



Blockchain & Cryptocurrency Regulation

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The custody of digital assets

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Introduction

The growing fascination with digital assets, including cryptocurrencies and tokens, presents legal and operational challenges to investors, entrepreneurs and service providers, not to mention the regulators who oversee them. Perhaps no cryptocurrency issue presents more challenges than custody: how do individuals, broker-dealers, investment advisers, private funds and registered investment companies legally and effectively safeguard digital assets?

On the surface, the answer is simple: individuals can store their cryptocurrencies in digital wallets. Private funds managed by registered investment advisers can store their cryptocurrencies with “qualified custodians.” Registered investment companies can store their cryptocurrencies only with custodians that meet additional statutory requirements.¹

But alas, as is often the case with digital assets, it is not so simple. In reality, the operational and regulatory issues are more complicated, including whether the custody arrangements meet regulatory requirements, and whether they provide adequate safeguards, regardless of regulatory requirements.

This chapter examines the custody requirements that apply to various industry players under U.S. investment management laws and regulations, and analyses the challenges that they and the regulators face in evaluating arrangements for safeguarding digital assets.²

Terminology

Before we examine the legal requirements for custody, it is helpful to ensure that we use consistent terminology.

For the purposes of this chapter, “cryptocurrencies” refer to digital assets that function as a digital representation of a store of value, such as Bitcoin or Ethereum. Cryptocurrencies are not issued or backed by a central government, and thus are not legal tender. Alternatively we refer to cryptocurrencies as “digital currency” or “virtual currency.”

“Utility tokens” refer to coins or tokens that serve a particular (non-incident) function, or give the holder rights or access to goods, licences or services. A common form of utility token may give the holder the right to use a computer program that provides a kind of service for a defined period of time. Some refer to utility tokens as “app coins,” “app tokens,” or “utility coins.” Some utility tokens may be securities, others are not. As we will see later, whether or not a utility token is characterised as a security becomes critical in evaluating what custody rules apply.

“Securities tokens” or “investment tokens” are tokens or coins that are securities for purposes of federal securities laws. The status of a token as a security token may be intentional or unintentional. Some utility tokens may start out as securities and at some

point morph into non-securities, depending on their usage, how they are sold, and the expectations of the holders of those tokens.

Simply labelling a digital asset as a utility token, however, does not mean that the digital asset is not a security.³ The analysis of whether or not a utility token functions as a security token, or when a security token transforms into a utility token is beyond the scope of this chapter, but, again, the distinction is relevant for purposes of the custody analysis.

Legal requirements for custody of digital assets

Background

The safeguarding of client assets has long been a priority of Congress and the Securities and Exchange Commission (the SEC). The legislative history of the Investment Company Act of 1940 (the ICA), and, by implication, its companion statute, the Investment Advisers Act of 1940 (the Advisers Act), shows that Congress was clearly concerned with the potential for abuses or misappropriation of client assets held in investment trusts and managed by investment advisers:⁴

That investors in investment trusts and investment companies are subject to substantial losses at the hands of unscrupulous persons is obvious from the very nature of the assets of such companies. Their assets consist almost invariably of cash and marketable securities. They are liquid, mobile, and easily negotiable. These assets can be easily misappropriated, 'looted,' or otherwise misused for the selfish purposes of those in control of these enterprises. In the absence of regulating legislation, individuals who lack integrity will continue to be attracted by the opportunity available for personal profit in the control of the liquid assets of investment trusts and investment companies.⁵

The Senate had similar concerns:

Basically the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.⁶

These issues made national headlines in December 2008, when Bernard L. Madoff admitted to perpetrating a massive Ponzi scheme in which he convinced his clients that they owned securities that did not exist. For years, he evaded regulatory scrutiny until the scheme began to unravel. This scandal prompted the SEC to take actions to reduce the chance that a Madoff-style fraud would occur or go undetected in the future.⁷ While the SEC took steps to bolster its oversight and enforcement functions, it focused on rules designed to enhance the custody rules for investment advisers and broker-dealers. In December 2009, the SEC amended Rule 206(4)-2 (the "custody rule"), which was designed to provide greater assurance that investors' accounts contain the funds that their account statements say they contain.

Among other things, the rule encouraged advisers to maintain their clients' assets with independent custodians. For investment advisers who can control their clients' assets, the rules require enhanced procedures, such as surprise asset-counts, third-party reviews and audited financial statements. To be sure, when the U.S. Congress enacted the ICA and the Advisers Act, it clearly did not contemplate, or could even dream of, how the law would apply to digital assets such as cryptocurrencies or utility tokens. But the basic concerns of preventing fraud or misappropriation are just as valid today as they were in 1940. The only difference, of course, is that we are now attempting to apply 80-year-old laws designed to protect assets consisting of cash and securities to an entirely new class of digital assets created by a technology that did not exist at the time the laws were written.

What is "custody"?

Rule 206(4)-2 under the Advisers Act defines custody to mean "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." The regulation provides that you have custody of an asset "if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients."

Rule 206-4(2) defines custody of an asset to include:

- possession of client funds or securities;
- any arrangement (including a general power of attorney) under which you are authorised or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

A threshold question is whether the SEC's custody rule applies to digital assets? The answer depends on the facts and circumstances.

The SEC's Division of Investment Management has said that Rule 206(4)-2 does not apply to an adviser to the extent that it manages assets that are "not funds or securities."⁸ Does this mean that advisers to clients or funds that invest in Bitcoin are free to hold these assets in personal digital "wallets" without regard to federal regulation? If not, to what standard will an adviser be held? Again, it depends. In light of the legislative history, which makes the protection of investors' assets a priority, it is possible that most, if not all, digital assets would be considered "funds or securities" for the purposes of the Advisers Act and the custody rule. The matter is not free from doubt.

What are the legal custody requirements for an investment adviser?

The first step in analysing the legal requirements for the custody of assets is to determine the nature of the investment adviser. The two threshold questions are:

- What law applies? That is, is the adviser an "investment adviser" as defined in the Investment Advisers Act of 1940, as amended (the "Advisers Act")?
- If yes, is the adviser registered or required to be registered under the Advisers Act?

Next, we examine the nature of the assets and the nature of the entity that holds them.

What law applies?

To determine what law applies, we must look at the nature of the person or entity that holds or proposes to hold a digital asset. The holder of a digital asset can be:

- a natural person, directly or in a managed account;
- a pooled investment vehicle that is not publicly offered in the U.S., such as a hedge fund, private equity fund, or other private fund;
- a pooled vehicle that is registered as an investment company;
- a regulated entity such as a broker-dealer, bank or investment adviser;
- an operating company; or
- other pooled investment vehicles which might be commodity pools that otherwise would be investment companies but for an exemption under the 1940 Act.

Our focus here will be investment advisers and their clients, including natural persons, private funds and investment companies. We first discuss investment advisers and then registered investment companies.

What is an investment adviser?

Section 202(a)(11) of the Advisers Act defines an investment adviser as a person or entity that:

- engages in the business of advising others, directly or indirectly,
- as to the value of securities or as to the advisability of investing in securities,
- for compensation.

If you satisfy each of these three elements, you are an investment adviser for purposes of federal law.

Investment advisers who satisfy each of these three elements will be investment advisers for the purposes of federal securities laws, unless they fall within one of the statutory exemptions.⁹

This analysis is important, because whether a person falls within the statutory definition of an investment adviser determines whether (a) the person is subject to regulation by the SEC, and (b) the person is subject to the substantive provisions of the Advisers Act and its rules, including Rule 206(4)-2 (the SEC rule that applies to the custody of client assets, if the person is required to register as an investment adviser).

Is the adviser providing advice to anyone about *securities*? For example, an adviser that solely provides investment advice about a “pure cryptocurrency,” such as Bitcoin or Ethereum, is not an investment adviser, because these cryptocurrencies are not securities.¹⁰ The answer will be different if the adviser is providing advice about a derivative, the reference asset of which is a cryptocurrency. In that case, the advice may relate to a security (e.g., a structured note that links a return to a benchmark reference cryptocurrency or shares of a trust that holds cryptocurrency) or a commodity-related instrument that is regulated under the Commodity Exchange Act (e.g., a forward, future, put, call, straddle, swap, etc. relating to a cryptocurrency).

If the person is providing advice with respect to securities, the person may have to register with the SEC, depending on whether the person: (a) meets the statutory thresholds that permit registration; (b) is required to register by the Advisers Act; or (c) is eligible for status as an “exempt reporting adviser.”¹¹

Investment advisers not required to register under the Advisers Act

The Advisers Act provides several voluntary exemptions from registration, including, among others:

- intrastate advisers, that is, advisers whose clients all reside in the state in which the adviser maintains its principal place of business;
- advisers to insurance companies;
- “foreign private advisers,” which generally are advisers that (a) have no place of business in the U.S., (b) have fewer than 15 clients and investors in private funds in the U.S., (c) have less than \$25 million in assets under management attributable to those clients and investors; and (d) do not hold themselves out as investment advisers in the U.S.;
- charitable organisations and plans;
- commodity trading advisers;
- private fund advisers, which generally are advisers solely to private funds that have less than \$150 million in assets under management in the U.S.;
- venture capital fund advisers; and
- advisers to small business investment companies (SBICs).

Advisers that rely on the private fund adviser exemption and the venture capital fund exemption are considered “exempt reporting advisers.” Exempt reporting advisers must file with the SEC certain disclosures on Form ADV, but generally they are not subject to the substantive rules of the Advisers Act, including the custody rule (discussed below).

Exempt reporting advisers, and investment advisers that fall within the definition but are not required to register are, however, nonetheless subject to the anti-fraud provisions of the Advisers Act, not to mention their fiduciary obligations to those clients under federal law. This includes state-registered investment advisers and investment advisers that are not required to register anywhere. While these advisers are not subject to the custody rule, it is reasonable to presume they still must exercise care and prudence in maintaining or arranging for the custody of their clients’ digital assets, including a responsibility to disclose related risks.

We discuss some of the challenges that they face in maintaining custody of digital assets below.

Investment advisers required to register under the Advisers Act

Rule 206(4)-2, the custody rule under the Advisers Act, applies to investment advisers registered, or required to be registered, with the SEC (RIAs) and their related persons that have “custody” of client funds or securities.

As noted, an RIA is deemed to have “custody” of client assets if the RIA (or its related person) directly or indirectly holds client funds or securities, or has any authority to obtain possession of them.¹² This authority can arise out of custodial or advisory arrangements. For example, an adviser that has access to a client’s private key to a cryptocurrency holding could be deemed to have access to the client’s asset, even if the same key is held by a third-party custodian. Depending on the facts and circumstances, the SEC staff has said, “custodial agreements could impute advisers with custody they otherwise did not intend to have.”¹³ Other arrangements in which an RIA is presumed to have custody of client assets include when an RIA or an affiliate acts as general partner or managing member to a private fund.

Put another way, it would be difficult for an RIA to avoid having custody of client funds and securities unless an RIA neither holds, nor has authority to obtain possession of, client funds and securities, including cryptocurrencies. When an RIA or its related person is deemed to

have custody of client funds or assets, it must comply with certain requirements under Rule 206(4)-2(a), unless an exception in Rule 206(4)-2(b) applies. Unless the RIA qualifies for such an exception, an RIA that fails to comply likely violates the anti-fraud provisions of the Advisers Act.¹⁴

What does the custody rule require of RIAs? Unless an exemption applies, if an RIA or its “related person” has custody of a client’s assets (including funds and securities), Rule 206(4)-2(a)(1) requires the RIA to use a “qualified custodian” to maintain those client funds and securities:

- in a separate account for the client under the client’s name; or
- in accounts that contain only the client’s funds and securities, under the RIA’s name as agent or trustee for the client.

Qualified custodian. A “qualified custodian” includes:

- many federal and state chartered banks;
- registered broker-dealers holding client assets in customer accounts;
- registered futures commission merchants holding client assets in customer accounts (but generally only with respect to futures contracts and other securities incidental to transactions in futures and related options); and
- foreign financial institutions that customarily hold financial assets for customers, provided that they keep advisory clients’ assets in customer accounts segregated from its proprietary assets.¹⁵

Notice, Account Statement and Examination Requirement. Rules 206(4)-2(a)(2), (a)(3) and (a)(4) impose certain notice, account statement, and examination requirements on RIAs if RIAs or their “related persons” have custody of client funds or securities, unless an exemption is met. These requirements are relatively burdensome.

Notice to clients requirement. When an adviser opens an account with a qualified custodian on the client’s behalf, Rule 206(4)-2(a)(3) requires the RIA to notify the client *in writing* of the qualified custodian’s name, address, and the manner in which the custodian maintains the funds or securities in the account, promptly when the account is opened and following any changes to this information.

Account statement requirement. Rule 206(4)-2(a)(3) requires that the qualified custodian send account statements to each client for which it maintains funds or securities, unless an exemption applies. The statements, which must be sent at least quarterly, must identify the amount of funds and each security in the account at the end of the period, and all transactions during the period. RIAs must “have a reasonable basis, after due inquiry” for believing that the qualified custodian has sent the required account statements. This necessarily entails due diligence. Advisers have the option of sending their own account statements to their clients, in addition to those required to be sent by the qualified custodian. In this event, the notice to clients (summarised above) must include a statement “urging the client to compare the account statements from the custodian with those from the adviser.”¹⁶

When the RIA (or a related person of the RIA) serves as general partner or the equivalent of a pooled investment vehicle, the qualified custodian must send the account statement to each beneficial owner of the fund.¹⁷ This is so unless the audit exception for pooled investment vehicles (described below) applies.

Surprise audit requirement. Under Rule 206(4)-2(a)(4), at least once during each calendar year, RIA and “related person” custodied funds and securities must be verified by actual

examination in a “surprise audit,” unless an exemption applies. The surprise audit – which is really a securities count and not a traditional “audit” of financial statements – must be conducted by an independent public accountant and must be chosen by the accountant without prior notice or announcement to the RIA and that is irregular from year to year.

The surprise audit must be subject to a written agreement. The written agreement must provide for an initial surprise examination within six months of becoming subject to the surprise audit, except that if the RIA is a “qualified custodian,” then the agreement must provide for the first surprise audit to commence not later than six months after the adviser obtains an “internal control report” as described below.

The written agreement must require the independent public accountant to: (a) file a certificate on Form ADV-E within 120 days of the examination date, stating that it has examined the funds and securities, and describing the nature and extent of the examination; (b) notify the SEC within one business day of any findings of “material discrepancies” during the examination; and (c) notify the SEC by filing Form ADV-E accompanied by certain statements regarding the registration if the independent public accountant resigns, or is dismissed, removed or terminated.¹⁸

Surprise audits of cryptocurrency assets may pose significant challenges for independent auditors, who must validate that the private key actually represents ownership of a cryptocurrency without the benefit of traditional ownership indicia supported by securities registrars, control practices associated with regulated securities intermediaries, known and trusted parties to receive verification requests, etc.

Pooled investment vehicles. When the RIA (or a related person of the RIA) serves as general partner (or the equivalent) of a pooled investment vehicle, it can satisfy the notice, account statement and surprise audit requirements described with respect to the fund that is subject to an annual audit:

- (a) if at least annually, the fund sends its audited financial statements, prepared in accordance with generally accepted accounting principles, to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year;
- (b) by an independent auditor that is registered with and subject to regular inspection as of the commencement of the engagement, and as of each calendar year-end, by the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules; and
- (c) upon liquidation, and distributes its audited financial statements prepared in accordance with generally accepted accounting principles (GAAP) to all limited partners (or members or other beneficial owners) promptly after the completion of the audit.

Similar asset verification challenges to those described above apply during the audit process.

Independent advisers or related parties acting as qualified custodians. RIAs that maintain custody of client funds or securities, directly or through a related person that has actual rather than deemed custody (i.e., those acting as a qualified custodian) “in connection with” advisory services, must comply with two requirements that require the use of independent public accountants.¹⁹

First, a PCAOB-registered and inspected independent public accountant must satisfy the surprise audit requirement (discussed above). RIAs must obtain, or receive from their related person, a written internal control report *within six months of becoming subject to such requirement and at least once per calendar year.*

Second, the internal control report must be prepared by an independent public accountant. The internal control report must include an opinion of a PCAOB-registered and inspected

independent public accountant “as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the RIA or a related person on behalf of the RIA’s advisory clients, during the year.” The independent public accountant must verify that the funds and securities are reconciled to a custodian other than the RIA or its related persons. A copy of any internal control report obtained or received is subject to record-keeping requirements.²⁰

Non-U.S. advisers. Generally, non-U.S. RIAs with a principal place of business outside of the U.S. are not subject to the custody rule with respect to their non-U.S. clients. This includes a client that is a non-U.S. fund (organised outside the U.S.), whether or not the fund has U.S. investors.²¹

Registered investment companies

Section 17(f) of the Investment Company Act, as amended (“1940 Act”) governs how registered investment companies must maintain custody of their assets.²² This section requires a registered fund to maintain its securities and other investments with certain types of custodians under conditions designed to assure the safety of the fund’s assets.²³ While the section addresses custody of fund assets by certain banks, broker-dealers and futures commission merchants (FCMs), as well as securities depositories, unsurprisingly it does not specifically address custody of digital assets.

Notably, Section 17(f)(1) refers to “securities and similar investments,” which is a broader category of assets than covered the custody rule under the Advisers Act.

Section 17(f)(1) provides that every registered management company shall place and maintain its securities *and similar investments* in the custody of:

- a bank;
- a company that is a member of a national securities exchange, subject to the SEC’s rules; or
- the investment company itself, subject to the SEC’s rules.

When Congress enacted Section 17(f), of course, no-one anticipated how it would apply to digital assets. The term “and similar investments,” however, can readily be read to include digital currencies.

Rule 17f-1 under the 1940 Act governs custody of investment company assets maintained by broker-dealers that are members of a national securities exchange. Among other things, Rule 17f-1 requires that the securities *and similar investments* held in such custody shall at all times be individually segregated from the securities and investments of any other person and marked in such manner as to clearly identify them as the property of such registered management company, both upon physical inspection thereof and upon examination of the books of the custodian. The rule, however, is a bit dated if its terms are to be taken literally: “The physical segregation and marking of such securities and investments may be accomplished by putting them in separate containers bearing the name of such registered management investment company or by attaching tags or labels to such securities and investment.”

Rule 17f-2 governs custody by the investment company itself or by a bank.

Rule 17f-2(a) provides that “[t]he securities and similar investments of a registered management investment company may be maintained in the custody of such company only in accordance with the provisions of this section.” While the rule is deemed largely

unworkable by the industry, it is in any event not clear how an investment company itself could take custody of cryptocurrencies without running afoul of the other provisions of the 1940 Act.

This section also addresses custody by banks:

Except as provided in paragraph (c) of this rule, all such securities and similar investments shall be deposited in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by Federal or State authority. Investments so deposited shall be physically segregated at all times from those of any other person and shall be withdrawn only in connection with transactions of the character described in paragraph (c) of this rule.

Rule 17f-4 allows investment companies to maintain custody of assets with a securities depository or intermediate custodian, subject to certain conditions.

Rule 17f-6²⁴ generally provides that investment companies may “place and maintain cash, securities, and similar investments with a Futures Commission Merchant in amounts necessary to effect the Fund’s transactions in Exchange-traded futures contracts and commodity options,” subject to certain conditions to safeguard the assets.

In sum, a registered investment company can comply with the requirements of Section 17(f) by placing cryptocurrencies in the possession of a bank, a broker-dealer that is a member of a national securities exchange, or a securities depository.

Funds that utilise derivatives related to cryptocurrencies (e.g., swaps, futures, options) can maintain custody with the futures commission merchant, but the custody arrangements present challenges when the derivative calls for physical settlement of the underlying asset, which we discuss below.

Other custody considerations for registered investment companies include oversight by chief compliance officers and the fund’s board of directors.

Funds that invest in cryptocurrencies directly or indirectly through derivatives must ensure that their compliance policies and procedures address the attendant risks.

Legal and practical custody challenges faced by investment advisers and investment companies with respect to digital assets

Investment advisers, whether or not they are registered with the SEC, and investment companies, face challenges when designing a custody arrangement that meets the regulatory requirements as well as protecting the client’s assets.

How does an investment adviser maintain custody of a digital asset? To start, an investment adviser can satisfy the custody rule by maintaining the digital assets with a “qualified custodian.” To be sure, some qualified custodians have begun to accept digital asset custody accounts, and more are expected to enter that business.

Arguably, that is the easy part. Now comes the challenge: how does the qualified custodian maintain custody of digital assets in a way that satisfies regulatory scrutiny and provides adequate safeguards for the client or fund’s assets? How much protection against fraud can a qualified custodian of digital assets really provide, and what liability would it be willing to accept by contract?

In the final analysis, cryptocurrencies exist merely as computer-coded entries on a digital ledger, or blockchain, visible to and verifiable by all “nodes.” Ownership is reflected in a string of numbers on a distributed ledger, accessible only by a public key and a private key,

much the same way access to a safe deposit box is accessible by the bank's key and the depositor's private key.

A custodian, for example, can take physical possession of a stock certificate. It also can take "possession" of an uncertificated stock certificate, because the custodian's name is registered on the books of the issuer. Cryptocurrencies, which are recorded in digital form on the distributed ledger, reflect the transfer of ownership, but not necessarily who is the record owner of the cryptocurrency. Whoever has possession of the private key has access to that asset.

To satisfy regulatory requirements, a custodian could hold a "private key" and a "public key" to the digital asset. But what steps can a custodian take to ensure that the private key cannot be misappropriated? A custodian can maintain private keys in digital form on a computer hard drive unconnected from the internet and protected by layers of cybersecurity. Or, the custodian can place a piece of paper (or hard drive) containing the private key and lock it in a physical vault encased in concrete and (to wax metaphorically) surrounded by an alligator-filled moat. In any event, the technology used for safeguarding digital assets is emerging.

Moreover, cryptocurrencies are essentially bearer assets. In general, a bad actor who obtains possession of the private key can, in theory, misappropriate the asset, no matter where the private key is maintained. Some industry participants have addressed this risk by proposing to obtain insurance against loss or theft of the cryptocurrency. While insurance may address some of the counterparty and custody risks associated with cryptocurrencies, it may be costly and may not completely cover potential risks.

As already suggested, there also are other practical considerations that apply to the auditors of accounts holding cryptocurrency. For example, how will independent auditors verify ownership of the cryptocurrency? To whom would they send the audit letter requesting confirmation?

Registered funds must also ensure that the board of directors has sufficient information to provide meaningful oversight of the fund's custody arrangements. Among other things, fund directors must approve the compliance policies of the investment company and its investment adviser, and also must approve of contractual arrangements with fund custodians. While some qualified custodians are willing to take custody of cryptocurrencies held by registered investment companies, they may face some challenges. For example, will the fund directors be satisfied that the custodian has adequate safeguards in place to protect the assets? Will the custodian's limitations on liability be acceptable to the directors? Will the directors conclude that the cost of cryptocurrency custody is reasonable?

The staff of the SEC raised these issues in a letter dated January 18, 2018 by Dalia Blass, Director of the Division of Investment Management:²⁵

The 1940 Act imposes safeguards to ensure that registered funds maintain custody of their holdings. These safeguards include standards regarding who may act as a custodian and when funds must verify their holdings. To the extent a fund plans to hold cryptocurrency directly, how would it satisfy the custody requirements of the 1940 Act and relevant rules? We note, for example, that we are not aware of a custodian currently providing fund custodial services for cryptocurrencies. In addition, how would a fund intend to validate existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records? To what extent would cybersecurity threats or the potential for hacks on digital wallets impact the safekeeping of fund assets under the 1940 Act?

These custody issues carry over to settlement of cryptocurrency-related derivatives. That is, when a fund holds derivatives that are based on the value of an underlying cryptocurrency, the futures commission merchant, which holds the derivative position for the benefit of the fund, will satisfy the qualified custodian requirements. But a fund that takes a long position in a Bitcoin futures contract may be required to accept Bitcoin when the contract matures, or to deliver Bitcoin to a futures commission merchant upon settlement of a short position. The Blass Cryptocurrency Letter noted the challenges that registered funds will face when taking positions in cryptocurrency-based derivatives:

While the currently available bitcoin futures contracts are cash settled, we understand that other derivatives related to cryptocurrencies may provide for physical settlement, and physically settled cryptocurrency futures contracts may be developed. To the extent a fund plans to hold cryptocurrency-related derivatives that are physically settled, under what circumstances could the fund have to hold cryptocurrency directly? If the fund may take delivery of cryptocurrencies in settlement, what plans would it have in place to provide for the custody of the cryptocurrency?

These challenges are just some of the issues facing the industry and its regulators as RIAs and registered investment companies begin to invest in digital currencies.

To be sure, however, the current environment of persistent uncertainty cannot last; as the markets for cryptocurrencies and other digital assets mature, so too will custody standards. Custodians, auditors and other trusted parties that comprise the infrastructure for reliable custody in the securities markets will develop a battery of tailored procedures appropriate to this new and growing asset class.

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Endnotes

1. Broker-dealers, commodity pool operators, commodity trading advisors and advisers to certain retirement plans are subject to separate requirements, which are not the subject of this chapter.
2. For a general discussion of blockchain issues for investment managers, see Jay G. Baris and Joshua Ashley Klayman, “Blockchain Basics for Investment Managers: A Token of Appreciation,” 51 *The Review of Securities and Commodities Regulation* 67 (Mar. 21, 2018), available at https://www.shearman.com/-/media/Files/Perspectives/2018/03/Baris_Klayman_RSCR_Final_1.pdf?la=en&hash=4CD602B56ED60D38CB5EAC232EF3D80981026B0F.
3. William Hinman, Director SEC Division of Corporate Finance, Digital Asset Transactions: *When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>.
4. The Advisers Act does not specifically address custody of clients. Rather, the SEC addressed this issue in the Rule 206(4)-2 under the Advisers Act (the “custody rule”), which is discussed below.
5. H.R. Report No. 76-2639 (1940).

6. Senate Report No. 76-1744 (1940).
7. The Securities and Exchange Commission Post-Madoff Reforms, available at <https://www.sec.gov/spotlight/secpostmadoffreforms.htm>.
8. The SEC staff has taken the position that if an adviser manages client assets that are not funds or securities, the custody rule does not require the adviser to maintain the assets with a qualified custodian. Question II.3, *Staff Responses to Questions About the Custody Rule* (online FAQ), available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm. The issue now presented is whether the SEC staff considers cryptocurrencies to be “funds or securities” for purposes of the custody rule.
9. For example, family offices, banks, insurance companies and broker-dealers that provide advice incidental to their brokerage business, among others, are excluded from the definition of an investment adviser under the Advisers Act.
10. We are assuming that at least these two cryptocurrencies are not “securities” for purposes of the federal securities laws. The analysis of whether a particular digital asset is a security is beyond the scope of this chapter.
11. The provisions of the Advisers Act relating to whether an adviser is required to register are beyond the scope of this chapter.
12. Advisers Act Rule 206(4)-2(d)(2).
13. SEC Division of Investment Management Guidance Update No. 2017-01 February 2017, available at <https://www.sec.gov/investment/im-guidance-2017-01.pdf>.
14. One notable exemption is that Rule 206(4)-2 does not apply with respect to mutual fund accounts of the RIA. See Rule 206(4)-2(b)(5).
15. Advisers Act Rule 206(4)-2(d)(6).
16. Advisers Act Rule 206(4)-2(a)(2).
17. Advisers Act Rule 206(4)-2(a)(5).
18. Advisers Act Rule 206(4)-2(a)(4)(iii).
19. Advisers Act Rule 206(4)-2(a)(6).
20. Advisers Act Rule 204-2(a)(17)(iii).
21. Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun 22, 2011) at note 515, available at <https://www.sec.gov/rules/final/2011/ia-3222.pdf>: “[W]e do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission.” See also Robert E. Plaze, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, at note 374 (June 2018), available at: <https://www.proskauer.com/report/regulation-of-investment-advisers-by-the-us-securities-and-exchange-commission-june-2018>.
22. Investment Company Act of 1940, 15 U.S.C. § 80a (1958).
23. See generally Securities and Exchange Commission, Custody of Investment Company Assets with a Securities Depository, Release No. IC-25934 (Feb. 13, 2003), available at <https://www.sec.gov/rules/final/ic-25934.htm>.
24. Final Rule: Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Release No. IC-22389 (Dec. 11, 1996), available at <https://www.sec.gov/rules/final/ic-22389.txt>.
25. SEC Staff Letter: *Engaging on Fund Innovation and Cryptocurrency-related holdings* (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm> (the “Blass Cryptocurrency Letter”).



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An active speaker and writer on issues concerning investment management and the regulation of financial institutions, Jay has been published in a variety of trade and general interest publications, *Insights: The Corporate & Securities Law Advisor*, *The New York Times*, *The Wall Street Journal*, *The Review of Securities & Commodities Regulation*, *Fund Action*, *The Review of Banking & Financial Services*, *Fund Directions* and *Fund Board Views*.

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