

Cryptocurrency and the Custody Rule: Legal Pitfalls in Managing Digital Assets

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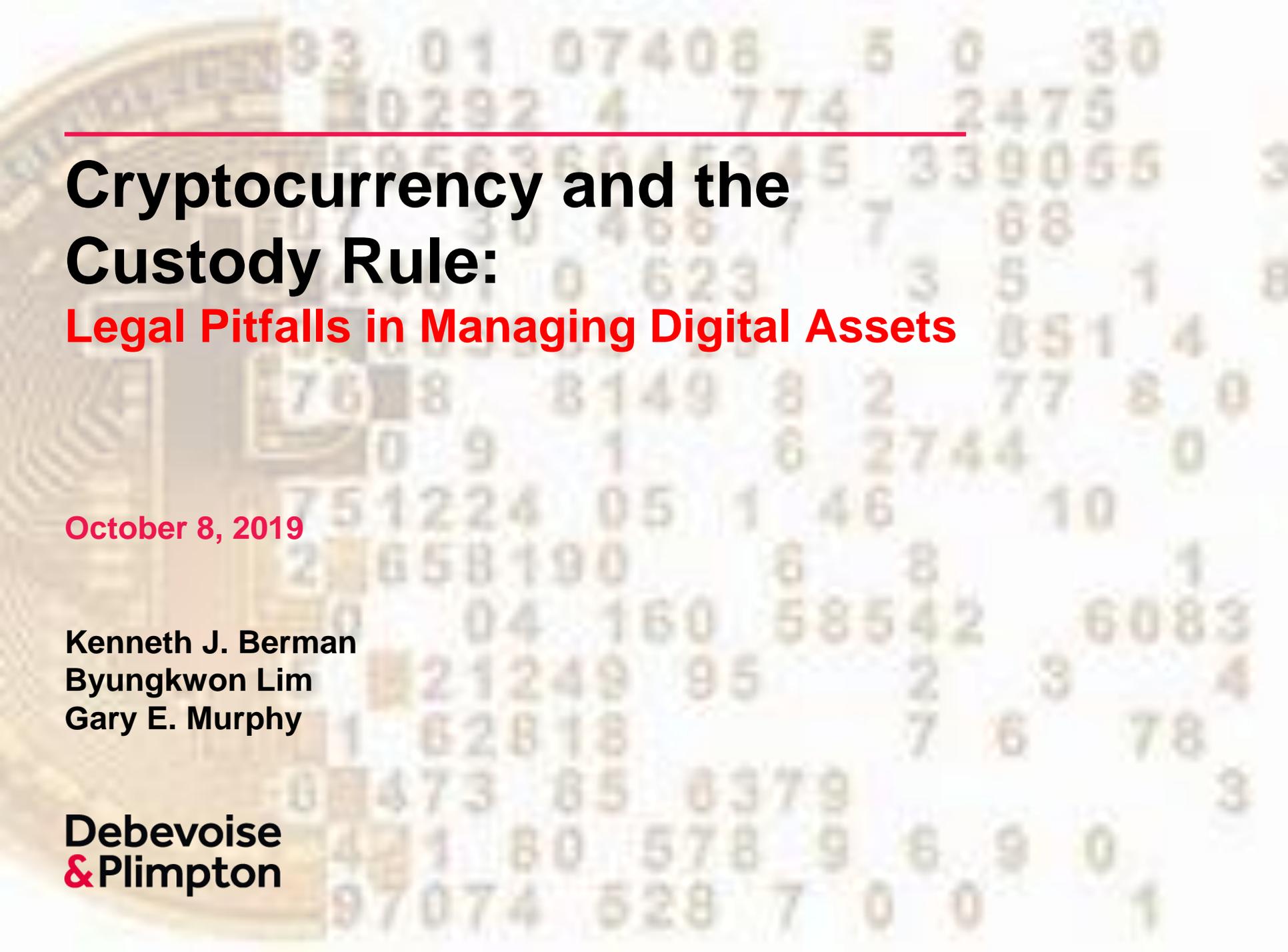
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What Constitutes Custody?

- **Custody: the possession and/or control of an asset.**
- **Various methods to establish custody:**
 - Physical Assets (e.g., precious metals, artwork, bottles of wine)
 - » Custody through physical possession
 - Intangible Assets (e.g., uncertificated shares in a company)
 - » Various methods developed to evidence custody under applicable laws and industry practices
 - » Example: central securities depository as holder of legal title to publicly traded securities, with a series of custodians (or securities intermediaries) holding entitlements through a chain of book entries
 - Focus of SEC is on custody of securities and funds

SEC Custody Requirements in Advisory Context

- **Investment Advisers Act of 1940 (the “Advisers Act”)**
 - Rule 206(4)-2 under the Advisers Act (the “Custody Rule”) establishes certain safekeeping requirements applicable to funds or securities held on behalf of clients by SEC-registered investment advisers.

SEC Custody Requirements in Advisory Context (cont.)

- **Investment Company Act of 1940 (the “Investment Company Act”)**
 - Section 17(f) of the Investment Company Act governs the custody of assets of a registered investment company (“RIC”), including its portfolio securities
 - Generally requires that securities and similar investments be placed in the custody of a U.S. bank
 - Rules under Section 17(f) allow a RIC to maintain custody with a broker-dealer, securities depository, futures commission merchant and foreign bank.
 - Rules also permit “self-custody.”

The Custody Rule under the Advisers Act

- **Our focus today is on the Advisers Act Custody Rule**
- **Scope of the Custody Rule**
 - Applies to client “funds or securities” (i.e., designed to deal with cash and conventional securities)
 - Applies only to registered investment advisers

The Custody Rule under the Advisers Act (cont.)

- **The definition of “custody” is extremely broad:**
 - The holding of client funds or securities, directly or indirectly
 - Having the authority to obtain possession of client funds or securities
 - » Examples:
 - Power of attorney to sign checks on client’s behalf
 - Authority to withdraw funds or securities from client’s account (other than for client-authorized trading)
 - General Partner of a pooled investment vehicle

The Custody Rule—Purposes

- **Purposes of the Custody Rule**

- In adopting amendments to the Custody Rule in 2009 in the wake of the Madoff scandal, the SEC stated:
 - » “We believe these amendments...will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers’ financial reverses....We believe...that this rule, together with our examination program’s increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.”

The Custody Rule—Purposes (cont.)

- **Purposes—Three Key Purposes of Requiring Custody of Assets with a Third Party:**
 1. Protection against theft or misappropriation by third parties
 2. Protection against bankruptcy or insolvency of the adviser or custodian
 - » Segregation of assets and identification as being held on the client's behalf
 3. Protection against fraud, theft or misappropriation by the adviser itself

The Custody Rule—Primary Requirements

- **Primary Custody Rule Requirements**
 - Qualified Custodian
 - Notice to Clients
 - Account Statements
 - Verification and “Surprise” Audit

The Custody Rule—Qualified Custodian

- **Qualified Custodian**

- Funds or securities must be maintained by a “qualified custodian”
- Qualified Custodians:
 - » Certain banks and savings associations
 - » Registered broker-dealers
 - » Registered futures commission merchants
 - But only to the extent incidental to certain commodities futures transactions
 - » Foreign financial institutions that customarily hold financial assets for their customers

The Custody Rule—Other Requirements

- **Notice to Clients**

- Notice must be provided to clients if an account is opened with a qualified custodian on a client’s behalf

- **Account Statements**

- Adviser must have a reasonable belief that the Qualified Custodian is sending account statements to the client at least quarterly

- **Verification and “Surprise” Audit**

- Funds and securities held in custody must be verified at least once during any calendar year by an independent public accountant (registered with the Public Company Accounting Oversight Board)

- » At a time chosen by the accountant without prior notice and irregular from year to year

The Custody Rule—Rules for Private Funds

- **Special Rules for Private Funds**

- Base requirements can differ when clients are private funds
 - » Not subject to Notice and Account Statement requirements
 - » Deemed to have satisfied Surprise Audit requirement if:
 1. The Fund sends its audited financial statements, prepared in accordance with GAAP, to each limited partner (or other member or other beneficial owner) at least annually within 120 days of fiscal year end,
 2. The audit is conducted by an independent public accountant registered with the Public Company Accounting Oversight Board, and
 3. The Fund is subject to audit upon liquidation.

The Custody Rule—Delivery versus Payment

- **Delivery versus Payment (“DVP”)**
 - Not explicitly addressed in the Custody Rule
 - However, SEC statements and guidance have focused on DVP as a means of protecting client assets and addressing issues around “inadvertent custody”
 - Agreement with custodian (and acknowledged by client) whereby the Adviser’s authority to transfer funds or securities out of an account can only be made upon a corresponding transfer of funds or securities into the account

The Custody Rule—Delivery versus Payment (cont.)

- **DVP (cont.)**

- Intended to minimize the risk that an adviser could withdraw or misappropriate the funds or securities in the custody account
 - » In a March 2019 letter, the SEC’s Division of Investment Management solicited input from market participants on the types of assets that typically settle on a non-DVP basis and whether there are other protections and controls that address misappropriation risks

What Constitutes Custody on a Blockchain?

- **The Custody Rule and DVP concepts generally work well in the context of custody of traditional securities and cash.**
- **But the concepts become more blurred when applied to digital assets, such as blockchain tokens.**
 - What does it mean to have custody of a digital asset?
 - Does the Custody Rule apply?
 - What are the key requirements, and challenges?

Blockchain—Public Key and Private Key

- **Public Key and Private Key**

- A digital asset is recorded to an address that is cryptographically derived from a specific private key.

- » **Public Key:** The digital identity associated with a holder of digital assets. A public address (derived from the public key) is available to the public and is the address to which third parties can direct transfers of digital assets.

- » **Private Key:** Intended to be secret and known only to the holder. Necessary to claim and spend (transfer) the digital assets associated with the corresponding public key.

- **Control of the *private key* is a paramount concern and is the basis for establishing custody of digital assets on a blockchain.**

Hot and Cold Storage: Security Vulnerabilities

- **Hot and Cold Digital Wallets**

- » Hot Wallets: Online and connected.

- Pros: Faster Execution and Transfer

- Cons: Higher Risk of Cyber Attack
Private Key may also be lost/forgotten

- » Cold Wallets: Offline, such as a hardware wallet.
("Air Gapped")

- Pros: Decreased Risk of Cyber Attack

- Cons: Slower Execution and Transfer
Private Key can still be lost/forgotten

- **Can be used as a means of self-custody. But also can form part of the custody services provided by third parties.**

Third-Party Custodial Arrangements

- **As an alternative to self-custody, an investor can seek to use the services of a third-party custodian.**
 - Custody fees remain high
 - Services often limited to institutional and high-net-worth investors

Custody Example

- **While there are variations and continuing developments, a basic approach to digital asset custody can work as follows:**
 - Customer owns 100 Bitcoins (BTC)
 - Customer sends output transaction for 100 BTC to an address designated by Custodian
 - Once mined and included in a block (typically confirmed by waiting for 6 new blocks built on original block), Custodian sends 100 BTC to another address it has established for this customer
 - Once this second transaction is mined/confirmed, the private key is put into cold storage.
 - » Customer does not know this private key
 - » In fact, the private key is often not known to any human being and is instead machine-generated

Custody Example (cont.)

- **Withdrawal from Custody**

- Customer requests Custodian to retrieve the private key so that Custodian can sign the instructed transaction for Customer to spend those 100 BTC
- Added Security Requirements can be Employed
 - » Multi-signature Wallets
- Custodian typically employs a procedure to verify the recipient and its control of the address to which the BTC are being transferred
 - » Video Conference
 - » Small Transfer with Confirmation
 - » May Permit “Whitelisting” of Recipients to Expedite Transfer Process

The Custody Rule in the Blockchain Context

- **The custody approach discussed above provides some useful safeguards against third-party cyber attacks and inadvertent loss of private keys.**
- **But there are still limitations:**
 - Insufficient protection against misappropriation of assets by an investment adviser
 - Introducing new risk (“single point of failure”), since there is now the possibility of theft by an employee of the Custodian or loss resulting from destruction or other physical failure to the Custodian’s computer system or facility

Where Does the SEC Stand?

- **The SEC has released several letters in the last two years addressing questions, and requesting input, on the custody of digital assets.**
 - January 2018 Staff Letter (Division of Investment Management to officers of the Investment Company Institute and SIFMA)
 - » Context is RICs under the Investment Company Act, but the questions raised are representative of other contexts
 - » Raises a variety of questions and issues regarding cryptocurrency, including valuation and liquidity issues
 - » On custody, it raises questions regarding:
 - Use of permitted custodians
 - Validating existence and exclusive ownership of private keys
 - Cybersecurity and other risks

Where Does the SEC Stand? (cont.)

- March 2019 Staff Letter (Division of Investment Management to President of the Investment Advisers Association)
 - » Raises questions in the Advisers Act context
 - » Queries on the extent and nature of non-DVP custodial practices generally
 - » On custody of digital assets, raises a number of questions for market input, including:
 - Challenges faced by advisers in complying with the Custody Rule with respect to digital assets
 - Extent to which advisers are construing digital assets as funds, securities or neither
 - Extent to which advisers are using state-chartered trust companies or foreign financial institutions to custody digital assets

Where Does the SEC Stand? (cont.)

- July 2019 Joint Staff Statement (SEC Division of Trading and Markets and FINRA)
 - » Context is custody of digital assets by registered broker-dealers, who are subject to broker-dealer financial responsibility rules (including the Customer Protection Rule)
 - Customer Protection Rule requires broker-dealers to safeguard customer assets and keep customer assets separate from firm assets (in a good “control location”)
 - Broker-dealer may face challenges in determining appropriate custody arrangements, including:
 - The fact that the broker-dealer (or third party custodian) maintains the private key may not be sufficient to prove exclusive control.
 - Also may not permit reversal or cancellation of unauthorized or mistaken transactions.

Does the Custody Rule Apply to Digital Assets?

- **As previously noted, the Custody Rule on its face applies to the custody of client “funds or securities.”**
- **Are digital assets “funds or securities”?**
 - SEC has taken the view that certain blockchain tokens issued to raise funds for platform development or for similar purposes—so-called Initial Coin Offering tokens—are securities.
 - » These tokens would certainly fall within the scope of the Custody Rule

Scope of Custody Rule (cont.)

- **Bitcoin and other “pure” virtual currencies are not regarded as securities by the SEC**
 - Do they constitute “funds” for purposes of the Custody Rule?
 - » No Definitive Guidance
 - » SEC March 2019 Letter solicits input on the extent to which investment advisers are construing digital assets as “funds,” “securities” or neither for purposes of the Custody Rule
 - » From a policy perspective, difficult to distinguish BTC and other virtual currencies from other types of funds or securities held for clients.
 - » As such, and based on heightened scrutiny of digital assets by the SEC, it seems possible that the SEC would view virtual currencies as the equivalent of “funds.”

Operational and Practical Issues

- **Qualified Custodian**

- Certain digital asset custodians have sought to take steps to establish “qualified custodian” status
 - » Acquiring an existing broker-dealer or trust company
 - » Establishing a state-chartered trust company
 - Potential issues around whether a state-chartered trust company that provides only custodial services meets the definition of “bank” for purposes of the Custody Rule (i.e., substantial portion of business to consist of receiving deposits or exercising fiduciary powers similar to those of national banks)
 - » Registering a custodial entity as a broker-dealer

Operational and Practical Issues (cont.)

- **Audit Difficulties**

- But it remains to be seen whether typical independent accountants will be willing to provide the required surprise audits
 - » Custodian reluctant to expose private keys to accountants
 - » Accountants face technical difficulties in confirming that the private key held by Custodian actually represents an ownership interest in the particular underlying digital asset
 - Unlike typical investments in securities and debt instruments, there are no registrar or securities intermediary records, administrative agents or other traditional sources of ownership verification

Operational and Practical Issues (cont.)

- **Audit Difficulties (cont.)**

- Two Key Difficulties

- » Existence of Asset (Linkage): Establishing a linkage between the assets recorded at the public address and the private key associated with the customer

- Multi-step Process

- 1. Confirm assets at public address

- 2. Establish that the private key held in custody is associated with that public address

- 3. Establish that the private key provided is actually associated with the identified customer

- » Exclusivity: Establishing that the Custodian is the only entity that holds the private key

- Can multi-sig custody arrangements satisfy exclusive control requirement?

Operational and Practical Issues (cont.)

- **DVP**

- Custodians typically support only a limited range of digital assets
- May not have the capability or desire to hold cash for a client
- These factors can make DVP difficult
 - » Compounding Factors:
 - Digital asset transfers can happen almost instantaneously and cannot be reversed
 - Even if digital assets associated with an unauthorized transfer are later flagged or blacklisted, innocent recipients of the proceeds may suffer harm and the assets still won't be recoverable unless the adviser provides the private key of the blacklisted address

Possible Solutions?

- **Potential Custodian-Side Solutions**

- Expansion of the Custodian Role: Expansion in Digital Assets Supported and in the ability to hold cash can make DVP a more realistic possibility
 - » Custodian as Broker: Custodian could act as the equivalent of a broker in digital assets (similar to custody bank services used in foreign exchange trades)
 - Locate trades through exchanges or other brokers based on buy/sell instructions of adviser
 - Execute those trades
 - Collect commission or spread

Possible Solutions? (cont.)

- **Potential Custodian-Side Solutions (cont.)**

- » New Custodian System Technologies

- Technologies may be developed that permit traders to access and effect trades on the Custodian's system, with proceeds settling into wallets and cash accounts maintained by the Custodian
- If the Custodian also operates an exchange, then a custody client may be able to trade assets on such exchange without removing them from cold storage
 - This concept might be employed and/or expanded to require that assets flow in/out of custodian-controlled accounts only pursuant to an applicable instruction set

Possible Solutions? (cont.)

- **Potential Adviser-Side Solutions**

- Digital Asset Investor Committee: Adviser to commingled investment vehicle could establish a Digital Asset Investor Committee to sign off when instructions to transfer a digital asset are communicated to a Custodian
 - » Potential for greater transparency with key investors
 - » But some obvious issues:
 - Timing Delays
 - May not be possible for members of the Digital Asset Investor Committee to confirm and approve the address of the recipient (given nature of cryptographically generated addresses)

Possible Solutions? (cont.)

- **Potential Adviser-Side Solutions (cont.)**

- Enhanced Reporting and Auditing

- » Adviser could voluntarily adopt special reporting and/or auditing procedures for digital assets

- More Frequent Surprise Audits by Specialized Accounting Firms

- Detailed Reporting on Digital Asset Holdings to Investors or a Subset of Investors

- » Such procedures may not in themselves reduce the potential for adviser fraud. But they would provide investors with potentially increased transparency (and perhaps enable the earlier detection of fraud).

Possible Solutions? (cont.)

- **Potential Combined Solutions**

- Multiparty Custody Arrangements

- » May be possible for an Adviser and multiple Custodians to enter into a coordinated set of custody arrangements, including digital and other assets.

- Example:

- One Custodian supports only token X and another supports only token Y
 - Adviser wants to sell X for Y
 - Enter into arrangement whereby signature and destination address provided by the second Custodian (as well as Adviser) is required by the first Custodian for the transfer

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