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SEC Safeguarding Rule Proposal: What a Crypto Investment Adviser Needs to Know

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Highlights of the Proposed Rule:

- **The Proposed Rule would expand the types of "assets" subject to the Safeguarding Rule to include crypto asset positions held in a client account.**
- **Despite a historical lack of guidance on the topic, Qualified Custodians would nonetheless be required to have "possession or control" of advisory client crypto assets.**
- **Limited Qualified Custodian crypto asset offerings may materially impact crypto asset trading strategies.**

Please see our companion client alert here for further details on the Proposed Rule.

On February 15, 2023, the U.S. Securities and Exchange Commission (SEC) released a proposed rule change (the Proposed Rule) redesignating the "custody rule" (i.e., Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended) (the Custody Rule) as the "safeguarding rule" (the Safeguarding Rule). The Proposed Rule would require investment advisers (Advisers) and qualified custodians (Qualified Custodians) to take enhanced steps to safeguard clients' assets, including with respect to crypto assets.

Custody; Qualified Custodians

The Proposed Rule would expand the circumstances under which an Adviser is considered to have custody of client assets and thus an obligation to safeguard those assets. The Proposed Rule would retain the Custody Rule's definition of "custody," which exists when either (1 the Adviser has physical possession of the assets; (2) an arrangement exists whereby the Adviser is authorized or permitted to withdraw the assets maintained with a custodian; or (3) the Adviser is in a capacity that gives it (or its supervised persons) legal ownership of, or access to, the assets. But it would expand the definition to provide that "custody" also exists when there is an arrangement in which the Adviser has the discretionary authority to transfer beneficial ownership of the client assets.

The Proposed Rule would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions to act as Qualified Custodians, but, in a change from the current rules, such custodians must have "possession or control" of client assets pursuant to a written agreement between the Qualified Custodian and the Adviser (or between the client and the Adviser if the Adviser serves as the Qualified Custodian). A Qualified Custodian would have "possession or control" of a crypto asset if it holds private keys for the wallets containing the crypto assets sufficient to ensure that the Adviser is unable to change beneficial ownership of the crypto asset without the custodian.

Applicability to Crypto Advisers

The SEC acknowledges that many crypto asset Advisers (Crypto Advisers) currently take the position that the crypto assets they advise on are neither funds nor securities and therefore their actions with respect to such assets do not implicate the requirements of the Custody Rule; however, the SEC

makes clear in the Proposed Rule release that it believes most crypto assets are in fact either funds or securities, and therefore subject to the current Custody Rule.

Crypto Asset Trading

The Proposed Rule has significant implications for the way most Crypto Advisers currently custody and trade client crypto assets on centralized and decentralized exchanges. Currently, many Crypto Advisers hold client crypto assets with non-Qualified Custodian exchanges, have access to a client's (e.g., an individual's or a fund's) crypto wallet through smart contract or otherwise (such as through API key access), and are generally authorized to execute trades on behalf of their clients through this access, whether on a discretionary or a nondiscretionary basis. Going forward, these types of arrangements will no longer be possible.

In order to satisfy the requirements of the Proposed Rule, Crypto Advisers will only be able to continue these current activities to the extent client assets are held (1) in a wallet maintained by a Qualified Custodian, and (2) in a manner sufficient to ensure that the Adviser is unable to change beneficial ownership of the crypto asset without the Qualified Custodian.

This poses a challenge to many Crypto Advisers who have, up until now, relied predominantly on various exchanges and crypto asset platforms that do not constitute Qualified Custodians. In addition, these Crypto Advisers have historically relied on technology to exercise control and use automated and/or algorithmic trading strategies (Automated Strategies). If the Proposed Rule is adopted without any material changes, Crypto Advisers would need to (1) potentially revamp their current custody solutions to utilize Qualified Custodians and (2) adjust the manner in which they execute Automated Strategies (through a Qualified Custodian).

In light of these changes and requirements under the Proposed Rule, Crypto Advisers who rely on Automated Strategies should assess whether their Automated Strategies can continue to perform as intended. For instance, if a Crypto Adviser has built its Automated Strategies based upon the assumption that the underlying crypto assets do not constitute funds or securities and therefore are not subject to the Custody Rule (i.e., there is no need for a Qualified Custodian), the Crypto Adviser will need to determine whether its Automated Strategies will be materially impacted by (1) moving to utilize a Qualified Custodian structured to satisfy the Proposed Rule and (2) the limited crypto assets currently available for trading through existing Qualified Custodians (as opposed to their non-Qualified Custodian counterparts).

Other Notable Changes and Considerations

Some Crypto Advisers engage in buying or selling crypto asset securities through private placement offerings. Under the current Custody Rule, Crypto Advisers generally are not required to utilize Qualified Custodians for private crypto asset securities – rather, they may rely on the privately offered securities exception (the Private Securities Exception). The Proposed Rule largely maintains these requirements but clarifies that a crypto asset security does not qualify an Adviser to rely on the Private Securities Exception because the securities must be capable of only being recorded on the nonpublic books of the issuer (or its transfer agent) in the name of the client. As crypto asset securities are issued on public, permissionless blockchains, they do not satisfy the conditions of the Private Securities Exception under the Proposed Rule.

Therefore, if an Adviser seeks to purchase such crypto asset securities on behalf of its clients, it will need to do so through a Qualified Custodian under the Proposed Rule. In addition, in the event a fund or client owns a beneficial interest in a warrant or other convertible security that qualified under the Private Securities Exception (including a customary token warrant), in the event a conversion event occurs that converts the securities to crypto assets, the Adviser will need to maintain custody of such converted assets with a Qualified Custodian consistent with the requirements under the Proposed Rule.

Next Steps

Lowenstein Crypto has significant experience advising Crypto Advisers, financial institutions, exchanges, and crypto asset custodians across a broad range of regulatory matters. Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the Proposed Rule and its applicability to Crypto Advisers.

Contacts

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