PAUL HASTINGS

Stay Current

March 2023

Follow @Paul_Hastings

Proposed SEC Custody Rule Amendments Could Drive Structural Changes in the Digital Asset Industry

By Eric Sibbitt, Lawrence D. Kaplan & Gabe Khoury

Introduction

The U.S. Securities and Exchange Commission ("SEC") recently proposed amendments to its so-called custody rule[1] under the Investment Advisers Act of 1940 ("Advisers Act"). The Proposed Rule seeks to expand the range of assets that registered investment advisers (each a "RIA") are required to hold with "qualified custodians" to clearly include digital assets. The Proposed Rule would also update recordkeeping and reporting requirements, and impose portfolio segregation, among other requirements. In 2021, $128 trillion in assets were managed by 15,000 SEC-registered investment advisers for 64.7 million clients.[2] Accordingly, any changes to rules governing RIAs can have significant impacts on all asset classes, including digital assets.

The Proposed Rule follows an Office of the Comptroller of the Currency (the "OCC") statement cautioning banks on digital asset custodial activities,[3] a joint SEC and Financial Industry Regulatory Authority statement expressing concerns with digital asset custody,[4] and a 2022 SEC Staff Accounting Bulletin[5] requiring public companies to make certain disclosures and record on their balance sheets a liability and corresponding asset of crypto assets that they are holding as custodian.

In the release for the Proposed Rule, the SEC stated that "most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians," and that "this practice would generally result in an adviser with custody of a crypto asset security violating the current custody rule because custody of the crypto asset security would not be maintained by a qualified custodian from the time the crypto asset security was moved to the trading platform through the settlement of the trade."

This Proposed Rule could have significant practical and strategic implications for digital asset market structure and participants throughout the digital asset ecosystem for years to come.

Qualified Custodians; The Custody Rule

RIAs help manage assets for individuals, institutions, pooled investment vehicles like mutual funds, and others. Under the Advisers Act, a RIA is required to hold "securities and funds" with "qualified custodians." While the SEC has expressed broad views about whether digital assets are securities, a determination as to whether digital assets are securities, commodities, or otherwise remains subject to vigorous debate and substantial uncertainty. RIAs have either taken the position that digital assets in

their portfolios are not securities or funds for purposes of the Custody Rule, or kept digital assets with entities held out to be qualified custodians.

Digital Asset Qualified Custodians

"Qualified custodians" are banks, savings associations, registered broker-dealers, registered futures commission merchants ("FCM"), or certain types of foreign financial institutions ("FFI") that meet specified conditions and requirements. Additionally, state-chartered trust companies under certain circumstances may be treated as a bank.[6] The SEC notes that who qualifies as a qualified custodian is "a complicated, and facts and circumstances based, analysis given the critical role qualified custodians play within this framework by safeguarding the client assets entrusted to investment advisers."[7]

Custodians for digital assets have often chosen to organize as state trust companies, commonly in South Dakota, Wyoming, and New York, based on the definition of "bank" under the Advisers Act.[8] As summarized in the preamble to the Proposed Rule, there are currently only a relatively small number of qualified custodians specifically for crypto assets. Specifically, one full service OCC-regulated national bank, four trust banks regulated by the OCC, approximately 20 state-chartered trust companies and other state-chartered-limited-purpose banking entities, and at least one FCM currently offer crypto custodial services.

The main utility of a "qualified custodian" for a crypto investor is to simplify the often complex task of dealing with the technical aspect of securely storing digital assets and to enable institutional investors (who are required to store their investment at a regulated custodian) to enter the digital assets market. For RIAs, it is also a means of satisfying obligations under the custody rule if an asset is deemed a security or fund for purposes of the custody rule. Current crypto custody solutions are often third parties that provide storage (hot or cold) and security services and crypto investors, both retail and institutional, could benefit from "qualified custodian" services.

What Assets Does the Proposed Rule Intend to Cover?

The Proposed Rule avoids the larger question of whether digital assets are securities or funds for purposes of the Custody rule, and instead broadens the definition of "asset class" under the Advisers Act to ensure that RIAs are also protecting "other positions held in a client's account." As proposed, "other positions" would include physical property like artwork that advisers are holding on behalf of clients and "all crypto assets, even in the instances where such assets are neither funds nor securities." Thus, this Proposed Rule influences both the ability of the investor to invest in crypto assets and the investment adviser's ability to choose assets that most align with their client's investment preferences.

What Other Requirements Does the Proposed Rule Impose?

In addition to clearly expanding the scope of the Proposed Rule to digital assets, several additional requirements could influence digital asset custody:

Enhanced Custodial Protections. The Proposed Rule would require that a qualified custodian does not "maintain" a client asset for purposes of the rule if it does not have "possession or control" of that asset.[9] This is especially important to crypto firms as it may be difficult to prove exclusive "possession or control" of a crypto asset as that asset may live on the underlying blockchain protocol and not with the crypto firm itself.

Updated Recordkeeping and Reporting Requirements. The Proposed Rule will also require the qualified custodian to deliver account statements to clients and the adviser as well as promptly provide

information to the SEC upon request. This may prove difficult for many crypto firms depending on how assets are held and the pseudo-anonymous nature of cryptocurrency may make reporting difficult.

Asset Segregation. Under the Proposed Rule, advisers with custody of client assets will be required to segregate those assets by (1) titling or registering the assets in the client's name, (2) not commingling the assets with the adviser's, and (3) not subjecting the assets to any right, charge, security interest, lien, or claim of any kind in favor of the investment adviser. All three of these proposed requirements may create technical and operational challenges for digital assets.

Strategic Implications and Digital Asset Market Structure

Most digital assets trade on platforms that are not qualified custodians. While some trading platforms and others have subsidiary entities that may qualify as qualified custodians, their execution of transactions might not necessarily flow through a qualified custodian as most digital asset trading platforms, lenders, and other service providers are not generally qualified custodians under the Advisers Act. As a result, to address regulatory requirements, firms may need to restructure their operations, build up or buy qualified custodians or enter into new commercial arrangements with qualified custodians, or forgo access to the $120 trillion in assets managed by RIAs. If adopted as proposed, we expect the Proposed Rule would spark additional strategic transactions and partnerships in the digital asset industry.

Conclusion

The Proposed Rule is significant and will affect numerous industry participants, including RIAs, investors, custodians of assets, and others. If adopted as proposed without significant changes, the Proposed Rule will restrict the ability of RIAs to participate and will create costly new requirements on digital asset transactions.

As the SEC is soliciting comments until at least 60 days from publication in *Federal Register,* digital asset ecosystem participants should consider comments addressing how best to shape the form of any final rules.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

San Francisco

Eric C. Sibbitt
1.415.856.7210
ericsibbitt@paulhastings.com

Washington, D.C.

Lawrence D. Kaplan
1.202.551.1829
lawrencekaplan@paulhastings.com

Gabe Khoury
1.202.551.1913
gabrielkhoury@paulhastings.com

[1] Proposed SEC Rule 206(4)-2 is promulgated by the SEC under the Investment Advisers Act of 1940. Individual states may have their own definitions of a "qualified custodian," which could be subject to different interpretation by some state regulators than federal regulators, but such state-interpretations do not impair federal definition of the term.

[2] Investment Adviser Association, 2022 Year in Review.

[3] *See* OCC Interpretive Letter 1179 (November 18, 2021), available at https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf.

[4] *See* Joint Staff Statement (July 8, 2019), available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities (emphasizing how digital asset securities, as opposed to traditional securities, are particularly susceptible to being lost due to cyber fraud, cyber theft, or the loss of a private key. The SEC stated that the traditional infrastructure "contains checks and controls that can be used to verify proprietary and customer holdings of traditional securities by broker-dealers, as well as processes designed to ensure that both parties to a transfer of traditional securities agree to the terms of the transfer").

[5] *See* SEC Staff Accounting Bulletin No. 121 (April 11, 2022), available at https://www.sec.gov/oca/staff-accounting-bulletin-121 (providing interpretive guidance for reporting entities that engage in activities in which they have an obligation to safeguard customers' crypto assets. SAB 121 requires a reporting entity that performs crypto asset custodial activities, whether directly or through an agent acting on its behalf, to record a liability with a corresponding asset, among other requirement).

[6] A "qualified custodian" is defined in the custody rule as "a bank as defined in section 202(a)(2) of the Advisers Act or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811)," and "bank" is defined in section 202(a)(2) to include "…(C) any other banking institution, savings association, as defined in section 1462(4) of title 12, or 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 […]".

[7] *See* Division of Investment Management Staff in Consultation with FinHub Staff Statement, "NAL on Custody of Digital Assets and Qualified Custodian Status," November 9, 2020, available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[8] The Investment Advisers Act of 1940, 15 U.S.C. 80b-1(2).

[9] "Possession or control" could mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets. In the Proposed Rule, the SEC acknowledges that proving exclusive control of a crypto asset (e.g., private key creation, maintenance, etc.) may be more challenging than for assets such as stocks and bonds.