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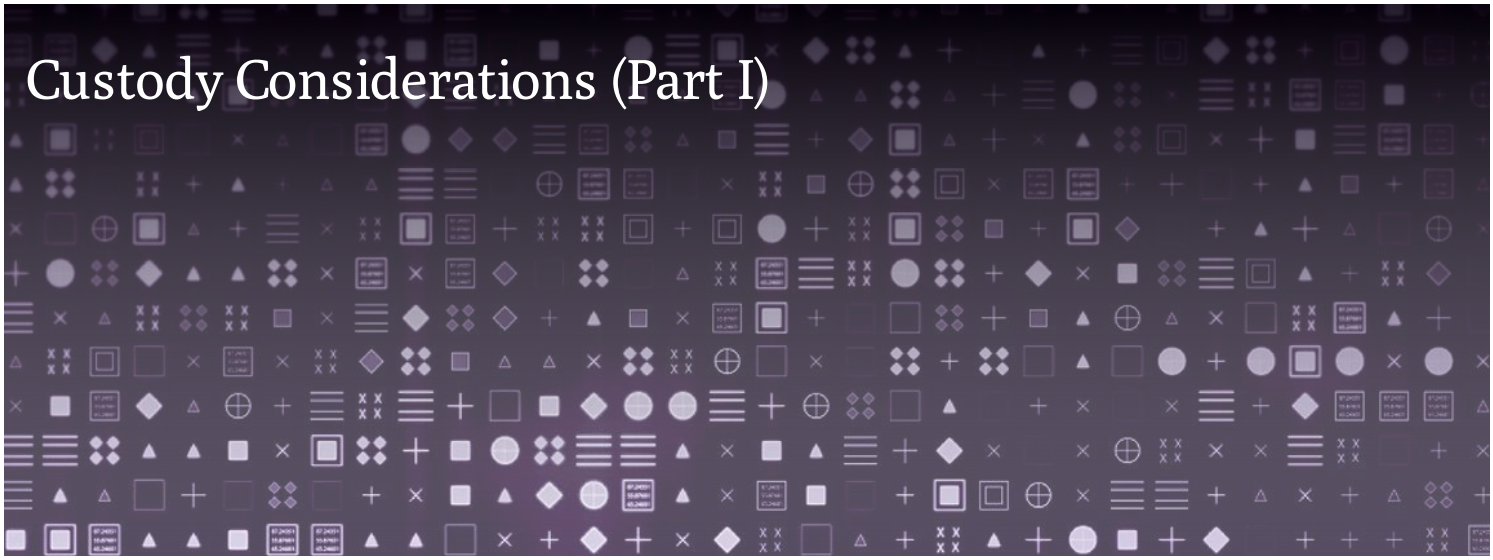
BLOG



MARCH 7, 2019

In this post, we will discuss whether:

- Item 9 of Part 1A of SEC Form ADV (relating to the custody of client funds or securities) requires an SEC-registered investment adviser to disclose its custody of crypto assets (and related custodial practices) in response to that Item; and
- Rule 206(4)-2 under the Investment Advisers Act—the so-called Custody Rule—applies to an SEC-registered investment adviser's custody of crypto assets.

In our next post, we will discuss how an SEC-registered investment adviser that has custody over crypto assets could comply with the Custody Rule with respect to those assets.

Background – Item 9 of Part 1A of SEC Form ADV

Item 9 of Part 1A of SEC Form ADV requires an SEC-registered investment adviser to disclose (among other things):

- whether the adviser and/or its "related persons"[1] have "***custody***"[2] of the adviser's clients' "***cash or bank accounts***" and/or "***securities***" and, if yes:
- the approximate amount of client "***funds and securities***" over which the adviser and/or its related persons have custody, and the total number of clients for which the adviser and/or its related persons have custody;
- the adviser's and/or its related persons' custodial practices; and
- how many persons act as "qualified custodians"[3] for the adviser's clients.

The questions in Items 9.C and 9.F refer to the clients' "***funds*** and securities," whereas the questions in Items 9.A and 9.B refer to the clients' "***cash or bank accounts***" and "securities." Presumably, Item 9 equates "***cash or bank accounts***" with "***funds***," but this is not entirely clear. And, as we shall see below, the "Custody Rule" relates to custody over clients' "***funds*** and securities." As a matter of prudence, it would be advisable to consider the term

"funds" not to be limited to "cash and bank accounts." Still, as we shall see, the term "funds" is not infinitely elastic, and strong arguments can be made that crypto assets that are not "securities" generally are not "funds."

Background – The Custody Rule

The Custody Rule applies by its terms to SEC-registered investment advisers that have:

- "***custody***"[4] over their clients'
- "***funds or securities***"

An SEC-registered investment adviser that has custody of a client's funds and/or securities must satisfy the following four requirements:

1. the adviser must maintain such funds and/or securities with a "qualified custodian"[5] (the Qualified Custodian Requirement);
2. the adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to the client identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period (the Account Statement Requirement);[6]
3. the adviser must send a written notice to the client setting forth the qualified custodian's name, address, and the manner in which the client's funds and/or securities are maintained—promptly when the account is opened and following any changes to this information (the Custodial Notice Requirement);[7] and
4. the adviser must enter into a written agreement with an independent public accountant in which the accountant agrees to verify the client's funds and/or securities by actual examination at least once during each calendar year, at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year (the Surprise Examination Requirement).[8]

These requirements (***other than the Qualified Custodian Requirement***) are subject to certain exceptions set forth in Rule 206(4)-2(b).[9]

One of the principal exceptions to compliance with the Account Statement Requirement, the Custodial Statement Requirement, and the Surprise Examination Requirement is the so-called Audit Exception provided by Rule 206(4)-2(b)(4).

Under the Audit Exception, an adviser that has custody of client funds and/or securities is not required to comply with the Account Statement Requirement, the Custodial Notice Requirement or the Surprise Examination Requirement (but is not relieved of the requirement to comply with the Qualified Custodian Requirement) with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) if such vehicle:

- is subject to audit (as defined in Rule 1-02(d) of SEC Regulation S-X) at least annually, and upon liquidation, by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and
- distributes 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 (180 days if such vehicle is a "fund of funds") of the end of its fiscal year, or promptly after the completion of the liquidation audit, as the case may be.

What Are Client "Funds or Securities?"

Even if we assume that a registered investment adviser has "custody" over a client's crypto assets, this does not ***necessarily*** mean that the adviser must disclose that is has custody over such assets in response to Item 9 of Part 1A of SEC Form ADV, or to comply with the Custody Rule with respect to those assets.

Rather, insofar as crypto assets are concerned, the disclosures required by Item 9 of Part 1A of SEC Form ADV are triggered with respect to those assets only to the extent the SEC-registered investment adviser has "custody" over them ***and*** such assets constitute either "***cash or bank accounts***" or "***funds or securities***."

Similarly, insofar as crypto assets are concerned, the Custody Rule applies to an SEC-registered investment adviser only to the extent it has "custody" over them ***and*** such assets constitute "***funds or securities***."

This argument finds substantial support in Question II.3 of the SEC staff's FAQs regarding the Custody Rule, where the SEC staff asks:

> "If an adviser manages client assets that are not funds or securities, does the… custody rule require the adviser to maintain these assets with a qualified custodian?"

The staff's answer?

> "No. Rule 206(4)-2 applies only to clients' funds and securities."

While the staff's answer addresses the scope of "funds and securities" in the context of the Custody Rule, not the scope of "cash or bank accounts" or "funds or securities" in the context of Item 9 of Part 1A of SEC Form ADV, it is difficult to see how the staff could take a different position regarding Item 9 disclosure, since the Custody Rule and Item 9 are clearly designed to operate in tandem.

So, it is apparent that the staff believes that are certain types of client assets that are not "funds or securities" and therefore are outside the scope of the Custody Rule (and, presumably, not subject to Item 9A disclosure). (A direct investment in real estate comes immediately to mind as an example.)

To the extent that crypto assets are "securities" (which brings us back once again to the possible need to apply the "*Howey* test," discussed in our post dated January 17), they clearly are subject to Item 9 disclosure and the Custody Rule if the SEC-registered has "custody" over them.

But what about crypto assets that are not securities (for example, Bitcoin and Ether)?

Are they "funds?" "Cash or bank accounts?"

If they are "funds" over which the SEC-registered investment adviser has "custody," they are subject to the Custody Rule and Item 9 disclosure (and if they are "cash or bank accounts" they are also subject to Item 9 disclosure).

Strong arguments can be made that, to the extent crypto assets are not securities, they ordinarily would be commodities and therefore would not be subject to the Custody Rule or Item 9 disclosure.[10]

This would mean, among other things, that an SEC-registered investment adviser that has "custody" over them is not required to (i) disclose them in response to Item 9 or (ii) maintain them with a qualified custodian and otherwise comply with applicable requirements of the Custody Rule with respect to them.

Whether the SEC will consider these arguments to be compelling in the specific context of crypto assets that are not securities remains to be seen.

Further, in situations where crypto assets are not "funds or securities," a registered adviser still has a duty—stemming from its fiduciary duty of care—to take reasonable measures designed to ensure that such assets are protected from loss, destruction, and theft.[11]

So, in conclusion:

- An SEC-registered investment adviser that has "custody" over clients' crypto assets that are "securities" must maintain such assets with a "qualified custodian," and comply with other applicable provisions of the Custody Rule with respect to such assets.
- Until the SEC issues guidance on the matter, it would be prudent for an adviser who has custody of crypto assets that are not securities to treat them as "funds" and, accordingly, to maintain them with a "qualified custodian" (and to comply with other provisions of the Custody Rule with respect to such assets).
- In any case, regardless of whether crypto assets are "funds" or "securities" for purposes of the Custody Rule, an SEC-registered investment adviser must (insofar as it is able to do so) take reasonable measures designed to ensure that such assets are protected from loss, destruction, and theft.

In our next post, we will discuss how an adviser would comply with the Custody Rule in connection with investing/trading in crypto assets on behalf of clients.

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[1]The Glossary to SEC Form ADV defines a "related person" of an adviser, for purposes of SEC Form ADV, as any "advisory affiliate" of the adviser and any person that is under common "control" (as defined in the Glossary) with the adviser. The Glossary defines "advisory affiliate" of an adviser to include: (1) all of the adviser's officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly "controlling" or "controlled" by the adviser; and (3) all of the adviser's current employees (other than employees performing only clerical, administrative, support or similar functions). (A special definition applies if the adviser is a "separately identifiable department or division" (SID) of a bank.)

[2]The Glossary to SEC Form ADV provides that "custody" means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."

"Custody" includes:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;
- any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's 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 the adviser or a supervised person of the adviser legal ownership of or access to client funds or securities.

An investment adviser is deemed to have "custody" of client funds or securities if a "related person" of such adviser holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services such adviser provides to its clients.

These provisions can be more complicated in practice than they appear to be on paper, as evidenced by the SEC's extensive FAQs on the definition of "custody" as contained in the Custody Rule, which can be found here.

[3]The definition of a "qualified custodian" will be discussed later in this post (see note 5 and accompanying text).

[4]The definition of "custody" in the Custody Rule is identical to the definition of "custody" in the Glossary to SEC Form ADV (see note 2). The definition in the Glossary is the definition to be used in connection with responding to questions in Item 9 of SEC Form ADV.

[5]Rule 206(4)-2(d)(6) under the IAA provides that the term "qualified custodian" means any of the following:

- A bank as defined in Section 202(a)(2) of the IAA* or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation under the

Federal Deposit Insurance Act.

- A broker-dealer registered as such with the SEC under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the adviser's clients' assets in customer accounts.
- A futures commission merchant registered as such with the CFTC under Section 4f(a) of the Commodity Exchange Act, holding the adviser's clients' assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon.
- A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the adviser's clients' assets in customer accounts segregated from its proprietary assets.

*Section 202(a)(2) of the IAA defines the term "bank" to mean (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in Section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in Section 2(4) of the Home Owners' Loan Act, 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 the IAA, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) above.

[6]An adviser has the option of sending its own account statement to its clients, in addition to (not in lieu of) those required to be sent by the qualified custodian.

If the adviser or a "related person" of the adviser (as defined in Rule 206(4)-2(d)(7)) is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle), the account statements must be sent to each limited partner (or member or other beneficial owner), unless the exception from this requirement provided by Rule 206(4)-2(b)(4) (the so-called Audit Exception, discussed in detail below) applies. (Note: Rule 206(4)-2(d)(7) defines the term "related person" in a manner that is somewhat different from the manner in which the Glossary to Form ADV defines that term (see note 1); however, at least for purposes of the discussion in this post, those differing definitions do not appear to have any regulatory consequences.)

[7]If an adviser elects to send its own account statement to its clients (in addition to those required to be sent by the qualified custodian), the adviser's written notice (as well as such account statements) must contain a statement urging the client to compare the account statements from the custodian with those from the adviser.

[8]Rule 206(4)-2(a)(4) imposes certain additional requirements that apply to every surprise examination.

Rule 206(4)-2(a)(6) imposes certain additional requirements that apply to surprise examinations where the adviser or a "related person" (as defined in Rule 206(4)-2(d)(7)) is a "qualified custodian" and the adviser or such "related person" (as defined in Rule 206(4)-2(d)(7)) has custody of the client's funds and/or securities. (An adviser, however, is not required to comply with the Surprise Examination Requirement if: (i) such adviser is deemed to have custody of client funds and/or securities ***solely*** because a "related person" (as defined in Rule 206(4)-2(d)(7)) holds, directly or indirectly, such funds or securities, or has any authority to obtain possession of them, in connection with advisory services such adviser provides to its clients and (ii) such "related person" is "operationally independent" (as defined in Rule 206(4)-2(d)(5)) of such adviser.)

A discussion of these additional requirements is beyond the scope of this blog.

[9] For example, under Rule 206(4)-2(b)(5), a registered investment adviser is not required to comply with any of the requirements of the Custody Rule with respect to the account of an investment company registered as such under

the Investment Company Act (ICA) – in that case, the adviser is subject instead to the custody rules (Rules 17f-1 through 17f-7) adopted under the ICA.

[10]The Commodity Futures Trading Commission (CFTC) has clearly and unequivocably staked out the position that virtual currencies like Bitcoin and Ether are encompassed in the definition "commodity" under Section 1a(9) of the Commodity Exchange Act (*see*, *e.g.*, *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*,CFTC Docket No. 15-29

(September 17, 2015); *In the Matter of: TeraExchange LLC,* CFTC Docket No. 15-33 (September 24, 2015); *In the Matter of: BXFNA Inc. d/b/a Bitfinex*, CFTC Docket No. 16-19

(June 2, 2016); Proposed Interpretation Regarding Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 at p. 60337 and accompanying text (December 20, 2017);

In the Matter of: Joseph Kim, CFTC Docket No. 19-02 (November 9, 2018)), and the courts have supported the CFTC's position (*see*, *e.g.*, *CFTC v. Gelfman Blueprint, Inc., and Nicholas Gelfman,* United States District Court for the Southern District of New York (final judgment entered October 16, 2018); CFTC v. My Big Coin Pay, Inc., Randall Crater, and Mark Gillespie, United States District Court for the District of Massachusetts (Memorandum of Decision in Respect of Motion to Dismiss filed September 26, 2018). Further, paragraph 2(d)(6)(iii) of the Custody Rule can be read to suggest that the SEC does not consider commodity futures or options on commodity futures to be "funds or securities" for purposes of the Custody Rule. Accordingly, it is difficult to see how "commodities" should be subject the Custody Rule. *See also*, *Charles C. With d/b/a/ Collectors Coin Exchange* (SEC No-Action Letter dated Feb. 14, 1985); *Granite Fund* (SEC No-Action Letter dated Sept. 29, 1983; pub. avail. Oct. 31, 1983); *Peavey Commodity Futures Fund I, II, III* (SEC No-Action Letter dated June 2, 1983; pub. avail. June 2, 1983); *Charles E. Rickard* (SEC No-Action Letter dated July 28, 1981).

[11]*See also* IAA Release No. 2204 68 Fed. Reg. 74714 (Dec. 17, 2003) at p. 74716, where the SEC stated that it expects a registered investment adviser to adopt compliance policies and procedures appropriately designed to safeguard client assets from conversion and inappropriate use by advisory personnel.

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