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SEC Custody Rule Creates Crypto Compliance Conundrum

By **Justin Browder, Kristina Littman and Michael Passalacqua** (December 6, 2024)

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Under its current leadership, the U.S. Securities and Exchange Commission has taken an aggressive stance toward the crypto-asset industry, which has been evidenced by a slew of enforcement actions against market participants, including recent charges against formerly registered investment adviser, Galois Capital Management LLC, over allegations of custody failures.

This approach has drawn considerable criticism from the industry as stakeholders argue that the SEC has attempted to enforce its regulatory regime against an evolving industry without dedicating policymaking resources to resolving the challenges of applying a legacy regulatory regime to an innovative asset class.

Aside from the SEC's well-publicized litigation against leading crypto-asset exchanges, other notable examples include the commission's 2023 proposed amendments to the rule governing the custody of client assets by registered investment advisers and recent enforcement actions targeted at crypto custody practices.

With new incoming leadership, the SEC has an opportunity to change course and begin offering regulatory on-ramps for registered investment advisers that seek to serve their clients' significant interest in this asset class while complying with the commission's custody requirements.

Custody Rule

Rule 206(4)-2 under the Investment Advisers Act, as amended, requires registered investment advisers with custody of client funds or securities to follow a set of requirements designed to safeguard those assets from loss, theft, misuse or misappropriation. These include, among others, a requirement that such advisers maintain client funds and securities with a qualified custodian.

Qualified custodians are limited to banks, broker-dealers, futures commission merchants and certain types of foreign financial institutions. As is relevant for the crypto-asset industry, certain state-chartered trust companies may meet the definition of "bank," and thus may act as qualified custodians for the purposes of the custody rule.

Despite ongoing uncertainty and debate surrounding whether crypto-assets should be classified as securities, the SEC has expressed the view, in its proposed 2023 amendments to the custody rule, that "most crypto assets are likely to be funds or crypto asset securities covered by the current [custody rule]."[1]

In that regard, the SEC recently charged Galois, a formerly registered investment adviser, with custody rule violations, alleging that Galois failed to maintain certain crypto-asset securities with a qualified custodian in violation of the rule. The SEC claimed that Galois

stored client assets that were crypto-asset securities on online crypto trading platforms, including FTX Trading Ltd., a portion of which was lost in FTX's collapse.

Furthermore, in early 2023, the SEC proposed amending and replacing the custody rule with Rule 223-1 under the Advisers Act — the safeguarding rule. Although the safeguarding rule appears unlikely to be adopted, as proposed it would expand the reach of the custody rule even further to cover all client assets, and not just client funds and securities. Such an expansion would make it even more challenging for advisers with crypto-asset strategies to comply with the Advisers Act's custody requirements.

Challenges for Registered Investment Advisers

Under the Advisers Act, all investment advisers are fiduciaries and subject to the duty of care and the duty of loyalty when managing client assets.

As fiduciaries, advisers are obligated to "adopt [their clients'] goals, objectives or ends,"[2] according to a 2019 SEC interpretation regarding the standard of conduct for investment advisers, and must provide investment advice in the best interests of their clients, based on client objectives. At the same time, advisers are obligated under the custody rule to safeguard client assets to mitigate the risk of misappropriation, theft or loss.

The current SEC's views that most crypto-assets are securities or funds covered by the custody rule place these two compliance obligations at odds with one another. Specifically, current regulatory, technological and commercial challenges make it difficult for advisers to make certain crypto-asset investments and participate in crypto-native activities — e.g., staking — that are within the scope of agreed-upon client mandates, while simultaneously ensuring that clients' crypto-assets are maintained by qualified custodians in accordance with the custody rule.

The challenge that advisers face in complying with their fiduciary obligation to manage assets according to client objectives while also adhering to the custody rule's qualified custodian requirements implicates considerations that are core to the Advisers Act's regulatory regime. As the SEC itself said in its 2019 interpretation, "[a]n adviser's fiduciary duty is imposed under the Advisers Act in recognition of the nature of the relationship between an investment adviser and a client and the desire 'so far as is presently practicable to eliminate the abuses' that led to the enactment of the Advisers Act."[3]

Limited Availability of Qualified Custodians

There are currently very few qualified custodians that are capable of providing solutions for crypto-assets. This can be explained in part by regulatory action and in part by regulatory inaction.

In March 2022, SEC staff issued Staff Accounting Bulletin No. 121, which specifies that it would be appropriate for financial institutions to present a liability on their balance sheets to reflect any obligation to safeguard crypto-assets for users.[4] By effectively requiring custodians to take a capital charge for providing crypto custody services, SAB 121 makes offering those services commercially undesirable for many financial institutions, and limits the number of qualified custodians for crypto market participants.

Although a bipartisan resolution overturning SAB 121 passed through Congress in May, President Joe Biden vetoed the resolution, and thus SAB 121 remains in effect.

To exacerbate the situation, regulators have also generally been reluctant to issue licenses or registrations to crypto-focused institutions seeking to qualify as qualified custodians. For example, to date, virtually no SEC-registered broker-dealers provide comprehensive crypto-asset custody services.

Limited Custodial Platforms With Trading Capabilities

Of the crypto-asset custodians that do exist, even fewer provide comprehensive trading solutions through a qualified custodian architecture. Crypto-asset markets trade 24 hours a day, seven days a week and 365 days a year, and advisers need the ability to execute trading strategies quickly — and continuously — to capture market opportunities that are in the best interests of their clients, including to avoid unnecessary losses.

Trading strategies may require client crypto-assets to be maintained in hot wallets on crypto-asset trading platforms to facilitate rapid trading in response to market movements.

The problem, however, is that few crypto-asset trading platforms are hosted through an entity that meets the definition of a "qualified custodian," and the SEC made clear in the 2023 proposed amendments that the practice of moving crypto-assets from a qualified custodian to a trading platform (whether affiliated or not), which is not a qualified custodian, would "generally result in an adviser with custody of a crypto asset security being in violation of the [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."[5]

In practice, this conundrum leaves advisers with a Hobson's choice: Maintain client assets with a qualified custodian to satisfy the requirements of the custody rule, or position client assets to maximize gains and avoid unnecessary losses.

Although the small number of crypto-asset qualified custodians is ostensibly the result of regulatory policy initiatives designed to protect U.S. investors, reducing the universe of eligible service providers in this space has resulted in significant concentration risk for advisory clients, which, in the event of an insolvency, distress or a cyberattack, presents a broader risk to the investing public. These factors militate in favor of a new approach.

Staking and Governance

Crypto-assets afford holders unique opportunities to generate returns in ways that are not possible with traditional asset classes that the SEC is accustomed to regulating.

For example, certain networks allow users to earn network rewards — typically in the form of additional units of the network's native crypto-asset — by contributing to the security of the network. This often involves contributing crypto-assets to smart contracts in a process known as staking.

Moreover, certain software protocols require users to stake assets to be eligible to participate in the protocol's community-driven governance process, participation in which can be accretive to the value of the staked assets. Depending on the technical features of a staking arrangement, however, the process of contributing client crypto-assets to staking contracts may result in those assets being moved outside the domain of a qualified custodian — a result that is inconsistent with the requirements of the custody rule.

Novel Crypto-Assets

To further complicate matters, as blockchain technology continues to develop, there can be a substantial amount of lag time between the launch of a novel crypto-asset or protocol and the development of custodial solutions for those assets, leaving advisers whose clients receive or acquire such assets at the time of their launch with no practical way to comply with the qualified custodian requirement under the custody rule.

In these circumstances, an adviser is forced to choose between complying with the qualified custodian requirement and delivering additional value to clients.

Custody vs. Compliance?

While the SEC's views on the application of the custody rule may be a good faith attempt to enhance consumer protections for client assets, the current approach fails to appreciate the unique characteristics of crypto-assets, and can force advisers to choose between pursuing their clients' objectives in accordance with the Advisers Act's fiduciary standards and complying with technical requirements of the custody rule.

Instead of engaging in investigations and bringing enforcement actions, the SEC should issue agency guidance or exemptive relief, or propose amendments to the custody rule to take into account the technological nuances native to the crypto-asset industry.

One potential solution involves a new exemption to the custody rule to permit self-custody of crypto-assets where an adviser is reasonably unable to identify a qualified custodian with suitable capabilities to maintain a particular crypto-asset. The custody rule already contains an exemption for "privately offered securities," which exempts private fund advisers from the qualified custodian requirement with respect to securities that are: (1) acquired from the issuer in a transaction not involving any public offering, (2) uncertificated with ownership recorded only on the books of the issuer or its transfer agent in the name of the client, and (3) transferrable only with prior consent of the issuer or shareholders.

There is no obvious policy reason why the SEC could not adopt a similar exemption to permit self-custody of crypto-assets subject to certain enhanced controls, which could include, for example, a requirement to engage an independent auditor to monitor and verify on-chain transactions involving the wallets holding the self-custodied assets. Indeed, the SEC proposed a similar exemption for physical assets in the safeguarding rule.[6]

Beyond the SEC, other regulators should also reconsider their positions with respect to applications for licenses or registrations that would allow crypto-focused custodial service providers to serve as qualified custodians.

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[1] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) (the "Proposing Release").

[2] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Inv. Adv. Act Rel. no. 5248 (Jul. 12, 2019) at 7-8 (the "Interpretation").

[3] Interpretation at 6-7, quoting SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).

[4] Staff Accounting Bulletin No. 121, 87 Fed. Reg. 21015 (Apr. 11, 2022).

[5] Proposing Release at 14689.

[6] Proposing Release at 14677-14678.