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Regulation in the Post-FTX Environment: SEC's Proposed Enhanced Custody Rule and Its Effects on Crypto

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When it rains, it pours. On January 23, 2023, the New York Department of Financial Services announced that it had issued certain Guidance on Custodial Structures for Customer Protection in the Event of Insolvency in which it emphasized the importance of sound custody and disclosure practices to protect customers in the event of an insolvency or similar proceeding. This month, the Securities and Exchange Commission ("SEC") followed suit.

On February 15, 2023, the SEC proposed amendments to the Custody Rule under the Investment Advisers Act of 1940, which, among other changes, expands the current custody rule's application to a broader array of client assets under the rule managed by registered investment advisers and clarifies certain aspects of the existing rule (see more digestible SEC Fact Sheet here).

The SEC's proposed amendments are aimed at reducing the risk of loss of client assets by expanding the types of assets covered by the rule beyond "funds and securities" that will be subject to custodial safeguards and helping ensure assets are properly segregated. The proposed amendment would also impose certain reporting and compliance requirements on investment advisers, including requiring them to provide information about their practices in safeguarding client assets. Notably, if the amended rule is adopted after the 60-day comment period, which is not certain, then crypto assets will undoubtedly be affected. In a statement discussing the proposed amendments, SEC Chair Gary Gensler noted that the rule "covers a significant amount of crypto assets" and that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule."

Custody is a safekeeping activity by a financial institution involving storing, protecting, and securing assets separately from those of other customers or the investment firm itself. TradFi investment advisers are typically required to maintain customer funds and securities with a qualified financial firm (i.e., a custodian). Most assets are intangible assets held "on account" with a broker-dealer (i.e., stocks and bonds, which are rarely held in certificate form), though some assets may consist of physical certificates, cash, or other tangible assets. On the other hand, crypto custody consists primarily of bookkeeping because there is no physical asset and no centralized ownership record for a digital asset: the blockchain records wallet activity and balances. While there is the option for self-custody of crypto assets, a crypto investor may allow a custodian or crypto exchange to hold their private keys for them, enabling the custodian to use the wallet to transact. This arrangement potentially opens up a range of risks, including the risk of hacking, insolvency risk, or malfeasance involving the commingling of investors' cryptoassets with those of other investors or institutional assets.

As we have previously reported, in the post-FTX dawn, regulators are zeroing in on insolvency risks to customer assets. Several high-profile bankruptcies have highlighted custodial issues, leading to questions surrounding the ownership of customer assets. First, the FTX proceedings, where, among others, the SEC has alleged co-founder Samuel Bankman-Fried concealed the diversion of FTX customer funds to the co-founder's private crypto hedge fund. Second, the Celsius proceedings, where the chief judge for the United States Bankruptcy Court for the Southern District of New York issued a decision holding that Celsius' Terms of Use made clear that customer deposits into Earn Accounts became Celsius' property at the time of deposit, such that the digital assets now constitute property of the debtors' bankruptcy estate. In Celsius, customers argued that the deposits in the Earn Accounts were held by Celsius as a custodian, but the court found that the plain language of the Terms of Use made clear that ownership interest had passed to the debtors.

As discussed in our recent article, New York Department of Financial Services Issues Guidance on Cryptoasset Custody in Wake of Recent High-Profile Bankruptcies, state financial regulators in New York moved to protect customer's cryptoassets in the event of bankruptcies by issuing guidance that makes clear that customer assets should remain segregated and the property of the customer.

It appears that the SEC took note as well. In his statement, Gensler referenced how customer assets “often have become the property of the failed [platform], leaving investors in line at the bankruptcy court.”

Notable changes under the proposed amendments include:

1. Expanding of the current rule beyond client funds and securities to bring *any client assets* of which an adviser has custody into the rule’s scope. Specifically the proposed rule defines “assets” as “funds, securities, or other positions held in a client’s account.” As outlined in the proposed rule, assets under the rule also would include “financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not clearly be funds or securities covered by the current rule,” language that was undoubtedly influenced by recent losses during the crypto winter. Moreover, the proposal states that “other positions held in the client’s account” covers current asset types and asset types that develop in the future regardless of their status as funds or securities, include “crypto assets when not otherwise covered by the rule’s references to funds and securities.” Although this portion of the new proposal has received a lot of media attention, the SEC, in the proposed amendments, stated that its position is that “most crypto assets are likely to be funds or crypto asset securities covered by the current rule.” In a footnote, the SEC noted that “the application of the current rule turns on whether a particular client investment is a fund or a security.”
2. Stating that discretionary trading authority triggers the application of the rule unless the trades are limited to those effected on a delivery versus payment (DVP) basis. The effect of this is to deem advisers whose client assets include bank loans and other securities to have custody of those assets.
3. Requiring that advisers enter into written agreements with and obtain reasonable assurances from qualified custodians to ensure clients receive standard custodial protections when an adviser has custody of the assets. Such assurances would require, among other things, that qualified custodians undergo annual evaluations from public accountants, provide account statements, and provide records upon request. The effect of this provision would be to attempt through contract to extend SEC regulation to activities of bank and other custodians over which the SEC does not have regulatory jurisdiction.
4. Expanding the availability of the current rule’s audit provision as a means of satisfying the surprise examination requirement, which requires an adviser to undergo a surprise examination by an independent public accountant to verify client assets. Note this would codify an SEC Staff Response to Questions about the

Custody Rule.

5. Amending the investment adviser recordkeeping rule requiring advisers to keep more detailed records of trade and transaction activity, including position information for each client account of which it has custody.
6. Imposing additional restrictions on foreign financial institutions that serve either as qualified custodians or as sub-custodians to a qualified custodian, the consequence of which may be to restrict the ability of a non-US client to retain its non-US custodian if it engages a US registered adviser.
7. Amending Form ADV to revise reporting obligations with the proposed safeguarding rule's requirements and to improve the accuracy of custody-related data available to the Commission, its staff, and the public.

Like the recent NYDFS guidance on crypto asset custody, the SEC asserts that the amended rules are designed, in part, to ensure client assets are segregated and held in accounts designed to protect assets in the event of a qualified custodian bankruptcy or other insolvency. ("[S]ince its adoption [the Custody Rule] has been designed to safeguard client funds and securities from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated"). The crux of the proposed amendment is that qualified custodians must maintain crypto assets, which promotes proper segregation.

One potential concern is that the proposed amendments suggest that an adviser trading crypto assets on a platform might violate the proposed rule if those platforms are not qualified custodians. If this is indeed the case, advisors should note the SEC's renewed focus on this and will need to find avenues to comply.

Critics of the proposed amendments additionally argue that crypto investors and users may become more vulnerable to theft and fraud by forcing investors to use self-custody or unregulated custody arrangements, while also discouraging capital formation if the rule is adopted. This appears to be contrary to the SEC's mission. Indeed, the proposed rule states that entities that provide platform users with the ability to transact in crypto assets that do not wish to take on the additional compliance burdens as a qualified custodian would have to give up custody of such assets back to investors or another qualified custodian. In addition, as argued by SEC Commissioner Hester Peirce in her statement, the rule's broad effect could shrink the number of qualified custodians that handle crypto assets and cause investors to remove funds from platforms that may already practice robust safeguarding procedures ("The proposal would expand the reach of the custody requirements to crypto assets while likely shrinking the ranks of qualified crypto custodians. By insisting on an asset neutral approach to custody we could leave investors in crypto assets more vulnerable to theft or fraud, not less"). The proposed amendments also make it more costly for hedge funds, private equity funds, and pension funds to invest in crypto and hold custody of such assets for their clients, effectively blocking access to crypto as an asset class to those advisors that are unwilling to take on additional compliance burdens. Critics are further concerned that this will not only push innovation offshore but also investors, users, and firms to seek offshore services that are not as well-regulated, leaving investors in a similar situation that led to the FTX implosion. On the other hand, given the lingering crypto winter and the fallout of the FTX collapse and the resulting erosion of investor confidence in certain types of crypto assets, investors wary of this asset class might be reassured to see custodial safeguards put in place at the federal regulatory level. Additionally, in the proposed amendment, the SEC sees multiple benefits from its proposal. It contends that "the proposed amendments will reduce the risk of loss of client assets by expanding the types of assets covered by the rule beyond 'funds and securities' and that expansion of the rule's scope will "reduce uncertainty over the status of assets under advisement that must be held in the custody of a qualified custodian, thereby reducing the legal uncertainty and risk associated with advisory services and custodial arrangements for the assets." Under this reasoning, the SEC contends that perhaps, such actions "may increase investment opportunities and the availability of advisory services for [crypto assets]."

The 60-day comment period begins following the publication of the proposing release in the Federal Register. During this period, expect the SEC to further debate with stakeholders. Already some in the industry have stated that could comply with the proposed amendments; yet, others have concerns. While the form and timing of a final rule remains uncertain regulators are looking to rulemaking, guidance and enforcement actions to address perceived shortcomings in the crypto industry, particularly in the absence of federal legislation.

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