WINSTON & STRAWN LLP

BLOG

SEC Seeks Public Comment on Questions Posed by Digital Assets under the Custody Rule

MARCH 14, 2019

In our blog posts dated March 7 and March 12, we discussed, among other things, the application of Rule 206(4)-2 under the Investment Advisers Act—the so-called Custody Rule—to an SEC-registered investment adviser's custody of crypto assets.

On March 12, 2019, the SEC's Division of Investment Management (IM) issued a letter to the Investment Adviser Association in which the Division solicited public comment on a series of questions to "inform our consideration of how characteristics of digital assets impact the application of the Custody Rule."[i] IM describes its letter as the result of the broad and ongoing dialogue between IM (together with the staff of the SEC's Strategic Hub for Innovation and Financial Technology (FinHub))[ii] and investment advisers, broker-dealers, market observers, academics, and others to understand the compliance questions associated with investments in digital assets:

> "Through this dialogue, staff and market participants have discussed, among other things, whether and how characteristics particular to digital assets affect compliance with the Custody Rule. These characteristics include, for example, the use of DLT to record ownership, the use of public and private cryptographic key pairings to transfer digital assets, the 'immutability' of blockchains, the inability to restore or recover digital assets once lost, the generally anonymous nature of DLT transactions, and the challenges posed to auditors in examining DLT and digital assets."

The letter seeks comments on the following specific questions, noting, however, that in light of the "swiftly developing" digital asset markets, additional questions may arise in the future:

- What challenges do investment advisers face in complying with the Custody Rule with respect to digital assets? What considerations specific to the custody of digital assets should the staff evaluate when considering any amendments to the Custody Rule? For example, are there disclosures or records other than account statements that would similarly address the investor protection concerns underlying the Custody Rule's requirement to deliver account statements?
- To what extent are investment advisers construing digital assets as "funds", "securities," or neither, for purposes of the Custody Rule? What considerations are advisers applying to reach this conclusion?

- To what extent are investment advisers including digital assets in calculating regulatory assets under management for purposes of meeting the thresholds for registering with the Commission? What considerations are included within this analysis?
- To what extent do investment advisers use state chartered trust companies or foreign financial institutions to custody digital assets? Have these investment advisers experienced similarities/differences in custodial practices of such trust companies as compared to those of banks/broker-dealers?
- What role do internal control reports, such as System and Organization Controls (SOC) 1 and SOC 2 reports (Type 1 and 2), play in an adviser's evaluation of potential digital asset custodians? What role should they play?
- How should concerns about misappropriation of digital assets be addressed and what are the most effective ways in which technology can be leveraged to address such concerns? How can client losses due to misappropriation of digital assets most effectively be remedied?
- What is the settlement process of peer-to-peer digital asset transactions *(i.e.*, transactions where there is no intermediary) and what risks does this process present? What is the settlement process for intermediated transactions in digital assets, such as those that execute on trading platforms or on the over-the-counter markets, and what risks does this process present?
- To what extent do investment advisers construe digital assets as "securities" for purposes of determining whether they meet the definition of an "investment adviser" under Section 202(a)(11) of the Investment Advisers Act? What considerations are included in such an analysis?
- To what extent can DLT be used more broadly for purposes of evidencing ownership of securities? Can DLT be useful for custody and recordkeeping purposes for other types of assets, and not just digital asset securities? What, if any, concerns are there about the use of DLT with respect to custody and recordkeeping?

Persons who would like to provide input on these questions are encouraged to do so through the following address: IMOCC@sec.gov (inserting "Custody Rule and Digital Assets" in the subject line). IM expects that it will make all submissions pursuant to this process public at some time in the future.

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[i]As a separate matter, the letter solicits public comment on application of the Custody Rule to trading practices that are not processed or settled on a "delivery versus payment" (DVP) basis.

[ii]See https://www.sec.gov/news/press-release/2018-240.

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