified Custodians with respect to crypto assets of clients was dealt an initial blow by Staff Accounting Bulletin 121 ("**SAB 121**"), which was issued by the staff of the SEC's Office of the Chief Accountant in March 2022. This initiative set new accounting standards for companies providing custodial services with respect to crypto assets for customers. Ostensibly due to the unique risks of custodying crypto assets, SAB 121 requires that, among other things, companies subject to the bulletin record a liability (and corresponding "indemnification asset") on their balance sheets at fair value for all crypto assets held for third parties. This change caused any entities subject to the bulletin and acting as a custodian to have to record additional theoretical assets equal to the amount of crypto they held for clients, inflating their balance sheets and thereby discouraging this activity.[3]

Background

The Custody Rule is used by the SEC to regulate the custodial practices of Advisers. Although previously amended a number of times, historically, the Custody Rule has focused on safeguarding client funds and securities held by Advisers with the goal of preventing these assets from being lost, misused, stolen, or misappropriated, including in an insolvency of the Adviser. As initially adopted in 1962, the Custody Rule applied to segregating client funds held at banks and safeguarding physical securities by Advisers in a "reasonably safe" place. With changes in market practice and technology (most notably, the migration of many securities to being held indirectly through the facilities of The Depository Trust Company ("**DTC**")), the Custody Rule was amended in 2003 to apply to any Adviser holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.

In addition to technological changes, the low interest rate environment in the U.S. over the last several years encouraged Advisers and their clients to look to a wide variety of non-traditional assets for yield, including art, commodities, collectables, and crypto assets, which generally fell outside of the Custody Rule to the extent not considered "securities" or "funds".[4] The increasing popularity of privately issued securities in "uncertificated" form (historically generally excluded from the Custody Rule), as well as the recent high-profile bankruptcies in the crypto asset sector have all lead the SEC to revisit and expand the scope of the Custody Rule.

[3] Ongoing valuation and reporting obligations were also placed on entities providing custody services, further increasing the cost of providing these services.

[4] There is an active debate as to whether most fungible crypto assets constitute securities under federal securities law. The SEC Chair, Gary Gensler, has repeatedly taken this position, including in testimony provide before the Senate Banking Committee. However, another SEC Commissioner, Hester Peirce, commenting on the Proposal stated, "I disagree with the main premise that most crypto assets are securities and the sub-premise that crypto assets sold in a securities offering are necessarily themselves securities." *See* SEC Commissioner Hester M. Peirce, "Statement on Safeguarding Advisory Client Assets Proposal", February 15, 2023. *See also*, L. Cohen *et al.*, "The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities" (November 10, 2022), available at https://ssrn.com/abstract=4282385. Nevertheless, it is also possible that certain crypto assets such as bitcoin and ether could be considered "client funds" and currently subject to the Custody Rule.

Expanded Asset Coverage

As an initial matter, the Proposal would expand coverage of the Custody Rule beyond client funds and securities to include *any* client assets, which are defined as "funds, securities, or other positions held in a client's account." This definition would include crypto assets (including both fungible crypto assets (sometimes referred to as "**tokens**") and non-fungible tokens ("**NFTs**")), financial contracts held for investment purposes, physical assets (such as artwork, real estate, and physical commodities) and others.

- Under the Proposal, crypto assets would be covered by the broad definition of "assets", regardless of whether the assets were properly characterized either as "funds" or "securities".

New Requirements for Qualified Custodians

The Proposal would largely retain the current definition of "qualified custodian" in the current version of the Custody Rule which requires the custodian to be a "bank", savings association or foreign financial institution.[5] However, in connection with the Proposal's focus on setting certain minimum protections for client assets, the revised Custody Rule would require that a qualifying bank or savings association hold the assets of an Adviser's client in an account that is designed to protect the assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association. This effectively requires that the funds (*i.e.*, "cash") deposited with a custodian be held on a non-interest earning basis. This is because the reason that financial institutions are able to pay interest on deposits is that the funds they hold are used by the institution to make loans to others, allowing the institution to earn a spread between the interest rate it charges to its borrowers and the interest rate it pays to its depositors.

This change would be a radical departure from current custody practice as to client funds (which are held in interest-bearing deposits, meaning that the funds held by the custodian are general assets of the bank or savings association and not fully isolated from the risk of an insolvency of the financial institution – subject, of course, to the availability of deposit insurance provided by the Federal Deposit Insurance Corporation (the "**FDIC**")). In the Proposal, the SEC makes clear that they are referring to a very obscure concept in U.S. banking law – that of "special deposits", stating:

> This debtor-creditor relationship typically does not create a special or fiduciary relationship. While applicable insolvency law and procedures vary depending on any particular bank or savings association's regulatory regime, we understand that assets held in accounts of the type proposed by the rule are more likely to be returned to clients upon the insolvency of the qualified custodian because they may pass outside of a bank's

[5] For these purposes, "bank" is defined in Section 202(a)(2) of the Advisers Act, a "savings association" refers to an entity defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation and a "foreign financial institution" includes any foreign financial institution that "customarily holds financial assets for its customers, *provided* that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets".

insolvency, may be recoverable if wrongly transferred or converted, and are not treated as general assets of the bank.[6]

The SEC seeks to justify this position by arguing that requiring U.S. financial institution custodians to hold client funds in non-interest-bearing accounts brings the requirements for these custodians "in line" with the protections required for broker-dealers, futures commission merchants ("**FCMs**"), and FFIs acting as qualified custodians. However, there are important differences between broker-dealers or FFIs holding securities for clients or FCMs holding commodity interests like swaps or other derivatives for clients. In all of those cases, the Adviser's client has bargained for the economic experience of owning the underlying asset (and whatever return that asset may provide). The required custody arrangement does not interfere with that economic experience. However, with "cash" (*i.e.*, client funds generally resulting from dispositions of other assets or interest or dividends collected on other assets and temporarily held pending redeployment) that is held with a U.S. financial institution, an Adviser's clients will likely be very surprised and concerned to learn that these amounts would very likely no longer earn interest under the revised Custody Rule.

- It will be interesting to see how this proposed new requirement plays out with the banking industry. We would expect that the banking sector in the U.S., especially the small number of large banks that provide the bulk of the custody services to the securities industry, will respond negatively as providing custodial services is generally a low margin business and the funds associated with client securities held by these banks likely provide an important part of the overall economics for these services.
- Likewise, investor clients may resent the SEC taking away their ability to earn interest on the custodied funds and many investors would be happy to accept the extremely small risk of lost funds in a bank insolvency in order to receive market interest on their idle funds, particularly in the current (relatively high) interest rate environment.
- If investor clients are unable to earn interest on cash balances held at banks, we would expect that they may choose to have idle cash swept into money market funds, which are securities, to earn interest.

In addition, as noted above, the term "qualified custodians" includes FFIs, a category that is currently broadly defined to include *any* foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its own proprietary assets. The Proposal would significantly narrow the definition of FFI to include only entities that, in addition to the foregoing, meet specified conditions and requirements (including being regulated by a foreign government agency and being required to comply with anti-money laundering laws similar to the U.S. Bank Secrecy Act).

[6] *See* Proposal at p. 45 (footnotes omitted). In a footnote, the SEC make this point clear ("We understand that a deposit in a bank is either general or special and that a deposit is a general deposit unless there is an agreement or understanding that it should be special." *Id.*)

- During the past month, the Board of Governors of the Federal Reserve System (the "**Board**") raised "safety and soundness concerns" with respect to crypto asset-related activities by banks and issued a policy statement discouraging banks from transacting with crypto assets. As a result, even if an Adviser is still permitted to custody crypto assets at a bank under the Proposal, it is unclear how many banks would be interested in providing such service in light of the Board's latest policy statement and the impact of SAB 121.

- It may take time to learn what standards the SEC expect to be met when an Adviser is determining whether a non-U.S. entity it seeks to use for the safeguarding of customer assets meets the conditions of being an FFI – for example, which foreign government agency in a given jurisdiction would be sufficient to act as a regulator, and which foreign anti-money laundering laws would be sufficiently similar to the Bank Secrecy Act in the U.S. It is also unclear how Advisers are to determine whether customer accounts at foreign entities providing safekeeping services are segregated in the context of foreign bankruptcy laws.

Defining "Custody"

Under both the current Custody Rule and the Proposal, Advisers are required, with limited exceptions, to maintain client funds and securities with Qualified Custodians. The Proposal specifies that by maintaining an Adviser's client's assets, a Qualified Custodian would need to have "possession or control" of the assets such that the custodian is required to participate in any change in beneficial ownership of those assets.

- The Proposal acknowledges that establishing exclusive control of a crypto asset could be challenging due to the unique characteristics of crypto assets—specifically, crypto assets may be transferrable by anyone with knowledge of the private key associated with the public address containing the asset(s). Given this, it is unclear how an Adviser would be able to satisfy the revised version of the Custody Rule included in the Proposal with respect to crypto assets.
- In addition, due to the "all hours" nature of crypto asset trading, it appears that a Qualified Custodian would be required to be available 24/7/365 to effectuate a change in beneficial ownership requested by an Adviser on behalf of a client.
- It is unclear under what circumstances, if any, the adoption of multi-party computation technology (known as "**MPC**" technology) by an Adviser and their Qualified Custodian would address the SEC's concerns and provide sufficient protection for client assets.

The Proposal explicitly provides that an Adviser's discretionary authority to give trading instructions in respect of client assets falls within the definition of "custody". At the same time, the Proposal also observes that, since crypto assets are often traded on platforms operated by entities that would not be considered Qualified Custodians, an Adviser that trades a customer's crypto assets on such a platform would violate the Custody Rule, if the Proposal were adopted in its current form.

- Reading these statements together, it appears that the SEC are rather unsubtly sending a message to Advisers they are unlikely to be able to advise their clients to hold crypto assets in circumstances that would involve custody by the Adviser without violating the rule.

Written Agreements

The Proposal would also require that an Adviser enter into a written agreement with, and obtain certain reasonable assurances from, Qualified Custodians to ensure that their clients receive certain minimum protections. In particular, Advisers will be required to enter into an agreement directly with each of their proposed Qualified Custodians[7] that requires, among other things: (i) the custodian to promptly, upon request, provide copies of the client's records relating to the assets it holds, (ii) provide statements, at least quarterly, to the client and Adviser, identifying the amount of each client asset in the account at the end of the period and setting out all transactions in the account during that period, including all investment advisory fees; (iii) at least annually obtain, and provide to the Adviser, a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that custodian during the year), and (iv) specifies the Adviser's agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits the Adviser and the client to reduce that authority.

- The requirement that Advisers enter into agreements with their custodians is new and potentially problematic. Custody is a low margin business and the few entities that would likely be considered "qualified custodians" may not be very enthused about the process of developing new forms, negotiating them with many different entities acting as investment Advisers and then putting into operation the various required provisions.
- As a result, we will likely see customer costs increase significantly as those custodians that are available ensure that the services are priced to take into account the significant additional work required by the Proposal.
- There will likely be practical difficulties identifying public accounting firms that are sufficiently familiar with crypto assets willing to undertake an engagement to prepare a written internal control report relating to custodial services involving crypto assets. This is a significant concern, especially with a short implementation period.

Reasonable Assurances

The Adviser must also obtain reasonable assurances in writing from each of its Qualified Custodians that the custodian will comply with the following requirements (and the Adviser is required to maintain an ongoing reasonable belief that the custodian is complying with these requirements): (i) the custodian will exercise due care in accordance with reasonable commercial

[7] Currently, most custody agreements are strictly between the relevant custodian and the asset owner/client.

standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss; (ii) the custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the custodian in the event of the custodian's own negligence, recklessness, or willful misconduct; (iii) the custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct; (iv) the custodian will clearly identify the client's assets as such, hold them in a custodial account, and segregate them from the custodian's proprietary assets and liabilities; and (v) the custodian will not subject client assets to any right, charge, security interest, lien, or claim in favor of the custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

- The details of all of these "assurances" will have to be negotiated on a bespoke basis between custodians and Advisers, resulting in additional time, cost, and potential delays.
- The insurance requirements are particularly concerning as we understand that the amount of insurance available to even the most respected custodians is very limited.

Independent Verification of Assets

The client assets an Adviser is custodying must be verified by "actual examination" at least once during each calendar year by an independent public accountant. The independent verification must be performed pursuant to a written agreement between the Adviser and the public accountant. The exam needs to take place at a time that is chosen by the accountant (without prior notice to the Adviser) and that occurs on an irregular basis from year to year. The written agreement with the accountant, the terms of which the Adviser must reasonably believe have been implemented, must require the accountant to (i) notify the SEC that it has conducted the required examination and describe the nature and extent of the examination; (ii) to the extent that any material discrepancies are found during the course of the examination, notify the SEC within one business day of the finding, and (iii) upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, promptly notify the SEC.[8]

Interestingly, Advisers would *not* be required to obtain an independent verification of client assets if the Adviser is deemed to have has custody of its client assets solely because the Adviser has discretionary authority with respect to those assets, although this exception applies only for client assets that are maintained with a Qualified Custodian in accordance with the revised Custody Rule and for accounts where the Adviser's discretionary authority is limited to instructing its

[8] The Proposal does propose to exclude client assets that are privately offered securities or physical assets, subject to certain conditions. However, this exception will be unlikely to apply to Advisers with discretion over clients' crypto assets. Note also that Advisers will *not* be required to obtain an independent verification of client assets maintained by a qualified custodian if the Adviser is deemed to have custody of the client assets solely as a consequence of the Adviser's authority to make withdrawals from client accounts to pay its advisory fee, opening a limited window for discretional withdrawals where an Adviser's fees are paid in crypto assets.

client's Qualified Custodian to transact in assets that settle exclusively on a delivery-versus-payment ("**DvP**") basis.

- While the general idea of an examination that verifies the existence of crypto assets held by a custodian would likely find broad support by market participants in the crypto asset sector, the practicalities of identifying public accounting firms that are sufficiently familiar with crypto assets and willing to undertake such an engagement raise significant concerns, especially with a short implementation period.
- Even where a public accounting firm has been identified, the costs of this service will invariably be passed back to the clients, without leaving room for more sophisticated clients to negotiate actual examinations that may be more tailored to their needs and at lower cost.
- Although the DvP exception would likely not assist in the context of crypto assets held on a centralized crypto asset marketplace (unless the marketplace provider was itself a Qualified Custodian and otherwise complied with the Custody Rule), the combination of an MPC solution used by the Custodian, together with the execution of trades on platforms that utilize "smart contracts" to ensure that transactions occur strictly on a DvP basis may be an option to explore.

Conclusion

In our view, the Proposal if adopted in its current form could result in an effect contrary to its stated purpose, which is to protect client assets of Advisers. By imposing costly, inflexible and, in places, unworkable requirements on Advisers and increasing the direct and indirect costs of Advisers engaging Qualified Custodians, it is possible that Advisers will seek to avoid taking any steps that may result in them being deemed to have custody of their client's crypto assets while still advising clients with respect to those assets. Although discretionary trading authority will trigger compliance with the revised Custody Rule, Advisers and clients may work together to find more business-friendly solutions that meet the particular clients' needs. As a result, clients may be encouraged by Advisers to hold their crypto assets directly, resulting in transactions based on recommendations of Advisers winding up occurring outside of the purview of the Custody Rule. For crypto assets in particular, the Proposal may reduce, rather than enhance, SEC oversight, potentially diminishing investor protection.

Please feel free to contact the DLx Law team for any questions you may have.

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